The New Eurozone Crisis

- It is a matter of time before Italy triggers another eurozone crisis. It is stuck in a debt trap.
- Italy has done all the right things from an orthodox austerity perspective, reining in government expenditures, and running a primary budget surplus.
- But the interest bill on a 130% public debt mountain has meant that it runs small overall deficits.
- Real GDP per capita has remained virtually unchanged since 2001 and total factor productivity has been abysmal. Microeconomic reforms rather than notional competitiveness gains are needed.
- Absent a productivity jump, the missing ingredient is the inability to use an active fiscal policy, which requires a eurozone central Treasury function proposed by France, but resisted by Germany.
- It will need a crisis to get one in place, which represents an existential threat to the eurozone.
- Short a basket of Italian financial stocks and Euro High Yield against a long basket of Gold, US Treasuries, and the US$ (DXY).

Italy: Don’t miss the opportunity of a good crisis

“Imagine a world without institutions. It is a world where borders between countries seem to have dissolved, leaving a single endless landscape in which people travel in search of communities which no longer exist. There are no governments anymore, on a national scale or even a local one. There are no schools or universities, no libraries or archives, no access to information whatsoever……There are no banks, but that is no great hardship because money no longer has any worth. There are no shops because no one has anything to sell.”

No, the above quotation is not a description of a world in the aftermath of a nuclear holocaust, but of Europe in 1945 taken from a book by Keith Lowe entitled “Savage Continent”. It provides a stark insight into the conditions that sparked the dream of a single European political entity. It also gives a clue as to why the euro system has lurched from crisis to crisis, since its establishment in 1999. Political divisions caused the horrors of 1933-45 and the same schisms are now threatening the entire euro project. An attempt at economic convergence has erroneously preceded political integration and with the wrong convergence criteria to boot.
The road to populism

Granted, markets believe the immediate problems have been surmounted. Italian and Greek 10-year yields have both dropped sharply over the past few weeks as Italian politicians towed the orthodox line - at least verbally - and Greece reached agreement on a debt restructuring package. Structurally, there have also been competitiveness improvements in the eurozone periphery, as unit labor costs were squeezed in Spain and Portugal. Indeed, our own measure of eurozone convergence, which integrates 8 different convergence metrics, highlights that, all else being equal, this should be a major positive for markets (Chart 1).

Chart 1: ClearMacro’s convergence gauge highlights structural progress by the periphery

Unfortunately, all else is not equal. Our “break up gauge” signal captures both the current political risk climate and economic outlook in one measure. But further unrest in Italy could tip the gauge into deeper negative territory and when a crisis erupts the risk premium that would be applied to the Italian convergence data would need to rise.

Chart 2: Break-up fears are likely to re-emerge on the back of political trends and a weakening economy.

Italy represents the biggest problem that the system has faced to date and it is one that will not disappear in a hurry. Falls in nominal incomes forced upon countries by their exchange rate arrangements almost always result in severe political fallout. Hong Kong’s adjustment in the late 1990s is the exception which proves the rule, as it had enjoyed rapid growth in the run-up to the Asian crisis and quickly returned to growth after it.

By contrast, Italy’s real GDP per capita is almost unchanged from 2001 with the inevitable growth in populism, and the recent stagnation in activity will only add to the disquiet (charts 3 and 4). The result should surprise no one. Nazism did not really take hold after the hyperinflation policies of the early 1920s. It took the deflationary policies of Chancellor Bruning in the late 1920s to pave the way for the Nazi victory in the 1933 election.
Neither do they address how politically resilient and stable countries will be in the face of a needed economic adjustment (Chart 5).

Chart 5: A tentative jump in Italian political confidence won't be maintained

The only real convergence which will bring harmony to Europe is if the southern countries play beta catch-up with northern countries GDP per capita levels via higher growth rates. Long-term growth rates, though, are driven by total factor productivity- with the south lagging severely. This has been compounded by the absence of a central eurozone Treasury function, which has resulted in sometimes quite large bond premiums over bunds. In Italy’s case, this has meant that while the primary fiscal accounts have been in a surplus of 1.6% of GDP, this becomes a 1.6% shortfall once interest on Italy’s 130% of public debt to GDP is accounted for.

Italy is a different case

The first casualties of these divergences were Portugal and Greece. The interconnectivity of the financial system created strains throughout the eurozone in 2010/11- but it was relatively easy to smother the economic consequences.
Greece accounted for barely 2% of eurozone GDP as did Portugal. But Italy is a different kettle of fish, accounting for over 17% of the zone’s total income.

