MORNING BRIEFING
May 30, 2018

The Italian Job

See the collection of the individual charts linked below.

(1) The same Old Normal for Italian politics. (2) Eurosceptics ascending in Italy. (3) How much more can Draghi do to save the euro? (4) ECB likely to postpone monetary normalization till next year. (5) ECB has failed to revive inflation and to stimulate much lending…and now this! (6) TARGET2 payments system shows mounting imbalance between Germany's surplus and PIIGS deficit. (7) Italian crisis flattens US yield curve in a way that might pause the Fed's gradual normalization. (8) Another summertime crisis in Eurozone.

Italy I: Gray Swan. Italy always seems to be in a political crisis. Governments don't last very long there, as the ruling party's coalition tends to splinter rapidly, requiring yet another election and another effort to form a government by the mostly incompatible coalitions. This time, after the March 4 election, the latest popular coalition is dominated by so-called "Eurosceptics," who believe that Italy's problems might be solved by dropping out of the Eurozone.

This development isn't a black swan. Rather, it is more like a gray swan. It doesn't come as a big surprise, yet it wasn't widely expected either. The question is whether this problem will be contained. Yesterday, my Outlook inbox included a bunch of messages from accounts wondering whether the latest political mess in Italy might be the trigger for the next global financial crisis, which could trigger a global credit crunch and recession. The short answer is that I don't think so.

During the various Greek debt crises that started in 2010, there were similar concerns. Yet the problem was contained as the IMF and EU worked out bailout deals with the Greeks. When the ongoing Greek crisis first started, pessimistic pundits predicted that even if Greece didn't cause the next global calamity, Italy certainly could do so if push ever came to shove over that country's messed up financial situation. That didn't happen because the European Central Bank (ECB) bailed out all the PIIGS by providing ultra-easy monetary policy that allowed these highly indebted "peripheral" Eurozone countries to stay afloat as the ECB purchased their dodgy debts. (The PIIGS are Portugal, Ireland, Italy, Greece, and Spain.) Consider the following implications of the latest development:

(1) *ECB stuck in an easing place.* I think it's safe to say that the Italian crisis will force the ECB to postpone any plans for normalizing monetary policy in the near future. After all, it was the bank's president, Mario Draghi, who famously declared in a 7/26/12 speech: "Within our mandate, the ECB is ready to do whatever it takes to preserve the euro. And believe me, it will be enough." That set the stage for a dramatic drop in government bond yields in the Eurozone through mid-2016 (*Fig. 1*).

The yield spread between Italian and German bonds narrowed significantly, as did the spread between Spanish and German bonds (*Fig. 2*). However, on Monday the former spread jumped to 204bps from 162bps the previous Monday (*Fig. 3* and *Fig. 4*). The Spanish-German spread also widened. Nevertheless, the Italian yield remained relatively low at 2.38%, while the Spanish yield was even lower at 1.61%. Contributing to the widening spreads was that the German bond yield fell back down to 0.34%, the lowest since December 18.

(2) *Inflation remains well below target.* Even before the Italian crisis hit, the ECB was stymied from normalizing monetary policy by the latest CPI reading for the Eurozone. It was up only 1.2% y/y through April, and just 0.7% excluding energy, food, alcohol, and tobacco (*Fig. 5*). The ECB's target is 2.0% for inflation. It hit that target during February 2017 mostly as a result of rising energy prices. The core inflation rate has mostly been marking time just south of 1.0% since 2014 despite all the ECB's efforts to stimulate the economy.

(3) *Lending remains weak in PIIGS.* Draghi's ultra-easing monetary policies included a massive QE program, which increased the ECB's balance sheet from €2.0 trillion at the end of 2014 to €4.6 trillion in late May, led by purchases of "securities of Euro Area Residents in euro" (*Fig. 6*). In addition, the ECB's official borrowing rate has been slightly below zero since June 2014.

All that huffing and puffing by Draghi has revived Eurozone lending activity since 2015, but not by a lot (*Fig. 7*). However, the same cannot be said of Italy, where private-sector net lending by MFIs (monetary financial institutions excluding the ECB) has been mostly negative since the second half of 2011, and increasingly so since mid-2017 (*Fig. 8*).

