SALVINI'S RISE: CULTURE WARS TRUMP SOUND ECONOMICS

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Back in April, the Italian public was so incensed at its state of affairs—a broken government budget, endemic graft, unaffordable inward migration in a country that does not have jobs to spare—that half the general election vote went to two protest parties. On the left, the Five Star Movement (5SM) topped all with 32% support, while the right-wing League party surged to 18% from fringe status. Together, these parties somehow formed a coalition government despite having many conflicting views. The status quo players in Rome didn't take kindly to the comeuppance.

At first, President Sergio Mattarella didn't rubber-stamp the parties' selection of euroskeptic Paolo Savona as finance minister. He also snubbed 5SM and League voters further by nominating Carlo Cottarelli, formerly of the IMF, for prime minister. Voters were outraged. Just days later, with the Roman establishment realizing that their rejection of democracy would likely embolden the public even more, the plan for Cottarelli died. Instead, Giuseppe Conte, a little-known professor, was plugged in as the new prime minister on June 1.

If we were writing this in the spring, 5SM would be our focus because its support was clearly larger than that of the League. But the situation on the ground has changed, at least for the moment. The League and its leader, Matteo Salvini, have risen in popularity, and Salvini is arguably the most powerful man in Italy at this time.

SALVINI'S ANSWER TO THE EUROPEAN QUESTION

Common Europe has a long list of referendums and plebiscites that resulted in public rejection. Going back to 2005, both the French and the Dutch voted on referendums for a pan-European Constitution. "No" won handily in both countries. Yet Brussels continued its multigenerational European Project anyway, a few years later bailing out banks, countries and individuals, and in the process federalizing the continent despite popular protest.

In 2008, the "European question" was put to another national plebiscite, this time in Ireland, and the vote embarrassed Brussels yet again: no to the Lisbon Treaty, the constitutional foundation for unified Europe. No matter. The Irish government and the EU put on a massive PR campaign the rest of that year and made them vote again. In 2009, the Irish said yes.

Then in 2016, the British went to the polls and told Brussels what they thought of Common Europe. The city of London was shocked by the result: Brexit. And now there is demand in some circles for another referendum because London didn't like the way the first vote went.

Across east, west, north and south, many European states have seen anger at the establishment lead to the rise of new parties and new political faces. Unable to afford its own bloated welfare state even before the expense of recent years' wave of migration from North Africa and the Middle East, Italy finds itself dealing with culture clashes and a scramble to find the money to house and feed migrants.

Now the country is being run by a strange bedfellows coalition of the anti-corruption 5SM and the anti-immigrant League, the latter witnessing its popularity surge higher with the migrant arrivals. But amid all the talk of the migrant crisis, what has gone largely unnoticed is that both Five Star and the League have some economic policies that are irrational at best, dangerous at worst. With the news cycle focused on cultural issues, we are wise to remember that Salvini, currently positioned as the champion of nativist Italy, has communist roots. In his early days in the regional predecessor party, the Northern League, he was in its communist subgroup. His economic belief system has shifted with age, but this can be no solace to EUR longs.

KEY PLANKS

With 5SM, a positive is worthy of note: The party's main issue is a rejection of corruption, which is much needed and applauded by markets.

The good news generally ends there. On the economic side, its intellectual equivalents are somewhere between Greece's Syriza party and the American left's Bernie Sanders faction. The party represents the antithesis of laissez faire. For example, its coalition with the League rests on a series of economic overtures to a voting bloc that can only be described as far left, at least as far as the spending side is concerned. The major coalition agreements include overturning the Fornero law, which increased retirement ages a few years back. Imagine reducing retirement ages in 2018, with all that we know about longevity risk, in an economy with a debt-to-GDP ratio[1] of 130%, in a world where extending the working life of seniors is considered a near-universal priority from Japan to Poland to Canada.

Then there's the "right wing" League, again led by a formerly self-declared communist. Right wing on cultural issues, no doubt, but there is little that is Friedmanite in this group, although Salvini interestingly has embraced a Ross Perot-style flat tax.

