ALTERNATIVES

The Underappreciated Story: How Brexit Threatens to Shift the Balance of Power in the EU

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For fixed income investors eyeing opportunities in Europe, 2018 should be the year economic fundamentals reassert their worth, according to David Zahn, Franklin Templeton's head of European Fixed Income. Nonetheless, Zahn believes many investors are underappreciating the long-term implications for Europe of the biggest political uncertainty for the region—Brexit.

TALKING MARKETS WITH FRANKLIN TEMPLETON INVESTMENTS

Here are some highlights of Zahn's thoughts in our latest "Talking Markets" podcast:

- There may be some noise around politics in Europe, but overall I think politics will take a backseat and people will be more focused on what's happening with the European Central Bank and the macro economy.
- I think one of the important points people haven't been focused on regarding Brexit is what happens to the voting situation within the EU Parliament once the UK leaves, as the UK has 12% of the votes. People will realize it does change how the EU functions.
- I think that you will have this whole argument over when quantitative easing in Europe is coming to an end and what the impacts will be. That means rates will probably be quite volatile this year.
- In the run up to the Italian election in March, we will probably see a lot of noise from the different parties talking about their policies. Five Star is the one people will be most focused on, because they are the ones that are saying, "we don't want to be in the eurozone."

The full transcript of the podcast follows.

Host/Richard Banks*:* Hello and welcome to Talking Markets with Franklin Templeton Investments: exclusive and unique insights from Franklin Templeton. I'm your host, Richard Banks.

On this episode I'm joined by David Zahn, Franklin Templeton's head of European Fixed Income, to talk about what 2018 has in store for the region.

Host/Richard Banks*:* David, it's good to have you back on Talking Markets.

David Zahn: Great to be here.

Richard Banks: 2017 was a year in which politics dominated the investment agenda. How do you see that changing in 2018?

David Zahn: I think in 2018, we probably won't have a lot of major political events in Europe. There is only one major election coming up, which is in Italy, and that seems to be heading towards a hung parliament of some sort or a grand coalition. I think there may be some noise around politics, but overall I think politics will take a backseat and people will be more focused on what's happening with the ECB [European Central Bank] and also what's happening with the macro economy.

Richard Banks: There were a sway of high-profile elections across Europe last year, notably in France and in Germany. So what do we think the legacy of those could be in 2018?

David Zahn: Well, we have to remember that Germany still doesn't have a government, they are still trying to form the coalition. That is going to take time, but it probably means that [Angela] Merkel is a weaker leader than she was prior to the election. In France, we had the election of [Emmanuel] Macron, and he has all these plans to revolutionize France and do a lot of good reform. But I think most politicians don't quite deliver as well as expected, and so there is scope for the market to be disappointed if he doesn't do as well as people hope. But also putting the two together, having Merkel on one side and Macron on the other, I think it means a much more stable European area, especially in the eurozone, because Macron definitely wants further integration and that's something Germany wants as well. I think it means that the leadership at a European level is probably more stable—even though we don't have one single leader—than we have had in quite some time.

Richard Banks: So a little more stability there, politically. What does that mean for investors?

David Zahn: I think for investors it means we will start looking at the fundamentals as we talked about before, and we will start looking at [things like] what is the growth in Europe, what is the inflation, what are some of the issues in Europe that need to be dealt with, where are levels of [bond] yields? I think that's where people will start to refocus. In addition, I think we may get some political noise in the short term, but really, the major issue we have coming up is that the ECB has begun their tapering. We will find out, probably in the summer, how long they are going to extend it after September and also we are going to start hearing talk about who is going to replace [Mario] Draghi. There are several other members of the ECB that are going to be stepping down, so the composition of the ECB will be changing quite a bit over the next 18 months. So I think that's something that investors will start to focus on.

