Sunday Wrap

Happy Sunday and – belated – Happy Thanksgiving,

This morning, at the special summit in Brussels, the European Council endorsed the Brexit deal (the "Withdrawal Agreement and Political Declaration on the future EU-UK relations", as it's officially called), thereby moving this miserable Brexit process on to the real hurdle, namely the ratification in the UK Parliament.

Today's decision was always going to be a formality, but it's still one of these sad milestones in the UK's descent into internal political chaos. In comparison, the general unity among the EU-27 has been remarkable.

I don't think there is much doubt that the UK Parliament will reject the deal in its first attempt, possibly around 10-11 December, after which the ongoing horse-trading will accelerate. The FT reports this weekend that – in this great, old democracy of the UK – Theresa May has knighted Eurosceptic Tory MP John Hayes (who is "immensely proud" of his achievement and recognition, whatever that is) in the first of several knighthoods she is planning to hand out to Brexiteers for "voting the right way" … along with some ever-so-minor adjustments to the deal.

I continue to think there is something like an 80% probability of Theresa May getting her deal through Parliament and that the UK therefore moves into the transition period at the end of March (i.e. nothing changes for at least 21 months, apart from the UK having lost its influence). I would assign maybe 18% risk to a hard Brexit, in which the UK crashes out, and only some 2% chance of a referendum that cancels the whole mess (but which will not heal the deep division in British society). As much as I wish for a cancelation of the whole Brexit thing, I just can't see the political turn-around that would make it plausible. Of course, these three possible outcomes might all be slightly delayed if Theresa May ends up calling early elections, which might then lead to an extension of Article 50. However, I seriously struggle to see EU-27 agreeing to an extension beyond the European elections in May.

Well, let me move on to cheerier matters:

For the most parts, global politics, economics and markets developed inside the range of our forecasts this past week, although two "data points" were tested the boundaries of those forecasts a bit: Friday's eurozone November PMIs were on the weak side, and, after the first shock, markets seemed less bothered than I would have expected by the very weak take-up by the Italian retail sector of the BTP-Italia offer.

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Let me discuss these two issues in some detail. I'll argue that:

- **While the eurozone PMIs are not a cause for concern, the risk of an earlier (and/or steeper) global slowdown, than our forecast, needs to be watched very carefully – and that this may call for policy action, as highlighted in this week's new OECD Economic Outlook.**

- **The Italian government should take notice of the several tough messages they received this past week – particularly from the Italian public and Banca d'Italia – and I think they will, although maybe not quite yet.**

1. European growth. Not worried… at least not yet.

As you may recall, we expect eurozone GDP growth to bounce back in the present quarter to 0.5% qoq, as Germany presumably recovers from the exceptionally weak (but technically driven) 3Q. We then think the eurozone will cruise through most of 2019 at an annualised growth rate of about 1.6%, before dropping off a bit (with the rest of the world) towards the end of next year. Because of the base effect, this quarterly path will give you an average GDP growth rate next year of 1.7%.

Then came Friday's eurozone November PMIs, showing a decline in the Composite PMI to 52.4, from 53.1, and the doomsday-commentators popped up again with their predictions of a more serious (self-generated) European slowdown. But I don't buy it.

First, the November reading is still equivalent to GDP growth of about 1.5% annualised, so we are still talking '"trend-like" numbers', although the weaker new orders component is a bit of a concern, which I'll come back to.

Second, oil has taken a serious beating in recent days (in this unreal world, reportedly because Saudi Arabian Crown Prince, MBS, now needs to please Trump after the CIA reportedly says MBS was involved in the murder of Khashoggi), closing below $60 on Friday. That's a whopping 20% below our forecast for the average of 2019, so if we stay around here for most of next year, there'll be a boost to (annualised) eurozone GDP of about 0.15pp.

