MARKET INSIGHTS

Market Bulletin

19 May 2017

Political risk in Europe has fallen

IN BRIEF

2017 was billed as a year of potential political turmoil for the eurozone. Investors feared that elections in the Netherlands, France and Germany could lead to a victory for an anti-euro party plunging the very future of the eurozone into doubt. Instead, political risk has so far proved to be all bark and no bite, with voters in both the Netherlands and France following the Austrians in rejecting populist anti-euro candidates. The risk of an anti-euro victory in Germany in September is negligible. The biggest risk to the euro remains Italy, where popular support for the euro is much lower than elsewhere in Europe. Even in Italy though, a referendum on euro membership, is not the most likely outcome following the election. In the UK, the Conservative Party look likely to increase their majority but the outcome of the Brexit negotiations remains highly uncertain although continued single market membership remains very unlikely.

GERMANY – FEDERAL ELECTION IN SEPTEMBER – RISK TO EURO EXTREMELY LOW

What is happening?

The year started so well for Martin Schulz and the Social Democrats (SPD). After he had secured the candidacy in a surprise upset, the Social Democrats surged an unprecedented 10% in the polls transforming an apparently boring re-election bid by Angela Merkel into a tight race. Two weeks later, in mid-February, the SPD inflicted a defeat on Angela Merkels's Christian Democrats (CDU), securing the presidency for Frank-Walter Steinmeier. The German president has only symbolic duties, but the election was significant since it marked the first time that the CDU was unable to nominate a candidate.

Since then, however, the pendulum has swung back in favour of Chancellor Angela Merkel's CDU, with three successive disappointments for the SPD in state elections. In Saarland, Schleswig-Holstein and North Rhine-Westphalia (NRW) the CDU secured the necessary majority to appoint the next state prime minister. The recent defeat in NRW, the most populous state in Germany, was particularly painful for the Social Democrats, given that the state is traditionally viewed as SPD-heartland. The swing in electoral support from the centre-left to the centre-right since 2012 makes it once again possible to imagine a coalition between the CDU and the free market Free Democratic Party (FDP) after the federal election on September 24.

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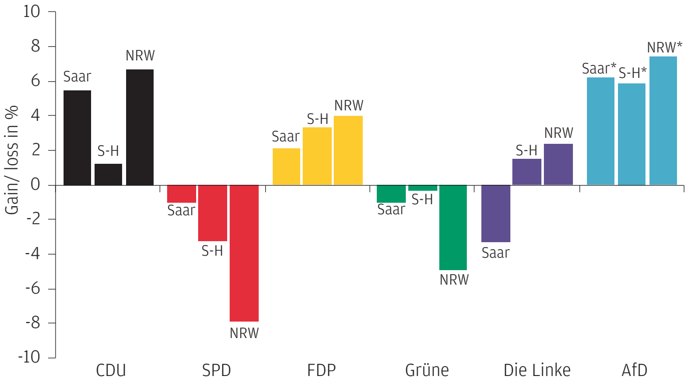
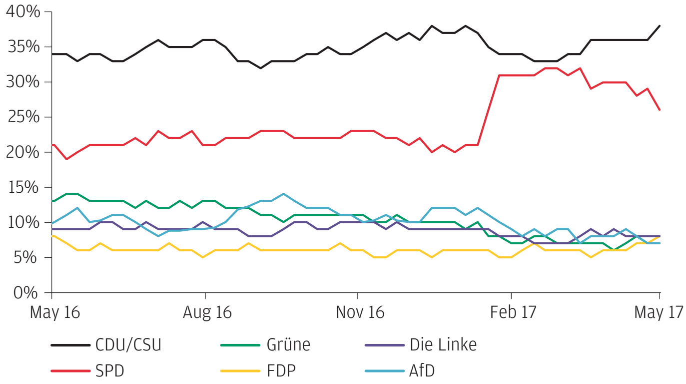
EXHIBIT 1: GAIN AND LOSS IN POPULAR VOTE IN % VS. 2012 STATE ELECTIONS



Source: www.wahlrecht.de, J.P. Morgan Asset Management data as of 18 May 2017.
*NRW= North Rhine Westphalia, S-H= Schleswig-Holstein, Saar= Saarland.

EXHIBIT 2: LATEST POLLS ON GERMAN VOTING INTENTIONS



Source: Forsa, J.P. Morgan Asset Management; data as of 18 May 2017.

