November 13, 2018

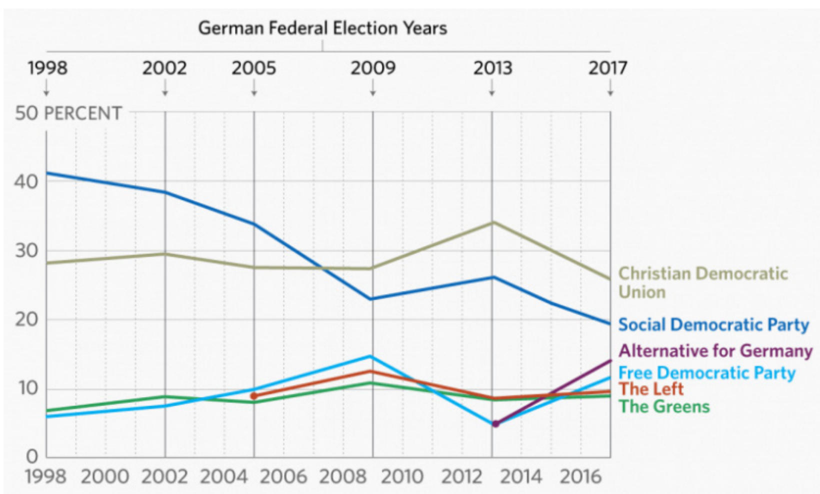
Euro zone uncertainty spreads to its core

While the outcome of the U.S. midterm elections continues to grab most of the headlines, investors would be wise to pay closer attention to the political landscapes in Germany and Italy. The higher the level of political uncertainty in these two key countries, the harder it will be for the EU to overcome its many formidable challenges.

Chancellor Merkel resigns

On October 29, German Chancellor Angela Merkel announced she would not seek another term as leader of the Christian Democratic Union (CDU) but would remain Chancellor until the end of her term in 2021. However, seeing how her governing coalition is growing increasingly unpopular, her tenure could end sooner than expected. **Indeed, nothing weakens a leader's authority more than setting a date for stepping down.**

Merkel's decision follows a succession of poor election results that began with last year's federal ballot, when the CDU suffered its worst showing since 1949. The Social Democratic Party (SPD), Germany's other major political force, also had its worst electoral outing of the post-war era.



