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IT COULD HAVE BEEN WORSE: GERMAN AND ITALIAN RISK UPDATE

Berenberg Macro Flash

GERMANY: A NARROW ESCAPE FOR MERKEL

No real reprieve for German Chancellor Angela Merkel - but it could have been worse. Heavy losses for her own centre-right CDU and her federal coalition partner SPD at the regional election in Hesse keep the risk alive that she may be toppled by her own party or the SPD shortly. On balance, however, it remains quite likely that she can stay in office until at least late 2019 with a better than even chance that she can serve out her full term until late 2021 if she chooses to do so.

For two reasons, the Hesse result did not add to the risks that Merkel is facing anyway. First, the losses for her CDU (-11ppt to a mere 27% of the vote) were in line with expectations. Second, on the state level, her CDU can most likely continue its coalition with the Greens who advanced as expected to 20% of the vote. If CDU state prime minister Volker Bouffier, a close Merkel ally, had lost office, the pressure on Merkel would have been more significant.

Whereas the Hesse result has not added to Merkel's woes, we still need to watch the two key risks for her: First, will a potential successor dare to challenge her for the position as CDU party leader at the CDU convention on 7-8 December? Probably not, but it certainly remains possible. If she lost the party leadership, she might have to resign as chancellor as well. Second, will the badly battered SPD leave the government in Berlin? Fear of new elections will probably prevent that for the time being. But a grassroot revolt within the SPD could still happen. Even SPD leaders who want to stay on may rethink their position upon a scheduled half-term review of their position within the Merkel government in late 2019. Next year could be as challenging for Merkel as this year has turned out to be

ITALY AVOIDS FULL S&P DOWNGRADE, BUT RISKS REMAIN LARGE

Late Friday night, S&P refrained from following in the footsteps of Moody's. Upon downgrading the outlook for Italian sovereign bonds to negative from stable, S&P kept its credit rating two notches above non-investment grade. Italian risk spreads (the spread between 10 year Italian and German sovereign bond) reacted positively to this news (down c. 10bps this morning). Still, the current risk spread of c. 300bps remains dangerously close to levels where some Italian banks might need a helping hand in a while. According to Cabinet Undersecretary Giancarlo Giorgetti, Italian banks would need recapitalization if the risk spread would get close to 400bp.

Meanwhile, the disagreements in the Italian government continue and highlight the risk that Finance Minister Giovanni Tria, who is arguably the most market friendly actor in the Italian government, might not stay in his position forever. Tria declared that the current risk spread was damaging and defended ECB President Mario Draghi's comment that Italy should refrain from questioning “the existential framework of the euro”. Draghi had been heavily critized earlier by 5Stars leader Luigi Di Maio for making this comment.

Overall, not much has changed for Italy over the last week. As expected the European Commission (EC) rejected Italy's 2019 budget: The EC asked the Italian government to take back, revise and resubmit its plans at the latest until 13 November. This is the first time in its history, that the EC has officially rejected a budget. We think that only a further sharp rise in risk spreads will lead the Italian government to soften its budget spending plans, such as delaying the implementation of the pension reform reversal. Italy is still an accident waiting to happen. Unless the government changes tack, the key question is not if but when Italy may face a debt crisis.

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