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"Setting the scene for Italy's constitutional vote"

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- Italy is due to due to hold a referendum on changes to its constitution that include a downgrading of the Senate.
- We investigate the context and potential ramifications of this public vote.

When Matteo Renzi became the Italian Prime Minister in February 2014 his agenda included (i) making changes to the electoral voting system of the lower house and (ii) bringing about constitutional reform that would mean the end of the near perfect bicameralism of the Italian parliament. Therefore in this piece we:

- Take a look at the new voting system in the lower house and how it relates to its predecessors.
- Lay out how the seats are currently distributed within the lower house and what polls are implying about how this could change.
- Give an update on where we stand in the constitutional reform process for the upper house and which way polls are indicating that the referendum on the matter will go.
- Investigate potential ramifications of the referendum for the Italian credit rating.

The concept

The two houses of the Italian parliament, both of which have five year terms, are known as the Chamber of Deputies (lower house) and the Senate (upper house). The electoral voting systems used to allocate the seats in each house are different and have changed over time. However, a common theme is that they have been prone to resulting in messy coalitions (in which small parties often have influence well above their size). Meanwhile the fact that a slightly different system is used in each house means that there is the potential for each to have a different political make-up. This is particularly troublesome in Italy due to the nearly pure bicameralism of the two houses[1] and has meant that legislation often bounces between them, increasing the time taken to pass laws and often resulting in them eventually being passed in a 'watered down' form. Renzi's way of dealing with this was intended to be two-fold:

- Electoral law change: Introduce an electoral voting system for the lower house which promotes the formation of stable governments but is also deemed to be in line with the Constitution.
- Constitutional reform: Significantly reduce the power of the upper house (which would also mean that reform of its own electoral voting system would become irrelevant) in order to make government more effective and reduce its cost.

Electoral law change: 1993 to 2013

The Chamber of Deputies ('the Chamber') has 630 seats in total, with 618 of these being elected from within Italy and 12 being allocated to Italians living abroad. Meanwhile the Senate has 315 elected members (six of which represent Italians abroad) and 6 senators for life (which includes the Italian president). The most recent set of parliamentary elections took place on 24-25 February 2013 and the next are due to happen no later than 23 May 2018. Between 1946 and 1993, in a period referred to as the First Republic, Italian elections used a purely proportional representation (PR) based voting system. This system encouraged the formation of coalitions, which were almost always led by the Christian Democracy party and supported by an alternating variety of smaller parties from both the left and right. However, the "Tangentopoli" scandal led to far-reaching reforms of the electoral system. Since then, in a period known as the Second Republic, two different voting systems have been used:

[1] This means that both houses can initiate laws but also both to need to approve them.

1993-2005 – "Mattarellum"

Laws 276 and 277 were approved in August 1993 (following a national referendum) and used for the elections in 1994, 1996 and 2001 (legislatures XII to XIV). The laws introduced an 'additional member' voting system that consisted of the following:

- *Chamber:*
  75% of seats were filled by individual candidates who won the largest number of votes in each electoral college - a simple first-past-the-post (FPTP) and open list system. The remaining 25% of seats were allocated by proportional representation (PR), on a national basis, amongst parties obtaining at least 4% of the vote and from closed party lists.
- *Senators:*
  75% of seats were filled from single-member districts by individual candidates according to FPTP. The remaining 25% of seats were allocated by PR[2], on a regional basis, from closed party lists. There was no minimum threshold of votes required in order to participate but the d'Hondt method used to allocate seats effectively imposed one.

At the instigation of the new voting system it was thought that the 75% FPTP element would reduce the fragmentation in Italian politics. However what actually happened was that small parties with a similar ideology to a larger one would have the potential to split the vote in the 75% of seats allocated by FPTP. At that time there were no bigger parties with a sufficiently large percentage of the vote to not be concerned about this 'splitting'. This meant that bigger parties were encouraged to form coalitions with the smaller ones and in the process would give them 'assured' seats corresponding to their share of votes (this meant that parties with less than 4% of the national vote would often be represented in parliament). This lead to what became known as the 'proportionalisation of the first-past-the-post system'[3] and the parliament actually became more fragmented than was the case prior to 1993, with government majorities decreasing and the number of parties actually increasing. When in government the winning coalitions had their effectiveness undermined by the differing views of the parties within them. In summary, the coalitions were good at winning elections but then ineffective at governing.

2006-2013 – "Porcellum"

In December 2005 laws 276 and 277 were replaced by law 270 and it was this that applied in the elections of 2006, 2008 and 2013. The law saw the following voting systems used:

- *Chamber:*
  A 'majority assuring' PR system, on a national basis, was used to allocate seats from blocked/closed party lists. The 'majority assuring' element of the PR meant that if the party or coalition with the highest number of votes failed to win 340 seats, it was given 'bonus' seats to meet the 340 requirement (this is equal to 55% of the seats within the Italian mainland). In such a situation, the 277 remaining seats were then distributed among the other qualifying coalitions or parties using PR[4].
- *Senate:*
  A PR system with majority premiums was used with closed party lists. However, it was applied on a regional rather than national basis. This combination meant that a party or coalition which got the majority of votes in a region but did not achieve 55% of seats would automatically be awarded no less than 55% of seats in that region[5]. The remaining seats were then distributed amongst the other qualifying parties and coalitions using PR. The application of the winners' bonus on a regional rather than national basis meant that there was no guarantee that one party would have a majority in the Senate as a whole (unlike the Chamber). This effect is amplified by strong North/ South voting differences in Italy.

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[2] While both houses used PR to allocate 25% of their seats, each made use of a different 'proportional representation quotient'. In the Senate the votes obtained by the winners in each electoral college were fully excluded from the PR process, while in the Chamber the votes were only partially excluded. ("The New Italian Republic: From the Fall of the Berlin Wall to Berlusconi")

[3] "The unfinished story of the electoral reforms in Italy", http://www.tandfonline.com/doi/full/10.1080/23248823.2014.1002244

[4] There are four minimum thresholds, applied on a national basis, for a seat in the Chamber: (i) for a coalition: 10% of votes, (ii) for a party within a coalition: 2% of votes (with the exception of the largest party in the coalition that does not achieve 2%), (iii) for a party not in a coalition: 4% of votes and (iv) for a language minority party: 20% of votes in their district.

[5] There are three minimum thresholds, applied on a regional basis, for a seat in the Senate: (i) for a coalition: 20% of votes, (ii) for a party within a coalition: 3% of votes and (iii) for a party not in a coalition: 8% of votes.