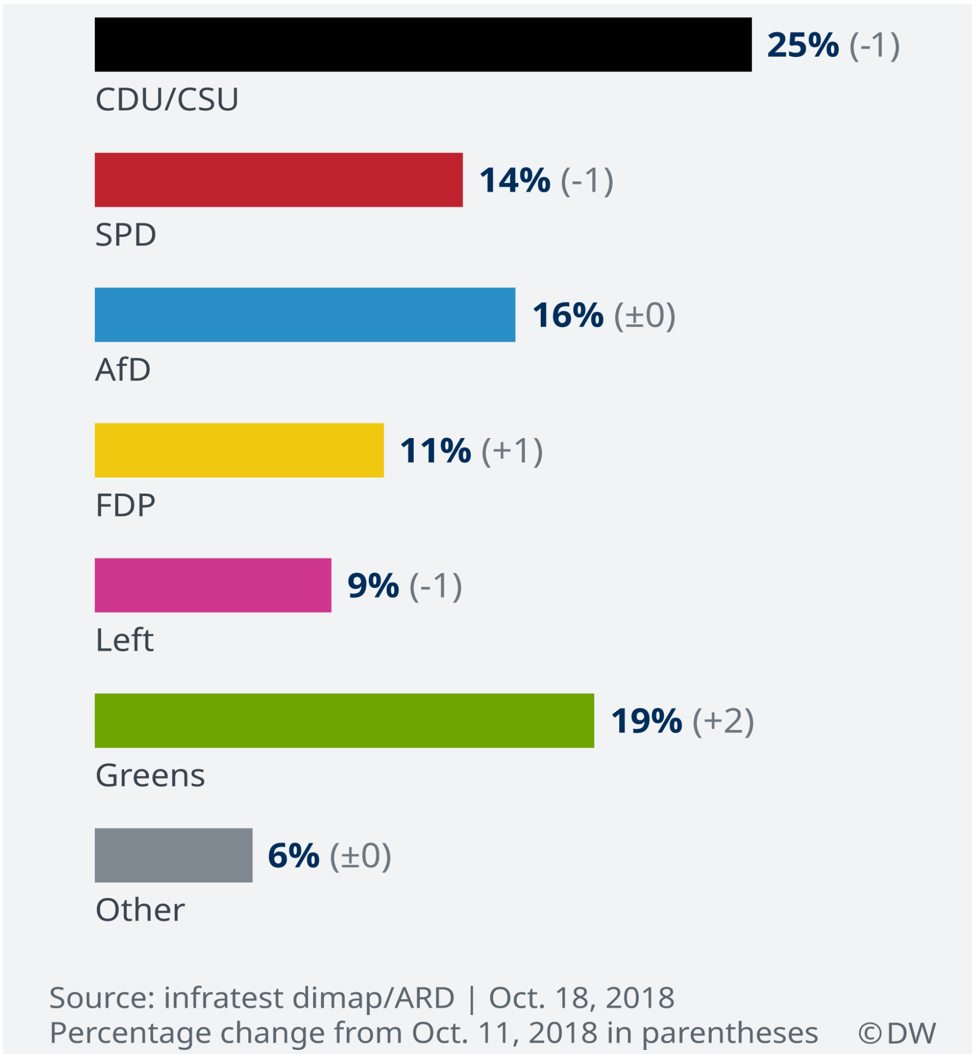
Party	Ideology
Alternative for Germany	Right-wing, nationalism, euroskepticism
Christian Democratic Union	Center-right, conservatism, Christian democracy
Free Democratic Party	Center-right, conservatism, economic liberalism
Social Democratic Party	Center-left, social democracy
The Greens	Center-left, environmentalism
The Left	Left-wing, anti-capitalism, democratic socialism

"Germany's Political Woes Spell Trouble for Europe," Stratfor, November 2018

The recent state election in Hesse was the tipping point for Merkel. The CDU garnered only 27% of the vote, 11 fewer points than in 2013 and the party's worst tally since the 1960s. The SPD, too, lost 11 percentage points. This followed a similar defeat for the Christian Social Union (CSU), the CDU's sister party, in Bavaria a few weeks earlier.

The end of Germany's two-party system

Germany has now joined the long list of European countries that have witnessed a dramatic decline in support for its traditional mainstream parties. Indeed, the combined support for Germany's two traditional main parties—the CDU-CSU alliance and the SPD—has plunged from 90% in the late 1970s to 67% in 2013 to only 40% or so today.



Source: "Record-low support for Angela Merkel's government," Deutsche Welle, October 2018

Diminishing support has forced the two traditional mainstream parties to form coalitions

At first glance, such a strategy appears sound. The two main political parties demonstrate that they have the national interest at heart by joining forces to form a government that excludes extreme parties. However, the unintended consequence of this move has been an increase in popularity for formerly marginal political forces. This is because the longer the two main political parties govern in a grand coalition, the more Germans will come to view these parties as one and the same.

As a result, Germans looking for a change have increasingly been voting for parties on the far right or far left of the political spectrum, especially since they constitute the only real opposition. Indeed, Germany's largest opposition party is now the far-right Alternative for Germany (AfD), which won 13% of the vote in last year's federal election. The AfD is now represented in every one of the country's 16 state legislatures and has a particularly strong following in the former East German region.

In last year's general election the two major parties took home their lowest combined share of the vote since the country's reunification (53%). If an election were held today, the two would most likely not get enough votes to form another government and would require the support of a third or even a fourth party.

A leaderless Europe

Having to focus more and more on its internal challenges ranging from declining support for mainstream parties to the impact of the migrant crisis, Germany is slowly pulling back from its traditional leadership role in the EU. This tendency is driven further by the widespread sentiment among Germans that many countries are unjustly refusing to share in the burden of taking in migrants.

