LOMBARD ODIER
INVESTMENT MANAGERS

Global Perspective

Could the EU handle another crisis?

For professional investor use only • Asset Management

June 2018

Executive summary

Leading central banks are shifting gears amid a rapidly evolving risk landscape. The ECB is striking a delicate balance, announcing the forthcoming end of quantitative easing while pledging to keep interest rates low. The Federal Reserve, in contrast, is signalling that faster rate hikes may be needed, given low US unemployment.

The policy divergence is likely to contribute to US-dollar strength, a key risk factor for risky assets. Meanwhile, both the ECB and the Fed have warned that an escalation in US-China trade tensions could cause significant economic damage – a concern that is likely to shape monetary policy.

Another worry for investors is how EU institutions will respond if the situation in Italy precipitates a Eurozone crisis. Although markets are taking a more sanguine view of Italian politics, the populist coalition's policy agenda puts it on a collision course with the EU. We think it is highly likely that sentiment around Italy will deteriorate again in the coming months. The next big challenge could come in the autumn, when the Italian government is likely to announce its first budget.

EU institutions are much better prepared for a crisis than they were in 2011/2012, but they remain untested – especially in the event of a problem the size of Italy. The ECB now has multiple tools at its disposal to deal with a crisis, but they all have the same flaw: political constraints could severely limit their use and effectiveness.

Key implications

- Further divergence of US/European central bank policy could strengthen the US dollar. This is a key risk for risky assets over the near-term, especially emerging markets (despite stronger fundamentals than in 2013)
- Central-bank concern over US-China trade tensions is likely to shape monetary policy
- Italy remains a threat, and we think a re-escalation of market tensions is highly likely
- Despite having many more tools at its disposal, the ECB may face political constraints on its ability to respond to another crisis

Dr Salman Ahmed
Chief Investment Strategist

Charles St Arnaud
Senior Investment Strategist

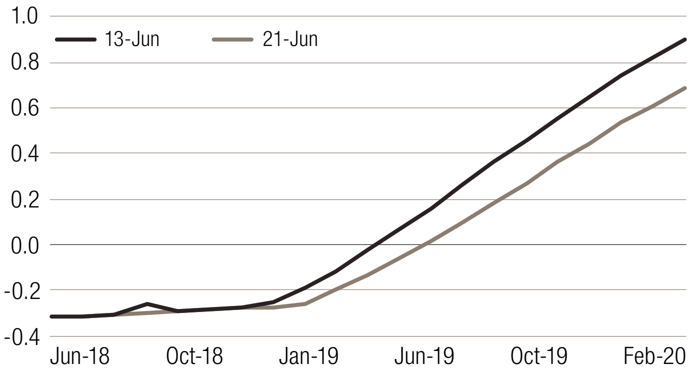
Jamie Salt
Analyst

Introduction

Over recent days, both the European Central Bank (ECB) and the US Federal Reserve have shown signs of renewed dynamism. The ECB, led by President Mario Draghi, has struck a delicate balance, announcing the end of its quantitative easing (QE) programme in December while promising to keep financial conditions easy in the single currency union. This was achieved by issuing more explicit guidance on the timing of future rate hikes (i.e., no hikes until the summer of 2019 at the earliest) and verbal assurances that the ECB's Governing Council stands ready to act if economic conditions deteriorate.

Given recent signs of an economic slowdown in the Eurozone and the re-emergence of political issues in Italy, there was a case for the ECB to wait until July for its next policy-shift announcement. However, noise from the usual hawks – led by Germany's Bundesbank – meant that the ECB instead opted to offset its pre-announcement of the end of QE with confirmation that interest rates will remain anchored at low levels (a notably different approach than the Fed took in 2013, which was widely considered a mistake).

FIG. 1 3-MONTH EURIBOR CURVE



Source: Bloomberg.

The ECB's new policy appears to be a yield-control mechanism focused on the short-end of the curve, which Japan has shown can be a valuable tool to stabilise financial conditions, especially when QE is being phased out. Indeed, full-blown yield-curve control remains at the disposal of the ECB should the Italian situation deteriorate and the usual backstops (discussed below) become less effective given the accompanying political brinkmanship.