It was thought that the majority premium voting system introduced under the 'Porcellum' would result in increased political stability. However, the reality was that there remained a big incentive to form coalitions prior to elections taking place in order to win the majority premium. The system therefore continued the theme of the Mattarellum, with large coalitions being formed to win elections but these coalitions then struggling to govern effectively due to the disparate views of the parties contained within them. Table 1 below shows the current make-up of the Chamber and Senate.

Chart 1: Make-up of the Chamber

Political Party		Orientation	Seats
Government			***377***
Democratic Party	**PD**	Centre-left	302
Popular Area	**AP**	Centre-right	31
Civic Choice	**SC**	Centre	20
Solidary Democracy	**Demo.S**	Centre-left	13
Mixed Group	-	N/A	11
Opposition			***253***
Five Star Movement	**M5S**	Left/ populist	91
Forza Italia	**FI**	Centre-right	53
Italian Left	**SI**	Left-wing	32
Lega Nord	**LN**	Right-wing	17
Brothers of Italy	**FdI**	Right-wing	10
Mixed Group	-	N/A	50

Source: Internet sources, Rabobank

Chart 2: Make-up of the Senate

Political Party		Orientation	Seats
Government			***164***
Democratic Party	**PD**	Centre-left	113
Popular Area	**AP**	Centre-right	31
For the Autonomies	**AUT**	Centre-left	20
Supportive of government			***20***
Liberal Popular Alliance	**ALA**	Centre	20
Opposition			***137***
Five Star Movement	**M5S**	Left/ populist	35
Forza Italia	**FI**	Centre-right	40
Great Autonomies and Freedom	**GAL**	Centre-right	15
Lega Nord	**LN**	Right-wing	12
Conservatives and Reformists	**CR**	Cente-right	9
Mixed Group	-	N/A	26

Sources: Internet sources, Rabobank

The way the majority premium voting system was used in the 'Porcellum' also posed constitutional problems. This ultimately led to the Italian Constitutional Court declaring several elements of the voting system unconstitutional in December 2013, including the way the majority premium was awarded and the use of closed lists[6]. The specific problem with the premium was that it was awarded regardless of the percentage of the vote received by the winner. By abolishing the premium but leaving the other main seat distribution rules intact the Court had by default returned Italy to a pure PR system (if an election needed to be held prior to any further reform). Meanwhile the Court's issue with the closed list system was that it meant that voters couldn't choose specific candidates, giving party leaders the opportunity to allocate seats to unpopular candidates. Therefore this would also need to be adapted going forward.

In summary there were constitutional issues involved with the 'Porcellum' voting system and, in any case, the system had not aided the formation of stable governments in Italy. In addition, the perfect bicameralism of the two houses made passing legislation difficult. This leads us into the desire/ need for the twin reforms instigated by Renzi when he became Prime Minister at the start of 2014, with these being a new voting system for the Chamber and a downgrading of the powers of the Senate.

Italicum – Changes to the voting system

The new voting system for the Chamber that was championed by Renzi is known as the Italicum[7]. The law was ultimately approved in May 2015 and came into force in July 2016. The new voting system is meant to be a constitutional compatible version of the majority assuring PR used under the Porcellum but with a further tweak that should reduce the bargaining power of smaller parties:

- If a single list (rather than coalition) wins at least 40% of the vote but fails to gain 340 seats, it will automatically be awarded seats sufficient to bring it up to controlling 340 in total. The remaining seats are divided among the other parties (with the proviso that they must have gained more than 3% of the national vote) by PR. If no single list gets 40% of the vote, a second round vote is held between the two biggest lists and the winner gets 340 seats. The other parties share the remaining seats by PR according to their vote share in the first round of voting.
- There are 100 multi-member districts and each party presents a list of candidates in each district. Each candidate can only run in one district, with the exception of the 'head of list' who can run in up to ten districts. This is essentially a hybrid between an open and closed list system.

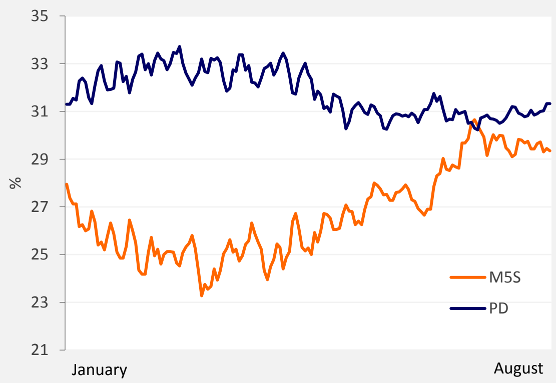
[6] "The unfinished story of the electoral reforms in Italy, the difficult attempt to build a majoritarian-style of government."

[7] Law 6 May 2015, no.52.

The theory behind awarding the majority assuring premium to a single list rather than a coalition is that it will help to stop the need for larger parties to form sometimes disparate coalitions prior to elections in order to win the premium (i.e. the bargaining power of smaller parties will be significantly reduced). However, the new system is not fully 'coalition proof'. This is because a 'single list' does not necessarily mean a single party. For example, parties could join forces prior to an election in order to form a single list and then separate afterwards. The new system also gives the opportunity for a sizeable anti-establishment party to win the premium. The thinking here is that under the old system such a party would struggle to form coalitions as the establishment parties would not join them. This meant that it was very unlikely that they could win the majority premium. However, the new system in which the premium goes to a single list means that an anti-establishment party can 'go it alone' but still have a reasonable chance of winning it.

The new electoral voting system means that, in theory, the key consideration for who will form the government should be who the largest single party in the lower house is (this being as they are guaranteed a majority). The two parties polling the largest vote share in recent times have been the PD of Renzi and the anti-establishment and anti-euro M5S. Chart 1 shows how the vote share of both of these parties has changed since the start of 2016. It can be seen that in the last three months the advantage enjoyed by the PD has rapidly shrunk and if an election was to be held today it would be extremely close.

Chart 1: How the two largest parties have polled in 2016



Notes: Four poll rolling average

Sources: Internet sources, Rabobank

Constitutional reform

In what is actually a package of constitutional reforms, the changes to the Senate are the most significant element. These changes would see both the size and powers of the Senate significantly reduced, with this being expected to reduce costs and make government more effective (by bringing an end to perfect bicameralism). Dealing first with its size, the Senate will be reduced to a maximum size of 100 members and be composed of indirectly elected representatives. Of these 100 members, 74 must come from among the regional councillors[8] while 21 must come from among the mayors (one from each region). The remaining members will be appointed by the President. The term of a senator will correspond to that of the elections for their local role.

