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ABOUT THE COUNCIL FOR THE UNITED STATES AND ITALY

The Council for the United States and Italy is a private non-profit organization, founded in Venice in 1983 by Gianni Agnelli and David Rockefeller, who served as honorary presidents until 2003. Marco Tronchetti Provera followed them as Chairman, then Sergio Marchionne until 2018. Domenico Siniscalco is the current Chairman, Gianni Riotta Executive Vice Chairman. The Council for the United States and Italy promotes and creates economic relations between Italy and the United States, linking them to Europe, Asia and Africa through knowledge and free trade. Its members are leaders in the economy, industry, finance, technology, services, consulting, law, and culture - a team in which economic growth is viewed as promoting humanity and wealth as a cultural value to be shared.

This monthly newsletter is prepared jointly by the Council for the United States and Italy and The European House - Ambrosetti.

WEBINAR | Pandemonium Covid: a colloquium with Professor Ricciardi| January 26th

Walter Ricciardi *(Professor of Hygiene, Catholic University of the Sacred Heart in Rome; President, World Federation of Public Health Associations; President, Mission Board for Cancer of the European Commission)*

Two years into the beginning of the Covid-19 pandemic – and two years after Professor Ricciardi participated in the first webinar of the Council – it is time to collect ideas and information on what has happened, and what hopefully will not happen again. "Pandemonium" clearly symbolizes this era: a disaster, a confusion that still permeates our everyday life. Four narratives emerged from the Covid-19 pandemic and its management:

- Government capacity: while it should always be coherent and coordinated, when Covid-19 spread many countries did not maintain a clear chain of command and efficient communication style.
- Length: presumably, we are experiencing the end of the beginning. Learning from previous pandemics that came wave after wave, the Covid-19 pandemic is slowing down thanks to extensive vaccination coverage. Without a coherent strategy, it is likely that we might experience additional waves in the near future.
- Ignorance: over the last few months, there have been demonstrations and expressions of stupidity, ignoring the current situation and the information provided by the scientific community.
- Darwinian epidemic: if survival is not mandatory, it is not necessary to change our habits. In this sense, no-vax believers are paying with their life because of their assumptions.

As representative of Italy at the WHO, Professor Ricciardi had a privileged view at the dawn of the pandemic. As a result, some government decisions such as the air travel restrictions were improper; instead, what was needed were quarantines. After the deathly impact of the pandemic was evident, Italy was the first country to implement a full national lockdown and was later taken as a model by other countries all over the world. A full lockdown was the only existing tool to interrupt the chains of transmission, without any vaccines or drugs available yet.

From December 2019 to April 2020, the Covid-19 pandemic was an Italian affair: every decision taken by the Italian Government was later followed by international organizations and national governments. Thanks to the containment measures, the epidemic curve could be flattened, reducing peak number of cases and the demand on the healthcare system. According to a study by the Imperial College, the implementation of the lockdown saved approximately 38.000 lives.

In the spring of 2020, the vaccine games officially open, paving the way for the second part of the pandemic with some signals of recovery. Vaccines are our solution to the pandemic: this breakthrough has been possible thanks to a 360°-degree approach and unprecedented effort of the scientific community. However, as it was easily predicted, a new wave came in autumn 2020 together with a new dilemma: coexistence or elimination of the virus? Bold government decisions brought to a third wave in early 2021.

Despite the decline in death and hospitalization rates, with 160 deaths per 100,000 people, Covid-19 still represents the third cause of death in Italy, after circulatory system diseases and cancer. In Italy, several matters need to be addressed:

- The state-region-province relations, and their respective systems of governance and coordination.
- The relation between hospital care, primary assistance, and community care.
- The integration between healthcare and social issues.
- The public-private approach, under a financial and functional point of view.
- The implementation of an adequate system of prevention and preparedness.
- Education and management of human resources.
- An adequate and stable financial system in the medium-long term.