Meanwhile, the Fed has reacted to the low US unemployment rate by signalling (via its "dot plot" – a chart showing interest-rate forecasts) that faster rate hikes may be needed. The divergence between the ECB and the Fed is not new, and will likely contribute to further US-dollar strength as the interest-rate differential moves strongly in favour of the US currency (a key risk factor for risky assets, especially emerging markets assets).

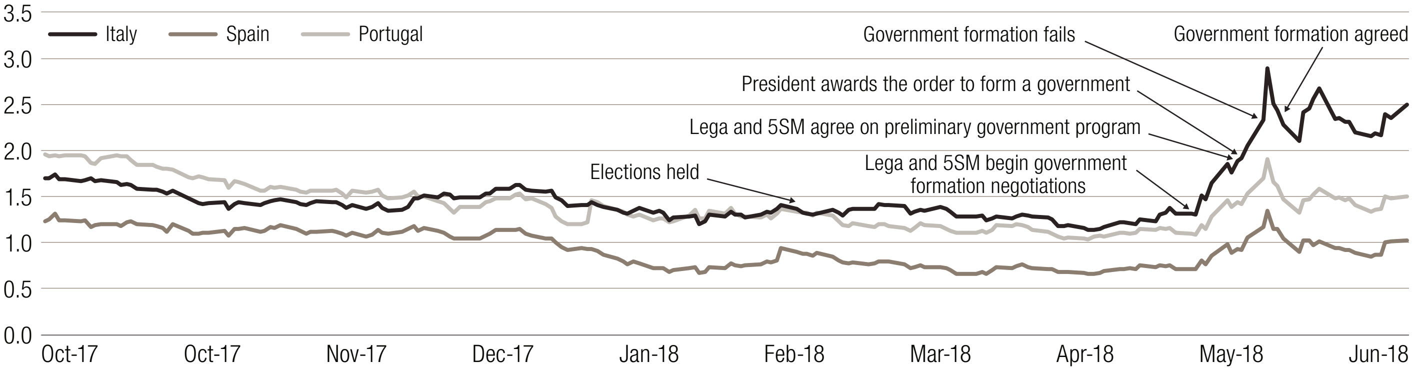
The negative impact on risky-asset markets of the recent escalation of US-China trade tensions is still fresh. But key central bankers are already striking a concerned tone (as Draghi and the Fed's Jerome Powell did at the ECB Forum on Central Banking in Sintra, Portugal), highlighting the scope for damage to both sentiment and fundamentals if matters get worse. Indeed, there are emerging signs that the US and China are becoming stuck in a "prisoner's dilemma" situation, with both parties focusing on narrow self-interest when a collective approach could produce a better outcome.

It is important to remember that the tariffs confirmed so far remain insignificant in economic terms. For China, the potential hit to growth is only 0.1 percentage point. But the negative signals being sent to markets are very concerning and likely to shape monetary policy in the coming months as investors revise their expectations.

The ECB and Italy

The formation of a coalition government in Italy, between the populist Five Star Movement and Northern League parties, led to a sharp rise in Italian sovereign spreads (see **"An Italian remake of a Greek tragedy"**). This reached a peak when President Mattarella vetoed the coalition's very eurosceptic choice for finance minister, causing investors to reprice the probability of Italy exiting the euro. Since then, the coalition has comprised a more diverse mix of europhiles, eurosceptics and technocrats, calming markets.

FIG. 2 YIELD SPREAD OVER GERMAN 10-YEAR BUNDS (PERCENTAGE POINTS)



Source: Bloomberg.

Nevertheless, while investors are taking a more sanguine view, we believe the Italian government's agenda puts it in conflict with many of the rules underpinning the monetary union (see **"An Italian remake of a Greek tragedy"**). The proposal for a mini-BoT is particularly concerning, in our view, given its close resemblance to a parallel currency.

Investors need to be mindful that the risk remains high that tensions in the Italian bond market will flare up again in the coming months. Below, we look at developments in Italy since our initial article and assess how the ECB might react if tensions escalate.

Italy's political situation

In our original assessment in late May, we warned that Italy's political situation was reminiscent of Greece in 2015. While the initial market turbulence supported this view, Italian politicians were much quicker than their Greek counterparts to soften their stances, allaying market concerns.