This leadership void will be accentuated further by the likelihood Germany will hold early elections in 2019. If elections are called, Germany's leaders and the EU would be forced to postpone making decisions on key issues until after the vote. However, the elections would likely produce an even more fragmented political landscape, which means it could take months of negotiations for the parties to agree on a new coalition. It also tends to be more difficult for coalition governments to agree on a common strategy for tough issues.

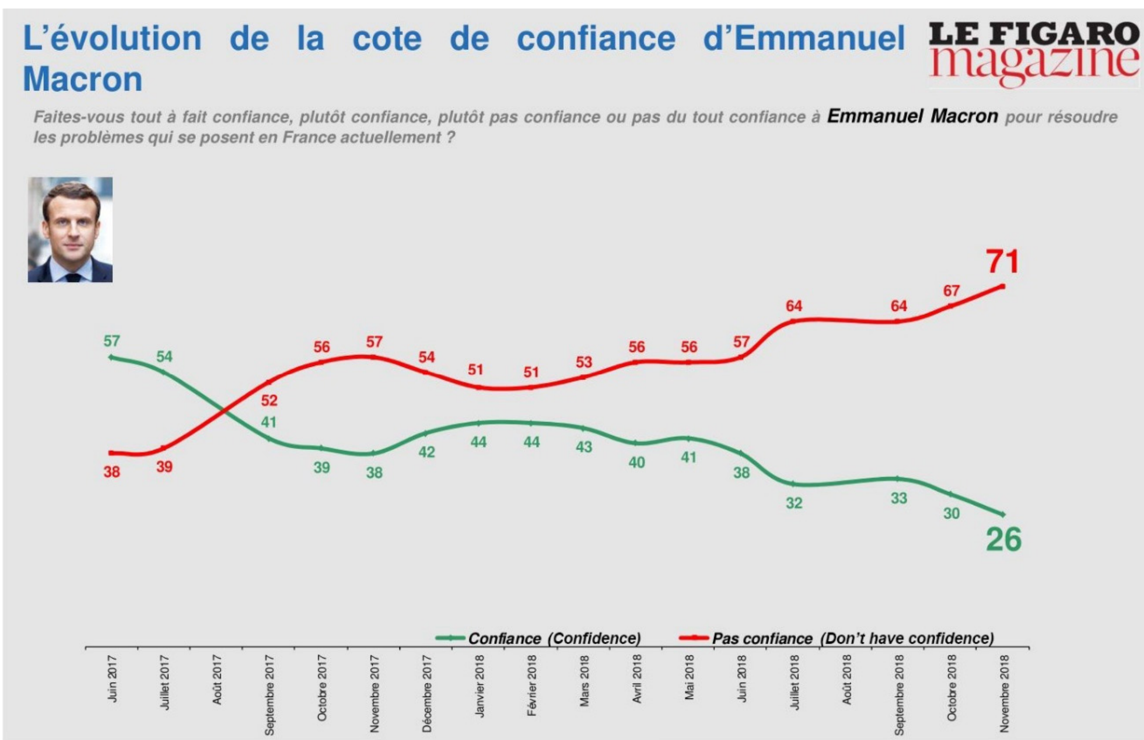
Further, it is highly probable that Merkel's successor at the head of the CDU will seek to move the party back to the right in an attempt to regain support. To this end, we can expect a tougher stand to be taken regarding refugee policy and EU reforms.

All of the above factors will make Germany even more reluctant in the future to support hard-pressed EU countries financially.

France cannot fill the void

France, the most likely candidate to inherit the mantle of leadership from Germany, is burdened by too many of its own internal challenges. French President Emmanuel Macron's popularity has plummeted owing to unpopular labour market reforms (which usually take a few years to have a noticeable effect), a slowing economy, and a governing style perceived by many as arrogant.

