09/25/2019

The beginning of a new cycle?

Italy and Europe between continuity and change

Banca Promos
Investment Banking Desk

Alessandro Sica
Analyst

+39 081 01 70 622
alessandro.sica@bancapromos.it
investment.banking@bancapromos.it

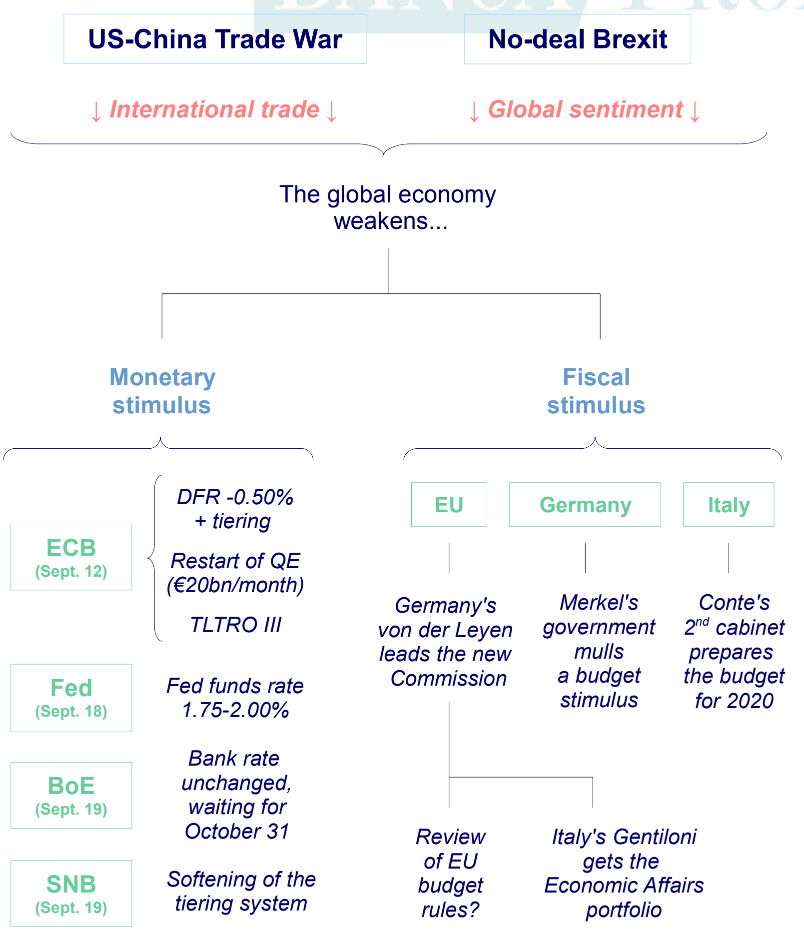
Paolo Cozzolino
Managing Supervisor

+39 081 01 70 617
paolo.cozzolino@bancapromos.it
pcozzolino2@bloomberg.net

Over the next three months, Italy and Europe will face **a series of important changes**. For the first time in the history of the EU, two women, **Ursula von der Leyen** and **Christine Lagarde**, will take on the leadership of the most important EU institutions (Commission and **ECB**), the **UK** could definitely leave the **European Union**, and **Italy** will be led by a new government that is more aligned than the previous one with European partners and financial markets.

Indeed, set aside (at least for now) the radical projects of the sovereign movements, it seems that the renewal looming on the horizon will be in the name of continuity. **France** and **Germany** will formalize their leadership of the EU, **Brexit** could undergo an additional delay of three months and the second cabinet led by **Giuseppe Conte** will have to negotiate (like the previous one) with the new **European Commission** some degree of flexibility for Italy's 2020 budget.

Wind of change?



