GREENLEAF TRUST

Perspectives

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William D. Johnston
Chairman, Greenleaf Trust

Economic Commentary

Current economic data and news seems mostly positive, and yet there are those who are uneasy about the near-term future and seem increasingly convinced that a recession is not far off. Why is there seemingly a disconnect between the current condition and what lies ahead of us? In this month's article, we will try to offer some perspective on the topic.

While it is true that the consumer is employed, labor participation rates are increasing, and wages are growing, many economists would argue that those are at best current data points and at worst lagging indicators. Further, they would suggest that those data points are "rear view mirror" measures that reflect the conditions of previous months and quarters, not predictors of future conditions.

Retail sales increased for the month of June, in large part due to employment and consumer confidence, yet it reflected the first advance since the first quarter of the year; a good number of economists would certainly claim retail sales to be a revelation of what did occur and not what will happen in the future. In fact, of the fifty economic indicators, whose data collection results are released monthly (70%) and quarterly (about 30%), most would reflect results that have occurred and are not predictive about the future.

In essence, most economic analysts would evaluate the current condition of our economy as that of moderate growth as measured by the data sets that we currently have. They would also caution that moderate GDP growth would only continue if the economic conditions that are currently in place continue without change. What signs are economists seeing both globally and domestically that have them concerned?

China

The Chinese government reported that in the second quarter of 2019, China's economy grew at 6.2%. In isolation, a growth rate twice the amount of our expected GDP might look very robust; however, the 6.2% growth rate announced was the slowest rate of growth in twenty-seven years (when the Chinese government began publishing growth numbers). The rate published was within the government's expected range of growth (6.5%) but confirms that their growth rate is slowing.

Commentary, continued

As our Federal Reserve has turned more dovish (easing rather than increasing rates) so too have many other central banks. The European Central Bank (ECB) signaled an intent to ease monetary policy as have the central banks of Indonesia, South Africa, South Korea, New Zealand, India, the Philippines, and Malaysia, which are all significant trading partners of China. Central banks all utilize the tools on hand to stimulate growth and control inflation, and it is clear that the global move is to assist growth and is therefore an indicator that the risk of recession globally is increasing.

We have stated before that the PMI (purchasing manager index) is a reflection of current manufacturing activity and, therefore, optimism. A recording below 50% on the survey implies contraction and conversely results above 50% demonstrate growth. The current recording for the US PMI in June was 50.6% while the 19 member Eurozone PMI fell to a six-year low of 47.6%. The United Kingdom posted a six year low as well at 48.0%, and China came in at 49.4%. So there you have it, economies representing over 73% of the total global economy are producing PMI survey results at or near recessionary levels.

"So there you have it, economies representing over 73% of the total global economy are producing PMI survey results at or near recessionary levels."

Brexit

The United Kingdom has a new Prime Minister who must now deliver on promises made to his political party, the Conservative party, and to the citizens of the United Kingdom who voted for the United Kingdom's exit from the European Union over three years ago. Prime Minister Johnson was a vocal leader of the Brexit movement and has stood in stiff opposition to any attempt to exit the European Union under any terms negotiated by the former Prime Minister Theresa May. The United Kingdom has its own Central Bank and is a trading partner with the entire globe, yet the terms of trade between the European Union and the United Kingdom have expired, and the opportunity to continue as is, is quickly coming to an end. The change in leadership will allow Prime Minister Johnson to extend the agreement date until October; however, the expectation of his success by his party and those who voted for Brexit is enormously high, and therefore results must be attained. As a political leader, he stood his ground and gained political capital among the conservatives in the United Kingdom. His negotiation, however, is not with them but with 18 trading partners, which includes the messy and complicated agreement with Northern Ireland. We could write an entire article about the complexity of the needed agreements; however, the real impact for the rest of the globe is the continuation of commerce and trade. Until the resolution is known the economic forecasts are more clouded than clear and add an element of concern for global GDP.

Anti-Growth Policies

There are many surveys of CFOs among large global consulting companies and in last month's article I referenced McKinsey as one of them. Another survey that is gaining traction for thought leadership is the Duke CFO survey produced by Duke's Fuqua School of Business. The survey has concentrated on the forward focus of CFOs of the largest US companies. On the question of recession, the survey is clear. Two thirds of the survey respondents feel that we will enter a recession in 2020 with the undercurrent of thought being in three main categories: Current US trade disputes with significant trading partners; Tariff policy and Brexit uncertainty; and lastly, there was significant mention of the length of our current expansive business cycle at 121 months.

Geopolitical

We have endured over six decades of tensions and wars in the Middle East in the post-World War II era and the present escalation of tension between the US and Iran adds to the uncertainty of the continuation of global trade and commerce. The conflict is, at its core, the perception among the Shi'a sect of Islam that the US supports the Sunni sect of Islam (representing approximately 85% of all Muslims) even though within both the Shi'a and Sunni sects there are many smaller sects. The historical legacy of conflict between Iran and the US is long and amplified by the US backing of the Shah of Iran, prior to the Iranian Revolution, which was followed by Iranian hostage taking during the Carter administration and now failed denuclearization. There is a difference between political tension and war when it comes to global economic activity, but the increasing military buildup has elevated a long-standing political conflict to the top of the economic concern list.

So the essence of thoughts among mainstream economists seems to land around the acceptance of an economy that is growing moderately yet facing some stronger headwinds that could slow growth in the future months. Events that change the condition that we are in are not easily predictable with respect to probability, but are always easy to identify as "increases in risk," and I think that is a fair place to land.

"... the present escalation of tension between the US and Iran adds to the uncertainty of the continuation of global trade and commerce."

Michael F. Odar, CFA
President

Greenleaf Book Club

Do you remember writing book reports in school? I often felt the structure of the specific questions, required formatting, and deadlines associated with the report took away from the enjoyment of actually reading the book. The joy in reading for me has always been the creative thoughts inspired by the content of the book, not necessarily analyzing the symbolism of a specific motif used throughout the story. Sharing and discussing those creative thoughts with others that have also read the same book inspires critical thinking.

