

August 1, 2022

Political Crises for Top U.S. Allies

It's been a hot summer for some of the United States' key allies, and we don't just mean the weather. We've seen a major political assassination in Japan, the scandal-driven ouster of a prime minister in the United Kingdom, and a failed vote of confidence that led to the resignation of the prime minister in Italy. Since all these political crises happened in such a short amount of time, we decided to explain each of them in this report and discuss their common features and geopolitical implications. As always, we end with a discussion of the ramifications for investors.

Japan

[The most violent of the three crises was in Japan, where Former Prime Minister Shinzo Abe was shot and killed while giving a campaign speech for a member of his party on July 8.](#) Fortunately, the assassination did not appear to reflect any broader turn toward political violence in Japan. By all accounts, the assassin was motivated solely by anger over his mother's financial problems, which apparently stemmed from her large contributions to a religious group supported by Abe and other high-profile Japanese leaders. [Nevertheless, the killing silenced one of Japan's most important political figures who had continued to influence the country's domestic and international policies despite resigning for health reasons in September 2020.](#) A key question is whether Abe's absence from the political scene will now weaken his policy legacy.

Ironically, nostalgia for Abe and sympathy over his death seem to be having the opposite effect: current Prime Minister Fumio Kishida, who served as foreign minister through most of Abe's nearly nine years in power between 2006 and 2020, appears to be capitalizing on Abe's death to continue pushing some of the former leader's proposals. [For example, in the elections for Japan's upper house of parliament, held just two days after Abe's death, Kishida's coalition performed significantly better than anticipated, winning most of the seats being contested.](#) Importantly, the coalition may have won enough seats to push through constitutional revisions.



Former Prime Minister Abe, moments before his assassination. (Source: CNN.com)

With his strong new position in parliament, Kishida has called for accelerated discussions on amending Japan's pacifist constitution to affirm the legality of the country's military forces and grant the government new authority to deal with national emergencies—ideas long advocated by Abe. [The proposed constitutional amendment would require a two-thirds vote in both houses of the legislature, but with Kishida's strengthened majorities and rising](#)

[popular concern about China’s geopolitical and economic aggression, the amendment may have a better chance of passing than when Abe failed to push it through.](#)

- Shifting Japan’s constitution away from its current pacifist orientation would complement other initiatives Kishida has launched to boost the country’s defense capabilities, including a [planned hike in its defense budget](#), the development of [new offensive missiles](#), and closer military cooperation with the U.S. and other allies. [If implemented, these changes would likely make Japan a more important player in the evolving U.S.-led geopolitical bloc.](#)
- In domestic economic policy, Abe’s shadow may be more problematic. Kishida continues to pursue most of the famous “Abenomics” program, including accommodative monetary policy, loose fiscal policy, and deregulation to enhance economic efficiency and bring more women into the labor force. [However, he has also championed a “New Capitalism” program in which the government would adopt some wealth and income redistribution policies aimed at greater equality.](#) Kishida is a member of the Liberal Democratic Party, just as Abe was, but he belongs to a more liberal faction and even criticized Abenomics for worsening wealth and income inequality in his electoral campaign. At least until the nostalgia for Abe dissipates, it could hinder Kishida’s push for redistributionist policies.

United Kingdom

In the U.K., the domestic political turmoil wasn’t nearly as sudden. [After a long series of scandals, Prime Minister Boris Johnson was forced to announce his resignation as the head of government and Conservative](#)

[Party leader on July 7.](#) Johnson’s political position worsened dramatically early in 2022 when investigations revealed that his government had flouted its own pandemic social-distancing regulations. Johnson himself was fined for breaking those rules and attending a boozy party in the prime minister’s offices at 10 Downing Street. The final straw was a scandal over Johnson’s decision to fill a parliamentary whip position with an official accused of sexually harassing multiple men both in and out of government.

