Weekly Market Summary

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What Would It Take to Save Italy?? Super Mario or Wonderful Trump??
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Italy's government continues playing with fire!

In last week's market coverage, I noted that EU Commissioners Valdis Dombrovskis and Pierre Moscovici wrote a letter to the Italian government describing Italy's fiscal expansion plans and the size of its deviation from original numbers as "*unprecedented and unacceptable*"! The letter had been delivered by Moscovici, the EU's economics chief, during a meeting in Rome - on Thursday 18th October - with Italian Finance Minister Giovanni Tria. It was meant to mark the start of a process that could potentially culminate in a decision by the Commission to issue a negative opinion (essentially rejecting Italy's budget) and ask the Italian government to send it back with revisions (something that has never happened before and would result in millions of euros in fine!).

On Friday (19th Oct.) night, rating agency Moody's downgraded Italy's credit rating in a widely expected move that left it one notch above junk territory. Moody's cut Italy's local and foreign-currency issuer ratings to Baa3 from Baa2 - citing weakening of Italy's fiscal strength and stalled plans for economic and fiscal reforms - and changed the outlook to "*stable*" from "*negative*". "*The shift towards an expansionary fiscal policy suggests that, rather than falling over the coming years as was projected under the previous government's fiscal stance, Italy's public debt will instead remain around the current 130% of GDP, a level that makes Italy vulnerable to future domestic or externally-sourced shocks, in particular to weaker economic growth*," Moody's noted in the report. It also suggested that while the government's economic plans are supportive of near term growth, they "*do not amount to a coherent programme of reforms that will lift Italy's mediocre growth performance on a sustained basis!*" (S&P is scheduled to update its view later today).

In the face of mounting market pressures (widening credit spreads, depressed equity prices and rapidly rising yields) and a near countdown to fiscal crisis, one would have expected reason to prevail in the land of the pizza & pasta! Instead, Italian politicians opted to continue playing their dangerous game!

Last Monday, Italy's populist government defied Eurozone budget enforcers, refusing to curtail its plans for a sharp increase in public spending and insisting that breaking the EU's fiscal rules would not threaten the currency union's stability. Giovanni Tria, economy minister, sent a letter to the European Commission stating that the new spending proposed by Rome was needed to restart growth in the Eurozone's third-largest economy after a decade of economic stagnation. Mr Tria wrote that challenging Brussels' request for changes to the budget "*was a hard, but necessary decision in light of Italy's delay in getting back to pre-crisis levels of GDP and the desperate economic conditions in which the most disadvantaged citizens find themselves*". Rome's refusal to budge marked the first time a member of the common currency has ignored a formal reprimand from Brussels since EU fiscal rules were overhauled at the height of the Eurozone crisis.

Then on Tuesday morning, whilst EU commissioners were discussing Italy's violations at a meeting in Strasbourg, Conte sounded more conciliatory – suggesting in a Bloomberg News interview that he was looking forward to explaining the 2019 budget to them and adding that Italy has some leeway to tweak aspects of the plan, but not actual spending. If I am asked to change the substance, "*it will be difficult for me because I cannot accept that!*" Hours later (I am guessing the poor guy was never asked for an opinion ☺), the European Commission - the bloc's executive arm - officially rejected the budget and asked Italy to take back, revise and resubmit its plans. But Italian Prime Minister Giuseppe Conte insisted his government has no "*Plan B*" for its budget (how about a plan C, Conte, for a change?!). "*There isn't any B plan,*" Conte said in the interview in English at his Rome office. "*I said that the deficit at 2.4%of GDP is the cap. I can say this will be our cap*," he insisted.

Financial markets responded immediately to the news, with Italian bonds falling for the fourth time in five sessions, while the 10-year spread over similar German debt jumping to a five-year of 315 basis points (after the EU rejection was reported).

The decision puts Italy's populist government on a collision course with Brussels as its spending targets far exceed EU limits. Now that the EU has rejected Italy's budget, the country will have three weeks to revise its spending plans and resubmit them to Brussels. "*This decision should be a surprise for no one*," Economic Affairs Commissioner Pierre Moscovici said at a briefing in Strasbourg to announce the measures. "*We are not looking at a borderline case. We are looking at a clear deviation.*" "*The Italian government is openly and consciously going against commitments made*," Commission Vice President Valdis Dombrovskis told reporters in Strasbourg. "*Europe is built on cooperation. The euro area is built on strong bonds of trust*."

Talking about trust, one can directly think of president Donald Trump! According to a recent Washington Post report – FAKE NEWS of course! - Trump's tsunami of untruths has helped push the count in its Fact Checker's database past 5,000 on the 601st day of his presidency, amounting to an average of 8.3 Trumpian claims a day!! And if those lies weren't enough, the US President has thrown his weight behind Italy's immigration policy, offering support to the coalition government which has had a bruising week over its budget. "*Just spoke with Prime Minister @GiuseppeConteIT of Italy concerning many subjects, including the fact that Italy is now taking a very hard line on illegal immigration*," Trump said on Twitter. "*I agree with their stance 100%, and the United States is likewise taking a very hard line on illegal immigration*." Italian Deputy Premier Matteo Salvini has clashed with the European Union over migration and greatly increased his popularity in opinion polls in Italy by making it his top issue. Trump also offered his take on Rome's economic program. "*The prime minister is working very hard on the economy of Italy - he will be successful!*" he said in his Twitter post (one surely hope that Trump won't be successful in maintaining a Republican majority in both the House of Representatives and the Senate at the upcoming US midterm elections in 10 days, and also pray that his former chief strategist – Steve Bannon – fails in his efforts and designs for right-wing super group to gain a populist foothold in the European Parliament next year!).

Last, but not least, a quick coverage of Super Mario's latest performance and views. European Central Bank's president Mario Draghi said on Thursday he remains assured about the Eurozone's "*broad-based economic expansion*" and is "*confident*" the Italian government will reach a budget agreement with the EU. Speaking at a press conference following a meeting of the Bank's governing council; Draghi said that he still sees risks to the bloc's economy as "*broadly balanced*" despite "*weaker momentum*." Mr Draghi's remarks come in the wake of data pointing to emerging challenges in Germany and France, the Eurozone's two biggest economies, in addition to the Italian's tumult amid its budget row with Brussels. ECB policymakers said earlier on Thursday they still plan to end the central bank's bond-buying programme at the end of this year despite the potential hazards and added that Euro rates will stay at historic lows until at least next summer. Mr Draghi also emphasised the importance of central bank independence (Goldman Sachs' connections not included I presume? ☺). "*Central bank independence is a precious thing," he said. "[It is] essential for credibility of central banks and creditability is essential for effectiveness*." His remarks come as US President Donald Trump has in past weeks harshly criticised the Federal Reserve for raising interest rates during a time in which the federal government has deployed substantial fiscal stimulus in the form of tax cuts.

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