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Amundi ASSET MANAGEMENT

INVESTMENT TALKS

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European elections: not a game changer, opportunities from divergences

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- ***Election results:*** *The results are broadly in line with what opinion polls had indicated, although with a slight "pro-institution" surprise. Together, all these pro-institution, pro-European forces command roughly 67% of the Members of Parliament (MP) vs. 70% before the elections. The two historic mainstream parties can build a majority through a coalition either with the liberal center, or with the Greens: it will be a bit more difficult than it used to be, yet it should still be manageable.*
- ***Implication on Brexit:*** *In the UK, the political situation is still very open. Conservatives and Labour were sanctioned by voters. Nigel Farage's Brexit party is the big winner. Consequently, Boris Johnson has the wind in his sails to succeed Theresa May. But nothing is done yet and all the options are on the table. Elsewhere, the good news is that fewer and fewer protesting/populist parties in Europe are calling for the exit of the euro (which would require an exit from the EU). It is likely that they are being vaccinated by the British turmoil.*
- ***Investment implications:*** *market reaction has been mute. Market focus is now on economic data, and the implications of further escalation in trade disputes, as the European economy is open and sensitive to the global cycle. This said, the domestic demand component is still resilient, financial conditions are very accommodative and the ECB is committed to implementing all the necessary measures to avoid further economic deterioration.*
- ***From a fixed income perspective****, we believe that the economic uncertainty and increased risk scenario will keep the "cost for protection" very high and, as a consequence, the core government bond yield very low. We prefer semi-core bonds (France, Netherland, Austria), to the German Bund. In peripheral bonds, we see value in Spain and Portugal. In Italy, pressure for adding fiscal stimulus will likely put BTP spreads (and banks) under pressure and add volatility. Even though we do not consider this to be a major threat over the short run, because Italy and the EU could find an agreement on a more flexible fiscal stance, we prefer to adopt a cautious stance for the moment. In general, we believe that divergences in fiscal measures at the country level and country/sector fundamentals could offer potential opportunities for active selection and risk allocation.*
- ***Equities:*** *Just having the election done should remove one source of uncertainty. However, our view is that Brexit and US/China trade relations pose an even bigger risk to the sentiment around Europe – these are two uncertainties that are still not resolved. We believe there are still good opportunities in the more cyclical compartments of European equities. In particular, domestically exposed names should see the benefit of a stabilisation of economic indicators and a potential pick up in H2. One interesting point of this election is the result of Green parties in main EU countries. The awareness of European companies to the climate challenge is increasing, and many companies have taken significant steps to address the issue. This is an area in which we have a high conviction going forward and could bring interesting opportunities for investors.*

What are the initial key takeaways of the European elections, for the equilibria in the EU parliament and for the next important deadlines for the European Union?

The results are broadly in line with what opinion polls had indicated, although with a slight "pro-institution" surprise. Key takeaways are, first, a decline in the votes for the two large political groups which are the social-democrats and the Christian-democrats or moderate right; these two parties had, since 1979, commanded a combined majority in the European Parliament, and this is now over. Second, a rise in other so-called "mainstream" forces, the pro-market liberal center, including the Party of French President Macron, and, even more

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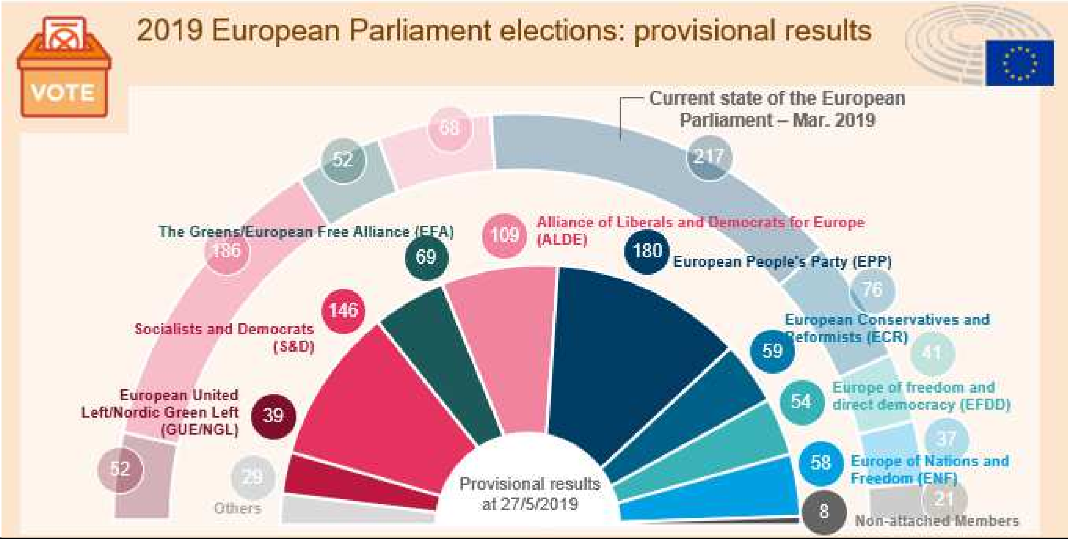
notably, the Greens. **Together, all these pro-institution, pro-European forces command roughly 67% of MP vs. 70% before the elections.** Then the other major take-away is that far-right (or right-wing Eurosceptic) parties see their share increasing from roughly 20% to 25%, with prominent cases being France, where the far-right national front comes first before the President's party, and Italy. However, far-right parties also scored a bit short of expectations in other key countries such as Germany and the Netherlands, while far-left party have seen their share diminish from 10% to 7%.

