

Quick Takes

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TIMELY TOPICS FOR INSURANCE EXECUTIVES

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Wave of Populism Across Europe

Europe faces some key political events in 2017 in the midst of a rising wave of populism as manifested by the rise of smaller extreme parties across the continent. Investors are worried about the possibility of these parties having some electoral success and potentially reigniting another Euro Area financial crisis.

BACKGROUND

2016 was marked by surprise populist votes in both the UK, with Britain's vote to exit the EU, and the US, with the election of Donald Trump as US President. These political events have had important effects on financial markets. In 2017, Europe faces some key political events. General elections are being held in the Netherlands, France, Germany and possibly Italy (see Table 1), four of the founding members of the EU. These elections are taking place against a backdrop of rising populism across Europe. According to a recent Bank of America Merrill Lynch Global Research poll of high-grade credit investors,¹ populism in politics was listed as their biggest concern for the next 12 months.

Table 1. Key Political Events in Europe - 2017

Date	Country	Event
15 March 17	Netherlands	General Elections
31 March 17	UK	Proposed Deadline for Triggering Article 50*
23 April 17	France	Presidential Elections [1st Round]
07 May 17	France	Presidential Elections [2nd Round]
11-18 June 17	France	General Elections [2 Rounds]
24 Sept.17	Germany	General Elections [earliest date 27 August]
30 Sept. 17	Spain	Catalonia Plans to Hold Independence Referendum
Feb.18	Italy	The Next Italian General Election Due to be Held no Later than 23 May 2018

* Part of European Union law that sets out the process by which the UK may exit from the EU.

Source: NEAM

¹ Bloomberg

The wave of populism in Europe is manifested in a fragmentation of the traditional political centre and the rise of smaller parties who have all seen an increase in their popularity in recent years (see Table 2). These parties who have different origins in each European country, generally share a common scepticism towards the EU as well as an active hostility towards the euro.

Table 2. Rise of Small Extreme Parties in Europe

Country	Party	Stance	Anti-EU?	Anti-Euro?
Germany	Alternative for Germany (AfD)	Far Right	No	Yes
France	National Front	Far Right	Yes	Yes
Italy	5 Star Movement	Anti-Establishment	No	Yes
Italy	Northern League	Far Right	Yes	Yes
Spain	Podemos	Left Wing	No	No
Netherlands	Freedom Party	Far Right	Yes	Yes
Belgium	Flemish Interest	Far Right	No	Yes
Austria	Freedom Party	Far Right	No	Yes
Greece	Golden Dawn	Nationalist	Yes	Yes
Portugal	Unitary Democratic Coalition	Far Left	No	Yes
Finland	Finns Party	Conservative	No	Yes
Ireland	Sinn Fein	Republican	No	Unclear

Source: Bloomberg

EUROPEAN POPULISM – RISING RISKS FOR INVESTORS

The key question for investors is whether these populist parties can translate their high poll ratings into success at the ballot box and therefore wield some power in government. Such an outcome in any of the upcoming elections, particularly after the referendum decision by the UK to leave the EU last year, would have serious negative consequences for the European Union “project,” for the euro and for European financial markets. Our country by country analysis leads us to conclude however, notwithstanding rising risks, that the political centre ground will hold in Europe and that 2017 will prove to be “a turning point that didn’t turn.”

The global rise of populism has been well documented and while its rise across European countries shares many of the same causes, it also has its own uniquely European aspects. The 2008-09 financial crisis and the subsequent 2010-2012 European debt crisis has led to a long period of income stagnation, particularly in periphery countries where it was accompanied by rising unemployment, increasing inequality and declining living standards. Equally important factors, however, have been the recent rise in terrorist related events in Europe, as well as an increasing questioning of “identity” in some countries, partially arising from a large-scale influx of immigrants and refugees to the EU.

To determine the risks for investors of these key political events in Europe in 2017 we need to analyse each one of them in turn:

Netherlands

First up on the political calendar is the Dutch general election in March of this year. Geert Wilders and his euro-sceptic Party for Freedom (PVV) are currently ahead in the polls (about 30%). Proportional representation (PR), which is a characteristic of the Dutch political system, encourages small parties. To form a government under this system typically requires a coalition of two or three parties. While political fragmentation has increased and the share of seats held by the three main parties has been steadily declining, all of the main political parties have ruled out any coalition with PVV. Given this, our view is that a government will be formed perhaps after a longer coalition building process but without the PVV.

France

In terms of the potential for a major political shock in 2017, investors are most concerned about France due to its importance for the EU and to the fact that Marine LePen, the candidate of the far right National Front, is leading in the first round presidential polls. France is a so called dual democracy which means that presidential elections are held in April/May while parliamentary elections are held a month later in June. The

French electoral system is tailored to secure a clear majority and uses a runoff voting system that involves two rounds of voting where only two candidates make it to the second round.

While it looks likely that LePen will make it to the second round, all polls indicate that she has little chance of winning a second round head-to-head against any major candidate as the main parties coalesce around the opposing candidate. This would be what actually happened to her father as leader of the National Front in 2002.

