EQUITY

Italian Politics + US Trade Tariffs = Market Turmoil

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There seems to be no shortage of market-moving events of late, and no shortage of market volatility. In recent days, oil has hit a four-year high, Italy has been thrust into the spotlight amid a political crisis and trade-war fears between the United States and several of its key allies have again flared up after US President Donald Trump's administration slapped them with tariffs. Katrina Dudley, portfolio manager and research analyst with Franklin Mutual Series, weighs in on it all.

Italian Politics: Turmoil Breeds Volatility and Contagion Fears

Italy has been without a government since March, when the general election failed to produce a clear winner. A new coalition had formed between two groups at opposite ends of the political spectrum, the right-wing La Lega and left-wing Five Star movement. The coalition's choice for Prime Minister, Giuseppe Conte, resigned after Italian President Sergio Mattarella refused to accept the candidate presented for the post of Economic Minister, a well-known radical eurosceptic. The situation escalated, and we heard cries of presidential impeachment and the threat of a renewed crisis in the country.

We saw markets around the world react to the news out of Italy amid fears of a risk of contagion and the potential breakup of the euro.

However, the European Central Bank (ECB) does have tools to prevent a crisis from moving outside of Italy. These include the European Stability Mechanism (ESM) and the ECB's Outright Monetary Transactions (OMT) Programme—basically, the eurozone has a lender of last resort, and that is what could control the contagion risk.

We were expecting a caretaker government to be put in place, but that didn't happen. And even if this coalition does come to power, it could continue to be messy in Italy. The markets are reacting to the very short-term news headlines, and it's creating heightened market volatility because of the uncertainty around how this situation will be resolved.

Populism Moves Back to the Forefront

We have seen populist sentiment ebb and flow, rising significantly since the 2008-2009 global financial crisis and into the Greek crisis that followed, but then lessening with the decisive victory of President Emmanuel Macron in France last year.

However, just as we thought populist risk had begun to abate, the Italian elections brought it back to the forefront, with the electorate supporting populist parties at both extremes of the spectrum. The union of these two parties represents the coming together of somewhat strange bedfellows, and whether their often-opposing interests can come together to effectively govern the country remains to be seen.

Keeping a Close Eye on Spain

We also are watching the situation in Spain, although their issues are very different from those in Italy. In that market, rather than a rise in populist politics, we have seen a fight against corrupt officials following the National Court's convictions of former members of the governing party. The situation there is fluid, particularly with Prime Minister Mariano Rajoy's ousting and calls for new elections, so we think it's something to continue to monitor.

Trade: Issues to Consider

Tariffs and other barriers that cause friction in global trade create disorderly trading markets. While we don't believe there will be an outright trade war, we are now living in an environment of significantly higher uncertainty. We don't see this backdrop as being supportive for financial markets and business confidence.

There are many trade issues that need to be considered from an investment standpoint. We have seen multiple measures from the current US administration on this front, from proposed tariffs into the United States to the current focus on China, which it believes to have been dumping product into the market at reduced rates.

The other issue that factors into trade discussions is exchange rates. With the political turmoil in the eurozone, we have seen a depreciation in the euro-US dollar exchange rate. Given the significance of exports to various economies, particularly those in Europe, the depreciation should help them from a competitiveness standpoint. However, we would note that many of these European companies have tried to naturally hedge their revenues by moving manufacturing closer to their end customers where possible, thereby mitigating somewhat the benefits of currency movements on their businesses.

We think an outright trade war is a low-probability event, but it is a risk we continue to monitor. The imposition of trade barriers—and how they are implemented—is something we think needs to be considered, in particular the potential impact on supply chains. To the extent that these trade barriers can increase prices of inputs, we could see near-term margin pressures on companies if these higher costs can't be passed through to the end user in the form of higher prices.

Volatility—and Potential Opportunities

Recent events have caused short-term volatility in the markets, but the ECB has the tools to contain the crisis, and we do not see current events derailing the recovery we have seen in the European region.

We are continuing to monitor the policies of the Italian coalition, where the parties ran on competing platforms. The left party called for minimum income guarantees and a rollback of the pension reforms, while the right ran on a platform of tax cuts. We are hopeful, but not optimistic, that the coalition could bring change to the country. There are many areas of the Italian economy that could benefit from reform—starting with the labour market—but at this stage we are unsure of the appetite and ability of the coalition to achieve this.

The energy and financials sectors dominate the Italian market, so if you are investing there, you need strong views on those sectors. We still see companies we like in those sectors, and are looking for potential opportunities amid the turmoil.

We don't currently see liquidity risk in the Italian banking sector.

Regarding the potential for further trade sanctions and an outright trade war, we are looking for companies that are being unfairly punished or companies operating in sectors that seem immune. For example, companies in service-related industries tend to be more immune to trade turmoil as they do not, generally speaking, earn their revenues from the sale of manufactured products. Hence, they are relatively untouched by sanctions.

We are stock pickers, so short-term volatility often presents an opportunity to acquire attractive franchises at valuations that are overly discounted due to perceived political risk. No matter what the overall environment is like, there are always potential winners and losers.

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