A considerable portion of the League's economic views overlap with Five Star's desires, particularly when it comes to demand-side economic initiatives. It supports experimenting with universal basic income (UBI) of €780 per month, a program similar to the one that failed in Finland last year.

One more thing about the League: Before Salvini dropped "Northern" from its name, the party's key rallying cry was a secession of northern Italy from the poorer south. This is critical, because everyone in Italy knows that a party that for generations was keen to split its own country will probably have few qualms about upsetting a bunch of German politicians.

TAX CUTS: THE TAIL RISK POSITIVE

Figuring out the intellectual economic foundation for both 5SM and the League can be head spinning, because it is rare indeed to find people who are sympathetic to reducing retirement ages and implementing universal basic income while also supporting a flat tax.

[1] Debt-to-gross domestic product (GDP) ratio: The ratio between a country's government debt and its gross domestic product.

As for those potential tax cuts, many economists are concerned that Italy's 2.3% budget deficit would swell. But the country needs to do something to show business that the state is not hostile to commerce. With anemic economic activity at home, as well as in nearby Greece and Portugal, tax revenues aren't the region's biggest intractable problem; government spending is. Italy's 50.2% government spending-to-GDP ratio is seventh in the world, trailing Greece, France and the aforementioned Finland, which ranks first.[2] To the extent the coalition is putting a flat tax on the table, it signals to commercial interests that Rome realizes there is a problem with its reputation for business friendliness. A flat tax could enhance compliance in a corrupt system and also signal to markets that the new leadership is serious about reform.

EUROPE'S SICK MAN: WHAT HAPPENS IN RECESSION?

Not long ago, Germany was Europe's "sick man," as it grappled with fits and starts in unifying after the fall of the Berlin Wall. A quarter century ago, the country succumbed to a recession that brought -2.0% real GDP growth in 1993. But it emerged from contraction by 1994 and had economic expansion every year through 2001. Yet Germany couldn't shake the sick man title despite registering 1.9% yearly GDP growth from 1993 to 2001.

Italy's situation today is bleaker than Germany in the 1990s, but this is no Great Depression. Its most recent economic growth figure, 1.4%, may be anemic but it is positive, and high by Italian standards; the norm this century has been +0.4%. The truth is that Italy today makes the "sick" Germany of the 1990s look like an economic miracle.

Five Star and the League toppled the mainstream parties of the center-left and center-right amid an economic backdrop that is about as robust as anything Italy has seen in most memories. For example, the manufacturing Purchasing Managers' Index, at 52.7, has essentially been in nonstop expansion since Q1 2015.[3] Unemployment is down to a still-troubling 11.1%, but it was nearly 13% at the end of 2014. Investors must ask: What odd fiscal and/or monetary policies will voters demand if conditions become recessionary again?

Start with one such policy—Brussels' big fear—that is haunting the bond market and EUR.

THE SPECTER OF A PARALLEL CURRENCY

A "new lira," side by side with the euro. Of course, Five Star and the League will not come out and say it at the moment, but that's what their proposal for "mini-BOTs" would mean. If they do go down this path, a radical endeavor indeed, mini-BOTs would be short-maturity debt instruments that can be used to pay welfare and other state obligations. On the other side of the ledger, owners of the mini-BOTs could use them to pay for state services or taxes.

The plan for mini-BOTs ushers in fears of de facto default on Italy's government debt via debasement, the oldest trick in the book. And the bond market isn't happy about it; long-dated Italian bond yields have risen significantly amid the political uncertainty.

[2] Source: OECD, as of 2015.
[3] Source: Markit. Data as of 5/18.

Consider how this parallel currency would come into being. Suppose the government owes a supplier. Rather than pay the actual €100, Rome would give a newly issued promissory note, which could maybe then be used at nearby retailers. The Italian government would reiterate that the mini-BOT is not legal tender (because only the euro is) and that Italy remains, at least orally, committed to the euro. Such declarations would be consistent with both parties' more radical elements backing down from "Italexit" rhetoric.

However, the state would make it abundantly clear that these non-legal tender mini-BOTs could be used for many purposes, such as paying taxes and parking tickets. And they could be exchanged around the neighborhood.

