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European elections: five things to know and market implications

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- *The next European Parliament elections will take place on 23-26 May 2019 in the Member States of the European Union. Given the current complex political context,* ***these elections are becoming a sort of referendum on the EU project****, and a key political test for many countries.*
- *According to the polls,* ***the elections will likely return a more fragmented Parliament****, with an increased weight of populist parties, although it seems unlikely that we will see a coalition of Eurosceptic forces vs mainstream parties. The two major political forces – the European People's Party and the Progressive Alliance of Socialists and Democrats – will likely lose their current majority. However, these two political forces are still expected to remain the two largest parties in the EU Parliament and could thus look to include other smaller pro-European political formations under their umbrella (eg, the Greens).*
- ***It may take more time than usual to find the right balance between parties and to form the European Commission (EC)****. Therefore, we don't expect the EC to be fully operational before 2020. We believe that* ***the emergence of a new "anti-populist" coalition may pave the way for a more pro-European agenda from 2020 onwards****. This Commission will have to deal with the 2021-27 Multiannual Financial Framework that is essential for Europe's future.*
- ***Investment consequences****: From a* ***European fixed income perspective****, in the short term, an outcome of a softening of European integration could result in an increase in market uncertainty, leading to a weaker euro currency, market volatility, and an increased focus on sovereign spreads. A longer-term perspective will depend on agreement regarding the EU Commission and the role of pro-Europe parties.*
- *From an* ***equity*** *perspective, much of the uncertainty is already priced into European equities, except for a no-deal Brexit or a further material deceleration of the EU economy, which is not our view currently. We believe the opportunities within European value are the most compelling.*

"EU parliamentary elections will likely be a sort of referendum on the EU project".

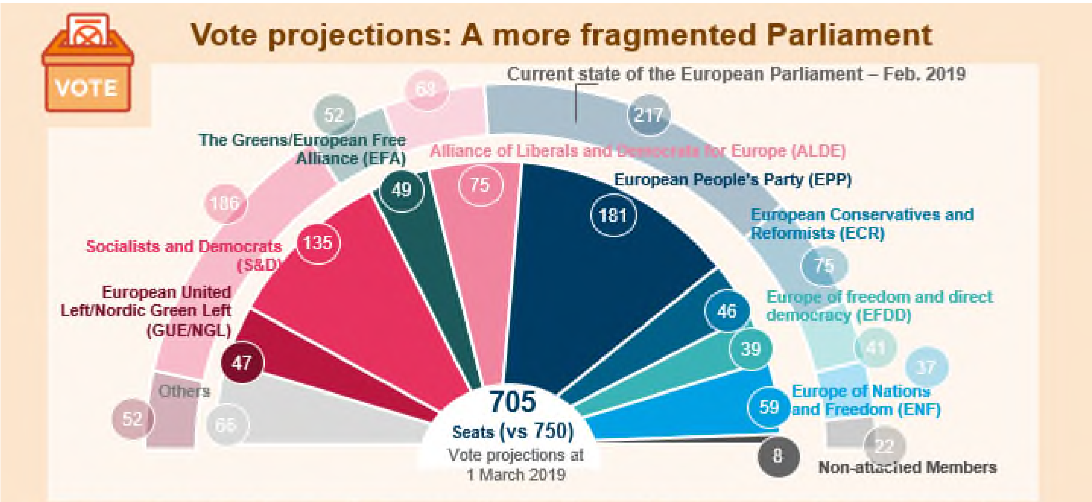
Source: Amundi. Data as of 5 March 2019.

"The probability that Eurosceptic parties will make a united front against mainstream parties seems very low, given that "anti-system" and nationalist parties remain very divided among themselves".

What are the expectations regarding European Parliament elections?

The generally low turnout for these types of elections makes it difficult to make projections. In 2004, for the first time, turnout fell below 50% (49.5%) and it has dropped further since then (42.6% in 2014), far below the level seen before the launch of the single currency (close to 57% in 1994). In a period of great uncertainty (protectionism, rise in populism, climate change), it will be crucial to see how Europeans (and especially young Europeans) are mobilising ahead of these elections. As far as political composition, polls tend to point to a high level of fragmentation in the new parliament. The weight of the Eurosceptics will likely be much more relevant in the European Parliament vs mainstream parties than today. However, the probability that all these parties will make a united front against mainstream parties looks very low, given that "anti-system" and nationalist parties remain very divided among themselves.