Next relevant dates in Italy and the EU

2019

September 27
Italy: the Update to the DEF (NADEF) is submitted to the Parliament

October 15
Italy: the Draft Budgetary Plan (DPB) is submitted to the Commission and the Eurogroup

October 20
Italy: the budget law is submitted to the Parliament

October 23
Vote by the European Parliament on the new Commission

October 25
Italy: rating review by S&P (BBB/Negative)

October 31
The UK is planned to leave the EU

October 31
End of mandate: JC Juncker (President of the Commission)

October 31
End of mandate: Mario Draghi (President of the ECB)

November 1
The ECB restarts net purchases under the APP

November 15
Italy: rating review by DBRS (BBBh/Stable)

November 30
End of mandate: Donald Tusk (President of the European Council)

November 30
Italy: European Commission's assessment on the budget

December 31
End of mandate: Benoit Coeure (ECB's Executive Board)

December 31
Italy: Paliament approves the budget law

Plus ça change

A new cycle?

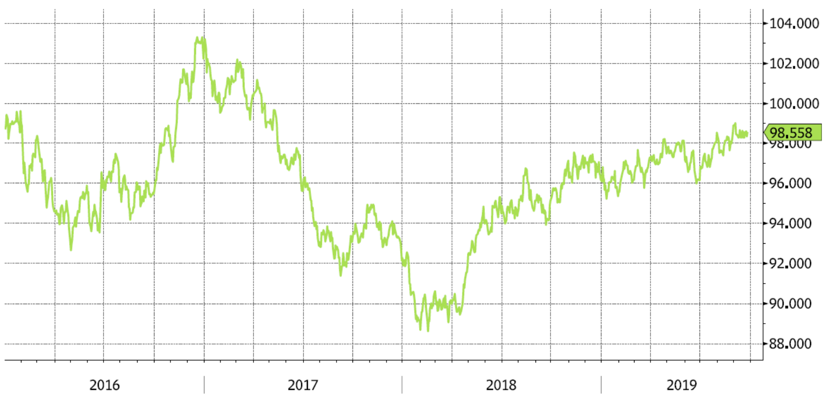
By the end of the year, a new European Commission will be established in Brussels, Christine Lagarde will take on the helm of the ECB, the United Kingdom could definitively leave the European Union, and the newborn Italian government will deliver a complex budget law.

Reading this sequence of changes in the European political landscape, it comes to mind a famous idiom by the French writer Alphonse Karr: "*plus ça change, plus c'est la même chose*". This ironic and at the same time resigned aphorism was coined in 1848 when, after the third French revolution and the abdication of Louis Philippe I, Louis Napoleon was elected president of the Republic. Within a few years, the Empire was restored in France. The more things change, the more they stay the same. [1]

Geopolitical uncertainties...

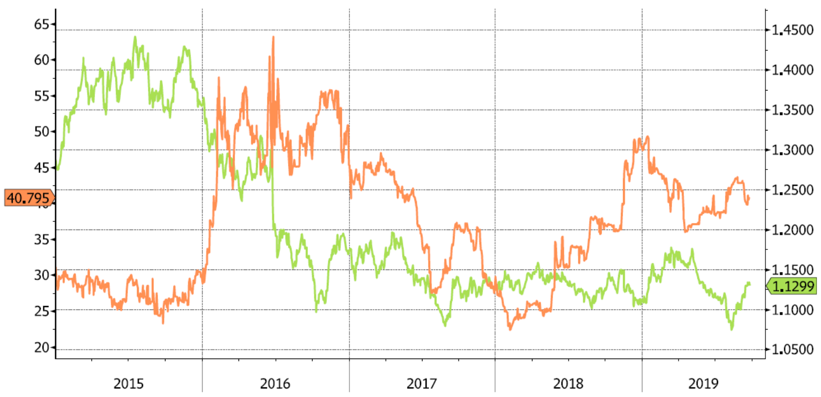
The global economic environment has been marked since January 2018 **by the trade clash between the United States and China**. As US presidential elections move closer, on the one hand Donald Trump is encouraged to speed up talks (to strengthen his image as a successful dealmaker), on the other the Chinese delegation is induced to slow down the negotiations (hoping for the victory of a Democratic candidate less inclined to carry on a trade war). However, November 2020 is still relatively faraway.

