

Euro Area Political Risks Rise To The Fore

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KEY TAKEAWAYS

- Despite solid economic growth in the euro area in 2016 and thus far in 2017, contentious populist candidates representing many alienated voters continue to attract votes in many euro area countries.
- We look for the euro area economy to grow around 1.5% again this year, still above trend.

In 2017, the risks to the euro area stem from politics, not the economy. Despite solid economic growth in the euro area in 2016 and thus far in 2017, contentious populist candidates representing many alienated voters continue to attract votes in many euro area countries.

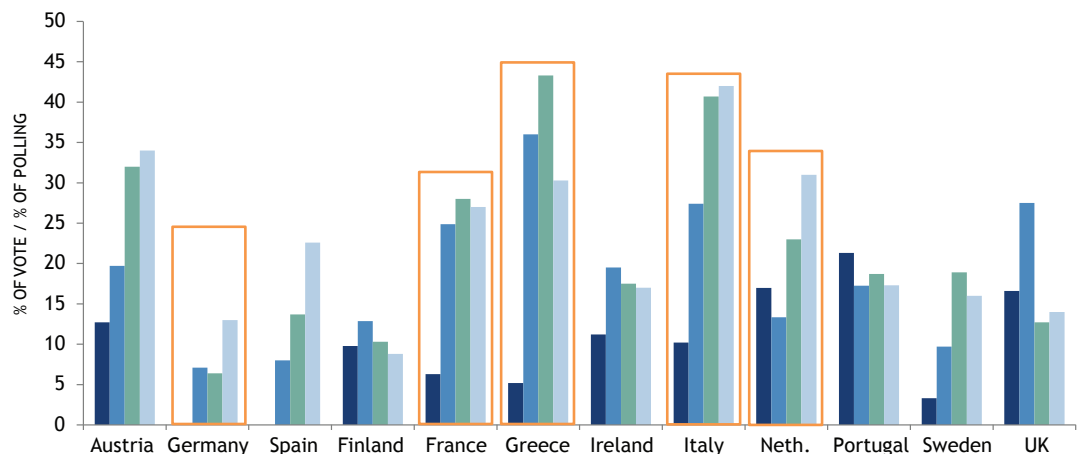
The scheduled elections in the Netherlands, France and Germany this year all offer populist candidates. There is also the possibility of game-changing elections later in the year for Italy. Given that markets were wrong in their expectations about Brexit and the subsequent US election of President Donald Trump, there should be heightened attention to the potential for political risks driving markets this year.

PERFORMANCE OF POPULIST PARTIES

Source: Eurasia. A selection of reputable independent European polling organizations - Research Affairs, INSA, Inyymark, Taloustutkimus, Elabe, Metron Analysis, IPSOS, EMG, De Stemming, Eurosondagem, Opinium.

The countries outlined in a box are scheduled or likely to have elections this year. The latest polls for the populists are shown in light blue.

- European Parliament 2009
- European Parliament 2014
- November 2015 Opinion Polls
- January 2017 Opinion Polls





ISSUES MOST IMPORTANT TO EUROPE'S POPULIST PARTIES*

	ANTI-AUSTERITY	ANTI-GLOBALIZATION	ANTI-EURO ZONE	ANTI-ESTABLISHMENT	ANTI-EUROPEAN UNION	ANTI-IMMIGRATION	ANTI-ISLAM
PODEMOS SPAIN	X	X		X			
SYRIZA GREECE	X	X		X			
FIVE STAR MOVEMENT ITALY	X		X	X			
UK INDEPENDENCE PARTY BRITAIN		X	X	X	X	X	
NATIONAL FRONT FRANCE		X	X	X	X	X	X
FREEDOM PARTY NETHERLANDS			X	X	X	X	X
ALTERNATIVE FOR GERMANY GERMANY			X	X		X	X
FREEDOM PARTY AUSTRIA		X	X	X	X	X	X

Source: Europe Elects, data as of January 2017.

*Parties shown represent current dominant populist parties in selected European countries.

March 15, 2017: The Dutch Election

POPULIST PARTY MOMENTUM

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- The Dutch election is the first major one on the 2017 calendar, notable also for being a ‘core’ European country where the populist party has gained significant momentum. That said, in January Prime Minister Mark Rutte ruled out any coalition with Geert Wilders’ populist Freedom Party (PVV). Polls suggest that the PVV may come first in the polls but is not likely to form the government given other parties’ unwillingness to work with them. This probably means a messy coalition of other parties. Also, bear in mind that in all probability it will take some time to actually form a government; it took 49 days in 2012 and 127 days in 2010 to do just that.
- The anti-euro PVV party, created in 2004, won 6% of the vote in 2006, 16% in 2010, and 10% in 2012. Despite being a meaningful presence for the last seven years, the party has mostly been in the opposition, as other parties won’t work with them. They came closest to participating in forming a government in 2010 when PVV backing was key to supporting the minority coalition government of the People’s Party for Freedom and Democracy (VVD) and the Christian Democratic Appeal (CDA).
- The PVV is exerting a gravitational pull—Prime Minister Rutte is looking to pull votes from the far right with his recent full-page ad run in all major Dutch papers stating that immigrants should “act normal or leave”, according to an article this past January in the Washington Post. The Prime Minister’s coalition government also recently suffered a setback when a cabinet minister resigned as a result of an ongoing investigation about misinforming parliament regarding the government giving funds to a convicted drug trafficker.
- To date, this election has not gotten enough market attention, in our view, but we expect the pendulum will swing the other way as the election approaches.



