Macro Wrap-Up: A Five Star League of Their Own

June 1, 2018

Markets can seem silly. Italy has had 65 government changes since World War II, [1] yet somehow markets can still find a way to be shocked by politics there. Italian elections in March ended with a strong showing by two anti-establishment parties, but without a clear majority for any coalition. For a while it looked like the populist Five Star Movement might form a government with the center left PD party, but senior members of the PD balked at an agreement. Together the parties had more than half of the votes, so it would be impossible to put a majority government together without at least one of them. [2] After a bit more negotiation, the Five Star party came to an agreement with the League, another ascendant populist party. This alliance surprised a lot of political analysts because of differing views on taxes, social spending and many other issues. However, both parties are suspiscious of the EU and its institutions, so many analysts considered this unlikely coalition to be the most problematic outcome for markets.

The real trouble in markets began when the two parties tried to form a government. In Italy, the President, whose role is otherwise mostly ceremonial, must appoint the Prime Minister and form the government. The current President, hoary veteran Sergio Mattarella, objected to the League and Five Star’s initial choice for Finance Minister on the grounds that he “would lead Italy to exit the euro.” [3] [4] This led to the appointment of an unaffiliated economist to form a caretaker technocratic government, but he was unable to do so without the support of either party. The President was left with little choice but to allow for a Five Star-League government with their original choice for Prime Minister, law professor Giuseppe Conte. It did not result in a Europhile cabinet: the new Finance Minister Giovanni Tria has expressed some doubts about the EU.

Concerns about the possibility of a new election (which did not materialize) or just understandable general confusion led to poor performance in Italian assets. The chart of Italian bonds on Monday and Tuesday resembles the cliffs on the Amalfi Coast. International investors were worried about two related outcomes. The first is that Italy requests a write-down from holders of its bonds. [5] Such a move would be difficult because many Italian households keep their savings in Italian bonds, but that doesn’t mean default is impossible. And there is a lot of exposure out there. After the Greek crisis, European banks reduced some of their cross border exposure to European sovereign bonds, but at the same time the ECB has bought a lot of Italian bonds in its QE program. [6] Second, there is concern that Italy could leave the euro, which could lead to a breakup of the common currency and some real economic and market chaos. However, giving the EU the boot would be difficult to carry out because it would require a change to the constitution. Italian opinion polls show mixed feelings toward the euro so it isn’t clear how popular such a move would be or that either party really wants to leave the EU. [7]

The situation has been compared to Greece in 2011-2012, but there are some major differences. Italy does not have as high a debt to GDP ratio as Greece did, and it funds more of its debt domestically so it has a little less exposure to outflows. On the other hand, Italy is much larger than Greece in population and GDP, so there is a lot more at stake if something does go wrong. There is also a chance that, unlike Greece, Italy may have the ability to drive major changes to the EU. Both Five Star’s Luigi Di Maio and the League’s Matteo Salvini say that Italy should renegotiate its relationship with Europe. Italy may have enough influence to get some easing of the EU’s strict budget constraints. [8] The new coalition between the League and Five Star will probably promote stimulative economic policies at the expense of budget discipline. The League wants lower taxes and Five Star wants more social spending. The compromise could be for both. [9] Negotiations with other EU members such as Germany and France could be messy.

Perhaps the strangest part about this brouhaha is that the Italian economy is actually doing okay. Growth has been positive, and unemployment is down more than 2.0% from its peak in late 2014. [10] Italy’s debt levels have been fairly stable as a percentage of GDP, and low interest rates have reduced service costs a little. [11] The economic problems are structural not cyclical – even though the economy has grown a bit in the past couple years, Italy’s long-term national growth rate has been close to zero. [12] The immediacy of the problems is caused by the politics. In 2011 and 2012, a lot of articles claimed that the markets were forcing action from the politicians. In this case it’s the opposite.

Still, markets calmed down on Wednesday after Italy held a fairly successful bond auction. [13] Though the five-year issue priced a little better than the ten-year, demand for the tenors was good enough to reassure markets around the world. [14] This also led to some retracement of safe haven bids to the Japanese yen, the U.S. dollar and other assets that don’t have a lot of exposure to Italy. German bunds have also acted as a safe haven, as Germany is considered the most fiscally sound of the large euro countries. Investors may be buying bunds as a sneaky way to get German marks in the event of a euro break-up. This is puzzling because Germany may turn out to have a lot exposure to Italy both via the ECB and the private sector. In a compromise outcome where budget constraints are renegotiated, there will probably be higher inflation and interest rates around Europe, which could also be bad for bunds. But all of that is a long way
off. In the meantime, markets will probably forget and remember Italy several times before we get any certainty. Ciao.