Dollar Index (Spot)



Source: Bloomberg

Brexit risk



Legend: GBP/EUR *(right)*, UK CDS $ Sr 7Y D14 *(left)*

Source: Bloomberg

---

[1] Sergio Romano, Strategia del 'Gattopardo' cambiare per non cambiare, Corriere della Sera (10/25/2009)

The much closer deadline of October 31, 2019 -- when with or without an agreement, the Brexit issue should finally come to an end -- seems quite distant too. **The British political and institutional system is under pressure** and it is still not possible to exclude that the current situation of uncertainty may persist well beyond the night of Halloween.

An additional source for geopolitical and economic **concern is the ongoing escalation in the Persian Gulf,** especially after a drone attack against two major oil facilities in Saudi Arabia, for which the United States, Germany, France and the United Kingdom have accused Iran. The fear of the outbreak of war in the region soon added to the worry of the consequences of the increase in oil prices on inflation and growth in importing economies, such as those in the euro area. However, such an outcome could only occur if crude oil prices were to stay for several months at levels above $70-80 per barrel.

Crude oil ($)

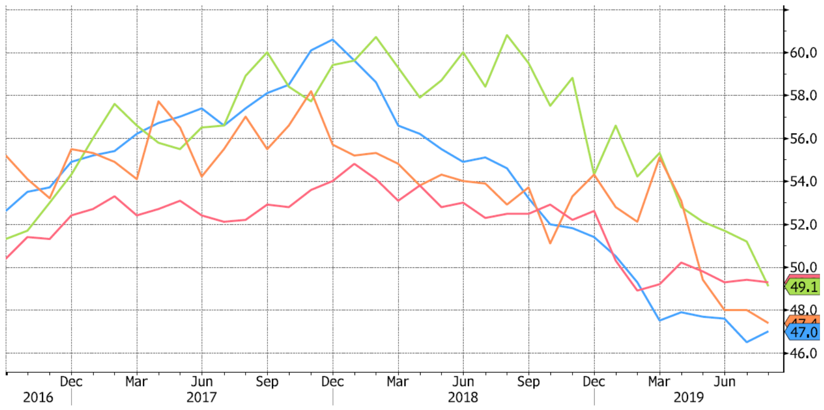
Legend: WTI, Brent

Source: Bloomberg

… weaken global growth

The worsening in global sentiment due to commercial and geopolitical tensions **is at the hearth** of the slowdown in international trade and **of the weakness of export-driven economies**, especially in Europe. The decrease in global growth expectations is the immediate consequence.

Manufacturing PMI SA



Legend: United States, Eurozone, United Kingdom, Japan

Source: Markit, ISM, Bloomberg

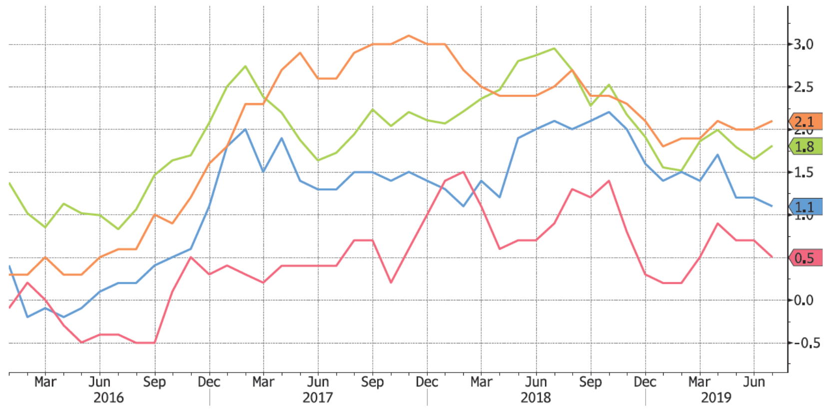
A currency war between the Fed and the ECB?

The response of the Federal Reserve to the deterioration of the global economic environment **has not been long in coming**, **with** the implementation of **two consecutive rate cuts** in July and September, which brought the Fed funds target rate **in a range between 1.75% and 2.00%**.

On September 12, **the European Central Bank too has decided to act**, unleashing a wide set of measures: **the deposit facility rate has been reduced to -0.50%**, **a two-tier system has been introduced** for excess reserves deposited by banks at the central bank, **the resumption of net purchases** under the Asset Purchase Program (APP) **has been announced** (at a pace of €20bn per month), **and the features of the third round of TLTROs have been relaxed** (lower interest rate and longer maturity).

