

# Italy: 2018 – all change please

## A serious look at the odds of a M5-NL victory

On the basis of the data we collected in Italy over the course of July, and our own analysis, we believe that the approval rating of the Northern League and the small left-wing parties is being meaningfully underestimated currently in the opinion polls, while the support base for the ruling Democratic party appears to have peaked, in our view.

We believe that support for the 5 Star movement is broad, across incomes and age cohorts, but it is soft in the northern part of the country, where Northern League and the smaller left-wing parties have a stronger influence. As a result, while we found no enough evidence to signal strong momentum for the party at the moment, nor did we find any evidence that its current approval rating is overestimated.

In our view, the two most likely outcomes of the next general election is a centre-right coalition led by the Northern League, or a minority government led by 5 Stars with the unofficial support of the Northern League (potentially also with the support of a smaller left-wing party). A continuation of a grand coalition as is now in place, in our view, is likely to be unable to secure enough seats in parliament. On the margin, the Democratic party and Forza Italia are now competing for the same votes.

The data signal that a fairly brisk economic recovery is under way; but this is not the impression we gathered on the ground. Two-thirds of respondents in our sample reported no change in living conditions or a worsening of their status. We saw a strong desire to support entrepreneurs, as people see the effects of several years of de-industrialisation, as well as a strong desire to boost public spending to upgrade infrastructure and services for citizens (which includes education, healthcare, security, etc.). We found few enthusiasts for the universal minimum income and flat tax proposals – the two big policy changes proposed in this campaign. However, improvements in both ideas could be effective in securing votes and lifting the economy's potential growth rate.

Somewhat ironically, although we expect the two EU(ro) sceptic parties to be the winners of the next elections, we found no evidence that a return to the Lira is a priority for the electorate. A referendum will be held in Lombardy and Veneto on 22 October – we believe that this will be a good barometer via which to gauge people's genuine interest on the question of "independence". That said, it would be impossible for any government to seriously introduce a referendum on the (EU)ro before 2021, at the earliest, in our view.

Recently, we have done some work on the affordability of the housing market, given the growing evidence of a recovery in transactions. Our field study showed that, across the country, bar Milan, people perceive house prices to be low/attractive, but a significant part of the population is not able to take advantage of current valuations because of low savings and lower loan to value criteria for mortgages relative to before the crisis. This means that the housing market is recovering, but that it is not a sustainable recovery for the long run.

Raffaella Tenconi, August 2017

## How to use this report

This report is based on ADA's proprietary small data survey technique, which is a methodology for gathering local information primarily about government policies and voters' political views. We have developed and perfected this technique over the past year and a half, testing it in various ways during the UK EU referendum (2016), the US presidential elections (2016), the Italian Constitutional referendum (2016), the French presidential elections (2017) and the UK general elections (2017), and we have also used it for other EU countries. Our sample as of today is of 500 people in various European countries.

We have built our small data surveys to create a standardised methodology to assess political shifts, as well as the effectiveness and implementation of macroeconomic and fiscal policies. Our methodology has proven successful in correctly predicting major shifts in opinion polls with a lead of several months. Perhaps even more importantly, the insights we gather have a long shelf life as, de facto, we look for signals about emerging long-term trends (positive or negative) in a given country.

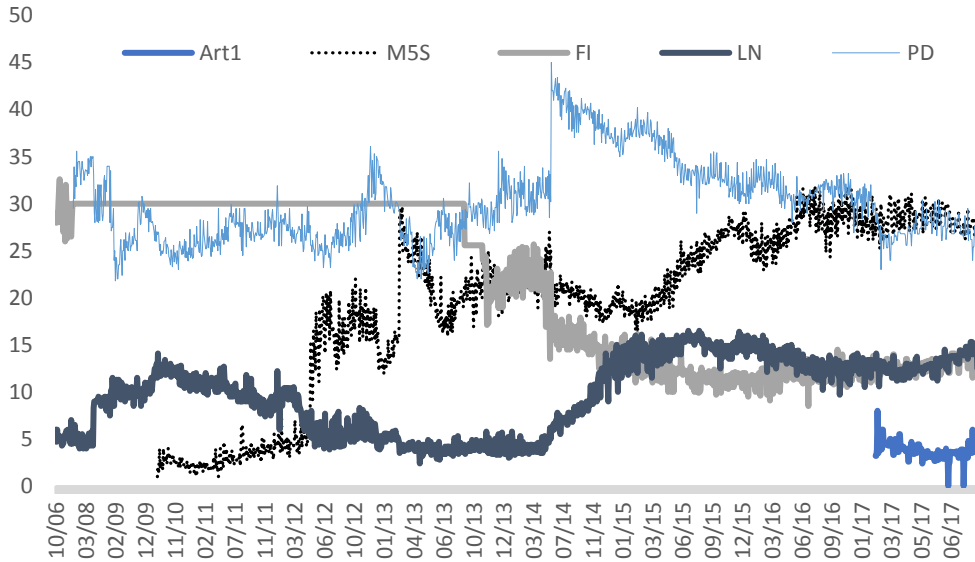
"Small data" means that our sample is smaller than a normal opinion poll, and much smaller than the much discussed "Big data" methodologies used to infer consumer trends, for example. However, what we lack in size, we make up for in content as we spend significant amounts of resources, strategy and time on gathering evidence on what people think and why, what they are experiencing and what they perceive to be a likely or desirable outcome.