All in all, while combined radical parties, Eurosceptic parties see their total share increasing from 30% to 32%, this is not the tsunami that could really have been a shock to institutions.

The two historic mainstream parties which can build a majority through a coalition either with the liberal center, or with the Greens will find it a bit more difficult than it used to be, yet it should still be manageable. Radical parties will have a bit more power, especially through parliamentary committees, they could try to propose amendments but they should not be able to block key legislation except on topics where mainstream forces could be very divided.

What is also remarkable is the rise in the participation rate at the vote. Turnouts at the European election had been historically low and falling and this time it rose from 43% to around 50%, which shows a rising interest in European affairs.



Source: EU commission, data as 27/5/2019.

"The UK is in the midst of a deep political crisis; all the options are still open".

Do you see any implication on Brexit?

The UK is in the midst of a deep political crisis. Conservatives and Labour were sanctioned by voters. Nigel Farage's Brexit party is the big winner. Consequently, Boris Johnson has the wind in his sails to succeed Theresa May. But nothing is done yet. Theresa May's resignation will be effective on 7 June. From 10 June, the procedure to find a successor will begin. Theresa May will remain in office until the end of the procedure. There is no shortage of candidates. We should be fixed by the end of July at the latest. It should be noted that staunchly pro-Bremain parties (such as the Liberal Democrats) also scored well in the election, making the political situation even more polarised and, possibly, bringing more impulse to those demanding a second referendum. It should be remembered that the 27 EU countries must be unanimous on 31 October for a further extension of the deadline, which is not a foregone conclusion. Against this backdrop, the likelihood of the UK leaving the EU without an agreement has increased and it is therefore necessary to continue to prepare for it both at national and company level. **However at the end of the day, everything remains possible:** no-deal Brexit, new elections, new referendum, new Article 50 extension, not to mention that it cannot be ruled out that the British Government could simply revoke Article 50. The only good news is that fewer and fewer protesting/populist parties in Europe are calling for the exit of the euro (which would require an exit from the EU). It is likely that they are being vaccinated by the British turmoil.

"Despite major disappointments in 2018, above-forecast Q1 2019 figures showed that fears of a general recession were probably exaggerated".

What are the key strengths and weaknesses for European economies and for Europe's political setup in the context of the current trade disputes?

The economy has been improving a lot since 2013. Despite major disappointments in 2018, above-forecast Q1 2019 figures showed that fears of a general recession were probably exaggerated, especially in Germany, and that, while the manufacturing sector is under stress, it has not, so far, contaminated the rest of the economy. Internal demand remains robust.
Nonetheless, Europe remains vulnerable for three reasons:

1) **From an economic standpoint, the crisis has split the Eurozone in two**, between one half at full employment and another where growth is too recent and unemployment is still high. This divorce is likely to come back to the fore if the slowdown worsens.
2) **From a political standpoint,** Eurozone leaders and populations are much more divided than they were a few years ago. In particular, Southern Europe is convinced that it has had imposed excessive austerity while Northern Europe is worried by the fact that reform initiatives may put their savings at risk looking ahead.
3) **And from an international standpoint,** the world has become multipolar and divided. During the sovereign debt crisis, our main partners (US and UK) helped Europeans save the euro. The leadership in these countries has changed and nobody knows how their leaders would react in the next crisis. Moreover, Europe appears more and more to be lagging behind the United States and China when it comes to new technologies with key geopolitical implications.

