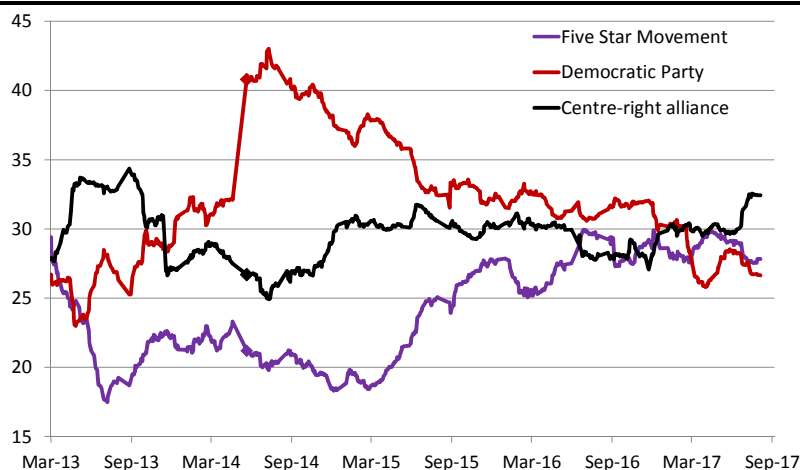


25 August 2017

Italy: the next big test for Europe

Italian opinion polls of the three major parties/party alliances (%)



The centre-right alliance comprises Forza Italia, Lega Nord and Fratelli d'Italia, average of 7 latest available polls. Drop in support for PD after 25 February 2017 caused by defectors who founded a new left-wing party MDP. Source: National opinion polls, Berenberg calculation.

- **Could Italy leave the euro?** This is the key question ahead of the general election in Italy likely to be held between March and early May 2018. Ever since Matteo Renzi resigned as prime minister (PM) in December 2016, the risk that political instability may sweep eurosceptic parties to power has hung over Italy like a sword.
- **Neck and neck, and neck:** Opinion polls show support split across three major political blocks – see chart: 1) the staunchly pro-European centre-left Democratic Party (DP) of Renzi and current PM Paolo Gentiloni – c27%; 2) a hypothetical alliance between former PM Silvio Berlusconi's centre-right Forza Italia (FI) with the far-right Lega Nord (LN) and Fratelli d'Italia (FdI) – c32%; and 3) the populist and somewhat eurosceptic Five Stars movement – c28%. Sicilian regional elections on 5 November could offer a glimpse of what to expect.
- **Get ready for a hung parliament:** Although it is still early days, a hung parliament remains the most likely outcome. No party has had the critical 40% required to gain a majority – according to the current election rules for the lower house – for almost three years. Italy could end up with a minority government, a grand coalition between the centre-left DP and centre-right FI, a technocratic government, or fresh elections some six months after the regular vote. The biggest risk for the Italian economy and for markets would be an anti-euro/EU coalition. But that seems unlikely.
- **Market nervousness may rise as the election nears:** At one time or another, Five Stars, LN and FdI have all signalled that they could seek an Italexit if they came to power. Earlier this week, Berlusconi repeated earlier comments that FI would favour a parallel currency. Including the FI, parties that have occasionally called for a parallel currency or other forms of euro exit have 65% support according to opinion polls. As a result, markets have priced in a slightly higher risk of Italexit. Italian spreads over German bunds rose by c10bp this week.
- **The Italexit risk remains low:** Berlusconi's comments seem to reflect campaign tactics more than long-term strategy. A genuine threat to leave the euro could cost Berlusconi's party significant support among its core voter base. His comments are most likely an effort to establish common ground for a potential alliance between his centre-right FI and the far-right LN and FdI which he might hope to lead. But Berlusconi may be barking up the wrong tree. Even the LN has turned softer on the euro recently. Meanwhile, some leaders of the Five Stars no longer regard a referendum on Italexit as plan A after Le Pen's proposal for a Frexit did not go down well with voters in France. For Italy, the economic risks of Italexit are even higher than for France. Support for the euro among Italians has risen to c60% according to the latest Eurobarometer survey from the European Commission.
- **A firmer recovery:** Thanks partly to Renzi's 2015 labour market reforms, Italy is primed for sustained growth driven by employment gains. That should mitigate the political tail risks over time. As long as the Italexit risk does not manifest after the election, the Italian upswing can continue.

