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## Disruption from Catalonia

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The events in Catalonia are a new disruptive political element on the capital markets. The basic question is whether the generally favourable environment for risky assets is sustainable.

### Favourable environment

Growth indicators such as the purchasing managers indices by Markit and the leading indicators by the OECD continue to suggest strong, broadly based global economic growth. At the same time, inflation is low in many countries and the monetary policies pursued by the central banks are very supportive, i.e. key-lending rates are low. That being said, more and more central banks have been reducing their very expansive monetary stance. – For two reasons: economic growth has become more self-sufficient; and forecasts suggest a moderate increase in (the currently excessively low) inflation towards the central bank target. The most important central bank of the world, i.e. the US Fed, has increased the Fed funds rate four times already to currently 1.125%. The statements made by Fed members indicate another rate hike for December. The European Central Bank will very likely announce on 26 October that it is going to taper the bond purchase programme from January 2018 onwards. While political events such as the Brexit referendum and Donald Trump's election as US President have had their repercussions on asset prices, the general environment has remained favourable for risky assets such as equities.

### Higher risk premium (spreads)

The referendum in Catalonia has led to widening spreads i.e. risk premiums, for Spanish bonds relative to credit-safe German government bonds. Prior to the referendum, on 29 September, the yield differential for 10Y maturities amounted to 1.14 percentage points; at the moment, it is 1.34 percentage points. We can also see certain spill-over effects: the spread of Italian vs. German government bonds has widened from 1.65 to 1.75 percentage points.

### Illegal referendum

According to the referendum of 1 October, 90% of the votes cast were in favour of independence. However, the referendum itself was deemed illegal. It is generally prohibited by the Spanish constitution. The Spanish government has also declared it illegal. Voter turnout was only 40%. This suggests that the supporters of staying with Spain did not even cast their vote. Also, an orderly process could not be guaranteed, not the least due to the seizing of ballot boxes and police brutality.

### Self-determination

Catalonia has a long tradition of independence movements. This is among other things due to efforts to maintain an independent culture. Also, the disproportionately high contribution to the Spanish budget is often mentioned. If this were to suffice for self-determination, many states would have already fallen apart. Catalonia is not suppressed by the Madrid government, even though the use of police brutality on the day of the referendum might have suggested a different narrative. The behaviour shown by the central government could therefore play into the hands of supporters of the independence movement.

### Independence

What is next? In the coming days, Catalonia may unilaterally declare independence. But for actual independence, two conditions would have to be met: 1) Monopoly over the legitimate use of executive power within clearly defined geographic borders; and 2) international recognition.

Neither of the two conditions are being met. The European Commission is taking the stance that this is an internal, Spanish issue. Even if the Commission were to only assume the role of mediator, the topic of Catalonia as independent state would gain in legitimacy. This is not the Commission's goal.

### Negotiations about autonomy

Of course, the decision in favour of independence is ultimately always a political one. This is what the Catalanian government seems to bank on. This leaves us with two possible developments after the possible unilateral declaration of independence: 1) Imminent negotiations about the expansion of the autonomy; and 2) the suspension of autonomy and/or arrest of the Catalan politicians, and the refusal to enter into negotiations by the central government. If the pressure on the streets were to increase, snap elections could be the result in Catalonia or indeed, in Spain. If the parties supporting independence won said elections, negotiations would probably be launched – although they would be geared towards a higher degree of autonomy rather than independence.

### Politics as driving factor

The developments in Catalonia differ from other political tendencies in the EU in one point. Catalonia wants to remain both in the EU and the Eurozone. Indeed, a State of Catalonia does not make sense outside the EU from an economic point of view. However, frictions might intensify. In this case, spreads might be widening. Still, other factors are more relevant for the capital market. For example, we were positioned for a moderate widening of spreads in the Eurozone vis-à-vis German government bonds even before the referendum in Catalonia (via the underweighting of Italy). This was mainly due to the uncertain outcome of the elections in Italy next year. Along with the favourable economic development, political events therefore remain an important driving factor for the capital market in the Eurozone.

**The environment remains favourable for risky assets as long as the central banks continue to act cautiously and political developments do not escalate (trade war, hard Brexit, North Korea, chaos in Spain).**

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