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Europe's New, Right-Wing Leaders

Late summer can often be a quiet time for global affairs, economics, and the financial markets. Especially in Europe, people are off on their long summer holidays, making it difficult to find a “quorum” for political events and business meetings while sapping liquidity in the investment markets. This year, however, August and September were marked by groundbreaking political changes that could have big consequences for investors going forward. This report takes a look at the new, right-wing leaders in the United Kingdom and Italy. As always, we will wrap up with a review of the implications for investors.

The U.K.: Prime Minister Liz Truss

Whenever a large, powerful country has a change in leadership, we typically give our readers an overview of the new leader's biography, a discussion of their major policy goals, and an assessment of their likely prospects. As the world's fifth-largest economy and one of the United States' closest allies, the U.K. certainly fits the criteria. Liz Truss (see Figure 1) took office as the U.K.'s 56th prime minister in early September after the Conservative Party membership chose her to replace former Prime Minister Boris Johnson. Given that Truss succeeded to the leadership position based only on the votes of some tens of thousands of party members, she begins her term of office with relatively limited political capital. Nevertheless, she has hit the ground running with some dramatic policy proposals.

Figure 1



U.K. Prime Minister Liz Truss (Source: AP)

[The most notable aspect of Truss's biography is probably her ideological journey from the far left to the far right of the political spectrum.](#) Born in 1975, she was raised in Scotland by left-wing parents who would take her along to rallies against conservative Prime Minister Margaret Thatcher. By the time she was studying at Oxford University, however, she had drifted into the center-left Liberal Democratic Party and then became a leader of the party's student branch at the school. Finally, she joined the Conservative Party in 1996. Her professional career included stints at oil giant Shell (SHEL, \$51.97) and privately held telecom firm Cable & Wireless. By the time she entered government, Truss was known for her passionate beliefs in personal freedom and free enterprise. She was elected to parliament in 2010 and served in progressively higher ministerial positions in several previous governments.

- Although she voted against Britain's exit from the European Union in its 2016 referendum, she subsequently recast herself as an avid Brexiteer.

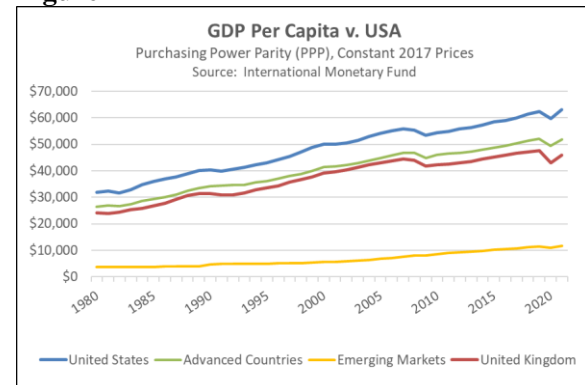
- As trade minister, she negotiated the U.K.'s post-Brexit trade deal with the EU, and as foreign minister, she took a hard line over the way the EU was implementing the deal.

Foreign Policy Goals. Truss's policy goals sit on the far-right side of the Tories' political spectrum. In foreign policy, Truss wants to continue building up the British military, while strongly rebuking authoritarian countries like China, Russia, Iran, and North Korea. She pledges to continue Britain's strong support for Ukraine as it tries to defend itself from Russia's invasion. Illustrating Truss's big goals in foreign policy, [she has pledged to increase the U.K.'s defense budget not only to the NATO standard of 2% of gross domestic product \(GDP\), but all the way to 3% of GDP by 2030](#). In other aspects of Britain's foreign relations, Truss also aims to clamp down on immigration and send asylum seekers to third-party countries for processing. Importantly, Truss also appears set to keep pursuing the promises of Brexit. She has indicated she will continue to strive for free-trade deals with the U.S. and other major countries despite their poor near-term prospects. She is also likely to continue pushing back against the U.K.'s post-Brexit trade agreement with the EU to further reduce the EU's influence on the British economy.

Domestic Policy Goals. [Truss's primary focus in domestic policy is to shock the economy out of its recent slow growth \(see Figure 2\) through a Reagan-esque mix of radical tax cuts and deregulation](#). Almost immediately upon becoming prime minister, Truss's government announced that it would reverse a planned hike in the corporate income tax that would have taken it from 19% to 25%, pare the top personal income tax rate from 45% to 40%, rescind a recent

increase in payroll taxes, and roll back higher contributions to the National Health Service. [Importantly, Truss has also insisted that she won't curtail spending to match the revenue cuts, arguing that the tax cuts will spur enough growth to generate additional funds](#). She has even championed about £140 billion in subsidies to shield British households and businesses from skyrocketing energy prices. Even though Truss was forced to abandon her cut to the top personal income tax rate earlier this month, the new subsidies and remaining tax cuts as of this writing threaten to expand Britain's budget deficit by some £300 billion over the next few years, equal to almost 13% of GDP.

