Weekly Market Flash

The Ides of March Come Early This Year

March 2, 2018

What a difference a year makes. For Exhibit A, consider the upcoming election this weekend in Italy. Wait, what? There's an election in Italy this weekend? Must've missed that one…what with steel tariffs, Jared Kushner, incoherent crossfire between Trump and his own party on the issues of the day…only so much information one can consume, no?

The Way We Were

Other urgent media cross-currents notwithstanding there is, in fact, a national election in Italy this coming weekend. You would have known about it had it happened a year ago. Remember that time of slumbering volatility and gently ascending risk asset markets? Misty water-colored memories…There was an election in the Netherlands a year ago. The Netherlands is quite a bit smaller than Italy, GDP-wise, and it would be fair to venture that a not insignificant number of Americans would be hard-pressed to locate it on a map.

But for a few weeks in late winter last year the attention of global investors was focused on the outcome of elections in the land of dikes and canals. As in, it was about the only event on the radar screen that punters thought might unsettle the market's placid waters, if it looked like the far right, anti-EU populist party would carry the day. It didn't. A short time later the same singular focus turned to France (a larger country, the capital of which more Americans could probably name correctly).

Again, the far right threat failed to materialize as Marine Le Pen went down and Emmanuel Macron ascended as A New Hope (or, to the cynics, The Last (Classic Liberal) Jedi). The world resumed not caring about European elections. Oddly, the one the chattering class barely paid attention to, assuming the outcome was a given, was the German vote last September that produced a chaotic mess still in the process of being figured out six months later. The wisdom of crowds.

Two Matteos and a Clown Walk Into a Bar…

Which brings us to today, with Decision Italy about to happen amid a chaos of economic and geopolitical forces slamming markets this way and that with all the force of the Nor'easter currently having its gusty way with the DC region. Most of the same issues that concerned investors last year are very much front and center in this contest: neo-populism, anti-EU and single currency sentiment, hostility towards Middle East and North African immigration and, in this particular case, some disturbing reminders of Italy's fascist history in the platforms of some of the leading political movements. The difference between this and last year's elections is that a positive outcome – in the sense of being good for the EU, good for liberal democracy, bad for Russian meddlers – is actually the least likely one to happen.

That positive outcome would involve a decisive victory by the incumbent center-left Democratic Party (PD), which would probably mean the return of former prime minister Matteo Renzi, a EU-friendly technocrat inclined towards global free trade and the integrity of the single currency Eurozone. But the PD, similar to the fate of other established European center-left parties, has dropped precipitously in the polls. The likelihood of their winning a governing majority is vanishingly slim.

Enter the other two characters in our set-up to a bad joke: Matteo Salvini, the head of the far-right Northern League, and Silvio Berlusconi, the eternal court jester and sometime-leader of the Italian political scene. Berlusconi has cobbled together a right-leaning coalition between his own Forza Italia movement, Salvini's League, a neo-fascist Brothers of Italy party and a southern alliance that calls itself "We're With Italy" (if nothing else, Italy wins the Colorful Naming of Political Parties award). This unsavory coalition is the only political grouping with a reasonable chance at gaining majorities in either or both of the upper-house Senate or lower-house Chamber of Deputies come Sunday. If that happens, the next prime minister could very well be Mr. Salvini, who has personally referred to the euro as a "crime against humanity" and represents a movement founded on a northern Italian separatist agenda.

Chaos Has a Lean and Hungry Look

Slightly more likely than an outright win by the right is a hung election in which nobody gets a majority. That outcome could have the modest saving grace of keeping the current prime minister, the PD's caretaker Paolo Gentiloni, at the helm for awhile longer while the various interests try to cobble together a grand coalition. But this result also does not bode well for the country or for regional stability. Italy's debt to GDP ratio is already 130 percent, and the various public programs floated by the parties most likely to be in some form of power stand to add considerably more. Italy's borrowing costs will be challenged as the ECB steps back from its full-throttle support of European bond markets. Global bond markets are already nervous this year; another Eurozone crisis would inflame an already investor-unfriendly environment. A competent response to economic challenges from any side looks unlikely.

For many months we have cited the "global macroeconomic context" as the main reason why we do not believe that a serious market reversal is right around the corner. The numbers continue to support that view today, despite the obvious return of long-dormant volatility among risk asset classes. But we also have to pay attention to the canaries in the coal mine – the factors that could loom ever larger as the current cycle plays out.

We know that much of the financial media world's attention today is focused on the steel tariffs announced by Trump yesterday, and the (likely not unrelated) growing indications that the wheels are coming off this administration. Ultimately it will likely take more than one or two fumbling own goals to really take the nine year bull off its course. But there is evidence of a mosaic of chaos around the world – potentially including another Eurozone crisis, potentially including a China whose leader now possesses something close to absolute dictatorial powers, potentially including a whole new level of sophistication in global cyberterrorism. This mosaic of chaos is not (yet) showing up in macroeconomic headlines or in the steady stream of strong corporate earnings. But it is a mosaic we cannot ignore.

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