However -- despite the magnitude of the monetary intervention announced by the ECB -- with a bond market where Germany's yield curve is not only inverted (like those of the United States and the United Kingdom, among others) but is entirely placed, from 1 month to 30 years, below zero, **fears are growing that the Frankfurt-based central bank is** actually **running out of tools to stimulate the economy** and inflation in the euro area.

Headline inflation rate (%)

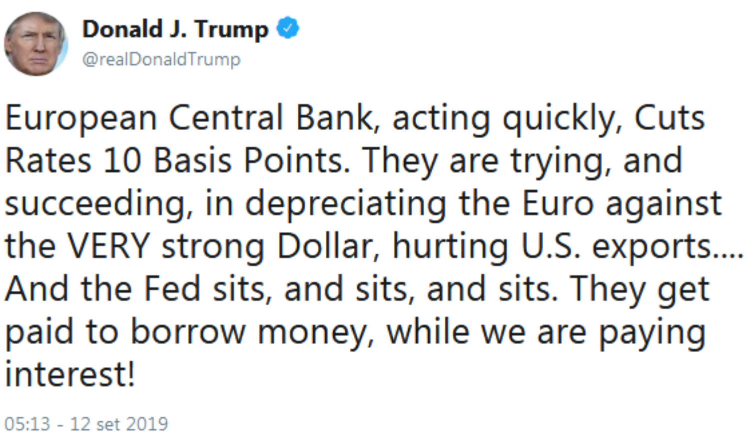


Legend: United States, Eurozone, United Kingdom, Japan

Source: Bloomberg

As a consequence, **there is a growing feeling** among ECB watchers -- starting from US President Donald Trump -- **that the only channel that is still effective in stimulating the European economy** -- in particular that of export-driven countries such as Germany and the Netherlands -- **is** actually the 'foreign' channel of **the exchange rate** rather than the 'domestic' channel of bank credit.

Currency war: ECB

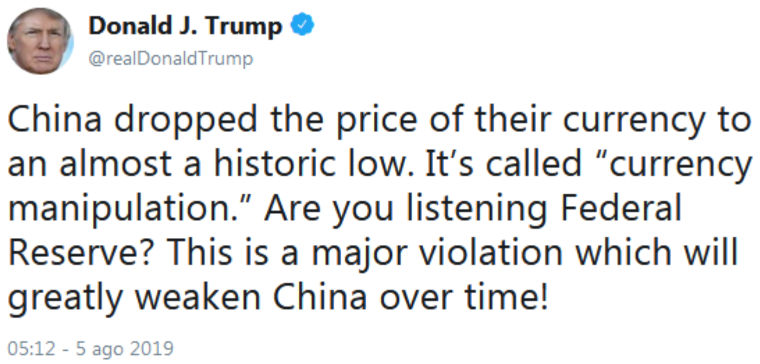


Source: Twitter

Already on July 30, the Chief Economics Commentator of the Wall Street Journal, Greg Ip, argued that **the Fed and the ECB are currently involved in an undeclared currency war**. [2]

A war which is virtually global, if one takes into account the accusations of competitive devaluation advanced by Donald Trump against China. In this case -- to paraphrase the Prussian general and military theorist Carl von Clausewitz -- it would be a continuation of the trade policy with the means of the currency war.

