01/25/2018

Tocqueville's Italy

Trade Alert: Buy 1/3 EUO ProShares UltraShort Euro

(New position, this trade can be expressed in other, more cost-efficient ways - in futures of course).

In this Note:

Italian Elections: Europe is once again gearing up for another year of major elections. Italy’s general election on the 4th of March is by far the most important of the year. In 2013 the markets were shocked by the surprisingly strong showing of the anti-establishment 5-Star Movement. The selloff was brief as investors appear to have grown accustomed to European political and economic blow ups that started with Greece in 2010. Today the market is complacent, still in rally mode across all across asset classes. After brilliant victories found in Brexit vote and the U.S. Presidential election, populism mean reverted in 2017. The French elections were a major let down and capital flows betting on populist' upsets have come to a crawl.

Richly Priced: For the Italian elections, the markets expect the outcome to bring a hung parliament (with no party controlling over 50% of the vote) and subsequently the formation of a broad center-right/left coalition that promises a continuation of business as usual. **Bottom line, the Euro is richly priced relative to unappreciated near-term risks.**

Mad Mob Themes: Heading into 2018, the two "mad mob" themes are focused on the long Euro trade and of course the obnoxious-ly consensus U.S. Treasury curve flattener. There isn't a Euro bear to be found, they're all in extended hibernation. The last time Wall St. was this bulled up on the Euro, she proceeded to lose 25% of her value in short order (May 2014-March 2015), we'll be happy with ten percent reality check.

Italy Anchor on the ECB's Capital Key: We take a look at the "capital key" which shows one where Mario's ECB is allocating their $30B a month of asset purchases. Per

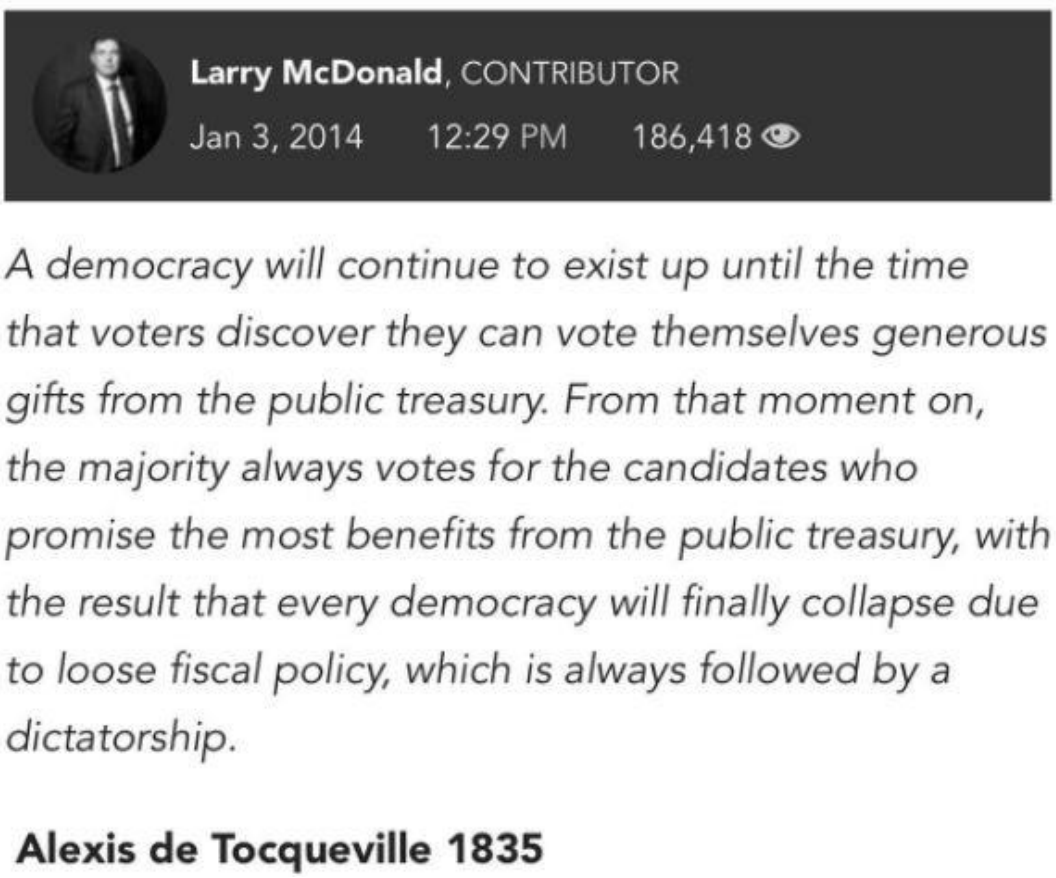
Bloomberg, Italy has $840B of debt maturities coming due between now at 2022, that's nearly 40% of their total $2.25T debt load - some bills have to be paid here indeed. The ECB's capital key has an Italian anchor around its neck. Draghi has been overweight Italian bond purchases, bailing out Italian politicians who've (for decades) made far too many mathematically unsustainable promises in an effort to get reelected.

Special thanks to our friends at ACG Analytics.

Historical Cycle of Democracy

Bondage
Spiritual faith
Courage liberty
Abundance
Selfishness
Apathy
Dependency
Bondage