We believe that you should see this report as complementary to opinion polls/big data analysis/country reports provided by international institutions and any other type of research you use currently.

We hope you will find it interesting and useful; please give us your feedback so we can keep on improving it!

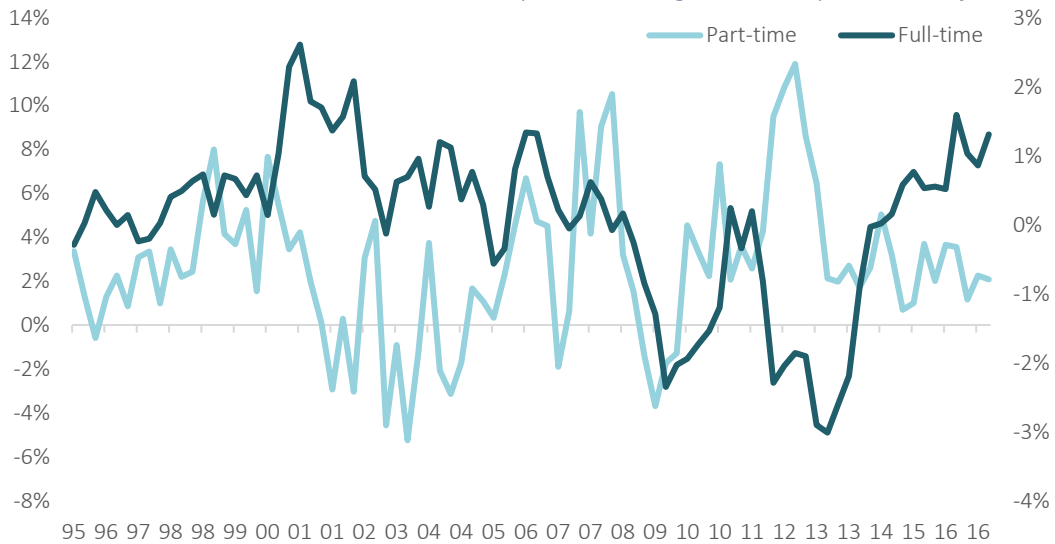
## The status quo – what the data say about Italy currently

Current opinion polls: PD and 5 Stars trending close to each other



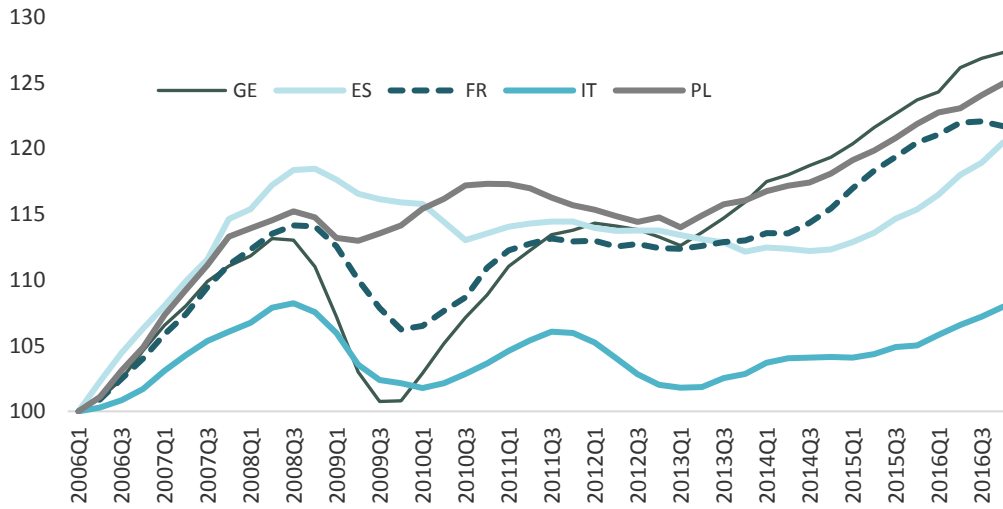
Source: Macrobond, ADA Economics Ltd. Notes: Art1 = Articolo 1 Progressive and Democratic movement, smaller left party, M5S = 5 Star Movement, FI = Forza Italia (Berlusconi's party), LN = Northern League (Salvini's party), PD = Democratic party (Renzi's party).