Economics

Chart of the week



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Contacts: Investment Banking

www.berenberg.com

e-mail: firstname.lastname@berenberg.com / e-mail US: firstname.lastname@berenberg-us.com



BERENBERG

PARTNERSHIP SINCE 1590

JOH. BERENBERG, GOSSLER & CO. KG

Internet www.berenberg.com

E-mail: firstname.lastname@berenberg.com

EQUITY RESEARCH

AEROSPACE & DEFENCE

Ryan Booker +44 20 3753 3074
Andrew Gollan +44 20 3207 7891
Charlotte Keyworth +44 20 3753 3013
Ross Law +44 20 3465 2692

AUTOMOTIVES

Alexander Haissl +44 20 3465 2749
Paul Kratz +44 20 3465 2678
Fei Teng +44 20 3753 3049

BANKS

Adam Barrass +44 20 3207 7923
James Chappell +44 20 3207 7844
Andrew Lowe +44 20 3465 2743
Andreas Markou (EM) +44 20 3465 3022
Alex Medhurst +44 20 3753 3047
Eoin Mullany +44 20 3207 7854
Peter Richardson +44 20 3465 2681
Jonathan Sharpe +44 20 3753 3031

BEVERAGES

Javier Gonzalez Lastra +44 20 3465 2719
Batuhan Karabekir (EM) +44 20 3465 2631
Adam Mizrahi +44 20 3465 2653
Matt Reid +44 20 3753 3075

BUSINESS SERVICES, LEISURE & TRANSPORT

Roberta Giaccia +44 20 3207 7805
Najet El Kassir +44 20 3207 7836
Stuart Gordon +44 20 3207 7858
Josh Puddle +44 20 3207 7881
Katherine Somerville +44 20 3753 3081
Julia Winarso +44 20 3465 2627

CAPITAL GOODS

Sebastian Kuenne +44 20 3207 7856
Philippe Lorrain +44 20 3207 7823
Rizk Maidi +44 20 3207 7806
Horace Tam +44 20 3465 2726
Simon Toennessen +44 20 3207 7819

EQUITY SALES

SPECIALIST SALES

AEROSPACE & DEFENCE, CAPITAL GOODS

Bruna Zugliani +44 20 3207 7818

AUTOMOTIVE & THEMATICS

Chris Armstrong +44 20 3207 7809

BANKS, DIVERSIFIED FINANCIALS & INSURANCE

Iro Papadopoulou +44 20 3207 7924
Calum Marris +44 20 3753 3040

BUSINESS SERVICES, LEISURE & TRANSPORT

Rebecca Langley +44 20 3207 7930

CONSTRUCTION, CHEMICALS, METALS & MINING

James Williamson +44 20 3207 7842

CONSUMER STAPLES

Rupert Trotter +44 20 3207 7815

CONSUMER DISCRETIONARY

Victoria Maignot +44 20 3753 3010

HEALTHCARE

Frazer Hall +44 20 3207 7875
Abigail James +44 20 3753 3078

MEDIA & TELECOMMUNICATIONS

Julia Thannheiser +44 20 3465 2676

SPECIAL SITUATIONS

Jeremy Grant +44 20 3207 7890

SALES

BENELUX

Miel Bakker +44 20 3207 7808
Martin de Laet +44 20 3207 7804
Alexander Wace +44 20 3465 2670

GERMANY

Michael Brauburger +49 69 91 30 90 741
Nina Buechs +49 69 91 30 90 735
André Grosskurth +49 69 91 30 90 734

CHEMICALS

Sebastian Bray +44 20 3753 3011
Rikin Patel +44 20 3753 3080
Andrew Heap +44 20 3207 7918

CONSTRUCTION

Saravana Bala +44 20 3753 3043
Lush Mahendrarajah +44 20 3207 7896
Robert Muir +44 20 3207 7860
Olivia Peters +44 20 3465 2646

ENERGY

Yuriy Kukhtanych (EM) +44 20 3465 2675

FOOD MANUFACTURING AND H&PC

Rosie Edwards +44 20 3207 7880
Yordana Mavrodieva +44 20 3207 7817
Fintan Ryan +44 20 3465 2748
James Targett +44 20 3207 7873

