



Aquila & Co. AG | 01. March 2018

A critical time for Europe: GROKO and the Italian elections

On Sunday the results of the vote by SPD members on the Grand Coalition agreement should be announced. A “yes” vote will bring GROKO into being. Towards Monday morning the result of Sunday’s Italian elections should become clear. As Italy’s membership of the EU and the Eurozone is not an election theme, the result, whatever it is, ought not to upset investors overmuch. In the short term, the market reaction might be positive as the result, being known, could imply less political uncertainty. Looking further out, we expect the present recovery rally, following the mini crash at the start of February, will eventually fizzle out.

Sunday will see two important events so far as European politics are concerned.

First, on Sunday morning the results should be known of the vote by SPD members as to whether that party should participate in another Grand Coalition. This is the last hurdle to cross before GROKO can become reality. We think that a majority of SPD members voters will back GROKO and are confident about this forecast.

But should, against expectations, the vote go the other way, Germany risks its politics becoming Italianized and Europe would be confronted by a sharp rise in political risk.

Here is a curiosity. We know already how one Swiss SPD member will vote. (Foreign members of Germany’s SPD may also register their votes). Joel Bühler (22) will vote against the proposed coalition, primarily on the grounds that it would likely fuel support for the AfD. On this point (though not on others) we agree with Mr. Bühler.

An SPD rejection of GROKO could lead either to fresh Federal elections or to an attempt by the CDU/CSU to form a minority government. Indeed, the FDP has already signaled a “green light” for the latter path, characterized by some as a “brave experiment”. Because Germany’s political establishment is desperate to avoid fresh Federal elections, fearing a disaster with yet more votes lost to the smaller extremist parties, and because Mrs. Merkel has psychological challenges in “letting go”, we think a minority government would be more likely than fresh elections.

But the above are possibilities in the event the SPD votes “no”. We stress we are expecting a “yes” vote. For an in-depth analysis of GROKO, see the previous Aquila Flash or the latest Aquila blog post.

But what about the Italian elections, the other major political event this weekend?

First, an analysis of the importance of the Italian elections for financial markets. In recent years, especially during the various Eurozone credit crises and the “Brexit shock”, financial markets have been extremely sensitive to political events in Italy.

Currently this is not so. It seems Italian elections no longer involve an existential threat to European institutions such as the Eurozone and the EU. The main reasons why current credit spreads for Italian bonds do not indicate stress and why investors no longer feel a need to “get the hell out” are, in order of importance, as follows:

1. The Italian ECB President is “not a non-Italian”. At times of stress, the ECB will buy everything it can.

2. The 5 star movement and the Lega, which are opposed to Italy's continued membership of the Eurozone, have rowed back on demands for a referendum on this issue. This time, the manifestos of these parties did not contest Italy's staying in the Eurozone.
3. That Italy's Eurosceptical parties could successfully make common cause is about as likely as Germany's Linke and FDP being able to do the same.
4. With 1.5% growth last year, the Italian economy has managed its best growth performance in seven years. Italy's primary Budgetary surplus should grow in 2018 to around 1.8% of Italian GDP.
5. Most probably, the Italian constitution would not allow a referendum on Italy's place in Europe to be held.
6. Germany itself is moving away from reform and towards an undesirable sort of convergence. GROKO will kill what's left of former Chancellor Schröder's Agenda 2010.

An Italian exit from European institutions can be ruled out for the foreseeable future and this is now well understood by the often hysterical, Anglo-Saxon dominated financial press.

What else is there to say? If you want to know precisely the likely winners in Italy's elections, we don't have the answers but we have the following thoughts:

Uncertainty regarding the Italian elections is high, not least because the revised electoral law now has similarities with the German electoral system: More than one third of all seats in the new Italian parliament will be elected directly by constituencies according to the "first past the post" system with less than two thirds of seats allocated under proportional representation. Thus, the composition of the new parliament will depend in part on the personal attractiveness of candidates nominated by the parties for the electoral constituencies. The new rules mean national political opinion surveys are probably less good indicators of the eventual result than in the past. We believe that the direct election component will tend to favor the larger, more established parties.

In Italy, party alliances have already been established prior to the elections. The three biggest groupings are: (i) the center left alliance around the Partito Democratico, (ii) the center-right alliance of Silvio Berlusconi's Forza Italia, Lega Nord and Fratella d'Italia and (iii) the Cinque Stelle (Five Stars) movement.

While polls suggest that the Cinque Stelle movement is ahead of the others, its program is anti-federal and its politics and politicians unconventional. The likelihood of a clear win for Cinque Stelle is almost zero.

Of the other groupings, the center-right is probably the stronger. Forza Italia and Lega Nord both have charismatic leaders, which could position them well for the parliamentary seats that are directly, rather than proportionally, elected. And the center-right grouping appears to have gathered momentum of late. A strong showing for the center right, which we expect, is probably the most favorable outcome for markets.

The next most likely outcome is some sort of Grand Coalition whereby the principal parties share government, perhaps by switching roles halfway through the life of the next parliament. Probably Forza, the PD and some other parties could cobble together some sort of coalition agreement that would have at least some staying power. Financial markets could probably live with this result.

Another round of elections or a coalition involving Eurosceptical parties such as Cinque Stelle are both very unlikely outcomes.

Assuming events in Germany and Italy avoid outcomes clearly unfavorable for markets, we would rather expect the Euro and European equity markets to appreciate, once the results are known, and that European bonds could come under pressure.

But investors should probably not expect any market strength to last long. The equity recovery rally, following the mini-crash at the start of February, is getting on for four weeks old and may be due to run out of steam in any event.

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