Labour market: the Jobs Act has helped to change the composition of jobs



Source: Macrobond, ADA Economics Ltd

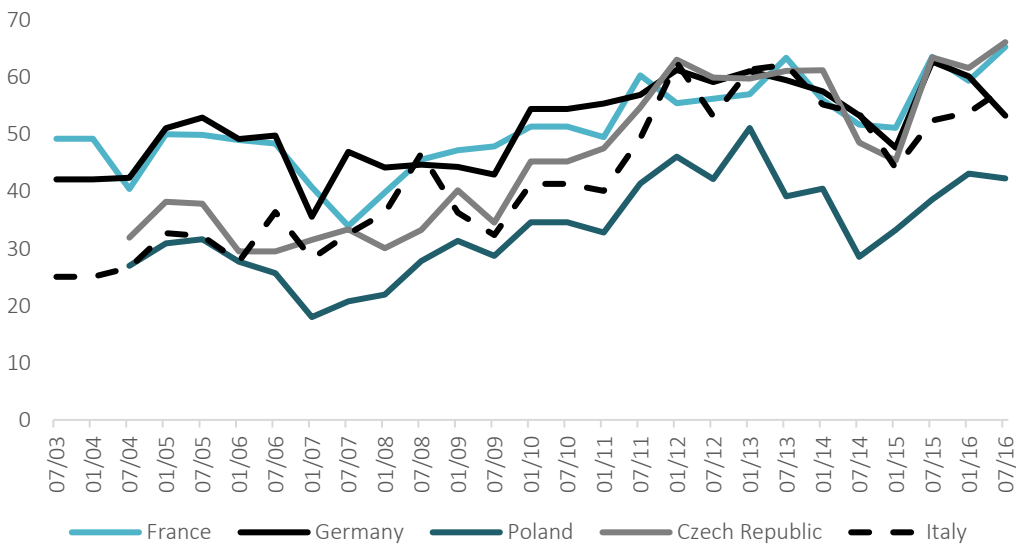
### Gross profits are recovering, but not as much as elsewhere



Source: Macrobond, ADA Economics Ltd.

Notes: Gross profits as provided in the national accounts dataset indexed to 2006Q1=100

### Distrust in the EU: not too different from that seen in Germany



Source: DG COMM survey, question: How much do you trust the European Union, share of those that respond "tend not to trust", data reported by Macrobond, ADA Economics Ltd

## Support for political parties: Northern League has momentum

Our field study has highlighted five strong trends. The approval rating of the Northern League is broadening across the country and has momentum. The support base of the Democratic party, led by former Prime Minister Matteo Renzi, is changing: some voters felt alienated by his decisions and are moving further left, but Renzi is gaining votes from Berlusconi's supporters in search for a younger leader. As some of our respondents put it: "*Renzi is a centre-right man after all*". The support for the 5 Star movement is strong and broad-based, notwithstanding that we found a meaningful number of voters disappointed with its performance. The support for the smaller left-wing parties is being underestimated in the current surveys, in our view: we expect it to double or even treble once we approach the 2018 elections.

Popular support for the Northern League is expanding across the whole country, not just its traditional core areas of the northern regions. This is a change compared with our previous small data core survey, which we conducted almost a year ago. Now, we have found that Salvini, the leader of the Northern league, and the "movement with Salvini" are perceived to be right, in terms of: his position on immigration; his emphasis on supporting companies; and the so-called "Italy for Italians" – overall, he is seen as pushing only a few ideas, but at least with credibility, consistency and the "right" ones needed by the country. We found support for Salvini across the country, which suggests to us that the approval rating of the Northern League will rise from around 14% currently to 20% by the time the elections take place.