Though the betting now favours Angela Merkel, her re-election as Chancellor is not a done deal, for three reasons. First, because state elections scheduled before the federal election are somewhat influenced by federal politics but they are still dominated by local politics and issues. Second, the 2005 campaign between Chancellor Schröder (SPD) and Merkel (CDU) shows that even a healthy margin in the polls can erode very quickly. Schröder's SPD trailed the CDU by almost 20% after the surprising defeat in NRW, but was able to close the gap to only 1% on election day. As of today Martin Schulz is trailing Angela Merkel by 12%. Based on the current polls, the following coalition governments are possible:

- Grand coalition (CDU/SPD) currently with 64% of popular vote; Chancellor Angela Merkel
- "Jamaica coalition" (CDU/FDP /Green) currently with 53% of popular vote; Chancellor Angela Merkel
- Center-right coalition (CDU/FDP) currently with 46% of popular vote; Chancellor Angela Merkel
- Red-Red-Green (SPD/Linke/Green) currently with 41% of popular vote; Chancellor Martin Schulz

No other combination is currently likely, since all parties rule out a coalition with the right wing populist party Alternative für Deutschland (AfD). The eurosceptic and anti-immigration party AfD managed in all three of the recent state elections to jump over the 5% popular vote threshold to enter into the local parliaments for the first time, but the gains were much smaller than initially expected. The left populist party Die Linke failed to clear the 5% threshold in two state of the three state elections. On the face of it, the declining refugee crisis and the strong state of the economy have weakened the appetite for radical change among German voters.

Key issues and implications for investors

Looking at the current data, Germany's economy is in a comfortable position. At 3.9%, the unemployment rate is at a record low, while net exports are at a record high, consumer sentiment is benign, and the fiscal budget is in balance. In the latest 5 year projection from the Federal Ministry of Finance the cumulative tax revenues are expected to be 55 billion euros higher than in last year's projection.

Against this favourable backdrop, the political debate is less about economic reforms than it is about living standards and the preservation – and redistribution – of wealth. Both Chancellor Merkel and the Christian Democrats are likely to raise the idea of tax relief on middle-income households, while Schulz and the Social Democrats want an increase in spending for education and infrastructure, financed partially by higher taxation of the wealthy and capital income. However, the recent local election defeats suggest that the Schulz camp will need to broaden its message to succeed. Social justice and equality do not seem appealing enough to bring him enough votes to overtake Merkel.

Recent developments in Germany should offer some reassurance to investors that populism in Europe is losing momentum and a political black swan event out of Germany is now a very low probability. We could see uncertainty about the federal election in September reflected in bond markets, if a victory for Martin Schulz becomes more likely. If the former president of the European parliament (and strong advocate of Eurobonds and a European deposit insurance scheme) succeeds the spreads between Bunds and periphery bonds should tighten. A Schulz victory, on balance, could also make a hard Brexit scenario more likely – adding further pressure on sterling. But a Merkel victory would likely have much less impact on financial markets and would be seen as business as usual.

ITALY – ELECTION BY MAY 2018 - RISK OF EURO EXIT IS NON NEGLIGIBLE BUT NOT THE BASE CASE

What is happening?

Populist winds in Europe may be abating, but Italy remains the one European country where anti-establishment and anti-euro parties still pose a significant risk. The constitutional court decided in January that there should be no second round in elections to the lower house of the Italian parliament. A party gaining 40% of the vote in the first and now only round would still be awarded a majority of the seats though. The removal of the second round of voting has reduced the risk that any anti-euro party will be able to govern Italy alone after the elections, as no party is currently polling close to 40%. However, while the risk of an anti-euro government is not the most likely outcome, the risk has not been completely removed.

In March, the former ruling party, the Partito Democratico (PD), decided to split into two, with the anti-reform extreme left wing of the party creating a new progressive, democratic movement. In the short term, the split has weakened the PD and increased the power of the main anti-establishment party, the Movimento 5 Stella (M5S). The PD and M5S have been running neck and neck, with each commanding around 30% in the polls, but lately the pendulum has swung slightly in favour of M5S.[1]

However, the split could pave the way for former prime minister, Matteo Renzi, to regain leadership of the party in May, with a victory potentially giving him a fresh opportunity to re-launch the PD with a renewed focus on reform and innovation.

Italy must hold a general election by May 2018, and M5S has called for a vote as soon as possible in order to take advantage of its positive position. However, the president, Sergio Mattarella, is against early elections under the current system, which elects members to the Senate and the Lower House using slightly different rules, and there is little sign that the parliament will agree legislation in the short term to give both chambers the same system.

Against this backdrop, the government of Paolo Gentiloni, who replaced Renzi as prime minister after the failed constitutional referendum in late 2016, is proving unexpectedly resilient. Gentiloni still has sufficient support in the Senate and the House to drive the current coalition to the natural end of the legislature in the spring of 2018.

Key issues and implications for investors

Italy remains a key area of political concern for Europe and is the only large country in the eurozone where popular support for membership in the single currency is below 50%[2]. Early elections cannot be excluded, and the reality is that only one of the country's four leading political parties is an active supporter of Italy remaining in the eurozone.

However, investors should weigh these concerns against some compensating positives. Early elections in Italy are still unlikely, particularly given lack of progress on the approval of a new, single electoral law for the two chambers of Parliament.