There is not epilogue of this pandemic yet, but the dramatic Covid-19 experience taught us that four conditions are essential to overcome it: advanced level of scientific knowledge, efficient healthcare systems, adequate individual behaviours, responsible politicians.

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INFLATION WILL HURT BOTH STOCKS AND BONDS

Nouriel Roubini *(Professor Emeritus, New York University's Stern School of Business; Chief Economist, Atlas Capital Team; CEO, Roubini Macro Associates; Co-Founder, TheBoomBust.com; Former senior economist for international affairs, White House's*

The longstanding negative correlation between stock and bond prices is an artifact of the low-inflation environment of the past 30 years. If inflation and inflation expectations continue to rise, investors will have to rethink their portfolio strategies to hedge against the risk of massive future losses.

NEW YORK - Rising inflation in the United States and around the world is forcing investors to assess the likely effects on both "risky" assets (generally stocks) and "safe" assets (such as US Treasury bonds). The traditional investment advice is to allocate wealth according to the 60/40 rule: 60% of one's portfolio should be in higher-return but more volatile stocks, and 40% should be in lower-return, lower-volatility bonds. The rationale is that stocks and bond prices are usually negatively correlated (when one goes up, the other goes down), so this mix will balance a portfolio's risks and returns.

During a "risk-on period," when investors are optimistic, stock prices and bond yields will rise and bond prices will fall, resulting in a market loss for bonds; and during a risk-off period, when investors are pessimistic, prices and yields will follow an inverse pattern. Similarly, when the economy is booming, stock prices and bond yields tend to rise while bond prices fall, whereas in a recession, the reverse is true.

But the negative correlation between stock and bond prices presupposes low inflation. When inflation rises, returns on bonds become negative, because rising yields, led by higher inflation expectations, will reduce their market price. Consider that any 100-basis-point increase in long-term bond yields leads to a 10% fall in the market price – a sharp loss. Owing to higher inflation and inflation expectations, bond yields have risen and the overall return on long bonds reached -5% in 2021.

Over the past three decades, bonds have offered a negative overall yearly return only a few times. The decline of inflation rates from double-digit levels to very low single digits produced a long bull market in bonds; yields fell and returns on bonds were highly positive as their price rose. The past 30 years thus have contrasted sharply with the stagflationary 1970s, when bond yields skyrocketed alongside higher inflation, leading to massive market

losses for bonds. But inflation is also bad for stocks, because it triggers higher interest rates – both in nominal and real terms.

Thus, as inflation rises, the correlation between stock and bond prices turns from negative to positive. Higher inflation leads to losses on both stocks and bonds, as happened in the 1970s. By 1982, the S&P 500 price-to-earnings ratio was eight, whereas today it is above 30.

More recent examples also show that equities are hurt when bond yields rise in response to higher inflation or the expectation that higher inflation will lead to monetary-policy tightening. Even most of the much-touted tech and growth stocks aren't immune to an increase in long-term interest rates, because these are "long-duration" assets whose dividends lie further in the future, making them more sensitive to a higher discount factor (long-term bond yields). In September 2021, when ten-year Treasury yields rose a mere 22 basis points, stocks fell by 5-7% (and the fall was greater in the tech-heavy Nasdaq than in the S&P 500).

This pattern has extended into 2022. A modest 30-basis-point increase in bond yields has triggered a correction (when total market capitalization falls by at least 10%) in the Nasdaq and a near-correction in the S&P 500. If inflation were to remain well above the US Federal Reserve's target rate of 2% – even if it falls modestly from its current high levels – long-term bond yields would go much higher, and equity prices could end up in bear country (a fall of 20% or more).

More to the point, if inflation continues to be higher than it was over the past few decades (the "Great Moderation"), a 60/40 portfolio would induce massive losses. The task for investors, then, is to figure out another way to hedge the 40% of their portfolio that is in bonds.

