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MACROCOSM

Italy Gets Hung

Tuesday, February 26, 2013

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An uprising of populism is a blow to Italy's growth, but not an existential threat to the euro.

Yesterday's Italian election results did not produce the expected Bersani majority. We warned that markets were vulnerable because they were pricing that benign outcome (see "Elezione!" February 14, 2013). Now they are reacting to the under-anticipated risks of a hung parliament and the specter of a populist uprising, evoking fears of renewed risk to euro area reform and integration -- and, by extension, a renewed bout of existential risk to the currency itself.

While the election outcome is worse than we expected, it doesn't fundamentally change our view that the euro area has turned the corner (see "Correction, Not Crisis" February 4, 2013). But it surely demonstrates what can happen when markets are priced for perfection will little risk premium, as we talked about last week (see "The Incredible Shrinking Equity Risk Premium" February 21, 2013).

- The biggest surprise in the election was the performance of Beppe Grillo's Five Star Movement (M5S), far surpassing anything suggested by pre-election polling.
- Pier Luigi Bersani's center-left coalition managed to scrape out a victory in the lower house, getting 29.53% of the vote to Silvio Berlusconi's center-right coalition's 29.13% and Grillo's M5S 25.55%. But under Italian electoral law, coming in first is all that is important -- plurality winner Bersani is granted a majority in the lower house.
- In the senate -- which was always going to be more difficult to capture because of its complex regional voting structure (again, see "Elezione!") -- Bersani failed to win the critical regions. The seat breakdown ended up with Bersani 121, Berlusconi 117, Grillo 54, and Mario Monti's center coalition 22, leaving no coalition with a majority -- or an easy chance of forming one.
- Monti's performance is disappointing. It denies formal political legitimacy to his reform agenda, and makes it more difficult for the next government -- whenever that arrives -- to continue along this essential path.

What's next?

Update to strategic view

EUROPE MACRO, EUROPE STOCKS, EUROPE BONDS, FX: The Italian election produces a hung parliament, with an alarmingly strong showing by radical populist Beppe Grillo's Five Star Movement. As a repudiation of Monti's reform agenda, it's a blow to growth prospects in Italy. It increases sovereign risk in Italy, and raises the specter of existential risk to the currency. But unless Grillo's party comes to power -- a vanishingly small probability -- these are mere tail risks. We now face weeks of uncertainty as an interim government is established, most likely a Bersani/Berlusconi coalition that excludes Monti, because Berlusconi will not work with him. New elections probably won't happen until September, giving the establishment parties the opportunity to change electoral laws to block Grillo.

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- Already Grillo has said that his party will not support either Berlusconi or Bersani in forming a government. Despite this, Bersani's party said this morning that it would try to gain support from M5S in the Senate. While this is probably no more than posturing, it would tie M5S to decisions taken by the interim government.
- Berlusconi says he will not work with Monti.
- This leaves the unlikely proposition of a Bersani/Berlusconi interim government bridging the gap to another round of elections in September.
- Bersani is still the favorite to be the next prime minister, given a 75% to 80% probability by the online futures markets at Intrade.
- Another election is unlikely before September because current president Giorgio Napolitano is due to step down in early May, and under Italian law cannot dissolve parliament in the last six months of his tenure. The president is elected by the parliament -- both houses -- rather than by popular vote. This means that deputies returned after yesterday's election have to agree upon a candidate to become president, elect him, and then ask that president to dissolve parliament.
- If parliament is dissolved after the election of a new president, the earliest elections could be held is September -- the same month as the German national elections.

So for now, an interim government needs to be put in place. The odd couple of Bersani and Berlusconi would be strongly motivated to find a way of working together, not only to produce a new president but possibly also to change electoral laws to rule out Grillo turning his surprise insurgency into a parliamentary majority at the next election.

- The key will be to reform the provision that grants a majority to a party that earns a mere plurality. Ironically, this was one of several reforms sought by Monti, but which he was unable to achieve during his brief tenure as prime minister.

