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TRENDMACRO LIVE!

On Sunday's Italian Referendum, and the November Jobs Report

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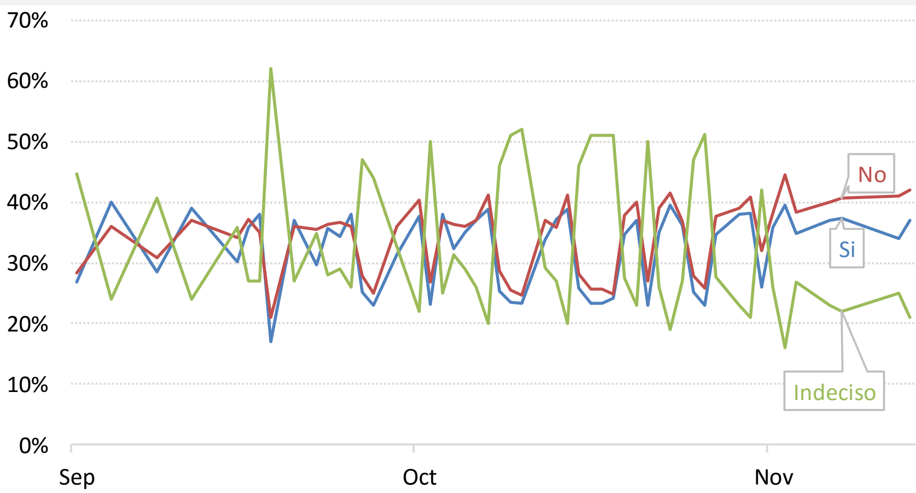
Donald Luskin

Markets are already priced for "No." But "Si" could be another pro-growth electoral surprise.

FIRST, THE REFERENDUM *Brexit turned out not to be an existential event* (see "Brexit: Who Won, Who Lost, What's Next?" July 11, 2016) – *and we don't think Sunday's referendum to amend the Italian constitution will be either.*

- The referendum would change the balance of legislative power in subtle ways that most citizens probably don't really understand. It is not at all the clear-cut and passion-driving matter that the UK referendum on European Union membership was, yet in a year of such political upheavals, comparisons are irresistible.
- Prime Minister Matteo Renzi has indicated that he would resign if the referendum is not passed, so its importance to markets is for the continuity of the present government. It is feared that Renzi's resignation, and a subsequent snap election, would interfere with plans to recapitalize Italy's troubled banks – potentially leading to global systemic risk (see "Brexit Panic: It's The Italian Banks, Stupid" June 29, 2016) – or open the door to a government of the populist Five Star Movement, which opposes the euro currency.
- As with Brexit, "No" is ahead in the polls (please see the chart below). But there is large undecided bloc. And if we have learned

Public opinion polling for Italian constitutional referendum



Source: Wikipedia, TrendMacro calculations

Update to strategic view

EUROPE MACRO, EUROPE BONDS, FX, US MACRO, US FED: Polls show "No" ahead in Sunday's Italian referendum, which would potentially cause Renzi's government to fall, leave Italy's troubled banks without restructuring, and open the door to the anti-euro populist Five Star Movement. Based on the perfect recent record of polls to fail to predict "outsider" or pro-growth elections world-wide, we're inclined to think that "Si" will be the surprise winner. A "No" vote is already largely impounded in markets, so we wouldn't expect much effect. "Si" would cause Italian yields to fall, and the euro to rally. This morning's jobs report, with a drop in average hourly earning showing absolutely no "wage pressure," gives the Fed no cause to posture more aggressively after the inevitable hike at the December meeting.

[Strategy dashboard]

anything this year, it is that polls seem to always be wrong, especially when there is a battle between "the establishment" and "outsiders." *Polls always show the outsiders will lose, but then they always win. The problem on Sunday is telling whether "No" or "Si" is the outsider position. We are leaning to thinking it is "Si." This is, after all, a referendum for change – putting even Renzi's populist Five Star opponents in the odd position of defending the status quo alongside deeply establishment figures such as former prime minister Mario Monti.*

- This would seem to be Renzi's explicit strategy, saying in a recent Facebook session, "For the first time, you citizens can change the rules of politics. You can cut the number of politicians and how much they cost."
- To be sure, Barack Obama has endorsed "Si" – which proved to be a kiss of death for the "Remain" vote in the Brexit referendum.
- There's another way to look at this. Perhaps the correct axis of analysis isn't "establishment" versus "outsider," but rather "anti-growth" versus "pro-growth." The polls completely failed to predict the strong vote for Spain's incumbent prime minister Mariano Rajoy in June (see "Post-Brexit Europe Passes Its First Test" June 27, 2016), or the surprise win last weekend by François Fillon in France's presidential primary. Both men are strongly "establishment" figures. But both unashamedly advocate pro-growth reform of sclerotic labor and product markets (Fillon even identifies Thatcherite).
- Renzi's referendum has has no specific economic content. But he has positioned it as enabling his government to enact pro-growth economic reforms that have been blocked by Italy's chaotic and sclerotic legislature.
- Even if "No" prevails, it's not certain that Renzi will actually resign, especially if it's a close call. And if he does resign, it's not certain the Parliament would accept his resignation. If it does, he could stand for re-election, and it's not certain that he would not win. And if he loses, it's not certain that Five Star would win. If it does win, it would likely proceed with a merely advisory referendum on Italy's leaving the euro currency, but it is not certain that it would pass, or what effect it could have even if it did.
- As for the banks, during a period of uncertainty, there are several safety valves through which the Italian government could intervene to maintain order, which could be implemented by Finance Minister Pier Carlo Padoan, who would likely act as interim prime minister (again, see "Brexit: Who Won, Who Lost, What's Next?"). And in the post-Brexit European world, Italy will have considerable