FOOD RETAIL

Batuhan Karabekir (EM) +44 20 3465 2631

GENERAL MID CAP - EU

Gunnar Cohrs +44 20 3207 7894
Martin Comtesse +44 20 3207 7878
Charlotte Friedrichs +44 20 3753 3077
Flavien Hias +44 20 3465 2693
Aymeric Lang +44 20 3753 3037
Gerhard Orgonas +44 20 3465 2635
Anna Patrice +44 20 3207 7863
Benjamin Pfannes-Varrow +44 20 3465 2620
Simona Sarli +44 20 3207 7834
Julia Scheuffler +44 20 3753 3016

GENERAL MID CAP - UK

Robert Chantry +44 20 3207 7861
Sam England +44 20 3465 2687
Ned Hammond +44 20 3753 3017
Edward James +44 20 3207 7811
Benjamin May +44 20 3465 2667

GERMANY (cont'd)

Florian Peter +49 69 91 30 90 740
Joerg Wenzel +49 69 91 30 90 743

UK

Alexandra Clément +44 20 3753 3018
Fabian De Smet +44 20 3207 7810
Karl Hancock +44 20 3207 7803
Sean Heath +44 20 3465 2742
David Hogg +44 20 3465 2628
Gursumeet Hhaj +44 20 3753 3041
Peter Kaineder +44 20 3753 3062
James Matthews +44 20 3207 7807
James McRae +44 20 3753 3036
David Mortlock +44 20 3207 7850
Eleni Papoula +44 20 3465 2741
Bhavin Patel +44 20 3207 7926
Kushal Patel +44 20 3753 3038
Richard Payman +44 20 3207 7825
Clémence Peyraud +44 20 3465 2651
Christopher Pyle +44 20 3753 3076
Joanna Sanders +44 20 3207 7925
Mark Sheridan +44 20 3207 7802
George Smbert +44 20 3207 7911
Anita Surana +44 20 3207 7855
Paul Walker +44 20 3465 2632

FRANCE

Thibault Bourgeat +33 1 5844 9505
Alexandre Chevassus +33 1 5844 9512
Dallia Farigoule +33 1 5844 9510
Benjamin Voisin +33 1 5844 9507

SCANDINAVIA

Frederik Angel +44 20 3753 3055
Marco Weiss +49 40 350 60 719

GENERAL MID CAP - UK (cont'd)

Owen Shirley +44 20 3465 2731

GENERAL RETAIL

Conrad Bartos +44 20 3753 3053
Michelle Wilson +44 20 3465 2663

HEALTHCARE

Scott Bardo +44 20 3207 7869
Jakob Berry +44 20 3465 2724
Alistair Campbell +44 20 3207 7876
Klara Fernandes +44 20 3465 2718
Tom Jones +44 20 3207 7877
Joseph Lockey +44 20 3465 2730
Louise Pearson +44 20 3465 2747
Laura Sutcliffe +44 20 3465 2669

INSURANCE

Trevor Moss +44 20 3207 7893
Emanuele Musio +44 20 3207 7916
Iain Pearce +44 20 3465 2665
Sami Taipalus +44 20 3207 7866

LUXURY GOODS

Mariana Horn +44 20 3753 3044
Zuzanna Pusz +44 20 3207 7812

MEDIA

Robert Berg +44 20 3465 2680
Laura Janssens +44 20 3465 2639
Alastair Reid +44 20 3207 7841
Sarah Simon +44 20 3207 7830

METALS & MINING

Alessandro Abate +44 20 3753 3029
Fawzi Hanano +44 20 3207 7910
Yuriy Vlasov +44 20 3465 2674

REAL ESTATE

Kai Klöse +44 20 3207 7888
Tina Munda +44 20 3465 2716

SWITZERLAND, AUSTRIA & ITALY

Andrea Ferrari +41 44 283 2020
Carsten Kinder +41 44 283 2024
Gianni Vignina +41 44 283 2038
Jamie Nettleton +41 44 283 2026
Benjamin Stillfried +41 44 283 2033

CRM

Laura Cooper +44 20 3753 3065
Louise Hughes +44 20 3753 3066
Jessica Jarmyn +44 20 3465 2696
Edwina Lucas +44 20 3207 7908
Greg Swallow +44 20 3207 7833