Currency war: PBoC



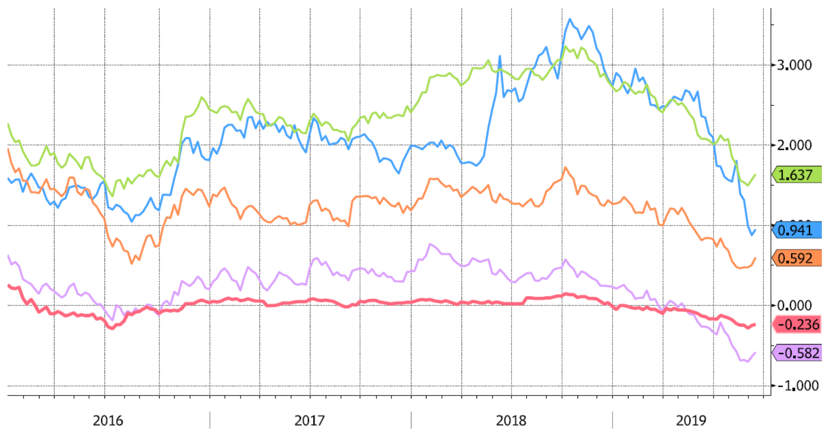
Source: Twitter

Germany gets ready for a recession...

And yet, something seems to be moving in the realm of fiscal policy. While **the European Union is mulling a** potential **review of the budgetary rules** that bind its member countries' spending plans, **in Germany a debate has begun on the desirability of a fiscal stimulus** to counteract a recession looming at the gates. **Mario Draghi himself has alluded to Germany** during the press conference that followed the latest ECB meeting, **stating that European countries** with fiscal space "***should act in an effective and timely manner***".

Under current market conditions, Germany is literally paid by its creditors to issue new debt. **Public investments in infrastructure** and tax cuts would benefit not only Germany's economy but also those of the rest of the continent and **would allow a faster return to 'normal' interest rates.** [3]

10Y sovereign bond yields (%)



Legend: United States, Italy, Germany, United Kingdom, Japan

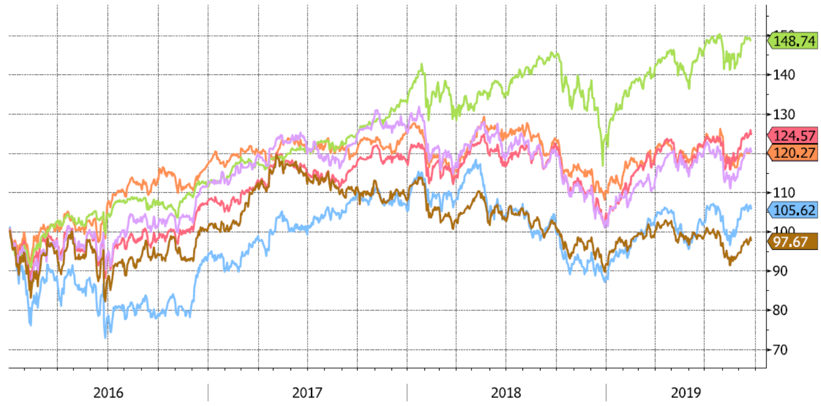
Source: Bloomberg

[2] Greg Ip, The Undeclared Currency War: How the ECB Is Forcing the Fed's Hand, WSJ (07/30/2019)

[3] Editorial Board, Germany's Obsession With Fiscal Prudence Needs to Go, Bloomberg (09/02/2019)

The use of the fiscal dial by the German government (which has recently announced a €100bn plan for climate protection by 2030) **could act as a catalyst for consumption and private investments**, leading to a broad rise in interest rates which, given current rate levels, could also prove beneficial for financial markets, being it a symptom of recovery in the real economy.

Stock markets (01/01/2016 = 100)



Legend: S&P 500, FTSE MIB, DAX 30, FTSE 100, CAC 40, IBEX 35

Source: Bloomberg

P/E Ratio

DAX 30	20.02
S&P 500	19.58
CAC 40	19.40
FTSE 100	17.86
FTSE MIB	13.20
IBEX 35	13.02

Source: Bloomberg

… while Italy has a new government

And finally, there is Italy. **The sudden** (but not unexpected) **crisis of the coalition government led by the 5 Star Movement and the League has turned into reality** what, on previous occasions, seemed impossible: **a 5SM-Democratic Party cabinet**. The birth of the new alliance has been accompanied by a repricing in the Italian bond market, while the spread between 10-year BTPs and Bunds has progressively approached the levels of the first quarter of 2018.

