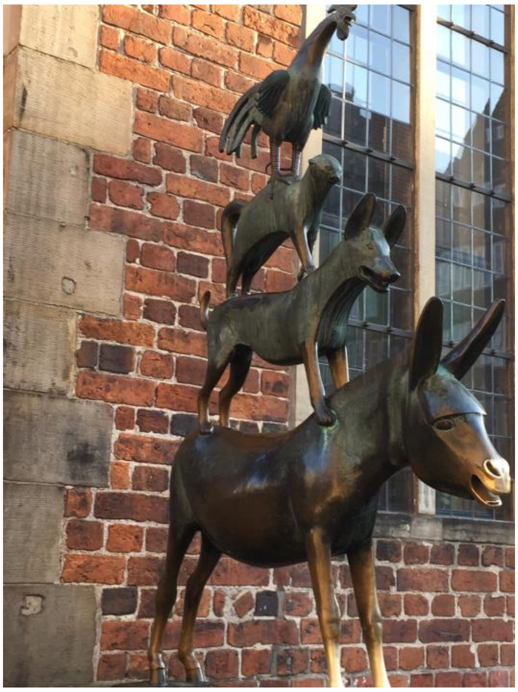
Harbour Navigator

European Growth and Politics

Harbour Navigator 24/02/2017 contactus@harbourasset.co.nz +64 460 8300

Andrew Bascand, Harbour Asset Management's Managing Director, recently returned from a visit to Europe. This piece reflects on what he observed of the European political landscape.

The European political timetable is heating up, although politics is never far from the heart of European market sentiment. I visited London and four cities in Germany last week, and met with many strategists, fund managers and then over 140 financial advisers at hosted lunches and dinners. It provided an opportunity to share a New Zealand perspective on the world, and to listen to different perspectives on Europe, Brexit, and Trump.



In the fairy tale, the Town Musicians of Bremen by the Brothers Grimm, an unlikely bunch of animals succeed at all odds to find a new home. For obvious reasons the European "project" seems still to have legs despite the upheaval of Brexit and changing public opinion.

The economic undertone in Europe has improved markedly since last year, although there is still significant political angst. Munich was hosting the Global Security Conference and was close to lock-down mode when I was there.

In terms of straw polls, very few actually think that Le Pen will win the second round presidential election in France, but after Brexit and Trump, market positioning is becoming cautious. Actual polls show Le Pen trailing substantially for a second round vote, but the polls do remain volatile. Similarly the Dutch elections seem unlikely to create much real change but the noise level is high, and in Germany the political tide seems to be moving, but in a more centrist trend than extreme. Compared with pre-Brexit and pre-Trump dismissive tones, financial advisers are more optimistic about the economy, but remain politically very cautious, perhaps too cautious.

Despite the headlines, Greece seems to be a distant concern. More risk could be attached to another significant bout of Greek nervousness with various reports suggesting that the IMF are reluctant to extend terms. The options seem more limited and less palatable for Greece, and the eventual exit of Greece from the Eurozone could become a plausible scenario and hence a transitory risk for markets. Transitory, because very little Greek debt is held by private banks or in private investment portfolios.

European worries are not uniform. In a poll last week across European countries, potential voters were asked to name their two biggest concerns. In Germany, immigration and terrorism dominate over housing (negligible) and unemployment (not statistically significant from zero). In contrast, in Spain, unemployment is by far the largest concern, while in Ireland housing is the number one concern (ironically, terrorism concerns in Ireland don't rate a score). These polls underline how Europe is travelling - as always, at totally different speeds.

The German economy, thanks to its industrial pharmaceutical and technology orientation, is strong. The low Euro is boosting exports, the only complaints I heard were about doing business in the UK (with the pound so relatively weak).

But economic strength now is not consistent with voter anxiety; a large part of the European electorate want change. In a survey by BoA Merrill Lynch[1] of 210 fund managers, 36% said that disintegration of Europe is the biggest tail risk in markets. This high percentage suggests that investors are at least partly anticipating political change, and yet the polls are nowhere near considering such an outcome at the moment.

After a period of relative economic strength, the UK economy may be seeing the first signs of economic weakness, as sharp price rises for goods begin to hit demand. Although the export side of the U.K. economy may be picking up, retail activity appears to be slowing. When the population eventually wake up and find that inflation is rising more sharply than expected, and that Marmite is actually made by Unilever in Holland, and that increased UK exports of marmalade, biscuits and hard cheese are not going to offset the downturn in earnings from London's current banking and fund management sector, it could be an interesting 2-3 years.

Meanwhile, Europe's perspective on Trump risk is interesting, to say the least. The US equity market, and global indices have made fresh highs. Some put this down to expectations Trump will engage in reflationary policies. But not everyone stands in that camp. Markets appear to be reflecting three things.

First, after almost a decade of watching both political and financial disasters, financial markets have tuned out, unable to predict Trump, and instead are focussing on the data. Second, the

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[1] *The Financial Times, 15th February 2017*

economic data has been much stronger than expectations, so on the facts markets have a reason to take equity prices higher. And third, there is simply too much cash in portfolios, everyone has been too cautious. Ed Yardeni, a stock market analyst, says that US deposit and money market funds have doubled from $4.5trillion to $9.0trillion between 2009 and 2016. We might now be beginning to see a reversal in that flow.

There are other things as well; company earnings are beating expectations in the US, Japan and Germany. In addition last week the world's largest pension fund, Norway's sovereign wealth fund, announced they will apply to parliament to increase their allocation to global equities from 60% to 70%. This fund already owns 1.3%, on average, of every listed company in the world.

After reflecting on a week in Europe I left with less "depression" about the intractable divergence that makes up the Union. The near term political risks seem important but everyone seems cognisant, and positioned for difficult outcomes. As a result, when we worry about market risk, it is more about complacency on cyclical global inflation and wage pressures, especially if data signals that the US Federal Reserve or any other central bank are behind the curve.

There is always a healthy dispersion of views on the business cycle, strategic trends, and market valuation and positioning. Right now everyone is talking about politics. Perhaps then, the real risks aren't political.

One of the world's oldest Astronomical clocks is housed in the Muenster's St Paul's Cathedral. The clock started in 1540, and will run until 2071 in association with the Dionysian calendar. European political developments tend to have time horizons longer than financial markets, perhaps in 2071 it will be a time to panic.

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