(4) *TARGET2 divergences widening.* The weak link in the Eurozone financial structure may be that despite all of Draghi's efforts to balance the inherent imbalances among the economies of the region, the imbalances are worsening, according to TARGET2 data (*Fig. 9*). TARGET2 is an interbank payment system for the real-time processing of cross-border transfers throughout the EU. ("TARGET," or the Trans-European Automated Real-time Gross Settlement Express Transfer System, was replaced in November 2007 by TARGET2.) The data show that the cross-border transactions within the region were relatively well balanced during the second half of 2008 through the end of 2009. But then the Greek crisis hit in 2010 and threatened to spread to the other PIIGS during 2011. As a result, money poured out of Italy and Spain. It went mostly to Germany.

The imbalances diminished significantly following Draghi's July 2012 speech. But now they are bigger than ever with surpluses totaling €1.3 trillion during March in Germany, Finland, Luxembourg, and Netherlands. The rest of the Eurozone has a net deficit of €1.0 trillion (*Fig. 10*).

Hans-Werner Sinn, president of the Munich Ifo Institute, first warned about the increasing TARGET2 balances in a 2/21/11 article in *Wirtschaftswoche*. He drew attention to the enormous increase in TARGET2 claims held by Germany's Bundesbank, from €5 billion at the end of 2006 to €326 billion at the end of 2010. He also noted that the liabilities of Greece, Ireland, Portugal, and Spain totaled €340 billion at the end of February 2011. He added that in the event that any of these countries should exit the Eurozone and declare insolvency, Germany's liability would amount to 33% of their unpaid balances. Wikipedia reports that before Sinn made them public, the deficits or surpluses in the Eurozone's payments system were usually buried in obscure positions of central bank balance sheets.

(5) *Good for US bonds and the dollar*. The Italian political crisis helps to remind us why the 10-year US Treasury bond yield has continued to trade well below the growth of nominal GDP in the US, despite the deteriorating outlook for the US fiscal deficit. When global investors are spooked and decide that it's time to move from a risk-on to a risk-off strategy, they tend to buy US Treasury bonds, which means that they also have to buy US dollars to do so.

The trade-weighted dollar has appreciated 5% since February 1 (*Fig. 11*). That strength seemed to be fueled by Trump's protectionist threats. Now the strength is likely to be driven by a weaker euro while we all are waiting to see whether the Italian political crisis morphs into a more serious economic crisis.

Meanwhile, the US Treasury bond yield has clearly been globalized rather than normalized. In normal times, it should be trading around the growth rate of nominal GDP, which is about 4.0%-4.5% currently. Instead, it is back below 3.00% because comparable German and Japanese yields are close to zero Fig. 12.

(6) *More gradual Fed?* As Melissa and I noted yesterday, the latest FOMC minutes show that several participants of the FOMC are concerned about the flattening of the yield curve. They noted that it's been a very reliable indicator of recessions when it has inverted in the past.

Until recently, the yield curve has flattened as the Fed raised the federal funds rate more than bond yields rose in response to the Fed's hikes. Now several Fed officials might argue for an even more gradual normalization of US monetary policy because the bond yield is falling in reaction to the Italian crisis.

Italy II: More of the Old Normal. "Italy is not Greece. But not all the differences are encouraging. Its economy is 10-times bigger. Its €2.3tn public debt is seven-times bigger; it is the largest in the eurozone and fourth largest in the world. Italy is too big to fail and may be too big to save," observed a 5/22 *FT* opinion piece. "The question is whether its new government will trigger such a crisis and, if so, what might follow?," posed the article's author Martin Wolf. Indeed, that's a critical question facing the markets right now.

Sandy, Melissa, and I have been writing about the brewing troubles in Italy since last year. Late last year, Matteo Renzi, the former Italian Prime Minister, bet his job on a reform referendum to streamline the country's legislative bodies. He lost both, and the country spiraled into political turmoil once again. Eurosceptic leaders were waiting in the wings for Renzi's Democratic Party (PD) to weaken, as we previously discussed, and it did.

