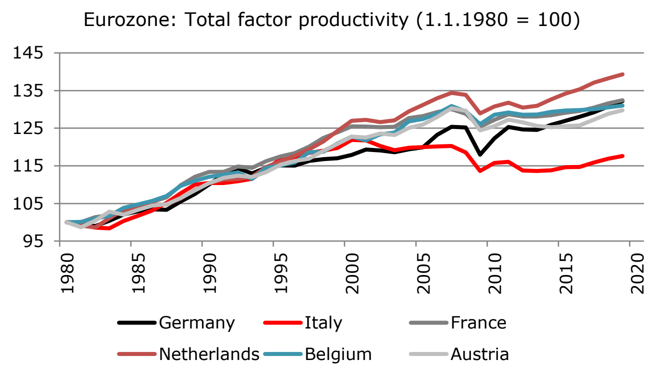
M.M.WARBURG & CO
BANK

ECONOMIC SITUATION AND STRATEGY

June 1, 2018

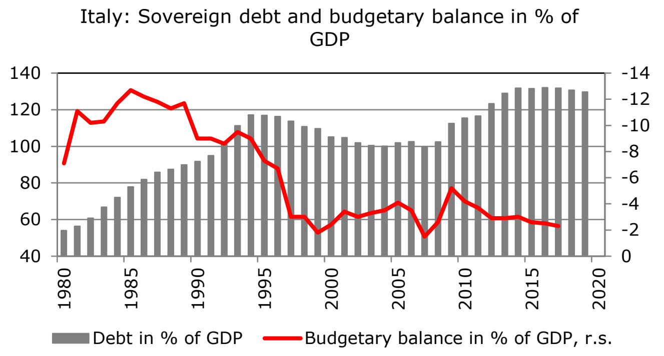
Italian tragedy: Will there be a "Quitaly"?

The euro crisis has gradually faded from the headlines since summer 2015, when Greece's euro zone membership was in question. One reason is that the European Central Bank (ECB) has pursued monetary policy that has enabled euro zone countries to obtain refinancing at unprecedentedly low interest rates in recent years. Another is that euro zone countries have benefited from the global economic recovery, which has brought the strongest growth to the region since 2007. But not all the countries have benefited to the same extent from this upswing. Instead, existing imbalances have continued to increase. Nevertheless, this did not seem to matter much to the capital markets for a long time, until politics rudely disturbed the peace.



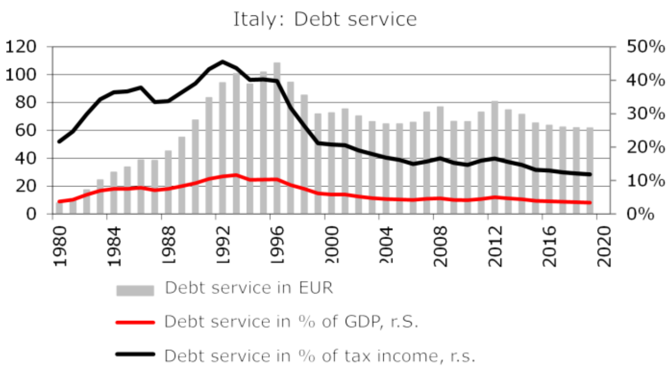
As in 2015, when the left-wing populist Syriza party led by Alexis Tsipras won Greece's parliamentary elections, the future of the euro zone is now in question again because of the government crisis in Italy. The trigger for this turmoil was the intention of the Five Star Movement (M5S) and the League, the two winning parties in the March 2018 elections, to form a governing coalition together. Before the election, the M5S had increasingly distanced itself from its euro-critical views and the League's position was not entirely clear. So, the capital markets were lulled into a sense of security, especially since the two populist parties initially had no plan to form a governing coalition. But after no other coalition came about, the two parties recently agreed to join forces. They then set off a bomb with their draft of a governing platform that has caused considerable fear on the capital markets. One of their demands, that the ECB forgive EUR 250 billion in debts, was quickly dropped, but the other points on their agenda are also problematic. Both parties want to put the country back on a growth track by means of ultra-expansionary fiscal policy. The League intends to bless its voters with a flat tax that will supposedly put the income tax rate below the current bottom marginal tax rate of 23%. According to estimates, this would probably lead to revenue shortfalls for the Italian government of EUR 50-80 billion, depending on the tax rate adopted. The M5S, which is very popular mainly in southern Italy, has a plan aimed at its voters for a "citizen's income," which is like an Italian version of Germany's Hartz IV labor market reform. This is expected to cost just under EUR 20 billion. Moreover, both parties want to repeal the pension reform adopted by the Monti government in 2011 and lower the retirement age. The related costs amount to almost EUR 10 billion. Last, but not least, the increase of the value-added tax planned for next year is to be cancelled. This also leads to revenue losses of about EUR 10 billion. These plans basically correspond to what Syriza promised its voters in 2015. So, history apparently does repeat itself.