When elections do occur, it is not the most likely outcome that the anti-establishment M5S would win an outright victory. It is also unlikely that M5S would be able to form a coalition government, given the ideological obstacles it would face forming a coalition with either Lega Nord or Forza Italia, the other parties that are either tepid or hostile towards the euro.

Under Renzi's renewed leadership, the PD is likely to become a more centrist and reformist movement. This could attract some of the voters that were previously in favour of other centrist parties like Forza Italia, which is still in search of a new identity and a more solid leadership.

For better or worse, the next election in Italy is likely to increase the fragmentation of Italian politics. This is not helpful from an investment standpoint, since it would make important reforms more difficult and continued political uncertainty more likely. However, it should also make it much harder for any single party to take the country out of the eurozone.

For Italy, leaving the eurozone would also mean leaving the European Union, and that would require major constitutional reform—something that a weak coalition government might struggle to push through. In fact, leaving Europe has featured less prominently in M5S rhetoric in recent months.

Spreads between 10-year Italian bonds and German bunds remain higher vs. Spanish bonds, although they have fallen since the French presidential elections, in line with other European countries. However, the Italian equity market has been one of the eurozone's best performing markets this year, second only to Spain. Investors appear, probably correctly, to place a relatively low probability on Italy calling a referendum on leaving the euro.

1 Note: The average of various polls provided by EMG, Ipsos, Tecnè, SWG at the beginning of May 2017.

2 Source: http://ec.europa.eu/economy_finance/articles/euro/2016-12-09-eurobarometer_en.htm

UNITED KINGDOM – ELECTION ON JUNE 8TH – LARGER CONSERVATIVE MAJORITY WOULDN'T REMOVE BREXIT UNCERTAINTY

What is happening?

The UK is unexpectedly holding a general election on 8 June after the prime minister, Theresa May, overrode legislation intended to fix the length of parliaments at five years. She said the surprise election was necessary to obtain a "clear mandate" for negotiating the terms of Britain's exit from the European Union (EU). Whatever the main motivation, by holding the election now May can be reasonably confident of increasing her parliamentary majority due to the low standing of the opposition Labour Party. How the result will affect future Brexit negotiations is much less clear.

Recent polls suggest that the ruling Conservative Party will receive slightly more than 45% of the vote in the election. The Labour Party is forecast to gain about 30% of the vote with all other parties trailing significantly behind. Current forecasts suggest the Conservatives will win a landslide victory with a much larger majority in parliament than they currently have.

Given the polling suggests a comfortable victory for the Conservatives, markets are already pricing in a continuation of the current government. The election itself is therefore unlikely to be a major event for markets. Sterling has rallied since the election was announced on the assumption that it would reduce the pressure on Theresa May to deliver Brexit by 2019 and give her potentially until the end of the next parliament in 2022 to negotiate some sort of trade deal with the EU. Whether this assumption proves to be correct, and what that trade deal might include, only time will tell.

The outlook for the Brexit negotiations will remain highly uncertain, even with a larger Conservative majority, because the prime minister has herself ruled out "softer" forms of Brexit, in the Conservation manifesto. The fact that there will not now be an election in 2020 might make it slightly easier for the UK to negotiate a two or three year transition period for leaving the EU, which would be helpful for businesses struggling to adjust. But the prime minister shows little sign of softening her insistence that the UK will leave the single market and the EU Customs Union. She has also flatly ruled out the possibility of the European Court of Justice having any role in UK laws and regulations after Brexit. These conditions together suggest that the UK will end up with significantly less access to EU markets after Brexit, especially in services.

Key issues and implications for investors

These basic realities explain why we do not expect sterling to recover its losses since the referendum anytime soon. However, we would expect a degree of volatility in the currency over the coming months, in response to news about the negotiations. Signs that the UK could get a reasonable deal should support the pound, whereas fears that the UK will get a bad deal, or no deal, would likely lead to further sterling weakness.

If sterling rallies, companies that get most of their revenues from abroad could underperform those with a more domestic focus and vice versa. Large cap UK equities get most of their revenues from abroad, whereas the majority of mid and small cap revenues come from the UK. So, while the outcome of the election is not very uncertain, the outlook for sterling and for the relative performance of large cap, internationally focused companies relative to mid and small cap domestic focused companies, is likely to remain highly uncertain for several years. In this environment, UK equities could still perform well, but investors would be well advised not to take large sector or size bets and focus instead on stock picking.

HOW DOES IT WORK?

The UK is split into 650 constituencies, which each elect a member of parliament on a simple first past the post system. There is only one round in UK elections and each voter can vote for only one candidate. To form a ruling majority, a party needs to have 326 of its candidates elected. In the last election in 2015 the Conservative Party gained 36.8% of the overall vote, but because of the first past the post system this translated into 330 seats, a slim majority.