In the March 4 general elections, the anti-establishment Five Star Movement won the largest number of votes, delivering a blow to the governing center-left coalition. Voters were electing the 630 members of the Chamber of Deputies and the 315 elective members of the Senate of the Republic. The League, a rightist anti-immigration party, scored a plurality of seats in the Chamber and the Senate. No group won a majority.

More than two months after the Italians voted, the country's Parliament continues to hang in the balance. The Five Star Movement was reportedly on the verge of forming a coalition with the League to govern the country. Over the weekend, however, that effort has been blocked by the country's president. We are not hopeful that it will all be sorted out anytime soon.

If a coalition is successfully formed by the anti-establishment parties, Italy could be on the brink of leaving the euro. The political populists might not even take their Euroscepticism that far. But at a minimum, the new leadership is sure to challenge the status quo in Brussels. Either way, the latest developments are not too promising in terms of political continuity or stability for the Italian government, which is not too promising for European investors, at least in the foreseeable future. Consider the following:

(1) *Populist coalition blocked*. Over the weekend, the country's President, Sergio Mattarella, blocked the coalition government that Italy's two leading populist parties were attempting to form. The anti-establishment Five Star Movement and the right-wing League, which had won significant electoral gains during Italy's March 4 election, failed to gain approval for a slate of ministers in the Italian

government.

For finance minister, the populist parties backed Paolo Savona, an 81-year-old Eurosceptic economist and a former Bank of Italy official who has harshly criticized the euro. But the Italian president rejected the choice. Mattarella has the constitutional power to approve or reject cabinet choices.

The 5/25 *FT* reported that Mattarella is concerned that Eurosceptic leaders could damage Italy's credibility in both the EU and the markets. We previously wrote that in agreeing to generous tax cuts and big increases to entitlement programs, the two groups appear to be putting Italy on a collision course with the budgetary constraints of the EU. Further, the President said that he feared Savona as finance minister could endanger Italy's membership in the euro, according to a 5/28 *WSJ* article.

(2) *Ministers in waiting*. Meantime, Mattarella asked Carlo Cottarelli, who formerly headed the IMF's fiscal affairs department and is pro-euro, to try to form a new government as prime minister-designate, reported the *WSJ* article. It noted: "The move stirred accusations that the president had usurped the popular will expressed in March parliamentary elections." Taken together, the Five Star Movement and the League won about half of the votes.

Even if Cottarelli is "able to form a new government, the prime minister-designate is unlikely to win a vote of confidence in parliament. Instead, he will likely lead a caretaker government only until fresh elections are called, which could occur in September." On Sunday, the head of the League said that it "won't be an election," but a "referendum" between Italy and the European Union. In his own words: "It will be a referendum between Italy and those on the outside who want us to be a servile, enslaved nation on our knees."

Last Monday, the populist party leaders settled on Giuseppe Conte, a weak technocrat, as a compromise candidate to lead the populist parties to form a government. Conte was supposed to propose a cabinet to Mattatella this past Friday to be formalized over this past weekend. Instead, an informal meeting was held with the Italian President, and no list of ministers was proposed. On Sunday, Conte gave up his mandate as Cottarelli usurped the caretaker designation.

Yesterday, Cottarelli was expected to present his own list of ministers to Mattarella. But according to an article in yesterday's *FT*, the designee asked for one more day to finalize a cabinet. That could suggest that there was trouble brewing with the launch of the newly appointed technocratic administration.

(3) *Moody fiscal atmosphere.* It didn't help markets that Bloomberg reported on Friday that Moody's is considering cutting Italy's rating. The debt-rating agency is concerned about the proposed Eurosceptic government's fiscal plans and the possible reversal of past austerity measures. Moody's said in a statement that coalition parties' proposals would lead to a weaker fiscal position going forward. Italy's public debt amounted to €2.3 trillion at the end of March, according to Italy's central bank. Currently, Italy is rated Baa2, the second-lowest investment-grade rating.

On Monday, prices on Italian bank bonds plummeted as fears of political turmoil weighed heavily on the country's lenders. Yesterday's *FT* observed: "Riskier forms of bank debt that count towards financial institutions' capital ratios have seen the sharpest sell-off." Yields on the debt of the world's oldest bank, Monte dei Paschi di Siena, and Italy's largest bank, UniCredit, surged on Tuesday.

