Euro Assets to Pause as Social Media Influence (SMI) Forecasts Populist/Regionalist Strength in Italian Election

March 2018

Summary

Social Media Influence ('SMI') ratings measure influence of political candidates, topics, companies, stocks, and products. It was the only forecasting method to forecast Trump would win the 2016 US Presidential Election with the correct number of electoral votes and the first known to forecast that Macron would win the 2017 French Presidential Election.

In March 2017, when the Euro was trading at 1.06, ZettaCap published a Long Euro Asset call based on SMI forecasts showing populists significantly underperforming in the then-upcoming 2017 elections in the Netherlands, France and Germany. At the time, most in the market believed that risks involved with populists winning those elections justified Euro and Euro-Asset underperformance. ZettaCap's forecast for Euro and Euro-Asset appreciation was well out-of-consensus, but with the Euro currently trading at 1.23 it has paid off handily.

At present, the situation has inverted. Excessive confidence has returned to the Euro and the market has mostly written off populists after their underperformance during the 2017 European elections. The SMI, in contrast, shows that their positions have strengthened in various countries in 2018.

Specifically, the highlighted risk is in the upcoming Italian General Election on March 4, 2018. Betting markets and polls show a mixed race with a variety of potential outcomes likely but with a bias towards the largest three mainstream political groups. *SMI forecasts differ in that smaller and lesser well known right-wing parties are seen as outperforming poll expectations. Their expected outperformance of polls and the fact that they have entered the leading coalition should be enough to jumpstart political risk perception*.

Appreciation of Euro and Euro-Assets should pause as markets begin to reevaluate risk in this asset category that has handily outperformed due to declining political risk.

zettacap

DISCLAIMER

The views, opinions, estimates and strategies expressed herein constitutes ZettaCap's judgment based on current calculations and market conditions and are subject to change without notice, and may differ from those expressed by other data or reports from ZettaCap. Any projected results and risks are based solely on hypothetical examples cited, and actual results and risks will vary depending on specific circumstances. We believe certain information contained in this material to be reliable but do not warrant its accuracy or completeness. We do not make any representation or warranty with regard to any computations, graphs, tables, diagrams or commentary in this material which is provided for illustration/reference purposes only. We do not recommend making investment decisions without speaking first to a registered investment advisor. Investors may get back less than they invested, and past performance is not a reliable indicator of future results. Forward looking statements should not be considered as guarantees or accurate predictions of future events.

There may be different or additional factors which are not reflected in this material, but which may impact on a client's portfolio or investment decision. The information contained in this material is intended as general market commentary and should not be relied upon in isolation for the purpose of making an investment decision. Nothing in this document shall be construed as giving rise to any duty of care owed to, or advisory relationship with, you or any third party. Nothing in this document is intended to constitute a representation that any investment strategy or product is suitable for you. You should consider carefully whether any products and strategies discussed are suitable for your needs, and to obtain additional information prior to making an investment decision. Nothing in this document shall be regarded as an offer, solicitation, recommendation or advice (whether financial, accounting, legal, tax or other) given by ZettaCap and/or its officers or employees, irrespective of whether or not such communication was given at your request.

ZettaCap and its affiliates and employees do not provide tax, legal or accounting advice. You should consult your own tax, legal and accounting advisors before engaging in any financial transactions. Contact your registered investment advisor for additional information concerning your personal investment goals. You should be aware of the general and specific risks relevant to the matters discussed in the material. You will independently, without any reliance on ZettaCap, make your own judgment and decision with respect to any investment referenced in this material.

ZettaCap, its affiliates, officers, or employees may hold positions which may not be consistent with the information, opinions, estimates, strategies or views expressed in this document.

Forecasting Record of Social Media Influence in Political Elections
Social Media Influence (SMI) forecasting is relatively new as applied to politics. In a sense, this forecasting method is still experimental but to-date it has had phenomenal successes in the face of one of the most difficult political forecasting environments in a generation.

SMI forecasting was first applied to politics during the 2016 US Presidential Election. SMI ratings forecasted that Trump would win with 306 electoral votes, or the correct number of votes. It is the only known forecast to correctly predict the election. In contrast, many well-known forecasters did exceptionally poor jobs, as has been well documented elsewhere. In fact, the day of the election, most of the major forecasters still had Clinton winning by a landslide with most calculating the probability of Clinton's victory at over 90%. Additionally, polls by a wide margin expected a Clinton victory.

