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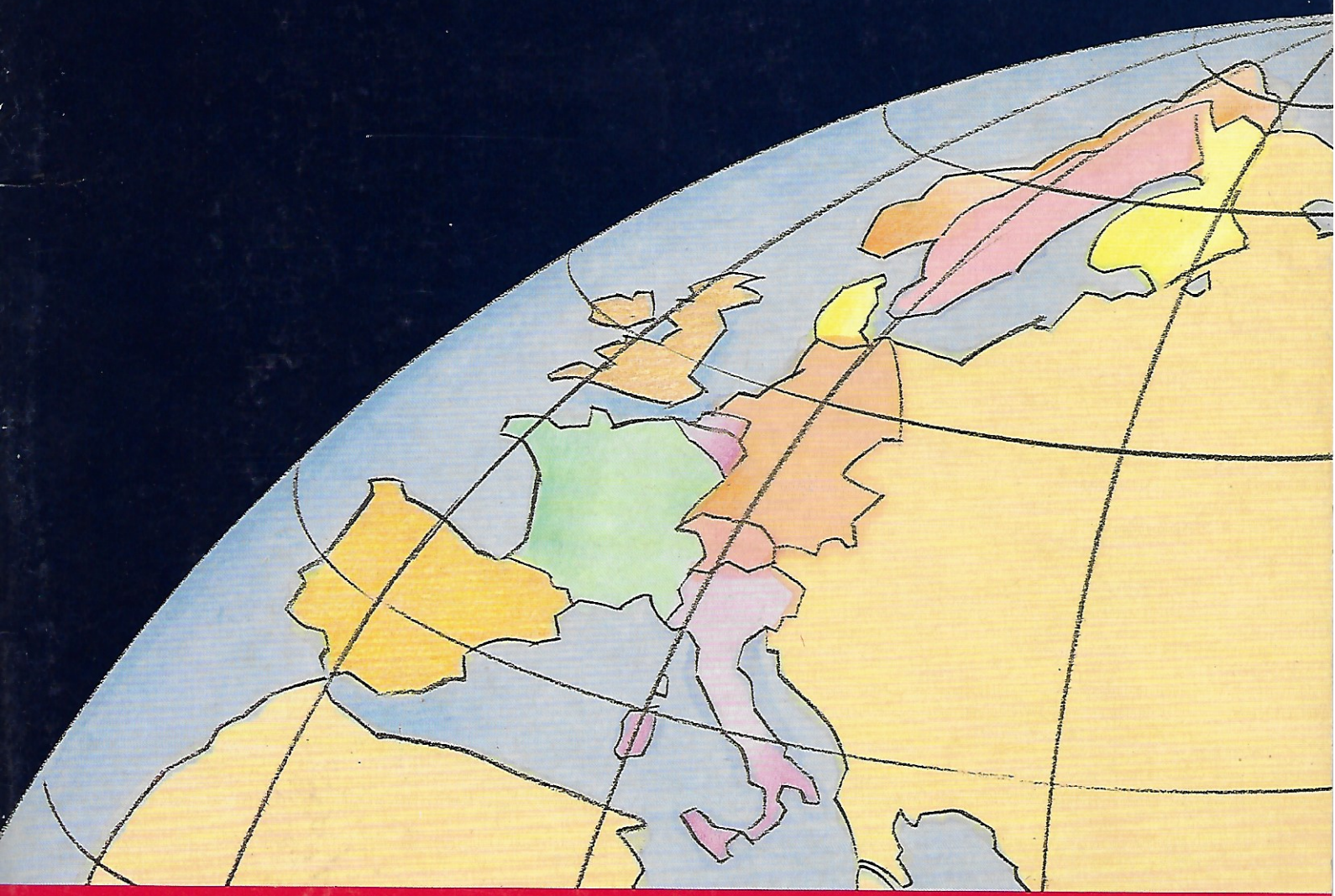
EUROPEAN EQUITY STRATEGY