This is exactly why I started our Greenleaf Book Club shortly after becoming president of Greenleaf Trust. The goal was to engage our leadership team's collective critical thinking skills to better each other and our company. We will typically read two to three books a year. No reports, just candid discussion on what everyone thought about what we read, and how we could apply the concepts to Greenleaf Trust and ourselves. We have focused our readings on such topics as leadership, strategy, innovation, teamwork, diversity, emotional intelligence, etc. The resulting discussions are approached with a growth mindset and have been honest, thought provoking, and challenging. Some of the books from our recommended list include:

1. *Scaling Up Excellence* by Robert I. Sutton and Huggy Rao;
2. *Switch* by Chip and Dan Heath;
3. *Multipliers* by Liz Wiseman;
4. *The Five Dysfunctions of a Team* by Patrick Lencioni.

> "We have focused our readings on such topics as leadership, strategy, innovation, teamwork, diversity, emotional intelligence, etc."

Most recently, our Director of Research, Nick Juhle, led us through a discussion on the last few chapters of the book *Small Acts of Leadership* by G. Shawn Hunter. The premise of the book is that by adopting small intentional behaviors and practicing them every day, leaders can make a broader impact. Specifically, the author describes twelve critical competencies that are consistently present in the daily routines of the most successful leaders. We spent a fair amount of time discussing the chapter on inspiring others. From the book, we challenged ourselves with the question "When people leave an interaction with me, do they leave feeling more or less energized?" We had to be honest with each other. You are not being honest with a blanket answer to the question of simply "more." Therefore, the discussion evolved into ways we could all consistently be energizers by doing more of the simple things like being present, following through, and asking supportive questions.

Having our leadership team spending purposeful time collaborating on how to inspire those they lead is important. Highly talented, inspired people doing important work together leads to impactful outcomes for our clients, which is the collective goal. Our book club meetings provide the time and forum to learn and grow like this. And that's my book report.

Michigan Economic Update

Christopher D. Burns, CFA®, CPA®
Investment Strategist
Senior Fixed Income Analyst

Summer is a special time in our pleasant peninsula. Many Michiganders pack the kids into the station wagon and head off to explore areas outside of their home towns.

This article will address what Michiganders might observe on their travels. Specifically, it will cover how Michigan's economy is faring 10 years after the financial crisis. To get a sense of the health of the state we will cover the labor market, the auto industry, and home prices.

Fortunately, this article comes after two important conferences which addressed the outlook for Michigan.

1. In mid-May, the state government's House Fiscal Agency hosted the Consensus Revenue Estimating Conference. The unimaginative name belies the excellent information and forecasts provided by economists and auto industry experts. These forecasts help Michigan's lawmakers establish the state budget, and provide useful information to investment managers like Greenleaf Trust.
2. At the end of May, the Detroit Branch of the Chicago Federal Reserve Bank hosted the Automotive Outlook Symposium. Economists from Ford and various industry research groups provided near-term outlooks for auto sales, production, and labor negotiations.

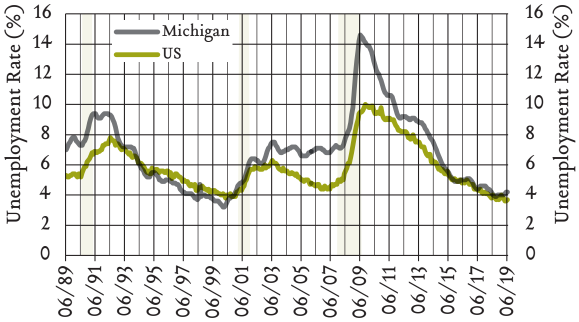
As this article will detail, progress has been great over the past 10 years, but the outlook may be more challenging in the future. Let's start with a review of the labor market.

Michigan's Labor Market

Almost exactly 10 years ago, Michigan was struggling through its highest levels of unemployment in a generation. The unemployment rate peaked at 14.6% in June, 2009 and has fallen to a current level of 4.2%. Michigan has spent much of the past two decades above the national level of unemployment rates. That remains the case today. National unemployment is 3.7%, down 0.3% since last summer, while Michigan's unemployment rate has risen 0.2% to its current level of 4.2%.

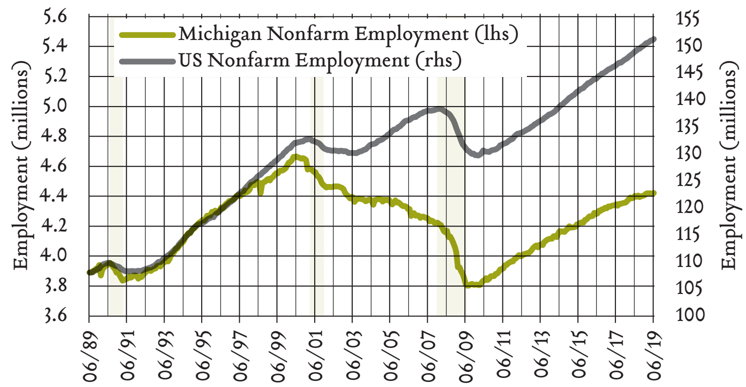
> "Almost exactly 10 years ago, Michigan was struggling through its highest levels of unemployment in a generation."

Michigan Unemployment Rate



Even the strong recovery since the financial crisis has failed to bring total employment back to its prior peak. In mid-2000, the state had nearly 4.7 million employees on business payrolls. Today, there are roughly 4.4 million.

Michigan Job Growth Lags US



"Today, travelers heading to the east side of the state will find counties with worse-than-average trends in unemployment rates."

Today, travelers heading to the east side of the state will find counties with worse-than-average trends in unemployment rates. Among the 20 largest counties, only Muskegon and Jackson have lower unemployment rates than a year ago.