Much will depend also on how the Brexit situation evolves. With the UK potentially leaving the EU, the European Parliament could have fewer MEPs (Members of the European Parliament), at 705 vs the current 751. Of the 73 UK seats, 27 would be reallocated to 14 EU countries, 46 would be kept in reserve for future enlargements. Regarding the UK exclusion, the situation is still very fluid at the time of writing, with a number of possible outcomes. In case of a **long-term postponement of Brexit** (ie, more than three months), the UK should take part in the May elections, keeping the 73 MEPs (out of 751 total). Keep in mind that this scenario – which appears very unlikely as we write – would be a game-changer for Europe, as it could reinforce the "anti-EU" forces within the EU Parliament. It would also be a key political test for internal UK politics. At this stage, Theresa May has pledged not to request an extension longer than three months. A soft Brexit with a long-transition period would probably have little impact on the election. The threat of a hard Brexit could, however, paradoxically benefit the pro-European camp, as, when voting, citizens would consider the economic and financial costs faced by the leaver (the UK).



The two major political forces – the European People's Party and the Progressive Alliance of Socialists and Democrats – will likely lose their current majority. However, these two political forces are still expected to remain the two largest parties in the EU Parliament and could thus attract other smaller pro-European political formations that may gain ground (eg, the Greens).

Source: Amundi, European Parliament European Elections 2019 - Report on the developments in the political landscape. Data as of 1 March 2019.

All in all, the Parliament is likely to be more fragmented. According to polls, populists and nationalists would probably not secure more than 25% of seats. And, the two major political forces – the European People's Party[1] and the Progressive Alliance of Socialists and

[1] EPP, center right, pro Europe.

Democrats[1] – will likely lose their current majority (55%). However, these two political forces are still expected to remain the two largest parties in European Parliament and could thus try to attract other smaller pro-European political formations that may gain ground (eg, the Greens). Against this backdrop, it may take more time than usual to find the right balance between parties and to form the European Commission (EC). Thus, we do not expect the EC to be fully operational before 2020. But, we believe that the emergence of a new "anti-populist" coalition may pave the way for a more pro-European agenda from 2020 onwards. This Commission will have to deal with the 2021-27 Multiannual Financial Framework that is essential for Europe's future.

"We see three main short-term implications of the EU election for European Fixed Income markets: regarding the euro currency, spreads, and peripheral bonds".

What could be the implications of political uncertanty on European Fixed Income?

Financial markets dislike uncertainty – political uncertainty in particular. In 2019, we are facing Brexit and the European Parliament elections. Based on currently available polls, the European election could result in a more fragmented Parliament and a rise in Eurosceptic parties. In this scenario, in the short term, we see three main implications:

1. **The euro currency could depreciate** to reflect the inability of the Parliament to take bold decisions towards more integration.
2. Spreads and peripheral bonds could be impacted. Should the fragility of the European political landscape increase, this would likely lead to a rise in the general **market volatility** and contribute to **wider spreads on corporate and peripheral bonds** and lower interest rates on the safest assets (ie, German bunds).
3. A softening in Euro integration would mean a stronger focus on **assessment of each country's fiscal strength**, which would likely be reflected in **sovereign spreads**.

The main point with regard to the European Parliament elections is that the impact will not materialise on day one, but the medium-term consequences could be significant. The main decisions are the appointments of the President of the Parliament and of the European Commission. These represent "technical" steps, with no obvious direct impact on financial markets. But, the signalling effect of the electoral outcome on the different local elections scheduled for 2019 and their effect on the agenda of the EU's governments will have by far a more relevant impact on markets.

What are your key convictions regarding EU fixed income markets in this phase?

After recommending a defensive stance in 2018, we have cautiously moved to a neutral view on credit and to a slightly more positive duration stance. In particular, the primary market offered at the beginning of this year interesting opportunities across both corporate and sovereign issuers.