Tocqueville, 1835

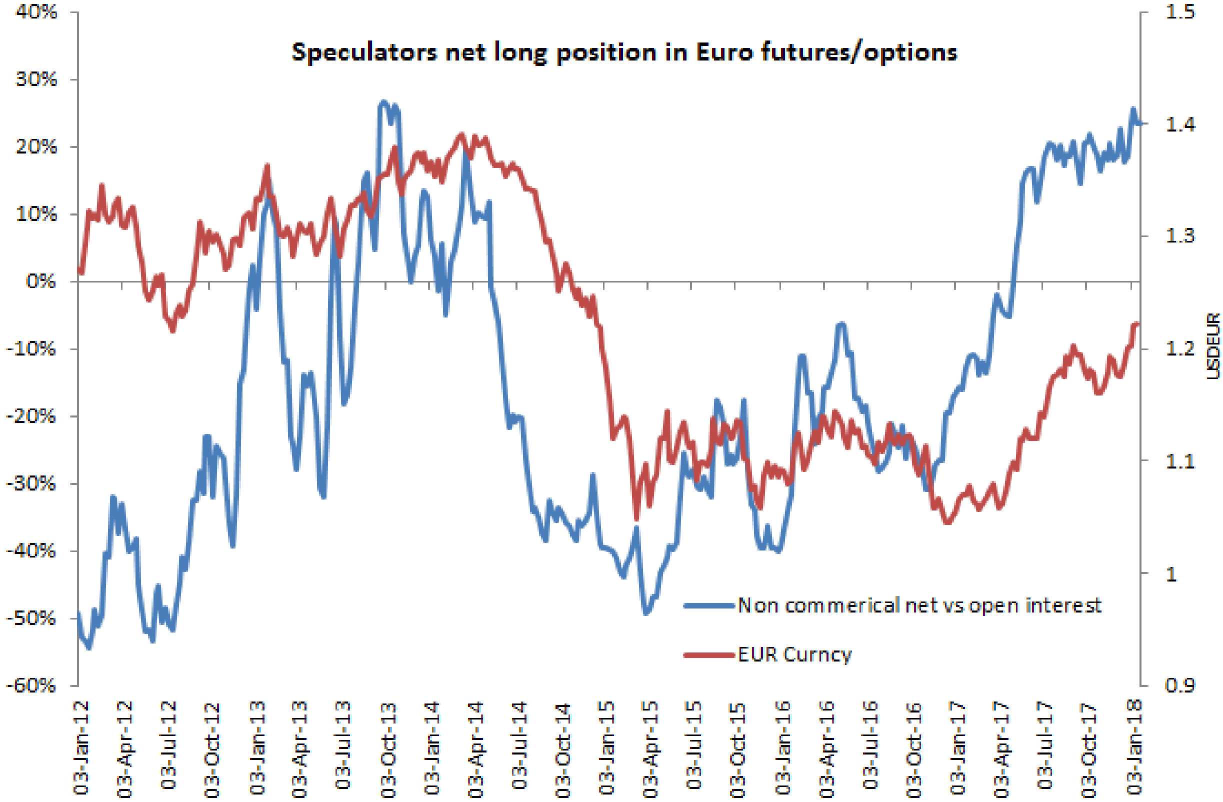


Larry McDonald, CONTRIBUTOR
Jan 3, 2014 12:29 PM 186,418

A democracy will continue to exist up until the time that voters discover they can vote themselves generous gifts from the public treasury. From that moment on, the majority always votes for the candidates who promise the most benefits from the public treasury, with the result that every democracy will finally collapse due to loose fiscal policy, which is always followed by a dictatorship.

Alexis de Tocqueville 1835

One Crowded Trade

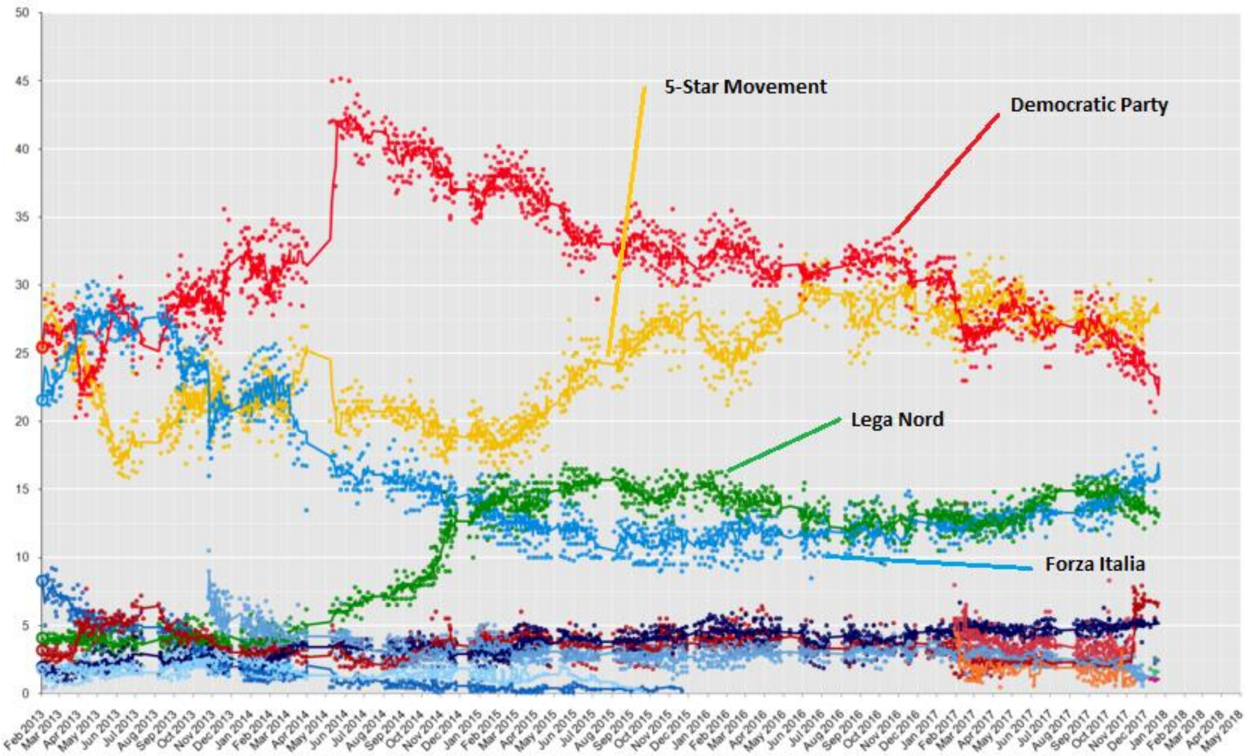


Positioning is a key factor in our work. We meticulously search through global markets for the uniquely crowded trade. Heading into 2018, the two "mad mob" themes are focused on the long Euro trade and of course the obnoxious-ly consensus US Treasury curve flattener. As you can see above, there isn't a Euro bear to be found, they're all in extended hibernation. The last time Wall St. was this bulled up on the Euro, she proceeded to lose 25% of her value in short order (May 2014-March 2015), we'll be happy with ten percent reality check.

