CROSSBRIDGE CAPITAL

Market Viewpoints

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The poor have sometimes objected to being governed badly; the rich have always objected to being governed at all.

- G.K. Chesterton

Italy is a sorry shadow of its former self. Italy's economy has shrunk by approximately 12% since the financial crisis of 2007. Overall unemployment is 11.5% and youth unemployment stands at 36.5%, far above the Eurozone rate of 20.8%. Italy was not always in such bad shape. Between 1950-70, Italy was a powerhouse of economic growth and in 1987 its GDP passed that of the UK, an event termed by the Italian press as *"Il Sorpasso" (*Italian for "the overtaking") and prompted wild celebrations in the streets of Rome. However, over the last two decades, Italy's economy has essentially stagnated. Is the Euro to blame for Italy's current economic mess? Only partly, in the sense that a weaker currency would certainly help Italy grow faster, create more jobs and provide the favourable backdrop needed to carry out unpopular reforms. The Euro may have made the Italian economic situation worse but it certainly isn't the root cause. On the other hand, years of rampant corruption, lack of reform on the labour, judicial and economic fronts, most certainly are. What Italy needs is a "Yes" vote in this Sunday's referendum. What it will likely get is a "No", more upheaval and surprises that will threaten the Euro and the foundation of the European Union in the years ahead.

Italy: A 5 star mess

Former Italian Prime Minister Benito Mussolini once said: "Governing the Italians is not impossible, it is merely useless." Current Italian Prime Minister, Matteo Renzi may have some sympathy for that remark after struggling to get his agenda accepted by people and politicians alike during the past two years. Having said that, it would help if Italy didn't have such a democratic deficit. Renzi is Italy's ninth Prime Minister since 1992 - and only two of them have stood in elections to become Prime Minister (Romano Prodi and Silvio Berlusconi). Renzi has never stood in a national election or been elected to either Italy's Lower or Upper Houses of Parliament. Before becoming PM, Renzi was the Mayor of Florence. Italy's government is more conspicuous for its instability than its stability. Italy's post-war cabinets have had sixty governments in the seventy years since the creation of the Italian Republic in 1945. Such a system makes achieving the kinds of reforms Italy needs extremely difficult.

Italy is a sorry shadow of its former self. Italy's economy has shrunk by approximately 12% since the financial crisis of 2007. Overall unemployment is 11.5% and youth unemployment stands at 36.5%, far above the Eurozone rate of 20.8%. At the end of 2015, nearly 60% of jobless Italians had been unemployed for at least a year, compared with 19% in the U.S., according to the *Organisation for Economic Co-operation and Development (OECD).* Italy was not always in such bad shape. Between 1950-70, Italy was a powerhouse of economic growth and in 1987 its GDP passed that of the UK, an event termed by the Italian press as *"Il Sorpasso"* (Italian for "the overtaking") and prompted wild celebrations in the streets of Rome. However, over the last two decades, Italy's economy has essentially stagnated.

Is the Euro to blame for Italy's current economic mess?

Only partly, in the sense that a weaker currency would certainly help Italy grow faster, create more jobs and provide the favourable backdrop needed to carry out unpopular reforms. Reforms, big or small, when the economy is not growing are unpalatable. Italy didn't prepare to replace the fading momentum of the post-war bounce with a new source of growth. Italy's total productivity began a steady decline from its 1970s pace and turned negative in the years after Italy joined the Euro area. Italy's virtual economic stagnation after 1999 reflects, above all, a dismal productivity performance, lack of investment in R&D and an inability to keep Italians with university education from emigrating. The more the highly-skilled Italians leave, the worse the domestic economic performance. This perpetuates the tendency for future generations to leave as well. The Euro may have made the Italian economic situation worse but it certainly isn't the root cause. On the other hand, years of rampant corruption and lack of reform on labour, judicial and economic fronts most certainly are.

In light of the recent results in the *Brexit* referendum and the US election - in what is turning out to be the year of the protest vote - it seems almost foolhardy that any government would risk another referendum. Yet, Renzi had no choice. The political reforms he initiated in 2014 passed through Parliament on wafer thin margins and after long delays. More reforms in the current set up look unlikely. Renzi has made himself hugely unpopular by implementing two major reforms. The Jobs Act, intended to free up the country's labour market, has not only failed to improve permanent employment but it has given employers too much power. The educational reform package gave new powers to head teachers and proved widely unpopular among teachers who will be forced to contend with future pay increases based on merit rather than seniority.

