

*November 13, 2017*

## **The Situation in Catalonia: Part II**

In Part I of our report, we examined the historical background of the Catalan independence movement. This week, we will continue our discussion by summarizing the constitutional crisis, identifying the significant players and their motives, noting the possible outcomes and concluding with market ramifications.

### **Constitutional Crisis: A Summary**

In addition to the historical differences mentioned in [Part I](#), the Catalan separatist movement can be partially attributed to the vagueness of the Spanish constitution. Although the constitution states that Spain is made up of 17 autonomous communities, the term “autonomous community” is loosely defined. According to the constitution, an autonomous community is a self-governing region in which people share “...common historic, cultural and economic characteristics.”<sup>1</sup> Furthermore, the preamble of the Spanish constitution fails to group people under the same nationality. For example, the preamble of the U.S. constitution states, “We the people of the United States,” whereas the Spanish preamble states that the constitution “protects all Spaniards and peoples of Spain.” As a result, the constitution’s recognition of ethnic regions and its failure to establish a unified Spanish identity have bolstered ethnic pride at the expense of national identity.

The constitution’s vagueness has also led to tensions between the autonomous community governments and the central government. Autonomous communities like Catalonia frequently ask for additional powers and greater independence from the central government. To the Catalan separatists, Catalans are not “Spaniards” but rather a “people of Spain.” This sentiment is expressed in the Catalan constitution, which refers to Catalans and Spaniards as separate groups, although both groups have the same rights.

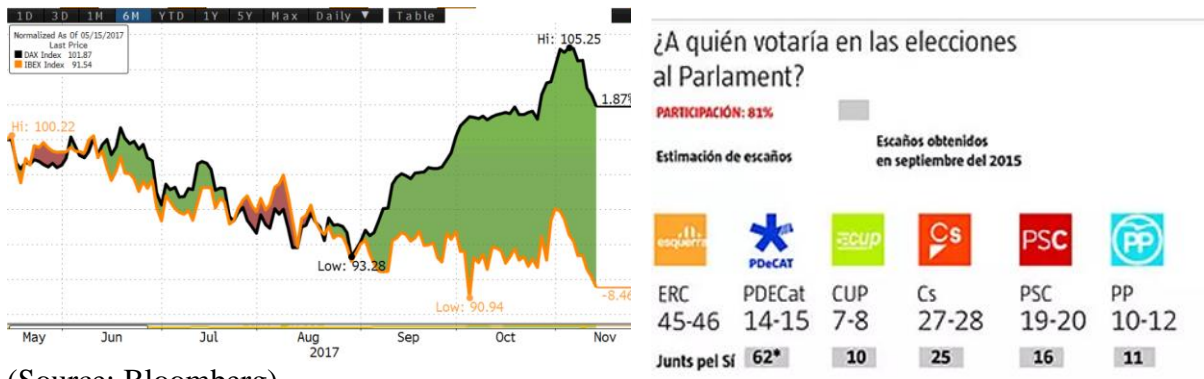
The use of Article 155 of the constitution has muddied the waters between Spain’s central government and the governments of the autonomous communities as it clearly asserts the former’s dominance over the latter.<sup>2</sup> Article 155 of the Spanish constitution allows the central government to dissolve the government of an autonomous community if it believes that the autonomous community is acting against the interests of Spain. The separatists’ decision to take part in next month’s parliamentary election shows that the parties recognize the central government’s authority over Catalonia. There is still growing uncertainty as to whether the central government can maintain its authority as a separatist majority in next month’s election would lead to even more calls for independence. Since the Catalan crisis started two months ago, Spanish equity markets have underperformed.