Macron may be celebrated by global policy analysts, but he faces growing discontent at home.



Source: Le Figaro, November 2018

Germany's internal challenges coincide with growing risks in Italy

The Italian government—a coalition made up of the anti-establishment 5 Star Movement (M5S) and the nationalist League—is engaged in a game of chicken with European authorities and financial markets over plans to increase deficit spending to 2.4% of GDP. This is three times as much as originally agreed upon by the previous government.

The EU recently took the unprecedented step of rejecting Italy's draft budget for being incompatible with the bloc's rules on fiscal discipline. It warned that higher spending would keep Italy from lowering its debt (133% of GDP), the second highest in Europe after Greece's.

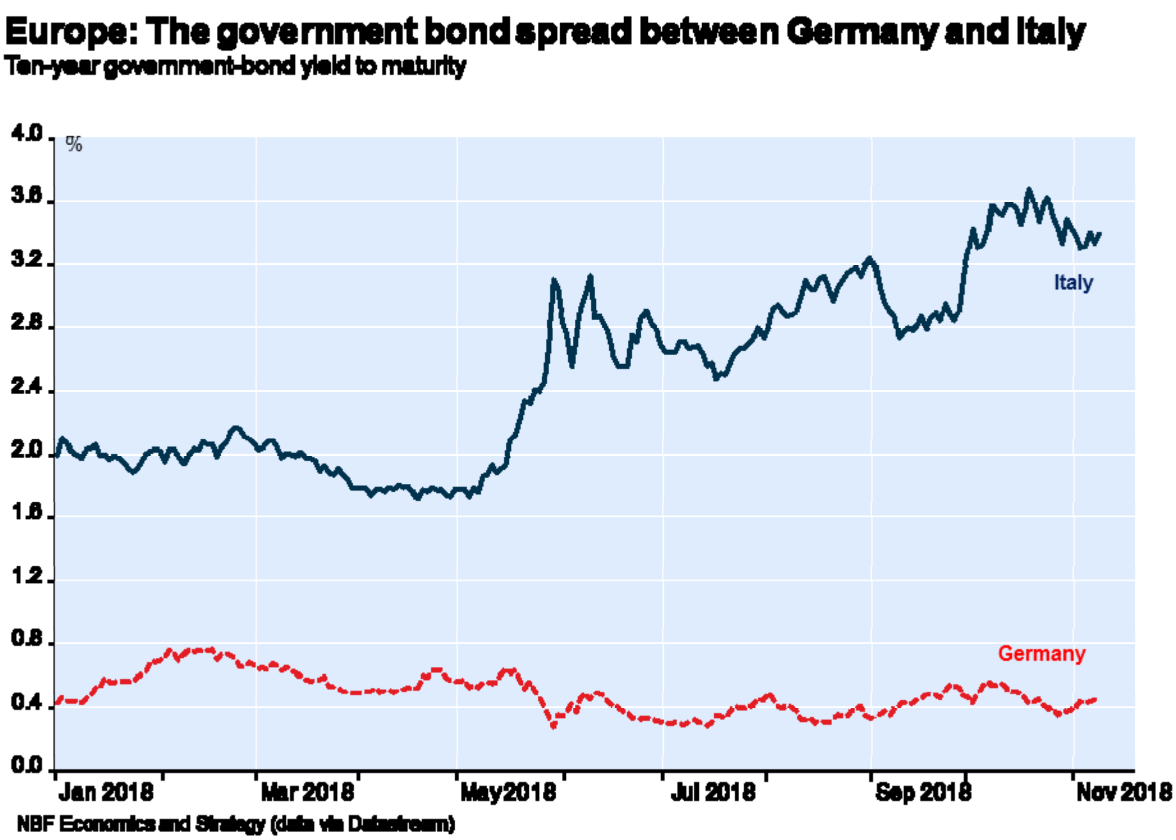
If the Italian government does not revise its budget, the EU has threatened to eventually impose a fine and cut EU funding. It should be noted, however, that fines have never actually been imposed on a country before. **Nonetheless, failure to arrive at a compromise over Italy's budget (even without a fine) would only inflame the dispute and further rattle financial markets.**

One factor steeling the Italian government's resolve is its 57% approval rating, which is among the highest in the EU (Ipsos, October 30).

