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Buy European politics, or just ignore it

Two big political events happened in Europe this weekend: Italian elections; and the confirmation, in Germany, that a government can be set up. In our opinion, and despite headlines, the effect on markets should be positive. **Gone are the times when political risk in Europe was at the center of the stage**.

Political events during the weekend

Headlines remark that, **in Italy, the anarchic 5 Star Movement outpaced polls by far and became the most voted party** (c.32% of votes). However, the right-center coalition, which comprises Lega (another surprise relative to polls) and Forza Italia, seems to have won the election with c.37% of votes. The geographical distribution of votes together with the new electoral system make it easier for such coalition to control the Houses (c.43% of seats in the Congress), **although it won't be easy to set up a government**. In either case, the 5 Star Movement has not the ability to prevent the formation of a traditional coalition government.

On the other hand, **in Germany, the SPD voted to join the government coalition which will vote Merkel for chancellor**. Should they have done the opposite, the country would have had to repeat the election, with a message of instability. But now the situation seems to be a full Merkel legislature with hardly any opposition. **The odd thing about this is that the elections, back in September, meant a political shock due to the fact that both traditional parties suffered big losses. But now, they managed to turn that into a positive surprise**.

Expected economic policies

Italy

It may well take several months until a government is formed in Italy. Political gridlock is the norm, not the exception, in a country which has had more than 60 different administrations in the last 70 years. In this case, **the maintenance of current economic policies does not seem a bad option**: some fiscal loosening in the form of tax breaks still has to reach the whole economy, which may be very growth supportive. Anyway, to form a government, with the currently known vote distribution, three options emerge.

Option 1.- A center right coalition between Forza Italia and Lega seems, by far, the most likely option, since, actually, it has been talked about even before the election took place. Given the relative success of Lega in the election, probably the main roles would come from their staff, maybe even the Prime Minister. They seem to favor some fiscal loosening, which was expected even before the elections. In fact, it was already suggested by the current Finance Minister. In addition they have talked about some innovative initiatives like a flat income tax to improve public income and legal labor, as well as fostering "mini-bonds" to improve money flow to companies. **All of these proposals seem very supportive of growth**, whereas the current economic figures show that a fiscal loosening is affordable. The main issue is the extent to which they can be implemented.

Option 2.- A leftist coalition between M5S and Partito Democratico seems the natural counterpart to the first option. Together they have a clear majority in votes, although it may be tough to control the Houses. Anyway, the PD works as a rational and technocratic counter balance for the extreme proposals of some M5S members. In these sense, the M5S proposed Economics Minister, although anti austerity is not against the euro. If we join this with the staff coming from PD, this option is far from being a Greek style disruptive administration. **They both agree on looser fiscal policies**, probably more than Option 1, since they both have talked against the 3% deficit limit, and they would also agree in raising the minimum wage.

Option 3.- A Lega-M5S coalition, would be the union of the largest surprises in votes, but it is by far the less likely option. They are too different, both in their ideas and in their geographical distribution. Many commentators agree that some members of both parties would never work with the other. Anyhow the only economic policy proposal for which they seem to agree is, again, some fiscal loosening.

So summing up, it seems clear that **looser fiscal pressure is in the cards** for any administration that emerges. The current economic momentum of Italy may afford it quite well, and in fact, it may bolster consumption.

Germany

The **economic policies of a Merkel government balanced by the SPD may be more important for Europe than for Germany itself**, even further than the negative-turned-positive surprise, which is, in itself, a mood boost for investors.

The **key issue is that SPD will take control of the finance ministry**, in a **U-turn from the excessively orthodox** and sometimes even anti-euro finance ministers that have prevailed since the financial crisis. Currently, the German economy is booming (even overheating, by some opinions). So, it's easy to stick to the balanced budget law imposed by the former minister Schauble. But in case it was needed, **the new administration would be far more flexible**.

For the whole Europe, the view of the SPD means support for France's Macron. One of the key ideas of the French Prime Minister was to **foster European integration, as well as market discipline and risk sharing**. The SPD shares that view, contrary to the former German minister, so we could see an impulse to European reforms towards more integration. This would not only bolster growth but it would also protect Europe from another crisis. This way, it would be very positive for investors.

Risks

The above view has several risks, since it's based on some assumptions that may not happen. **The first one is based on the fact that the results of the election in Italy**

show a growing breach between the north and the south of the country, with the former being pro-Euro and pro-business, and the latter more anti-Euro and left tilted. That poses the risk of instability emerging from future elections.

Secondly, the prospect of European reforms than emerges from the SPD "yes" may has very limited time to be implemented. From fall 2018 other issues will be the focus of discussion among European policymakers, like elections to the European Parliament or, over all, the Brexit deal. So we can see interesting advances in the next months, but they should be very quick in order to exploit its full potential. Otherwise, it won't live up to (our) expectations.

And finally, there is a risk of excess optimism regarding populism. Recent developments could imply a false closure of the European populism risk. Although in recent moves we have seen haw populism has been losing steam, it may not be as dead as it seems. Namely, elections in Bavaria next fall could see a victory of nationalist politicians, as well as in other parts of Europe.

Conclusion and market view

Initially, markets seem to attach more importance to the Italian election result, than to the "Yes" of the SPD, when, as stated above, we think it should be the opposite. This is a **classical behavioral bias**, based on fear being stronger than calm research. But it can reverse quickly.

Actually, **the main message of this weekend could be the end of the populism risk in Europe**, at least for some time. We have seen how, after populism being the main worries at the start of 2017, several events have made investors turn their minds and focus on other things. Pressure on markets arising from the Italian election could be the epilogue of such risk.

If this proves true, **the environment is still very supportive for European stocks**: earnings are rising. And more than dividends, so money is being invested on the basis of gaining a growing ROIC (see chart). The new governments could foster that, and, at the same time; liquidity is still growing, although at a slower pace; and the correction in February has not broken the trend or derailed fundamentals but has improved ERPs. One of our main bets for this year was for **European stocks to catch up with US ones**. The political developments of this weekend reinforce that view since they make European assets relatively more attractive. **In the end, it is global nominal growth and interest rates which determine markets evolution. Politics is important only if it modifies such variables; and most times, economics is more stubborn than politics**.

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