Trend Macro™

Trend Macrolytics, LLC
Donald Luskin, Chief Investment Officer
Thomas Demas, Managing Director
Michael Warren, Energy Strategist

MACROCOSM

USD, Euro and the Risk of Italeave

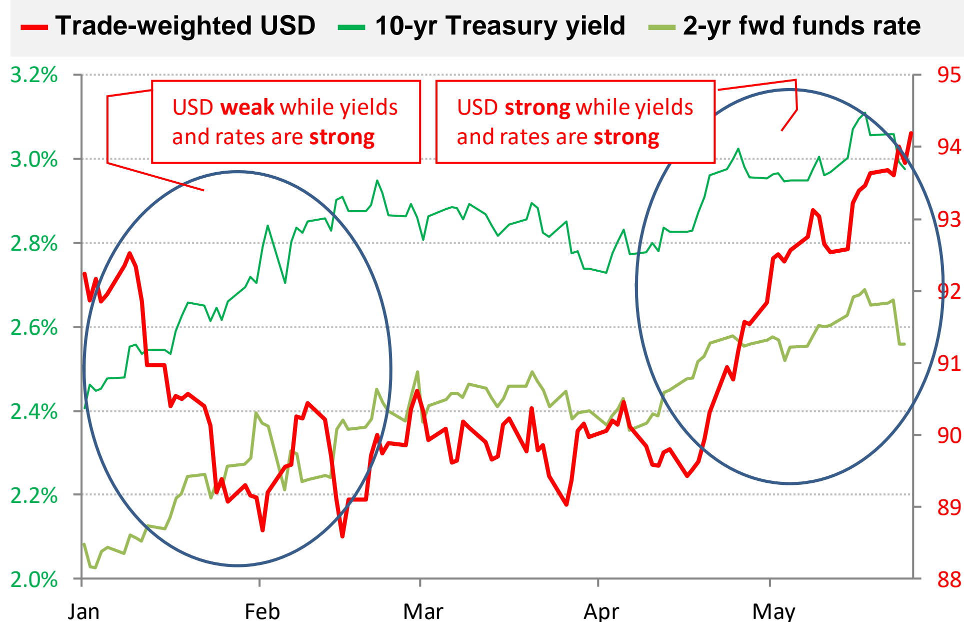
Friday, May 25, 2018

Donald Luskin

Brexit was easy, because the UK never used the euro. Now we face a systemic threat.

In almost every client meeting over the last several weeks we're always asked, "What about the dollar?" We have to be asked, because we don't bring it up proactively, because *we don't think anything notable has been going on with the dollar. That's changing now, at least indirectly, because of the potential threat to the euro from Italy's new coalition government*, a threat we warned about last year-end as we looked ahead to what might go wrong in 2018 (see "2018 Outlook: From Denial to Acceptance" December 29, 2017). We'll spend most of this report dealing with that specifically, but first let us dispense with broader USD concerns.

- Yes, the trade-weighted dollar has strengthened about 5% in just five weeks since mid-April. The typical explanation has been that, over the same period, the US Treasury 10-year yield has backed up as much as 41 bp, and 2-year forward funds rate expectations have backed up as much as 33 bp – supposedly drawing capital-flows away from other currencies.
- We hear this explanation constantly, and it sounds good if you say it fast, but it is not robust. For one thing, why pay so much more for



Source: Bloomberg, TrendMacro calculations

Update to strategic view

FX, EUROPE MACRO, EUROPE BONDS: USD is about flat for the year – but has strengthened over the last five weeks as Treasury yields and the forward funds rate have backed up. But USD was weak early in the year, during larger back-ups. Large pair-wise moves against USD have been event driven, especially EUR, which faces the tail-risk of break-up if the new coalition government in Italy tries to exit. A break-up of the common currency, or even the threat of it which would drive a run-on-the-bank across Europe, would be a catastrophic systemic event. Italy's coalition may not last very long, and it faces high hurdles to euro exit, but could court disaster with the proposed halfway-measure of circulating "mini-BOTs" as a parallel currency. Italy is highly indebted, but has a low deficit and has been fiscally stable for two decades. Its problem is growth, and we don't rule out that the coalition's proposal for massive tax cuts and tax simplification could set better growth in motion.

