Weekly Market Flash

Europe's Woes

December 11, 2020

Every language has particular features that give it distinction. Perhaps the most distinctive feature of the German language is its sparkling ability to encapsulate an extensive idea into a terse single word. "Schadenfreude" is one such word: "the expression of one's joy or pleasure at the misfortune of another." It's a bitter-edged sort of emotion but not necessarily a nasty one: not so much laughing outright at someone else's woes as it is saying "well, things might be bad here but hey, at least we're not the only ones having problems." That kind of Schadenfreude is a sentiment any American citizen might feel these days when, contemplating the three-ring circus of dysfunction that is our current political environment in Washington, she casts an eye towards Europe and realizes that the Old Continent, too, is beset with its own fair share of troubles. Two of them have been prominent news stories this week: the fading prospects of an EU-UK post-Brexit trade deal, and the tortuous progress of a €1.8 trillion regionwide budgetary spending program.

Europe After Brexit: Mind the Gaps

Recall that just about one year ago Boris Johnson's Conservative government swept into power in Westminster with an electoral victory that reached into and upended some of the most durable redoubts of Labor Party support in the country. Voters were tired of the never-ending Brexit negotiations and ready to move on. Johnson promised, Johnson delivered, Brexit was done. End of story? Not quite.

When Brexit came into effect on January 1, 2020 it meant that the UK and the EU would have exactly one year in which to work out a trade deal to govern economic relations between the two sides going forward. Not having a trade deal would upend virtually every aspect of economic life between Britain and its main trading partner. Supply chains would be disrupted, consumer goods prices would likely rise, and even the City of London – the world's leading financial center for cross-border finance – would stand to lose its pre-eminence. So the pressure was on for a deal to get done.

Fast forward to the present. After a number of weeks of back-and-forth negotiations over a handful of contentious issues, the body language from both Brussels and Westminster suggests that hopes for a deal are fading fast. There are two primary issues that have proven elusive in bringing the parties to agreement. One of them sounds a bit farcical to the outside observer: access to British fishing waters for the EU fisheries industry. The fishing fleets of European countries that abut the English Channel and the North Sea have long enjoyed access to these fish-abundant waters for their own domestic consumption. For whatever combination of reasons – and notwithstanding the fact that Britain itself does not get most of its own domestic marine products supply from these particular waters – a new deal to supersede the current arrangement has been extremely hard to pin down.

Oh, and anyone still in the mood for a bit of Schadenfreude might enjoy this little tidbit: at a dinner earlier this week between PM Johnson and European Commission president Ursula van der Leyen, the point of which was to finally reach agreement on the trade deal, the meal's courses were described by the official state protocol as a "fish banquet." There is no longer room for satire in the world we inhabit.

The second fishbone (sorry) of contention is somewhat more far-reaching: an assurance of a "level playing field" between the two sides as their trading relationship evolves. UK negotiators argue that this language is meant to permanently bind the UK to the rules and regulations of the EU – which of course was precisely what Brexit was meant to get away from. For its part, the EU maintains that this is simply meant to ensure that one side cannot take measures that would give its own companies an unfair advantage over those of its trading partner. Despite numerous go-arounds, the gap between the two sides on this issue appears to be as far apart as ever.

Now, there is still a chance that a deal will be done. The EU is famous for furiously cobbling together something at the very last minute, duct-taping the disparate parts and claiming success. Investors by and large still lean ever so slightly towards this as the most likely outcome. But a no-deal is looking more likely as each day goes by. For both sides, but for Britain especially, a no-deal will likely be a very stiff economic and social headwind for a long time to come.

Autocrats Versus Bureaucrats

Speaking of its ability to put Band-Aids on a problem and call it a solution, the EU just today adopted a €1.8 trillion regionwide budget that includes a significant amount of coronavirus pandemic relief and, notably, a recovery fund mechanism that will give Brussels the ability to raise €750 billion for programs via EU sovereign bonds – raising by several magnitudes the total volume of securities that will effectively be the European counterpart to US Treasuries. This has important implications down the road for capital markets as countries around the world – including economic giants like China and Japan – will have a new potential source of funding for their foreign exchange reserves.

So the budget was a big deal for many reasons. But it almost didn't happen. One of the standard provisions in EU region-wide policy initiatives is a rule of law standard; basically, any country that does not abide by the rule of law (as set forth in the European Constitution and the many decades of legislation going back to the supranational body's origins in the 1950s) can be denied the benefits contained in the policies. That might seem unremarkable. But this is 2020, and the rule of law is fighting for its survival in much of the world. In Europe it has been subsumed by ethno-nationalist autocracies in two countries: Poland and Hungary. Those two countries objected to the rule of law provisions contained in the budget, complaining that they discriminated against the ability of Poland and Hungary to continue running roughshod over their own domestic institutions of democracy (Hungarian prime minister Viktor Orban has proudly referred to his own regime as an "illiberal democracy", which is simply a different way to say "autocracy").

In the end the two sides patched things up with a compromise non-binding resolution that Hungary and Poland would not be singled out over the new rules. That will at least allow the spending plan to go forward – but it also serves as a reminder that what the EU purports to stand for – not only as a regional economy but as a social organism – is under threat. The impulses that led to autocracy in Poland and Hungary are alive and on the move elsewhere – in Germany, Italy, France and other longstanding core member nations. This will very likely not be the last time that the technocrats in Brussels have to deal with the hostility of the nativist populism in their midst.

Markets are normally somewhat oblivious to geopolitics. The assumption is that national and regional political structures are just backdrop scenery – the names may change but the institutions endure. That assumption has held for most of the postwar era, but its future effectiveness is by no means certain. There are many geopolitical developments that have the potential to upend anyone's complacency about the coming year and those to follow.

Masood Vojdani
President & CEO

Katrina Lamb, CFA
Head of Investment Strategy & Research

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