Afterwards, SMI was applied to the 2017 French Presidential Election. Our forecast in early December 2016 was for Emmanuel Macron to eventually win the election. At that time, the betting or prediction markets placed the probability of Macron winning at approximately 9% putting him in a rather distant third place. SMI was the first known forecast to choose Macron as the winner. Later, SMI forecasted that Macron would win the most votes in the first round of voting, which he did though at the time of the forecast it was again against the consensus. Macron eventually won a major second round victory over Le Pen.

SMI performed well in other elections during the 2016/7 period. It correctly forecasted the underperformance of populists in the Netherlands and Germany well ahead of these elections. Populists in these countries were polling extremely well 6 to 12 months before the respective elections. At various points, polls forecasted electoral wins for populists, which tended to spook markets in general. SMI concluded that populists in both countries would greatly underperform early positive expectations of polls and betting markets. The eventual outcome of both elections was that establishment parties won while pushing populists aside, in-line with SMI forecasts. These elections showed further evidence of SMI's ability to tap into the underlying political currents better than polls and betting markets. Additionally, they showed that SMI is effective in elections independent of the front-runner or eventual victor in that SMI has shown to be party agnostic.

SMI was also applied in snap elections. The UK and Japan each called snap elections in 2017 which did not allow for much lead time or trend analysis. In both cases, SMI forecasts performed very well, arguably better than the consensus. SMI warned of a surprisingly close election in the UK which turned out to be correct. In Japan, SMI forecasted a larger-than-consensus win by the sitting PM Abe, which again turned out to be correct.

Summarizing, in a variety of electoral examples, SMI forecasts performed extremely well during one of the most difficult political forecasting environments in a generation.

Italian General Election – Consensus Expectations
The next Italian general election will be held on March 4, 2018.

Consensus expectations are mixed but do not point to anything radical. Polls show three parties leading, all of which have performed well in previous general elections. These leading parties do not show significant fringe tendencies and markets are happy to generally ignore this election as an event capable of shifting the perception of the attractiveness of investing in Euro assets.

3

The Five Star Movement is currently ahead, obtaining around 28% in the polls versus 26% of the actual vote in the 2013 general election. This party is labelled 'populist' but it pales in comparison to more severe European populist parties in the sense that its positions tend to be less extreme. It tends to focus more on anti-establishment topics such as direct democracy and preventing career politicians. (As we will see later, there are other parties that are much more akin to traditional populist parties in Italy.)

The Democratic Party is polling in second place with approximately 23% versus 30% in 2013. It is currently the incumbent party holding the senior position in the governing coalition, with one of its senior members as Prime Minister. It is center-left and is heading the Center-Left Coalition in the current election.

Silvio Berlusconi, the three-time Italian Prime Minister, heads Forza Italia which currently polls around 16%. It is leading the Center-Right Coalition in the current election. Adding in the other parties in the coalition, its poll figures shoot up to around 37%, placing it in the lead as a coalition but still vulnerable as polls indicate its difficultly in reaching a majority.

Betting markets show a split as well. There are four individuals with a 15% or greater probability of becoming Prime Minister, which is unusually spread out this late in the election campaign and underscores the low level of visibility assumed by the market. An additional complication is the leading contender in the betting markets (at 32% probability) is the current Prime Minister, who is not actively seeking the position. In other words, the market sees as the single most likely outcome a stalemate in forming a stable coalition and having to resort to the current PM to help calm the situation.