Go back to the €100 obligation to the supplier. This person or entity now has something that is not as good as cash in hand—a promissory note, face value of €100, and from the Italian state, not from a more reliable counterparty like Berlin. If this entity then chooses to exchange the mini-BOT, perhaps the market clearing price is €99 or maybe €95, or if crisis strikes, lower.

Then, as the government issues more and more of them, ultimately paying many counterparties in the mini-BOTs, their ubiquity becomes obvious; everyone has some notes in their pockets. Ten euros here, 50 there, 10,000 over there. Now the convenience stores do accept them. The exchange rate is widely known, and it fluctuates. And since their value is in the billions, there is a Bloomberg quote too, with Japanese banks engaging in swaps with Swedish banks in the middle of the night, while Italians sleep.

The new lira.

FOR THIS PRIVILEGE

We know that Five Star and the League are sympathetic to euro and EU hostility, so the new lira may be the "lite Italexit" that strategists have been trying to diagram for the last decade.

We imagine EURUSD wouldn't take kindly to mini-BOTs, because Rome would be able to do what Rome is wont to do, which is spend with abandon without answering to Brussels.

Due to the European Central Bank's (ECB) €30 billion-per-month bond-buying program, which ends this year, Italian bond yields have not provided much compensation for extra political risk. With the U.S. Federal Reserve one of the few developed governments that is tightening monetary policy, there is a paucity of foreign sovereign bonds that exceed the yield on U.S. 2-Year Treasuries. The few and far between that are higher are highlighted in blue in figure 1. Only Australian paper of 10-year maturity and beyond, along with similar long-dated Italian paper, manages to exceed 2-Year obligations of the U.S. Even "high" yielding Canadian government bonds due in 2048 pay less than Washington's 2020 obligations.

FIGURE 1: Sovereign Yields (Highlighted Blue if > U.S. 2-Yr. Treasury)							
Sovereign Bonds	2 Years	3 Years	5 Years	7 Years	10 Years	20 Years	30 Years
U.S.	2.53%	2.62%	2.72%	2.80%	2.84%	2.90%	2.98%
Germany	-0.69%	-0.61%	-0.31%	-0.07%	0.30%	0.72%	1.02%
Italy	0.73%	1.09%	1.78%	2.34%	2.73%	3.24%	3.45%
France	-0.49%	-0.33%	0.00%	0.22%	0.66%	1.15%	1.51%
Canada	1.91%	1.97%	2.06%	2.13%	2.17%	2.21%	2.20%
Spain	-0.26%	-0.08%	0.38%	0.74%	1.30%	1.96%	2.48%
UK	0.71%	0.72%	1.01%	1.11%	1.26%	1.72%	1.73%
Australia	2.00%	2.02%	2.23%	2.43%	2.73%	3.24%	3.45%
Japan	-0.13%	-0.13%	-0.12%	-0.07%	0.02%	0.49%	0.70%

Source: Bloomberg, with data as of 6/30/18. Past performance is not indicative of future results.

With at least the prospect of mini-BOTs on the table, plus all the other Italian drama, U.S. Treasuries look appealing relative to Italian bonds. In parallel, USD looks like a bastion of stability relative to EUR.

DECEMBER LOOMS

The ECB's stated aim is to "keep prices stable, thereby supporting economic growth and job creation." But since 2008, when Lehman collapsed, what has mattered is not its explicit mandate but its implicit one, which is to keep the European Project from splintering.