County	May 2019	May 2018	12-month net change	Population
Wayne County*	5.1	4.3	0.8	1,753,893
Oakland County*	3.5	2.7	0.8	1,259,201
Macomb County*	4.2	3.3	0.9	874,759
Kent County	2.7	2.6	0.1	653,786
Genesee County*	5.6	4.3	1.3	406,892
Washtenaw County*	2.9	2.8	0.1	370,963
Ingham County	3.2	3.2	0	292,735
Ottawa County	2.6	2.5	0.1	290,494
Kalamazoo County	3.1	3.1	0	264,870
Livingston County*	3.3	2.6	0.7	191,224
Saginaw County*	4.6	4.2	0.4	190,800
Muskegon County	3.9	4.1	-0.2	173,588
St. Clair County*	4.6	3.7	0.9	159,337
Jackson County	3.4	3.5	-0.1	158,823
Berrien County	3.8	3.8	0	154,141
Monroe County*	4	3.7	0.3	150,439
Calhoun County	3.8	3.7	0.1	134,487
Allegan County	2.8	2.8	0	117,327
Eaton County	3	3	0	109,826
Bay County*	4.3	4.3	0	103,923

*Denotes counties east of Ingham

This is due, in part, to slower hiring and to layoffs among auto manufacturers. We monitor layoff notifications to the state and noted the following impacting more than 200 jobs in a particular county over the last year.

Date	County	City	Number Affected	Description	Industry
2/4/19	Macomb	Warren	1,298	GM Warren Technical Center Layoff	Automotive
4/1/19	Wayne	Detroit	703	FCA Temporary Layoffs, Mack Engine Plant Retooling	Automotive
12/17/18	Wayne	Detroit	696	GM Hamtramck #1 & #2 Closure, Relocation Offered to Some	Automotive
5/24/19	Macomb	Warren	265	GM Warren Transmission Operations	Automotive
6/26/19	Kalamazoo	Portage	247	State Farm Closure	Insurance
11/5/19	Genesee	Flint & Burton	235	Lowe's Store Closures, Relocation Offered	Retail
12/21/19	Eaton	Charlotte	212	Adient Facility Closure	Automotive
11/7/19	Oakland	Southfield	209	Concentrix Layoffs	IT Consulting
1/29/19	Ingham & Oakland	Lansing & Waterford	208	Tribus Services Closure	Utilities

Additionally, in May 2019, Ford announced that it will reduce its global salaried workforce by 10%, roughly, 7,000 jobs, including 500 in the US by the end of August.

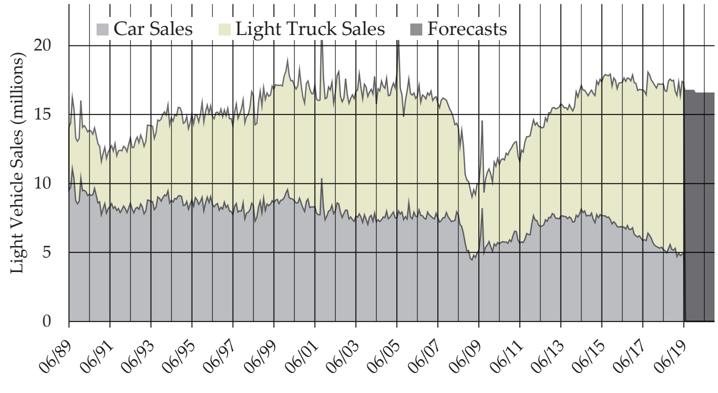
Summing up, unless demand for auto jobs increases, Michigan's labor market may face headwinds in the coming years. With that in mind, let's take a look at the outlook for the auto industry.

"…unless demand for auto jobs increases, Michigan's labor market may face headwinds in the coming years."

The Auto Industry

Michigan has benefitted greatly from a rebound in auto sales over the past 10 years. Unfortunately, it appears that sales growth is harder to generate today. In particular, car sales have fallen to an annualized rate of just 3.6 million units as consumers have shifted to purchase more trucks & SUVs. 2018 delivered car & light truck sales of 17.2 million units. Forecasters at the Chicago Fed Conference predicted reductions to 16.8 million in 2019 and 16.6 million units in 2020.

Boost from Increasing Auto Sales Likely Over



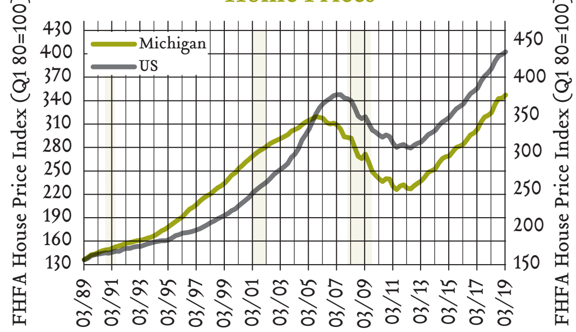
The Consensus Revenue Estimating Conference produced expectations of further reductions to 16.5 million units in 2021. In addition, the Big 3 (Ford, GM, and Fiat Chrysler) market share, which in the 1990s topped 70% of the domestic market, is expected to fall from 41.7% in 2018 to 40.9% in 2021.

So, it seems the boon from auto sales recovering is likely over. Let's turn to take a look at how the housing market has progressed across the state.

Michigan's Housing Market

Similar to trends in employment and autos, Michigan's housing market recovered significantly, but has failed to match gains made in the rest of the country. Today, Zillow lists the median home value in Michigan at $152,600.

