

AQUILA FLASH



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The beach, the ice cream sellers and our overweight in European equities

Voter intentions and opinions have shifted markedly in many countries. We expect that established political parties will try to accommodate this shift by adopting more populist programs. While future Italian elections are likely to produce “extreme” or “populist” results we don’t think this will lead to an Italian exit from the Euroland. The costs of leaving would be far too high. So any Italian referendum on the issue, held subsequent to a national election, is unlikely to result in a vote to leave. European equities are much cheaper than US equities, partly due to the exaggerated fears of financial market commentators. We recommend to overweight Europe.

Many investors are nervous about upcoming elections in France and Germany. Italy is also cause for concern. The underlying investor worry is that nationalist opinion, opposed to the European idea, has gained so much support that a break-up of the European currency union has become more probable. Thus, Beppe Grillo, widely considered an opponent of the European Union and of Globalization, could win with his MoVimento 5 Stelle (M5S) grouping, when there are new elections in Italy. He would then be in a position to initiate a referendum on Italy’s continued membership of the Eurozone.

But these days predicting the outcome of elections is notoriously difficult, even if the canvassing organizations do their best – with large samples and other statistical work – to organize useful surveys. That much has been made clear by the surprising results of the UK’s Brexit referendum and last November’s US Presidential election.

In the following text we present a relatively simple hypothesis which suggests that the established parties will not lose as many votes as is widely feared. This is because these established parties will shift their positions to better reflect the change in public opinion. Just imagine – you are lying relaxed on a beach. Pearls of sweat are starting to appear. You really want an ice cream but don’t want to have to move far to get it. There are just two ice cream sellers with an identical selection of ices on sale. Those ice cream sellers obviously want to sell as many ices as possible but the ice cream buyers want to walk as little as possible to get them. They are thus strongly motivated to buy from the seller that has set up his stand nearest to them. Position rather than product is the crucial factor for the buyer. Let’s assume that the “sun worshippers” are fairly evenly spread across the beach but there is a bit of a concentration in the middle. How will the seller’s optimally position themselves? The answer is they will both be in the middle of the beach, where they are likely to sell broadly the same amount of ices. (See graph 1).

Graph 1 The initial position – ice cream sellers opt for the middle



Source: <http://www.die-ruegen.de/freizeit/badestrand-schaabe.cfm>

Those “sun worshippers” lying around the middle of the beach are of course very happy. They have two sellers just a few feet away. But if we consider the happiness of all those on the beach, we can well imagine that those in the farthest corners – in voter terms the “Extreme Left” and the “Extreme Right” - are pretty unhappy. They have a long hot walk to the center before they can get a cooling ice, (and it might melt on the way back).

Now imagine that “sun worshippers” find themselves more attracted to that part of the beach that is at the “Extreme Right”. (There is a bit of entertainment going on there.) Those hitherto lying on the “Extreme Left” have decided to move there. They are joined by others previously happy in the middle of the beach. Graph 2 depicts how the beach might look after such migrations.

Graph 2: The ends of the beach after a shift to the “Extreme Right”



Sources:
<http://www.bing.com/images/search?view=detailV2&ccid=U0%2fG1pX5&id=06F53B73C9418F6E7E614F750393A275C92FC54B&q=verschmutzer+strand&simid=607986273231373008&selectedIndex=0&ajaxhist=0>
<http://www.bing.com/images/search?view=detailV2&ccid=WHS7GH4I&id=3C04CD18B0EC7D0792D0473E314A27BB6C33476F&q=vller+strand&simid=608042077728148432&selectedIndex=>

Opportunistic ice cream seller No.1 sees immediately what is afoot. He packs up his stall and quickly moves it from the middle of the beach to the right. In his new position he soon starts selling more than his competitor who (perhaps on account of inflexibility) has decided for the time being not to move. Moving will cost seller No.1 sales to beach lovers in the middle of the beach and on the left of it. But he is relaxed about this because his now more important market on the right will more than offset this. He has correctly positioned himself to sell as many ices as possible.

Meanwhile, sales for seller No. 2 decline steadily threatening him with a disastrously high level of

(perhaps) perishable inventory. In desperation, he sees salvation in a tentative shift to the right. Soon he notices that sales are picking up and realizes he has moved in the right direction. Probably another shift would be a good idea, and another....and another.

What does all this tell us?

The shift in the distribution of “sun worshippers” on the beach has forced the ice cream sellers to respond. The power of the market was such that even seller No.2 who had initially decided to stay in the “Moderate Middle”, eventually had no choice but to move to the right. That was where his market had decided to go.