First, President Mattarella's decision to veto the original cabinet, especially the choice of fervent eurosceptic Paolo Savona as finance minister, was welcomed by market participants, despite the initial sell-off in Italian bonds. This gave investors confidence that the powers given to the president in the Italian constitution may help avoid a Greek-style crisis. Second, Italy's populist government was much quicker to come out in favour of Italy staying in the euro, despite previous pledges to leave the common currency. The nomination of Giovanni Tria as finance minister helped on that front as he is viewed as "pro-euro", though he advocates reform.

Nevertheless, Italy's government remains in conflict with EU institutions, via policy pledges including:

- To overhaul all EU fiscal and monetary rules
- To review rules related to the single market
- To oppose "all aspects" of the CETA (EU-Canada Comprehensive Economic and Trade Agreement) and TTIP (Transatlantic Trade and Investment Partnership)
- To propose a radical review of bank bail-in rules
- To propose the withdrawal of sanctions on Russia and be much tougher on immigration

The most serious conflict is likely to arise from fiscal policies, where the coalition's flagship proposals include:

- Simplifying the tax code by introducing a two-tier flat tax rate of 15% and 20%
- Guaranteeing EUR 780 a month to Italians below a certain income level
- Scrapping the pension reforms agreed in 2001

Tensions are already developing with other euro-area countries on migration and the ratification of the CETA. The former issue is likely to take centre stage at the EU summit at the end of June and is destabilising Germany's coalition as it is.

The next big test may come in the autumn, when the Italian government is likely to announce its first budget. We think it will show a fiscal deficit exceeding 3% of GDP, given the promises of a flat tax and universal income. A confrontation is likely: either between the government and the president, if the latter judges the deficit excessive, or with other European countries. Either way, it is probable that tensions in the BTP market will rise again.

What can the ECB do if Italy precipitates another Eurozone crisis?

Increased tensions in European financial markets have led some investors to wonder how EU institutions would respond to a crisis. The most important observation is that they are far better prepared than they were in 2011-2012, but they remain untested, especially in the face of a problem the size of Italy. The country is the third-largest in the Eurozone and Italian government debt accounts for a little more than 20% of the total government debt issued by Eurozone countries.

The ECB would play an important role in supporting a country under market stress. The main tools it could deploy are the following:

Outright Monetary Transactions (OMT)

The OMT policy was put in place in the wake of Draghi's "whatever it takes" speech in 2012. It allows the ECB to purchase government bonds in the secondary market to correct market distortions that are hampering the transmission mechanism of monetary policy. By reducing these risk premia, OMT safeguard the monetary union and the single currency. However, OMT support is conditional on a member state being deemed in compliance with the rules underpinning the monetary union.

Liquidity operations

In the event of increased tensions, the ECB is also likely to inject liquidity into the banking sector. Before the financial crisis, the ECB only offered liquidity of up to three months. Now, it can provide long-term liquidity, of up to four years, through LTRO (long-term refinancing operations). In a crisis, these operations become very important as they ensure banks have enough liquidity to meet their financing needs and therefore remove doubts as to their short-term solvency.

Emergency Liquidity Assistance (ELA)

This is a lender-of-last-resort facility provided to a bank by a national central bank. However, ECB Governing Council approval is required for assistance above EUR 2 billion. A ceiling on ELA can also be set by a national central bank and approved by the ECB Governing Council, as happened in Greece in 2015, to give the national central bank the flexibility to increase ELA, as needed.

European Stability Mechanism (ESM)

The ESM is not one of the ECB's tools, but it would likely be used in a crisis. ESM works in a very similar fashion to an IMF programme. A loan is extended to a country that has lost access to markets for financing. In exchange, the country agrees to certain macroeconomic adjustments, mainly fiscal ones. These are set by the European Commission in collaboration with the ECB. The IMF would usually also be involved, but ESM is not conditional on this.

The main design problem with all the above tools except the ELA (which were put in place post 2011/2012 crisis) is that all of them require a strong degree of political judgement by the various institutions involved, especially when the issue is caused by a problematic/populist government's actions and policy intentions. Given these potential political constraints, shifting rate guidance further into the future (a rolling yield control) is a policy tool that could come in handy if sentiment around Italy deteriorates again (which we think is highly likely in the coming months).

IMPORTANT INFORMATION