Renzi's Democratic party is experiencing a change in its voter base. Overall, the party continues to command strong support at the national levels, but we suspect this may be the peak, unless Forza Italia drops out of the race completely. We found reasonable consistent support for PD only among either the very young (20-25 years, in the low income quintiles) or the 40-years plus (at the top of the income distribution). Several traditional PD voters claimed to feel alienated and will switch to some of the small left-wing parties. This shift, in our view, could push Sinistra Italiana and Articolo 1 from less than 4% to 8-12% at the national level (combined) – however, it is not clear to us whether both can make it into the next government – perhaps only one will succeed, taking most of the votes.

On average, people have taken notice of some of the key measures introduced by the government: the EUR 80 support for employees; the bonus for culture (for 18-year olds); and the jobs act are the most frequently-mentioned policies. However, none of these measures were uniformly evaluated positively; in fact, only a minority of people expressed a positive view. Instead, they were often criticised both for lack of coherence in term of implementation (the EUR 80 was not disbursed to the self-employed, for example, and some people had to return the cash the following year; or they could not understand why they received the money once, but not the following year), as well for their lack of long-term benefits (people criticised the fact that the measure was, by and large, a way to buy votes, rather than structurally address the needs of the economy).

In our view, the support base for the 5 Stars movement remains strong, although less so in the northern part of the country compared with the centre and the south. First, those that have voted 5 Stars in the past are highly likely to continue to do so, even though we found evidence of meaningful disappointment with their performance both in some of the large cities (Rome chiefly) and at the national level. Secondly, in our view, the party is still attracting new votes; we were surprised to see new votes coming in from the 55-year-olds and up – generally, these people see 5 Stars as the last option for genuine change. Thirdly, although the 5 Star movement has disappointed in Rome, it has delivered well in the eyes of voters in various smaller towns.

Whilst we did not find enough evidence to see the approval rating of 5 Stars as overestimated currently, neither did we find evidence that it is underestimated. Frequent criticism of the party relates to the founder of the movement – Beppe Grillo – and a perceived lack of sufficient competence or a clear message. Those that do not even consider M5 often do it because they perceive a lack of democratic process within the party and too much extremism in their policy views. In our view, some of these criticisms could be addressed over the course of the campaign and could yield an increase in its support base of 1-5 points on average. Importantly, 5 Stars is missing meaningful support from voters in the highest income brackets, which prevents, in our view, a rise in the opinion polls to 40%.

Equally importantly, the support for 5 Stars is capped somewhat in the north by the competition with the Northern League and Articolo 1; both are probably “easier” to relate to as both parties are perceived to have a clearer track record.

Forza Italia (FI), the party of former Prime Minister Silvio Berlusconi, launched its electoral campaign with a wide policy programme that aims to cater for both entrepreneurs and less affluent voters. We found strong support for Berlusconi in Sicily, making FI a serious contender to win the upcoming regional elections, due on 5 November (the other potential winner is the 5 Star movement). However, we did not find that much support for FI elsewhere; in our view, the key problem is that, while Berlusconi can recapture some of the disillusioned votes he lost in the past two elections, he is unable to gather more because of his age – in fact, he is losing support because of his age. The common feedback we collected was: some votes are shifting to Renzi, because he is seen as a “centre-right man”, with his younger age as an important advantage over Berlusconi (who is currently 80 years old, turning 81 on 29 September); and some support is shifting to Salvini because of his tougher stance on immigration.

| Party                     | Current approval rating | ADA expectations in 2018 |  |
|---------------------------|-------------------------|--------------------------|--|
|                           |                         |                          |  |
| Democratic party          | 28                      | 23-28                    |  |
| 5 Stars                   | 28                      | 25-33                    |  |
| Forza Italia              | 14                      | 10                       |  |
| Northern League - Salvini | 14                      | 20                       |  |
| Brothers of Italy         | 4                       | 5                        |  |
| Small Left Parties*       | 4                       | 8-12                     |  |

*Source: Sondaggipoliticoelettorali.it, ADA Economics Ltd*

## Election scenarios and policy outcomes

Election scenarios at this stage are subject to a major unknown as the details of the electoral law have not been agreed on yet. We assume that the new system will be a majoritarian one, with some proportional adjustment and a cut off for representation at the national level for the lower chamber set at 3-5%. We expect to see a majority premium for the party/list that reaches 40% of the votes at the national level, but it remains unclear how similar the rules will be for the lower house and the Senate and what will be the requirements to access the majority premium.