The constitutional reforms, proposed by Renzi, aim to streamline and reduce the powers of the Upper house, the Senate, including making the country's twenty regional governments less influential. Under the proposal, most bills would no longer have to be approved by both the Senate and the lower chamber to become law, and the Senate would lose the power to bring down governments with a vote of no confidence. It would improve the stability of forthcoming Italian governments and a streamlined legislative process would have a chance to reform the Byzantine state bureaucracy and the delay-plagued judiciary.

However, opponents of Renzi are many, including ex-PMs Mario Monti and Silvio Berlusconi. Renzi has suggested that should he lose, he would resign, thereby plunging the country into a period of political chaos. What Italy needs is a "Yes" vote in the referendum and something like the Agenda 2010 program; a series of reforms planned and executed by the German government, that turned Germany from the "sick man of Europe" in 2004 into the economic powerhouse it is today. What it will likely get is a "No", more upheaval and surprises that will threaten the Euro and the foundation of the European Union (EU) in the years ahead.

Trumponomics: A basket of unknowables

President-elect Donald Trump made plenty of promises during the US election campaign but gave very little detail. There are now widespread expectations that Trump will attempt *Reaganomics* with tax cuts, leading to increased spending that boosts growth and inflation.

The Question is - Can he? And to what extent?

The policy priorities of Trump are a basket of unknowables but studying *Reaganomics* provides a useful template when assessing an economic programme he could follow. The US Dollar and the US economy face very different conditions today compared to 1981. If we look at debt and demographics, the difference couldn't be starker:

- US Debt / GDP: *Reaganomics* started from a much more favourable base. The US Debt/GDP ratio was 31% in 1981. Today, it stands at 105%. A low debt / GDP ratio gave President Ronald Reagan room to add debt for fiscal expansion. Total government debt rose from 31% to 50% during the Reagan administration. If Trump embarks on a similar path, US debt / GDP could balloon to potentially unsustainable levels
- Demographics: With rising debt levels, debt sustainability becomes an inevitable topic of discussion. Reagan again benefited from a favourable starting point. Back in the early 1980s the last batch of baby boomers entered the labour market and the working age population grew by almost +2% year-on-year (yoy). The comparable rate is less than +0.5% today and is forecast to decline to +0.1% yoy by the early 2020s. Besides, if Trump were to follow up on his campaign rhetoric of removing unauthorised immigrant workers from the country, the working age population could possibly go into the negative territory very soon. According to *Pew Research*, unauthorized immigrants currently account for approximately 5% of the US labour force

Therefore, the Trump administration's ability to pursue debt-fuelled growth is more limited than many think. It is also evident that Trump's promise to use "cheap" debt to finance investment is not so "cheap" anymore, as yields have risen precisely in anticipation of increased borrowing and inflation. The US 10yr yield is now at +2.4% (it was +1.4% in July and +1.8% on the day of the US election).

The US current account deficit was flat when Reagan came to office. It will be -2.5% of GDP when Trump takes over at the White House. Will overseas investors be sufficiently confident in the long-term prospects for the US economy to fund a rapidly growing current account deficit? The trade-weighted US Dollar (DXY) was 90 when Reagan came to office. It stands at 101 today i.e. Trump faces a strong USD. A strong USD will only make US trade deficits bigger, not something Trump wants if he is to fulfil his promise of bringing jobs back to US shores.

On infrastructure spending, some Republicans, especially House conservatives, aren't nearly as enthused as Trump seems to be about using deficit spending to improve roads, bridges and airports. Trump may have to use tax cuts to win them over and then use Democrats in the House of Representatives to support his planned spending on infrastructure. Expect some pushback on trade too, particularly with China. Trump announced that he will abandon the Trans Pacific Partnership (TPP), and China is stepping in to fill the free-trade void in Asia to the potential detriment of US economic interests.

At the core, Trump is a mercantilist who believes trade deficits are bad for workers and the economy. As such, he would renegotiate trade treaties. Trump's protectionist policies could weaken the USD and risk a trade war that could unsettle global markets and the bond market would worry about outsized budget deficits. However, an all-out trade war was campaign rhetoric and the reality of government may sober President-elect Trump. Trump will be well advised to concentrate on achieving lower taxes, minimal regulation and endorsing trade deals (albeit renegotiated ones) for the US to recreate the pre-conditions that could see him fulfil his campaign pledge to restore growth of +3.5% per annum and to create 25 million jobs over the next decade.