Although the Italian economy remains substantially stagnant and the new government has to deal with a complex budget law, **the pro-Europe attitude of the cabinet could make the negotiation between Italy and the EU easier than before** (albeit not simple in absolute terms). With the League relegated to opposition and the accomodative stance of the ECB, **yields on Italy's sovereign bonds could have room to decline further**.

Italy: Credit Default Swap ($, Sr, 5Y, D14)

Source: Bloomberg

FOCUS #1: Von der Leyen and Lagarde at the head of the EU

Wind of change

In Germany it is a tradition that the outgoing Defence minister can choose some of the songs that the brass band of the army will play during the handover ceremony to her successor. The choice of Ursula von der Leyen, Defence minister since December 2013 and now president-elect of the European Commission, fell on 'Wind of change' by the Scorpions.

The wind of change that Ursula von der Leyen wants to bring to Europe is certainly not the one advocated by sovereign and Euro-skeptical movements in the wake of the European elections, given that her dream is admittedly that of a federal Europe (i.e. the United States of Europe). The change carried by the first woman at the head of the European Commission **will** rather **be in the name of continuity**.

Between rules and flexibility

On July 16, for example, in her speech to the European Parliament, **von der Leyen reiterated the need to make use of "*all the flexibility allowed by the rules*"** to make investments and reforms.

On closer inspection, this statement is not very different from those already made by members of the previous European Commission, such as Jean-Claude Juncker and Pierre Moscovici. However, one cannot fail to highlight that they now come from **a conservative German politician**, that has joined the CDU in 1990 (the same party which includes among its members the former Finance Minister and current president of the Bundestag, Wolfgang Schauble, as an example) and has proved close enough to Angela Merkel to lead three different ministries (Family, Work, Defense) over the four governments chaired by the Chancellor in the last 14 years.

The approach of 'change in continuity' could involve not only the incoming European Commission but also the European Central Bank, whose leadership will be entrusted from November 1 to France's **Christine Lagarde**.

The EU rediscovers fiscal policy

As for monetary policy, **the outgoing director of the IMF is set to follow the footsteps of her predecessor**, supporting the need for a significant monetary accommodation still for a long period of time. The same can be said of her point of view on fiscal policy.

According to the Financial Times, in answering a questionnaire by the European Parliament (one of the steps in her nomination process), the former minister of Finance of the French Republic **has called for "*changes that would create extra room for economies to use fiscal policy during downturns*"**. [4]

The British newspaper had previously revealed that **"*Brussels is planning to simplify the eurozone's complex budgetary rules*** *to provide governments with softer debt reduction targets that do not push struggling economies into trouble during downturns*".

French-German leadership

A spokeswoman for the Commission has subsequentely said that the brainstorming document seen by the FT "*should be given zero credibility and credence*". One thing, however, is for sure: **starting from next November, the EU will have, even formally, a French-German leadership**. Such a guide will be political and not merely technical, because political is the role of the president of the European Commission and because political will likely be Christine Lagarde's interpretation of her role as president of the ECB (given that she hasn't a background as an economist).

If change is really stirring in the continent, France and Germany are certainly the two countries most legitimized to lead it.

---

[4] In his last hearing at the European Parliament, on September 23, Mario Draghi has stated that "*the budget rules should be revised (...) because they do not have anti-cyclical capabilities*".

FOCUS #2: A second cabinet led by Giuseppe Conte

Coalition 'Orsola'

Romano Prodi had not participated to a 'Festa Nazionale dell'Unità' for eleven years. His return, on August 29, to the event organized by Italy's Democratic Party in Ravenna has coincided with a moment of particular fibrillation for the party he contributed to found.

The decision of the leader of the League, Matteo Salvini, to trigger a political crisis in the middle of summer, driven by a strong electoral consensus, **has ended up favoring the approach of the 5 Star Movement to its all-time rival, the Democratic Party** (or PD).

Prodi, former Italy's prime minister and former president of the European Commission, was among the first to give his approval to an alliance between PD and the Movement. **A coalition** he **named 'Orsola'**.