If one adds up the cost of all these ideas, the total comes to about EUR 90-120 billion, which is equivalent to 5-7% of Italy's gross domestic product. Previous planning foresaw a budget deficit of just under 2% for this year and next. Without cuts somewhere else, the deficit could thus jump to levels of 7-9%.



Italy's future debt sustainability is questionable given a debt ratio of 130% relative to gross domestic product. A few simple considerations make that abundantly clear. A country's equilibrium debt rate is determined by the relationship of the budget balance to nominal economic growth. We may use the Maastricht criteria to illustrate. A budget deficit of 3% and a nominal growth rate of 5% give rise in equilibrium to a debt ratio of 60%. Italy's main problem is low nominal growth, running at only about 2% in the past years. To keep the debt ratio stable at 130%, Italy can thus only afford a deficit of 2.6% given such low growth. With the significantly higher deficit that would result from implementing all the campaign promises made by the left and right populists, one does not have to be math genius to conclude that Italy would be on its way to displacing Japan (2017: 240%) as the nation with the highest debt ratio. With a deficit of 7% and unchanged growth of 2%, the debt ratio would rise to near 350%. Such a development could only be prevented if Italian growth were to accelerate beyond 5% in the coming years. That seems pretty unlikely.

How Italy could get into this difficult situation in the first place is a frequently raised question. Some try to pass responsibility for their own situation to others. As in Greece three years ago, there are now those in Italy who blame "the euro" in general or Germany in particular for the predicament. But they often ignore that after East and West Germany came together and in the context of European unification, the euro was supposed to prevent Germany from possibly becoming economically dominant in Europe. Moreover, German taxpayers have paid almost EUR 22 billion into the European Stability Mechanism (ESM) in recent years to overcome the debt crisis and have assumed guarantees for almost EUR 170 billion. Germany guarantees the European Financial Stability Facility (EFSF) for more than EUR 200 billion. Added to that are TARGET2 claims in excess of EUR 900 billion. To accuse Germany of having an interest in the economic collapse of other euro zone countries is therefore worse than not being to the point. Far too much is at stake for that. The fact is that Italy is stuck in a downward spiral from which there is practically no escape.



It now looks to us as if the country will go the same way as Greece did. In view of developments in recent years, the Italian people are disappointed in the "establishment" and placing their trust in new parties and politicians that promise everything will be better. Unfortunately, they cannot implement those promises in the real world. Moreover, the spending policy announced by the League and M5S conflicts with the Italian constitution. The constitution states, for example, in Article 81: "The State shall balance revenue and expenditure in its budget, taking account of the adverse and favorable phases of the economic cycle. No recourse shall be made to borrowing except for the purpose of taking account of the effects of the economic cycle or, subject to authorization by the two Houses approved by an absolute majority vote of their Members, in exceptional circumstances." And it further states in Article 97: "General government entities, in accordance with European Union law, shall ensure balanced budgets and the sustainability of public debt."[1]

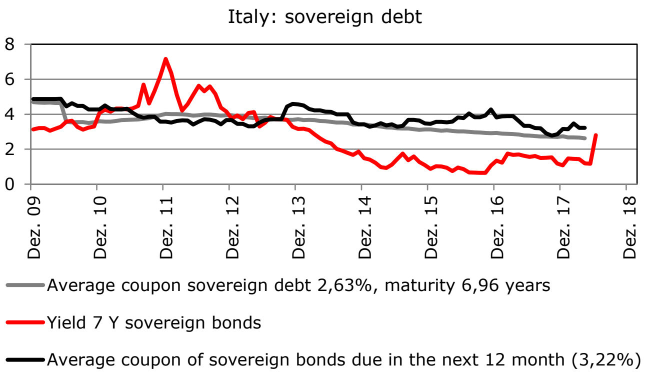
If the new Italian government sets course for confrontation with the EU, Italy will run the risk of suffering the same fate as Greece's in 2015. It could lose access to the capital market because investors are only willing, if at all, to finance the country at significantly higher interest

[1] The Constitution of the Italian Republic, http://www.quirinale.it/qrnw/costituzione/pdf/costituzione_inglese.pdf

rates. If Italy should lose its investment grade rating, the ECB might stop purchasing Italian government bonds in the framework of its quantitative easing program. Aid programs, like the ESM or Outright Monetary Transactions (OMT), are linked to reform commitments and fiscal policy that is the exact opposite of what the League and M5S promise.