August 1988



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The Italian stock market index has gone up 9% by the end of July since the beginning of 1988. This relatively poor performance can essentially be ascribed to fundamental market uncertainty on the critical issues of political stability and fiscal policy, which constitute both the primary target and the key test for the new coalition government headed by the Christian Democratic leader Mr de Mita. In the month of July, however, the market has experienced a considerable acceleration, gaining 4 of the 9 percentage points since the end of 1987, and more than doubling average daily volumes. This appreciation is due to an improvement in market sentiment on the budget deficit issue, despite the fact that, until now, government activity has been more concerned with well-presented statements of intent than with tangible and effective action. Although there is no doubt that the elimination of the primary deficit by 1992 is an essential pre-condition for future economic stability, and that every single politician is well aware thereof, it is still not clear whether the implementation of such a plan contradicts the very essence of the Italian political system. It is indubitable, however, that the unprecedented emphasis the new government has placed on its anti-deficit plan would lead, among other things, to a significant and dangerous loss of international reputation in the case of an even partial failure. The bet the Italian government is now embarked on is thus a crucial one indeed and its upshot will set the pace for the future development of the Italian nation.

For the short run we are still recommending a reasonably cautious but more positive attitude towards the market, at least until tougher anti-deficit measures planned for September are put into practice and the prospect of higher interest rates becomes more remote.

GOOD FUNDAMENTALS

Our full weighting of Italy is justified by the good performance of the Italian economy and the strong growth of corporate profits in 1987 and 1988. Estimated GDP growth for 1988 has been repeatedly revised up, and now stands in the range of a 3-3.5% annual rate. A buoyant domestic demand has been the driving force of economic activity and has generated a strong growth in industrial production, especially in the investment goods sector. At the same time, inflation has remained stable at a 4.9% annual rate, despite strong consumption demand and the recent appreciation of the dollar. Although current and planned VAT increases will probably contribute to a slightly faster growth in consumer prices - probably in the region of a 1% additional growth - the Italian inflation differential is unlikely to show major variations in 1988, given the current upgrading of price levels in major competitor countries.

Some concern is raised by the current worsening of the Trade Balance and the overall Balance of Payments - a natural consequence of stronger relative growth. However, the effective exchange rate, the measure of Italy's price competitiveness, is showing no signs of instability and the growth differential is sustained by a high investment rate. Corporate profitability has been exceptionally strong in 1987 and in the first half of 1988, and we expect it to be so until 1989 at least, sustained by high aggregate demand and stable prices, improved balance sheets, cost reductions and the recent appreciation of the dollar. Moreover, a possible downturn of the US currency in the fall would not be overly detrimental to the Italian market, whose highly dynamic performance coincided with the end of the dollar bubble in 1985.

INSTITUTIONAL REFORMS

A global reform of the institutional and administrative apparatus of the Italian state is another major concern of the de Mita government. The aim is to make legislation a less lengthy and cumbersome process and to increase the efficiency of the Public Administration. While the debate on these matters goes on in a usually lengthy, cumbersome and inefficient way, more effective decisions have recently been taken regarding issues more closely related to the stock market. In particular, three Bills on insider information, takeovers and anti-trust legislation are expected to be passed in the near future, and their implementation will certainly contribute to expand the flow of more visible and reliable financial information and to enhance the prospect of a smoother functioning of Italian capital markets, thus improving investors' confidence and reducing risk aversion.