There are at least three options for hedging the fixed-income component of a 60/40 portfolio. The first is to invest in inflation-indexed bonds or in short-term government bonds whose yields reprice rapidly in response to higher inflation. The second option is to invest in gold and other precious metals whose prices tend to rise when inflation is higher (gold is also a good hedge against the kinds of political and geopolitical risks that may hit the world in the next few years). Lastly, one can invest in real assets with a relatively limited supply, such as land, real estate, and infrastructure.

The optimal combination of short-term bonds, gold, and real estate will change over time and in complex ways depending on macro, policy, and market conditions. Yes, some analysts argue that oil and energy – together with some other commodities – can also be a good hedge against inflation. But this issue is complex. In the 1970s, it was higher oil prices that caused inflation, not the other way around. And given the current pressure to move away from oil and fossil fuels, demand in those sectors may soon reach a peak.

While the right portfolio mix can be debated, this much is clear: sovereign wealth funds, pension funds, endowments, foundations, family offices, and individuals following the 60/40 rule should start to think about diversifying their holdings to hedge against rising inflation.

THE FED IS PLAYING WITH FIRE

Stephen S. Roach *(Faculty Member, Yale University; Former Chairman, Morgan Stanley Asia; author)*

By now, it is passé to warn that the US Federal Reserve is "behind the curve" in fighting inflation. In fact, the Fed is so far behind that it can't even see the curve and may have to slam on the policy brakes to regain control before it is too late.

NEW HAVEN – The US Federal Reserve has turned on a dime, an uncharacteristic about-face for an institution long noted for slow and deliberate shifts in monetary policy. While the Fed's recent messaging (it hasn't really done anything yet) is not as creative as I had hoped, at least it has recognized that it has a serious problem.

That problem, of course, is inflation. Like the Fed I worked at in the early 1970s under Arthur Burns, today's policymakers once again misdiagnosed the initial outbreak. The current upsurge in inflation is not transitory or to be dismissed as an outgrowth of idiosyncratic COVID-19-related developments. It is widespread, persistent, and reinforced by wage pressures stemming from an unprecedentedly sharp tightening of the US labor market. Under these circumstances, the Fed's continued refusal to change course would have been an epic policy blunder. But

recognizing the problem is only the first step toward solving it. And solving it will not be easy.

Consider the math: The inflation rate as measured by the Consumer Price Index reached 7% in December 2021. With the nominal federal funds rate effectively at zero, that translates into a real funds rate (the preferred metric for assessing the efficacy of monetary policy) of -7%. That is a record low. Only twice before in modern history, in early 1975 and again in mid-1980, did the Fed allow the real funds rate to plunge to -5%. Those two instances bookended the Great Inflation, when, over a five-year-plus period, the CPI rose at an 8.6% average annual rate.

Of course, no one thinks we are facing a sequel. I have been worried about inflation for longer than most, but even I don't entertain that possibility. Most forecasters expect inflation to moderate over the course of this year. As supply-chain bottlenecks ease and markets become more balanced, that is a reasonable presumption. But only to a point. The forward-looking Fed still faces a critical tactical question: What federal funds rate should it target to address the most likely inflation rate 12-18 months from now?

No one has a clue, including the Fed and the financial markets. But one thing is certain: With a -7% real federal funds rate putting the Fed in a deep hole, even a swift deceleration in inflation does not rule out an aggressive monetary tightening to re-position the real funds rate such that it is well-aligned with the Fed's price-stability mandate.

To figure this out, the Fed must hazard an estimate of when the inflation rate will peak and head lower. It is always tough to guess the date – and even harder to figure out what "lower" really means. But the US economy is still running hot, and the labor market, at least as measured by the plunging unemployment rate, is tighter than at any point since January 1970 (on, gulp, the brink of the Great Inflation). Under these circumstances, I would argue that a responsible policymaker would want to err on the side of caution and not bet on a quick, miraculous roundtrip of inflation back to its sub-2% pre-COVID-19 trend.

