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MACROCOSM

Post-Brexit Europe Passes Its First Test

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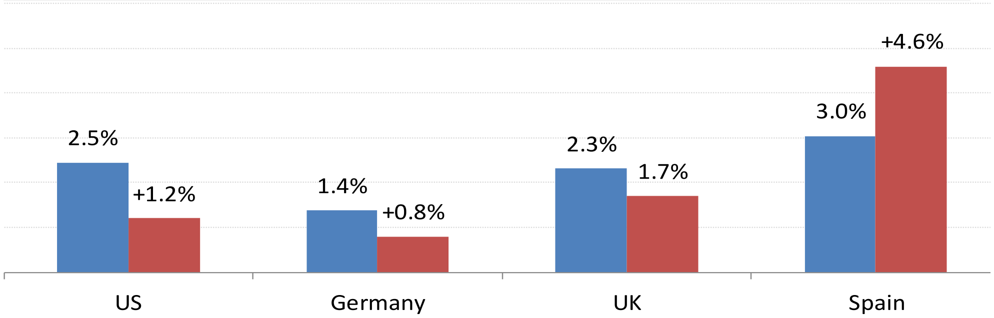
Donald Luskin

Defying polls and "prediction markets," Spain votes not to turn itself into the next Greece.

We continue to think that markets over-reacted Friday to the United Kingdom's decision to leave the European Union, and that this is a buying opportunity, and a chance to lighten up on haven assets (see "On the Brexit Referendum" June 24, 2016). *We're in the phase now where markets have spooked themselves, and just have to work it out for a bit.* In the meantime, Friday's action gives false credence to the pre-referendum warnings, which over the weekend have turned into a cascade of "I told you so's" in the global press, speaking for the elites to whom Brexit is an existential affront.

- *For all the high-minded scare-talk about global "unraveling," the reality on the ground is that, on Sunday, in Spain's do-over general election, Europe stubbornly stayed raveled.*
- "Prediction markets" and polls – even exit polls at the last moment – were forecasting that the far-left *Unidos Podemos* would overtake Spain's Socialists as the number-two party in the parliament. They would then be in a position to potentially dictate a ruling coalition with the Socialists and elect *Podemos'* Pablo Iglesias as prime minister – ejecting conservative *Partido Popular's* Mariano Rajoy, who presided over supply-side reforms that have matured into rapid growth (see "Europe's Supply-Side Revolution" February 17, 2012), which has persisted through the last two quarters of political uncertainty (please see the chart below).
- A *Podemos* takeover would not have led to a "Spexit," nor Spain's

Spain's trailing 8 quarters:
Real GDP growth per annum Improvement in unemployment rate



Source: Eurostat, BEA, BLS, TrendMacro calculations

Update to strategic view

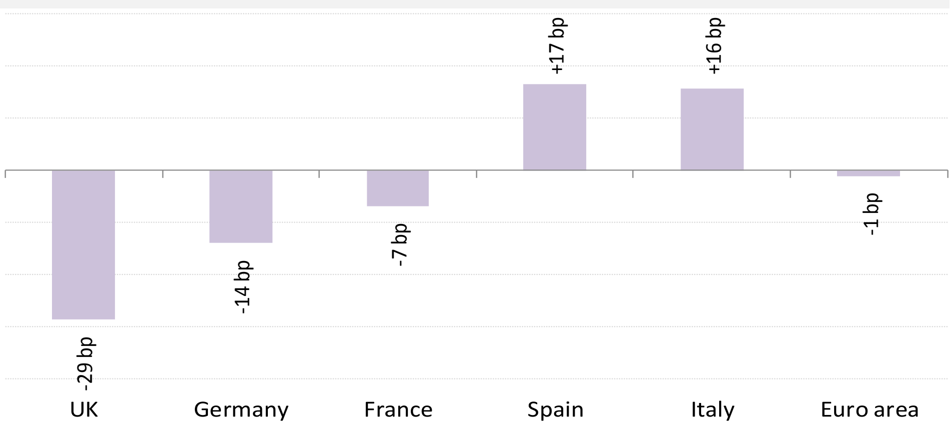
EUROPE MACRO, EUROPE BONDS: Friday's extreme reaction in global markets to Brexit has given false credence to the doom-and-gloom "I told you so's" of the global elites to whom this is an existential affront. We reiterate our position that this is a buying opportunity, and a chance to lighten up on haven assets. Already Europe has passed its first post-Brexit test. Defying "prediction markets" and polls, Spain's Marxist *Unidos Podemos* has done poorly, and the conservative *Partido Popular* has done well. It will still be hard to form a government, but the expected hard-turn to the left has not materialized. We continue to think that the UK will do fine without the EU, but that the EU won't do fine without the UK – but this opens up for the first time the chance for real EU reform, focusing first on immigration. Highly indebted Italy and Spain, both of which use the euro currency, are the flashpoints to watch, but Spain has now taken itself off the threat-board.