Though having generally low visibility in this election, the general consensus is that the outcome will not be that negative. A Democrat continuing as PM will just be a continuation of the current situation. If Silvio Berlusconi's coalition ends up in front, the market would not be overly concerned as he is a very well known quantity. The most 'radical' mainstream scenario is the Five Star Movement winning, but even then they are not as populist as some make them out to be. In short, it seems that the consensus is that forecasting the exact post-election scenario is extremely difficult but that it presents little real risk and the worst-case does not seem that bad.
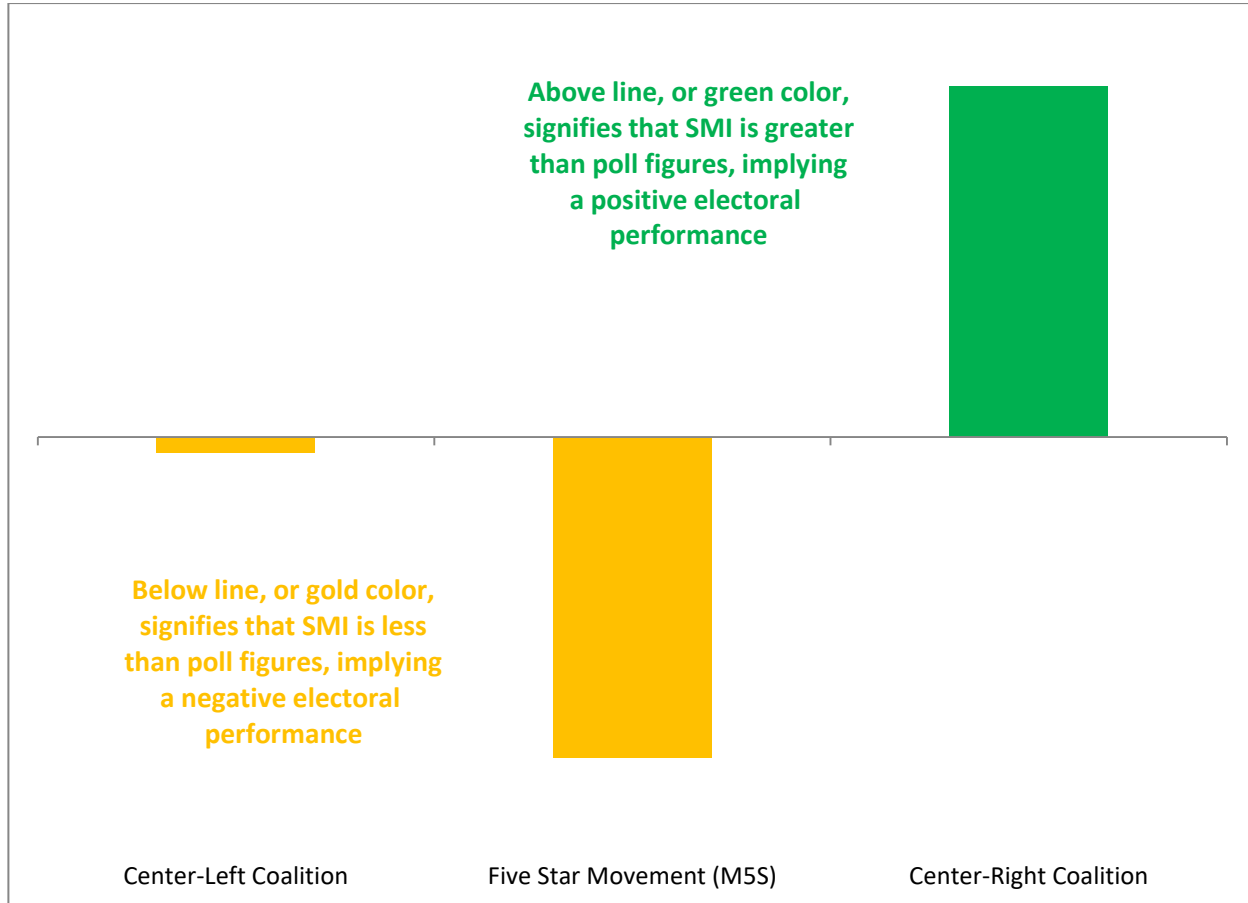
4

SMI Forecasts
Often SMI will pick up different underlying trends than those apparent in polls and betting markets. In the case of Italy, parties on the far-left and far-right have been gaining traction and have been performing superior to polls. The implication is that fringe parties will outperform current polls, potentially upsetting the market. Somewhat surprisingly, the Five Star Movement, the party currently leading in the polls, is forecast to underperform to the greatest extent.

The following exhibit shows for each of the main parties or groups the SMI rating in relation to poll figures. A positive figure, one above the line, forecasts increasing traction and expected electoral outperformance. A negative figure, one below the line in the exhibit, forecasts decreasing traction and expected electoral underperformance.

Chart 1: *Difference between SMI Ratings and Poll Figures for main parties and coalitions in the 2018 Italian General Election*

Above line, or green color, signifies that SMI is greater than poll figures, implying a positive electoral performance

Below line, or gold color, signifies that SMI is less than poll figures, implying a negative electoral performance

Center-Left Coalition   Five Star Movement (M5S)   Center-Right Coalition

Source: SMI data from ZettaCap. Poll data is the average of polls in the two weeks before election-day from Termometro Politico, Demopolis, Euromedia, Piepoli, Demos, Ixè, Index, SWG, Demetra, IPR, Piepoli, Tecnè, Euromedia, Bidimedia, EMG, and Lorien. 'Center-Left Coalition' includes Democratic Party (PD), Popular Civic List (CP), More Europe (+E), Together (I), and South Tyrolean People's Party (SVP). 'Far-Right Parties' include League (L), Brothers of Italy (FdI), and Us with Italy (NcI).