In conjunction with the Senate's significant reduction in size, there will also be a significant reduction in its powers. For the majority of laws passing through parliament it will be able to express its views to the Chamber but can be overridden by it (for example, this will include the Budget). The Senate will only retain its existing veto powers in relation to a small set of specific matters (such as amendments to the constitution) and the government will no longer be subject to confidence votes by the upper house. In conjunction with these changes, there will also be a transfer back to central government of decision making powers currently devolved to the regions.

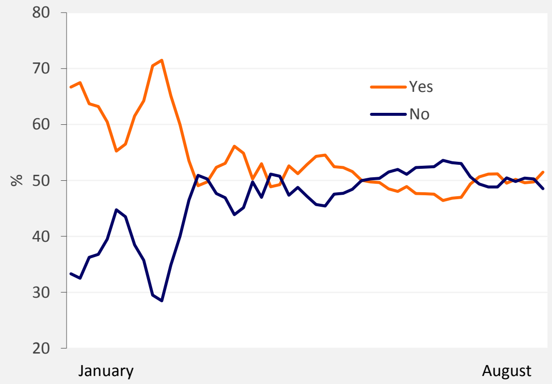
[8] The Senators will be elected by the regional councils. However, in the regional elections citizens will be able to select those councillors that they want to become Senators.

What about the referendum?

In order to enact the constitutional changes outlined above, each parliamentary house had to vote twice on exactly the same text (with a three month gap in between the votes of the lower and upper house). In order for the bill to pass through the second round of voting it needed to gain an absolute majority (i.e. half of the seats + one) in each house. This process was eventually completed in April 2016 but it did require several rounds of amendments and saw abstentions from opposition parties (broadly speaking, the 'Yes' camp consists of those parties in Renzi's government while the 'No' is made up of the opposition). However, the bill did not achieve a two-thirds majority in its second Chamber reading which means that it must be voted on in a national referendum rather than immediately written into law. This referendum does not need to be backed by a specific quorum of voters in order for the result to be valid. A fixed date for the vote has not yet been scheduled and the expected date has slipped from October to November[9].

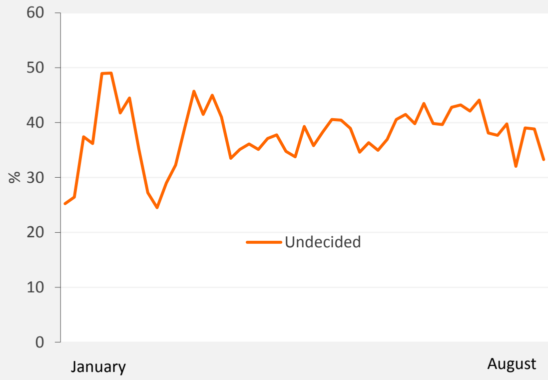
Chart 2 below shows how voting intentions in the referendum have developed since the start of 2016 ('yes' is a vote to implement the proposed constitutional changes and 'no' is to reject them). The chart shows that 'yes' originally had a substantial lead but this took a dramatic fall at the end of Q1 2016 and since then things have been very close. The difficulty in predicting the outcome of the vote is further clouded by the consistently high percentage of voters who are undecided (i.e. even though the exact subject matter of the referendum has been in place since April, many voters still have not made up their minds) – see Chart 3. Not aiding the 'yes' camp is that in some quarters the referendum is seen as an opportunity to air general discontent with the establishment and the changes to the Senate, combined with the voting system changes to the Chamber, are a negative for the influence of smaller parties.

Chart 2: Voting intention for constitutional referendum



Notes: Four poll rolling average, undecided voters excluded.
Source: Internet sources, Rabobank

Chart 3: Significant and steady percentage still undecided



Notes: Four poll rolling average.
Sources: Internet sources, Rabobank

How could things develop from here?

PM Renzi has repeatedly tied his own fate to that of the referendum, saying that a 'no' vote would herald his resignation. Therefore it perhaps comes as relatively little surprise that as he has suffered in the polls the 'no' camp has also gained significant ground as the vote is seen as a defacto confidence vote in Renzi. His decline in popularity has come about due to reasons such as Italy's continued economic problems (Q2 GDP came in at 0%), discontent that he is a reformist but has never won an election (he came to power via an internal leadership challenge), concerns about immigration and banking sector issues. The role of the latter helps to explain why the PM is keen to avoid the decline in popularity that would likely be associated with any banking resolution that saw the subordinated debt of retail investors take a haircut (even if it was followed by compensation).

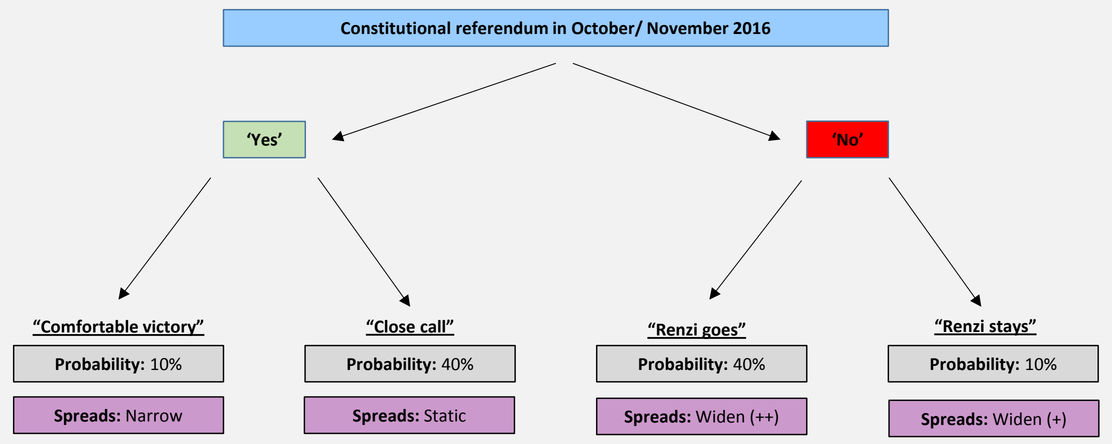
Renzi has received a lot of criticism for linking the constitutional reforms (which many see as necessary regardless of who is in power) to his own fate. Below we lay out four potential scenarios for how things could develop from here, with Diagram 1 below showing the probability that we have allocated to each and also what we think each situation means for Italian spreads (both versus Germany and Spain – see Charts 4 and 5 below for the current spread levels).