Figure 2



- In other domestic economic initiatives, Truss wants to set up dozens of new “investment zones” marked by looser planning rules, easier regulations, and lower tax rates as the cornerstone of her plan to boost economic growth.
- Truss's deregulation program also includes an immediate lifting of the U.K.'s ban on hydraulic fracturing, or “fracking,” to encourage new oil exploration and production in hopes of eventually boosting supplies and bringing down prices.
- One of Truss's most controversial proposals has been to “review” the Bank

of England’s mandate to ensure that the central bank is being tough enough on inflation. As discussed in our “Investment Ramifications” section below, the concern among economists and investors is that such a move would weaken the institution’s independence and make monetary policy more volatile and subject to political considerations.

Italy: Prime Minister Giorgia Meloni

In Italy’s parliamentary elections on September 25, a bloc of three right-wing parties including The League, Forza Italia, and the neo-fascist Brothers of Italy won a majority in parliament, although they apparently failed to win the two-thirds majority needed to push through constitutional changes. Once the winning parties agree on a government (a process that could take weeks), the coalition is expected to be led by Brothers of Italy leader Giorgia Meloni (see Figure 3), who would then become Italy’s first female prime minister.

Figure 3



*Brothers of Italy leader Giorgia Meloni
(Source: Times of Israel)*

[Somewhat similar to British Prime Minister Truss’s background, Meloni was born in 1977 into one of Rome’s more leftist neighborhoods, and her father voted Communist.](#) One big difference, however, is that Meloni has consistently been a

believer in Italian nationalism and cultural conservatism. In her school years, Meloni recounts that she was angered by what she felt was indoctrination by her schools’ leftist teachers. She was first inspired to join the neo-fascist Youth Front in the early 1990s after the assassination of the popular anti-Mafia prosecutor Paolo Borsellino.

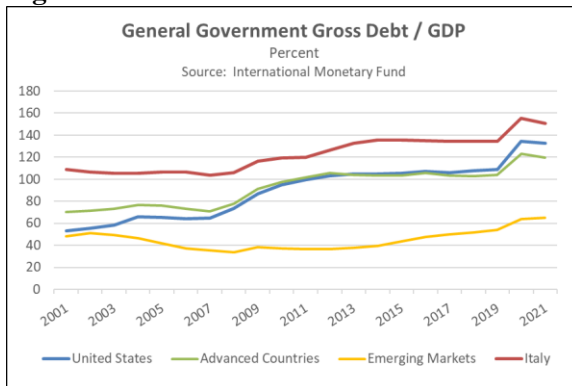
[Meloni later joined the right-wing National Alliance and served as Youth Minister in one of Silvio Berlusconi’s right-wing governments in 2008.](#) When the party began to cooperate more fully with Italian establishment parties, she broke away and helped form the Brothers of Italy party in 2014.

Foreign Policy Goals. Despite strongly criticizing the U.S. and the EU in the past, Meloni has moderated her views in an apparent effort to broaden her appeal in the Italian electorate. [For example, she no longer advocates for Italy’s withdrawal from the EU, but merely encourages “re-discussing” the country’s existing treaties with the EU and Italy’s use of the euro.](#) However, she still calls for a constitutional amendment to ensure that Italian law takes precedence over EU law. [She has also sided with Poland and Hungary as they try to strike an independent course that the EU says is at odds with the bloc’s rule-of-law, anti-corruption, and human rights requirements.](#) In other foreign policy directions, Meloni has vowed to maintain Italy’s strong support for Ukraine, although it’s important to remember that the other party leaders in her coalition have historically been much more supportive of President Putin and will likely look for an opportunity to water down Italy’s support for Ukraine.