Nevertheless, it's now a virtual given that the ECB will need to revise down (a bit) their 2019 outlook when they present it in December, which ought to cause them some trouble with their indicated policy path. My guess is that they may respond by expanding their forward guidance to "lock in" full reinvestment of the principal for at least two years after the end of QE; if not in December, then very likely so during Q1.

The fact is that the global picture is getting murkier, and that'll impact the eurozone via trade and sentiment. We don't really know why global trade is easing, and to be sure, it's not dramatic yet. Our leading indicator (a "now-casting" tool) suggests that global trade is growing by about 3% annualised as we move into the end of the year, compared with a longer term average of 4.5%.

It's not Trump's stupid tariffs, and the counter measures, which are slowing trade (so far only about 2% of global trade has been impacted), but his - and others' - nationalist nonsense is hurting sentiment, and thereby investments. In Europe, the capital goods orders series have eased significantly, and in the US, non-energy and non-defence capital goods (excl. aircrafts) are taking a real beating.

And it could get worse for the single reason that the US is led by a severely misguided president who tends to double-down when facing reality, rather than reverse policies. There are reports out this weekend that Trump is now complaining about Mnuchin because of his reluctance to embrace Trump's protectionism, his role in appointing Powell to the Fed (because of the rate hikes), and – more broadly – the weak stock market. You couldn't make up this stuff that comes out of the White House these days, even if you tried!

In their (highly recommended) Economic Outlook out this week, the OECD estimates that current, and already announced, US tariffs on China are likely to slice 0.6pp off Chinese GDP by 2021, with a potential of that going to a whopping 1.3pp if US tariffs are imposed also on the rest of US-China trade, and the hit to sentiment is included. That "full impact" US-China trade scenario would cost the US about 1.0pp, and the global GDP 0.8pp. Keep your eyes on next weekend's G-20 in Buenos Aires, and the chance of a Trump-Xi agreement. It won't be anything comprehensive or lasting, but in this environment, I'll take any easing of tensions I can get.

So, what if the downturn – let alone a crisis – were to come earlier than expected, and hence at a time of somewhat limited room for monetary policy easing? While this has been an often discussed topic for several months in financial markets, the OECD now lends their support to the most sensible response. In a welcome departure from the usual timidity on policy recommendations, the OECD argues in their new Economic Outlook that if the OECD area should face a measurable downturn during 2019-2020 (not their central scenario, as in our forecast, but only a risk in theirs) the major OECD governments (and others) should already now announce a pledge to undertake coordinated fiscal expansion, when rates are at the zero-bound. By announcing such a coordinated move pre-emptively, policymakers might even impact expectations to such a degree that they'll manage to reduce the risk of such a downturn. I tip my hat to the OECD!

The FT's Martin Sandbu wrote a nice piece about this in Friday's FT Free Lunch (https://www.ft.com/content/d6139e82-ee3f-11e8-8180-9cf212677a57), but argued that while the US and China can be counted on to agree to such fiscal policy action, the Europeans "will be hard to convince". I'm much less pessimistic here than Sandbu. European policymaking is not the same as during the great financial crisis. The new governments in France, Spain and Italy would not need much persuasion (although I hope the Italians would then would see their present budget plans as part of this), and I very much think the Germans – while not being the motor in such a move – will join forces given the change of guard at the BMF and the shifts in the political landscape, as illustrated by the elections in Bavaria and Hesse. And before you raise the usual "Germany will never do fiscal easing" claims, you may want to check the estimates by the leading German think tanks, which show that the expansionary fiscal impulse of already announced policy changes amounts to 0.4% of GDP for next year – not trivial at all.

But while the real risk to European growth stems from abroad, particularly from US politics, let me now turn to the one measurable risk to growth "from within", namely from Italian politics.

2. Italy: Not a good week for the government

I'm sure you are fully aware of the debates about the Italian government's budget, so I'll just remind you that on present plans, fiscal policy in 2019 implies an increase in government net supply of debt to EUR 55-60bn, from about EUR 45bn this year. Including roll-overs, gross supply is set to increase to about EUR 260bn from some EUR 235bn this year.