[9] The referendum seems unlikely to be held before the 2017 Budget is approved. The draft of the Budget must be presented to parliament by 20/10/2016.

'Yes' result

- *"Comfortable victory"*: As noted above, the probability of a 'yes' vote in the referendum and Renzi's popularity are positively correlated. This scenario assumes that Renzi's popularity picks up, possibly as a result of the Five Star Movement's recently elected mayors[10] (which include those in Rome and Turin) showing ineffective leadership[11]. This means that 'yes' achieves a relatively easy victory and emboldens Renzi to call a national election in early 2017 (remember that he has never actually won a national election) and claim the Chamber's majority premium. This means that he is able to continue with his reformist programme (which includes improvements to the efficiency of the public sector, product market deregulation and changes to the judicial system).
- *"Close call"*: Renzi manages to achieve a narrow victory in the referendum but his position is too weak to be sure of winning a snap national election. In order to rebuild his support he needs to put any contentious reforms on hold and push the European Commission to allow him to conduct additional fiscal easing. From the perspective of the market, the positives of constitutional reform are netted off by the negatives of lack of further reform and fiscal easing being applied on its own.

Diagram 1: How things could develop from here?



Sources: Rabobank

'No' result

- *"Renzi goes"*: The PM sticks with his promise and resigns following a 'no' result. Italy now has a Chamber and Senate which continue to have exactly equal power. The Chamber has a majority assuring PR system that is (probably[12]) in line with the constitution while the Senate will have a regionally based majority assuring PR system that needs alteration in order to be constitutionally legal. From a holistic perspective this is not a lot different to the voting systems and balance of power between the houses that existed between 2006 and 2013. It seems likely that some form of caretaker government would have to be appointed whose primary job was to make the Senate's voting system legal. Elections could perhaps be held during the course of 2017 but Italy would remain in a position where it continues to struggle to pass legislation due to (i) the combination of the equal power of the two houses and (ii) the slightly different voting systems used in each house meaning that different parties/ coalitions can have a majority in each. In addition, messy coalitions would still likely be formed to win the elections but then struggle to govern effectively (due to the majority premium going to the biggest coalition). The potential flip side is that M5S will find it harder to get into power as it struggles to find coalition partners (remember that, while neither the current or proposed constitution actually permits it, M5S has called for a referendum on Italy's membership of the Eurozone).
- *"Renzi stays"*: In recent weeks Renzi has slightly softened his assertion that he will resign on a 'no' result and therefore there is the possibility that he will stay on even if the vote goes against him. It will leave Italy with many

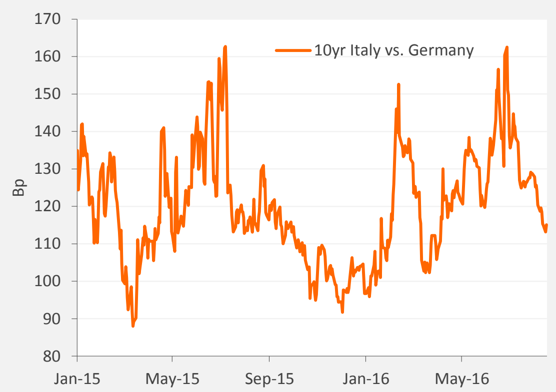
[10] The elections for these positions took place in June 2016.

[11] There are some indications that PD council members and interest groups are blocking/ stalling proposals in Rome, making M5S mayor Raggi look ineffective.

[12] This being as it appears that it will be reviewed again by the Constitutional Court.

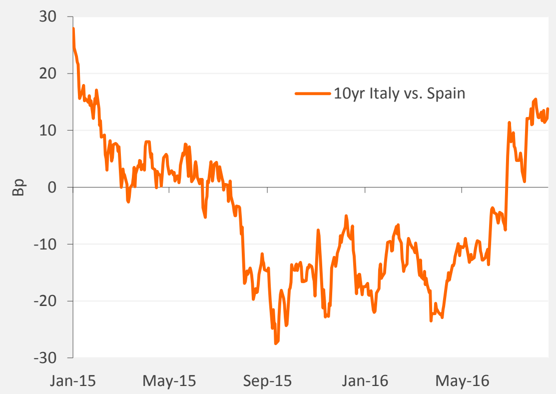
of the same issues as the "Renzi goes" scenario, with the primary difference being that Renzi rather than a caretaker government will be responsible for putting in place a legal voting system for the Senate so that elections can be held in 2017 (Renzi's position will be too weak for him to be able to wait until 2018). This scenario is marginally more market friendly than "Renzi goes" due to Renzi's reform minded nature (as opposed to the uncertainty associated with a caretaker government).

Chart 4: 10yr Italy versus Germany



Source: Bloomberg, Rabobank

Chart 5: 10yr Italy vs. Spain



Sources: Bloomberg, Rabobank

Impact on Italy's credit ratings

Table 1 below shows the current Italian credit ratings provided by the three major agencies and DBRS (note that Fitch, Moody's and S&P ratings all have the country on stable outlook while DBRS put it on negative watch on 5 August). The rating provided by DBRS is particularly significant because it is the one that means Italian govvies fall under Steps 1&2 in the ECB's haircut schedule for 'assets eligible for use as collateral in Eurosystem market operations'[13]. This means that BTPs attract lower haircuts than if they fell under Step 3. It is generally understood that commercial banks tend to use their worst quality eligible collateral at the ECB's lending operations, saving the best (such as govvies) for use in borrowing from the private sector

Table 1: Italian credit ratings

	Italy			
	Moody's	S&P	Fitch	DBRS
Investment Grade	Aaa	AAA	AAA	AAA
	Aa1	AA+	AA+	AAH
	Aa2	AA	AA	AA
	Aa3	AA-	AA-	AAL
	A1	A+	A+	AH
	A2	A	A	A
	A3	A-	A-	AL
	Baa1	BBB+	BBB+	BBBH
	Baa2	BBB	BBB	BBB
	Baa3	BBB-	BBB-	BBBL
	Ba1	BB+	BB+	BBH
	Ba2	BB	BB	BB
	Lower	Lower	Lower	Lower