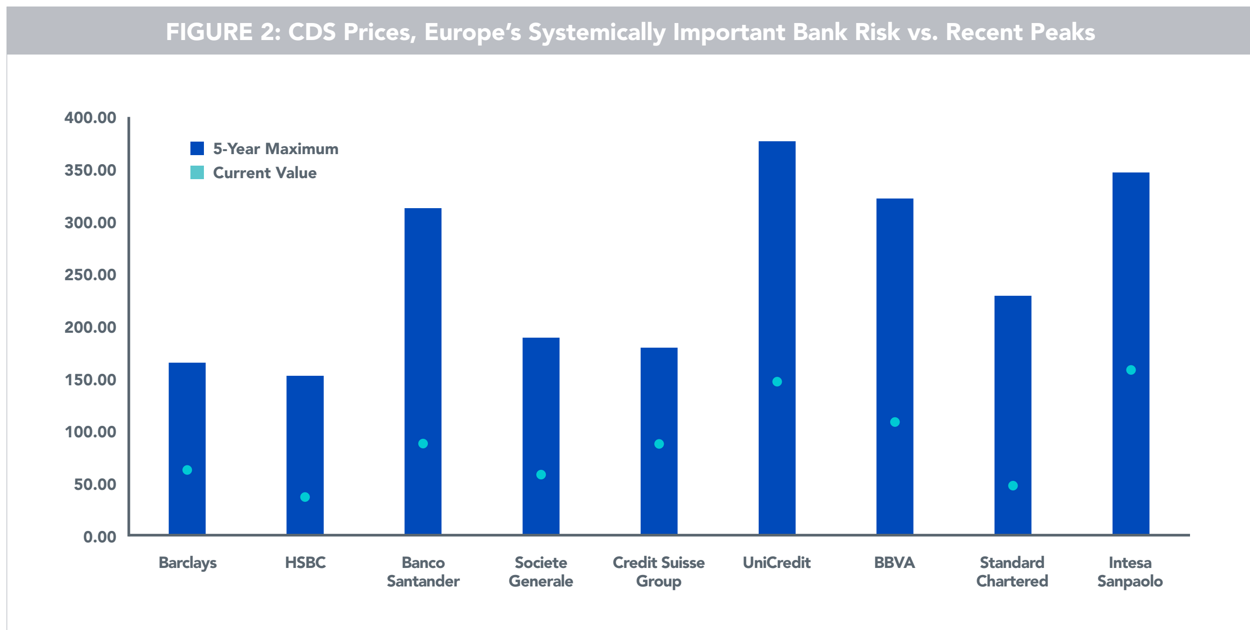
Meanwhile, the ECB has stated that it will let its €30 billion-per-month bond purchase program expire this year. The problem is that Mario Draghi is still ECB president, and his fame rests on his 2012 "whatever it takes" speech, whereby he vowed that the central bank stood steadfast to prop the system amid "Grexit" fears, when electoral victory by Greece's hard-left Syriza party threatened to break the monetary union. Remember too that the risk of Grexit was never just about tiny Greece, but about its implications for a follow-on exodus by the truly sizeable economies in Europe's south—namely Italy and Spain.

This means that the combination of fuzzier European economic data and the bond market's newfound concern with Italian mini-BOTs could cause a "dovish" surprise by Draghi, where he vows to extend the bloc's zero interest rate policy into the next decade, a portent that may hurt prospects for EUR bulls.

EUROPEAN BANKS NOT YET INDICATING CONTAGION

One way in which European systemic risks can be priced quickly and transparently is via bank credit default swaps (CDS). Figure 2 shows current CDS levels along with the peak fear points of the last five years.

FIGURE 2: CDS Prices, Europe's Systemically Important Bank Risk vs. Recent Peaks



Source: Bloomberg. Selected banks are among the largest issuers of additional Tier 1 capital convertible bonds for which 5-year senior CDS data was available through Bloomberg. Data from 4/30/13 to 6/30/18.