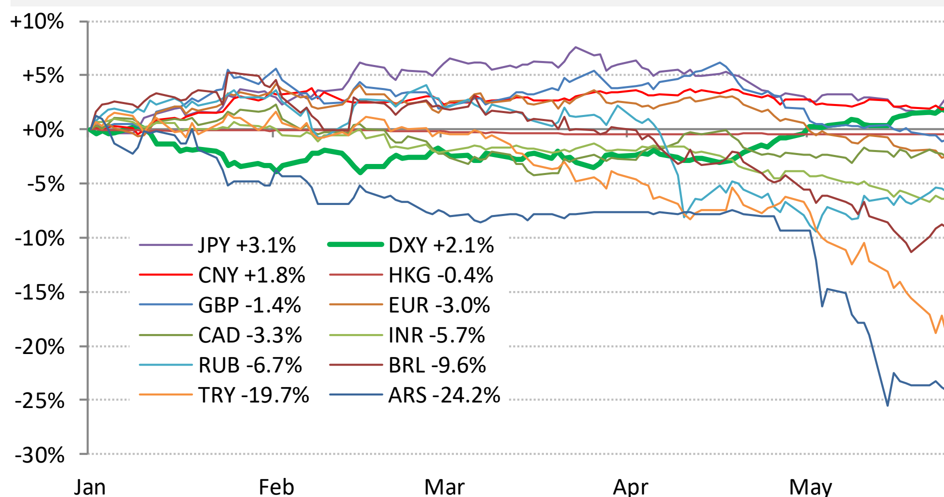
[Strategy dashboard]

Copyright 2018 Trend Macrolytics LLC. All rights reserved. This document is not to be forwarded to individuals or organizations not authorized by Trend Macrolytics LLC to receive it. For information purposes only; not to be deemed to be recommendations for buying or selling specific securities or to constitute personalized investment advice. Derived from sources deemed to be reliable, but no warranty is made as to accuracy.

a currency to earn such a small increment in yield? And why now? Over the first five weeks of 2018, USD *weakened* by about 5% while the 10-year yield backed up 54 bp, and the forward funds rate backed up as much as 40 bp. The same underlying factor – higher US yields and rates – shouldn't cause USD to both *strengthen in April* and *weaken in January* (please see the chart on the first page).

- Yes, there have been some high-profile currency blow-ups in emerging markets. But in 2018, the currency of the biggest emerging market of all – China – has been strong on net versus USD. Others started weakening to USD after mid-February, while the trade-weighted USD was flat for two months.
- India has been generally weak all year – weak when the trade-weighted USD was weak, and weak again when USD was strong. Hong Kong was weak when USD was weak, and stable when USD was strong. Russia, Argentina and this week Turkey have their own unique event-driven problems that have occurred at different points in time, and with no particular relation to moves in USD (please see the chart below).

Trade-weighted USD and USD exchange rates Cumulative, YTD



Source: Bloomberg, TrendMacro calculations

- We're not trying to minimize the importance of large exchange rate movements for emerging economies, especially if there is exposure there to USD obligations, and all the more so when they respond with self-destructive growth-killing rate-hikes.
- *All we're saying is that with this great diversity of non-dollar experiences, and USD itself stronger by just 2.1% year-to date* (again, please see the chart above), *we have no reason to think there is a dollar thing going on here at all. There are a lot of unique pair-wise currency things going on, that have more to do with the counterparty currency than USD. The most important: the euro.*

Which brings us at last to the true subject of this report: Italy, and the threat to the euro – whose 6% recent weakening mostly explains recent USD strength.

Contact TrendMacro

On the web at
trendmacro.com

Follow us on Twitter at
twitter.com/TweetMacro

Donald Luskin
Chicago IL
312 273 6766
don@trendmacro.com

Thomas Demas
Charlotte NC
704 552 3625
tdemas@trendmacro.com

Michael Warren
Houston TX
713 893 1377
mike@trendmacro.energy

[About us]

Recommended Reading

How Democracies End: A Bureaucratic Whimper
Victor Davis Hanson
American Greatness
May 21, 2018

[Reading home]