We believe that the current level of rates is very low, but an increased duration exposure in sovereign bonds works as a hedge against the credit risk in turbulent phases.

Our current main conviction in Euro fixed income remains euro curve flattening. We see this trend continuing in a bull flattening movement unless there is an option for the European Central Bank to begin normalisation of the Zero Rate Policy (in this case, we could see a bear flattening movement with short-term interest rates rising the most). Finally, there is scope to exploit relative value opportunities within euro assets: for example, on sovereign bonds, we like Spain and Portugal which offer yield premia and show ongoing improvements of fundamentals.

With negative economic momentum in Europe and possible further volatility ahead of the elections, what is your view on the ECB?

The ECB has clearly indicated that there will not be any interest rate move until the autumn (forward guidance). The ECB is not in a hurry to act, given the current economic slowdown. It is likely to put in place some measures to help banks to deal with the end of targeted longer-term refinancing operations (TLTROs). We do not underestimate the toolbox and creativity of

[1] S&D, center left pro Europe, the political group in the European Parliament of the Party of European Socialists, PES.

the ECB if economic momentum were to fade further. The most recent speeches point to the fact that the governing council remains vigilant.

Moving to equities, which areas of the European market are already priced for the worst-case scenario and therefore appealing even given higher political volatility?

"Much of the uncertainty is already priced into European equities, except for a no-deal Brexit or a further material deceleration of the EU economy, which is not our current view".

The political environment in Europe is uncertain, which has been the case for some time. We think it fair to say that a lot of the uncertainty is already priced in. The strong start to the year has corrected some of the "downside overshoot" we saw in the latter part of 2018. Following the very strong start of the year, our view, based on valuation, in favour of cyclicals vs defensives looks somewhat less compelling, but still positive. Within the cyclical sectors, there is very wide valuation dispersion among sectors. For example, the expectations priced into autos and transportation look particularly low and we identify selective opportunities here.
In general, we believe that the environment of more prevalent uncertainty, less intra-sector correlation, and higher stock-level dispersion is ideal for stock-picking within a fundamental bottom-up process.
Finally, while a lot of political uncertainty is already priced in for European equities, a very negative Brexit outcome or a significant deterioration in the political situation within Europe is not reflected and will likely cause a further sell-off of European equities.

Given weak economic momentum in Q4, most countries are turning to fiscal policy to sustain growth. What are the areas that could benefit from a more supportive fiscal stance?

We see scope for measured fiscal stimulus in several European countries. In fact, we have already seen evidence of this coming through. At this point, we believe that the deployment of fiscal stimuli across Europe would benefit domestic consumption rather than investment. With that in mind, we think that the natural beneficiaries would be domestically oriented sectors rather than the export-oriented sectors, which would be sectors such as banks and consumer discretionary.

What are your high convictions in EU equity at the moment and how might the outcome of the election change these?

"We view the opportunities within European value as the most compelling".

Fundamental bottom-up investors should focus in finding sound businesses that they can buy at attractive or fair valuations. Therefore, stock selection and portfolio construction should be unbiased for the outcome of any given political scenario. We follow this approach, balancing the need for downside risk mitigation (with the focus on quality stocks) and the search for opportunities which may arise if the risk weighting on European equities eases.
We accept that the political agenda is busy for Europe again this year and this is a risk we manage for. However, it is worth pointing out that a more benign outcome to some of these events such as Brexit could result in a significantly better outlook for Europe with a subsequent rerating of European equities. In terms of high conviction, we believe the opportunities within the European value space are the most compelling.

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Definitions

- **Correlation:** The degree of association between two variables; in finance, it is the degree to which assets or asset class prices have moved in relation to each other. Correlation is expressed by a correlation coefficient that ranges from -1 (perfectly negative correlated) through 0 (absolutely independent) to 1 (perfectly positive correlated).
- **Bull flattener/bear flattener** is a situation of the yield curve in which long-term rates are decreasing at a rate faster than short-term rates. This cause the yield curve to flatten as the short term and the long-term rates start to converge. In a bear flattener, short-term interest rates rise faster than long-term interest rates.

Important Information

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