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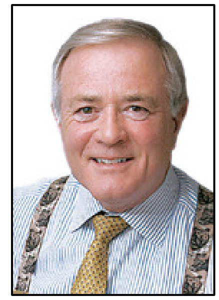

William Rutherford

Et tu, Italia?

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When the early returns of the Italian election for prime minister came in on Feb. 25, the markets took a steep dive. Voters were asked to prolong the policies of Mario Monti, prime minister since 2011.

Monti was considered a technocrat; he had led Italy into a policy of austerity. This financial approach was considered a road map for Spain, Portugal and perhaps France. Greece had already reluctantly stated down this path.

The Italian people were not happy with this austerity even though the financial markets, the Eurozone and the Euro had found comfort with this policy. Under Monti, Italian bonds found a bid, with lower interest rates, and the Eurozone had taken a respite from an extremely volatile period. Europe – Italy specifically – seemed on the mend.

The election featured an array of candidates, including a professional comedian and political buffoon, former Prime Minister Silvio Berlusconi. Already convicted of tax fraud, sentenced to four years in jail and under indictment for sex crimes involving minors, Berlusconi ran on a campaign of a repeal of austerity and Laissez les bons temps rouler (Let the good times roll). For instance, he pledged to return all property taxes paid in the prior year, among other giveaways.

Given the choice between austerity and good times, Italians chose "La Dolce Vita;" they tossed Monti, and placed Berlusconi in a position to win the prime minister's job again. Bond markets and equity markets were shocked and tumbled. Investors, already discouraged by Europe, pulled to the sidelines and dumped stocks. The U.S. equity market suffered its biggest drop of the year, 216 points on the Dow. Bonds rallied.

There was good basis for investor concern, because not only did the Italian elections worry local markets, but Spain, Greece, Portugal and France also looked to be a greater risk. Eyes again turned to Germany, and to Angela Merkel specifically.

The Germans alone had previously stood fast and held the eurozone intact. France, though willing to help, no longer had the economic or political will. Others who might help did not have the economic heft of the Germans. Merkel held the key, and she had just suffered an embarrassing setback in state elections. It was not clear that her government was secure. No wonder the markets tanked.

However, a strange thing happened on the way to the theater. When investors surveyed the damage and sought refuge for their money, the U.S. looked attractive. Big enough to absorb large amounts of money and with fixed-income markets yielding tiny sums, U.S. equities looked good, and the next several days saw powerful rallies in the U.S. equity markets. The Dow recorded all-time highs, accompanied by Dow Transports with the S&P not far behind. The status of the U.S. as the best house in a bad neighborhood was confirmed.

The U.S. is no beauty. With unemployment still at high levels, a budget impasse and sequestration just around the corner, the U.S. was not very attractive – but it was still better than most. It was still a fixer-upper.

The statistics for the past 10 years in the U.S. have been overwhelmingly negative, except when compared with all the rest of the markets. According to Bloomberg Businessweek (Feb. 24), the median U.S. household lost 47 percent of its wealth from 2007 to 2010. Between 2001 and 2010, household wealth dropped from $90,500 to $57,000 – less than it was in 1983. Yet investors who had stayed the course from the March 2009 lows were now finding their portfolios repaired as U.S. markets marched toward all-time highs.

The Italian elections contained lessons for U.S. politicians in the face of sequestration (the chopping of expenditures for the U.S. budget), and an austerity program much like Europe. President Obama ran against just such a program in the last election when he pledged to raise taxes to preserve sacred programs. The Republicans ran a program of austerity, pledging cuts to the budget. In a precursor to the Italian elections, voters rejected the Republican approach and embraced the president's approach.

We have now reached a stalemate in Washington, where the same policy battle is being fought. If the election results out of Italy are any indication, we know how the battle will turn out. Republicans have their supporters, but not enough to carry the day. President Obama appears to have the upper hand in the negotiations, so I do not anticipate any significant debt reduction. A stalemate may be the best that can be achieved. Indeed, as the deadline for sequestration passed, the parties agreed to a truce until November 2013, and stood down.

Fed Chairman Ben Bernanke, in two days in testimony before Congress, pled for politicians to get their fiscal house in order. But we know that is not going to happen. It is not clear what will break this impasse; however, until it is resolved, we will continue in this malaise.

Now is a good time to remember that for generations, through difficult times and good, the U.S. economy has grown. Every tomorrow brought risk; yet the U.S. has prospered, just not at an even rate.

Left with the state of affairs in Europe and the U.S., investors can expect a continuing state of volatility. Indeed, the Volatility Index has hit highs for the year after being somnolent for some time. For the time being, investors should stay invested in solid, proven companies with good earnings and prospects for a decent dividend. It will be a bumpy ride.

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