The potential financial repercussions of an Italian debt default are of a different magnitude as well, which makes private sector haircuts or debt forgiveness inconceivable. Italy's public debt amounts to 2.3 trillion euros compared with a mere 323 billion for Greece. Moreover, this does not include the bad debts in the banking system amounting to another 323 billion euros. Monetizing the debt would not only meet fierce German resistance, but also potentially send the euro into a tailspin, even if it did eventually go ahead. Notwithstanding likely German resistance though, that won’t stop periodic market speculation and a weakening euro.

**It gets worse**

Imagining an easy way out of this for Italy under current euro strictures is not easy. The austerity of the past two decades has resulted in a set of learned behaviors subconsciously built on austerity. The typical employee in their late 30’s has known nothing else other than economic stagnation and are unlikely to suddenly start spending anytime soon. A rise in the personal savings ratio - reinforced by the failure of corporations to find an outlet for their net savings in a low growth environment has in turn led to persistent current account surpluses.

Moreover, in comparison, to other troubled eurozone economies the problems are only getting worse.

In Spain, the current NPLs of the banking sector, for instance, have been falling and currently amount to below 5% of GDP - less than half the ratio in Italy. The Bank of Italy gave the banks a break, allowing their problem loans, particularly of small and medium sized businesses, to fester. The Spanish reform which really made a difference, though, was the early and aggressive restructuring of the labor market which has remained largely untouched in Italy. It is small wonder then that its 10-year Italian bond yield exceeds nominal GDP growth.

**How will it end?**

It won’t be a divergence in the convergence criteria that signals the next crisis. Unless the Italians decide to withdraw from the euro it is difficult to see how price levels can do anything other than fall. It will inevitably be politics and more than likely a banking casualty.

To date, the eurozone has avoided a crisis because global growth has been perky, and the ECB has been an active buyer of government and corporate debt in the secondary market. This will likely stave off any major crisis before QE ends in December. But beyond then, all bets are off, particularly if growth slows. History shows that like a water egress finding the weakest point, the vulnerable are targeted during risk off phases. And, the lessons of 2010/11, or indeed the Asian crisis in 1997/8, is that when systems are geared, contagion normally takes over. A fallout in Italy will almost certainly spell trouble for Spanish and French debt.
We implement an equal weight long/short basket, where we go short Italian financial stocks and EUR High Yield. Our longs are allocated to Gold, US Treasuries, and the $. We estimate that the risk of Eurozone crisis would be fully priced by the market on a sell-off equivalent to 50% of the previous move between 2009-12, and benchmark it against a “fully undiscounted” level just prior to the current volatility at an index level of 100.

**Implementing the Theme**

We reviewed 3 options for implementing the eurozone crisis theme. Each focused on a different asset class and with the selection loosely based on the biggest winners/losers of the last major break-up scare, between November 2009 and January 2012, and assumed a 50% repetition of these moves. We then compared the projected total return of each basket over the next 18 months, should our scenario materialise, to its risk, and looked at the ratio of return to the likely basket loss if the theme did not play out.

**Bottom line:** We go with the multi-asset option as it has a better return to risk profile. We tend to favor diversified asset class plays in our theme baskets, and while the short PIGS debt trade was the big winner of the last crisis – as we highlight above, there’s no guarantee it will repeat second time around.
ClearMacro is an independent WealthTECH solution empowering smarter investment decisions.

Imagine... A centralised, modular platform generating forward-looking, global, multi-asset investment insight to power investment decisions across short, medium and long term investment horizons. Integrating systematic and thematic investment frameworks using a global macro screening capability. Your portfolio running LIVE - with profitable opportunities and risks highlighted.

This is ...ClearENGINE™‘... ‘Next Generation’ Investment Framework.

“I wished to be able to answer two simple questions - what am I missing and what does it mean to me? I am delighted to say that we can now not only answer these questions with our portfolio running within the ClearENGINE Global Investment Framework but apply this intelligence LIVE to optimise our performance- CIO/Head of Multi-Asset : Inst. Asset Manager - London UK.

Our senior team harnesses decades of experience gained across the asset management and investment strategy industries with the very best expertise in data science. To discuss how ClearMacro can add value to your investment decisions, please call +44 (0) 203 972 6680 or simply email Head of Client Relations, chris.sandfield@clearmacro.com and we will be delighted to get back in touch.