Sources: Bloomberg, Rabobank

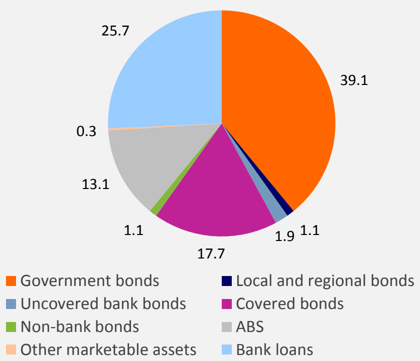
Italian banks have the combination of large holdings of Italian govvies (c. EUR 375bn at the end of February 2016, equating to 10.5% of their total assets[14]) and a large volume of borrowing from the ECB (EUR 174.7bn at the end of July). The collateral pool posted by commercial banks with the Bank of Italy stood at EUR 252bn, net of haircuts, at the

[13] http://www.ecb.europa.eu/press/pr/date/2010/html/sp090728_1annex.en.pdf

[14] Bank of Italy Financial Stability Report, No.1 -2016 (p.29). https://www.bancaditalia.it/pubblicazioni/rapporto-stabilita/2016-1/en-FSR-1-2016.pdf?language_id=1

end of March 2016. Chart 6 below shows that 39.1% of this consisted of government securities (we will assume the majority of these are BTPs), equating to a value of EUR 98.5bn. If we assume that the average maturity of these bonds is 3-5yrs, a downgrade by DBRS would shift the ECB haircut from 2.5% to 7.5% and therefore, in order to keep the pool the same size, banks would need to post EUR 5bn more in govvies. Clearly this isn't a huge amount, particularly given that the total collateral pool is currently EUR 77.3bn bigger than ECB bank borrowing (252 -174.7 = 77.3) and govvies outside the pool stand at c. EUR 241bn. However, the rating of many of the non-govvie assets in the collateral pool may also be impacted by a downgrade of the sovereign and a lot of the govvies outside the pool will already be being used in repo operations (bank repo market exposure in total is c. EUR 230bn). Overall this means that a DBRS downgrade would have a negative impact on Italian banks (and likely disproportionately impact the weaker ones).

Chart 6: Constituents of collateral pool posted at the Bank of Italy



Sources: Bank of Italy Financial Stability Report (No.1 2016), Rabobank

In terms of what the rating agencies currently think about Italy's constitutional reform (Table 2 below shows their latest economic forecasts and that of several other official bodies):

<u>Fitch</u>
Last opinion: 05/08/2016
Next rating review: 21/10/2016
View: Constitutional reform should produce more effective policymaking and, in combination with the new electoral law, should result in more stable future governments. Rejection of the referendum could lead to the resignation of Prime Minister Renzi and political upheaval.

<u>Moody's</u>
Last opinion: 02/08/2016
Next rating review: 07/10/2016
View: The constitutional changes would make it easier for reform legislation to be passed. A failure of the referendum would mean a heightened risk of early elections. The popularity of Eurosceptic opposition parties means that these elections could raise questions over both future reform prospects and fundamental issues such as Italy's euro area membership. A more turbulent political environment and a failure to follow through with structural macroeconomic reforms would be credit negative.

<u>S&P</u>
Last opinion: 13/05/2016
Next rating review: 11/11/2016
View: The Senate reform could help to significantly streamline Italy's legislative process and facilitate the government's executive role. However, while reforms are in the pipeline S&P don't think that their slow general progress will be accelerated prior to the next general elections. If it is concluded that reforms to restore sustainable growth and strengthen public finances cannot be implemented, the credit rating will come under downward pressure.

DBRS

Last opinion: 05/08/2016

Next rating review: 16/09/2016

View: If the constitutional referendum fails Renzi has said he could resign, in which case an interim government could be installed to amend the electoral law. However, this outcome is from certain and therefore there could be a period of uncertainty and a stalling of the reform agenda. This outcome could lead to a downgrade.

Table 2: Economic forecasts for Italy

Forecast	Date	Real GDP (% YoY)				Deficit (% GDP)				Debt (% GDP)			
		2015	2016	2017	2018	2015	2016	2017	2018	2015	2016	2017	2018
Rabobank	21/07/2016	0.6	0.8	0.8		-2.6	-2.8	-2.5		133.0	135.0	135.0	
European Commission	03/05/2016	0.8	1.1	1.3		-2.6	-2.4	-1.9		132.7	132.7	131.8	
Average		0.7	0.9	1.0		-2.6	-2.6	-2.2		132.9	133.9	133.4	
Fitch	05/08/2015	0.8	1.0	1.3	1.1	-2.6	-2.3	-2.0	-1.7	132.7	131.8	130.0	128.0
S&P	13/05/2016	0.8	1.1	1.3	1.2	-2.6	-2.4	-2.3	-2.1	130.4	130.4	130.1	129.4
Moody's	02/08/2016	0.8	1.0	0.9		-2.6	-2.4	-2.0		132.7	132.7	131.9	
DBRS	05/08/2016	0.8	0.9	1.1		-2.6	-2.4	-1.9		132.7	132.7	131.8	
Banca D'Italia	15/07/2016	0.6	1.1	1.2	1.2								
IMF	01/04/2016	0.8	1.0	1.2	1.0	-2.6	-2.7	-1.6	-0.5	132.6	133.0	131.7	129.4
OECD	01/06/2016	0.6	1.0	1.4		-2.6	-2.3	-2.0		160.2	160.3	159.4	
Bloomberg Survey	Latest	0.7	0.8	0.9	0.9	-2.8	-1.1	-0.8	0.0				

Sources: Bloomberg, European Commission, Fitch, S&P, Moody's, DBRS, Banca D'Italia, IMF, OECD, Rabobank

In summary, we think that a 'no' vote in the referendum is unlikely to herald an immediate downgrade from Fitch, Moody's and S&P. However, they are reasonably likely to move the outlook on their ratings to negative as they wait to see how things progress. When it comes to DBRS, the fact that the rating is already on negative watch makes the timeline more compressed. If it soon becomes clear that Italy has entered a period of political limbo, a downgrade before year end becomes likely. As we noted earlier, this will put more pressure on Italian banks as BTPs (and probably other eligible assets) will attract higher haircuts when used as collateral to borrow from the ECB.

Relative Value Trades

The tables below display the top ten bonds from both a country-switch and curve-play perspective that look particularly cheap according to Rabo's Rich/Cheap Model (with cheapness defined here as a yield spread that is a significant number of standard deviations above its 60-day moving average). The model covers bonds issued by Germany, France, the Netherlands, Austria, Belgium and Finland that have a remaining maturity of greater than one year. The 'Spread' column shows the current basis point spread of the cheap bond in relation to the rich bond while the 'No. of Stdevs' column shows the number of standard deviations that this current spread is away from its 60-day moving average.