THE CURRENT OUTLOOK FOR THE DUTCH PARTIES' LIKELY SEAT COUNT IN PARLIAMENT/HOUSE OF REPRESENTATIVES

	CURRENT SEATS IN HOUSE OF REPRESENTATIVES	DECEMBER 18, 2016 POLLS	FEBRUARY 19, 2017 POLLS
VVD	40	23	25
PVDA	35	10	11
SP	15	11	11
CDA	13	14	17
PVV	12	36	29
D66	12	14	14
CU	5	5	5
GL	4	14	18
SGP	3	3	3
PVVD	2	5	4
50PLUS	1	11	10
INDEPENDENT	8	4	3
TOTAL	150	150	150

Source: Peil Opinion Poll. (Leftish parties in grey, rightish parties in light purple).
Not all Dutch political parties are represented in the House of Representatives.

April 23 and May 7, 2017: The French Election

STILL UP IN THE AIR

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- There continues to be considerable uncertainty surrounding the possible outcome of French elections, given that the landscape can still change—other candidates may still jump in the race and partnerships between candidates, such as the recently announced Emmanuel Macron-Francois Bayrou alliance representing two powerful forces in the election, may meaningfully alter voters’ choices. If the current landscape persists, polls suggest Marine Le Pen of the anti-euro National Front could perform strongly, but ultimately lose in the second round on May 7, likely to independent Emmanuel Macron, former economy minister in the Francois Hollande government.
- Most notably, the two main establishment parties of the center-left and center-right have been pushed aside by voters, a trend we’ve seen across several European countries in the last few years. The center-left (Socialists) primary in January produced Benoit Hamon, a candidate broadly considered too far left to likely perform well in the April election. The center-right primary in November was upended by former Prime Minister Francois Fillon’s late surge to victory. Fillon quickly became the front-runner for the April election, and many analysts were excited about his structural reform plans. But Fillon’s prospects have fallen fast in the wake of revelations that Fillon paid large sums to his wife and children as staff members.



- While polls throughout 2016 and so far in 2017 suggest that Le Pen will lose in the second round on May 7, the unexpected landscape of candidates, paired with increased uncertainty given news flow and scandals, has raised market nervousness about a Le Pen victory and the potential for France to possibly pursue exiting the euro area. French government bond spreads over Germany have reached their widest levels since 2012.

September 24, 2017: The German Election

UPENDING THE RACE

“The entrance of former European Parliament President Martin Schulz as the center-left, Social Democratic Party’s (SPD) challenger to Chancellor Angela Merkel has upended the race.”

- While markets are now focused on the French election, the German election has been growing ever more interesting. The entrance of former European Parliament President Martin Schulz as the center-left, Social Democratic Party’s (SPD) challenger to Chancellor Angela Merkel has upended the race. Recent polls show that if the chancellor were directly elected (which does not happen in the parliamentary system), Schulz would tie with Merkel, and some polls have put Schulz’ SPD narrowly ahead of Merkel’s Christian Democratic Union (CDU).
- These rising poll numbers for the SPD create the possibility that a center-left coalition could run Germany, although the most likely scenario in our view at this point remains a grand coalition across the center-left and center-right. The anti-euro Alternative for Germany (AfD) party had attracted voters from both the left and right, and the recent bump in polls for the center-left SPD has seemed to sap some strength from the AfD.
- There’s still a long time until the vote, and a lot can happen between now and then, both in domestic German politics as well as geopolitics. Any wobble in the agreement with Turkey that has capped the refugee flow to Germany may also pressure the German election.

Italy

A HUNG PARLIAMENT

“The current political landscape suggests that elections could produce a hung parliament, similar to the last election in 2013, or a coalition government with dim prospects for the kind of strong reform agenda that could raise Italy’s persistently sluggish economic growth.”

- Italian government bond spreads over Germany have widened recently, partly on expectations that the European Central Bank (ECB) is past the peak point of monetary accommodation, but also due to decreased prospects for reform in Italy.
- While elections are due before spring 2018, we expect elections will occur late in 2017 after parliament revises the electoral law that was partly rejected by voters in December’s referendum and partly struck down by the Constitutional Court in January.
- The current political landscape suggests that elections could produce a hung parliament, similar to the last election in 2013, or a coalition government with dim prospects for the kind of strong reform agenda that could raise Italy’s persistently sluggish economic growth.
- The populist, anti-euro Five Star (M5S) party has polled within two-four points of former Prime Minister Matteo Renzi’s Democratic Party (PD) since last summer, with former Prime Minister Silvio Berlusconi’s Forza Italia (FI) polling steadily in third place and likely to be a factor in coalition negotiations. Former PM Renzi has resigned as party leader, seeking to re-establish authority over the PD after a party congress, but also opening the possibility that new party leadership could emerge this spring.



INFLATIONARY PRESSURE?

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Solid Economic Expansion In The Euro Zone

While politics throw up any number of risks for the euro area this year, it appears to be a far better story on the economic front. Activity has been expanding solidly, driven largely by growing consumption, with more moderate growth in investment. We look for the euro area economy to grow around 1.5% again this year, still above trend, as the healing process continues after the global financial crisis (GFC) and the acute phase of euro crisis. While the economy is absorbing some of the excess capacity generated by the crises, as indicated by year-on-year employment growth of about 1.7%, we believe there is still more capacity to use up before risking inflationary pressure. For example, according to Eurostat/Haver statistics there were still 15.6 million unemployed workers in the euro area as of December 2016, down from the euro crisis peak of 19.3 million reached in the second quarter of 2013, but still far above the pre-GFC level of 11 million workers reached in March 2008.

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