Europeans must thus find a way to overcome their differences to strengthen Europe (security and common defence, economic and financial architecture of the Eurozone). Regarding trade, they will have to find a way to speak with one voice.

"It is becoming increasingly clear that a stabilisation budget is not ready to come into being in the Eurozone: The broadest consensus is about the Capital Markets Union".

What will be the key macroeconomic and geopolitical themes driving the future of the European Union that will emerge from this election?

Many economists point to the incomplete nature of the Eurozone and the need for a common budget. A budget which, in the event of a serious shock affecting one or more Member States, could help stabilise their economies. Such a budget, fuelled by national contributions, would make it possible to support the activity when a country is facing a crisis, either alone or with the rest of the Eurozone, limiting the use of painful reforms. This would involve financial transfers to economies in need, unlike the European Stability Mechanism (ESM), created during the crisis to offer loans to states in crisis in return for structural reform plans. This budget of the Eurozone, if it is solely devoted to stabilisation, would not need to be very large. Small-scale fluctuations would still be borne by national economies. Finally, access to this fund could be conditional on compliance with budgetary rules (in order to avoid moral hazard).
It may be regretted but it is becoming increasingly clear that a stabilisation budget is not ready to come into being in the Eurozone. We must therefore strive to improve market mechanisms. **The broadest consensus is about the Capital Markets Union**. Europeans need to promote discipline and risk sharing. This would make it possible to better manage the abundant savings of the Eurozone (excess savings on investment amounts to € 340 bn in 2018) towards concrete investment needs such as energy transition, digital innovation or the development of Small and Medium Enterprises. And it would also facilitate macroeconomic adjustment in the Eurozone. Indeed, integrated capital markets can cushion asymmetric shocks in a currency Union. When the shareholding of a company is highly diversified geographically, the profits and losses are also widely distributed. In the United States, for instance, it is estimated that, thanks to capital markets, almost half of the impact of an economic shock is spread among the different states - more than by budget transfers. While in the Eurozone, only 10% of an economic shock is cushioned by private risk sharing.

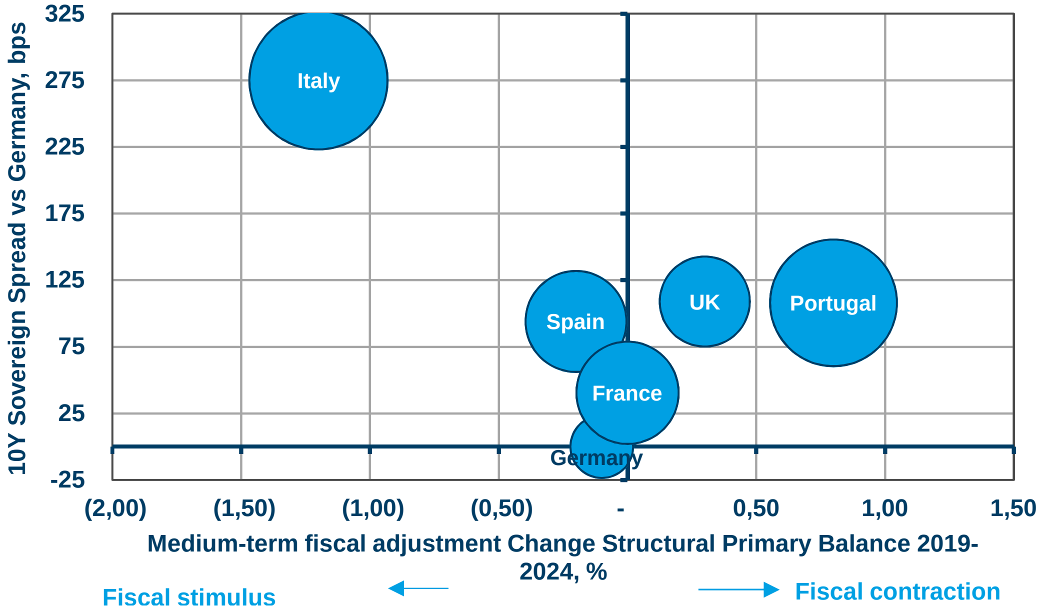
FIXED INCOME IMPLICATIONS

There have recently been voices in the Eurozone speaking louder and calling for more fiscal stimulus. What could be the short to medium-term implications for Euro fixed income markets?

