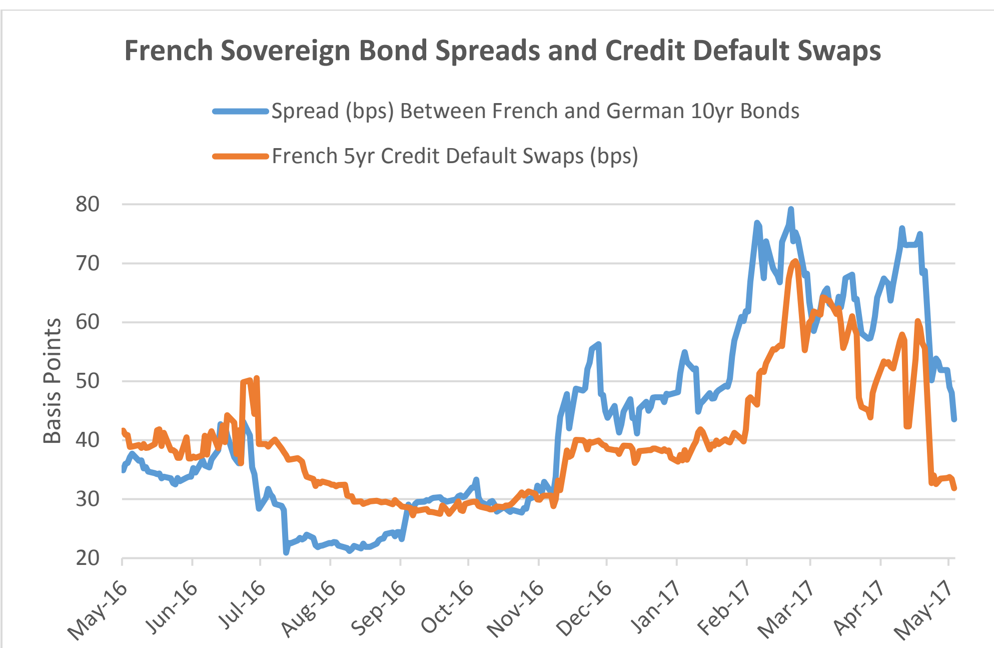
Europe and the UK – Politics and Market Impact

May 5, 2017

In the aftermath of last summer's post-Brexit market turmoil, investors have every right to be nervous about the emergence of a demagogue or the outbreak of extreme nationalism in the 2017-2018 European elections. An acrimonious, and for the UK, a trade-damaging Brexit also looms on the horizon. Although we believe that the Euro zone and the European Union ("EU") have less disintegration risk today than in the 2011 European banking crisis, we (nor anyone else) can completely dismiss the possibility. As for Brexit, although it seems economically irrational, we admit that there is a greater-than- zero probability of a failure of trade talks and UK isolationism. Utilizing our network of company managements, regulators, consultants, pollsters and academics, where possible, Causeway fundamental research weighs the likely electoral outcomes, and incorporates this risk in our assessment of equity returns. Specifically regarding Europe and the UK, we expect that rationality will prevail. Many politicians have their own reelection as a primary goal, and voters cast ballots for prosperity, not poverty. We have confidence in our forecasts of economic outcomes, but have no insight into the seemingly random nature of terrorist activity. A fearful voting public can become especially susceptible to anti-immigrant campaigns, threatening one of the major benefits of the EU, the free movement of labor. The UK faces difficult decisions regarding immigration and the cohort of legal EU citizens living in the UK. As active value managers, we attempt to take advantage of fear in the markets, and buy well-managed companies generating earnings capable of overcoming a European political setback. Some of the world's leading industrial and materials companies are headquartered in Europe and the UK, as well as some of the best companies in the global pharmaceuticals and integrated oil & gas industries.

Markets Appear Calm in Anticipation of the French Elections



Source: Bloomberg

Before diving into the electoral landscape, we suggest taking a look at recent market data. French and peripheral European sovereign bond yield spreads vs. Germany have narrowed in recent weeks. French credit default swaps spreads have also decreased as a far right wing victory seems increasing less likely. None of this data indicates an impending crisis.

The Incoming French President Needs a Decisive Victory

Centrist French presidential candidate, Emmanuel Macron's En Marche! (On the Move) social liberal political party fared best in the first round of the French presidential election, and appears well-placed to sweep round two on Sunday, May 7. Curiously, this election will occur the day before a bank holiday in France, possibly limiting voter participation. And a lukewarm Macron victory could slow his party's momentum into the general election (June 11 and June 18), possibly leading to a fragmented French parliament. Once elected, the new French president will face near insurmountable hurdles to implement his/her program without the backing of a majority in the French National Assembly.