SMI forecasts the Center-Left Coalition to within 0.6% of its poll average. All things considered, this is extremely close. The implication is that there will not likely be any surprises around this coalition.

The true potential surprise appears to be in the relationship between the Center-Right Coalition and the Five Star Movement. SMI ratings, as is clearly inferred in the previous chart, are far superior to polls in the case of the Center-Right Coalition implying it should greatly outperform on election-day. Also, it appears that it will grab votes from the Five Star Movement. The implications are significant in that the Center-Right Coalition will come close to gaining a pure majority, making their position much stronger in forming a government after the election than polls currently project.

The aforementioned is the most practical point to take away from SMI forecasts. The Center-Right Coalition should outperform polls and even come close to gaining a majority. However, this in and of itself will likely not shake the markets. The true surprise would come from the underlying party outperformance.

You might infer that the Center-Right Coalition is in fact a center-right group of parties. However, there are a number of smaller parties that have entered this coalition that are fairly populist and in the eyes of some, extreme. These are the parties SMI forecasts to significantly outperform and thereby pushing the Center-Right Coalition higher. It appears that votes are moving from the Five Star Movement to these further right-leaning groups.

We cannot prove this direct relationship of votes moving from the Five Star to the Center-Right. However, if patterns from other countries hold in Italy, it seems that individuals are withholding their true opinions in polls while allowing them to come out on social media due to perceived social pressure.

Implications for Euro Assets

From a market's perspective, the outperformance of the most right-leaning groups and of the Center-Right Coalition coming out on top will clearly remind investors that the populist wave that was beaten back in the Netherlands, France, and Germany has not disappeared. The Italian Election should show, through such outperformance of smaller right-wing parties and through the poll-leading party's underperforming, that polls can still be shaky as well.

Under these conditions, we believe investors will stop to reevaluate the risk / reward of the current environment. Recall that in early 2017, we made a long Euro asset call principally due to SMI forecasts showing underperformance of populists in then-upcoming European elections. At that time, the markets were extremely concerned over populists winning these elections as the US Presidential Election and the Brexit Vote were still on the top of mind. Our SMI showed that such a populist wave taking over European politics was not likely. As these forecasts came true, Euro assets ceased to underperform and began to outperform as we had forecast.

Currently, we are almost in the reverse situation. Euro assets, including the Euro, have performed very well over the last year or so. Furthermore, market and analyst expectations are that the populist threat in Europe has been proven to be a non-starter making it an inconsequential risk.

SMI ratings for the Italian Election highlight populist parties' unusual underlying strength. Also, it should be emphasized that because they have been successful in forming a coalition with other parties they have essentially left the shadows and have entered mainstream politics. This is a subtle point but very important in that populists in other European countries have been effectively sidelined as mainstream parties refuse to form coalitions with them. Italy has shown us that perhaps the image of populists might become more palatable from the perspective of other parties wishing to gain power. If successful or even close to successful, Italy could form a standard that some parties in Germany or Netherlands might try to follow. We are not saying that such a scenario will play out or that it is likely – but the thought of it occurring will change the perception of risk for investors when they consider Euro assets.

In short, the Italian Election should increase the perceived political risk for Europe in general. This is true even if the Center-Right Coalition ends up performing well but not forming the ruling coalition. The mere fact that right-wing populist parties outperform polls and are in a mainstream coalition should be enough for risk to increase. And, because Euro Assets have outperformed over the last year will make such a shift in risk perception more significant than at other times.

Assuming the Italian Election plays out more along the lines of SMI forecasts than polls, we recommend reevaluating Euro asset positions.

Possible Errors

Every analysis has potential errors. Possibly the most significant one identified in the case of using SMI to forecast the Italian Election revolves around the Five Star Movement. Its popular and somewhat quirky founder, Beppe Grillo, is not leading the party in the election. In his place, the much younger (31) but less well-known and perhaps less charismatic Luigi Di Maio is at the helm. This could partially explain why the Five Star Movement is registering such low SMI ratings in relation to its attractive poll figures in that people might simply have more natural affinity for the party's founder which could be reflected by relatively weaker SMI ratings for his replacement.