The Asynchronous Payoff

We see an asynchronous payoff here as the market pricing in almost zero risk of an anti-establishment victory. This appears to be the case **despite** widespread disillusionment towards mainstream political parties and with anti-establishment parties polling in aggregate over 50% of the vote. In the coming weeks, particularly after the Czech election, markets will increasingly turn their focus to the Italian election polls. If the anti-establishment parties continue to gain momentum, the Euro, where speculative positioning **is extremely net long now**, is vulnerable to a pullback. **We also believe that spreads between Italy BTPs and German Bunds have the potential to widen in coming weeks** as bond investors position more defensively into the vote. While we remain bullish on European and Italian equities, a surprise victory of 5-Star or far-right parties could jolt the FTSEMib 30 lower. In 2013, the day after the election where 5-Star came in first as a single party, the index sold off 5% and the Italian bank index dropped 8%.

The Polls



The populist and Eurosceptic 5-Star party is currently in first place with close to 30% of the vote. However, the party has a "no coalitions" policy while the center-right has already formed a coalition (Forza Italia, Lega Nor, and Brothers of Italy). Together they would receive close to 35% of the vote and win the election. This plurality may however not be enough to form a center-right government and therefore a broad coalition would be needed. This is what the market currently expects and hopes for but it is not prepared for a 5-Star victory that could lead to a government led by the populist party.

While few surprises are expected from Russia's and Sweden's elections, contests in Italy, the Czech Republic, and Hungary have the potential to destabilize Europe's political landscape or at a minimum, continue the political shift towards anti-establishment sentiment and against European integration. The first round of the Czech presidential election was held last weekend and the incumbent anti-immigrant Milos Zeman received the most votes but came up short of an absolute majority. The run-off election will be held January 26 and 27.

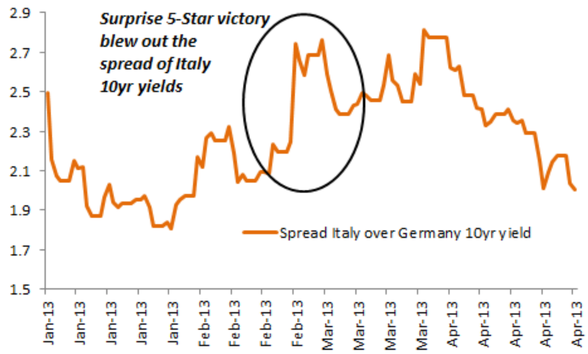
Euro RSI at Nose Bleed Levels

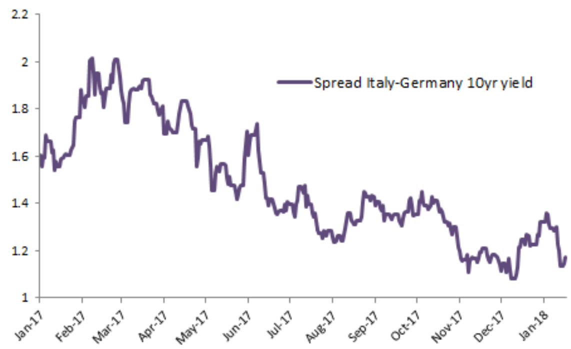
*After looking at crowded positioning, the RSI (relative strength) picture looks even more unsustainable. Rarely, in any asset, have we seen RSI indicators so "overbought". For nearly the entire month of January, Euro RSI has been north of 70, something which hasn't happened in the last five years. "Come one, come all, Euro bulls are on every Street corner." Historically, **currency trends are very sticky** (far more so than equities and commodities). A bit like turning around an aircraft carrier, a significant catalyst is required to break them and revert directionality to a long-term mean. This election has the ingredients to be that catalyst. The Bloomberg Dollar Spot Index, which tracks the performance against a basket of 10 leading global currencies, fell below 1,115 on Thursday. That put the currency's month-to-date loss at more than four percent, a level which would make it the worst month in the last half decade if it fails to turn itself around in the next week.*

The French and Dutch Elections Replay?

The Italian general elections are the most important political event for Europe this year. Thus far, markets appear relatively unfazed by the upcoming election, but the recent focus has been on USD weakness against the Euro, and the strengthening Euro's potential effect on ECB monetary policy (especially in Mario Draghi's January 25 press conference). A perceived replay of last year's French and Dutch elections has put most investors asleep. In these elections, after an initial panic over the potential victory for far-right, Eurosceptic candidates, the establishment parties won the election and the markets rallied.

Italy Germany Bond Spread





As we can see above (right), today's bond market could care less about the Italian elections. In February of 2013, we witnessed a sharp move wider (in 10-year bond yields) as the 5-Star made a splash onto the world stage. In 2013 ahead of the Italian elections the spread of Italian bonds over German bunds rose gradually. The surprisingly strong performance of 5-Star and hung parliament after the election blew out the spread by 60bp (+25%)in two days. ***Bottom Line, Currently, the spread between Italy and German equivalent bonds are extremely tight as the market appears to completely ignore the election risk.***

The assumption for Italy's elections is that the block of center-right parties, led by Berlusconi's Forza Italia, will receive the most votes, but fall short of a majority. The block currently polls at 35% of the vote. The populist, Eurosceptic 5-Star Movement party is currently the most popular single political party, polling between 27-29% of the vote.

Since this party is assumed to maintain its "no coalitions" policy, it will be unable to form a government on its own unless it wins by a larger margin. Moreover, the election law that was passed in October of 2017 implemented a "first past the post" procedure, which helps the party blocks in the center. This has made the markets even more complacent about these elections.