In 2002, Jacques Chirac beat Jean-Marie Le Pen in the second round, winning 82% of the votes. However, history suggests the electorate voted against Jean-Marie Le Pen, not for Chirac – thereby robbing the president of a powerful political mandate. At present, French opinion polls show Macron beating Marine Le Pen in the up-coming run off with a 20 percentage point lead.

The President must secure a majority in the National Assembly for his/her government to function effectively. In the French election timeline, voters will decide on the National Assembly over two rounds in June. As noted by Societe Generale strategists, Martinez and Mamalet (13 April 2017), "The two-round system and the proximity to the presidential election have traditionally given the historical mainstream parties a strong majority of the same political stripe as the President." The question arises: Is Marine Le Pen mainstream? We think not. As a result, even if she were to win the presidential election, it seems near impossible that she would be able to secure a majority in the National Assembly. Her presidential win would probably result in a fragmented National Assembly without a clear majority of any single political party. Even if Le Pen were able to gain a National Assembly majority, she would still need Senate majority, as only the Senate plus National Assembly can amend France's Constitution. French voters will get no rest as about half of the Senate seats will come up for election in September 2017.

In another check on populist excess, France is bound by the European Semester (as are all members of the euro area), an annual cycle of macro-economic, budgetary and monetary policy coordination. French fiscal stimulus that breaches European rules could trigger sanctions from the EU Commission. Le Pen calls for renegotiation of EU treaties and has campaigned for restoration of France's national sovereignty. She has threatened referendums to extract France from the EU. However, opinion polls show that French voters remain in favor of the EU and the euro – and appear most concerned about jobs and security. Macron seems the likely winner for reasons that transcend his poll results: he is pro structural reform but tempers that with demand side measures. This "…have your cake and eat it, too" approach has resonated with conservative voters unwilling to gamble with their pensions and healthcare. If he can also reassure voters that his proposed security-reinforcing measures will enhance French safety, he will likely win by a wide margin.

Fiscal and Regulatory Reforms – Will They Ever Happen in France?

With Macron in the lead, we look forward to more business friendly legislation and less regulation. Macron's pro-European stance would also be a plus for EU cohesion. His electoral program features supply-side reforms with demand side sweeteners such as deregulation of labor markets with no tax on overtime pay. He advocates a French corporate tax cut from over 33% to the European average of 25%. Of course, Le Pen has dangled her own sweeteners before voters, claiming she would nationalize the French motorways and some utilities, then cut household gas and electricity prices. Needless to say, this type of radical agenda would not sit well with markets. Despite the lack of certainty, we take comfort in knowing that reforms will require parliament's approval. The incoming French president will likely need to form a coalition between several parties, and – in the case of Macron - perhaps "cohabitation" with a traditional right-wing majority party in parliament could prove market friendly.

Brexit- Avoiding a Costly Shock

Prime Minister Theresa May's decision to hold a general election on Thursday, June 8, has improved the prospects for an orderly UK exit from the EU. If, as polls indicate, the UK prime minister wins a commanding majority, she will have the political momentum to navigate a less contentious transition out of the EU. Her government will likely need to make concessions, as expected in a negotiation, given that her European counterparts hold the upper hand. The costs of no deal would be far greater for the UK than the EU. Surveys indicate the UK voting public supports some type of favorable access into Europe. We expect the Brexit transition will take more than two years. During that elongated period, the UK will accept the free movement of labor and European Court of Justice jurisdiction until a final Brexit agreement is reached. We think the UK will ultimately transition from an owner to a renter of it's EU membership. A prominent European trade minister has proposed monthly renewals in a rolling one-year membership in the single market (and customs union) until the final agreement is reached. Along the way, the UK will need to pay an exit bill likely amounting to the equivalent of about 3% of its gross domestic product.

Humans, not machines, are running the Brexit negotiation process, and we should expect an uneven, possibly emotional road ahead, regardless of the prime minister's mandate. Assuming no hard Brexit, but rather a multi-year, transparent exit process, the UK should be able to improve domestic productivity and innovation. Any perceptible progress on these fronts will likely lead to demand for pound sterling and a more favorable growth runway for domestic UK businesses. With the possibility of corporate tax cuts and regulatory reform, we believe the UK will be well positioned to achieve the prosperity its voters crave.

In summary, our benign base case for the UK and Europe stems from 1) a rational electorate holding jobs and economic prospects paramount and 2) the checks and balances of a European electoral system which, through bitter experience, is designed to avoid the tyranny of the minority over the will of the majority. These benign electoral outcomes remain vulnerable, however, to major national security threats that make voters more susceptible to populist appeal. We will seek to take advantage of the inevitable electoral concerns and Brexit tensions to identify undervaluation and exploit mispricing to benefit our clients.

Causeway