The EU elections took place in a context of moderate economic growth. Easier fiscal policies are already in place overall. These calls for more fiscal stimulus reflect the sentiment that Europe needs further support at a moment when monetary policy tools are more limited. Easier fiscal policies translate into deeper fiscal deficit and deteriorating debt to GDP ratios, which is not favourable to bond markets in the long run. Shorter term, the implication for the fixed income markets may be quite different across the zone, depending on the situation of the different countries. Germany has obviously way more room for manoeuvre than Italy for instance, and the more indebted countries are exposed to tensions on their interest rates. A continuing trend could bolster inflation expectations, but would also mean additional fragmentation across the zone.

"If easier fiscal policy become a prolonged trend, it could lead to higher inflation expectations and bring more fragmentation and opportunities of selection".

The scattered fiscal picture of some EU members…and how the market prices it



Source: Bloomberg, data as 27/5/2019, IMF Fiscal Monitor Database April 2019. The size of the bubbles represents the public debt as a percentage of GDP.

In such fragmentation the fixed income space offers many opportunities of selection; on peripheral bonds, we prefer Spain and Portugal to Italy. In credit, for example we are positive on industrials but not so on cyclicals and we are cautious on the German auto sector; we see value in financials, and in particular banks, but we are prudent on Italian banks.

"Italy: not a major short-term threat but a wait and see, as the fiscal debate will be in focus".

Pressure has recently risen on Italian debt, in respect to the possibility of breaching the EU fiscal rules. What is your view on Italian debt?

We have adopted a moderately cautious stance on Italian debt which is going to navigate between potentially stronger fiscal measures, deeper deficits in a context of slow (negative in the second half of last year) GDP growth, with the risk of being put under an excessive deficit procedure by the European Commission. This could put BTP spreads under pressure and add volatility, not to mention the potential reaction of rating agencies and the additional damage on Italian banks. Even though we do not consider this a major threat over the short term, because Italy and the EU could find an agreement on a more flexible fiscal stance, we prefer to adopt a wait and see stance.

"The EU election is far from being the major factor weighing on the European markets and the euro currency"

Do you believe that with the EU election behind us, there will be relief for the Euro?
The market reaction on the euro currency has been very limited as the results were largely in line with expectations and they are not a game changer. The key questions at stake will remain the profile of economic growth, the development in the European political landscape after the election in each country, the need for more stimulus and the impact of the various threats that are still at work, whether tariffs or the Brexit. The current environment does not call for a sudden recovery in the Euro currency.

EQUITY IMPLICATIONS

Having passed the EU elections, do you expect an improvement of equity investors sentiment towards Europe and why?
Yes, just having the elections done should remove one uncertainty even if the full implication of the new European parliament will still need to play out: the new Commission as well as the new President of the ECB are still to be elected and those will be crucial steps in determining the path of the European Union over the coming years. Our view is that Brexit and US/China trade relations pose an even bigger risk to sentiment around Europe – these are two uncertainties still not resolved.

How could investors play opportunities in European equities in the coming months?
We believe there are still good opportunities in the more cyclical compartments of European equities. In particular, domestically exposed names should see the benefit of a stabilization in economic indicators and a potential pick up in H2. In addition, we see some selected opportunities within healthcare and telecoms among the more defensive compartments. Clearly the European economy is very exposed to global trade so it will be impacted by the developments in US/China trade relations.

"In the medium to long term there are challenges in the society which will require a corporate response: Europe is well placed to progress in this direction."

Do you see investment themes that could emerge in the future, influenced by the new political environment?
In the medium to long term there are some challenges in society which will require a corporate response. For the third year running, extreme weather driven by climate change has taken the top spot in the Global Risks Report presented in Davos – and in 2019 the second and third place have been taken by failed climate-change mitigation and natural disasters, respectively. The scale of the challenge is massive and the solution will need to be multidimensional. The very good results of the Greens in the elections, is a clear sign that these themes are gaining traction among the population of many countries. The awareness of European companies to the climate challenge is increasing, and many companies have taken significant steps to address the issue. This is an area in which we have high convictions going forward.
ESG is in our view a structural trend which is gaining traction among corporates and investors. European companies have a good ESG record from a relative perspective, but have further to go. Growing evidence suggests that companies improving ESG fundamentals tend to outperform the market. We believe that this will continue to be an area of focus and opportunities for investors in the years to come.

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