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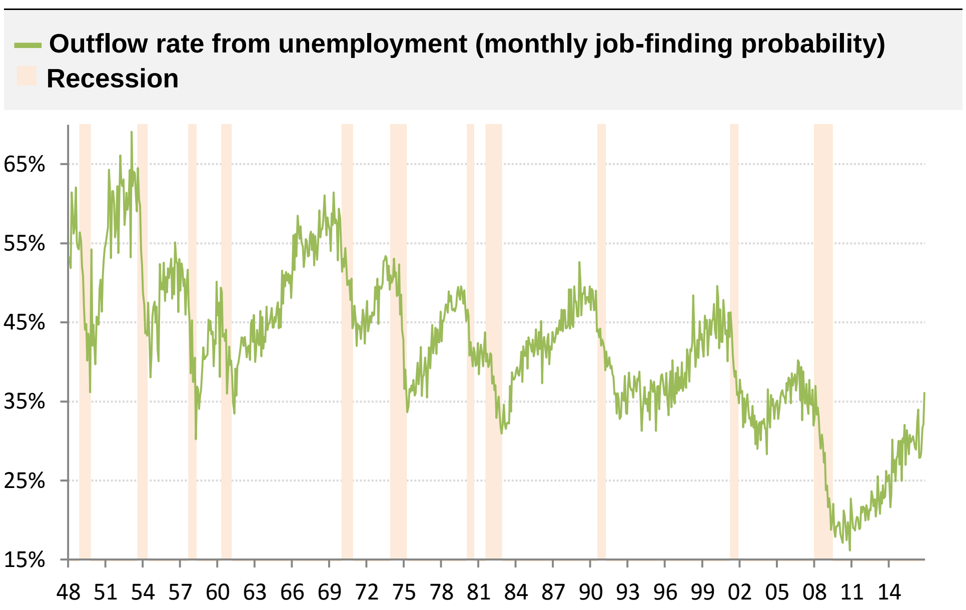
leverage with Brussels in carving out favorable exceptions for handling its banks.

- Obviously we will wait to see the results and the immediate political aftermath, but for now we are inclined to see it as only yet another political scare-story. Even if the vote is "No," that would only be in line with apparent expectations already impounded in markets. A surprise "Si" would reverse the large back-up in Italian government bond yields, and strengthen the euro.

NOW, ON TO THIS MORNING'S JOBS REPORT This morning's November Employment Situation report with 178,000 net payrolls was a very slight miss versus expectations for 180,000. There was a trivial net downward revision across the prior two months. *During a period when most macro data has been surprising to the upside, it failed to do so – and had some fairly downbeat internals.*

- The most critical number this morning was the 0.1% drop month-on-month in average hourly earnings, the worst month in over four years – and a reversal of last month's relatively hot reading of 0.4%.
- The headline unemployment rate fell to a new cycle low of 4.6%, but it did so the ugly way. The number of unemployed persons fell by 387,000 – with the long-term component falling by 226,000. But 226,000 persons left the labor force altogether (see "Data Insights: Jobs" December 2, 2016).
- There's a lot to be cheered about in this morning's report, too. The "ouflow rate" from unemployment – you can think of it as the probability of getting a job within a month – upticked to new cycle highs, and is now challenging the previous cycle highs (please see



Source: BLS, Shimer (2005), TrendMacro calculations the chart below). This suggests that some degree of dynamism is coming into the labor market.

- But dynamism isn't the same thing as over-heating. We simply don't understand views like that of Goldman Sachs, that pro-growth initiatives in 2017 under the new Trump administration will run aground on "a shortage of workers."
- So we see nothing here that ought to rationally make the Fed any more aggressive after the inevitable hike at the upcoming December FOMC.

Bottom line

Polls show "No" ahead in Sunday's Italian referendum, which would potentially cause Renzi's government to fall, leave Italy's troubled banks without restructuring, and open the door to the anti-euro populist Five Star Movement. Based on the perfect recent record of polls to fail to predict "outsider" or pro-growth elections world-wide, we're inclined to think that "Si" will be the surprise winner. A "No" vote is already largely impounded in markets, so we wouldn't expect much effect. "Si" would cause Italian yields to fall, and the euro to rally. This morning's jobs report, with a drop in average hourly earning showing absolutely no "wage pressure," gives the Fed no cause to posture more aggressively after the inevitable hike at the December meeting.