The European Commission has pointed out that the budget violates the EU's fiscal rules, which - along with Moody's downgrade, and indications that Fitch and S&P will likely follow next year, as well as the forthcoming end to the ECB's QE (which will have removed EUR 35bn of BTPs from creditors' portfolios this year) – led markets to more than double the 10-year BTP-Bund spread to an untenable level of more than 300bp.

The government's reactions to all this have included a dismissal of the EU's concerns and suggestions that they'll be able to trigger a change to the rules following the European election in May next year, suggestions by government advisors that if such change cannot be agreed, Italy might consider the introduction of a parallel currency or even an exit from the eurosystem, and that market reactions reflect speculation by foreigners. Just a month ago, deputy PM Salvini said that he was "convinced that Italians [whose private wealth is unequalled in the world] are ready to lend us a hand". (PS Italian private wealth is indeed impressive, although not quite "unequalled in the world".)

Given these views, it has not been a good week for the Italian government for at least five reasons:

First and most importantly, Monday's much-awaited BTP-Italia – the 4-year government securities with quite attractive terms launched exclusively to retail investors for the first three days – was received very poorly by the Italian public. Retail investors bought only EUR 863 mn, compared with EUR 4.1bn at the previous offering in May, and an average of EUR 3.5bn during the last five issues. After they then opened it for institutional investors, another EUR 1.3bn was sold, down from EUR 6.0bn in average purchases by institutional investors during the last five issues. If there really was a belief in the government that the Italian public would "lend it a hand" by being willing to finance its budget plans, this week has placed a very big question mark next to that hope. As a result, spreads widened significantly early in the week.

Second, things then got worse for the part of the government with the most hostile views of Europe when Eurobarometer released its latest opinion poll on Europeans' support for – or opposition to – the euro. For Italians, the poll showed one of the biggest jumps for any country in years (by 12pp to 57%) of people saying the euro is "a good thing", while the share of Italians saying it's "a bad thing" dropped an almost equally impressive 10pp to 30%. It seems to me that once faced by the prospect of a government actually willing to gamble with Italy's euro membership (if still extremely unlikely to be tested) led to a large percent of the population to express clearly which mast they want to tie their future to when it comes to their money. And it wasn't what the radical government advisors would have thought.

Third, on Wednesday, the European Commission announced they'll recommend opening Excessive Deficit Procedure (EDP) against Italy. The fact that they decided to make the EDP debt-based (instead of deficit based) and that there are no sanctions at this time made the market conclude that this was the Commission going soft on Italy, and spreads came back in again to close the week only marginally wider than a week earlier. With all respect, this was a poorly informed conclusion by market participants. We still need to see what the consequences of the Commission's decision to make the EDP debt, rather than deficit, based will be, but mind you, correcting excessive debt requires tougher measures than fixing an excessive deficit, so there is nothing obviously lenient in this. And – as I have explained previously – sanctions were never an option at this stage. They'll come the earliest in April, and more likely after the May.

But even if spreads have not broken out of the 300-320 range, there is no getting around the damage these funding costs, triggered by the budget plans, are about to impose on the Italian population.

The fourth uncomfortable message to the government this past week came via an excellently balanced note from the Petersen Institute's (former IMF Chief Economist) Olivier Blanchard et al, in which they analysed the impact of the budget on growth and fiscal solvency. They conclude that the larger budget deficit "will probably not increase growth. Under plausible assumptions, it may even reduce growth" because of the pass-through of the government's higher borrowing costs to the private sector. More comforting, they also conclude that unless yields move higher from here (a distinct possibility in my assessment, unless we get some policy moderation) then debt/GDP "should remain broadly stable over the next three years." (Their note is here, and highly recommended: https://piie.com/publications/policy-briefs/impact-italys-draft-budget-growth-and-fiscal-solvency).

