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State of the Markets: Macro Commentary

Views on Europe Part 1: Italy and Portugal And The Coming EMU Crisis

In my view, the sell-off in Italian debt reflects two powerful forces. The first is supply and demand, while the second factor is the reemergence of existential issues about the future of the EMU. The impact on yields of the first force is fairly straight forward. The ECB's plan to stop asset purchases could remove an important source of demand for Italian sovereign debt. The ECB now holds 18% of the outstanding supply of Italian sov debt. Supply could also be increasing if the new Italian government follows through on their plan to increase government spending and backing away from austerity. If this were the only force at work, this spike in Italian sov yields would likely be fairly short lived. Demand from other sources such as banks at the short-end and insurance companies at the long end could easily offset ending of the PPM program and grow substantially at these yields vs risk-weighting trade-offs. However, the second force is potentially even more powerful, and it could keep Italian yields at these levels if not push them higher.

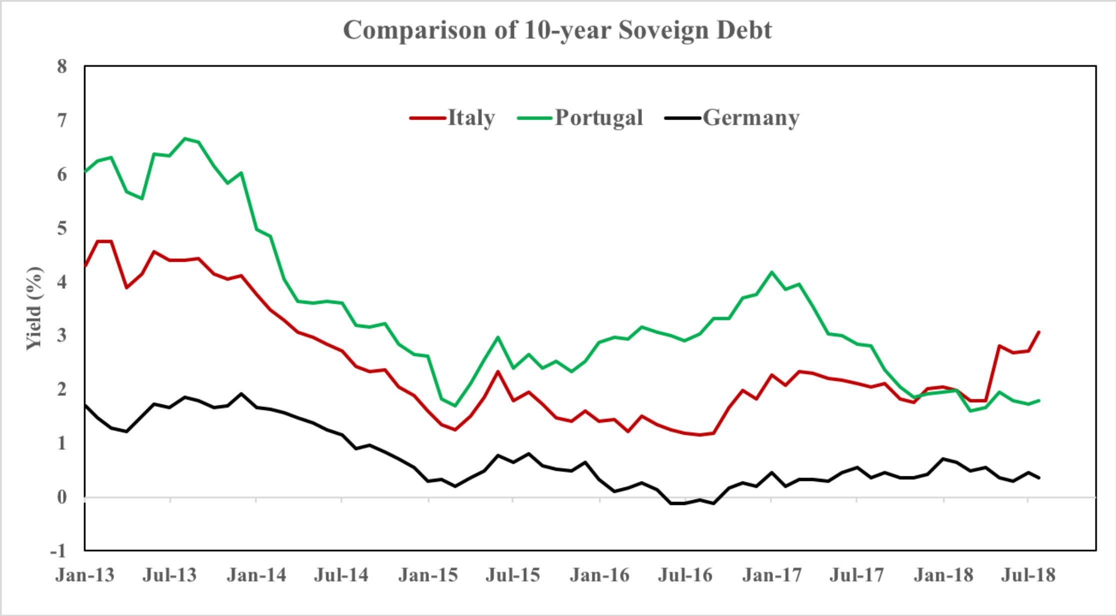
The reemergence of the existential issues for the EMU is again being driven by the growing battle between the north and the south. This battle reflects three main factors: economic growth differentials, immigration, and austerity. The ECB's decision to stop their asset purchase program reflects in part pressure from northern Europe given their normalization of growth and inflation. From the vantage point of Germany, everything is back to normal so why have accommodative monetary policy. The push by Germany to have a German to be the next head of the ECB would solidify this view. From the vantage point of Italy, growth is still anemic, an accommodative monetary policy is still needed as increase fiscal spending. Needless to say, they still appreciate an Italian as the head of the ECB.

Immigration is a hot button for all of Europe. Everybody wants emigration out of their country, no one really wants immigration into their country. Unfortunately, freedom of migration is one of the key pillars of the EMU. As I have written earlier, illegal immigration into the EMU has been a spark of political crisis in both Germany and in Italy. Illegal immigrants coming onto the shores of Italy end up moving to Germany because Germany has jobs and Italy does not. The Germans want this to stop and for southern Europe to take them back. Again this is politics. The native German population, which is shrinking, is being overwhelmed by the almost ¾ of million immigrates per year coming into Germany. Italy does not want them back because they have no jobs for them and would have to support them. So, the current detente between Italy and Germany is only temporary.

Finally, there is the issue of austerity. After almost ten years of austerity, the new Italian government wants to loosen the rains on spending. Anemic growth is one factor. However, the new government ran on a platform on lower taxes and more benefit spending, both of which would push their deficits above the EMU threshold. This in addition to the earlier threat from a working paper from the new government that argued that the ECB should write-down Italian sov debt.

So, what to do. Over the near term, it is likely that the quest for higher yields in Europe will push down Italian debt yields. With existential issues more likely to reappear in the fall as the Italian government's programs start to take shape. I still argue for a short euro position. I believe that the USD will continue to strengthen, while the ECB will be more dovish on rates than is priced into the market. In addition, short euro position would benefit from the reemergence of EMU pressures. One alternative to both shorting Italy and the Euro and is more of a pure EMU existential crisis short is to sell Portuguese government debt. As shown in the graph below, Portuguese yields are largely unchanged, while Italian yields have moved substantially. This is clearly an anomaly even going back to the original crisis of 2013.

Figure 1.



Given current yield differentials, Portugal has more asymmetry in an escalation in a crisis. First, the downside of shorting is less than shorting Italian debt given Italian yields could retrace their selloff. Second, the cost of the short is clearly lower. Third, Portugal is even more vulnerable to the same pressure that Italy pushed up their yields. As shown in the table 1 below. Portuguese government debt to GDP is about the same as Italy but Portugal has substantially more private sector debt, and almost twice amount of external debt. Portugal is even more dependent on ECB buying of their debt than is Italy, e.g. the ECB bought 100% of Portugal's net issuance in 2017. Portuguese banks have an even bigger NPL problem than Italian banks. Finally, Italian households are much wealthier, so they have more downside from leaving the EMU. Put this in perspective, Italian households have the same relative net wealth as the US, while HH in Portugal are about at the same level as those in Greece.

Table 1.

	Non-Financial Debt (% of GDP)					
	Gov	Private	External Debt (% of GDP)	ECB Sov Ownership (% of Outstanding)	Bank NPLs (% of Loans)	HH Wealth (% of DI)
Italy	132	112	128	18	10.80	550
Portugal	126	176	211	33	16.20	400

OECD, Eurostat, ECB

In my next commentary on Europe, I will talk about other implementation strategies.