Again, consider the math: Let's say the Fed's projected policy path, as conveyed through its latest "dot plot," is correct and the central bank takes the nominal federal funds rate from zero to around 1% by the end of 2022. Couple that with a judicious assessment of the disinflation trajectory – not too slow, not too fast – that foresees year-end CPI inflation moving back into the 3-4% zone. That would still leave the real federal funds rate in negative territory at -2% to -3% at the end of this year.

That's the catch in all this. In the current easing cycle, the Fed first pushed the real federal funds rate below zero in November 2019. That means a likely -2% to -3% rate in December 2022 would mark a 38-month period of extraordinary monetary accommodation, during which the real federal funds rate averaged -3.1%.

Historical perspective is important here. There have been three earlier periods of extraordinary monetary accommodation worth noting: In the aftermath of the dot-com bubble a generation ago, the Fed under Alan Greenspan ran a negative real funds rate averaging -1.1% for 31 consecutive months. Following the 2008 global financial crisis, Ben Bernanke and Janet Yellen teamed up to sustain a -1.9% average real funds rate for a whopping 62 months. And then, as post-crisis sluggishness persisted, Yellen partnered with Jerome Powell for 37 straight months to hold the real funds rate at -0.9%.

Today's Fed is playing with fire. The -3.1% real federal funds rate of the current über-accommodation is more than double the -1.4% average of those three earlier periods. And yet today's inflation problem is far more serious, with CPI increases likely to average 5% from March 2021 through December 2022, compared with the 2.1% average that prevailed under the earlier regimes of negative real funds rates.

All this underscores what could well be the riskiest policy bet the Fed has ever made. It has injected record stimulus into the economy during a period when inflation is running at well over twice the pace it did during its three previous experiments with negative real funds rates. I deliberately left out a fourth comparison: the -1.7% real federal funds rate under Burns in the early 1970s. We know how that ended. And I also left out any mention of the Fed's equally aggressive balance-sheet expansion.

By now, it is passé to warn that the Fed is "behind the curve." In fact, the Fed is so far behind that it can't even see the curve. Its dot plots, not only for this year but also for 2023 and 2024, don't do justice to the extent of monetary tightening that most likely will be required as the Fed scrambles to bring inflation back under control. In the meantime, financial markets are in for a very rude awakening.

Why the NFT Market Will Collapse

Patrick Reinmoeller *(Professor of Strategy, Institute for Management Development)*
Karl Schmedders *(Professor of Finance, Institute for Management Development)*

Prices of non-fungible tokens remain high for now and may continue to increase for some time, but a crash will come. With central banks set to tighten monetary policy in an effort to rein in inflation, new and untested a sset classes are likely to be punished harder than more reliable ones.

LAUSANNE – In March 2021, the auction house Christie's sold a JPEG file created by the artist Beeple for $69.3 million, a record for a digital artwork. The ownership of the "original" JPEG – entitled "Everydays: The First 5000 Days" – was secured as a non-fungible token, or NFT.

The sale made headlines, and NFTs have since become red-hot. Investors poured $27 billion into the market in 2021, and Meta, Facebook's renamed parent company, now reportedly plans to allow users to create and sell NFTs. There's just one problem: the NFT market will eventually collapse, for any of a host of reasons.

In essence, an NFT is a tradeable code attached to metadata, such as an image. A secure network of computers records the sale on a digital ledger (a blockchain), giving the buyer proof of both authenticity and ownership. NFTs are typically paid for with the Ethereum cryptocurrency, and – perhaps more importantly – stored using the Ethereum blockchain. By combining the desire to own art with modern technology, NFTs are the perfect asset for newly wealthy members of the Silicon Valley set and their train of acolytes in finance, entertainment, and the broader retail-investor community.

But, like other markets driven by exuberance, impulse purchases, and hype, the fast-moving and speculative NFT market could burn many investors. The current frenzy invites comparisons with the Dutch tulip mania from 1634 until 1637, when some bulbs fetched extremely high prices before the exuberance dissipated and the bubble collapsed.