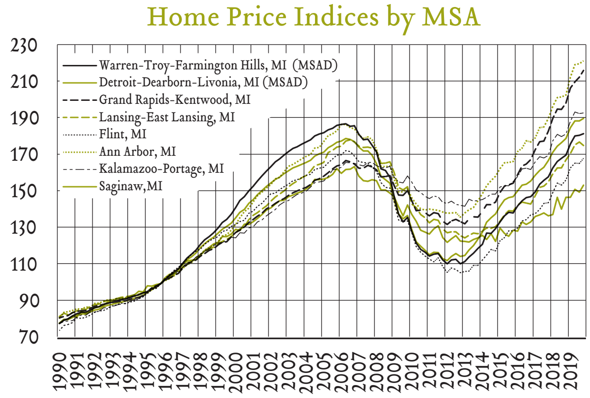
Home Prices



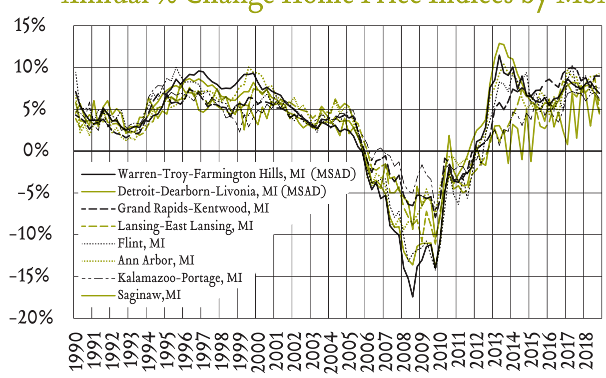
> "There has been significant variability in home prices across regions in Michigan."

There has been significant variability in home prices across regions in Michigan. With the notable exceptions of Grand Rapids, Ann Arbor, and Kalamazoo, home prices are near, or below their pre-crisis peaks.

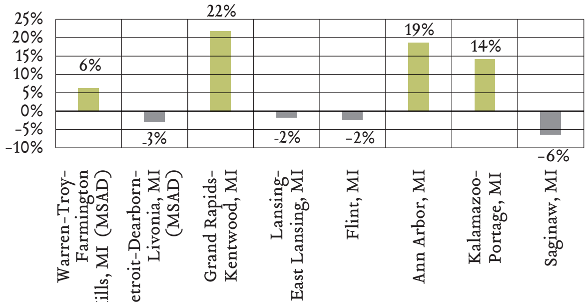
Home Price Indices by MSA



Annual % Change Home Price Indices by MSA



Current Home Price Indices vs. Pre-Crisis Peaks



Our expectation is that, without meaningful job and wage growth, further home price appreciation is likely to be muted. Zillow's 1 year forecast shows 3% expected appreciation. That seems like a fair estimate to us.

"Michigan has recovered appreciably from the financial crisis."

Conclusion

Michigan has recovered appreciably from the financial crisis. Today, unemployment is near all-time lows, auto sales are near record highs, and home prices are at, or near, all-time highs as well. To our summer travelers, the past five years must have looked increasingly sunny. Only now are we beginning to see some clouds on the horizon, though they are still faint. The good news is that no matter the weather in the future, Greenleaf Trust will be here to serve our Michigan communities and help our clients achieve their financial goals.

Sources:
Auto Sales: Bureau of Economic Analysis
Unemployment: Bureau of Labor Statistics Local Area Unemployment Statistics, https://www.bls.gov/lau/
Michigan Consensus Revenue Estimating Conference, http://www.house.mi.gov/hfa/Consensus.asp
Chicago Fed Automotive Outlook Symposium, https://www.chicagofed.org/events/2019/automotive-outlook-symposium
Layoffs: State of Michigan Workforce Development Agency, https://www.michigan.gov/wda/0,5303,7-304-64178_64179---,00.html
Home Prices: Zillow & Federal Housing Finance Agency Home Price Indexes, https://www.fhfa.gov/DataTools/Downloads/Pages/House-Price-Index.aspx

Carlene R. Korchak, CTFA
Vice President
Senior Trust Relationship Officer

The SECURE Act?

In late May 2019, with bipartisan support, the House of Representatives passed the SECURE Act (Setting Every Community Up for Retirement Enhancement Act) by a vote of 417-3. This legislation, if passed, is likely to have an impact on workers, retirees, and heirs. The SECURE Act aims to improve the nation's retirement system by providing greater access to retirement plans to more workers, as many small businesses do not offer a retirement planning option.

The bill contains three provisions, which are of significant interest to Individual Retirement Arrangement (IRA) owners:

- Required Minimum Distributions (RMD) – Beginning in 2020, the age at which an individual must begin to take RMDs will be increased from 70½ to 72.
- IRA Contributions – If an individual has earned income, beginning in 2020, she may contribute to an IRA after age 70. Previous rules prohibited IRA contributions once an individual reached age 70 despite having earned income.
- Inherited IRA RMDs – Perhaps one of the most significant proposed changes involves the rules that surround Inherited IRAs. Currently, a younger named beneficiary who inherits an IRA is allowed to "stretch" the RMDs over his remaining life expectancy. The SECURE Act would require the Inherited IRA to be fully distributed within 10 years after the IRA owner's death with a few exceptions [surviving spouses, minor children (a "stretch" would be permitted until age 18 followed by the ten-year payout provision) or beneficiaries with specified disabilities or illnesses].

These rules, if approved, are expected to become effective beginning in 2020.

The bill proposes other changes, a few of which are outlined below:

- Penalty-Free IRA Distributions – Distributions (up to $5,000) from an IRA will be permitted without penalty (but subject to income taxation) for the birth or adoption of a child. The withdrawal must be completed within twelve months of the birth or adoption.
- 529 Distributions Expanded - The definition of higher education expenses is dramatically broadened for the purpose of tax and penalty free distributions: (i) registered apprenticeship programs that require fees, supplies, books and equipment will all be treated as a higher education expense; (ii) homeschooling expenses (books, on-line computer classes, etc.) will also now be covered; (iii) educational therapies for students with disabilities will be covered; (iv) the repayment of a student loan, up to $10,000, will be covered, for both the designated 529 account beneficiary and that beneficiary's sibling (the same $10,000 could be used to repay a sibling's school debt – but the amount is limited, not tied to the number of siblings with school debts); and (v) tuition, books, fees, and other related expenses will be covered with regard to a designated beneficiary's elementary, secondary, public, private, or

"The SECURE Act aims to improve the nation's retirement system by providing greater access to retirement plans to more workers..."

religious education.