The runoff voting system creates a high hurdle for the National Front that is still a small party with currently just two of the 577 seats in the National Assembly parliament. Given the experience of 2016, there is some natural scepticism around electoral polls. In addition, the collapse of the ruling Socialist Party vote, the scandals surrounding the Republican Party candidate and a higher than usual number of second round voting possibilities all create more uncertainty around the outcome. Notwithstanding this, our base case is that LePen is defeated in the second round of presidential voting.

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Germany

The German general election in September of this year will see Chancellor Angela Merkel seeking a fourth term in office. The “mother of the nation” is facing widespread criticism for her handling of the refugee crisis, which is partly responsible for the rise of the Alternative for Germany party (AfD), a far right party with a realistic chance of entering the Bundestag Parliament. Martin Schulz, the former President of the European Parliament, will run in this year’s elections as the Social Democrats’ candidate for chancellor and offers a credible alternative to Merkel. While the AfD may exceed the 5% limit and may enter parliament, with an underlying strong economy combined with very low unemployment, Merkel still remains the clear favourite. Thus, the most likely outcome in the German elections remains some combination of conventional parties.

Italy

The Italian legislature is due to end in February 2018 but a recent constitutional court ruling has made it more likely that the President dissolves parliament and calls for early elections sometime later this year. The country's rising populist parties - the anti-establishment 5 Star Movement and the far right Northern League, as well as Matteo Renzi, the former Prime Minister and head of the ruling centre-left Democratic Party, are all in favour of early elections. While the populist parties would likely increase their share of the popular vote, the recent constitutional court ruling ironically cements Italy's proportional representation electoral system and makes a Grand Coalition - which would be Italy's 67th government since 1945 - the most likely outcome, locking the populist parties out of power. It is also worth noting that Italy has a constitutional ban on holding referenda on international treaties.

INVESTMENT IMPLICATIONS

Notwithstanding our view that the political events of 2017 will see majorities for the status quo, thereby excluding populist parties from power, financial markets remain nervous. This is evidenced by the widening of Euro Area sovereign yield spreads versus Germany, particularly in recent months [see Chart 1] with the premium on French Government bonds over German bonds in particular widening to a four year high of over 75 basis points.

The experiences of 2016, coupled with the recent questioning of electoral poll reliability and the possibility of "game-changing" terrorist events around election times, all contribute to heightened investor uncertainty. Political tail risk, with a low probability of occurrence but a high "severity" in terms of its market impact, is particularly challenging for markets to price. Taking France as an example, in the highly unlikely event that LePen would win the second round Presidential vote, while a euro or EU exit would still require an even further series of unlikely events, markets would almost certainly "sell first and ask questions later." Therefore the effect of a LePen victory would lead to a severe widening of Euro Area government bond yields versus German bonds, a fall in French domiciled and other so-called periphery country assets, a fall in the euro and a flight to perceived safety into the US dollar and US Treasury bonds.

Chart 1: Euro Area Yield Spreads to Germany



Source: Bloomberg

A key point, however, for investors to consider is that the elections of 2017 are not a binary event. To the extent that our base case does occur, with mainstream governments prevailing in 2017, European political risk would not be “off the table.” Challenger parties may continue their rise and the risk of this wave of populism is that increasingly fragmented national parliaments and a weakened EU cannot effectively deal with the ongoing issues facing Europe, including immigration, country debt sustainability, economic convergence and structural reform. The European Central Bank (ECB) continues to pursue a policy of extraordinary loose monetary measures, including negative policy rates and ongoing quantitative easing in the form of public and private asset purchase programmes. ECB policy support has been in place for a number of years both to support the Euro Area economy and to support the euro. In our view, this ongoing political uncertainty in Europe will mean that the ECB will continue to maintain their easy monetary policy stance longer than market participants currently expect, even in the face of German Bundesbank opposition. “Lower for longer” Euro Area interest rates will therefore continue to act as a major constraint on global rates and particularly on any rise in US interest rates that are already at an almost 25 year high in terms of their yield premium over Germany (currently 210 basis points) [see Chart 2]. Importantly, with the Euro Area running a record current account surplus, and with Euro Area yields continuing to hover around the zero percent yield level, the US bond market should remain an attractive play for Euro Area investors seeking yield and some diversification from rising Euro Area populism, subject to US policy uncertainty.

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Chart 2. US and German Yield History



Source: Bloomberg

KEY TAKEAWAYS

- Populism is on the rise in Europe and populist parties will likely make gains in each of the key political elections in Europe in 2017. Our country by country analysis, however, leads us to conclude that notwithstanding the increased risks, mainstream governments will prevail in 2017. Our cautiously benign view of political outcomes for 2017 is further supported by a Euro Area economy that is showing signs of robust growth that is increasingly spreading to peripheral countries.
- While we believe that Europe's governing status quo will hold in 2017, the political events of 2017 are not a binary event and the risk of a political "accident" in Europe may persist against a background of fragmented national parliaments and a likely policy vacuum at the EU level. Investors need to carefully monitor the evolving European political landscape and be open to all eventualities including the possibility of more pro-European national leadership and 2017 as being the high point of European populist politics.
- Throughout this period, ongoing political uncertainty should ensure that ECB monetary policy will continue to remain very accommodative. With Euro Area yields at the front end anchored around zero percent, this will act as a major supporting influence on US bond prices and the relative strength of the US dollar, further acting as a key constraint on US policymakers.





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