In our view, the combination that will receive the highest number of seats in parliament is likely to be Northern League-5 Stars, followed by a centre-right coalition of Northern League-Forza Italia and Fratelli d'Italia. Both options face some challenges, but not steep enough, in our view, for us not to take these scenarios very seriously. In the first case, an official cooperation between the two appears very unlikely before the elections, but viable at least on some issues after the elections, in our view. The table below shows the policy areas that each scenario could bring, in our view. In the second option, the big question will be whether Forza Italia will accept being the junior coalition partner in the government, and the number of seats overall will not be as significant as in the first case – especially in the Senate, some problems could arise if NL-FI do not perform as strongly as we expect.

A grand coalition between the Democratic party and Forza Italia (the Renzi government was supported by a spin-off of FI), in our view, has the highest risk of not reaching enough votes for a majority, with the same being true of a coalition between the Democratic party and the smaller left-wing parties.

| Coalition                                  | ADA's expectations on policy priorities   |
|--|---|
| NL+FI+Fdl                                  | <ul style="list-style-type: none"> <li>Introduction of a flat tax or a two tax rate system for the corporate sector</li> <li>Halt on immigration inflows from Africa</li> <li>Some increase in fiscal spending to support the lowest income bracket</li> <li>Partial repeal of the housing tax - most likely for residential properties - or similar measures to in support of construction/real estate</li> <li>Widening of the budget deficit goals agreed with Brussels</li> </ul> |
| NL - M5 (not necessarily a firm coalition) | <ul style="list-style-type: none"> <li>New lower corporate tax rate for SMEs (the bulk of companies in Italy)</li> <li>Halt on immigration inflows from Africa</li> <li>Public spending reduction continuing</li> <li>Simultaneous introduction of a minimum income support, limited in time for the lowest income bracket, including students</li> <li>Lifting up of the budget deficit goals agreed with the EU Commission</li> </ul>   |
| Democratic party + FI and/or Art1          | <ul style="list-style-type: none"> <li>Halt to privatisations</li> <li>Another round of labour reforms</li> <li>Privatisations continue</li> <li>Spending review continues</li> <li>Competition reforms continue as planned</li> <li>Reduction of social security contributions</li> </ul>  |

Source: Macrobond, ADA Economics Ltd



## The perception of the current economic situation

Overall, we found that people reported that the economy was stable – generally stagnant, but at least not worsening as seen in previous years. On the margin, we found more negative views in the centre-northern part of the country than elsewhere.

A recurrent theme in our conversations was the need to support entrepreneurs, and bring back companies that create jobs. Strong criticisms were voiced about the education reform of the Renzi government, the need to increase resources for the public healthcare sector, and a very strong sense of injustice for the high number of illegal immigrants that are coming into the country but failing to contribute to society.

People's trust in the future of the country, in our view, continues to weaken; this is visible both in our findings of low trust and support for the BTPs (which have been the bedrock of households' savings historically), and the generally high share of people that would leave the country if they could, to seek a better job/standard of living.

## Universal minimum income and flat tax: no vote winners for now

We surveyed voters' support for the two big policy proposals that are part of this election campaign: the universal minimum income (an idea initially launched by the 5 Star movement, and later transformed and partly implemented by the Democratic party) and the flat tax (supported by the Northern League and Forza Italia). To our surprise, neither measure was a trigger for voters' support in the vast majority of cases, in fact both were rejected by roughly two respondents out of three. However, we believe that both policies, if refined, could be welcomed by citizens and could help the economy.

### Universal minimum income – the feedback:

A very forceful criticism of this proposal is that it is perceived to be too expensive for the state of public finances and, even if it was not, people were often of the view that it would not be a solution for the economy's problems, but rather a temporary palliative. Voters across age brackets (although the younger cohorts, on the margin, tend to be more favourable on the idea due to the future of automation) want to see job opportunities, not income support.

A strong criticism of the proposal is that it will be open to abuse – this was a particularly common response in the centre-southern parts of the country, where practically everyone noted that the scheme would be abused. Overall, voters complained about high tax evasion and the need to improve the justice system and so the minimum income proposal as simply impractical as long as these two issues aren't tackled in a credible manner. Also, some thought that the country does not need to redistribute income further, but rather wealth. An equally important criticism to the minimum income proposal is the fact that most voters thought it is not the most pressing priority, or simply that the country overall would benefit more from using the resources and invest it in infrastructure, improvements in tourism or simply tax cuts for all.