After Johnson’s resignation announcement, eight Conservatives in parliament threw their hats into the ring to replace him, forcing multiple rounds of voting designed to whittle down the field to just two candidates. [The remaining candidates will now spend the rest of the summer courting the party’s grassroots members, who will cast the deciding votes by September 5.](#) Johnson would step down as caretaker prime minister the next day. The two finalists are:

- Former Chancellor **Rishi Sunak**, a moderate conservative who became wealthy in part through his marriage to the daughter of an Indian billionaire and in part through his work as an investment banker and hedge fund manager prior to entering public service. In his role as chancellor in Johnson’s government, Sunak developed key income-support programs for people and businesses affected by the coronavirus pandemic, while also insisting on increased taxes and fees to keep the budget deficit in check.
- Foreign Minister **Liz Truss**, a darling of Britain’s more conservative voters who grew up in a far-left household and worked for progressive causes in her youth, only to shift to the right as an adult. Although she initially voted

against Britain’s withdrawal from the European Union in 2016, she later became an ardent proponent of Brexit under Johnson. She casts herself as a virtual reincarnation of conservative icon Margaret Thatcher in her oratory, her fashion style, and her proposals for [more fiscal spending, lower taxes, greater control over monetary policy](#), and deregulation.



Former Chancellor Rishi Sunak. (Source: Tatler)

With Sunak and Truss as the candidates to succeed Johnson, the race has become a test of strength between the Conservatives’ moderate elites and their more demanding populists. The latest polls suggest Truss is most likely to win. That’s important because Truss’s policies could be a radical change from Johnson’s. She would likely continue Johnson’s unyielding demands for greater post-Brexit autonomy from the EU, possibly to include breaching the “Northern Ireland Protocol” that essentially imposes border controls between the U.K. and Northern Ireland. However, some of her domestic economic proposals would take a different approach. [For example, she has suggested changing the Bank of England’s monetary policy mandate to target the](#)

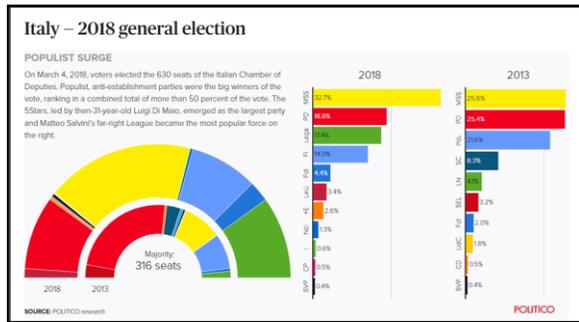
[growth in Britain’s monetary supply – an approach reminiscent of Paul Volcker during his chairmanship of the Federal Reserve in the 1980s.](#)



Foreign Minister Liz Truss. (Source: Bloomberg)

Italy

[In the most recent of our three crises, Italian Prime Minister Mario Draghi lost the support of the right-wing parties in his fractious government and was forced to resign definitively on July 21.](#) Despite not being elected, Draghi had been nominated to serve as prime minister by President Mattarella in early 2021. He agreed to take on the job, but because he lacked an electoral mandate himself, he insisted that he would only lead a “unity government” that was broadly inclusive of all major political parties in parliament. The government he put together included parties ranging from the populist Five Star Movement, the right-wing League, and the center-right Forza Italia to the center-left Democratic Party and Italia Viva, and the left-wing Free and Equal Party. All told, the government coalition held 519 of the 630 seats in parliament. However, the breadth of policy preferences within it made it ever more fractious. The final straw came when the populist Five Star Movement, which has long admired Russia, objected to Italy’s continued support for Ukraine in its fight against Moscow’s invasion.



