Tortoise QuickTake Credit Podcast

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

Hi I'm Graham Allen, Senior Portfolio Manager at Tortoise. This podcast is a follow-up to the Tortoise podcast published in March 2018. In that podcast we outlined the negative implications of recent European election results, including the Italian general election. Tuesday's global sell-off shows that the political instability in Europe has global market ramifications.

Let's fast forward to today. Three months on, the political impasse in Italy is now front and center and causing nervousness in the world's investment markets. This reaction that would have been appropriate at the time of the election result, because it was clear then that at some juncture a collision of ideologies was inevitable. And that would expose one of fundamental flaws of the Eurozone.

The use of a diminishing amount of pain-killing medicine after major surgery is often necessary to keep a patient comfortable through the healing process. While the careful use of medication is desirable for the patient, it is difficult to assess the real rate of recovery until the body is free to transmit pain signals to the brain uninterrupted by medication.

At present, the EU itself remains a heavily medicated patient, whose real condition is masked by the soothing effects of the European Central Bank's bond-buying program. Like the awareness spectrum narcotic, 'The Spice' in the movie Dune, the continued existence of the Union has been heavily dependent upon the continued injection of funds into the fixed income markets to support the spending of the various countries of the Union. The problem is that due to differing growth rates and competitiveness, some countries need more 'Spice' than others. The real state of the European Union itself as well as its member countries, which would normally be reflected in individual countries' bond yields, is distorted by this behind the scenes actions of the ECB. Alarmingly, the markets are not reflecting the real underlying dilemma which faces the EU and its member countries as this program gets ever bigger. Since the great recession, the ECB's balance sheet has grown from approximately €1.5 trillion to €4.5 trillion, mainly because of the sovereign and corporate bond buying programs. During this time, the ECB has effectively been the only stimulus in town as most countries in the Eurozone were forced by high debt levels and the restrictions of the European stability mechanism to curtail spending. Although the ECB program has been successful in calming markets and bringing down interest rates, the stimulus has been less effective at stimulating growth. As a result, Europe has been mired in a sub-par growth environment for most of the last ten-years. Among many other factors, this a root cause of the rise of the populist parties.

So why is the Italian election result so critical? One of the fundamental flaws of the Eurozone model is the difficulty of managing 19 different fiscal policies (the number of countries in the Eurozone) around the framework of one currency and one monetary policy. If each country shares the same currency, there has to be controls on spending for the system to be fair. Presently country spending is controlled through the European stability mechanism that limits the annual budget deficit to 3% of GDP of any particular country. If this target is not met, then theoretically there are penalties for offending countries, although in reality these are hard to enforce. The reality of this mechanism is that it restricts a countries' ability to fiscally stimulate its economy in order to promote growth. The result therefore has been mediocre growth across the region, with the exception of a few countries, and a pervasive feeling of austerity. This changed in 2017 when growth finally picked up across the EuroZone. However, this growth spurt already appears to be wilting as indicated by the various purchasing manager surveys, which show that the peak in growth may have already passed.

So with Europe possibly heading into a slowdown, BREXIT being finalized, more political uncertainty in Spain with a no confidence vote for Prime Minister Rajoy who remains the main opposition to the Catalonian independence movement, the last thing Europe needed was the election of a populist coalition in Italy.

Italy has been particularly hard hit, generally experiencing lower growth than other countries. Unemployment also remains stubbornly high. If the Italian election has done nothing else, it has thrown more light on the approaching philosophical collision which awaits the fate of the EU. The two coalition parties ran on a platform of divergent political philosophies, both of which involve spending policies that will ultimately violate the restrictions of the stability pact in clear defiance of Brussels. Add to that that Italy's debt to GDP ratio of 130% is approaching alarming levels. At its worst point Greece reached 175%. The poor relative performance of the Italian economy has also given rise to an estimated €300 billion of bad loans presently owned by the Italian banks. This was the main reason European banks led the markets lower on the May 29th sell-off. It was triggered when the attempted appointment of an anti EU finance minister, which was proposed by the new populous coalition, was rejected by the Italian President, the move was arguably in defiance of the electorate and gave rise to speculation of another snap general election.

Two days on, the markets have been calmed by the prospect of more talks between the coalition parties delaying another general election, and a relatively successful bond auction of Italian government bonds. However, none of these issues solve the underlying discords within the Union which will ultimately resurface. The conclusion of most commentators is that it is impossible to predict the outcome of the unfolding Italian political drama. That may be so, but there are no signs that the ultimate solution will be anything other than severely disruptive to the European Union as well as the European fixed-income markets.

There are signs that the patient is finally not responding to the medication and is waking up to feel the real pain of its condition. 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.