- 401(k) Eligibility Expanded / Plan Loans
    - ◊ Participation within a 401(k) plan would be expanded to include part-time employees (those who work more than 500 but less than 1,000 hours)
    - ◊ Going forward, the bill would prohibit the distribution of plan loans through credit cards or similar arrangements. This change is designed to ensure that plan loans are not utilized for routine or small purchases (preserving their retirement savings).
- Definition of Compensation Expanded: The amounts received by an individual, as a non-tuition fellowship grant or stipend will be treated as "earned compensation" for purposes of the recipient being eligible to make an IRA contribution.

While the bill has not yet been adopted into law, Greenleaf Trust will closely monitor its progress as the Senate reviews it. It should be noted that a few years ago the Senate unanimously adopted legislation that limited the payout duration of an Inherited IRA to five years. Additionally, most of the Senators who previously approved this change still sit on the Senate Finance Committee.

Greenleaf Trust continuously examines and explores planning opportunities for each of our clients. We encourage you to reach out to your tax advisor, attorney, or a Greenleaf Trust team member with questions. As always, thank you for the opportunity to serve on your behalf.

"While the bill has not yet been adopted into law, [we] will closely monitor its progress as the Senate reviews it."

Keeping Your Retirement Plan Beneficiary Up to Date

Natasha L. Tamminga
Participant Services Administrator

When was the last time you reviewed your retirement account beneficiary election? Many people forget to update their beneficiary after important life events such as marriage or divorce. However, it is very important to ensure your retirement beneficiary information is current. Greenleaf Trust makes updating your beneficiary information easy by offering an online option to review and update.

Many people believe that having an up to date Will ensures their finances will be handled according to their wishes in the event of their death. This is not the case with retirement accounts. The beneficiary designation for your retirement account is legally binding and supersedes your Will, which means that if you made a change to your Will but forgot to update your retirement account beneficiary, the retirement asset will go to the person last named as your

Keeping Your Retirement Plan Beneficiary Up to Date, continued

retirement account beneficiary, even if this contradicts the new information outlined in your Will.

So, who is best to name as your retirement account beneficiary? If you are married, federal law requires that your spouse be named as the 100% "Primary" beneficiary on your retirement account. The "Primary" beneficiary is the person who will inherit your benefit first. You also have the option to name a "Contingent" beneficiary on your account. If the "Primary" beneficiary is no longer surviving or if they passed with you, your "Contingent" beneficiary would then inherit the benefit. If you would like to name someone other than your spouse as the primary beneficiary, a Spousal Consent must be completed. If you elect not to name anyone as the beneficiary on your retirement account and you are unmarried, your retirement assets will have to go through probate court upon your passing and state law will likely determine who will receive the benefit, which may not reflect your personal wishes.

"The beneficiary designation for your retirement account is legally binding and supersedes your Will..."

The majority of individuals choose to name a person or persons as their retirement account beneficiary, which is the easiest way to ensure that your benefit goes to those you choose. However, it is also possible to name a non-person as a beneficiary, such as a trust, charity or institution. Many people choose to name a trust as either a primary or a contingent beneficiary on their retirement accounts. Naming a trust as a beneficiary can be a great way to ensure that your retirement benefit stays out of probate and that your wishes are followed; however, there can be a few caveats to when this is most advantageous. Namely, if you are currently married and trust your spouse to handle your retirement account benefit according to your wishes after your death, it is more beneficial to name your spouse as the primary beneficiary and name the trust as a contingent beneficiary, as this will give your spouse more options for claiming the benefit in a tax-advantaged manner, as well as providing more immediate access to the funds.

If you are considering leaving your retirement benefit to a minor child, it is recommended to name the financial guardian of the child or a trust as the beneficiary, as minor children cannot directly inherit retirement plan assets. This will help to ensure that your benefit does not end up in probate, allowing the state to decide who should be awarded the benefit for the good of the child. This can also be advisable if you have a special needs child who is old enough to inherit a benefit, but may not be able to handle their own financial affairs.

There are many important considerations to make when choosing the beneficiaries for your retirement account. The Participant Services Team at Greenleaf Trust is happy to assist with any questions you may have when establishing a beneficiary for your account for the first time, or when considering changes to your current beneficiary elections. You may also wish to consult with your attorney on this very important matter.

The Doom Loop

John Graham
Guest Contributor

When I first began dealing in global bonds and currencies in the mid-eighties, one of my most experienced clients, a mainstay on the London asset management scene, told me in the quiet conspiratorial tone that the Brits often use to cut people to the quick without really being explicit, "John, never buy bonds of countries which have green in their flag."

Today, of course, he would be accused of gross Islamophobia since most Islamic countries have green in their flag, but in the late eighties he was really talking about Italy where countless governments, unpredictable budgets and constant capital flight meant that until the mid-nineties, Italian bonds were the most unreliable of investments in the European government bond universe. My friend did eventually invest in Italy when the country initiated a reform process designed to get them into the Euro. However, once in, the Italians have consistently proved a thorn in the side of the European experiment and global bond managers. In fact, Central Banking institutions and portfolio managers in Europe have begun to talk about something called The Doom Loop with regards to Italy, its banking system and its potential for contagion in the European banking system.

The doom loop is the circle of vulnerability where a country's banking system can be severely hurt by volatility in the price of the sovereign bonds they hold for reserves resulting in a contraction in lending provided by the banks. This contraction in credit in turn slows the domestic economy, resulting in a further deterioration in the price of the sovereign's bond issues as the government is forced to increase its borrowing to maintain services in a period when tax receipts are falling. The loop can also begin with the banking sector if a contraction in bank lending due to liquidity or non-performing loan problems sparks volatility in the government bond prices by slowing the economy and eroding confidence in the sovereign credit. The circle can also be activated by external forces such as a slowdown in global economic activity due to natural recession or trade friction as well as, in the Italian case, a change in the provision of liquidity to the financial system by its external fiscal and monetary partners i.e., the EU or the European Central Bank (ECB). Going the other way in the circle, an Italian bank failure or a blowout in the sovereign spread can adversely affect foreign holders of Italian debt, particularly European banks.