First Past the Post

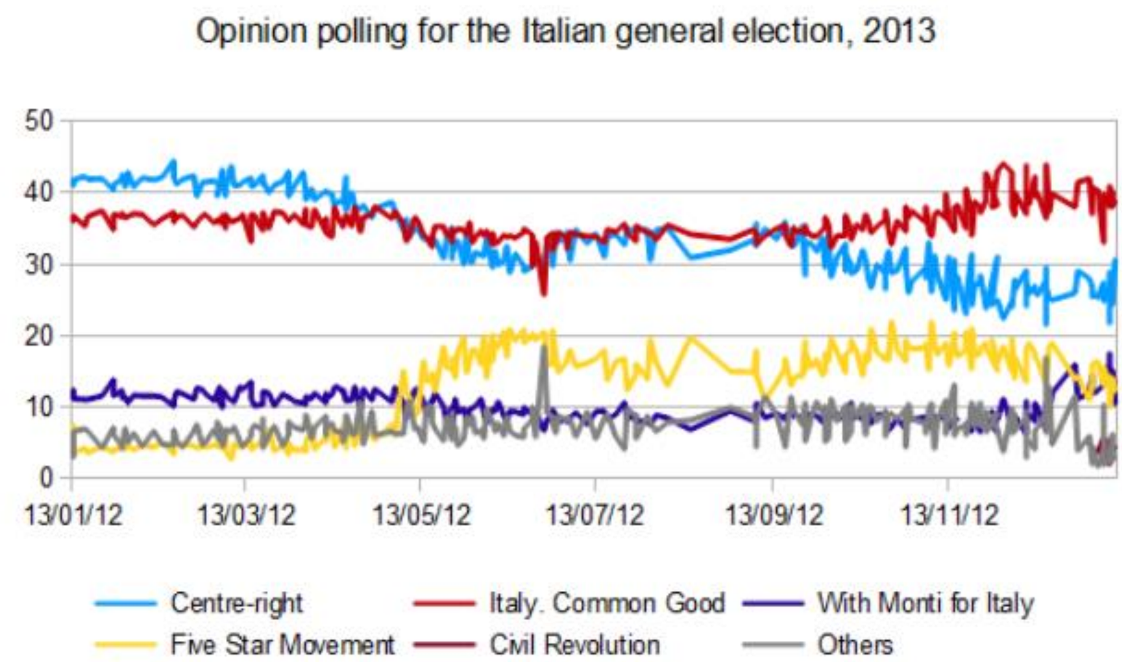
In 2017 the Italian parliament passed a new election law, known as the Rosatellum (after PD leader Ettore Rosato) that harmonized the election process in the Senate and the Chamber of Deputies. The current law distributes 37% of each Chamber's votes to the party or coalition block that is "first past the post", with the remaining 61% of seats are distributed using the proportional method based on the election result. Prior to this law, the lower Chamber had a different procedure for allocating seats than the upper Chamber, which made the formation of a government a complicated and lengthy process. This misalignment between legislative bodies was one of several reasons why Italian coalition governments were so fragile and short-lived; Italy has had 65 governments in the last 70 years.

Euro and the German Dax

Clearly, German equities are at risk for a runaway Euro. During the last surge in the Euro currency, the German DAX found itself nearly 9% smaller by the end of August 2017.

Government Formation, 5-Star Facing Road Blocks

The implementation of the "first past the post" election law favors coalition blocks at the expense of single parties. Needless to say, 5-Star was vehemently opposed to the passage of this law in October of last year as it diminished their chances of forming a government even if it wins the elections on a single party basis.



In 2013, the polls showed the center-left block with a comfortable lead, and 5-Star trailing both center right and center left by a large margin. The election result was much closer than polls projected and in the Senate, no one achieved an outright majority (hung parliament). Formal talks to form a new government took much longer than expected due to the absence of a clear majority in the Senate. Even though the elections were held in late February, only by the end of April did the coalition parties reach an agreement on the formation of a new government. Under-polling of socially contrarian views has been prominent in other elections, including the most recent U.S. Presidential Election. Polls, even in the days and hours before voting began, showed significantly weaker support for Donald Trump than what occurred on election day.

Polling Trends

Party (block)		2013 polling average	2013 election vote	2018 polling average
Anti-establishment	5-Star	20.0%	25.6%	29.0%
Center right		25.9%	27.6%	34.0%
	Forza Italia	20.0%	21.6%	15.5%
	Lega Nord	4.0%	4.1%	13.5%
	Brothers of Italy	1.9%	1.9%	5.0%
Center left		34.0%	29.5%	27.0%
	PD	30.0%	25.4%	24.0%
	Others			3.0%
	SEL	3.5%	3.2%	
	CD	0.5%	0.5%	
Left coalition	LeU			6.50%

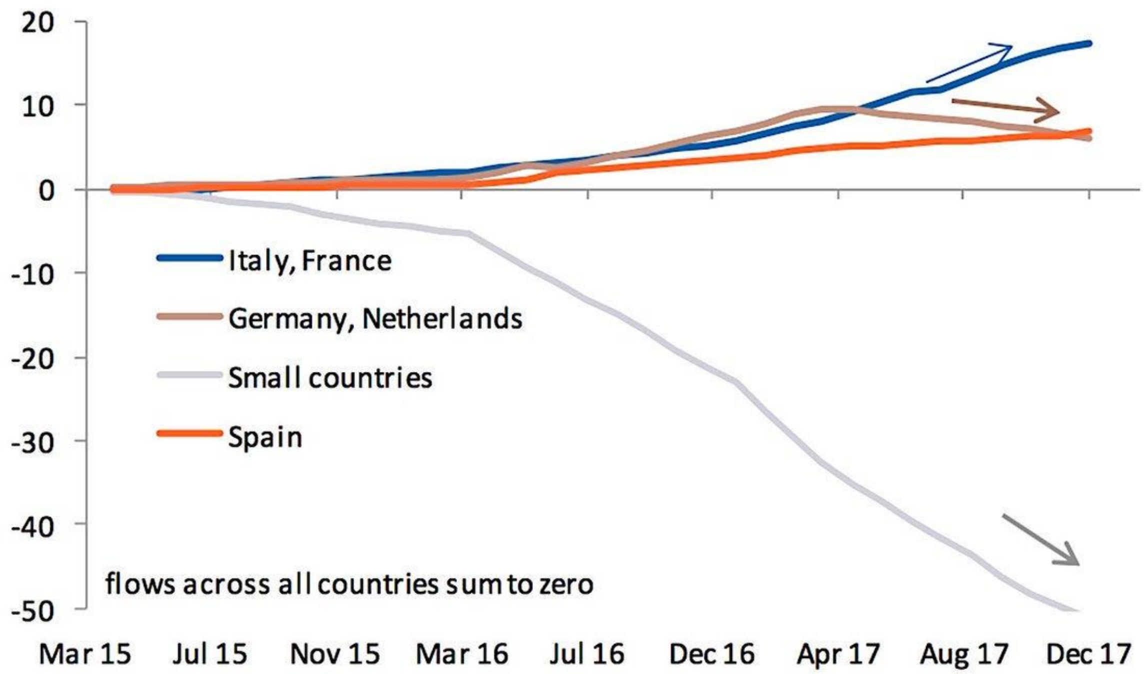
The table shows the divergence between the polling data and the final result of the elections in 2013. 5-Star polled around 20% but ended up winning 25.6% of the vote. It also shows the rise of the anti-establishment and populist parties on both sides of the political aisle. 5-Star and LeU combined with the right-wing Lega Nord and Brothers of Italy now receive a combined support of 53% of voters vs 30% in 2013.

