ECONOMY

Political upheaval in Europe leads to economic upswing in U.S. market; benefits not exhibited by P.R.'s crippled economy

Think Strategically: A Pessimist is Never Let Down

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Week in the markets: Spain, Italy, U.S. jobs growth

Spain and Italy surprised markets with a tsunami of changes during the week in their political structures at the highest levels. In Spain, President Mariano Rajoy was voted out following a vote of no confidence by Parliament after a corruption scandal was revealed and the Partido Socialista Obrero Español (PSOE, Spanish Socialist Workers' Party) leader Pedro Sánchez formed a new government. Meanwhile, in Italy, a populist government lead by new Prime Minister Giuseppe Conte was sworn in last Friday by Italian President Sergio Mattarella.

Investors mostly ignored Spain's change in leadership since most parties in that nation are pro-European Union and see less risk than in the new Italian government. Nonetheless, Spain's 10-year government bond yield dropped 13 basis points and established a two-week low of 1.36 percent.

The new Italian government is seen as anti-establishment, anti-European Union and mostly comprises the Five Star movement and the League. The new government is expected to increase confrontations with the EU, while most experts feel the thought of Italy leaving is simply nonsensical. At last count, Italy had nearly $2.6 trillion in debt with a stagnant economy. Should Italy leave the EU and bring back the lira, it would find itself unable to borrow in the open markets and would face insolvency.

Moving on to the U.S., total nonfarm payroll employment increased by 223,000 in May, and the unemployment rate edged down to 3.8 percent, the U.S. Bureau of Labor Statistics reported. Employment continued to trend up in several industries, including retail trade, healthcare and construction.

The U.S. economy reached its lowest unemployment rate in 18 years and is entering one of the longest periods of growth in recent U.S. history.

All these geopolitical risks have had an impact on the markets, with the Dow Jones Industrial Average closing the week at 24,635,21, up 0.9 percent, the S&P 500 Index closing at 2,734.62, up 0.5 percent, and the Nasdaq was at 7,554.33, up 1.6 percent. Investors are reacting positively to the favorable economic reports, including the strong May jobs data. In addition, Europe is facing strong gains after the recent incoming governments were put in place.

European banking M&As movement

Europe's banking sector reported better-than-forecasted results in Germany, France and Italy. The banking sector has been lagging in recent years with large write-offs, delinquency and negative rates. However, this past week, fourth-quarter figures published by Germany's Commerzbank, France's Société Générale and Italy's UniCredit, have all beat expectations. Italian bank UniCredit reported its best 4Q profit figure for a decade, which included reduced operating costs and large decreases in provisions for loan losses.

The results immediately fueled the rumor mill for banking mergers & acquisitions (M&As), placing UniCredit acquiring Société Générale. Should this transaction occur, it would place two of the EU's larger banks joining forces and fueling a highly expected round of banking consolidations in Europe. UniCredit's CEO Jean-Pierre Mustier was said to have been simmering the idea for months; Mustier used to run Société Générale's investment bank and sees his old employer as a perfect fit for his new bank. UniCredit seeks to increase its investment banking operations and branch network in eastern Europe. While for Société Générale, the benefit would be in the leading positions in Italy and Germany.

UniCredit Spa is trading at 14.90 EUR and has total assets of $823,98 billion, while SocGen is trading at 37.53 EUR and has total assets of $1.27 billion, with more to come.

The Final Word: A pessimist is never disappointed

Last Friday, following participation in the Puerto Rico Manufacturers Convention, Estudios Técnicos chairman & CEO José Joaquín Villamil joined Caribbean Business for lunch. We became reacquainted with a bottle of wine called Pessimist. While inspecting the bottle, "Joaco" noted the label read, "A pessimist is never disappointed."

With that introduction, we proceeded to discuss Puerto Rico's economic policy for the past 40 years. We highlighted every major economic development study presented in Puerto Rico, starting with Tobin and ending with the Society of CPA's Foundation study, aptly named "Puerto Rico: A Development Roadmap." The study goes on to say, "Roadmap: A high-level plan, defining an overarching strategic objective and capturing the major steps planned for achieving that objective. It is not backlog...[but] a to-do list of the required tasks to complete a strategic initiative...."

Upon revising the study, a detailed review of previous studies was provided with similar objectives. As a result, the Society of CPA's Foundation decided to concentrate on six factors:

- Strengthening the Industrial System;
- Rethinking Promotional Strategies;
- A Tax System that Stimulates Investment;
- Defining Municipalities' Role;
- Policies and Strategies to Stabilize Population; and
- Optimizing the Management of Federal Programs and Funds.

Each area has been formulated with implementation as a primary concern. Thus, an assessment was made about why other similar initiatives had little impact, and this effort tries to avoid the causes identified, among them recommending goals that exceeded the institutional capacity to achieve them.

Due to the importance of the study and to continue its discussion, two aspects are covered here:

- Population Estimates; and
- Real GNP Growth due to increased federal funding

Population estimates

- The Fiscal Plan assumes a severe population contraction in fiscal 2018.

Net Migration Projections (Fiscal Years)	
2014	55,092
2015	65,089
2016	64,757
2017	68,278
2018	142,059
2019	63,927
2020	51,441
2021	40,943

Source: Estudios Técnicos Inc.

- Given the recently observed reversal of migratory flows, it may appear unlikely that net migration for fiscal 2018 will surpass 200,000 people. Below are the study's projections for net migration.

According to Estudios Técnicos, the Puerto Rico population will reach 3,080,050 in 2020, while the Fiscal Plan is forecasting 2,909,940 people, or 170,110 fewer Puerto Ricans. This is a critical figure that must be followed.

Real GNP growth from increased federal funding

Puerto Rico's GNP growth will be fueled by an outsize increase in Government Construction Investment (GCI). During the past several years, the GCI had been in contraction, with each year growing less and less. However, in the aftermath of Maria, we will see the numbers increase to growth of 29.2 percent in 2018 and a whopping 411.5 percent in 2020, and then subsiding.

Private Construction Investment will also see growth of 29.7 percent in 2018, and then quickly subside to 1 percent in 2020.

While it is true the inflow of relief funds will be more significant than ever, it is not a recurring investment, and thus ends quite quickly. Puerto Rico needs not only a solid execution, but also the recurring economic activity that would increase economic development to all areas of the island. It might be true that "a pessimist is never disappointed, but once, only once, it would be great to surprise them.

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