Sunday Wrap

Happy Sunday from calm and sunny Chiswick,

So, it's the end of Q3 – a quarter mostly characterized by: (i) further political chaos (mostly in the US and UK, but with Italy a strong contestant and Germany a distant runner-up), (ii) strong growth numbers in the US and stabilizing ones in the eurozone, where Friday's EuroCoin picked up to a level consistent with annualized GDP growth of 2%; (iii) further normalization of Fed policies, pushing US yields higher across the curve by 18-28bp, pulling Bund yields along, particularly at the long end; (iv) general risk-on (as is normal in this part of the tightening cycle), particularly in the US where equities and HY did very well in Q3, taking eurozone HY along for the ride, but European equities less so; and (v) serious trouble in a few highly vulnerable, EM countries, including Turkey, but still no contagion.

Indeed, across the world and across asset classes, it's quite easy to argue that markets continue to react according to the underlying economics story, ignoring the severe mess in politics. With one clear exception: Italy.

This past week provided the perfect example: The sad theatre of US and UK politics descended further into farce, while German chancellor Merkel suffered an important defeat within her Bundestag group, with no measurable effect on markets. But when, on Thursday night, the Italian government announced – in the vaguest terms - its intention to increase the budget deficit to 2.4% of GDP, all hell broke lose.

- **So, let me devote today's note to Italy: What we know and don't know on the budget; the raw economic and financing data underlying the budget (not bad); and my guess on the underlying politics (troublesome).**

- **At the end, I'll also summarize our updated outlook for Q4 and 2019, as published in our Chartbook and CEE Quarterly this past week.**

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1. Italian budget matters…

I'll make three points on the chaos that erupted on Friday, following Thursday announcement in Rome of an agreement between the two coalition partners to increase the budget deficit to 2.4% of GDP next year, and to keep it at that level through 2021:

First, the news that triggered the massive sell-off was – and remains – extremely scarce, and subject to a lot of uncertainty. Second, even if the deficit were to increase to 2.4% of GDP next year, the effects on markets should be only a fraction of what Friday delivered. Third, the implied political message, however, is a serious concern.

Before I get to it, I need to emphasize how much I rely on my amazing team; for today's note, in particular, our chief Italian economist Loredana Federico, and our strategists Luca Cazzulani and Chiara Cremonesi. Like me, you really shouldn't form any opinion on Italy before you have spoken to these great colleagues. And still, as they say, all mistakes are mine…

First, what we know and what we don't know:

Following months of speculation on what the strange Italian government coalition might do with the 2019 budget to accommodate some (or all?) of their conflicting campaign promises, we got the first broad indication on Thursday night. With no details on underlying assumptions or the budget composition, and no Economic and Financial Document available, the government announced that they intend to set the budget deficit at 2.4% of GDP in 2019 and for each of the following two years.

The announcement was a disappointment – and a surprise to me – both in terms of the headline number as well as the fact that they would announce such a change without any of the underlying data. In the weeks running up to Thursday's announcement, Finance Minister Tria had insisted that the deficit would be kept below 2% of GDP, implying a bit of slippage from the 1.6%-1.7% of GDP that would be needed to balance the underlying structural deficit, as required by EU rules. Now, the 2019 slippage looks more like 0.7% of GDP, or about EUR 10bn.

M5S leader de Maio - celebrating from the balcony as if he had won a sports match, rather than been working on budget matters - hailed the (still not completed) budget as a success for his party because the EUR 10bn would be allocated as a "citizen income", to be distributed in cash to 6.5 million poor households, thereby – he claimed - fulfilling the M5S campaign pledge to end poverty. Sowing confusion about the expenditure side, on Friday night, PM Conte claimed that the additional budget deficit was not all due to new hand-outs, but also due to EUR 15bn in new investment. However, he didn't provide any details.

Since then, president Mattarella reminded the politicians, and the country at large, that the constitution requires "balanced budgets and the sustainability of debt … to protect the savings of our fellow citizens," and Banca d'Italia governor Visco noted the importance of putting the debt "on a downward path". Mattarella's implicit reference was to articles 81 and 97 of the Italian constitution, which requires a balanced budget over the cycle and sustainable debt, according to EU law. He didn't say how he'll play his cards.

In spite of (or because of?) the vague announcement and remaining uncertainties, including the prospect of a constitutional showdown with the president, the market went crazy on Friday - and commentators started the usual competition for the most dramatic headlines. BTPs widened by 25-40bp across the curve, with virtually no contagion to other peripheral sovereigns, but enough to send Italian bank shares down by 6%-8%, which, in turn, took French and German banks down by 3%-4%. The euro weakened a bit, but nothing to write home about.

Among commentators, the winner of the doomsday-race is – so far - Bloomberg editorial writer, Ferdinando Giugliano, who tweeted that “Europe’s leaders could soon find themselves facing awful options of trying to rescue Italy, overseeing an unprecedented debt restructuring, or allowing the euro’s third-largest economy to exit”.