[Strategy dashboard]

abandonment of the euro currency. The European far-left is very pro-EU and pro-euro (the “exit” agenda comes from Europe’s right). But it would have put in control of one of Europe’s largest economies a Marxist regime linked to Greece’s SYRIZA and Venezuela’s Chavez movement. *Podemos’* “programme” of 394 items – it has been likened to an Ikea catalog in its complexity – is an absurd laundry-list of free stuff for citizens, reversal of pro-growth labor and product market policy, and repudiation of debt.

- If *Podemos* were in control, dealing with that repudiation would have been most unpleasant. It was difficult enough with little Greece under *Podemos’* ally SYRIZA. It involved a great deal of brinksmanship, which at the time we forecasted would ultimately work to *Podemos’* disadvantage (see "On the Euro Summit 'Agreekment'") July 13, 2015), which apparently is has. That would be even more dangerous now with a larger, more indebted and more globally integrated nation like Spain.
- Happily, the polls were as wrong in Spain on Sunday as they were in Britain on Thursday. Turnout was the lowest in Spain’s electoral history, despite dire forecasts that Brexit would stir up the electorate. In Spain’s insanely complicated parliamentary election system, Rajoy’s *Partido Popular* was supposed to get 119 seats in the *Congreso de los Diputados* – it got 137, a result beyond the highest estimate of any poll in the whole run-up to the election. *Podemos* was supposed to get 93, and ended up with only with the same 71 it had before.
- Yesterday’s election is not the end of the story for Spain. *Partido Popular* and the friendly center-right *Ciudadanos* do not, together, have the votes in the *Congreso* to form a government. But *Podemos* and the Socialists, together, have even fewer votes. This impasse could potentially lead to a third election, until which Rajoy would remain acting prime minister. But today Rajoy is promising to deliver a new government within one month. That could be done if the Socialists could be persuaded to abstain in the investiture vote in the *Congreso*, giving *PP* a majority of votes cast.
- But the price of abstention may be the scandal-plagued Rajoy’s stepping down. In that case, he would likely give way to his

Change in 10-year sovereign yields on Friday, June 24, 2016



Source: Bloomberg, TrendMacro calculations

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attractive (and relatively scandal-free) deputy, Soraya Sáenz de Santamaría Antón, who would carry forward Rajoy's growth agenda – with a personal charisma that could be quite positive.

- *This stabilization in Spain, coming so quickly on the heels of the UK referendum, is non-trivial for Europe's post-Brexit future because it occurs at the center of where the risks really are.* Note that on Friday, while euro area sovereign bond yields overall were about unchanged (when each nation is weighted by its ECB capital-key), yields in the "periphery" (Italy and Spain, for example) were sharply higher, offsetting falling yields in the core (Germany and France, for example – please see the chart on the previous page).
- UK gilts yields fell most of all, and today as of this writing have fallen to their lowest in history. It's ironic, then, that on Friday Moody's put the UK on downgrade-watch, but reaffirmed the EU.
- Our view is just the opposite. *We reiterate our fundamental framework for thinking about this – the UK will be fine without the EU, but the EU won't be fine without the UK* (see "Brexit: Opening Pandora's Brox" May 23, 2016). The EU will have no choice now but to reinvent itself along more accountable, adaptable and democratic lines – taking into account many member nations' growing skepticism about immigration. This will entail risks, but at the same time it pushes out the frontier of what is possible for Europe beyond the technocratic anti-growth structure that traps it now.
- *The risks are, first and foremost in Spain and Italy. These are the two nations with enough debt that, if they left the European Union and abandoned its implicit guarantees, there would be default risk at levels that could do some real global damage. But the real issue is the euro currency – if Italy or Spain exit the EU, under current treaties they would have to exit the currency as well. That would court a truly systemic global event.*
- Spain has likely taken itself off the risk-dashboard for a while, with yesterday's election. Indeed, in today's trading as of this writing, Spanish 10-year yields have come back down to pre-referendum levels. But even before the election, again, the political threat from Spain comes from the left, where there is no exit agenda.
- In Italy, though, the threat comes from the right, from nationalist-oriented movements – Sylvio Berlusconi's Northern League and Beppo Grillo's Five Star Movement (which called early last week for a referendum on the euro, and one of whose members was just elected the first female mayor of Rome). Today, as of this writing, Italian 10-year yields are considerably lower, in sympathy with Spain's – but not all the way back down to pre-referendum levels.
- Facing these risks, German Chancellor Angela Merkel is rejecting advice to speed up separation from the UK, seeking instead to slow things down and cool off. That's the right attitude, and a good start toward Europe's reform.

Bottom line

Friday's extreme reaction in global markets to Brexit has given false credence to the doom-and-gloom "I told you so's" of the global elites to whom this is an existential affront. We reiterate our position that this is a buying opportunity, and a chance to lighten up on haven assets. Already Europe has passed its first post-Brexit test. Defying "prediction markets" and polls, Spain's Marxist *Unidos Podemos* has done poorly, and the conservative *Partido Popular* has done well. It will still be hard to form a government, but the expected hard-turn to the left has not materialized. We continue to think that the UK will do fine without the EU, but that the EU won't do fine without the UK – but this opens up for the first time the chance for real EU reform, focusing first on immigration. Highly indebted Italy and Spain, both of which use the euro currency, are the flashpoints to watch, but Spain has now taken itself off the threat-board.