We asked people what they thought would be the appropriate monthly net amount should this scheme be put in place, and the range of answers we gathered was from EUR 400 to EUR 1,400 per month, with the most frequent response set at EUR 700-800 per month.

Those that liked the idea mentioned did it for the following reasons: as a second choice if the "state can't deliver more job creation", as a desirable way to support the poorest including pensioners and as a way to offset the expected negative impact on the labour market from increased automation



## Potential improvements for the idea

Respondents both in favour and against the universal minimum income, de facto, suggested various ways that would make, in our view, this proposal significantly more popular than it is currently. It is important for the policy to have a clearer strategy and expected effect, and a solid funding proposal. Equally importantly, most people would prefer to see it have a limited timeframe and be conditional, in order to avoid abuse. For example, this could be used to widen the support surrounding maternity/paternity leave, or to support young/new entrepreneurs or people who want to advance their skills for career progression.

## Flat tax – the feedback

The flat tax system – for both companies and households – is still a new idea in Italy and generally one that the electorate is not yet overly familiar with. One out of three respondents in our sample were supportive of the idea (even including those that did not necessarily think that just one tax bracket is ideal) and we found more support in the northern part of the country, on the margin.

The majority of the people who argued against it said that a flat tax system is unjust – this was a common response even among high-income earners. Equally important was the concern that a low tax rate would be unsustainable for the public sector and, generally, people thought there was no solid analysis that would back this proposal. We found that some small entrepreneurs were against the flat tax because they thought that large companies ought to pay more, or that the shift to a flat tax system would create a sudden tax increase for them.

We note that, while the proposal of a single tax bracket (for companies or households) was forcefully rejected, the potential of two-to-three (maximum) tax rates for everyone was generally more welcomed.

## A much-needed revision of the tax system

In our view, a very important factor behind the lack of support for the flat tax scheme is the lack of convincing analysis available for the average person, which would show how the scheme would work and why it should stimulate the economy. Italians, by now, have developed a high distrust of anyone that promises a tax cut, as their experience of the past seven years has proved that there is no such thing as a free lunch. In addition, people are familiar with the web of tax thresholds, which change from year to year and do not really seem to be up to date with the current global economy. The following are some of the most frequent criticisms we gathered on the tax system; which, if they were to be addressed, could prove to be a strong vote-shifter in the upcoming campaign, in our view:

- The tax brackets for employees and the self-employed should be consistent with each other, should be more reflective of the growing income inequality and should incentivise tax disclosure (while they do the opposite currently). Examples that were given to us were an incoherence in the tax rate for lawyers up to EUR 30,000 per year, sudden changes in the tax rates for the flexible workers (*partite iva*), the EUR 80 support scheme was legislated for employees, but not self-employed, even if they are in equivalent income brackets.
- The recently implemented “studi di settore” – a way to reduce tax avoidance among entrepreneurs/SMEs – is widely perceived to be unjust and countercyclical to the business cycle (it imposes a high tax burden when the entrepreneur has a bad year and may not tax enough in the good (long gone) times).

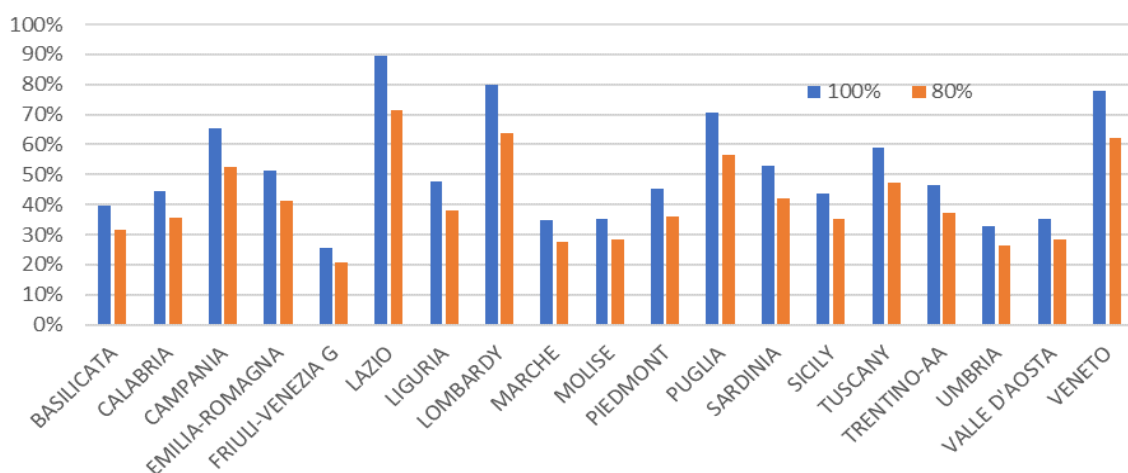
- The tax system is too complex overall.
- The housing tax is perceived by many as a fundamentally unfair tax, especially those that either are still paying a mortgage on it or those that have inherited a real estate asset but do not earn any return on it. We found a recurrent proposal of a complete elimination of the real estate tax for small companies and the suggestion of making the housing tax significantly more progressive.
- The tax burden is seen as too high – in particular, the VAT rate is seen as exaggerated (and will rise further next year), the IRAP is often criticised (the additional tax at the local level).
- People think that there is no support for small- and medium-sized entrepreneurs, especially young ones, and the tax system should provide significantly more support for those parts of the corporate sector, while increasing the burden on the “mega” companies.