Where to invest

The US economy continues to be one with the best growth outlook among the developed nations. Q3 GDP growth rate is +3.2% (up from the second quarter's more modest +1.4%).

While the equity indexes - S&P 500 (SPX), NASDAQ and Dow Jones Industrial Average (DJIA) - have scaled all-time highs, the real move is within the sectors. Heading into the US election, Technology (XLK) and Financials (XLF), (and to some extent

Energy (XLE) were driving the entire market higher. Sectors like Consumer Discretionary (XLY), Materials (XLB), and Industrials (XLI) had been rather stagnant or lagging for months. All that changed on November 8th when Trump and the GOP swept their way into power. Since then, the Technology sector has given up a significant amount of its gains accumulated over last 12 months, while sectors such as Financials, Consumer Discretionary, and Industrials have surged. Also notable is Health Care (XLV). This sector underperformed significantly leading up to the election due to expectations that a Clinton Presidency would be bad for drug pricing. When Trump won, the sector saw a huge bounce. But remarkably, most of the post-Trump victory outperformance has since dissipated.

Among the US equity sectors, I like Industrials (XLI) and the Financials (XLF). However, a recent good run in both keeps me on the side-line to allocate more. Industrials benefit from both infrastructure and defence plays but the measures that would benefit the sector will take some time to come through. I would wait for both Industrials and Financials to give up some gains before adding significant exposure to them. Materials (XLB) and Energy (XLE) offer better value at this time. Results this Sunday from the referendum in Italy will likely provide some volatility to pick up long trades in all four sectors.

I would recommend staying away from the Emerging Markets (EM) both in terms of bond and equity trading, at least until Trump is sworn in and we have heard more about his trade policies vis-à-vis EMs.

Slow growth and lack of reforms have always been a concern in Europe and add to that now political uncertainty over the next few months. On December 4, the same day as Italy’s referendum, Austria holds an election for the mostly ceremonial post of President. That vote could bring to power the first far-right leader of a Western European country since World War II. Although the victory would be symbolic, it would indicate the fanning of populism in Europe. If the Italian referendum passes away without major issues, then I would recommend one allocate to European equities for a couple of months until we hit elections in Holland in March 2017 which will test the appeal of Geert Wilders, who leads the anti-Islam Freedom Party and wants to emulate Britain with a vote on ending membership in Europe.

One other thing to bear in mind, if Trump goes on the attack on free trade and enacts trade limits, Europe and particularly its largest economy Germany, could come under intense pressure. Germany shipped $125 billion (2.5x what it imported from the US) in goods to the US last year. One and a half million German jobs depend on exports to the US. If US growth accelerates, as Trump has envisaged, and Europe continues to struggle, EUR/USD will hit parity (or even 0.95 is not unimaginable) in the next few months. It would make the US trade deficit with Germany even worse. Everyone looks at China to be hurt the most from protectionist measures gaining traction the world over, but the fact is Germany’s global trade surplus is now nearly 9% of GDP, far larger than China’s 2.5%.

I hold/recommend holding: JP Morgan (JPM US), Bank of America (BAC US), Allergen (AGN UN), Celgene (CELG UW), General Electric (GE), General Dynamics (GD US), Raytheon (RTN US), Northrop (NOC US), BAE Systems (BA/ LN), Boeing (BA UN), Google (GOOG US), Microsoft (MSFT US), Amazon(AMZN UW), Schlumberger (SLB US), Daimler (DAI GY), Airbus (AIR FP), Walgreen Boots (WBA US), Home Depot (HD UN), CBS Corp (CBS US), Alibaba (BABA US), Pfizer (PFE US), Societe Generale (GLE US), BNP Paribas (BNP FP), UBS (UBSN VX), Salesforce (CRM US), Estee Lauder (EL US), Johnson & Johnson (JNJ), Freeport McMoran (FCX US), Glencore (GLEN UN), Rio Tinto (RIO LN).

To end this edition of the newsletter, I want to introduce you to Crossbridge Capital's new digital platform: ***CONNECT*** by Crossbridge. In response to investor demand for an omni-channel business model, ***CONNECT*** is a natural extension for us; bringing together the human investment talent that we have in house with the latest technology, in order to enhance our service offering to you. Please take a look at www.crossbridgeconnect.com.

Best wishes,

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