"The doom loop is the circle of vulnerability where a country's banking system can be severely hurt by volatility in the price of the sovereign bonds they hold for reserves…"

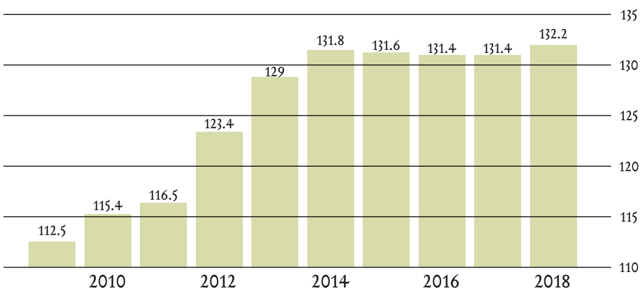
To understand the current situation in Italy, let's look in more detail at these moving parts.

Italian government debt is large and growing. The country's debt to GDP ratio is 132% as opposed to a Euro area average of 86% and is exceeded in Europe only by Greece whose debt to GDP is 182%.[1] Since Italy does not control its own money supply, she cannot print money to meet these debts nor can she

The Doom Loop, continued

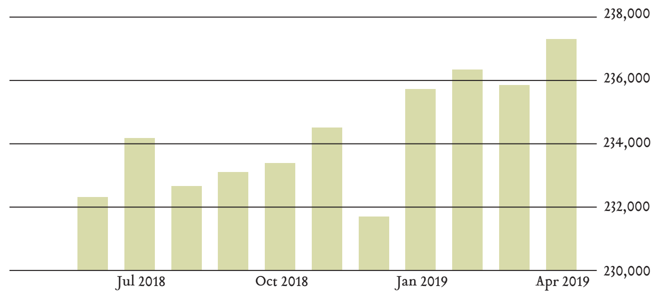
devalue her currency to boost her economy (her favourite pre-Euro trick). Moreover, the country's debt is largely owned by two groups. First, of the €2.3 trillion of public Italian debt, the Italian banking system owns 30%, a number that has risen steadily over the past few years.[2] Second, foreign investors hold around €575 billion in Italian public and private debt. About 80% of those investors are European investors, mostly asset managers but also banks and domestic households.[3] French banks are the most exposed among European banking institutions.

Italian Debt to GDP (percentage)



SOURCE: TRADINGECONOMICS.COM | NATIONAL INSTITUTE OF STATISTICS (ISTAT)

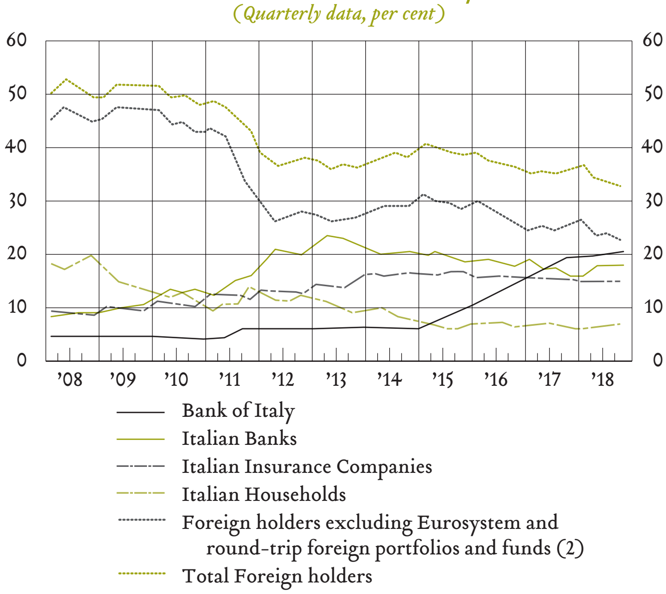
Italian Government Debt outstanding (millions of Euros)



SOURCE: TRADINGECONOMICS.COM | BANK OF ITALY

Italian Government Securities by Holder (1)

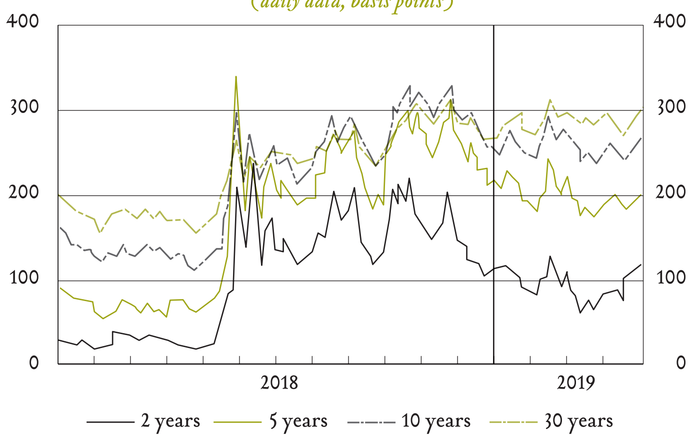
(Quarterly data, per cent)



Sources: Bank Of Italy, Financial Accounts; and estimates based on Assogestini and ECB data.
(1) Shares calculated on data at market prices and net of securities held by Italian general government. Data refer to a subset of holders.
(2) Securities held by foreign investors net of those held by the Eurosystem (exck=luding the Bank of Italy) and by foreign managed portfolios and investment funds attributable to Italian investors.