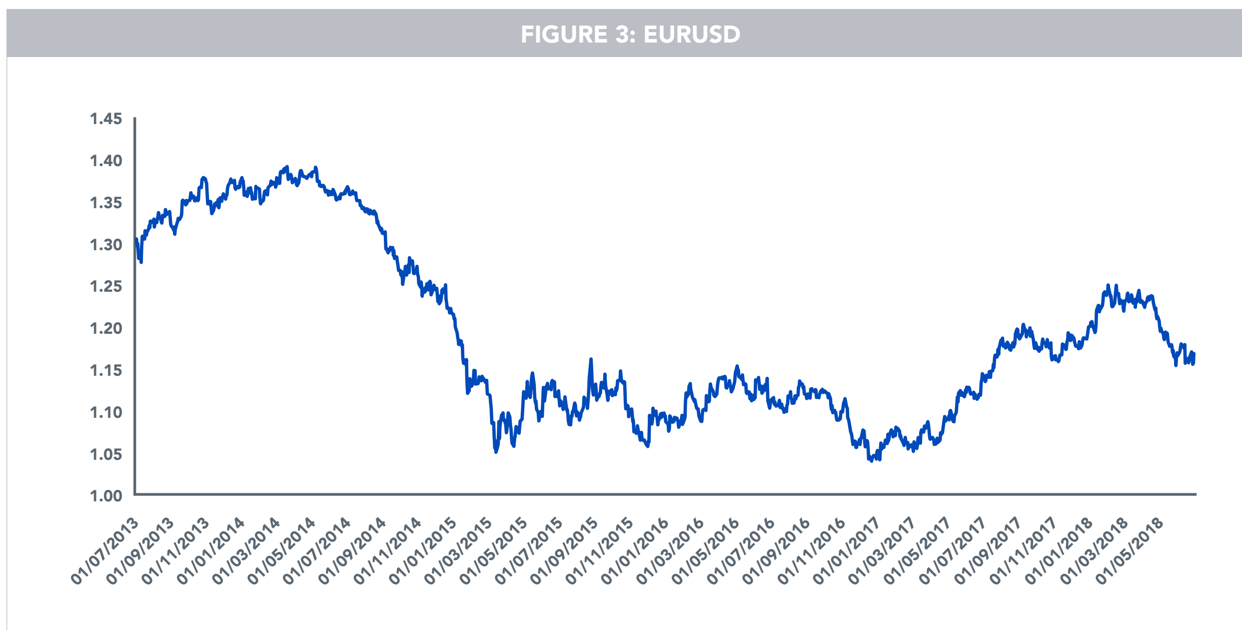
+ UniCredit and Intesa Sanpaolo are the two largest Italian banks shown, and their current CDS prices of 148 and 159, respectively, are still less than half of the June 2013 peaks of 386 to 387.
+ However, in viewing CDS action this year to better capture recent risk perception, the picture changes. Both Italian banks' CDS spreads have more than doubled since the beginning of May. However, Spain's BBVA and Banco Santander also saw their CDS prices spike.

The northern/southern eurozone risk divide is alive and well, with all eyes focused primarily on counterparty risk in Italy and Spain, as has been the case since Lehman.

RISK TRANSMISSION MECHANISM: THE EURO

An avoidable portfolio risk amid the Italian political saga is in euro-denominated securities that are not currency hedged. The euro has dropped nearly 7% against the U.S. dollar since its recent high on February 1, 2018 (figure 3). There is room for further declines, especially now that Draghi's announcement of an end to the bond-buying program leaves little prospect for "hawkish" surprises.

FIGURE 3: EURUSD



Source: Bloomberg, with data from 5/30/13 to 6/30/18.

We find five regimes of EURUSD in just the last half decade:

+ **Early Appreciation:** In the early period, the euro was quite strong, closing in on $1.40 before the ECB initiated Draghi's "whatever it takes" bond-buying program.
+ **Massive Depreciation:** Next, Draghi followed through—and radically—sending EUR to $1.05. At the time, many questioned whether we might see elusive greenback parity.
+ **Range-Bound Indecision:** Neither the bears nor the bulls received affirmation from 2015 to early 2017. Bouts of appreciation and depreciation prevailed.
+ **2017 Appreciation:** European economic growth surprised to the upside. EUR rallied more than 14%, confounding the consensus.
+ **2018 Italian Reaction:** It took a while for a catalyst that could crack EUR to emerge, and Italy's March 4 election appears to have been it. EUR has been declining in this regime.

HEDGING EURO RISK

It is far from certain how Italy's relationship with Common Europe will work out. Political surprises can be painful in real time, but with the benefit of hindsight, sometimes our original fears prove overblown in retrospect. But that doesn't mean that allocating to European equities must entail taking on unnecessary risks. To us, direct exposure to EUR is one of those burdens, especially since the act of hedging to USD allows investors to be paid an increasing amount of embedded interest income.