In response, Ignazio Visco, the governor of the Bank of Italy, warned that the country was close to losing the "asset of trust," reported yesterday's *MarketWatch*. Visco's comments were a "rare intervention" on behalf of the Italian central bank into the country's political crisis. In an intentional blow at the two leading populist parties, Visco implied that any new government must respect the EU treaties for debt and deficit limits.

Some speculate that a reprieve to the turmoil in the European bond market might come if the ECB changes its tapering plans. In response to the Italian drama, the bank could decide not to reduce its bond-buying program in September as was previously expected. It's important to realize, however, that the ECB's rules allow it to buy government bonds only as long as the country has an investment-grade credit rating.

(4) *Crisis for the euro?* Adding to the uncertainty across the pond, both parties have openly considered pulling Italy from the euro, regarding it as a failed project. Société Générale's Kit Juckes told the *WSJ* that this is not a liquidity issue. It is about a country where the populist parties in charge might not be that keen on being in the euro.

By the way, "The Italian Job" is a 2003 heist film starring Mark Wahlberg and Charlize Theron. It is about a team of thieves who plan to steal gold from a former associate who double-crossed them. It is an American remake of the 1969 British film of the same name.

CALENDARS

US. Wed: ADP Employment 186k, Real GDP & PCE 2.2%/1.2%, GDP Price Index 2.0%, Corporate Profits, Advance Merchandise Trade Balance -$71.0b, MBA Mortgage Applications, Beige Book, Fed to Issue Proposal to Modify Volcker Rule. **Thurs:** Personal Income & Consumption 0.3%/0.3%, Headline & Core PCED 2.0%/1.8% y/y, Jobless Claims 224k, Weekly Consumer Comfort Index, Pending Home Sales 0.7%, Chicago PMI 58.1, Challenger Job-Cut Report, EIA Natural Gas Report, EIA Petroleum Status Report, Bostic. (*Wall Street Journal* estimates)

Global. Wed: Germany Unemployment Change & Unemployment Rate -10k/5.3%, Germany Retail Sales 0.5%m/m/1.7%y/y, Germany CPI 0.3%/1.9%, France GDP 0.3%q/q/2.1%y/y, UK Gfk Consumer Confidence -8, Japan Industrial Production 1.4%m/m/3.6%y/y, Japan Consumer Confidence 43.9, BOC Rate Decision 1.25%, OECD Forecasts, Kuroda. **Thurs:** Eurozone CPI Flash Estimate 1.6%/1.1% y/y, Eurozone Unemployment Rate 8.4%, Canada GDP 1.9% (saar), Japan Housing Starts 900k, China M-PMI & NM-PMI 51.4/54.8. (DailyFX estimates)

STRATEGY INDICATORS

S&P 500/400/600 Forward Earnings (*link*): Forward earnings for these three indexes took a break last week from rising to record highs. LargeCap's forward earnings was unchanged w/w after rising in 42 of the prior 43 weeks, MidCap's dropped for the first time in 39 weeks to 0.4% below its record high, and SmallCap's slipped 0.6% w/w from its record high after rising in 36 of the past 39 weeks. Earnings momentum remains healthy, as the yearly change in forward earnings is up from six-year lows in early 2016 and should remain strong in 2018. In the latest week, the rate of change in LargeCap's forward earnings fell to 21.3% y/y from a seven-year high of 21.7% y/y, which compares to a six-year low of -1.8% in October 2015; MidCap's dropped to 22.8% from 23.6%, which compares to a seven-year high of 24.0% in mid-March and a six-year low of -1.3% in December 2015; and SmallCap's slipped to 29.1% from a seven-year high of 30.2%, which compares to a six-year low of 0.3% in December 2015. Here are the latest consensus earnings growth rates for 2018 and 2019: LargeCap 22.0% and 9.6%, MidCap 20.3% and 12.3%, and SmallCap 24.9% and 16.3%.

