Tortoise QuickTake Credit Podcast

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Welcome to the Tortoise QuickTake podcast. Thank you for joining us. Today, senior members of Tortoise provide a timely update on trending topics in the market.

Hello, I'm Graham Allen, Senior Portfolio Manager at Tortoise with a special podcast.

Recently, the market breathed a short sigh of relief when Italy's government indicated that it would reduce its budget deficit to a level more acceptable to the European Commission. The initial budget submission, which forecast a deficit of 2.4% to the year 2021, triggered a sell-off in global equities and Italian assets. When it emerged that an element of the plan reduced the deficit by simply raising Italy's GDP forecasts, one would be forgiven for remembering the Greek finance Minister known as the 'Magician'. In 2000, he would miraculously deliver whatever economic data was needed to facilitate Greece's entry into the European Union (EU). Most famously, the government purchase of the Greek national railway was treated as a capital cost rather than a revenue expense that would have increased the national debt. At the time it was said that the railway had more staff than passengers and was losing €1 billion a year. With hindsight, of course Greece was never financially ready to join the single currency union at the beginning of 2001.

Turning back to Italy, the latest change of course by the government seems more like an exercise in deferring the inevitable problem; in other words kicking the can down the road. The details of the plan are still not public and will not be known before the October 15th deadline. Let us examine why this issue is fundamentally important to the continuing existence of Italy within the EU.

Italy has two debt problems. Firstly a debt-to-GDP ratio of 130% of GDP, a level barely sustainable for a country with anemic growth expectations. In order to reduce this, Italy must achieve positive healthy GDP growth and generate budget surpluses.

Italy's second major debt problem is its debt-to-the-ECB, arising through the European Central Bank's (ECB's) asset purchase program. This is known as a target or target2 balance and is on the face of it a liability to the ECB. When funds shift between countries within the EU there is a theoretical debit made to the receiving country and a credit to the donating country. Of the total target balances held at the ECB of over €1trillion, Italy holds the bulk at €491 billion. Most of this is owed back to Germany and theoretically, must eventually be repaid.

These combined balances therefore represent the rock on one side of the Italian government's predicament. The hard place is keeping its anti-EU voters happy as well as the European Commission. By simply raising its GDP forecasts rather than say, offering real spending cuts, both are assuaged in the near-term along with the markets.

When assessing Italy's current problems its worth looking at how they came about. The two major issues giving rise to the anti-EU sentiment, which elected the most recent governing coalition, are economic- and immigration-related. They are similar to the issues that gave rise to BREXIT but not the same. Most notably, Italy's economic performance, or lack of it, has been a major driver of disillusionment with the EU. According to Eurostat since 2008, Italy's real GDP has fallen by 5% giving rise to chronic unemployment levels, especially among the young which stood at 31% in July 2018. By being a member of the Eurozone, Italy's exports are affected by the level of the Euro that generally reflects the competitiveness of the Eurozone as a whole. Furthermore, spending by the Italian government is restricted by the 3% deficit limit of the European stability and growth pact. As a result, its ability to stimulate the Italian economy by either tax cuts or increased spending has always been very limited and effectively determined by factors outside its control.

The latest GDP report from Italy is +0.2% for the three months to June 2018, a two-year low. This is clearly well below the level ultimately needed to reverse rising debt levels. The initial budget submission to the EU predicted a deficit of 2.4%, and was met with resistance from the EU. By raising growth forecasts, which would push tax receipts higher in coming years the

deficits are reduced to 1.4% of GDP which would turn into a surplus by 2020. The problem is, under the spending limitations imposed by the stability pact, it is difficult to see how the government can increase growth, especially as the traditional tool of currency devaluation is off the table.

So the Italian government is caught between its voters and the ECB. Voters want more growth and higher wages, more social spending, less immigration and lower unemployment. Among other things, these were promised in the last election campaign and look increasingly hard to deliver given Italy's predicament. On the other side of the equation, the EU wants Italy to stay within the rules.

Ultimately, the markets determine the credibility of any proposals. Italy's interest rates have been rising with its ten-year bond yields now 2.8% higher than Germany's. The ECB has not been shy about withdrawing its purchases of Italian bonds if the EU is not pleased with the actions of the Italian people or government. This action alone pushes rates higher, increasing Italy's interest costs. Given its level of debt, Italy needs to keep rates low so it can at least fund expenditures in the open market. If rates get too high, the Italian banks will quickly run into problems, potentially sparking a debt crisis similar to Greece, except much worse.

Although it's a delicate balance, this explains why both sides are reluctant to do anything drastic. It also explains why kicking the can down the road is an attractive option for both sides at this moment.

Thank you for listening.

Thank you for joining us. And stay tuned for our next cast. Have topics you want covered or other feedback to share? Write us at info@tortoiseadvisors.com.

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