What should investors do now? In the best case, reason will prevail and calm will return because Italian politicians realize they cannot push their demands through. However, before it comes to that, the situation could escalate even further, because the politicians will first try to find out how far they can go. If a new Italian government then switches to EU-compatible policies after all, the stock markets might calm down, considering that economic fundamentals continue to be favorable. In contrast to previous crises, we regard the risk of contagion for other countries as rather low. Investors often do react at first by lumping everything together without differentiating, but we see Spain, Portugal, and Ireland in a much more stable situation today than in 2011-12 or in 2015. That even applies to Greece. The yield premiums for bonds from these countries should therefore gradually decline.

On the other hand, the European stock markets might initially suffer from a longer phase of uncertainty until it is actually clear what path Italy will take. We therefore recommend reducing the investment ratio of European stocks somewhat until more clarity prevails. In particular, banks and insurance companies that have relative great exposure in Italian government bonds should be underweight for now. However, we believe one can continue to hold US stocks. Not only does the US dollar offer some protection from a politically induced spell of euro weakness, but economic conditions in the United States also continue to be favorable. Moreover, yields and oil prices have fallen somewhat lately, which should give the US economy additional tailwind. And whereas the Italy crisis may weaken European banks further, US banks are benefiting from a better capital base and less regulation.



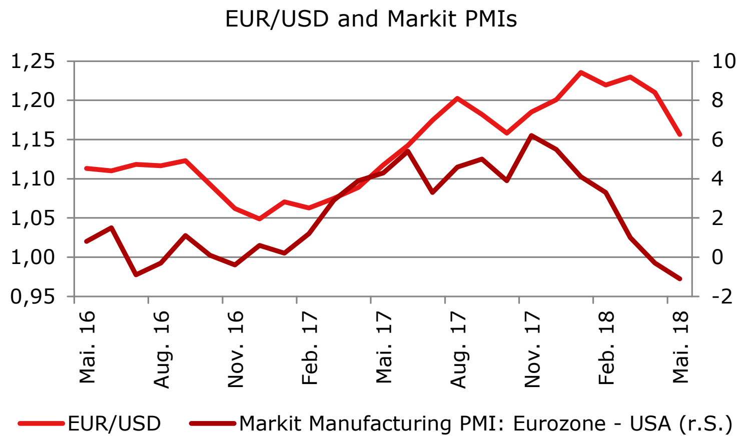
But we must remember that even if the situation calms down, the basic problem of Italy's excessive debt will remain. This topic is likely to catch up with us in the next economic crisis at the latest. That does not mean the country's departure from the euro zone will be unavoidable then. But it will scarcely be possible to resolve the Italian issue without partial debt forgiveness and/or use of funds from the ESM.

Weekly outlook for June 4-8, 2018

	Jan.	Feb.	Mar.	Apr.	May	June	Release
DE: PMI, services - final	57.3	55.3	53.9	53.0	52.1		June 5
DE: New orders, m/m	-3.5%	-0.2%	-0.9%	0.3%			June 7
DE: New orders, y/y	8.7%	3.1%	3.2%	3.0%			June 7
DE: Industrial production, m/m	0.1%	-1.7%	1.0%	0.4%			June 8
DE: Industrial production, y/y	5.9%	2.1%	3.2%	2.8%			June 8
DE: Exports, m/m	-0.4%	-3.1%	1.8%	0.5%			June 8
DE: Exports, y/y	7.4%	2.4%	4.2%	3.9%			June 8
DE: Imports, m/m	-0.3%	-1.4%	-0.2%	0.4%			June 8
DE: Imports, y/y	5.9%	4.7%	2.3%	2.0%			June 8
EUR19: Sentix	32.9	31.9	24.0	19.6	19.2	19.2	June 4
EUR19: Producer prices, m/m	0.5%	0.0%	0.1%	0.4%			June 4
EUR19: Producer prices, y/y	1.7%	1.6%	2.1%	2.4%			June 4
EUR19: PMI, services - final	58.0	56.2	54.9	54.7	53.9		June 5
EUR19: Retail sales, m/m	-0.3%	0.3%	0.1%	0.9%			June 5

MMWB estimates in red

Chart of the Week: Uplift for the US dollar



The US dollar has revalued significantly against the euro in the past months. A further widening of the interest rate differences between both short-term and long-term US and euro zone bonds has accompanied this gain in value. However, such widening has been observed over a much longer period in the past without leading to a revaluation of the US currency. On the contrary, there has even been persistent dollar devaluation despite higher interest rates in the United States. That suggests other forces must have been at work at the same time, suspending the inherent connection between interest rates and the exchange rate. One of them was the strong increase of economic activity in the euro zone, as reflected in the purchasing manager indexes (PMIs), for example. In recent months, however, the relationship has turned in favor of the United States, which is why the interest rate difference has come back to the fore again. That has enabled the US dollar to revalue significantly since March, with concerns about Italy and the euro recently contributing to the dollar's rise. But how much farther can the revaluation go? The difference between euro and dollar interest rates is striking and would actually argue in favor of a further significant revaluation of the dollar. At the same time, however, the Fed's interest rate cycle is already far advanced, which is why there are limits on a widening of the interest rate difference. This prospect should also make it difficult for the US dollar to revalue beyond USD 1.13 per euro – provided the crisis in Italy does not escalate.