On that note, let’s turn to the data:

To remind you: Italy grew by about 1% (annualized) during the first half of this year, a drop from 1.6% last year as global demand eased and Italy saw a less pronounced (than most other European countries) shift to domestic demand. In spite of decent job creation, unemployment still sits slightly above 10%. The budget deficit (estimated at 1.8% of GDP this year) will be in the low end for a eurozone country (higher than Germany’s +1.7%, but lower than the French and Spanish deficits) – and, of course, well below the deficits in several other countries, including the US, Japan and China.

But, as everyone knows, Italian public debt at 131% of GDP requires extraordinary care with the budget, not least because of Italy’s low potential growth rate. Some, including professors Reinhard and Rogoff, argue that the high debt level plays an important role in restricting growth (implicitly: you need a debt restructuring), but I disagree. The vast majority of Italian sovereign debt is owed to the central bank (which kindly recycles most of the profit from interest payments back to the budget) and to domestic creditors. This is important because interest paid to domestic creditors is a (relatively) simple issue of domestic redistribution of national resources, as opposed to a transfer of wealth to foreign creditors.

Others, including the present government, argue that years of tight fiscal policy (presently a primary surplus of about 1.8% of GDP) are stemming Italian growth. I have trouble with that one as well. It’s not the level of the primary surplus that impacts growth, but the change, and Italy hasn’t undertaken any measurable fiscal tightening since Monti’s big package in 2012 (guided by the questionable “demand” from markets and Brussels that fiscal tightening was just what Italy needed at the high of the crisis!) That said, the high debt level reduces the fiscal room when a downturn comes, and that is problematic and raises the necessity of lifting Italy’s potential growth rate.

And how do you do that? In my assessment, Italy’s disappointing growth is rooted primarily in demographics and institutional rigidities, and not in the fiscal policy stance. (The composition of tax and spending policies also play a role, but that can be said about most European countries.) So, change policies to encourage a greater participation rate, particularly among women, and the immigration of high skilled labor – and cut red tape, reform the judiciary branch etc.

Now to the financing of the budget: So far this year, the Italian government has raised EUR 325bn in bills and bonds at an average cost of just below 1% (0.98% to be precise), mostly to refinance maturing debt, which carried a cost of 1.3% on average. (79% of Italy’s total gross financing need this year is refinancing of maturing debt). To me, that’s a pretty good deal, still lowering the funding cost, at a rate of about half the growth rate of nominal GDP.

If this was all you knew about the country, and you didn’t know what country I am talking about, and I now told you that the government plans a decline in the primary surplus from 1.8% of GDP this year, to a surplus of 1.3% next year, thereby raising the nominal deficit from 1.8% of GDP to 2.4%, and net issuance from EUR 50bn this year to about EUR 57bn next year, would that worry you?

I suppose – and hope – your answer would be: That depends on what the additional deficit is used for. If it's investment, as indicated by Conte, or tax cuts for employment or business investment, I certainly wouldn't worry. If it's a hand-out to the poor, I would be less enthusiastic, not because I don't care about their social issues, but because I think training and other help with employment (or medical benefits) would be a better use of money than hand-outs.

But even so, in a fiscal analysis, a cash injection to poor people with low (or no) savings usually translates into additional demand, and GDP growth. Of course, in Italy, that may not be a given. As you may recall, Renzi's EUR 10bn injection (the EUR 80 bonus) ended up mostly as savings or pay-downs on debt. But then again, if they don't spend it, they'll help strengthens banks' balance sheets …

But here is my point: If the nominal deficit is indeed raised to 2.4% of GDP next year, as indicated, dropping the primary surplus to 1.3% of GDP, and if nominal GDP growth increases from 2.2% to 2.4% (the increase due to a higher GDP deflator only, as we expect), and given the average cost of the stock of debt (i.e. 2.8% - yes, even with Friday's prices, funding costs are still leading to a lower average cost of the debt, and with a 6.8 year long average maturity, it'll take a very long time for that to change), even then, the debt/GDP would still decline next year – if ever so marginally: On our numbers from 131.2% at the end of 2018 to 131.0% at the end of 2019.

Let me be clear: I don't like the indicated increase in the deficit, but the math just does not justify the price action we saw on Friday. Not even close! Roughly speaking, based on history, an increase in the deficit next year to 2.4% of GDP instead of the widely expected 2.0% of GDP should raise the average funding cost by maybe some 5-10bp – not by anything like 25-40bp!

And that, conveniently, leads me to my third point: The implied political message of Thursday's announcement.

I won't pretend to fully understand the shifting winds in Italian politics. As you may know, I had thought Tria's pledge of a deficit of max 2% of GDP (even if based on somewhat hopeful assumptions) was credible because of the underlying stand-off on fiscal priorities between the two coalition partners. In particular, I would have expected Salvini to veto a big hand-out via the so-called "citizens' income", a M5S pledge strongly opposed by core Lega voters and regional leaders in the north.