S&P 500/400/600 Valuation (*link*): Last week saw forward P/E ratios edge higher for these three indexes, and put a bit more breathing room above their recent post-election lows. LargeCap's weekly forward P/E rose to 16.3 from 16.2 in the prior week, but is down from 18.6 on January 26—the highest since May 2002. These recent levels are up from a post-election low of 16.0 in late March and the post-Lehman-meltdown P/E of 9.3 in October 2008, but remain well below the tech-bubble record high of 25.7 in July 1999. MidCap's forward P/E edged up w/w to 16.6 from 16.5, which is little improved from its 25-month low of 16.1 in early April. MidCap's P/E is down from a 15-year high of 19.2 in February 2017 and compares to the record high of 20.6 in January 2002; however, it is up from a three-year low of 15.0 in January 2016. MidCap's P/E had mostly been at or below LargeCap's P/E from August to March for the first time since 2009. SmallCap's P/E increased to 17.9 from 17.7, which compares to a post-election low of 17.0 in mid-March. That's well below its 51-week high of 20.2 in December (which wasn't much below the 15-year high of 20.5 in December 2016, when Energy's earnings were depressed), but is comfortably above its three-year low of 15.5 in February 2016. Looking at daily forward price/sales (P/S) ratios, they were steady w/w for all three indexes at levels well below January highs: LargeCap's P/S of 2.01 is down from a record high of 2.19 on January 26; MidCap's 1.31 compares to its record high of 1.40, also on January 26; and SmallCap's 1.01 is down from 1.05 then, which compares to its record high of 1.17 in November 2013, when Energy revenues were depressed.

S&P 500 Sectors Quarterly Earnings Outlook (*link*): With just 3% of the Q1 earnings reporting season remaining, analysts have become less busy adjusting their forecasts. The S&P 500's Q2-2018 EPS forecast dropped 10 cents w/w to $39.06. That's up 0.2% since the end of Q1, 7.5% ytd, and 8.2% since the passage of the TCJA. The $39.06 estimate represents a forecasted pro forma earnings gain for Q2-2018 of 20.0%, up from 19.8% a week earlier. That compares to Q1-2018's blended 26.3% (which is the strongest since Q4-2010), Q4-2017's 14.8%, Q3-2017's 8.5%, Q2-2017's 12.3%, and Q1-2017's 15.3%. Since the end of Q1, Q2-2018 estimates are higher for six sectors and down for five. Energy's Q2 forecast has risen 10.5%, followed by the forecasts for Real Estate (up 1.7%), Health Care (1.6), Materials (1.3), Tech (0.7), and Utilities (0.3). Consumer Staples is the biggest decliner, with its Q2-2018 forecast down 4.3% since the end of Q1, followed by Telecom (-1.6), Consumer Discretionary (-1.6), Financials (-1.5), and Industrials (-1.5). The S&P 500's Q2-2018 forecasted earnings gain of 20.0% y/y would be its eighth straight gain after four declines. Ten of the 11 sectors are expected to record positive y/y earnings growth in Q2-2018—with nine rising at a double- or triple-digit percentage rate—and four are expected to beat the S&P 500's forecasted y/y earnings gain of 20.0%. That compares to all 11 sectors rising y/y during Q1-2018, when ten rose at a double-digit pace and four outpaced the S&P 500. Analysts expect Energy to report another large profit jump in Q2 relative to very low earnings a year ago, with the pace improving from Q1. The latest forecasted Q2-2018 earnings growth rates vs their blended Q1-2018 growth rates: Energy (132.4% in Q2-2018 vs 85.8% in Q1-2018), Materials (29.3, 30.0), Tech (24.0, 35.9), Financials (21.4, 31.1), S&P 500 (20.0, 26.3), Consumer Discretionary (15.8, 19.3), Industrials (15.1, 24.7), Telecom (13.1, 14.8), Consumer Staples (10.1, 12.8), Health Care (11.3, 16.2), Real Estate (2.3, 3.1), and Utilities (-0.4, 16.9). On an ex-Energy basis, analysts expect S&P 500 earnings to rise 16.7% y/y in Q2, down from a blended 24.4% in Q1; compares to 12.7% in Q4-2017 and 6.1% in Q3-2017 (which was the slowest growth since ex-Energy earnings rose just 2.2% in Q2-2016).