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<sup>1</sup> Spanish Constitution, Section 143, Part 1

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<sup>2</sup>[http://www.congreso.es/portal/page/portal/Congreso/Congreso/Hist\\_Normas/Norm/const\\_espa\\_texto\\_ingles\\_0.pdf](http://www.congreso.es/portal/page/portal/Congreso/Congreso/Hist_Normas/Norm/const_espa_texto_ingles_0.pdf)

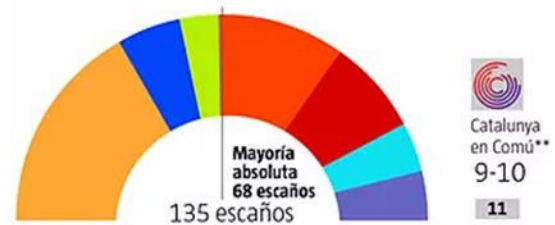


(Source: Bloomberg)

Last week's agreement among Catalan separatist groups to participate in the elections has done little to quell uncertainty. The chart above shows Spain's IBEX 35 Index performance relative to the German DAX Index. Since the Catalan crisis escalated in late August, the IBEX has drastically underperformed the DAX. This suggests that the Catalan crisis has led to growing concerns about the country's stability after the election. Markets are likely to remain volatile until December 21 when Catalans go to the polls to vote for a new provisional government. In order to understand how this election might unfold, it is necessary to understand the prominent groups and players involved in this dispute.

### Catalan Separatists

The Catalan separatist movement is being driven by three political parties within the Catalan Parliament: the Catalan European Democratic Party (PDeCAT), the Republican Left of Catalonia (ERC) and the Popular Unity Candidacy (CUP). Despite being aligned under the same broad cause, these groups have different political agendas in the event that Catalonia does secede from Spain.



(Source: GAD3)<sup>3</sup>

The chart above shows expected seats for the upcoming election directly below the party name. The seats from the previous Catalan government are shown in gray.

**PDeCat** represents the center-right of the Catalan Parliament. This group believes that Catalans have the right to self-determination and wants Catalonia to remain in the EU. We suspect that there is a slight majority within this party that does not support outright independence for Catalonia but would rather have increased autonomy. This party has been the most vocal about compromising with the central government to avoid a declaration of independence. Since the referendum, PDeCat has seen its support shrink as radical separatists feel the group is moving too slowly toward independence while moderate separatists believe the group is moving too quickly. This group is expected to garner 14-15 seats in the upcoming election.

<sup>3</sup>Junts pel Sí is the coalition party formed by the ERC and PDeCaT.

**ERC** represents the center-left party in the Catalan Parliament. This group believes that Catalonia should secede from Spain, but still remain in the EU. The ERC has been open to negotiations with the central government for increased Catalan autonomy, viewing it as a forerunner for eventual independence. This group's popularity has grown among radical separatists as the ERC has demonstrated that its support for Catalan independence is unwavering. Polls suggest that the ERC will likely take 45-46 seats in the election, the largest number of seats.<sup>4</sup>

**CUP** represents the left-wing populist movement. This group believes that Catalonia should not only be independent from Spain but also leave the EU. Despite having the least amount of support compared to the other two groups, it has the most strident supporters. As a result, this group has been able to exert a disproportionate amount of leverage in the push for Catalan independence. Polls suggest that the CUP will garner 7-8 seats in the upcoming elections.

**How they fit:** The Catalan Parliament has a total of 135 seats. Prior to the triggering of Article 155 of the constitution, separatists held a majority of seats. In the previous election, PDeCat and ERC joined forces to form a coalition group called Junts pel Sí (JxSi), or "Together for Yes," and they were able to form a government with the help of CUP. That being said, despite the success of JxSi in the past, they will not form a coalition for the upcoming election as moderate separatists within PDeCAT have expressed dissatisfaction with the direction

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<sup>4</sup> <https://www.gad3.com/single-post/2017/11/05/Barometro-de-noviembre-de-2017-para-La-Vanguardia>

of the coalition.<sup>5</sup> The lack of a coalition will probably threaten the separatists' ability to form a government as their projected win is only slightly above the majority. Separatists need 68 seats in order to form a majority; current polls suggest they will take between 66 and 69 seats in the upcoming election.

**Leader of the Separatists:** The face of the Catalan secessionist movement is former Catalan President Carles Puigdemont. Prior to becoming president, Puigdemont was the mayor of Girona, a small town in Catalonia. Puigdemont was chosen by the JxSi to gain CUP support to form a government. CUP members were confident in Puigdemont's ability to fight for Catalan independence as many of his admirers noted that he was a separatist "before it was cool."

