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An outlook on European assets for the next quarter

LMF International

Nicolas Roth, Co Head of Alternative Investments at Reyl Bank, outlined a big picture for LMF

What result do you expect from the Italian referendum and why?

As of mid-October, the polls are pointing toward a negative result for the referendum. There are probably several elements that could explain why a majority of voters are in the no camp. First, the referendum is rather technical and the media have oversimplified the outcome of the vote, i.e. for or against Renzi. Secondly, the figures advanced by Renzi and the opposition on the potential savings are quite far away, which does not do any good to the credibility of both camps. Finally, a reason lies in the current trend amongst Europeans to have defiance against Brussels. The Brexit vote and the rise of far right parties as well as nationalists across Europe are a sign that citizens are tired by the Brussel's bureaucracy and want change. A no outcome to the referendum could certainly be an expression of this general trend.

As a foreign investor, do you think that the Italian referendum may have a negative impact on the decisions to invest in our country?

Obviously a no vote on the referendum is going to have a negative impact on the decision to channel investments to Italy. Although the country has been able to deal with the previous constitution and, in theory, a status quo should not have a dramatic impact; the reality is that a no vote will be interpreted by the market as a break in continuity in terms of policies. It is complicated to assess the probabilities of events following a no vote, but a resignation of Renzi, call for early elections and ultimately majority gained by Cinque Stelle cannot be ruled out. Finally, the biggest risk of the referendum is a loss of confidence by investors.

One of the key issues from an investment standpoint in Italy today is to create a functioning secondary market for non-performing loans that are currently crippling banks. Although a number of large investors have expressed interest in this market and that there has been a few large transactions, the fact that judicial processes are extremely lengthy is certainly preventing the country from a rapid and efficient development of this market. The new constitution would support the reform of courts and judicial system which are a very significant factor for the resolution of bad loans.

Somebody said that if the no will win, the Italian referendum may bring in Europe instability as happened in the Brexit case, what do you think?

From a market standpoint, a number of investors were expecting a huge sell-off of the equity market after Brexit. Although the market tanked on the morning of the result and the day after, the speed of the recovery has been equally impressive and caught investors by surprise. At this stage, we anticipate that a no vote would impact negatively the EUR and Italian banks. The European equity market should suffer on the short term, but a no vote has more medium term implications, hence the market should be able to deal with it short term. From a political standpoint, it will clearly bring instability to Europe as it is a step back in the direction of inertia, lengthy procedures and, more important, loss of confidence in the ability of European countries to move forward and implement changes.

In the light of a negative result which asset allocation would you suggest to an investor and for this month?

No exposure to Italian banks, probably a short EUR bias, long European volatility and long Bund exposure.

We would add that credit exposure to Italian financials, especially additional tier 1, could take a hit and we would therefore avoid those bonds.

What will be the impact on the currency market?

Once again, the key parameter is confidence and a no vote could erode the faith of investors around the stability of the European Union. The event itself could be dealt with; however Europe has gone through a series of negatives (Greece, Brexit, tensions Turkey) and this sequence could spillover into 2017 with key elections in France, Spain and Germany which are adding uncertainty one after the other. EUR is likely to be sold-off short term, which can be exacerbated by the current strength of the USD. Levels of 1.05 and below could be tested. The Swiss Franc should be well bid as it is always in times of stress and the SNB could intervene to limit strengthening.

What about US elections and relations with Europe?

After the third debate in Las Vegas, it appears that Hillary Clinton has managed to clear the way for becoming the next president. Will she bring lots of changes after the Obama administration? Hard to tell at this stage, but Clinton surely represents more continuity in US politics than Donald Trump does. From a US point of view, the key focus is not Europe but the difficult relationship with Russia in light of what is happening in Syria. Europe has its own set of issues that it needs to solve, namely the humanitarian crisis as well as a growth problem, and those are clearly domestic difficulties for which the US will likely not be involved.

What do you think about the different approach used by Draghi in dealing with the German Deutsche Bank issue and the one adopted for Caixa in Spain? Is the economy and politics dominated by Germany?

This point has been raised multiple times recently, i.e. is Germany dictating the terms under which weaker economies can deal with their troubled banks. Although it is true that Germany has always been the posterchild for following the rules and acting in an orthodox manner, one must not forget the timelines. When Ireland and Spain were into the storm of the credit crisis, European banking rules were less stringent and the concept of contingent convertible instruments used to recapitalize banks in case of trouble was at its infancy. The world is different today and European governments are not anymore in a position to provide bailouts easily. On the particular case of Deutsche Bank, for the time being the German lender has been able to kick the can down the road and the market seems to be satisfied with the current situation judging by the recent performance of its stock price.