What We Are Watching

U.K. Services PMI (Tuesday) U.K. growth has slowed down in the nearly two years since the Brexit referendum. [15] but the economy has not fallen into the recession expected by some economists at the time. One reason for continued positive growth has been strong performance in the U.K. manufacturing sector, which saw its competitiveness increase significantly due to a weaker pound post-referendum. In recent months, however, manufacturing indicators in the U.K. appear to have lost momentum, suggesting that the country’s (much larger) service sector may need to contribute more to growth moving forward. The Services PMI published by Markit/CIPS, likely the best gauge of developments in the sector, has weakened somewhat since the start of the year, but remains at levels consistent with expansion. [16] If the Services PMI weakens from here, it might indicate a risk that GDP growth will fall to undesirably weak levels.

Turkey Central Bank Meeting (Thursday) The Turkish lira depreciated sharply in the first few weeks of May, losing over 10% of its value against the U.S. dollar. [17] Several factors were weighing on the currency: stubbornly high inflation, a widening current account deficit, rising crude prices (Turkey is a net importer of oil), and domestic political uncertainty in the run-up to elections in June. Faced with unwelcome currency depreciation, emerging market central banks will often raise interest rates. However, it was unclear whether the Turkish central bank (the TCMB) would be able to do so in the face of vocal opposition from President Erdogan, who recently declared that “interest rates are the mother and father of all evil.” [18] Last week, with the lira trading at a record low against the dollar, the TCMB announced an extraordinary rate hike, moving one of its policy rates to 16.5% from 13.5%. The lira strengthened in the aftermath of this move, and rallied further a few days later after the central bank followed up with a simplification of its interest rate framework. Markets will be watching this week’s regularly scheduled TCMB meeting to see if the central bank decides to take additional steps to bolster confidence in the lira.

Canada Employment Report (Friday) The most recent Bank of Canada (BoC) statement delivered a hawkish message, declaring that “developments since April further reinforce Governing Council’s view that higher interest rates will be warranted to keep inflation near target.” [19] Economist forecasts and market pricing now suggest high odds of a rate hike at the central bank’s next meeting in July. However, if high profile data releases such as the monthly employment report fall short of consensus forecasts, market participants could grow less confident that the central bank will proceed with planned rate hikes.

[1] “Why do governments in Italy change so often?” Euronews, 12/13/16.

[2] We had to run millions of simulations to be sure.


[4] The choice was the equally hoary Paolo Savona who had said that Italy should consider leaving the euro as a last resort if it can’t get a better deal with Europe. For some reason, most articles about Savona can’t mention him without using the word octogenarian. Ironically it looks like he will be the minister for EU affairs.


[6] The ECB’s QE BTPs are held by the Bank of Italy, but the BOI also holds a large Target 2 liability with the ECB which it could walk away from in the event of default.


[8] Large debtors often have more power in negotiations than their creditors. Italy may find some sympathy from Eastern European EU countries as well.

[9] Around the middle of May, the Five Star Movement and the League published a shared policy platform. Within the 58-page document, the two parties proposed introducing a basic income of 780EUR per month for those at risk of poverty, two income tax brackets of 15% and 20%

[10] Italy’s real GDP last printed at 1.4% YoY for Q1 2018. Italy’s unemployment rate has fallen from 13.0% as of Q4 2014 to 11.0% as of Q4 2017. Source: ISTAT.

[11] The debt service costs are still high because the stock of debt is so big. That is why it is so hard for Italy to bring down its debt/GDP level despite running primary budget surpluses.

[12] There is also a large regional disparity in growth rates in Italy.


[14] A third tenor, the Italian two-year, was not issued. It was the subject of less talk which sort of makes it the Jose Carreras of issuances. Maybe Spanish bonds also fit the analogy as their yields remain significantly lower than Italy’s despite ongoing political uncertainty in Madrid.
Office of National Statistics (ONS) data showed real GDP growth of 1.8% YoY in 2Q16 (the referendum occurred near the end of that quarter), slowing to just 1.2% YoY in 1Q18.

Readings on the Services PMI has averaged 53 in the first four months of 2018, down from an average of 54.2 in 2017.

Pricing data from Bloomberg.

"Turkey's Erdogan calls interest rates "mother of all evil"; lira slides," Reuters, 5/22/18.

Bank of Canada maintains overnight rate target at 1¼ per cent, 5/30/18.