## The housing market

Recently, we conducted a study on the affordability of the Italian residential real estate market, which highlighted that, aside from pockets of particularly high prices (Milan, Venice, Rome, especially the historical centres), the market appears overall significantly more accessible compared with the past. Our small data survey confirmed that most people see housing prices are much more affordable, and that it is generally a good time to enter the market if they have the means.

However, our study also revealed that a vast majority of people are not able to buy a property because they do not have enough savings, or their employment status is perceived to be “too risky” by the banks, which would lend only if guarantors are involved.

Debt servicing costs for a 60sqm flat in the regional capitals



Source: Agenzia delle Entrate, Istat, ADA Economics Ltd. Debt servicing costs measured by repayment of principal and interest for a 20 year mortgage at 2.1% divided by the estimate of regional disposable incomes, estimates for 2016. Estimates showing for a 100% loan to value mortgage and for an 80% one.

In our view, this suggests that, while the market is likely to continue to show signs of improvements, valuations could fall further, especially in the smaller towns, as a result of a lack of demand and as the country continues to go through a process of wage compression in the coming years.

## Trust in the BTPs... not much left

We asked people about their savings and whether they would consider investing in BTPs as a surreptitious way to assess their trust in the state. Historically, Italian families have saved large chunks in BTPs; more recently, they have continued to do so indirectly via savings products offered by the banks – what is going to happen in the future? The responses we collected, in our view, are a worrying signal that trust, knowledge and appeal are very low. First, a large share of respondents mentioned a complete lack of trust due to bad experiences related to corporate and bank bonds, as well as a general distrust over public sector finances. Secondly, a meaningful share of the sample mentioned a lack of appeal both because of the taxation on BTPs (which was increased during the Monti and Renzi governments), as well as a lack of appeal due to low yields. Last but not least, we also found a widespread lack of knowledge about these products, not strictly concentrated among the younger generations (which would normally have lower savings and less experience with financial instruments).