Country Switch

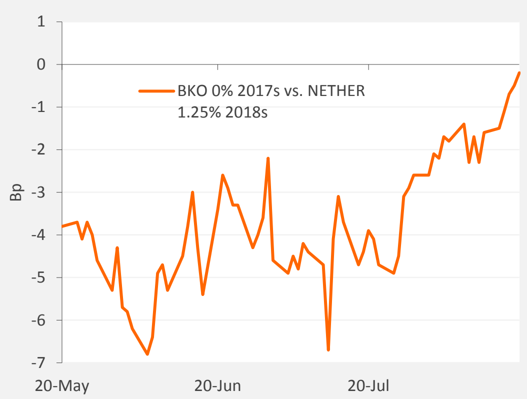
Cheap Bond	Spread	No. of Stdevs	Rich Bond
OBL 0.5 02/23/18 Govt	-0.14	2.33	NETHER 1.25 01/15/18 Govt
RAGB 4.3 09/15/17 Govt	3.19	2.17	BGB 5.5 09/28/17 Govt
DBR 4 01/04/18 Govt	-3.10	2.03	NETHER 1.25 01/15/18 Govt
OBL 0.5 10/13/17 Govt	-1.14	1.92	NETHER 1.25 01/15/18 Govt
BGB 4 03/28/22 Govt	-3.69	1.90	RFGB 1.625 09/15/22 Govt
RFGB 3.875 09/15/17 Govt	1.51	1.88	BGB 5.5 09/28/17 Govt
NETHER 4 01/15/37 Govt	-18.93	1.86	RAGB 4.15 03/15/37 Govt
OBL 0.5 02/23/18 Govt	-1.18	1.82	BGB 4 03/28/18 Govt
RFGB 3.875 09/15/17 Govt	0.59	1.82	NETHER 1.25 01/15/18 Govt

Curve Switch

Cheap Bond	Spread	No. of Stdevs	Rich Bond
BGB 4.25 09/28/22 Govt	-23.51	2.52	BGB 2.6 06/22/24 Govt
BGB 4.25 09/28/21 Govt	-30.19	2.18	BGB 2.6 06/22/24 Govt
BGB 4.25 09/28/21 Govt	-14.35	2.16	BGB 2.25 06/22/23 Govt
NETHER 2.25 07/15/22 Govt	-20.22	2.09	NETHER 2 07/15/24 Govt
RFGB 0.375 09/15/20 Govt	-2.38	1.95	RFGB 3.5 04/15/21 Govt
BGB 4.25 09/28/22 Govt	-52.12	1.95	BGB 1 06/22/26 Govt
BGB 0.8 06/22/25 Govt	-12.94	1.91	BGB 1 06/22/26 Govt
NETHER 2.25 07/15/22 Govt	-8.10	1.89	NETHER 1.75 07/15/23 Govt
BGB 4.25 09/28/21 Govt	-58.80	1.89	BGB 1 06/22/26 Govt

Best Country Switch

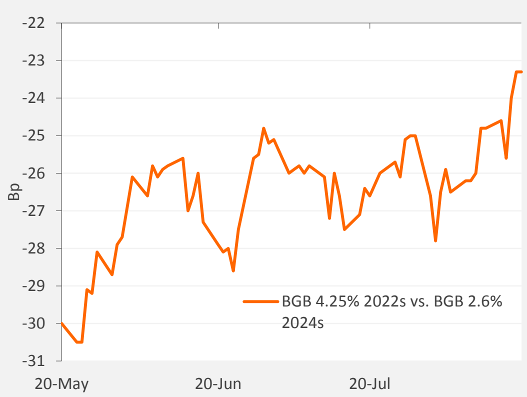
Long Germany 2018s vs. Netherlands 2018s



Source: Bloomberg, Rabobank

Best Curve Switch

Long Belgium 2022s vs. Belgium 2024s



Source: Bloomberg, Rabobank

Market Bias Indicator

The charts below provide some basic analysis on the Request for Quote data seen by our government bond trading desk with regards to Dutch Govvies. This analysis is based on two measurements:

i) Number of inquiries – An individual inquiry consists of a client asking for a price to buy/sell a particular bond from/to our trading desk.

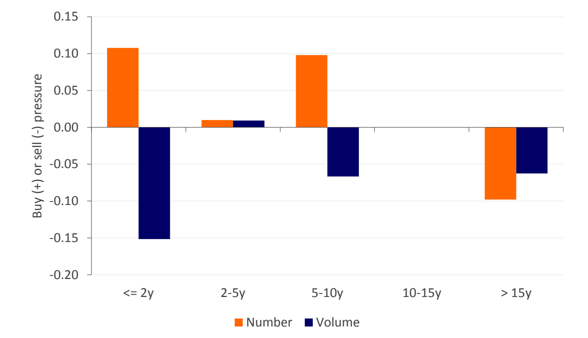
ii) Volumes of inquiries – The size in EUR of each inquiry.

All of the data are from the perspective of the client and we are only looking at bonds (i.e. no bills included).

<u>Charts 1 & 2 - Buy/ Sell pressure for the week and historic comparison</u>

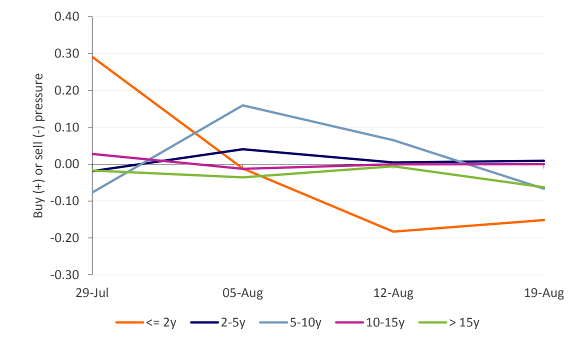
In terms of calculation, in each week a net amount of inquiries is calculated for each of the five maturity buckets. A positive number therefore indicates that there were more buy than sell inquiries from clients. This net amount of inquiries is then divided by the total amount of inquiries (not netted) received over all buckets. Thus the charts aim to show not only interest in a particular bucket but also how this compares relatively to the other buckets. Exactly the same methodology is followed for the volume data. Chart 1 shows this data for this week while Chart 2 gives an historic comparison with regards to the volume data (i.e. the actual market mover) only.

