Tortoise QuickTake Credit Podcast

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

Hello, I'm Graham Allen Senior Portfolio Manager at Tortoise Credit.

If you keep kicking the can down the road, eventually you run out of road. This year could see a perfect storm in Europe, potentially signaling the end of the European Union, as we know it.

There are three converging tectonic shifts that could trigger an existential threat to the European Union itself. They are political, financial and economic in nature.

Let us examine all three. The upcoming European elections have the potential to shift the underlying political balance in the European parliament from pro-Europe to anti-Europe. How this affects policy going forward is unknown as the European council makes executive decisions, only to approve by the democratically elected Members of the European Parliament. The growing disillusionment with the EU structure has been evident across the continent with the election of anti-European leaders. Most notably in countries such as Hungary, Italy and Holland. The results of the recent Dutch bi-elections were nothing short of shocking, as the nationalist FvD party not only caused the ruling coalition to lose its majority, surprisingly becoming the largest single party in the heavily divided Dutch senate. Holland could be considered a core European country so these results have to be seen as a warning shot to Brussels. Two other political facts are worth mentioning. The loss of German Chancellor Angela Merkel, heretofore the de facto leader of the EU, leaves a leadership vacuum in the EU. The obvious candidate to replace her would be French President Emmanuel Macron; however his popularity in his own country has dropped to below 30% since being elected.

Another unexpected negative variable is also the likelihood of the election of British MEP's to the European Parliament now that BREXIT is delayed. Many elected UK MEPS could be highly anti-European as polls indicate that the vote could force a much higher voter turnout than normal for the European elections due to the frustration with the Brexit process itself. Their presence in the new European Parliament could be highly disruptive.

Separately, the European Union's economic growth is slowing, spearheaded by Italy. Italy is in recession reporting two successive negative GDP reports in the second half of 2018. The outlook for growth in 2019 also remains stagnant by admission of the Italian Populist government itself, which forecasts +0.2% growth in 2019. Although the slowdown is less pronounced elsewhere in Europe, what happens in Italy is critical as it exposes one of the fundamental flaws of the existing structure of the Euro Zone. That is, the difficulty of managing 17 different fiscal policies using a single monetary policy. Until now, the institution responsible for providing economic stimulus has been the European Central Bank via its various bond-buying programs that have given rise to enormous amounts of negatively yielding government bonds across the continent. This action has essentially funded government spending at the expense of rising debt and deficits and extraordinary low yields. The situation is not tenable and will have to be addressed at some juncture. The problem is that any action to correct this will be anti-growth not pro-growth, the last thing you need when a continent is slowing rapidly. At present Italy's ten-year bond yield about 0.95% higher than the US, ten year bond yield and in no way reflects the difference in risk between holding 10-year US treasuries and 10-year Italian Government bonds. If growth continues to worsen, the ECB will have increasingly limited options to reverse the trend. This in turn will only increase calls for the constrictions of the EU to be lifted.

One obvious solution is more government spending. This is the third looming factor that has the potential to inflict a fatal blow to the Eurozone itself. For member countries inside the Eurozone, spending is limited by the rules of the original Maastricht Treaty. This includes limits on budget deficits, and debt to GDP ratios inflation etc. The problem is that the countries that underperform the most and need the highest spending boost, are nearly always the same as the countries that are struggling to stay within bounds of the Eurozone rules, Greece and Italy being good examples. The result is extended periods of economic underperformance resulting in growing anti-European sentiment and rising chronic unemployment. In the last 10 years, Italy's debt /GDP ratio has grown from 112% GDP to 132%, while total Eurozone debt stayed approximately the same at 81% by comparison. Greece's nominal GDP has decreased by almost 30%!

To conclude, many of these trends are not new so why are things different this time around? The answer may be the timing. Each one of the factors has a tipping point, and as time has evolved, all three appear to be close to breaking point. Furthermore, it is difficult to fathom what solutions can be offered up to correct these misalignments without making matters worse. In all three cases, something has to give, or more importantly, fundamental changes are needed inside the EU if it is to survive.

One thing is for sure, the road for kicking the can is running out!

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.