His analysis is straightforward: **the 5SM-League government has collapsed** on July 16 in Strasbourg, **after the vote of 5 Star Movement's MEPs in favor of Ursula von der Leyen** to become the next president of the European Commission. On that occasion, it was thanks to their 14 votes that the majority needed for the election was achieved (383 votes in favor versus a quorum of 374 votes). The League, on the other hand, voted against. Less than two months after that vote, the PD-5SM axis re-emerged, paving the way to a new Italian cabinet, chaired (like the previous one) by Giuseppe Conte.

2020 budget

On top of the cabinet's program there is the budget law for 2020, in which the "*neutralization of the VAT increase*" will be the priority. The government says it wants to "*pursue an expansionary economic policy*" that does not however "*put the balance of public finances at risk*".

In this regard, **the neutralisation of VAT clauses will require funding for €23bn**. If it is true that this amount could actually turn out to be lower -- thanks to a budget adjustment carried out in July, savings on 'Quota 100' and Citizens' Income (the flagship measures of the previous government), and lower interest expenses on public debt (about €3.5-4bn of savings only from the latter item) -- it is also true that **the government's program also makes refernce to** additional spending measures, such as **a cut in taxes on labour** (estimated around €4-5bn) **and the launch of a Green New Deal**.

Relations with the EU

A key position in the government's program is also reserved for relations with Europe. Italy's new cabinet states that "*it will work to promote the necessary changes to overcome the excessive rigidity of European constraints*". In this sense, **the birth of the second Conte-led government** in conjunction with the establishment of the new European Commission **could prove to be** a favorable coincidence, **the occasion for Italy to mend European political ties**, building on the decisive support of the 5SM in the election of Ursula von der Leyen.

An 'EU-insider' leading the MEF...

The choice of Roberto Gualtieri for the role of minister of Economy and Finance goes in this direction. Better known in Brussels than in Rome, the former president of the Commission for Economic and Monetary Affairs of the European Parliament has received an endorsement by Christine Lagarde even before his appointment was made official: Gualtieri leading the ministry of Finance (MEF) would be good for Italy and for Europe, according to the future president of the ECB.

Gualtieri is a politician (from the PD), **not an economist, but** in the last 10 years he has acquired significant experience and **has established important ties** thanks to the many tasks held **within the European institutions**. His name at the helm of the MEF reflects the awareness that the negotiation on the budget law -- and the potential future redefinition of Europe's budget rules -- requires Italy to be represented in front of the EU by an 'insider'.

… and an Italian dealing with EU Economic Affairs

This Italy's 'fresco' is completed by the choice made by Ursula von der Leyen to provide the former Prime minister and former Foreign minister **Paolo Gentiloni with the** strategic **role of European Commissioner for Economic Affairs, and by the words of Italy's Head of State Sergio Mattarella who**, in a message for the 45th Forum Ambrosetti, **has called for a "*review of the rules of the Stability Pact*"** aimed at relaunching growth and investments. Maybe, this can really be the beginning of a new cycle.

The contents of this document and, in particular, the processing of the information collected, is property of Banca Promos SpA. Therefore, without the prior formal consent of Banca Promos, the abovementioned material, in its entirety, can not be copied, downloaded, reproduced, used on other Internet sites, modified, transferred, distributed or communicated to third parties, except for personal use, remaining in any case, forbidden any commercial use. Banca Promos does not carry out portfolio management activities.

Banca Promos guarantees that the production, the distribution, and the use of investment research, is only for proprietary and/or treasury trading purposes, adopting the necessary safeguards in order to exclude this activity from the discipline regarding inducement.

This information is intended for qualified investors and no commercial agreement is necessary as no direct or indirect compensation has been or will be received in exchange for this service.

The information does not rappresent an investment advisory service and is not intended as an offer or solicitation related to the purchase or the sale of financial instruments.

Banca Promos guarantees that the parties carrying out the abovementioned analysis have no interests in the financial instruments processed and, therefore, there are no personal situations of conflict of interest. Banca Promos assumes no responsibility for errors or omissions of any kind about the information published, despite of the carefullness given to the production of the contents.

The content of this document excludes the "price sensitive" information character as it is based on qualitative and quantitative information publicy available on the market, and, each consideration expressed by the authors, reflects an independent and personal judgment of the analysed data.