Chart 1: Buy (+) or sell (-) pressure this week



Source: Rabobank Govvie desk

Chart 2: Historical <u>volume</u> of inquiries buy (+) or sell (-) pressure

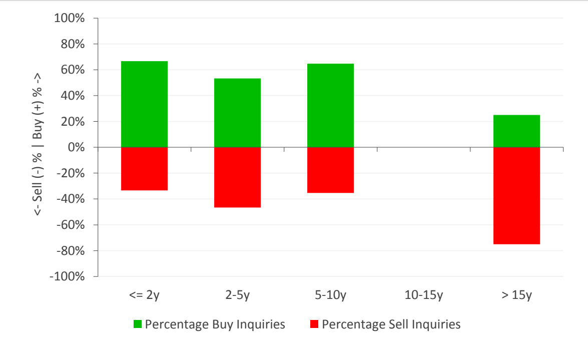


Source: Rabobank Govvie desk

<u>Charts 3 & 4 - Buy/Sell pressure per bucket for the week</u>

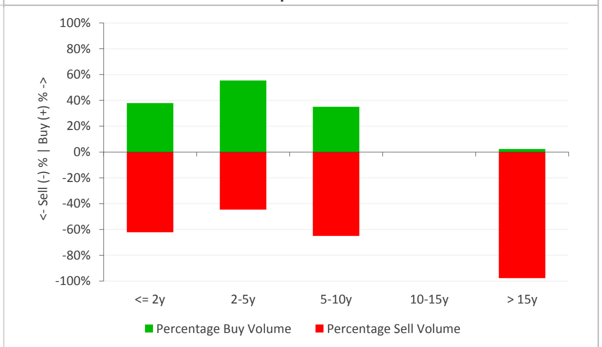
These two charts provide a simple graphic showing the strength of the buy/sell signal within each individual bucket – but not relative to the other buckets (differentiating it from the methodology used for Chart 1-2). The green portion of the bar shows the number of buy inquiries divided by the total number of inquiries in that bucket while the red portion shows the number of sell inquiries divided by the total number of inquiries in that bucket. The same methodology is used for the volume data.

Chart 3: Buy (+) and sell (-) pressure per bucket for the week (<u>number</u> of inquiries)



Source: Rabobank Govvie desk

Chart 4: Buy (+) and sell (-) pressure per bucket for the week (<u>volume</u> of inquiries)



Source: Rabobank Govvie desk

Auction Calendar

(all times in CET, international bonds not included)

Date	Time	Auction	Redemption	Coupon
Aug-24	11:30	Germany: Tap EUR 4bn 0% 8 Oct 2021 (OBL)		Netherlands: USD 33mn (2 different issues combined)
Aug-26	11:00	Italy: I/L bond auction cancelled		
Aug-29				Spain: EUR 65mn (6 different issues combined)
Aug-30	11:00	Italy: Medium-long term bonds	Italy: EUR 13.8bn 0% 2016s	
Aug-31	11:30	Germany: Tap EUR 4bn 0% 14 Sep 2018 (BKO)		
Sep-01	10:30 10:50	Spain: Bonds France: Bonds		Italy: EUR 8.5bn (21 different issues combined)
Sep-05				Germany: EUR 990mn (3 different issues combined) [1] EFSF: EUR 90mn [1] EFSF: EUR 89mn
Sep-06	11:00 12:00	Austria: Bonds Germany: I/L bonds		
Sep-07	11:30	Germany: Tap EUR 5bn 0% 15 Aug 2026 (DBR)		
Sep-08		Ireland: Bonds		
Sep-09				Slovenia: EUR 69mn
Sep-13	10:00 11:00	Netherlands: Tap up to EUR 3bn 0% 15 Jan 2022 Italy: Medium-long term bonds		
Sep-14	11:30	Germany: Tap EUR 1bn 2.5% 4 Jul 2044 (DBR)		
Sep-15	10:30 10:50/ 11:50	Spain: Bonds France: Bonds (OAT/ Inflation-Linked)	Italy: EUR 25.1bn (2 different issues combined) Austria: EUR 11.6bn 4% 2016s	EFSF: EUR 98mn Austria: EUR 1.3bn (3 different issues combined) Finland: EUR 428mn (5 different issues combined) Italy: EUR 2.1bn (14 different issues combined)
Sep-16			Germany: EUR 13bn 0% 2016s	

1 Scheduled for Sunday 04 September 2016

Auction Highlights:

On Wednesday Germany will be tapping EUR 4bn of the 0% 08 Oct 2021 (5yr benchmark). The last time this bond was auctioned, on 20/07/2016, it had a yield of -0.51% and a bid/cover of 1.03x (real bid/cover 0.70x).

Rating Review Calendar

August 2016				
Week 31 (Friday 05)	**Week 32 (Friday 12)**	**Week 33 (Friday 19)**	**Week 34 (Friday 26)**	
Austria *(Fitch)*	Slovakia *(Fitch)* EFSF *(DBRS)* ESM *(DBRS)*	Malta *(Fitch)* Portugal *(Fitch)* Netherlands *(DBRS)*		

September 2016				
Week 35 (Friday 02)	**Week 36 (Friday 09)**	**Week 37 (Friday 16)**	**Week 38 (Friday 23)**	**Week 39 (Friday 30)**
Malta *(Moody's)* Portugal *(Moody's)* Finland *(Fitch)* Greece *(Fitch)* Belgium *(DBRS)* Ireland *(DBRS)*	Lithuania *(Moody's)* Finland *(DBRS)* Malta *(DBRS)*	France *(Moody's)* Slovenia *(Moody's)* Austria *(S&P)* Finland *(S&P)* Lithuania *(S&P)* Luxembourg *(S&P)* Portugal *(S&P)* Italy *(DBRS)*	ESM *(Moody's)* Germany *(Fitch)* Lithuania *(Fitch)* Slovenia *(Fitch)*	EFSF *(Moody's)* Spain *(S&P)*

October 2016				
Week 40 (Friday 07)	**Week 41 (Friday 14)**	**Week 42 (Friday 21)**	**Week 43 (Friday 28)**	
Italy *(Moody's)* Latvia *(Moody's)* Spain *(DBRS)*	Greece *(Moody's)* Spain *(Moody's)* Luxembourg *(Fitch)* Malta *(S&P)*	Austria *(Moody's)* Germany *(Moody's)* Luxembourg *(Moody's)* Italy *(Fitch)* France *(S&P)* Portugal *(DBRS)*	Finland *(Moody's)* Netherlands *(Moody's)* France *(DBRS)*	