Market data overview

Stock marktes	As of 01.06.2018 16:31	Change versus 24.05.2018 -1 week	30.04.2018 -1 month	28.02.2018 -3 months	29.12.2017 YTD
Dow Jones	24624	-0,8%	1,9%	-1,6%	-0,4%
S&P 500	2725	-0,1%	2,9%	0,4%	1,9%
Nasdaq	7462	0,5%	5,6%	2,6%	8,1%
DAX	12751	-0,8%	1,1%	2,5%	-1,3%
MDAX	26576	0,1%	2,3%	1,1%	1,4%
TecDAX	2788	-0,5%	6,2%	6,0%	10,2%
EuroStoxx 50	3452	-2,0%	-2,4%	0,4%	-1,5%
Stoxx 50	3086	-1,0%	0,0%	1,6%	-2,9%
SMI (Swiss Market Index)	8617	-1,8%	-3,0%	-3,3%	-8,2%
Nikkei 225	22171	-1,2%	-1,3%	0,5%	-2,6%
Brasilien BOVESPA	77838	-2,9%	-9,6%	-8,8%	1,9%
Russland RTS	1170	-0,3%	1,4%	-9,0%	1,4%
Indien BSE 30	35227	1,6%	0,2%	3,1%	3,4%
China Shanghai Composite	3075	-2,5%	-0,2%	-5,6%	-7,0%
MSCI Welt (in €)	2093	-0,6%	3,9%	3,5%	2,3%
MSCI Emerging Markets (in €)	1121	-0,7%	-0,3%	-1,8%	-0,5%
Bond markets					
Bund-Future	163,14	292	440	370	146
Bobl-Future	132,13	42	113	109	52
Schatz-Future	112,08	3	16	11	11
3 Monats Euribor	-0,32	0	1	1	1
3M Euribor Future, Dec 2017	-0,25	3	6	1	0
3 Monats $ Libor	2,30	-2	-6	28	61
Fed Funds Future, Dec 2017	2,15	-1	-3	4	0
10 year US Treasuries	2,90	-8	-3	4	49
10 year Bunds	0,38	-9	-18	-23	-5
10 year JGB	0,05	0	-1	0	0
10 year Swiss Government	-0,05	-9	-14	-8	8
US Treas 10Y Performance	565,06	1,2%	0,9%	0,8%	-2,8%
Bund 10Y Performance	616,22	1,1%	2,1%	3,1%	1,5%
REX Performance Index	483,83	0,6%	0,9%	1,5%	0,7%
US mortgage rate	0,00	0	0	0	0
IBOXX AA, €	0,78	-2	-3	4	10
IBOXX BBB, €	1,60	5	17	27	37
ML US High Yield	6,56	3	5	14	41
JPM EMBI+, Index	797	0,0%	-1,2%	-2,0%	-4,7%
Convertible Bonds, Exane 25	7389	0,2%	-0,2%	0,8%	-0,1%
Commodities					
CRB Spot Index	445,87	0,2%	0,1%	0,5%	3,1%
MG Base Metal Index	352,43	0,0%	1,1%	-1,0%	-1,8%
Crude oil Brent	76,81	-2,9%	2,4%	16,9%	15,3%
Gold	1294,49	-0,8%	-1,4%	-1,9%	-0,7%
Silver	16,53	-0,7%	1,1%	0,6%	-2,8%
Aluminium	2263,25	-0,7%	0,3%	5,1%	0,3%
Copper	6830,50	-0,4%	0,9%	-0,9%	-5,2%
Iron ore	64,88	-2,2%	-0,6%	-16,2%	-9,0%
Freight rates Baltic Dry Index	1090	-1,7%	-18,7%	-8,6%	-20,2%
Currencies					
EUR/ USD	1,1660	-0,6%	-3,5%	-4,5%	-2,8%
EUR/ GBP	0,8750	-0,2%	-0,3%	-1,2%	-1,4%
EUR/ JPY	127,74	-0,6%	-3,3%	-2,3%	-5,4%
EUR/ CHF	1,1531	-0,7%	-3,7%	0,1%	-1,5%
USD/ CNY	6,4193	0,6%	1,4%	1,4%	-1,3%
USD/ JPY	108,91	-0,3%	-0,4%	2,1%	-3,4%
USD/ GBP	0,75	0,4%	3,4%	3,4%	1,6%

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