And finally at the end of a bad week for anyone questioning basic economics, Banca d'Italia published their regular Financial Stability Report on Friday. This (always read-worthy) report includes a box on the effects of the higher yields and the increase in volatility.

To my concern about the prospect of still higher yields, Banca d'Italia notes that "High volatility weakens demand [for securities] and can therefore exert additional upward pressure on yields. In fact, it discourages market participation by the most risk-adverse investors and by those subject to limits on portfolio variability, such as low volatility net asset value funds; in addition, it increases the costs of owning securities for intermediaries subject to regulatory requirements commensurate with the riskiness of the investments."

And echoing Blanchard & Co's point that "the government would probably have fared better by pursuing its social objectives through a roughly fiscally neutral budget", Banca d'Italia calculates that "Over the last six months, the rise in the yields at issue of government securities has generated an increase in interest expense that is almost €1.5 billion higher than what it would have been at the rates that the markets expected in April", and "if the rates remain consistent with current market expectations [as indicated by the forwards], it will cost more than €5 billion in 2019 and around €9 billion in 2020". In comparison, the government may want to consider that their pledge of the social program of a "Citizens' Income" is budgeted to cost in fresh – or new – funds some EUR 7bn next year. In other words, unless the government manages to persuade markets of the wisdom of their budget, they are already on track to blow more than 70% of the of the cost for their social program next year simply by turning off their existing and potential creditors.

And when it comes to the effect of higher yields on banks, their ability to finance the real economy and their solvency, the Banca d'Italia's Financial Stability Report sends a dire warning: "the reduction in the value of eligible collateral for Eurosystem refinancing operations … translates into a drop in [banks'] liquidity. Another effect is connected with the impact on capital of changes in the prices of government securities valued at fair value, which at the end of June amounted on average to 5.7 per cent of total assets, with a higher percentage for the less significant banks (11.3 per cent, compared with 4.7 per cent for the significant banks). Our simulations, based on banks' balance sheets and on the duration of the individual portfolio securities at 30 June 2018, indicate that an upward shift of 100 basis points in the government yield curve would reduce the CET1 ratio by 50 basis points (40 points for the significant banks and 90 points for the less significant banks)".

Needless to say, apart from the devastating economic consequences of undermining the solvency of smaller banks, there would surely be political costs for a government that has been very critical of previous governments rescuing banks, if they themselves now were to trigger a need for bail-outs (let alone if they were to allow small and locally important banks to fail.)

So, after a week of clear warnings to the government from its own population, from Banca d'Italia, from the European Commission and from one of the world's most respected independent think-tanks, what will happen now?

I hope the signals are clear enough to trigger a policy adjustment right away, but I doubt it. Rather, as we discussed in our Outlook last week, I still think spreads will rise from here… and then the government will adjust policies, e.g. by postponing some of the programs, many of which cannot be implemented in the short term anyway. Even a public acknowledgement of this reality might begin to help.

Again, the Citizens' Income is likely to cost some EUR 7bn next year, the increased flexibility for retirees another EUR 7bn and spending cuts worth EUR 3-4bn could possibly be accelerated. In other words, it is not inconceivable that a series of policy moderations could be made to reduce the net issuance next year to a range around this year's EUR 45bn. If then, also importantly, the rhetoric towards Europe were to change, from the top down, reflecting the clear shift in the population's views of the euro, maybe demand for BTPs would stabilise and return to a degree where spreads would start to tighten again. Not inconceivable, but it'll require a moderation in policies, and a change in rhetoric towards Europe.

And on that note, I only have one more point to make about the very traditional and fundamentals-based economic forecasting frameworks we use in my team -which also guides my view of cryptocurrencies. I feel sorry for anyone having bought the Ponzi-like lottery tickets called Bitcoin, but as an economist, I take a lot of comfort in seeing Bitcoin now fall like a rock. And trust me, it has a lot further to go…

Stick with fundamental analysis also in your investment decisions; it'll serve you well.

Best
Erik

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