Domestic Policy Goals. Meloni’s domestic economic policy goals are similar to those of

many other right-wing populists in Europe, but she faces serious external constraints on implementing them. [For instance, she wants to replace the country's progressive income tax with a flat tax of 15% on income above an individual's average income over the previous three years, and she wants to gradually end a regional tax on productive activity.](#) Despite Meloni's vow to maintain overall fiscal discipline, those plans would likely exacerbate Italy's extremely high debt levels (see Figure 4) and threaten to drive Italian bond yields to unsustainable levels. Meloni will probably also be forced to stand by the economic reforms that the previous government agreed to with the EU in return for some €200 billion of the bloc's pandemic relief funds and the EU's help in dealing with the current energy crisis touched off by Russia's invasion of Ukraine.

Figure 4



- If the external constraints on Meloni prevent her from pursuing her more dramatic economic changes, we suspect she will compensate by focusing more on the nationalist and culturally conservative social initiatives long championed by her party.
- The most high-profile of such measures may be to crack down further on illegal immigrants, possibly to include stronger interdiction of migrant boats crossing the Mediterranean Sea from Africa. On a related note, Meloni has also called for

measures to boost Italy's birth rate in an effort to reduce its demand for migrant labor. Meloni's government is also likely to generate controversy at home and abroad by instituting tough cultural identity policies, such as new limits on abortion and anti-gay laws.

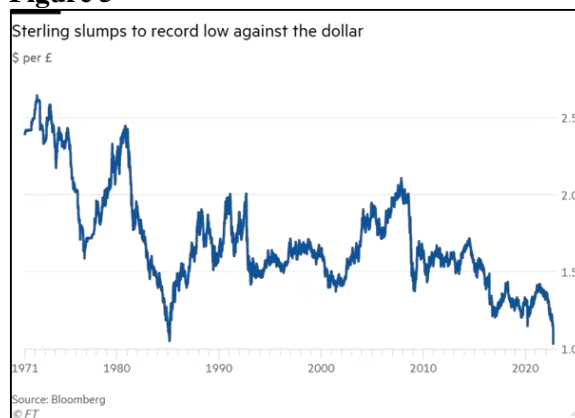
Investment Ramifications

Neither Britain's Truss nor Italy's Meloni should be considered dangerous radicals. Each may stand closer toward the right wing of the political spectrum than any of their recent predecessors, but both also seem driven as much by pragmatism as by ideology. If implemented, their policies would instill big changes in their respective countries, but they wouldn't necessarily be revolutionary in any fundamental way. Besides, both face important institutional and political constraints. Truss and her Conservative Party face new elections in just two years, and the economic and financial market turmoil touched off by Truss's fiscal policies have already begun to undermine her support within the party and in the broader electorate. Meloni in Italy will likely face pressure from her coalition partners to move even farther right, perhaps by fighting more stridently against EU requirements, but she needs to temper her policies to remain eligible for the EU's pandemic relief funds and to prevent a destabilizing sell-off in Italian bonds.

The investment ramifications of these two leadership changes have already begun. Immediately upon Truss's announcement on September 23 for major tax cuts, investor fears of massive new bond issuance and worsening inflation sparked a sell-off in British government bonds, driving the benchmark 10-year gilt yield as high as 4.51% in the following days. Just as considerable, the pound began to fall sharply, at one point reaching a record low

of \$1.0349, down 23.3% year-to-date (see Figure 5). Perhaps most dramatically, though, was that the volatility in the financial markets generated large, dangerous margin calls on insurers and pension funds. Urged on by the government, the Bank of England was forced to pause its quantitative tightening program on September 28 and announce that it would instead purchase longer-dated gilts “on whatever scale is necessary” to restore market order.

Figure 5



So far, Meloni’s win in Italy hasn’t had nearly the market impact as seen in the U.K., but that could easily change once she reaches a coalition agreement, forms a government, and begins to issue policy steps. Given the similarity in their economic programs, the new right-wing governments

in the U.K. and Italy will probably both pursue tax cuts, deregulation, import limits and/or export promotion, and looser spending, at least in the short term. As we’ve already seen in the U.K., those policies are likely to be negative for government bonds in both countries and beyond. Any outsized rise in Italian bond yields will be especially risky since it could blow out risk spreads in the Eurozone and make it difficult for the European Central Bank to manage. The key concern is likely to be increased inflationary pressure, and to the extent that the BOE or the ECB is unable to hike interest rates far enough to get inflation under control, the result will be further downward pressure on the respective currencies. The key short-term market concerns will center on increased inflationary pressure, rising bond yields, and falling currency values, all of which would likely be positive for commodities. Granted, Reagan-esque policies like those pursued by Truss could ultimately be bullish for the currencies, just as they were for the dollar in the early 1980s, but that would probably be in the longer term.

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