CORPORATE ACCESS

Lindsay Arnold +44 20 3207 7821
Jennie Jiricny +44 20 3207 7886
Stella Siggins +44 20 3465 2630

EVENTS

Laura Hawes +44 20 3753 3008
Suzy Khan +44 20 3207 7915
Charlotte Kilby +44 20 3207 7832
Natalie Meech +44 20 3207 7831
Ellen Parker +44 20 3465 2684
Sarah Weyman +44 20 3207 7801

SALES TRADING

HAMBURG
Tim Storm +49 40 350 60 415

PARIS

Vincent Klein +33 1 58 44 95 09
Antonio Scutto +33 1 58 44 95 03

TECHNOLOGY

Jean Beaubois +44 20 3207 7835
Georgios Kertsos +44 20 3465 2715
Gal Munda +44 20 3465 2746
Richard Odumusu +44 20 3207 7851
Tammy Oiu +44 20 3465 2673

TELECOMMUNICATIONS

Josep Bori +44 20 3753 3058
Ondrej Cabejsk (EM) +44 20 3753 3071
Nicolas Didio +44 20 3753 3091
Usman Ghazi +44 20 3207 7824
Siyi He +44 20 3465 2697
Laura Janssens +44 20 3465 2639
Paul Marsch +44 20 3207 7857
Michael Summerville +44 20 3207 7914

THEMATIC RESEARCH

Nick Anderson +44 20 3207 7838
Asad Farid +44 20 3207 7932
Robert Lamb +44 20 3465 2623
James Sherborne +44 20 3753 3073

TOBACCO

Jonathan Leinster +44 20 3465 2645

UTILITIES

Andrew Fisher +44 20 3207 7937
Neha Saxena +44 20 3753 3048
Lawson Steele +44 20 3207 7887

ECONOMICS

Florian Hense +44 20 3207 7859
Carsten Hesse (EM) +44 20 3753 3061
Kallum Pickering +44 20 3465 2672
Holger Schmieding +44 20 3207 7889

LONDON

Mike Berry +44 20 3465 2755
Stewart Cook +44 20 3465 2752
Mark Edwards +44 20 3753 3004
Tristan Hedley +44 20 3753 3006
Peter King +44 20 3753 3139
Christoph Kleinsasser +44 20 3753 3063
Chris McKeand +44 20 3207 7938
Simon Meehan +44 20 3465 2754
A.J. Pulley +44 20 3465 2756
Matthew Regan +44 20 3465 2750
Asbjorn Rogge +44 20 3753 3051
Michael Schumacher +44 20 3753 3006
Paul Somers +44 20 3465 2753

EQUITY TRADING

HAMBURG

David Hohn +49 40 350 60 761
Gregor Labahn +49 40 350 60 571
Lennart Pleus +49 40 350 60 596
Marvin Schweden +49 40 350 60 576
Linus Weidner +49 40 350 60 798
Philipp Wichmann +49 40 350 60 346
Christoffer Winter +49 40 350 60 559

LONDON

Edward Burlison-Rush +44 20 3753 3055
Richard Kenny +44 20 3753 3083

ELECTRONIC TRADING

Daniel Eichhorn +49 40 350 60 391
Matthias Führer +49 40 350 60 597

BERENBERG CAPITAL MARKETS LLC

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E-mail: firstname.lastname@berenberg-us.com

EQUITY SALES

SALES

Kelleigh Faldi +1 617 292 8288
Isabella Fantini +1 646 445 4861
Shawna Giust +1 646 445 7216
Rich Harb +1 617 292 8228
Zubin Hubner +1 646 445 5572
Jessica London +1 646 445 7218
Ryan McDonnell +1 646 445 7214

SALES (cont'd)

Emily Mouret +1 415 802 2525
Peter Nichols +1 646 445 7204
Kieran O'Sullivan +1 617 292 8292
Rodrigo Ortigao +1 646 445 7202

CORPORATE ACCESS

Olivia Lee +1 646 445 7212
Tiffany Smith +1 646 445 4874

SALES TRADING

Christopher Kanian +1 646 445 5576
Lars Schwartzau +1 646 445 5571
Brett Smith +1 646 445 4873
Bob Spillane +1 646 445 5574

ECONOMICS

Mickey Levy +1 646 445 4842
Roiana Reid +1 646 445 4865