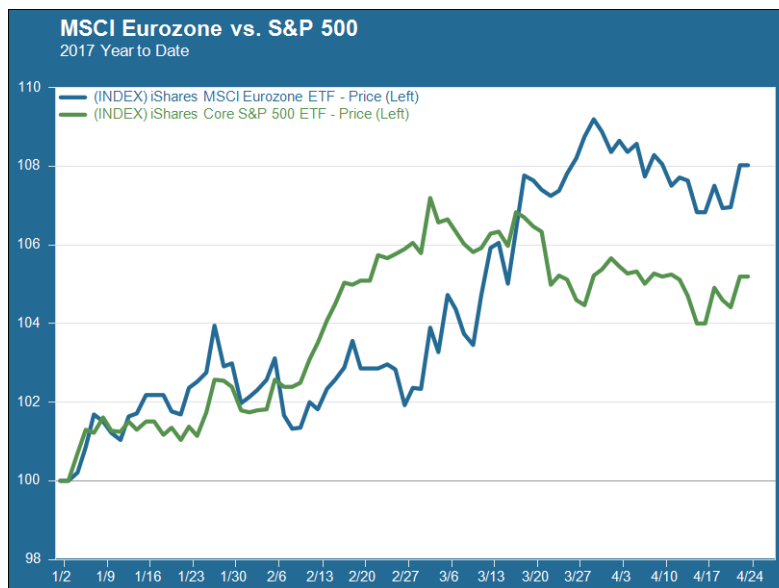


Weekly Market Flash

Eurozone Is Priced for More of the Same

April 21, 2017

How much of an X-factor is European political risk in 2017? We got a partial answer (not much) from the outcome of the Dutch elections last month, which maintained the status quo even as the traditional center right and center left parties fared relatively poorly. We will get another drip-drip of insight this Sunday evening, as election officials tally up the results of the first round of voting in the French contest. There has been some nervous chatter among the pundits, mostly revolving around the scenario – unlikely but plausible – of a second round contest between Marine Le Pen and Jean Luc Mélenchon. Markets, however, appear unfazed. The euro is holding ground at around \$1.07, and the spread on the French 10-year yield over the commensurate German Bund is 61 basis points, down from 78 in the wake of a flurry of Mélenchon-friendly polls last week. And, as the chart below shows, Eurozone equities are holding their outperformance gains versus the US S&P 500.



Source: MVF Research, FactSet

Macron-economics

The “what, me worry?” vibe boils down to a singular view that the ultimate winner of the election will be centrist Emmanuel Macron, a former economics minister and investment banker who cobbled together a new political movement to challenge the loathed traditional parties of the Socialists and Republicans. Macron’s platform is in line with the technocratic sensibilities of EU policy institutions and the IMF, focused on the integrity of the EU and the Eurozone with incremental rather than radical policies for dealing with the region’s ongoing difficulties.

Should Macron ultimately prevail, the market’s current positioning could augur for more outperformance ahead. Economic numbers continue to give cheer; the latest PMI readings show both manufacturing and services at a six year high. Growth, inflation and employment trends all continue to move in a positive, if still modestly so, direction. Other political risks lurk, notably in Italy, but the capacity to surprise will be greatly diminished if the French contest plays out as expected.

Zut alors, c’est le surpris!

What if Macron doesn’t win? If for no other reason, 2016 was instructive in explaining the pitfalls of polls and the many random factors that can lead to an outcome other than the highest-probability one. What will markets do on

Monday morning if the two candidates left standing are Le Pen and Mélenchon? The short answer, given where markets are priced today, would probably be a pullback of somewhere between 5 – 10 percent for regional equity indexes and a move to haven assets like US Treasuries and German Bunds. That is what happened after the shock delivered by the Brexit vote last June. That pullback, though, as you will recall, was brief and contained. Within weeks of Brexit, equity markets had rebounded and the S&P 500 finally set its first record high in 14 months.

In the long run, we believe a Le Pen or Mélenchon victory would be of enormous consequence for the EU, more so than Britain's exit. The market's apparent ability to breezily whistle past every potential calamity would be tested perhaps more than in other recent political risk events. But if we have learned anything about Europe in the last seven years, starting with the wheels coming off the Greek economy, it is that European policymakers are masters of the craft when it comes to kicking the can down the road.

At some point – whether it be from disgruntled citizens voting centrists out of office, a round of financial institution failures or something else – the original flaws of the single currency design will likely deal a potentially deadly blow. But we have no reason to believe that reckoning is any time soon. Our advice to our clients should not surprise any regular reader of this column: resist the impulse to make any rash positioning plays either in advance of or following Sunday's outcome, or that of the second round in early May.

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