If enough voters shift towards more “populist” or extreme opinions, they force these opinions to be taken into greater account within the political process. This happens in two ways. First, the parties long associated with more extreme views may get more votes and therefore be better placed to implement their programs. Second, and perhaps more importantly, the established “moderate” parties will realize that they must change their policies – to the “Right” in the case of European politics today – if they are to retain their grip on power. Thus European politics will make a general shift to embrace “populist” or extremist opinion, if though those parties most obviously associated with those opinions may not, in fact, greatly increase their share of the vote.

The recent elections in Holland validate this line of reasoning. Goldman Sachs assess the result as follows: “What happened last week in the Netherlands was NOT a defeat of populism. What happened is that the Centre (PM Rutte) has taken notice and moved towards populists: (1) His harsh reaction to the Turkish protests including the use of riot police and water cannons - not a usual sight in Holland – won him votes as it allowed him to show decisiveness and backbone. (2) There is currently no major party in the Netherlands that doesn’t think the EU needs reform. The good news is that Rutte-type “reactions” decrease the chances of the populist. The bad news is that this trend of “taking back control” increases the likelihood of “country first” politics in the Eurozone.” (Dutch Lessons, Bobby Vedral, GS Market Datapoints 23.03.2017.)

In France and Germany, the balance of voter opinions is not yet sufficiently extreme for the upcoming elections to pose an existential threat to either the EU or the Eurozone. The situation might become more dangerous if moderate politicians failed to adapt to the shift in general opinion. Voters might then – perhaps partly in protest – opt for politicians with more extremist programs, if only to force the established parties to adopt positions more in line their changed opinions. We see the risk of such a development as rather small in both France and Germany. In both countries the established parties have already moved quite a bit in a populist direction to accommodate the shift in voter sentiment. Moreover, opinion surveys suggest that French and German voters still feel themselves acceptably represented by the EU's political institutions.

But the situation in Italy is dangerous. The anti-consensus party M5S has a real chance of winning the next round of elections. Italy is the Eurozone's third largest economy, and thus big enough to seriously upset the whole European project. And in both Italy and Greece our "ice cream seller problem" is more complicated. Put simply, the established political parties have not moved sufficiently in line with the shift in voter opinion to satisfy a disaffected electorate. Moreover, Italian and Greek voters tend to feel that their interests are not sufficiently represented in the EU. There is therefore a strong desire to give a lesson to national and European political elites by punishing them.

There is, however, some comfort to be drawn from the fact that Greece is economically so small as to be more or less irrelevant to the future of the Euro. Also, opinion polls suggest that a majority of Italians want to stick with the single currency (even though a majority might also vote for Beppe Grillo). Instinctively, Italy's voters seem to feel that the financial and economic costs of exiting the Eurozone would mean penury for perhaps years to come, greatly outweighing any advantages. Bond yields would have to rise sharply. A flight of capital would develop and accelerate. The banking system might collapse and, if Italian access to international markets was no longer secure, capital controls would

be hard to avoid. In other words, national bankruptcy could threaten. More immediate would probably be a sharp fall in value of Italy's newly restored national currency, implying a serious loss of purchasing power relative to the rest of the world. All told, not an attractive prospect. Perhaps the children and the grandchildren might eventually benefit, but those gains would be a very long way off. We think the view widely communicated within the Anglo and America dominated financial markets – namely that the EU is about to fall apart – is too negative, given present circumstances.

How does our sun-kissed beach look now that the ice cream sellers have followed their customers? Graph 3 contains the answer.

Graph 3... and the same beach, sometime later



Sources:
<http://www.bing.com/images/search?view=detailV2&ccid=U0%2fG1pX5&id=06f53B73C9418f6E7E614f750393A275C92FC54B&q=verschmutzer+strand&simid=607986273231373008&selectedIndex=0&ajaxhist=0> und
<http://www.bing.com/images/search?view=detailV2&ccid=WH57GH4i&id=3C04CD18B0EC7D0792D0473E314A27B66C33476F&q=vller+strand&simid=60804207728148432&selectedIndex=2&ajaxhist=0> und
<http://www.bing.com/images/search?view=detailV2&ccid=he5JgISn&id=3311794460A584894D44D640640DD7F41617483C&q=sch%3fb6nster+strand+der+welt+2016&simid=608049417837347627&selectedIndex=10&ajaxhist=0>

And what are we doing in terms of our investment strategy?

If fears conflating the upcoming elections and serious trouble for the Eurozone are exaggerated and if financial market comment, overwhelmingly from outside the Eurozone, is too fixated on the possibility of a Eurozone collapse, we are inclined to embrace rather than sell our positions in European stocks. These exaggerated fears have resulted in European shares trading at a considerable discount in terms of standard valuation metrics. They are especially cheap relative to US shares. And this is why Aquila continues to overweight Europe, at the expense of the US, in equity portfolios.

Contact: Thomas Härter, Investment Office
 Tel.: +41 58 680 60 44