November 2016				
Week 44 (Friday 04)	**Week 45 (Friday 11)**	**Week 46 (Friday 18)**	**Week 47 (Friday 25)**	
Belgium *(Moody's)* Ireland *(Moody's)* Latvia *(Fitch)* Netherlands *(Fitch)*	EFSF *(S&P)* Italy *(S&P)* Austria *(DBRS)*	Estonia *(Moody's)* Estonia *(Fitch)* Netherlands *(S&P)*	Latvia *(S&P)*	

Legend

Negative Outlook	Negative Watch
Positive Outlook	Positive Watch

Current ratings

Country	Moody's		S&P		Fitch		DBRS	
	Rating	Effective as of*	Rating	Effective as of*	Rating	Effective as of*	Rating	Effective as of*
Austria	Aa1	24/06/2016	AA+	29/01/2013	AA+	13/02/2015	AAA	21/06/2011
Belgium	Aa3	16/12/2011	AA	28/02/2014	AA	14/11/2014	AAH	21/03/2014
Finland	Aa1	03/06/2016	AA+	25/09/2015	AA+	11/03/2016	AAA	11/09/2015
France	Aa2	18/09/2015	AA	10/10/2014	AA	12/12/2014	AAA	29/04/2016
Germany	Aaa	28/02/2014	AAA	13/01/2012	AAA	06/11/2007	AAA	16/06/2011
Greece	Caa3	25/09/2015	B-	22/01/2016	CCC	18/08/2015	CCCH	11/12/2015
Ireland	A3	14/05/2016	A+	05/06/2015	A	05/02/2016	AH	11/03/2016
Italy	Baa2	14/02/2014	BBB-	05/12/2014	BBB+	25/04/2014	AL	05/08/2016
Netherlands	Aaa	07/03/2014	AAA	20/11/2015	AAA	11/07/2014	AAA	12/05/2011
Portugal	Ba1	25/07/2014	BB+	18/09/2015	BB+	04/03/2016	BBBL	23/05/2014
Spain	Baa2	19/02/2016	BBB+	02/10/2015	BBB+	25/04/2014	AL	08/04/2016

** This date represents the date on which the last change to the country's rating or outlook was made. Reviews in which the rating/outlook was affirmed are not included in this.*

Legend

Negative Outlook	Negative Watch
Positive Outlook	Positive Watch
Recent Change (Last 7 days)	

Please note the disclaimer on the last page of this document

Event Calendar
(all times CET)

Date	Economic Event	Period	Cons	Prev
Aug-22				
08:00	NL: House Price Index (MoM)	Jul	- -	0.6%
08:00	NL: House Price Index (YoY)	Jul	- -	4.6%
Aug-23				
04:00	JN: PMI Manufacturing	Aug P	- -	49.3
09:00	FR: PMI Composite	Aug P	- -	50.1
09:00	FR: PMI Services	Aug P	50.5	50.5
09:00	FR: PMI Manufacturing	Aug P	49.0	48.6
09:30	GE: PMI Composite	Aug P	55.3	55.3
09:30	GE: PMI Services	Aug P	54.3	54.4
09:30	GE: PMI Manufacturing	Aug P	53.7	53.8
10:00	EZ: PMI Manufacturing	Aug P	52.0	52.0
10:00	EZ: PMI Services	Aug P	53.0	52.9
10:00	EZ: PMI Composite	Aug P	53.3	53.2
15:45	US: PMI Manufacturing	Aug P	53.0	52.9
16:00	US: New Homes Sales	Jul	575.0k	592.0k
16:00	EZ: EC Consumer Confidence Indicator	Aug A	-7.7	-7.9
	ECB: MRO allotment			
Aug-24				
08:00	GE: GDP (QoQ, SA)	2Q F	- -	0.4%
08:00	GE: GDP (YoY, NSA)	2Q F	- -	3.1%
15:00	US: FHFA House Price Index (MoM)	Jun	0.3%	0.2%
16:00	US: Existing Home Sales	Jul	5.6Mn	5.6Mn
Aug-25				
09:00	SP: GDP (QoQ, SA)	2Q F	- -	0.7%
09:00	SP: GDP (YoY, SA)	2Q F	- -	3.2%
10:00	GE: IFO Expectations	Aug	102.5	102.2
10:00	GE: IFO Current Assessment	Aug	115.0	114.7
10:00	GE: IFO Business Climate	Aug	108.5	108.3
14:30	US: Durable Goods Orders (MoM, SA)	Jul P	3.5%	-3.9%
15:45	US: PMI Composite	Aug P	- -	51.8
15:45	US: PMI Services	Aug P	52.1	51.4
	Start of Jackson Hole Symposium			
Aug-26				
01:30	JN: CPI (YoY)	Jul	-0.4%	-0.4%
08:00	GE: Consumer confidence	Sep	10.0	10.0
08:45	FR: Consumer confidence	Aug	- -	96.0
08:45	FR: GDP (QoQ)	2Q P	0.0%	0.0%
08:45	FR: GDP (YoY)	2Q P	1.4%	1.4%
09:00	SP: Retail Sales (YoY)	Jul	- -	6.0%
10:00	EZ: M3 money supply growth rate	Jul	5.0%	5.0%
10:30	UK: GDP (QoQ)	2Q P	0.6%	0.6%
10:30	UK: GDP (YoY)	2Q P	2.2%	2.2%
14:30	US: GDP (QoQ, annualized)	2Q S	1.1%	1.2%
16:00	US: Univ. of Michigan 5-10yr inflation expectations	Aug F	- -	2.6%
16:00	US: Univ. of Michigan 1yr inflation expectations	Aug F	- -	2.5%
16:00	US: Univ. of Michigan Consumer Confidence	Aug F	- -	90.4

Aug-27				
	GE: Retail Sales (YoY, SA)	Jul	- -	2.7%
	GE: Retail Sales (MoM, SA)	Jul	- -	-0.1%
Aug-28				
	UK: Nationwide House Prices (YoY)	Aug	- -	5.2%
	UK: Nationwide House Prices (MoM)	Aug	- -	0.5%

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Disclosure

In the past 12 months Rabobank has had a role in a publicly disclosed offer of financial instruments for the following:
BNG, Council of Europe, EFSF, EIB, ESM, Eurofima, FMO and KfW.

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