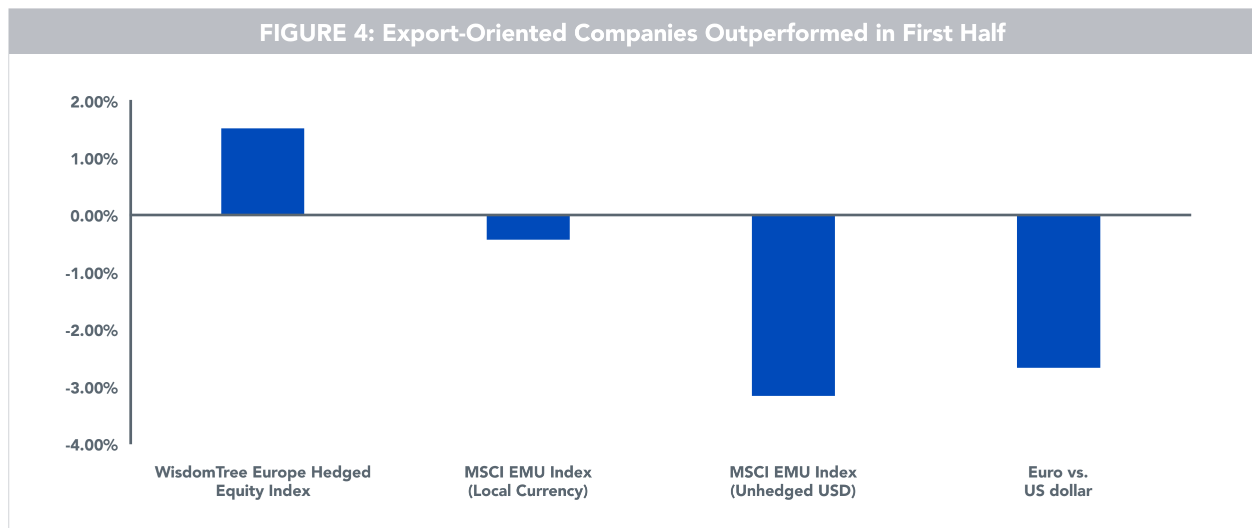
It is a falsehood, at least among developed markets, that currency hedging is expensive, especially now that the U.S. has the industrialized world's highest interest rates. The already sizeable "carry" earned from hedging EUR to USD will also increase if the Federal Reserve continues raising rates while the ECB sits on its hands.

GLOBAL GROWTH VIA EUROPEAN COMPANIES

Of note is that the market's current concerns are largely relegated to a single country—Italy—and whether it will hit EUR and cause debt market contagion or banking disruptions.

If Italy does weigh down continental economic activity, companies with business interests outside the eurozone may be of interest. Beyond emphasizing non-European revenues, strategies that focus on exporters also underweight Italy, because the country's stock market composition tends to be more insular than northern peers. This type of strategy worked nicely in 2018's first half (figure 4).

FIGURE 4: Export-Oriented Companies Outperformed in First Half



Source: Bloomberg, from 4/30/18 to 6/30/18. You cannot invest directly in an index. Past performance is not indicative of future results.

Of note:

- The performance of the WisdomTree Europe Hedged Equity Index—where every constituent derives 50% or more of sales from outside Europe—mustered a 1.5% return in the first half, while both hedged and unhedged versions of the MSCI EMU Index showed losses.
- The MSCI EMU Index—which is fully exposed to the vagaries of EUR—was down 3.2%, with the majority of its declines attributable to the currency.

Increased Risk Zones:

- Italian debt, and to some extent other peripheral debt (Greece, Spain, Portugal)
- Bank credit, in particular in Italian and Spanish banks, although CDS markets are tame in context of the Grexit fear of a half decade ago
- EUR itself, which peaked at $1.25 in February and has subsequently cratered to $1.17[4]

[4] As of 6/29/18.

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MSCI EMU Index: A free float-adjusted market capitalization-weighted index designed to measure the performance of the markets in the European Monetary Union.
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