MUTUAL FUNDS

Political uncertainty - which has kept foreign investors out of Italy for two years - is certainly among the key factors which explain the poor relative growth of the Italian market and the low level of current valuations relative to the performance and prospects of the Italian quoted companies. But restrained liquidity is also part of the story. Mutual funds, which had been the

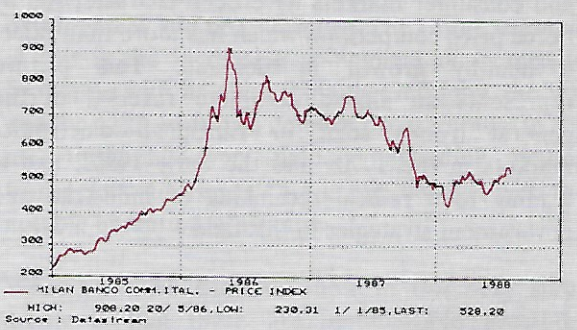
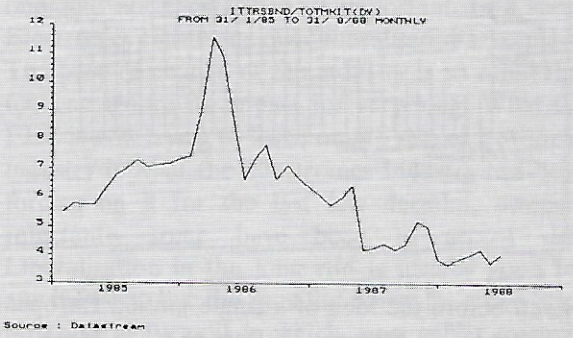
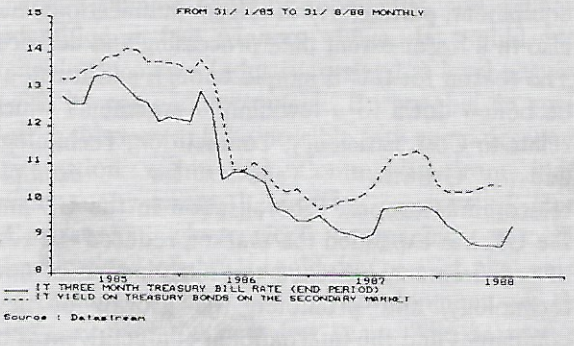
driving force of the 1985-86 boom, have experienced a year-long series of net redemptions, which has reduced their assets from L69tn to L53tn and forced them to be net sellers in the market. The most recent July figures show a 22% slowdown in redemptions which, although partly due to a seasonal factor, do reflect a mild decline in individual investors' aversion to stock market investment, after the severe blows of the 1987 slump. But although the recent upturn of the market has already improved the performance of mutual funds, July figures show only a small 1.5% increase in new subscriptions. A persistence of the present uptrend is likely to favour a slow but sustained build-up in investors' confidence. Provided general conditions do not deteriorate, we expect new subscriptions to exceed redemptions by the end of the year.

MODERATE GROWTH

Stronger foreign buying explains a large part of the recently improved performance of the Italian market. An even cautious reduction in expected risk premia has left global investors with a clearer view on the relative undervaluation of Italian companies and has given them a good opportunity to buy cheap stocks. We estimate the current market PE ratio to be in the region of 15x, which is a historically low figure for Italy and substantially underestimates corporate profitability and earnings growth prospects. This is especially true in sectors like Telecommunications, where a significant growth in demand is expected to drive up future earnings in state-owned service monopolies STET, SIP and Italcable (which are in the process of an overall restructuring) and equipment makers Sirti, Setemer, Italtel and Telettra (the latter is part of the FIAT group); Motors, where FIAT's spectacular performance will continue to be a powerful driving force; Chemicals, where Montedison's radical and controversial restructuring will finally induce a marked improvement in profitability. Good performances are also expected from paper producer Burgo, textile manufacturer Marzotto and food companies Eridania and SME. A cautious attitude is recommended towards hyperdynamic financial holding companies, while the Insurance and Banking sectors should be temporarily avoided, before clearer international strategies are better delineated.

On these grounds, we expect the market to remain on a moderate growth path in the next few months, with short rises followed by periods of consolidation.

MARKET STATISTICS

	PER	Yield %
1984*	18.6	3.5
1985*	17.0	2.7
1986*	26.5	1.7
1987*	18.2	2.2
1988+	20.3	1.9
1989+	22.4	1.8

*Annual Average PE: MSCI
+Prospective: end-88/89