- The new coalition government of Italy, an alliance of left-wing and right-wing parties, is being heaped with all the usual scaremongering put-downs that we heard from Europe's elites after the Brexit referendum – "populist," "anti-establishment," "liberal democracy's demise" – and the usual comparisons to the rise of fascism in the 1930s.
- We think a comparison to Brexit is perfectly fair – indeed, we said that Brexit would lead to exactly this kind of thing (see "Brexit: Opening Pandora's Brox" May 23, 2016) – but we would use less pejorative words, such as "reform," "accountability," "deregulation" and "pro-growth." Last year's French elections (see "On the French Presidential Primary" April 24, 2017) are part of the pattern, in that they rejected the traditional centrist parties that have dominated post-war Europe, and point toward the reform of the European Union's sclerotic institutions.
- The difference is in both degree and in style. Italy's new governing coalition of the left-wing *Movimento 5 Stelle* and the right-wing *Lega Nord* is very much less suave than Emanuel Macron's *En Marche*, and very much more in-your-face about its Euroscepticism.
- *We think it's all to the good for Italy to shake up the EU by threatening "Italeave" – except for one thing: unlike the United Kingdom, Italy uses the euro common currency, and if Italy leaves the EU it would have to leave the euro, and if it leaves the euro, the euro may well break up into 19 separate currencies, and if the euro breaks up, it could be a global systemic banking event that would make Lehman and AIG and Citibank and all that look like a buggy-ride.*
- Or for that matter, Italy wouldn't even have to leave the EU. It could just leave the euro. Same catastrophe.
- But wait, it's worse. *Italy doesn't have to actually leave the EU or leave the euro. All that is required for a global banking panic is for markets to think that Italy will leave the euro, whether or not is actually does.*
- The problem is that common currencies, throughout history and by their very nature, are "roach motels" – easy to get into, and impossible to get out of.
- To create a common currency, you simply create a schedule of agreed exchange rates for each constituent, and replace the constituents with the common currency at those rates (forcing market participants to convert, by announcing a deadline after which the constituents have no value).
- There is no analogous reverse-process. Once it is known that a common currency is to be broken up and redenominated into constituents, market participants will anticipate which constituent will be the most valuable, and move their holdings of the common currency to the relevant jurisdiction. *In the case of the euro, if a break-up is anticipated, there would immediately be massive capital flight of euros to German banks, because market participants would prefer to have their euros converted to deutschemarks rather than lire, pesetas and so on. That would mean a run on all European banks other than in Germany. The German banks wouldn't last*

long, because they have investments across Europe, an economic zone the goods and services and capital stock of which are suddenly not denominated in anything.

- *It's not clear to us that the ECB could successfully intervene with liquidity injections of a currency that is about to no longer exist.* Extremely tight capital controls might help, if they were slapped on well in advance – but that cure would be nearly as bad as the disease.
- There is some historical experience with this, all of it gruesome. Europe itself – indeed, some of the same nations – underwent the breakup of the krone (or korona), the common currency of the Austro-Hungarian empire, under the Treaty of St. Germaine-en-Laye imposed in 1919 after World War One (please see the image below). This unleashed years of currency smuggling, hoarding and

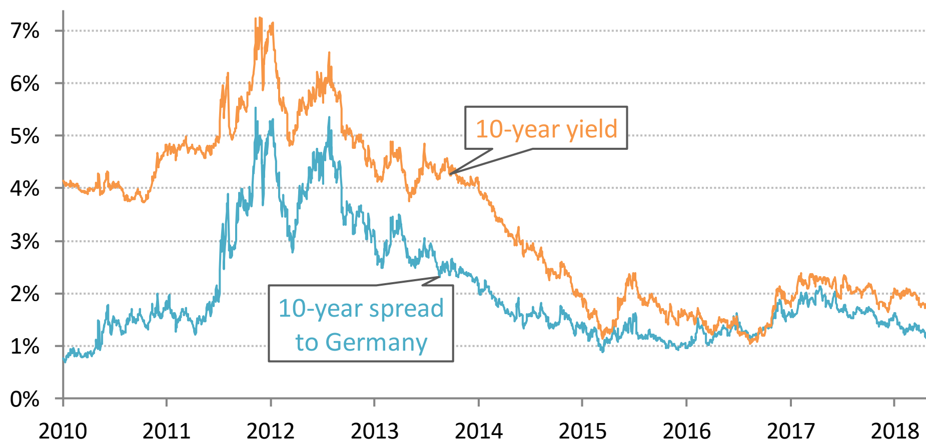
Krone or korona, the common currency of the Austro-Hungarian Empire

bank failures and some of the worst hyperinflations of the 20th century. One country that had used the krone – Fiume – didn't make it.