If Salvini has indeed agreed to a EUR 10bn cash hand-out to (mostly) M5S voters, I would conclude two things:

First, finance minister Tria is powerless, plain and simple. It's all politics.

Second, within Lega, Salvini has become all-powerful relative to his base among Northern League members in regional and city administrations, and the business community, in the north. This is, of course, quite possible, given his success in the opinion polls, but it's problematic because the focus of this now all-powerful party may then shift away from mostly business friendly policies to pure populist policies. And as I wrote last Sunday: Bad politics lead to bad policies, and bad policies lead to less growth.

Also, one would have to conclude that Salvini is not cruising for a confrontation with M5S, which would be convenient if he were to seek early elections, as widely expected. Rather, it now seems clear that he is cruising for a fight with Brussels (and maybe with Mattarella), which suggests that he has his eyes on the European elections in May.

This would put him squarely in line with his friends in other nationalist parties across Europe (and in Russia!) who view the European elections as an opportunity to fundamentally reshape (read: interrupt or reverse) European cooperation. I, for one, hope they'll fail miserably.

Without a doubt, this is a troublesome political outlook, but, while I certainly misjudged the political dynamics and impact on the budget intention, I struggle to see that Thursday-Friday provided so radically new news that would justify the market reaction.

Whether the spread over Bunds will soon come back in again will largely depend on three inter-connected factors:

First, if the government commits to a path towards a balance structural budget from 2020, so that the deviation is only for next year, then the EU is likely to be much easier with its criticism. As it is, it's a clear provocation, but whether Brussels takes the bait, thereby giving Salvini his (apparently) desired external enemy ahead of the European elections, or lays low, limiting the criticism to the private sphere, I don't know. Either way, a public fight with Brussels won't help spreads. Brussels is expected to express their view before the end of November.

Second, if President Mattarella goes on the attack, constitution in hand, and opinion polls suggest that he has strong backing, the government will need to rethink its budget plans. Tricky stuff, but worth watching carefully. Meanwhile, the parliamentary debate of the underlying assumptions for the budget in the Economic and Financial Document will begin on October 10.

Third, if the credit rating agencies downgrade Italy, it will prevent spreads from tightening, if not even push them wider. If the government does not move on one of the points above, I think you would need to expect a one-notch downgrade (to just one above junk status) by at least one of the major agencies, and possibly by all three. (To remind you, for the ECB, nothing changes unless all four agencies move their ratings to junk; a highly unlikely scenario).

Illustrating the normal market overshoot, probably in anticipation of a downgrade, based on a simple plot of European spreads over Bunds against the ratings, BTP/Bund spreads already priced 2-3 downgrades of Italy even before Friday – and now it's even more extreme. Maybe a case of "buy the rumor, sell the fact"?

Either way, anyone with a continuous need to roll over debt must play the confidence game. Illiquidity is the killer, not insolvency (whatever that may mean for a sovereign nation). The Italian government needs to appreciate this simple fact. Its fight should not be with Brussels or anyone else. The focus needs to be on Italian and foreigner savers and their decision to fund – or not fund - Italian policies.

2. Our broader outlook

Believe it or not, at UniCredit's very fine research shop, we do many other things than Italian politics…

This past week, we published our regular Chartbook and CEE Quarterly with our outlook.

In a nutshell, we think the global business cycle has lost some momentum as the geographical growth pattern has become more uneven. However, after having declined earlier in the year, our proprietary Global Leading Indicator now suggests stabilization in the growth rate of global trade at a level just below trend, which is quite comforting.

However, manufacturing PMIs in most countries are still drifting lower and trade tensions between the US and China have intensified, posing downside risks to the global economy. Since the US and China account for about 40% of global economic activity, an escalation would not only weigh on growth in these two countries but is likely to spill over to the rest of the world. That said, only about 2% of global trade has been affected by higher tariffs so far.

If you are interested – apart from the analytics, these are great reference pieces with tables and all – our Chartbook (produced by my entire macro team, and edited by Chiara Sylvestre) is here: The UniCredit Economics Chartbook - Global growth still resilient, but less synchronized and our CEE Quarterly (produced by our research team across the CEE region, and edited by Dan Bucsa) is here: CEE Quarterly - A test of resilience

And on that note, let me end on two other big political problems – but not for me:

As you may have noticed, my adopted home team, Hertha Berlin, destroyed Bayern Munich Friday night in a beautiful 2-0 victory. Hertha was clinical as they executed their perfect strategy. So, for those of you thinking that the Bavarian election in two weeks will cause further trouble for Merkel and her Berlin government, I'd suggest that you never want to underestimate Berlin!

And as we speak, Europe is crushing the US in the 42nd Ryder Cup in France. President Trump owns more golf courses, and plays more golf, than any previous president – and sometimes he even gets (confused) US golfers to praise him – but it isn't helping them… Maybe Trump might get some advice from his dear friend, North Korean leader, whose father in 2016 famously played a round of 38 under par … (according to the North Korean press.)

Best

Erik

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