After taking office, Puigdemont, a member of PDeCaT, has walked a fine line between remaining loyal to his party and remaining loyal to the separatists. Following the results of the referendum, Puigdemont pleaded with the Spanish central government to open a dialogue with the Catalan government in order to avoid a declaration of independence. The central government refused and threatened to trigger Article 155 of the constitution in the event of a declaration by him or his government. In addition, the Spanish government stated it was considering filing charges of sedition, misappropriation of funds and rebellion against him and others in charge of the referendum.

On October 27, Puigdemont decided to allow the Catalan Parliament to vote on whether Catalonia would declare independence from Spain. Earlier that day, it was rumored that Puigdemont was willing

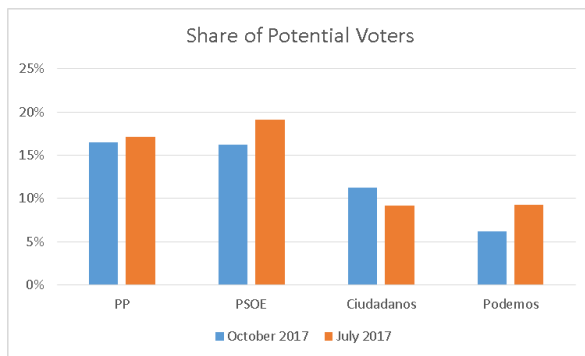
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<sup>5</sup> <http://www.ccma.cat/tv3/alacarta/noticies-324/no-hi-haura-candidatura-conjunta-de-lindependentisme/video/5700541/>

to renounce Catalan independence in exchange for guarantees that he would not be arrested and Article 155 would not be triggered. The day of the vote, Parliament achieved a majority in favor of Catalan independence, with 70 out of 135 votes, although 50 members chose not to participate. Following the vote, Puigdemont fled to Belgium and has remained there since. While in Belgium he has maintained that he is still the rightful president of Catalonia, and has vowed to continue the fight for Catalan independence.

**Spanish Unionists**

The unionist movement is being driven at the national level by primarily two establishment parties, the Spanish Socialist Workers’ Party (PSOE at the national level; PSC is the regional Catalan group) and the People’s Party (PP), as well as a Catalan fringe party, Citizens (Cs). Although these groups do differ ideologically, there is a broad agreement among them to protect the Spanish Union.



(Source: Center of Sociological Investigations)

**PSOE** represents the national center-left in Spain. This group believes that the government should be more decentralized. As such, the PSOE has historically been open to talks with Catalonia about increased autonomy. That said, the group is strongly in favor of maintaining the union and supported the limited use of Article 155.

For example, PSOE allowed the Catalan government to maintain control of its media. A recent poll by a Spanish polling agency suggested that PSOE lost some of its support during the referendum. According to the poll, potential PSOE voters fell by 2.9%, from 19.1% to 16.2%, from July to October. As a result, it fell behind its rival, PP, in popularity.<sup>6</sup>

**PP** represents the national center-right. This group believes that everyone with Spanish citizenship are Spaniards regardless of their ethnicity. PP has consistently balked at Catalonia’s demands for increased autonomy. Following the referendum, this group proposed the use of Article 155, viewing it as the only means to wrest control away from the Catalan separatists who it believes are a vocal minority. Despite polls showing that the share of potential voters for PP has fallen from 17.1% to 16.5% since the referendum, this group currently has the largest share of potential voters.

**Citizens (Cs)** represents the national center-right group and is based in Catalonia. This group believes that Catalonia should remain within Spain and generally opposes decentralization. Cs has been the PP’s primary ally and also advocated for the use of Article 155 to restore order in Catalonia. Polls suggest that potential Cs voters rose by 2.1%, from 9.2% to 11.3%. This group has seen the largest jump in support.