Spreads on Government Bonds (1)

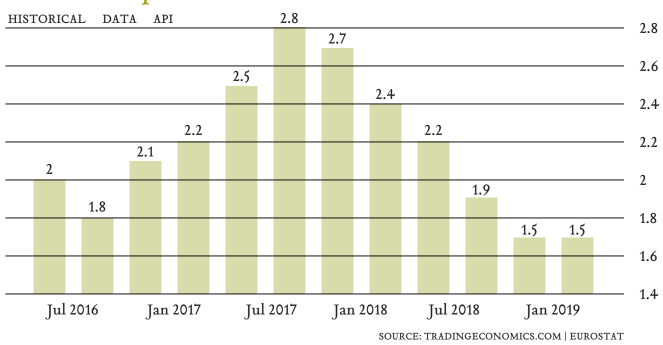
(daily data, basis points)



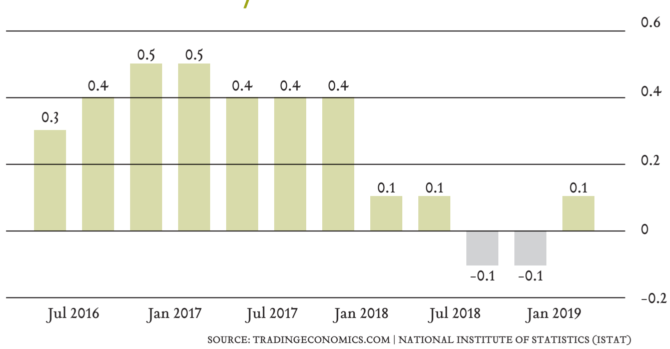
Source: Bloomberg
(1) Yield spreads between Italian government bonds and the corresponding German Bund.

In a strong economy with robust domestic savings, these kinds of debt to GDP numbers would be of concern, but not unmanageable. Japan after all has a debt to GDP ratio of 234% but with a larger, stronger economy and very high savings. Even the US seems to be determined to run a deficit of a trillion dollars a year going forward through the magic of supply side economics. However, the smaller Italian economy is slowing (shown below) and her savings rate is low (net saving is 0.7% as opposed to 10.6% in Germany).[4] This puts pressure on the government's balance sheet and will increase her borrowing further.

European Union GDP Annual Growth Rate



Italy GDP Growth Rate



One additional issue to consider when thinking about this debt is the rating of Italy by the world's credit agencies. Most of these agencies have Italy on very low credit ratings, only a notch or two above high yield (junk), and on negative watch. Many of the banks have the same ratings as the sovereign with a large number of them on negative watch as well. If the government's credit rating were to fall below investment grade i.e., below triple B, its bonds would no longer be eligible for holding among many investors. European banks in particular would no longer be able use Italian government bonds as low risk weighted/high yielding assets for their reserves. Thus, not only would a series of downgrades generate losses on Italian and European bank balance sheets, but it would compromise the ability of the Italian government to raise funds going forward and, perhaps, even to participate in the ECB's liquidity provision exercises.

"One additional issue to consider when thinking about this debt is the rating of Italy by the world's credit agencies."

Italian Credit Ratings: Long Term Rating Comparison			
Agency	S&P	Moody's	Fitch
Italian Ratings	BBB	Baa	BBB

The Doom Loop, continued

As we said above, the Italian banking system owns a great deal of Italian government debt. These bonds are held as part of their reserves and banks have increased their purchases since the Financial Crisis, in part, encouraged by European and National authorities. Italian government bonds are both much higher yielding than other European government bonds and are zero risk weighted meaning they are free from capital requirements reflecting the view that they are free from rescheduling or default. As we know from the Greek crisis, this may or may not be true. In any case, they are not free of extreme price volatility. In the doom loop scenario, a crisis of confidence among investors around the Italian government pushes sovereign bond yields sharply higher in an environment of weak growth and rising deficits, undermining the already weak balance sheets of the domestic banks.

"In the doom loop scenario, a crisis of confidence among investors around the Italian government pushes sovereign bond yields sharply higher… undermining the already weak balance sheets of the domestic banks."

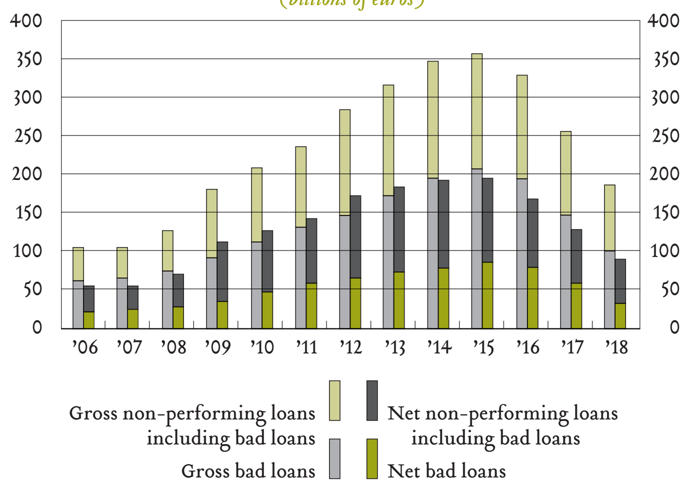
Late last year, The Bank of Italy highlighted this in their November 2018 Financial Stability Report.[5] "The fall in prices for Italian government securities has caused a reduction in capital reserves and liquidity and an increase in the cost of wholesale funding. The sharp decline in bank share prices has resulted in a marked increase in the cost of equity. Should the tensions on the sovereign debt market be protracted, the repercussions for banks could be significant, especially for some small and medium-sized banks." The Bank also noted that a reduction in the value of sovereign bonds on bank balance sheets reduces the liquidity which banks can obtain via Eurosystem refinancing operations.

While it can be said that Italian bond yields have dropped over the last few months, modestly improving the look of Italian bank balance sheets, this drop has been mostly due to the slowdown in the European economies, the need for the ECB to keep money rates low and the ECB's need to maintain the provision of liquidity to banks via special targeted funding. This slowdown is negative for bank lending and profitability.

10-year Generic Italian Government Bond Yields

The past few years, the Italian banking system has made slow progress in improving its balance sheet exposure to non-performing loans (NPLs). A series of bank bailouts and forced mergers plus ECB enforced sales of assets has seen the banking system's NPL exposure drop. However, most of the bond issues which bundle NPLs for sale or inject capital into Italian banks are being placed among Italian domestic investors keeping the insolvency risk further focussed in Italy. The current downturn in the economies of Italy and other European countries could derail the recent NPL progress. In addition, progress among the Italian banks has not been even, with some banks such as Banca Monte dei Paschi di Siena (the world's oldest bank) and Banca Carige still having much to do despite several bailouts and capital injections (NPL ratios of 19% and 23% respectively) versus the two largest Italian banks, Intesa Sanpaolo and UniCredit (NPL ratios of 8.1% and 7.5%, respectively).[5] The European Bank average NPL ratio is 3.1%.[6] These banks and other medium-to-smaller institutions remain vulnerable.