Italy's potential weak link: banking sector's government bond holdings

Italy's government bonds merit very close scrutiny. They account for about 10% (or €390bn) of the total assets of Italian banks. This is well above the euro-area average of 4%.[1] The higher Italian bond yields rise, the more banks will be forced to revise the valuation of their domestic government bond holdings downward. This, in turn, would mean tighter credit conditions for businesses and households.

These concerns over bond yields and the budget impasse come as the European Central Bank prepares to wind down its purchase of bonds by January 2019. If the ECB sticks to its plan, Italian public debt would lose a major buyer. To date, the ECB has bought 2.6 trillion euros worth of debt via quantitative easing, including 360 billion euros in Italian sovereign debt.



[1] "The fate of Italy's banks is still tied to public debt," The Economist, October 20, 2018

Which countries are most exposed to Italy's debt?

French and German banks alone have a combined $407-billion exposure to Italian debt (both private and public). By comparison, when Greece's budget problems triggered a crisis in 2010, French and German banks held only about $115 billion in various Greek debt instruments.[2]

Source: "Europe Is Too Exposed to Italy to Let It Go," Bloomberg, October 29, 2018

Italy's economy slowing down

To make matters worse, the showdown with the EU is coinciding with a slowdown for the Italian economy. Eurostat figures indicate economy stagnated in the last quarter, posting its weakest growth in four years. This raises the risk for recession, which would be the country's fourth in a decade. It is worth remembering that the Italian economy is still about 5% smaller than it was 10 years ago. **It remains to be seen whether Italians will blame the EU or the government for the economic downturn.**

[2] "Europe Is Too Exposed to Italy to Let It Go," Bloomberg, October 29, 2018

Italy vs. EU, Germany and France

Italy's growing tensions with the EU, Germany and France have rendered co-operation much more difficult. Below are a few examples that bring into sharp focus just how bad things have gotten.

- Last June, the widely read German magazine *Der Spiegel* published the following cover page. The German title translates in English as: "Italy is destroying itself and dragging Europe down with it." The article inside is entitled: "The moochers of Rome."[3] **It would be an understatement to say this article was not well received in Italy.**

- Referring to Hungary's nationalist leader Victor Orbin and Italy's Deputy Prime Minister Matteo Salvini, French President Macron stated last August: "If they want to see me as their principal opponent, they are right. I will cede nothing to the nationalists and their language of hate." Salvini countered with the following tweet: "Macron's main opponent, looking at the polls, is the French people."
- The Italian government and media have loudly complained about how much more leniently France has been treated for budget infractions than Italy has. They cite how, in 2015, the EU gave France two more years to rein in its deficit below 3% of GDP. When asked in 2016 why the EU had gone easy on France, Juncker famously said in an interview: "Because it is France."[4] In 2017, France's ratio of sovereign debt to GDP was 97%.

[3] "'Lazy Italians' and 'ugly Germans': How the euro sows discord," Handelsblat, June 1, 2018
[4] "EU gives budget leeway to France 'because it is France' – Juncker", Reuters, May 2016

