Mitch on the Markets

Will Turmoil in Europe Hurt the Market?

By Mitch Zacks
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One could argue that the phrase "political turmoil in Europe" has been applicable in nearly every year of the last decade. For many countries in the region, it has been a constant struggle for unity and political stability in the aftermath of the 2008 Financial Crisis, culminating in Brexit and the populist wave currently engulfing the area. The latest chapter in the saga comes from Spain[1] and Italy[2], both of which have governments in a state of flux and uncertainty.

At risk here, in my view, is further fragmentation in the European Union and ultimately the fate of the euro (currency). If we use bond yields as an indication of what the market thinks of all this (which I think is the right way to make an assessment) then the implication is pretty clear to me: unstable, 'eurosceptic' governments are negative for markets.[3]

At the height of the uncertainty – when the ruling Italian populist parties Five Star Movement (M5S) and the League nominated a eurosceptic finance minister – the spread between Italian 10-year bonds and those of Germany soared, and investors appeared to pour into the dollar and U.S. Treasuries as a measure of safety.[4]

Cautious investors would also note that this latest political drama in Italy and Spain comes at a time when global economic uncertainty is already heightened, as the Trump administration resumes implementing tariffs against China, the EU, Mexico and Canada.[5] In my view, there's an eerie feeling that the global economy has a ticking time bomb on its hands.

What Do the Economic Fundamentals Say?

If we look just at Europe, I would say it's not a great time to be enduring political instability. To be sure, Europe has positive growth and earnings momentum. But growth rates have been slowing, and Europe has arguably been lagging other developed regions (and Emerging Markets).[6]

In the manufacturing sector, for instance, the start of Q2 saw a continued slowdown in growth: the final IHS Markit Eurozone Manufacturing PMI fell to a 13-month low of 56.2 in April, down from 56.6 in March and slightly above the earlier flash estimate of 56.0. Although still signaling a solid rate of expansion, the upturn has lost noticeable momentum since the PMI hit a record high in December 2017. Five out of the eight nations covered (the Netherlands, Germany, Italy, Spain and Greece) registered slower rates of growth than in the prior month.[7]

In our view, however, ***though recent data has been soft, global growth should pick up later in 2018*** with Asia, Europe, and the USA pulling the wagon together. We could see Europe with +2.4% GDP growth and the U.S. notching growth a few basis points higher. Both Europe and the U.S. have seen recent improvements in the unemployment rate as well, with Europe's reaching 8.5%. Finally, the European Central Bank head Mario Draghi remains accommodative and has the option of making a judgment call later in the year on whether to remove European QE. As it stands today, politics aside, we do not think there is substantial weakness to sell into.[8]

But that all being said – our positive forecast hinges on the European Union remaining the European Union, with all the major players remaining a part of the currency bloc. If a major country decides to leave – which we do not think is likely and is also politically difficult to do – then our calculus would likely change quickly.

Bottom Line for Investors

In our view, it's probably still too early to assess the economic impact of Spain and Italy's revolving doors of government, but I do think the ongoing uncertainty could slow regional economic activity and investment, which could, in turn, serve as a headwind for European earnings. Any sustained uncertainty could also keep credit spreads widened – a condition generally not conducive to strong economic growth.

On balance, however, we expect global economic growth to press-on even as the headwinds grow. If that's the case, for investors it would mean having to do something that we're tasked with doing often: looking past the headline risk to see fundamental strength. This is what we do for our client's at Zacks Investment Management.

About Mitch Zacks

Mitch is a Portfolio Manager at Zacks Investment Management. Mitch has been featured in various business media including the Chicago Tribune and CNBC. He wrote a weekly column for the Chicago Sun-Times and has published two books on quantitative investment strategies. He has a B.A. in Economics from Yale University and an M.B.A in Analytic Finance from the University of Chicago.

[1] *The Washington Post*, May 31, 2018, https://www.washingtonpost.com/world/europe/spains-conservative-leader-faces-no-confidence-vote/2018/05/31/a3987026-64a2-11e8-81ca-bb14593acaa6_story.html?noredirect=on&utm_term=.0114e97531b7
[2] *Financial Times*,

https://www.ft.com/content/8edfb128-631f-11e8-90c2-9563a0613e56
[3] BackRick Blog, June 5, 2018, https://www.blackrockblog.com/2018/06/05/european-populism-implications/
[4] BackRick Blog, June 5, 2018, https://www.blackrockblog.com/2018/06/05/european-populism-implications/
[5] USA Today, June 5, 2018, https://www.usatoday.com/story/news/politics/2018/06/05/sen-bob-corker-challenge-trumps-tariffs-well-received-gop/674871002/
[6] BackRick Blog, June 5, 2018, https://www.blackrockblog.com/2018/06/05/european-populism-implications/
[7] Zacks Investment Management's Stock Market Outlook Report
[8] Zacks Investment Management's Stock Market Outlook Report

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