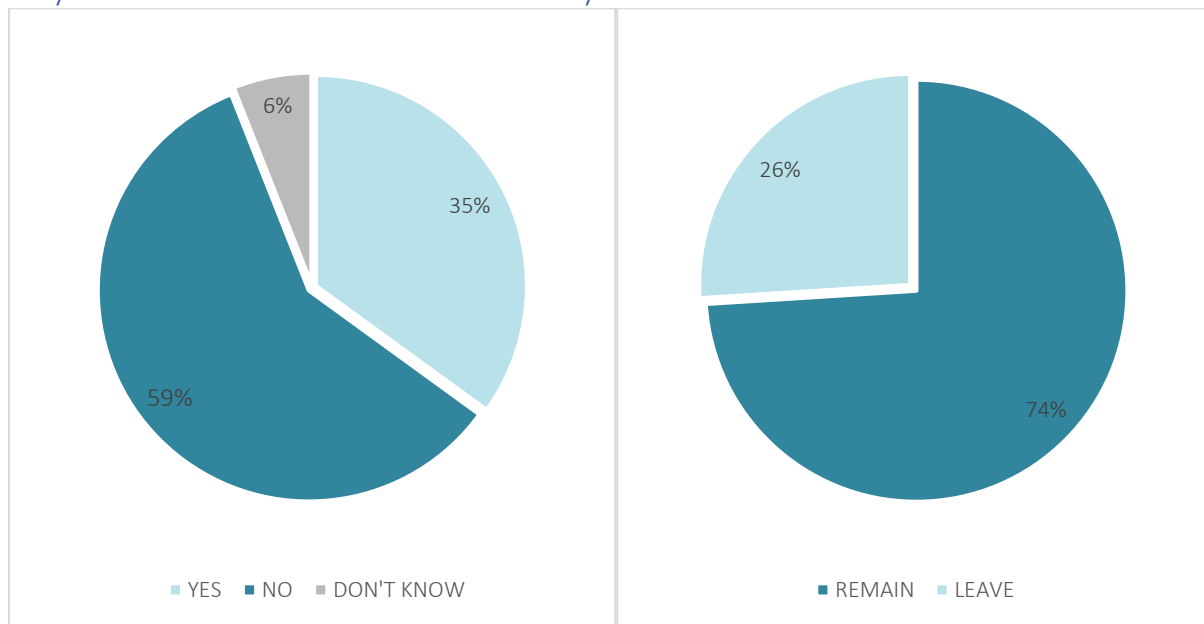
## The EU(ro) question

Commonly available surveys, such as the Eurobarometer or opinion polls on the EU and the Euro, show that there is a fairly high distrust of the EU but only a minority of people are willing to translate that into a hypothetical vote to LEAVE the EU(ro). During our exercise, we did not openly ask about support for the Euro and a very small minority of people raised the Euro as a key issue that needs to be addressed (1% of those sampled mentioned it as a policy priority, as much as those that mentioned a “closer EU” as a priority). In our view, this means that, even if the more Euro-sceptic parties do win, it would not necessarily mean that they would make the question of the EU(ro) a priority – in fact, this survey suggests that they should not, and its message is consistent with a study we conducted on Italy in 2016.

In our view, a EU(ro) referendum is not permissible by the Italian Constitution under article 75-80 and, even if it were to be implemented in the near term, there would be strong support for a REMAIN vote, if only because history shows that Italians do not rush into support of bold changes if a clear case is not made in their favour. Given the state of the debate and the steep challenges faced by the UK in the Brexit negotiations, we see no strong case to be concerned about ITEXIT, even if the next government is perceived to be Euro-sceptic. That said, time can change many things. The earliest feasible date that a EU(ro) referendum could take place, in our view, is 2021: it would need the new government to settle in, change the Constitution, and then start the process to have such a referendum. At best, this is a three-year journey and, most likely, a longer one.

Do you tend to trust the EU?

Would you vote to Leave or Remain in the EU?



Source: Sondaggipoliticoelettorali, DEMOPOLIS survey conducted in May 2017, ADA Economics Ltd

## Policy priorities

|   | <b><u>Policy priorities</u></b>  | <b><u>% of responses</u></b> |
|---|--|------------------------------|
| <u>Increase spending on human capital</u> |  | 25%                          |
| which includes (in order of priority)     | <ul style="list-style-type: none"> <li>education</li> <li>healthcare</li> <li>cut in the retirement age to free up jobs</li> <li>improve the justice system</li> <li>increase minimum pensions</li> <li>increase support for families</li> </ul>   |                              |
| <u>Restructure the tax system</u>         |  | 20%                          |
| which includes (in order of priority)     | <ul style="list-style-type: none"> <li>cut in taxes in broad terms (families/companies etc)</li> <li>cut taxes specifically for SMEs</li> <li>reduction in tax evasion</li> <li>reduction in the perceived tax inequality</li> </ul>   |                              |
| <u>Various structural reforms</u>         |  | 16%                          |
| which includes (in order of priority)     | <ul style="list-style-type: none"> <li>reduce the "cost of politics"</li> <li>cut bureacracy</li> <li>finish the electoral law</li> <li>structural reforms in broad terms</li> <li>legalise prostitution and drugs use</li> <li>reduce the public debt</li> <li>leave the EURO</li> <li>a closer Europe</li> </ul> |                              |
| <u>Address the immigration wave</u>       |  | 14%                          |
| <u>Increase spending on fixed assets</u>  |  | 12%                          |
| which includes (in order of priority)     | <ul style="list-style-type: none"> <li>increase infrastructure overall</li> <li>increase spending on tourism</li> <li>address the north-south income divide</li> <li>increase spending to protect the environment</li> </ul>   |                              |

*Source: ADA Economics Ltd*

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Released 1<sup>st</sup> of August 2017