Italian Banking System
Exposure to Non-Performing Loans (NPLs)
(billions of euros)



"The current downturn in the economies of Italy and other European countries could derail the recent NPL [non-performing loans] progress..."

Politics and Economics

In May 2018 a new government took office in Italy. Giuseppe Conte became Prime Minister backed by two populist, anti-immigration, and Eurosceptic parties. Matteo Salvini, leader of the Northern League, and Luigi Di Maio, leader of the Five Star Movement, became Deputy Prime Ministers of Italy, putting an anti-European spin on budget discussions. Their initial proposed budget was for a deficit of 2.4%, a figure well above the previous government's 0.8% budget deficit plan. Given the slowing of the European and Italian economies and the already high level of Italian debt, the European Commission protested. (Bond investors also took this badly; see the spike in yields in the chart above at the end of last year.) They pointed out that nothing in the deficit was designed as investment in the Italian economy (and so could be allowed under EU rules). In fact, the Commission argued that the main new spending plans, Universal Basic Income (UBI) for the unemployed, lowering the pension age to 60 and a flat tax proposal would likely only produce deeper deficits in years to come, especially as the new government also rolled back a scheduled VAT tax rise. The Commission argues that UBI will not be effective

The Doom Loop, continued

without an investment in training and retooling programs. Moreover, one struggles to think of another country which is reducing its pension age rather than extending it because, like Italy, most developed nations have an imbalance between younger taxpayers and a larger population of older citizens.

In December, the Commission and the Italian Government agreed on a 2.0% deficit. The proposals were modified, but concern remains as Italian growth for 2019 is projected to be just 0.1% by the Italian Finance Ministry. In fact, Italy's project budget deficit for 2020 is forecast, by the European Commission, to be 3.1% breaching, for the first time since 2011, the EU 3% deficit limit. These wider deficits are likely to have a negative impact Italian sovereign and hence bank debt.

Nonetheless, the Italian government – backed by the Italian public who support its populist, Eurosceptic and anti-immigrant stance – is likely to persist in its desire to create budgets "for the poor" which break EU rules and undermine the Italian credit market. In May this year, at the European elections, the League and Matteo Salvini won over 34% of the vote, with the Five Star Movement taking another 17% giving more popular backing to their initiatives.

"… the Italian government, … is likely to persist in its desire to create budgets 'for the poor' which break EU rules and undermine the Italian credit market."

So, what are the risks to investors in this environment of larger government deficits, a weakened banking system and a slower economy?

Investor risks

1. An internal credit crisis sparked by the current economic downturn could severely damage the ability of the Italian financial system to borrow and function. This would require further intervention from the ECB at a time when anti-centrist parties are in the ascendancy. The risk is not just domestic, however. With Italy being the 3rd largest economy in Europe and Italian bank credits widely held by European financial institutions as cheap capital, a European crisis which would test Euro and European credibility could result. As part of the doom loop, wider government deficits impact sovereign bond yields and hence bank balance sheets.
2. An external financial crisis/risk aversion episode could also severely hurt the government spreads, then bank spreads and then domestic investors via losses on bonds and equities producing bankruptcies, forced mergers and equitization of debt.

Investor Conclusions

Enjoy your Italian vacation this summer – opera, art, sunshine – la dolce vita. But…

Given the current conditions, it would be prudent for investors to be careful with Italian credits, particularly those with weaker balance sheets including the Italian sovereign. It would be a worthwhile exercise for investors to look through the holdings of their Global and European bond funds where Italian credits may be included to lift the running yield of portfolios to offset negative to low interest rates elsewhere, taking action where appropriate. Given the economic outlook for Italy and Europe in general, it would also be good for investors to look through their equity holdings seeking to prefer those companies with global rather than Italian domestic or European exposure only.

1. Italian National Institute of Statistics
2. European Banking Authority (EBA)
3. European Banking Authority
4. Saving rate
5. European Banking Authority
6. EBA Risk Dashboard Q1 2019

Further reading:

1. *Working Paper Series: Government debt and banking fragility: the spreading of strategic uncertainty.* Russell Cooper, Kalin Nikolov European Central Bank
2. *Financial Stability Reports* No. 2 2018 and No. 1 2019, Banca D'Italia
3. *European Banking Authority Risk Dashboard*

"Given the current conditions, it would be prudent for investors to be careful with Italian credits, particularly those with weaker balance sheets..."

Stock Market Pulse

Index	7/31/19	Total Return Since 12/31/2018
S&P 1500	685.11	20.04%
Dow Jones Industrials	26,864.27	16.69%
NASDAQ	8,175.42	23.95%
S&P 500	2,980.38	20.24%
S&P 400	1,966.72	19.36%
S&P 600	963.40	14.96%
NYSE Composite	13,066.60	16.69%
Dow Jones Utilities	808.94	15.39%
Barclays Aggregate Bond	111.30	6.04%

P/E Multiples	7/31/2019
S&P 1500	19.4x
Dow Jones Industrials	17.6x
NASDAQ	31.9x
S&P 500	19.3x
S&P 400	19.7x
S&P 600	22.8x

Key Rates

Fed Funds Rate	2.00% to 2.25%
Tbill 90 Days	2.00%
T Bond 30 Yr	2.52%
Prime Rate	5.50%

Current Valuations

Index	Aggregate	P/E	Div. Yield
SS&P 1500	685.11	19.4x	1.85%
S&P 500	2,980.38	19.3x	1.87%
Dow Jones Industrials	26,864.27	17.6x	2.19%
Dow Jones Utilities	808.94	21.1x	3.05%

Spread Between 30 Year Government Yields and Market Dividend Yields: 0.63%

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