Party representation in Italy’s parliament after recent elections. (Source: Politico)

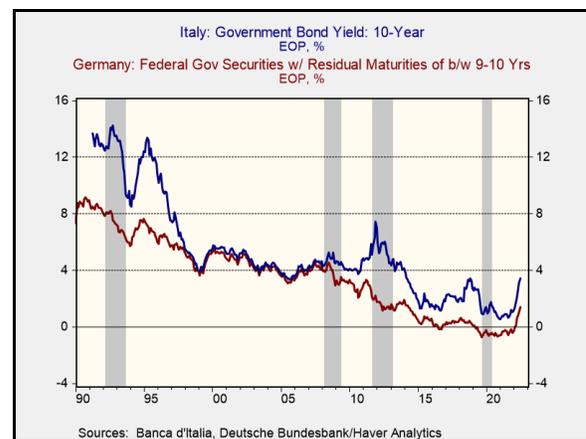
Powered by his stellar reputation from saving the Eurozone from a breakup in his previous stint as head of the European Central Bank, Draghi had begun to make progress pushing through long-needed reforms to Italy’s judicial system and economic policies. That success had helped improve investor views of Italy, leading to stronger demand for the country’s sovereign bonds and driving down their yields. However, some of the most important reforms were still yet to be finalized in the government’s budget for next year and were due to be passed by parliament in late 2022. Besides setting the stage for Italy to potentially enjoy stronger, more stable economic growth, those reforms would also unlock the remaining \$200 billion or so of the EU’s massive pandemic relief program and help keep Italian bond yields under control.

Italy will now face new parliamentary elections on September 25. Current polling suggests that right-wing, populist, and Eurosceptic parties are likely to win that election and form a new government, threatening Europe’s economic stability and its support for Ukraine.

Geopolitical Implications

The three crises described here may seem separate and different, but we think they reflect some common themes that are important to understanding today’s

geopolitical trends. For example, the quick response of Japan’s government to Abe’s assassination and the sudden leadership changes in the U.K. and Italy should remind investors in the U.S. and other countries with presidential government systems that parliamentary systems can be less stable. Or, from another perspective, they can be more responsive to the changing demands of the electorate. Investors need to be especially alert to the potential for sudden policy changes in such countries.



The three crises also show the ascendancy of more conservative, populist politicians across the world’s highly developed democracies. In Japan, Abe may have been the country’s longest-serving prime minister, and although he remained popular, he was never able to fully implement his vision of a stronger Japanese military and a foreign policy that was more assertive in promoting Japan’s national interests. Those policies are now set to be implemented by a successor who was long seen as more progressive. In the U.K., the Conservative Party leadership race has revealed the strength of more conservative populists who want to focus on national strength, independent foreign policy, deregulation, and low taxes, but not necessarily lower spending. In Italy, Draghi’s fall reflects a similar rejuvenation in Italy’s right wing.

Investment Ramifications

For investors, the three crises have both short-term and long-term implications. In the short term, Britain's upcoming party election and Italy's impending national poll could be uneventful if they are won by relative moderates like Sunak. However, if they are won by politicians who are more populist and farther to the right, like Truss or Brothers of Italy leader Giorgia Meloni, bigger policy shifts may be in the cards. Those shifts would likely favor corporate tax cuts and deregulation. That may sound good for investors, but it's important to remember that today's right-wing populists often espouse policies that can be less business-friendly, like controls on international capital flows, trade protectionism, less independence for central banks, and new regulations and spending to benefit the working class. The near-term risk could be especially high for Italy, causing its sovereign bond yields to blow out and threatening the unity of the Eurozone.

In the U.K., however, the Truss proposals to match big spending with low taxes and very tight monetary policy could be more positive, eventually touching off a strong rally in the pound.

In the longer term, we see disparate positives and negatives. In Japan and the U.K., which together are two of the U.S.'s most important allies, any probable policy impact is likely to bolster, not weaken, those countries' military capabilities and commitment to today's global order. In Italy, however, the advent of a populist, right-wing government could threaten the Eurozone or the ECB's ability to implement its monetary policy. It could also fracture the EU's foreign policy and lend support to authoritarian countries like China and Russia. Over the long term, that would likely hasten the fracturing of the world into relatively separate geopolitical and economic blocs, with negative impacts for supply chains, productive efficiency, corporate profits, and inflation. As we have argued before, such a deterioration in economic efficiency would likely be negative for corporate profit margins and stock prices, while the accompanying inflation would likely weigh on bonds. On the other hand, the potential for supply disruptions would likely buoy commodity prices.

Patrick Fearon-Hernandez, CFA
August 1, 2022

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