As the horse-trading begins, Berlusconi was first to comment this morning, saying in response to a question on whether he would join Bersani in forming a government, "Italy cannot be ungoverned, we must reflect." There is some speculation that he would be willing to form a coalition with Bersani's party if Bersani would support a Berlusconi bid for the presidency, a position of great honor but little actual power.

For markets, there are both short-term and longer-term worries here.

- In the short term, there will be a lot of noise as negotiations over an interim government are under way. Market sentiment this morning is very negative, and it will be tested tomorrow morning as Italy is due to issue €3 to €4 billion of 10-year debt.
- Longer term, the rise of Grillo is the biggest risk to stability in Italian markets.

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[About us]

- Grillo's Five Star Movement has done well in this election by flamboyantly opposing the status quo.
- Grillo, a former comedian, has used the internet -- especially through his blog -- to gain support for his anti-finance, populist rhetoric. And he does populist well.
- But when it comes to actual policies M5S is very hard to pin down. It has called for everything from nationalizing the banks to providing every Italian with a free iPad. It is anti-globalization, and has been in favor of leaving the euro, but it has recently backed down somewhat on that position.

We have seen populist movements rise in other euro area countries, and they have always been highly feared by markets -- the SYRIZA party in Greece, Geert Wilders in the Netherlands, Marine Le Pen in France, Catalonian secession in Spain. But they have all have turned out to be far less of a threat than originally feared. When voters have to make not just a protest but a serious choice about their future -- as Italian voters will have to do in the next election -- populist movements have never been able to build on their initial momentum. So far we have no reason to think that pattern won't repeat itself in Italy this time.

The rise of Grillo can be hamstrung by several factors.

- Grillo himself is a weak spot, because he cannot take a seat in parliament due to a conviction for manslaughter after a car crash in the 1980s -- so he will be distanced from any deals done.
- If the electoral laws are reformed to reduce the majority bonus for plurality winners, a Grillo government becomes unlikely unless he truly wins an overall majority at the ballot.
- The right (for whom Berlusconi has been the leading figure) and the left (for whom Bersani has) might use this electoral setback to change their own parties. If both Berlusconi and Bersani resign before the next election, younger leaders may have a better chance of facing down Grillo.

The big question for investors is whether this inconclusive election result has real power to disrupt the euro area, or is it just another speed-bump on the road to reform and integration.

- While the election has not returned a government, it can be viewed as a rejection of the so-called austerity measures of the Monti administration. This is a setback for Italy as a potential growth story. Ultimately reform of labor and product markets -- of the type being undertaken more effectively by Spain -- is essential for Italy's growth.
- But existential risk for Italy or the euro area is another matter entirely. The most critical risk for global markets is that Italy would leave the euro currency. We see this as highly unlikely. Even in the improbably event that Grillo's party would come to power, there is no reason to think the electorate would support a return to the inflationary bad old days of the lira -- any more than Greek voters

supported a return to the drachma when the question was implicitly put to them.

- Sovereign debt risk is also on the table, but we'd be surprised to see it flare up to anywhere near the levels seen in 2011. Any back-up in yields will clarify the minds of whomever is in power in Rome. It will force them to hew to at least the minimum reform agenda required by the European Stability Mechanism qualifying Italy for the ECB's Outright Monetary Transactions (OMT) safety net.
- For a return to existential crisis, Italy would have to elect a government that outright rejects both the euro and euro area fiscal rules. There is little sign of that yet.

Bottom line

The Italian election produces a hung parliament, with an alarmingly strong showing by radical populist Beppe Grillo's Five Star Movement. As a repudiation of Monti's reform agenda, it's a blow to growth prospects in Italy. It increases sovereign risk in Italy, and raises the specter of existential risk to the currency. But unless Grillo's party comes to power -- a vanishingly small probability -- these are mere tail risks. We now face weeks of uncertainty as an interim government is established, most likely a Bersani/Berlusconi coalition that excludes Monti, because Berlusconi will not work with him. New elections probably won't happen until September, giving the establishment parties the opportunity to change electoral laws to block Grillo.