Are the Polls Accurate? No.

Italian polling data is notoriously unreliable. In the 2013 general elections, 5-Star polled between 15 and 20% and ended up winning 25.6% of the vote. In the 2016 referendum on a new election law, polls showed a 40% to 37% against the new law. The ultimate result of the referendum was a 60% rejection of the new law, well ahead of expectations. Currently, 5-Star is polling as high as 30% with only the center-right coalition getting a larger share of the vote. **Bottom line, The establishment media's influence over polling data in recent years has called into question the credibility of polling data. Anti-establishment candidates globally are constantly discounted. The net result, real event risk has been discounted in the marketplace.** There is no reason to believe that polls are now more accurate, yet the belief that 5-Star is underperforming in polls is only an educated guess.

Draghi: The ECB Doesn't Play Favorites with Asset Purchases? (Yea, right).

Graph 1. Rising share of Italy, France in PSPP; small countries hit. Real purchases vs capital key. Difference in €bn sum to zero.



Source: SG Cross Asset Research

*A look at the "capital key" shows us where Mario's ECB is allocating their $30B a month of asset purchases. Per Bloomberg, Italy has **$840B of debt maturities coming due between now and 2022, that's nearly 40% of their total $2.25T debt load.** Some bills have to be paid here indeed, which leads us to the dark blue line above. As you can see, the ECB's capital key has an Italian anchor around its neck. Draghi has been overweight Italian bond purchases, effectively bailing out Italian politicians who've made far too many mathematically unsustainable promises in an effort to get reelected.*

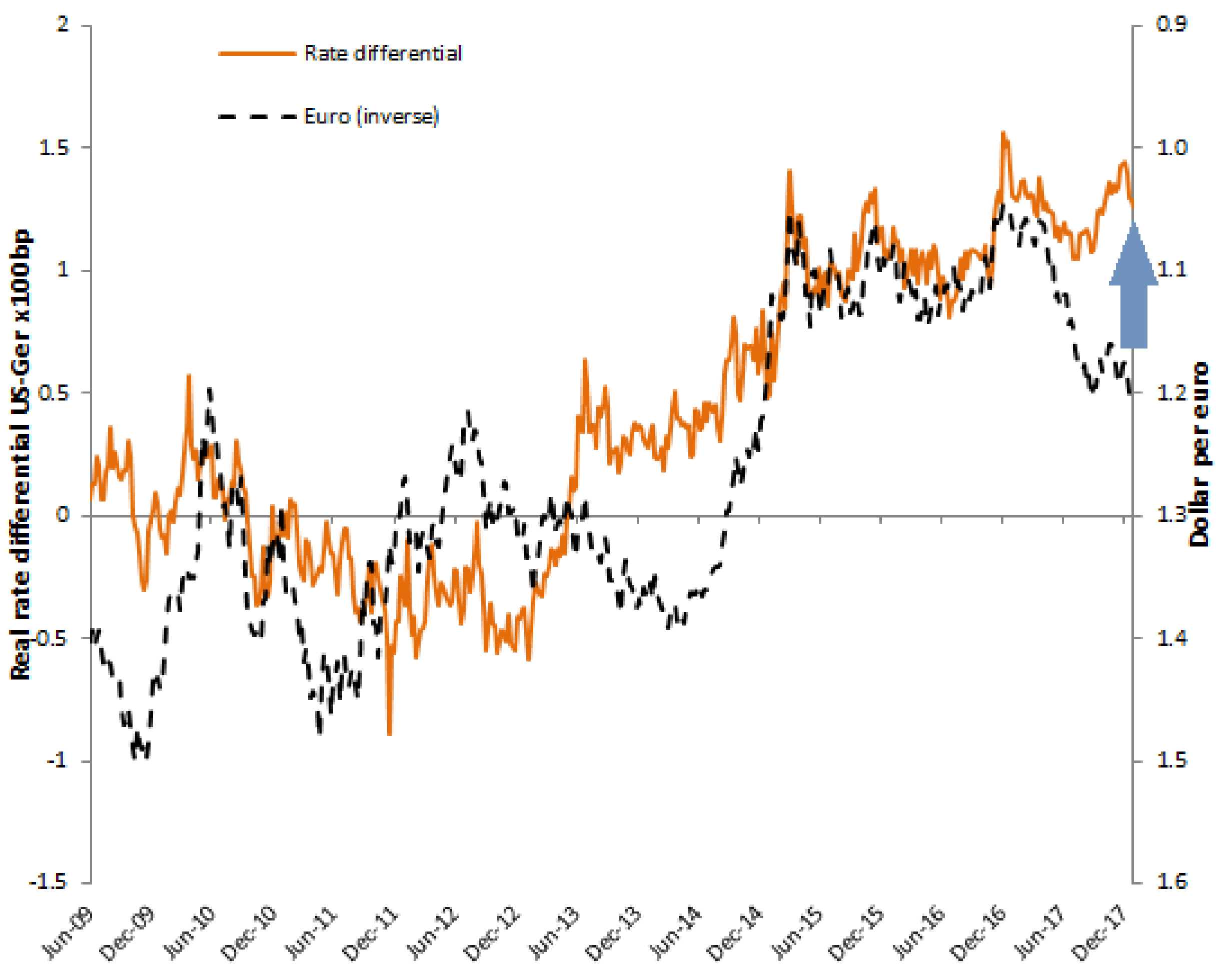
What are the Possible Outcomes?