S&P 500 Q1 Earnings Season Monitor (*link*): With 97% of S&P 500 companies finished reporting earnings and revenues for Q1-2018, the earnings metrics are stronger compared to the same point during the Q4 season and the best in seven years, but revenues are a tad weaker than during Q4. Of the 485 companies in the S&P 500 that have reported, 79% exceeded industry analysts' earnings estimates by an average of 7.0%; they have averaged a y/y earnings gain of 24.6%. At the same point during the Q4-2017 reporting period, a lower percentage of companies (75%) in the S&P 500 had beaten consensus earnings estimates by a lower 5.0%, and earnings were up a lower 16.7% y/y. On the revenue side, 76% beat sales estimates so far, with results coming in 1.1% above forecast and 8.1% higher than a year earlier. At this point in the Q4 season, a similar 76% had exceeded revenue forecasts by a higher 1.2%, and sales rose a tad higher 8.2% y/y. Q1 earnings results are higher y/y for

86% of companies vs a lower 78% at the same point in Q4, and Q1 revenues are higher y/y for 87% vs 88% a quarter ago. These figures won't change much as the remaining 15 companies release results; it looks like Q1-2018 will mark the seventh straight quarter of positive y/y earnings growth and the strongest since Q4-2010 in part due to lower tax rates.

US ECONOMIC INDICATORS

Consumer Confidence (*link*): "Overall, confidence levels remain at historically strong levels and should continue to support solid consumer spending in the near-term," said Lynn Franco, director of economic indicators at the Conference Board. Consumer confidence climbed to 128.0 in May, following a downwardly revised 125.6 in April (from 128.7), moving back near February's 130.0—which was the highest reading since November 2000. Both the present situation (to 161.6 from 157.5) and expectations (105.6 from 104.3) components moved higher, with the former at a 17-year high; the latter remained volatile around its cyclical high. The current jobs outlook was mixed in May, but remained very favorable: Jobs plentiful (42.4% from 38.2%) jumped to its highest percentage since March 2001, while jobs hard to get (15.8 from 15.5) rose slightly, continuing to hover close to February's 15.1%—which was the lowest percentage since July 2001. The six-month jobs outlook showed the percentage expecting more jobs (19.7%) continued to surpass those expecting fewer jobs (13.9), with the spread widening to 5.8ppts this month, remaining below its cyclical peak of 11.1ppts recorded just over a year ago.

Regional M-PMIs (*link*): Five Fed districts have now reported on manufacturing activity for May—New York, Philadelphia, Richmond, Kansas City, and Dallas—and they show growth was exceptionally strong in the Philly, Kansas City, and Dallas regions. We average the composite, orders, and employment measures as data become available. The composite index accelerated from 16.8 to 25.3 this month—which virtually matched its record high of 25.7 posted in July 2004. The Philadelphia (to 34.4 from 23.2) region expanded at the fastest pace in a year, while Kansas City (29 from 26) manufacturers posted their best month on record; activity in the Dallas (26.8 from 21.8) region accelerated back toward its rate of 38.4 in February—which was the fastest since the end of 2004. Meanwhile, activity in the New York (20.1 from 15.8) and Richmond (16 from -3) regions also increased at a robust clip—the latter from a negative reading last month. The new orders gauge (27.7 from 16.7) showed orders accelerated at their fastest pace in the history of this series (going back to June 2004), led by the Philly (40.6 from 18.4) region, which expanded at its fastest pace in 45 years, and Kansas City's (38 from 37), which recorded its best performance since the end of 2003. Meanwhile, orders in the New York (16.0 from 9.0) and Richmond (16 from -9) regions also picked up—with Richmond's moving from contraction to expansion; the Dallas measure (27.7 from 27.9) held steady around April's robust rate. The employment gauge (20.9 from 17.8) showed jobs growth accelerated at a record rate this month, as manufacturers in the Philly (30.2 from 27.1), Kansas City (24 from 26), and Dallas (23.4 from 17.8) regions continued to hire at a vigorous rate, while Richmond's (18 from 12) rate was more modest; New York (8.7 from 6.0) factories added to payrolls at less than half the pace at the end of last year.

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