The NFT market will likely suffer a similar fate – but not, as some might think, because of environmental concerns. To be sure, NFTs consume considerable amounts of energy, because cryptocurrencies like Ethereum and Bitcoin are "mined" using networks of computers with a large carbon footprint – one that grows with every transaction. But when it comes to understanding what will bring down the NFT market, climate impact is a red herring. The real problem is that the current NFT boom is built on a foundation of sand.

Start with the problem of infinite supply. NFTs offer ownership of a digital asset, but not the right to prevent others from using its digital copies. Part of the reason why wealthy investors are prepared to pay tens of millions of dollars (or more) for traditional physical artworks by the likes of Rembrandt, van Gogh, or Monet is that the number of masterpieces is finite; the artists are long dead and cannot produce new artworks. NFT copies, on the other hand, could become a commodity.

Moreover, as with all things digital, there is no difference in appearance between an original JPEG file sold for $69.3 million, and a copy downloaded for free online. In theory, the supply of legally usable copies of NFTs is infinite, potentially overwhelming demand for them and causing prices to collapse.

Because the blockchain is unable to store the actual underlying digital asset, someone buying an NFT is buying a link to the digital artwork, not the artwork itself. Although buyers gain copyright to the link, the transaction costs related to monitoring the infinite online venues for displaying NFTs, identifying illegitimate use, and pursuing and prosecuting infringement make it nearly impossible to enforce the copyright or deter misuse. This strongly limits monetization of the asset.

Another risk is that NFTs are being made and sold with infant technologies – blockchains and cryptocurrencies. There currently are multiple competing standards regarding how to generate, safeguard, distribute, and certify NFTs, including ERC-721, ERC-998, ERC-1155, flow and non-flow standards, and Tezos's FA2. The resulting uncertainty as to how ownership certification will be guaranteed in perpetuity endangers the value of the assets and even their ownership.

In fact, the value of NFTs may evaporate if the next wave of more advanced technologies that supersedes crypto or blockchain is incompatible with secure NFT ownership. Firms that deal in NFTs today may not be around

tomorrow, muddying ownership claims.

The price volatility of the cryptocurrencies underpinning the NFT market is a central issue as well. NFT prices tend to move in tandem with cryptocurrency prices. When crypto tanked in 2018, so did the nascent market for NFTs.

The psychology of buying luxury goods also will likely put downward pressure on NFT prices. Most luxury products are so-called Veblen goods, with limited utility beyond enabling owners to advertise their wealth. For that reason, they often generate large profits for sellers.

NFTs enable buyers to broadcast their wealth mostly through the high price they paid, but only if they receive a positive reaction from their peers. If such expenditure does not resonate with this audience, the investor might as well burn cash to light a cigarette.

Because owning an NFT does not prevent others from displaying the same assets and signaling ownership, these tokens hardly serve as effective indicators of unique spending power. And many NFT buyers remain anonymous anyway, because the blockchain ensures that knowledge regarding ownership is limited.1

Finally, changing macroeconomic conditions could negatively affect the prices of alternative assets such as NFTs and traditional artworks. In the past two decades, the number of billionaires worldwide has increased more than fivefold, and available income ready to be invested in alternative asset classes has ballooned as a result. The COVID-19 pandemic has so far reinforced this trend. Much of the vast economic stimulus injected by central banks went into financial markets, further boosting the net worth of the super-rich.

But investor attention can be fleeting. After the 2008 global financial crisis, sales of art and other luxury products declined by almost 40%. With central banks now starting to tighten monetary policy in an effort to rein in inflation, new and untested asset classes are likely to be punished harder than more reliable ones. And the hugely volatile NFT market, based on digital currencies with nothing to back them up, is hardly a safe haven.

Ultimately, NFT prices will suffer a large, permanent decline. They remain high for now and may continue to increase for some time, but the crash will come. Investors who think they can time the market are welcome to try, but their optimism will likely prove misplaced.