- Both 5 Star and the League have advocated Italy's leaving the euro, as part of a broader program of relaxing budget-discipline in one of the world's most highly indebted large economies. It was included in a leaked draft of the coalitions' policy "contract," but not the final version approved by president Sergio Mattarella.
- The coalition's proposed finance minister, the 82-year old economist Paolo Savona, is on record calling the euro a "German prison" and recommending that Italy "prepare a plan B to leave the euro if we were forced to do so – whether we like it or not."
- These potentially out-of-context statements by Savona, surfaced by the press in the last several days, belie the many reality-hurdles that stand between us and Italy pulling out of the euro.
- Savona has yet to get approval from Mattarella to serve as finance minister – but that's a trivial barrier if leaving the euro is something the coalition wishes to do.

- Of more substance is the fact that, under the Italian constitution, treaties – such as the Treaty of Maastricht which irrevocably commits Italy to the euro currency – can only be abrogated by national referendum. Considering how difficult it has been for this coalition to come together in the first place after March's indecisive parliamentary elections, and under the puppet leadership of unknown and inexperienced prime minister Giuseppe Conte, it's not clear at all that such a referendum could get organized – or any other major policy, for that matter.
- And then there is the fact that according to polls, 59% of Italians approve of the euro and only 30% disapprove – making leaving something so popular rather odd for a coalition of so-called "populists."
- *The coalition has floated an idea that would avoid those issues – the creation of "mini-BOTs" – small-denomination non-interest bearing Treasury bills (Buoni Ordinari del Tesoro) that would trade like cash, denominated in euros, alongside the euro.*
- On the face of it, this would seem to be a clever finesse to ease Italy out of the "German prison" of the euro, and yet at the same time not leave the euro. Be that as it may, *market participants may nevertheless treat the advent of mini-BOTs in circulation as a trigger for capital flight to Germany – triggering the stampede that could bring down all the banks – and Italy's banks, in particular, aren't in great shape to begin with.* (see "Brexit Panic: It's The Italian Banks, Stupid" June 29, 2016).
- Perhaps the European Central Bank could make assurances that would keep markets calm. It may feel it has no choice but to do so, considering the consequences of panic if it does not. It has done so before, quite effectively (see "On Draghi in London" July 26, 2012). But we think that would be too big a pill for the ECB to swallow. Under Article 105a of Maastricht, only the ECB can issue legal tender. Institutions do not relinquish monopoly control like that.
- There are other barriers to the mini-BOTs stratagem. The "populists" would have to explain why ordinary working people have