The Italian electorate remains greatly divided and there is a growing conviction that no one political party or even a political coalition will be able to form a governing majority. A hung parliament scenario remains the most probable electoral outcome, after which President Mattarella will negotiate either a broad coalition with centrist parties or join forces with a technocrat or institutional figure who can form a broad coalition.

The alternative scenario considered by the market is a victory for the center-right coalition, led by Berlusconi's Forza Italia. The coalition would likely need around 39% of the vote to be considered "first past the post". The market would cheer this outcome as well. Some market participants caution about center right dialing back some of the recently implemented reforms but ultimately little will change and the markets should rally.

Today, markets have turned a blind eye to the increasingly probable high-risk scenarios. A much better than expected result for 5-Star and/or a possible alliance with the hard-left LeU coalition would pave the way for a 5-Star led government. In 2013 5-Star exceeded polls by 5ppt, and a repeat of this scenario would put this Eurosceptic Party around 35% of the vote, well ahead of all the establishment parties. 5-Star's PM candidate Di Maio would be given the exploratory mandate to form a coalition government. A less probable scenario, whereby 5-Star forms an alliance with the left wing LeU, the two parties could achieve between 35% and 40% of the vote - would make it likely that Italy will be governed by a 5-Star led coalition.

Rate Differentials are Telling



As we can see above, interest rate differentials between the U.S. and Germany have been a key Euro driver in recent years. It's interesting to note, even as the spread between U.S. yields over German have widened in recent months, we've witnessed Euro strengthening. This speaks to the global shift, away from the dollar. The U.S. is *two to three years ahead of other G8 countries, whose economies are now in rapid catch-up mode.*

Assumptions in the Market

While the market still assumes 5-Star's no coalition doctrine, leader Di Maio said in September that he is open to a coalition with like-minded parties (This comment now appears to have been forgotten, and is empirically not being priced in.). At that time, the comments received little attention because of the uncertainty around the passage of the new election law (which triggered the new elections) and the absence of a significant coalition of anti-establishment parties. Since then, the hard left Liberi e Uguali (LeU), formed by disgruntled former PD party members.

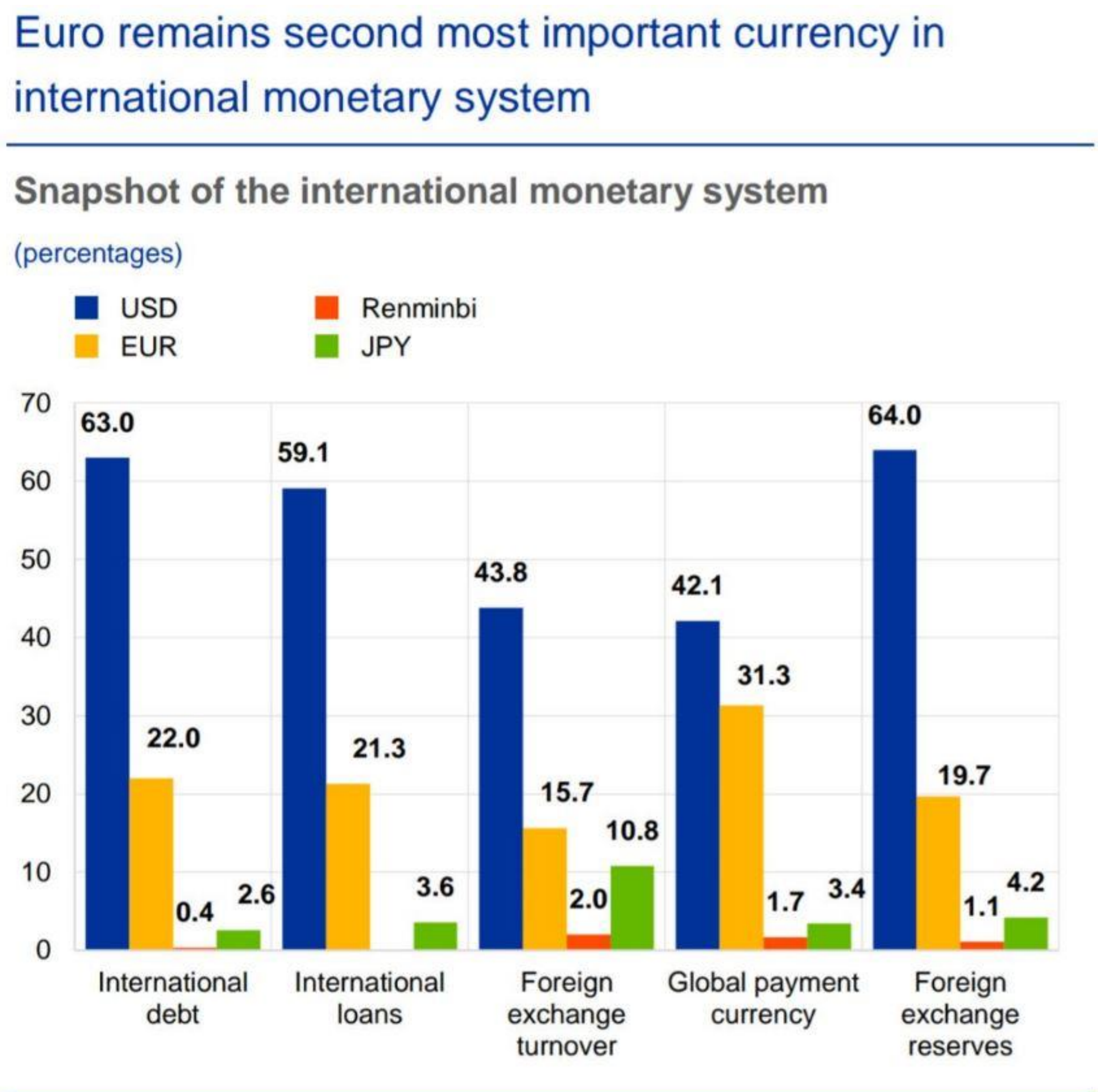
The Road Ahead

While this is a fat tail scenario, a 5-Star government might initially be perceived very differently than the Trump or Brexit victory. While these proved to be very bullish for markets, the 5-Star band of anti-establishment politics is notably different. Another possibility is that Lega Nord gets the most votes of a winning center-right coalition and demands a leading role in a governing coalition.

