Weekly Digest
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Investec Wealth & Investment

The weekly insight into world stock markets

Mamma Mia! Here We Go Again

As we basked in Bank Holiday sunshine last week, those who didn't have the luxury of a day off threw up their hands in disbelief at the madness of Italian politics. The expression "Mamma mia!" is properly Italian, and can convey emotions ranging from surprise, fear and exasperation to unbridled joy, and it was much the former group that was involved in this case. Of course, the phrase is now associated with the ABBA song, and related film and musical, and it seems poignant to me that said film is set in Greece, whose debt problems were a key trigger for the euro zone crisis. For a moment last week it looked as though we might have another one on our hands.

On March 12th I wrote about the outcome of Italy's general election, concluding with the sentence: "There are probably still a few more surprises to come from Italy's politicians this year, which will only add to the general sense of global political uncertainty." I'm not sure that I deserve any great accolades for making such an obvious prediction, but it was what I wrote immediately before that which really needs to be highlighted again, namely, that Italy could "again become a potentially weak link in the financial chain should we enter more stressful times". It is this underlying fragility of Italy's public finances combined with the inherent flaws in the single currency system of the euro which ensure that, despite the return to relative calm, we most probably haven't experienced the last market wobble related to these events.

Italy's problem is visible in a gross public debt to Gross Domestic Product (GDP) ratio of 132%, when any figure over 100% is deemed to be troublesome. As in many countries this ratio shot up during the financial crisis as the government was forced to support the financial system and the economy while tax revenues declined, but Italy's situation was exacerbated by a high starting level of debt thanks to previous profligacy and an economy that was already sluggish. While many within Italy blame the poor economic performance on the euro itself, citing a restrictively high exchange rate, the reality is that the country has done little to help itself, having eschewed the sort of supply side reforms that gave such a boost to the UK and Germany (and which France is now trying to implement). GDP has grown annually above 2% only twice in that last twenty years, with average growth of just 0.5% over that period (or a still poor 1.3% ignoring the recessions of 2009 and 2012). Average Real Wages remain lower than they were two decades ago, pointing to a complete lack of Productivity growth.

Even so, until last week the situation was deemed to be sustainable. Growth was chugging along around 1.5%, last year the government's finances generated a surplus before interest payments on debt of 1.5% of GDP, and a decent export performance created a current account surplus of 2.6% of GDP, something of which the UK can only dream. No doubt the European Central Bank's programme of Quantitative Easing has also helped, bringing the average interest rate on Italian debt below 3%. Up until now it has generally been assumed that the catalyst for another crisis in the euro zone is more likely to be an external one – something that causes a negative shock to economic growth and government finances. However, the current episode was very much domestically generated. The unlikely coalition partnership of La Lega and Five Star produced an economic plan designed to appeal to its supporters, featuring generous tax cuts alongside increased spending, including a €780 per month "Citizenship Income", which looks a lot like a Universal Basic Income. These plans were quickly calculated to cost as much as 6% of GDP, which would leave Italy on a path to insolvency without a sharp accompanying increase in growth and productivity, which, perhaps unsurprisingly, very few people saw as possible.

What pushed markets over the edge, though, was the rejection by the President of the coalition's choice of Finance Minister, the veteran euro-sceptic Paolo Savona, in a move that was seen as a Brussels-driven intervention. This was the point at which La Lega leader Matteo Salvini raised the possibility of forcing another election that would effectively become a referendum on Italy's membership of Europe and the euro: "A consultation on who wants a free Italy and who wants Italy as a slave. Italy today is not a free country; it's a country financially occupied by Germans, French and Eurocrats". Emotive words, I think you'll agree. Outside Europe and the euro, there would be no anchor for Italy's debt, and so the yields on Italian bonds jumped by unprecedented amounts, heading towards levels that would guarantee insolvency. Not only that, but the situation would set off the so-called "Doom Loop" which would undermine the capital position of Italy's banks, which own substantial amounts of the country's debt.

In the end there was a pragmatic stand-off (much as I have described before when talking about using Game Theory to analyse these sort of events – the worst outcome is so appalling that it is in nobody's interest to risk it), but that possibly overestimates the power of markets to impose discipline. Italy's debt problem remains, and flaws in the euro are plain to see: there is no mechanism for anybody to leave, and it will struggle to survive a deep recession without greater fiscal and banking union, the first of which, at least, appears a long way off. So we have dodged a bullet for now, but I doubt we have had our last "Mamma Mia!" moment. The sequel film looks much more fun.

John Wyn-Evans
Head of Investment Strategy

FTSE 100 Weekly Winners

Evraz	9.2%
Johnson Matthey	6.9%
BP	3.9%
Anglo American	3.8%
Burberry Group	3.6%
Randgold Resources Limited	3.5%
Smiths Group	3.5%

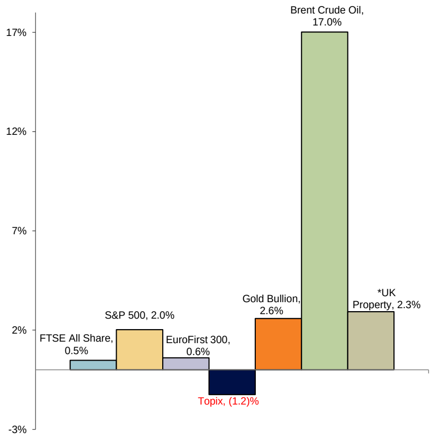
Source: FactSet

FTSE 100 Weekly Losers

NMC Health	-10.5%
Marks & Spencer Group	-8.4%
Royal Mail	-6.4%
National Grid	-5.9%
Direct Line Insurance Group	-5.2%
Severn Trent	-4.9%
Coca – Cola	-4.3%

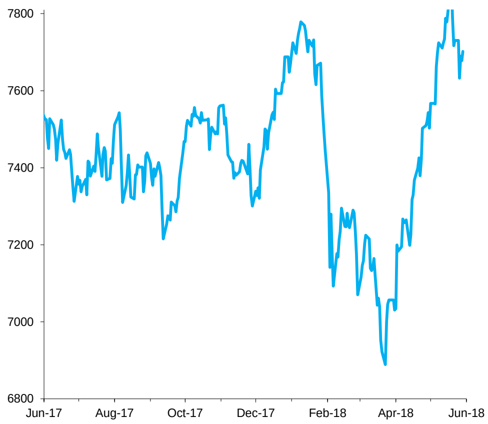
Source: FactSet

Year to Date Market Performance



Source: FactSet

FTSE 100 Index, Past 12 Months



Source: FactSet

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