FRANCE - FRANCE VOTED IN FAVOUR OF THE EURO - LEGISLATIVE ELECTIONS STILL TO COME ON JUNE 11TH AND 18TH.

What is happening?

France has rejected Marine Le Pen's anti-euro bid for the presidency but Emmanuel Macron, the newly elected French president, has had little time to celebrate his victory since the second round of the presidential election on 7 May. Indeed, his victory has left the country deeply divided. The turnout in the second round was the lowest since 1969, while 11.5%[3] of those who voted returned a blank ballot and 60%[4] of those who voted for Macron did so purely to block Marine Le Pen.

Against this backdrop, Macron quickly took steps to win the support of a majority of French voters for his political movement, recently renamed La République en Marche:

- On the evening of his victory, Macron's speech at the Louvre made it clear that he would do his best to reunite France and to make sure that voters would no longer feel the need to support populist parties.
- When choosing the 577 candidates who will represent La République en Marche at the June legislative elections, Macron was careful to integrate representatives from wider society and from other political parties, as well as ensuring equal representation from both men and women.
- Finally, he appointed Édouard Philippe, member of Les Républicains, as prime minister, in a sign of openness towards other parties and their electors.

It remains to be seen whether these measures will be enough to secure an absolute majority at the legislative election. On 11 and 18 June, French voters will elect their 577 representatives at the National Assembly. To be elected in the first round a candidate must gain an absolute majority, if no one achieves this, all candidates with more than 12.5% progress to the second round where the candidate with the most votes is then elected.

These elections may be less important in a global context, but they are critically important in a local context as they will have a significant impact on Macron's ability to successfully implement his agenda. The interim government is therefore unlikely to pass significant legislation before securing a majority in the National Assembly.

The French have historically given an absolute majority at the National Assembly to the party of their newly elected president. But the weakness of the two parties that have historically been the strongest, and the fact that many people who voted for Macron did so for strategic reasons, means that we cannot assume that this will remain the case.

The latest polls[5] show that Macron's party has 29% of the voting intentions, which could give it between 249 and 289 seats in the National Assembly—probably just below the absolute majority of 289 seats.

In this scenario, there are three potential outcomes:

- A majority government: Macron wins a majority in the National Assembly and can start to implement his agenda with relative freedom.
- A minority government: This could still be a workable solution as La République en Marche is expected to secure a near-absolute majority and could probably count on the votes of the centrists from the right- and left-leaning parties.
- A coalition: If another party, like Les Républicains, manages to secure an absolute majority, Macron will have to reflect this in his government, accepting a prime minister chosen by this party and implementing at least some of its political agenda. This probably represents the least positive outcome.

Key issues and implications for investors

For the financial markets, the outcome of these legislative elections is probably less important than the result of the presidential election, which could have had repercussions well beyond French borders. Even though some of the scenarios outlined above seem more favourable than others, all of them will lead to a reformist government, which should be positive for France in the medium term. In the short term, France—in common with most other European countries—should continue to benefit from the improving domestic and global economic outlook.

3 Ministry of the Interior.
4 Source: Survey Ifop-Fiducial for Paris Match, CNews and Sud-Radio.
5 Harris Interactive - 11 May and Opinion Way/SLPV analytics

INVESTMENT IMPLICATIONS

Euro break-up risk has reduced despite political fragmentation

The key conclusion is that political risk in Europe has diminished significantly since the start of the year with the victory of pro-euro leaders in the Netherlands and France. While markets have already reacted positively to this reduction in political risk, more than half of the money that came out of European equities since January 2016 has yet to return, suggesting potential further upside. While political risk has not gone away completely in Europe, and probably never will, many investors have already missed out on strong returns by focusing too much on the politics and not enough on the improving economic fundamentals. Eurozone business surveys suggest the best growth outlook since 2011 and Germany looks almost certain to elect a pro-euro government.

So the only real major eurozone political risk that remains in the next year is that parties with highly divergent political ideologies form an anti-euro coalition in Italy after the election, assuming that M5S can't muster the 40% of the vote needed to govern alone. If that relatively low risk, like all the others this year, doesn't come to pass then investors are likely to take another large sigh of relief and push European equities and the euro higher still. It may make sense to be cautious on eurozone government bonds but that is less because of political risk and more to do with the likelihood that a stronger European economy could lead to the ECB gradually ending QE, which should also support the euro. However, given the higher political risks in Italy than elsewhere in Europe some additional caution on Italian government bonds, in particular, may make sense.

The overall picture though is one of an improving European economy, with earnings growing very strongly and investors still relatively cautious despite falling political risk. In this environment, the outlook for eurozone equities should still be positive. However, in the UK uncertainty remains high and large size, sector or currency bets could prove costly, even though UK equities could still make gains.

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