These scenarios would initially spark market fears about a more confrontational stance of Italy towards the European institutions, or at the very least create an environment with heightened doubt about the structural soundness of the Eurozone stability.

In the past, 5-Star has called for Italy to abandon the Euro and has called for a referendum on Italy's membership in the EU. Recently, the party has toned down its rhetoric, it remains inherently anti-Eurozone. Should it lead the next government, it will demand concessions from the other Eurozone members. Specifically, 5-Star wants to reduce the yearly payments it makes to the EU and permission for higher government spending levels, far more than is currently permitted under the growth and stability pact.

Lega Nord advocates fiscal federalism, meaning that the northern States will keep more of their tax revenues, funneling less into the Treasury of Rome or to Brussels. The party has always been critical of the EU, calling it a "failed experiment". In recent weeks, the League's economic spokesperson asserted that, if put into power, the party would "begin all possible preparations to reach monetary sovereignty". Since Salvini took over as the leader in late 2013, public support has surged from under five percent to around 15%, according to recent opinion polls. The influx of immigrants, notably from northern Africa and Syria has bolstered Lega Nord, which has traditionally been the most fervent anti-immigration party in Italy.



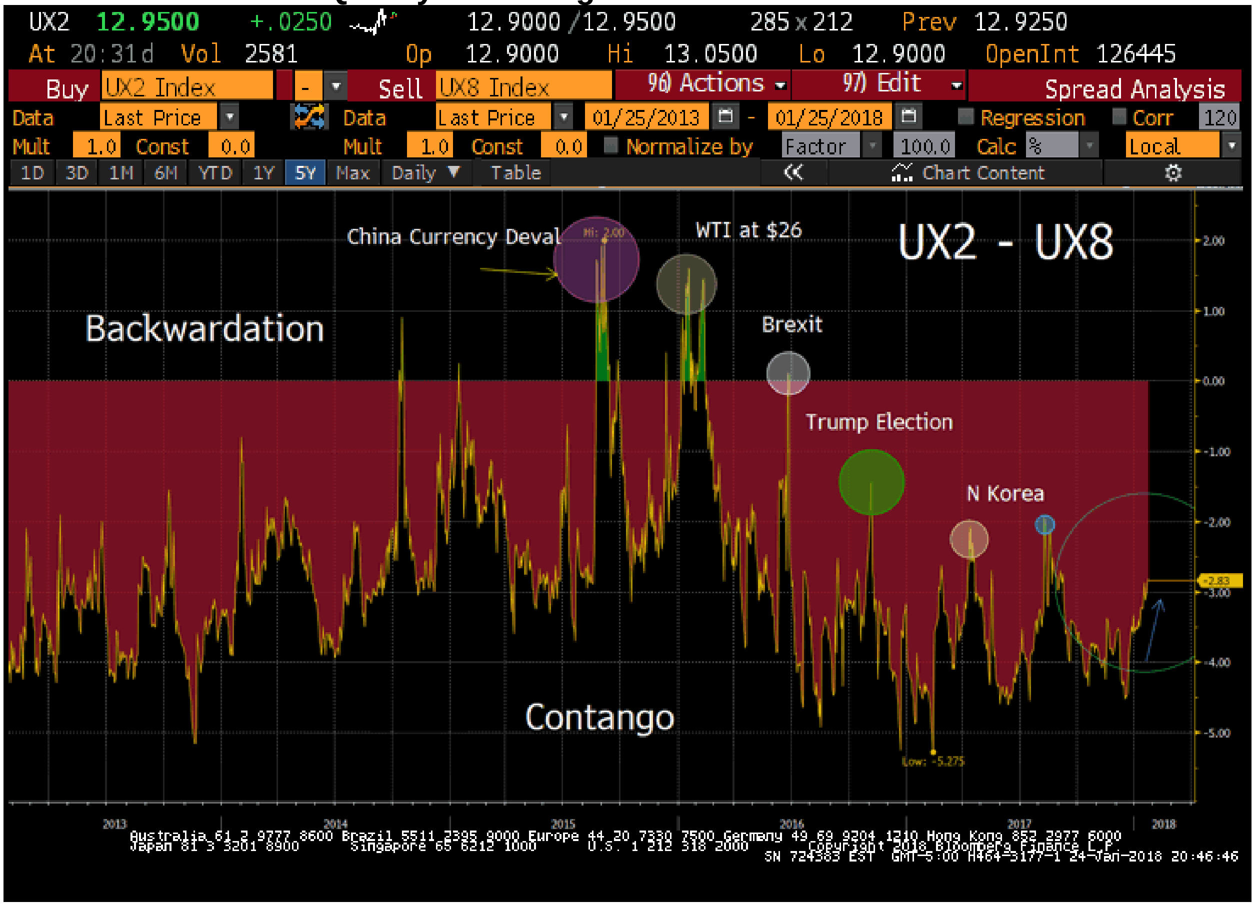
Sources: BIS, IMF, SWIFT and ECB calculations.

On the world stage, it's always an eye-opener to observe the U.S. dollar's true positioning. She has a long way to fall indeed, from one high perch.

Brexit Wake Up Call

The Brexit vote woke markets up; eyes became focused on the real risk of fractures within the European Union. Britain, however, was never a member of the Eurozone, which is a much tighter and more integrated union than the EU. If 5-Star wins the election with a decisive margin, with or without a coalition partner, or if Lega Nord becomes the biggest party in a right-wing coalition, it will ignite fears of real fractures within the Eurozone.