**How they fit:** In a rare sign of unity, PSOE and PP joined together to vote for the triggering of Article 155 of the constitution. It is worth noting that the alliance of PP and PSOE shows this was done out of a perceived duty that superseded their usual political differences. Typically, when a rival

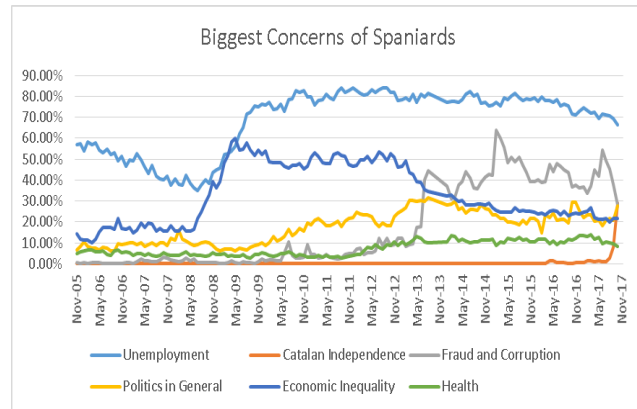
<sup>6</sup> [http://www.cis.es/cis/export/sites/default/-Archivos/Indicadores/documentos\\_html/sB6060500\\_10.html](http://www.cis.es/cis/export/sites/default/-Archivos/Indicadores/documentos_html/sB6060500_10.html)

political party receives the amount of negative press as the PP did during the October 1 referendum, we would expect a leadership challenge or at least a no-confidence vote by the rival party. However, since the referendum, PSOE resisted the urge to call for new elections, which suggests broad support for Spanish unity.

**Leader of the Unionists:** The face of the Spanish unionist movement is PM Mariano Rajoy. The prime minister not only believes that he has a duty to protect the union of Spain, but also has the right to defend the rights of unionists that live in Catalonia. Rajoy believes that the upcoming election will validate his claim that separatists do not represent the majority of Catalans.

From a strategic standpoint, Rajoy may have used the Catalan independence movement as a way to rile his party base and divert attention away from allegations of political corruption. Because Rajoy runs a minority government, his position has always been under threat from rival factions. In August, he survived a no-confidence vote due to fraud allegations made against members of his party. Current polls suggest that the Catalan crisis has given him a boost. According to the Center of Sociological Investigations, the Catalan crisis has replaced political fraud as the second biggest concern of Spaniards. In a span of one month, the Catalan crisis rose from 7.8% to 29.8%, whereas political corruption dropped from 38.0% to 28.3%.<sup>7</sup> The number one worry is unemployment, with 66.2% of Spaniards identifying it as their highest concern.

<sup>7</sup> [http://www.cis.es/cis/export/sites/default/-Archivos/Indicadores/documentos\\_html/TresProblemas.html](http://www.cis.es/cis/export/sites/default/-Archivos/Indicadores/documentos_html/TresProblemas.html)



(Source: Center of Sociological Investigations)

**Possible Outcomes**

The Catalan parliamentary election on December 21 is expected to see 80% turnout. As a result, the election will likely determine the direction of Catalan independence. If the Catalan separatists lose their majority in the parliament, we assume that the status quo will likely remain intact, at least in the short-term. So far, Prime Minister Rajoy has shown confidence that the separatists will fail in the upcoming Catalan parliamentary election. He has even advocated for freeing the politicians that were jailed and the safe return of former Catalan President Puigdemont. If the election does play out in his favor, we also expect Rajoy to call for national elections in 2018 in an effort to form a majority government.

If the separatists win a majority in the election, it will likely lead to a more assertive Catalan government as it would reaffirm their claims that most Catalans do not see themselves as Spanish. We expect that a separatist majority would likely double down on claims of sovereignty. Although we do not believe Spain will allow Catalonia to secede, this outcome would probably force PM Rajoy to the negotiating table and lead to another no-confidence vote against the current government.

**Market Ramifications**

Our analysis suggests that there is not enough support for Catalan independence. If we are correct, financial markets in Spain should stabilize. That being said, a

separatist win would likely be bearish for the euro.

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*This report was prepared by Thomas Wash of Confluence Investment Management LLC and reflects the current opinion of the author. It is based upon sources and data believed to be accurate and reliable. Opinions and forward looking statements expressed are subject to change without notice. This information does not constitute a solicitation or an offer to buy or sell any security.*

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