Italy sovereign debt

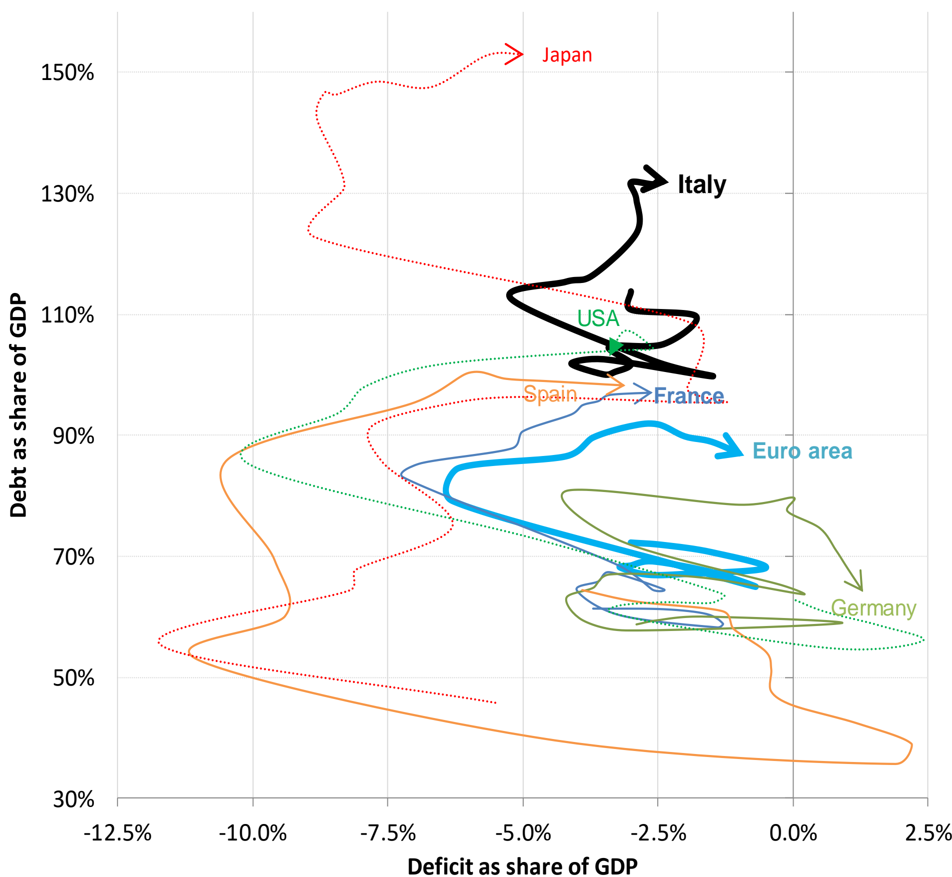


Source: Bloomberg, TrendMacro calculations

to exchange them, at a discount, to buy goods and services while the wealthy can tender them at par in payment of taxes.

- And the government would have to explain to the European Union – and the markets – why mini-BOTs, which are Treasury bills after all, are not simply more government debt – piled upon Italy's existing debt at 132% of GDP, more than twice the 60% limit under the European Union's Stability and Growth Pact and the euro's "convergence criteria."
- As the coalition government has come together, yields of Italian sovereign bonds, and spreads to German bonds, have backed up considerably (please see the chart on the previous page). *But let's not get too freaked out.* At 2.56% as of the writing, the Italian 10-year yield is well below that of the US Treasury at 2.93%. Until today, these levels – and spreads to Germany – were no higher than those seen in much of the first half of 2017.
- Consider this out-of-consensus narrative. *For the last two decades, highly indebted Italy has been right up there with Germany in terms of fiscal stability* (please see the chart below). Its deficits have been contained in a narrow range between about 1.5% of GDP and 5.2%, and its debt has grown by 18% of GDP. At the same time, France's deficits have swung between 1.3% and 7.2%, and its debt

Sovereign fiscal dynamics Annual, 1997 to 2017



Source: Eurostat, various, TrendMacro calculations

has grown by 36% of GDP. US deficits have swung between zero and 10.1%, and debt has grown by 40% of GDP.

- *With only a 2.3% deficit today, Italy's not in a debt death-spiral. The real problem with Italy is that it doesn't grow – real GDP has been only 0.5% per annum since 1997. Shouldn't we even consider that this new coalition government might help?*
- The coalition's contract calls for a simplified two-tier income tax system, with rates of 15% and 20% – replacing a today's five brackets ranging from 23% to 43%. Predictably, the elite European media treats this proposal as a dead-weight revenue loser.
- Just as predictably, perhaps, we'll take the other side of that bet (especially for a nation where tax-evasion is rampant, and where lower rates could increase compliance by lowering its cost).
- *The threat of leaving the euro or issuing mini-BOTs could be a weapon to get the EU's blessing to bust the budget.* But that's a sword that cuts both ways: there are other policy agenda items in the contract that are not so pro-growth, such as rolling back the reforms to the retirement age in Italy's social security system. And whatever is in the contract, we don't underestimate how difficult it will be for this fragile new coalition to get anything at all done in a balky and fragmented parliament. *For that matter, this coalition itself may not survive for long, requiring new elections.*
- And we are very mindful of the risks. The same procedural difficulties in the way of doing good are also in the way of doing bad – but the risk is there. And in the case of Italy possibly leaving the euro – or even taking a half-way step such as circulating mini-BOTs, which might spook the market into a deadly self-fulfilling prophecy that Italy *will* leave the euro even if it doesn't really intend to – the risks may be improbable but nevertheless very high-impact if they do eventuate.

Bottom line

USD is about flat for the year – but has strengthened over the last five weeks as Treasury yields and the forward funds rate have backed up. But USD was weak early in the year, during larger back-ups. Large pair-wise moves against USD have been event driven, especially EUR, which faces the tail-risk of break-up if the new coalition government in Italy tries to exit. A break-up of the common currency, or even the threat of it which would drive a run-on-the-bank across Europe, would be a catastrophic systemic event. Italy's coalition may not last very long, and it faces high hurdles to euro exit, but could court disaster with the proposed halfway-measure of circulating "mini-BOTs" as a parallel currency. Italy is highly indebted, but has a low deficit and has been fiscally stable for two decades. Its problem is growth, and we don't rule out that the coalition's proposal for massive tax cuts and tax simplification could set better growth in motion.