MARKETS

Italian Assets Dive After Government's Budget Plan

Milan stock index falls sharply while bond yields rise, with investors predicting more volatility ahead

By Alistair MacDonald and Christopher Whittall

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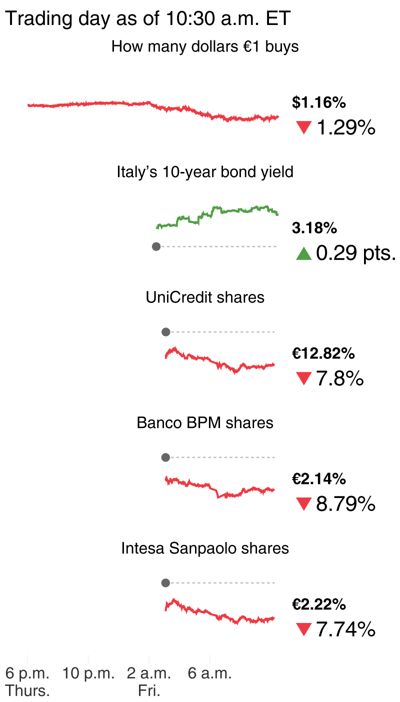
Italian stocks and bonds fell sharply Friday as investors expressed concern about the fiscal stability of a country that is continuing to weigh down European markets.

Investors are bracing for further volatility ahead of an October budget from Italy's antiestablishment coalition government, which has pledged spending and tax cuts that some fear could put the country's debt on an unsustainable course.



Source: WSJ Market Data Group

Late Thursday, the government significantly widened its budget-deficit target for next year to 2.4% of gross domestic product, setting up a likely clash with the European Union given the proximity to the bloc's 3% limit. The government has to send its budget to parliament for approval by Oct. 20.

Italy's main equity benchmark, the FTSE MIB, fell 3.7% Friday. Italian lenders were under particular pressure, with UniCredit SpA down 7.8% and Banco BPM SpA down 6.3%. Yields on 10-year Italian bonds climbed to 3.216% from 2.8% a week ago, while the two-year yield rose 0.36 percentage point to 1.09%, according to Tradeweb.

The selling in Italy put pressure on some other markets, with all of Europe's main stock indexes falling and the euro declining 0.5% against the dollar.

Stefan Isaacs, a portfolio manager at M&G Investments, sold his Italian bond holdings weeks ago and predicts yields will continue to climb, putting pressure on the government's finances.

"The economics might become unsustainable," he said.

In debt markets, the reaction was largely contained in Italy. The spread between Italian 10-year bonds and their German counterparts rose to 2.7 percentage points. Yields move inversely to prices.

Japanese bank Mizuho sees potential for that spread to reach three percentage points over the next two weeks. "For the time being, there is little positive to say about the budget, relative to expectations,” said Mizuho’s head of interest-rate strategy, Peter Chatwell.

Italy is the eurozone’s biggest government borrower, but its government has promised policies that will likely add to the debt pile, such as tax reductions, a so-called citizens’ income and pension reform.


Sun reflects off the headquarter offices of UniCredit in Milan. **PHOTO:** GERALDINE HOPE GHELLI/BLOOMBERG NEWS

The new budget target could lead to a credit-rating downgrade, analysts at Barclays said in a note to clients. Ratings companies Moody’s and S&P are both due to update their Italian ratings at the end of October.

Some Italian politicians shrugged off the selling.

“Markets will get over it,” said Matteo Salvini, deputy prime minister and leader of the League, one of the two parties supporting the Italian government.

Some analysts also think fears are overblown.

“There’s fiscal space—debt to GDP is not going to be rising substantially in this kind of budget projection,” said Themos Fiotakis, co-head of FX and rates strategy at UBS.

Mr. Fiotakis said that observers shouldn’t confuse the forthcoming budget negotiations between Italy and the EU with previous negotiations surrounding bailout programs in countries such as Portugal and Greece, which had less leeway to push back against Brussels. He believes Italian bonds now represent a good buying opportunity.

But concerns over Italy have deep roots. In May, fears that the country could leave the eurozone rattled markets around the world, pushing U.S. Treasury yields to their largest daily decline in nearly two years as investors sought havens.

Italy has been a key factor in keeping global investors out of Europe since.

“They look at Europe and frankly they feel to some extent it’s becoming univestible: the uncertainty, the volatility, the fact that the economy is much weaker than in the U.S.,” said M&G’s Mr. Isaacs.

“I’m not sure these kinds of [Italian] headlines help,” he said.

—Emese Bartha and Giovanni Legorano contributed to this article.

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