Investment conclusion

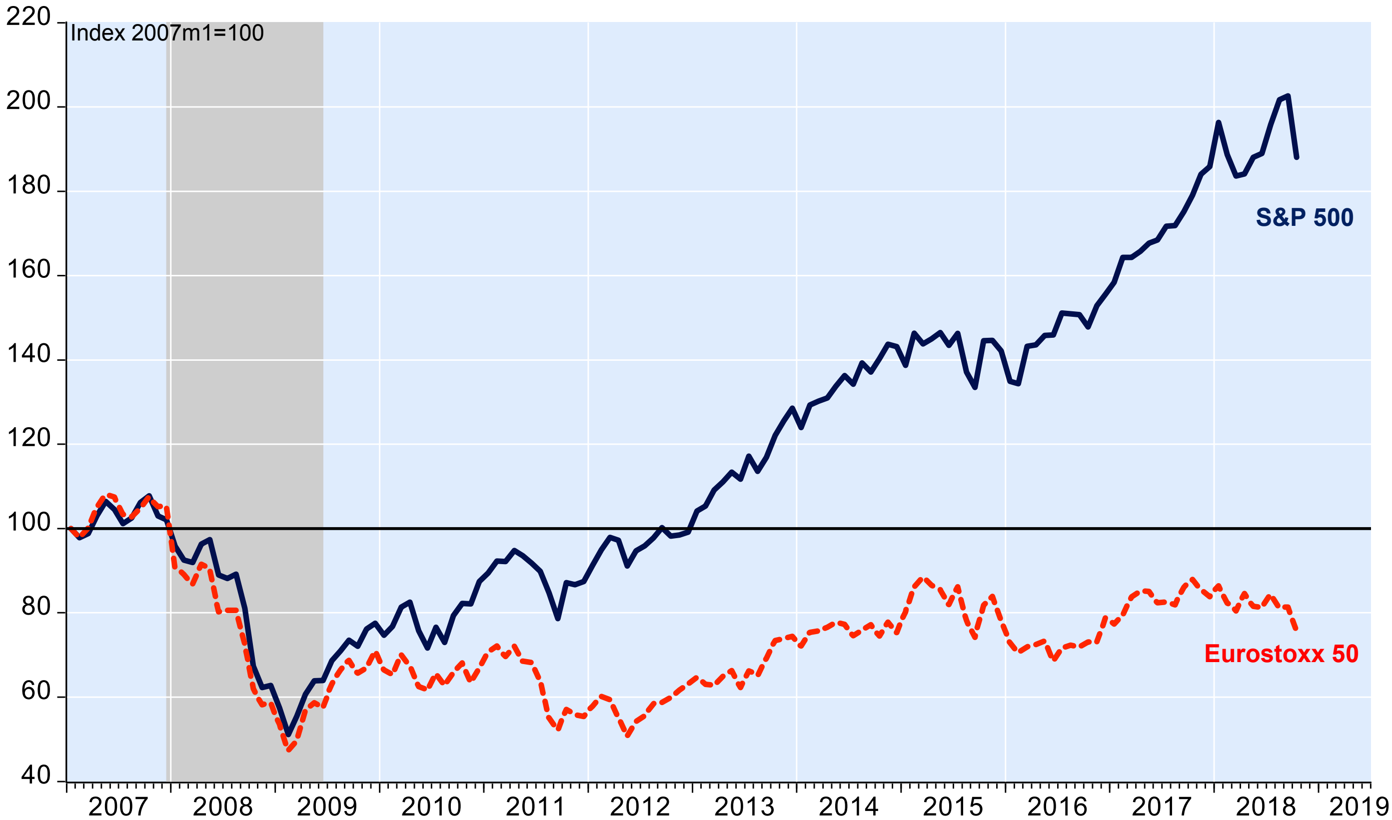
The political disarray in Germany, Macron's plummeting popularity in France, and Italy's populist uprising after a decade of virtually no economic growth signals that the EU's challenges have spread from the periphery to the larger core countries.

Further, the Italian government's insistence on increasing deficit spending in the face of EU restrictions will make it much more difficult, if not impossible, for the likes of Germany, Austria, Finland, and the Netherlands to support the creation of a Eurozone finance ministry and/or Euro bonds in order to provide greater financial assistance to struggling member states.

All of these factors explain why the EU will likely not be able to agree on meaningful reforms and why Europe's major stock indices will continue to lag behind those of the United States for the foreseeable future.

World: S&P 500 vs Eurostoxx 50

Comparison between major stock market indices (Last observation: 10/25/2018)



NBF Economics and Strategy (data via Datastream)

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