VIX Futures Curve is Quietly Flattening



Above is a look at the steepness in the VIX Futures curve, comparing the 2-month VIX future UX2 and the 8-month contract. What's remarkable, as the bull market has raged on in the new year, is that the curve is quietly drifting towards "risk off" backwardation. In Q4 2017, the front-month contracts were substantially cheaper than the outer months, a steep curve in deep "risk on" contango (see bottom right above). In 2017, market structures became fearless to any possible drawdowns and large, overnight spikes in volatility. Global markets have risen almost 40% since the Trump victory, nearly in one straight line with minimal pullbacks. Short positioning in volatility derivatives remains at unprecedented levels and a large spike in volatility forces many of these participants to immediately cover their short or buy VIX futures. To add to the drama, we have the U.S. debt ceiling deadline starring at the ides of March.

<u>While the initial shock may lead to weakness in the Euro and Eurostoxx, the second order effect on the Eurozone is likely to be positive</u>. A confrontation with Germany should mean a more controlled flow of immigrants into the Eurozone (thwarting risk of a real extreme-right victory) and more fiscal spending combined with more protectionism to salvage struggling industries. All this should end up being bullish for Eurozone equities, as it has been for US equities.

Market Reaction to the 2013 Election

(election results came out late Sunday Feb 25)

Italy banks:	-8%
FTSEMib 30:	-5% (From Friday until Tuesday)
Euro	-2% (from Sunday February 25 to Monday low)
Italy/Germany yield spread:	+30% (from February 26 until the March 25 peak)
VIX:	+40% (from 13.6 to 19.6)
V2X (Eurostoxx Vix):	

Worst performing sectors (2/22-2/26)

European energy:	-5.1%
European travel:	-2.9%
European banks:	-2.8%

Next Steps

January 21: Official deadline for announcing coalitions for the ballot. The Center right parties Forza Italia and Lega Nord and Brothers of Italy have already announced to form a center right coalition.
January 29: List of candidates has to be handed in for the ballots. Once the various candidates are known, opinion polling also becomes more informative as voters know the alliances, coalitions and candidates.
February 17: Deadline after which no Italian election polls are allowed to be published.
March 4: Polling stations are open from 7am until 11pm local time (5pm EST). Voting participation tallies will be released at 7pm local time. Exit polls will be released immediately after the polls close and updates as results come in. In 2013 the final results came in during market hours, which can create some volatility.
March 23: Parliament will meet for the first time after the elections to elect the leaders of the Senate and the Chamber of deputies. Before the President can begin consultations on appointing a Prime Minister to form a governing coalition.

Major Anti-establishment Parties in Italy

5-Star movement/M5S: In the 2013 election the charismatic founder of 5 Star Beppo Grillo ran for prime minister but he has now handed the baton to the young Luigi Di Maio. The party started as a movement in 2010 to promote honesty and direct democracy in corruption prone Italian politics. 5-Start has long promised a consultative referendum on whether to abandon the euro but in recent weeks Di Maio signaled that “now is not the time for such a referendum”. The party is trying to broaden support enough to win power, without alienating the hardliners who’ve driven the movement thus far. He "has to reconcile the populist origins of 5-Star with the aim of showing it is fit for government,” said Fabio Bordignon, a political sciences professor at the University of Urbino.

The popularity of 5-Star is rooted in the revulsion of many Italians against the political establishment, which has been infested with corruption and scandal and has protected a system of political insiders and special interest groups. After the 2008 financial crisis, the Italian economy entered a period of economic contraction, exacerbated by the Chinese export juggernaut. Italy competes with China more than almost any other Eurozone country, primarily due to its footprint in the textiles and clothing industry. The mounting competition with China in areas like textile has worsened due to the elevated level of the euro, which has made Italian products less competitive in the global marketplace.

Besides the erosion in Italy's competitive position, the country is hampered by an aging population (oldest worldwide behind Japan and Germany) and antiquated labor laws that protect older, overpaid workers and disadvantage young workers. As a consequence, many young, highly educated Italians have left the country for better prospects elsewhere. Finally, the country's banks are still laboring under the bad debt hangover from the financial crisis. Unlike France or the UK, Italy's banking system is fragmented and many banking conglomerates are controlled by family or union "Fondazione" that resist consolidation or reform. As a result, bank lending growth has been non-existent in the last ten years and real GDP still remains 5% below the level of 2007. Because of the eroding competitive position, Italy's per capita GDP is now just two-thirds of Germany from 90% ten years ago. The economic stagnation and control over politics by the establishment has fostered an explosion in economic inequality. Italy still has some of the highest unemployment rates in the developed world (11%), with youth unemployment above 30%.

The challenges of especially the aging population combined with the unintended consequences of the Schengen agreement have opened the floodgates of immigration. Currently, almost 10% of Italy's population is foreign-born and over the last decade, the overall population has grown by 2ml people despite the 1ml Italians that have left the country. The explosion of immigration has led to a mounting cry for border control and a sentiment of xenophobia. The economic stagnation, escalating income inequality and immigration crisis have fueled the success of Lega Nord and Brothers of Italy (hard right) and 5-Star (Eurosceptic).

LeU/Liberi e Uguali: Former Democratic Party (PD) leader and president of the Senate Pietro Grasso has broken away and has become the leader of a coalition of non-governing Leftwing parties; LeU. This coalition was formed on the 3rd of December of 2017 by PD break-away *Democratic and Progressive Movement* and the party Sinistra Italiana (Italian Left). Grasso, a greatly respected anti-mafia magistrate is expected to capitalize on disenfranchised voters in the north, who are disillusioned by the rightward move of the center left PD. Grasso is joined by other heavyweights of the Italian Left, former leader of the PD Pierluigi Bersani, former Prime Minister and Foreign Secretary Massimo D'Alema, both vocal opponents of the PD's rightward shift. The coalition currently polls around 6.5% of the vote, mostly at the expense of the PD. The support is sufficient to exceed the 3% threshold for seats in Parliament.

Best Regards,

The Bear Traps Report Team

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