I think one of the main focuses is how the European economy is doing. I would say growth is doing great, I mean it's over 2% [GDP] growth in aggregate. There are still some parts that are weaker than others, and so therefore, they [the ECB] need the accommodative stance. Inflation is up at 1.6%, 1.7%; however, this year with year-on-year effects, I expect inflation will probably come off a little bit, and so we probably will be down around 1.4%, 1.5%. Not a lot, but it's not at the 2% target, and I think that's what the ECB will be looking at; we have inflation that is well below their target because the target is 2%. [ECB President] Draghi alluded that inflation could go above 2% because this is over a longer period of time it's supposed to be below 2%, and we have been below for a very long time here. So I think there will not be much emphasis to try to tighten too early.

So I would expect that the ECB will probably extend its QE [quantitative easing] program slightly after September, just to gradually bring it down, and remember they are also reinvesting all the maturities, which is starting to become quite a large number of about €10 billion a month of reinvestment, so that actually helps with the monetary transmission. And lastly, I don't really see any reason why they should be looking to raise interest rates to well after QE is over, which now looks like will be at least 2019, so you would probably looking at 2020, 2021 before they start raising interest rates. And that all makes sense given their own inflation forecast.

I think that means for investors that bonds in Europe will probably be range-bound for the year. You know, could we see 1% on the [German] bund? Yes, we definitely could see that, but I think to see yields much above that, you would have to see inflation come back in a much stronger fashion outside of Europe as well as inside Europe for people to get more concerned about it. And so I think that means you will be in a range trade and you need to have active management to basically look at when should you be buying bonds and when should you be selling—should you be trading that range for most of the year? So, [I think] fundamentals will be supportive of yields slightly higher than where we are now.

Richard Banks: So in that popular phrase—pockets of opportunity—where have you got your eyes at the moment?

David Zahn: Well I think there are some pockets of opportunity in some of the currencies in Europe. I think that some of the Scandinavian currencies are things that we are interested in. I think there also will be some opportunities around the Italian election as I expect that there will be some noise coming out of the different political parties in Italy and while that will not have, I don't think, a long-term impact on Italy, it probably will create some volatility or maybe some opportunities in Italy at attractive levels. And also, I think you will have this whole argument over when is QE coming to an end, how is this impacting [the markets] and that will mean rates will probably be quite volatile this year, relatively. Therefore, we should be able to take advantage of that by basically—when things seem like they're getting to normal levels—making sure we own it. When things get too expensive, making sure that we don't own it.

Richard Banks: You touched on the Italian election there. What are your expectations around the Italian election coming up in March this year?

David Zahn: I think in March and in run up to March, we will probably see a lot of noise from the different parties talking about what their policies are. Five Star is the one people will be most focused on because they are the ones that are saying, "we don't want to be in the eurozone, we want to leave, it will be better for Italy not to be in the eurozone." And they have been polling quite well. They are in first or second place, but, we have to remember, that's only with a third of the votes. So even if they win and they have the most delegates, [I think] they won't have enough to form a government and they won't be able to rule, which means we will have to get some type of technocrat government, some type of grand coalition.

The other thing that could be of interest to investors is any coalitions that form in the run up to the [Italian] election, because there will be some smaller parties that will be trying to get together to try to get over the threshold to be able to get into the parliament, so I think that will also be something of interest. But overall, I think in the longer term, it will create a bit of noise. Probably presents some opportunities, but [I think] no party has such a strong vote right now that they should be able to get more than 50% and actually be able to rule, which is the most important thing.

Richard Banks: So, are there implications for the wider European Union project from the Italian elections?

David Zahn: I don't think there is a lot to be taken from the Italian election. It kind of depends on who does get in charge, but I think, in general, they will just want to keep Italy moving along in a similar fashion as they are at the moment, which does need to have more reform, there is no doubt about that. I don't think there will be the appetite to do that reform, so you will see some minor reform on the edges. But that means Italy is quiet, and [I think] Italy will not be talking about leaving, and that gives time for Europe to move forward. And we have seen some positive signs out of Italy; I mean Italy has growth for the first time in many, many years and so I think it is positive that growth is starting to percolate out into some of the countries where it has been quite difficult to achieve in the past couple of years.

Richard Banks: We can't avoid the topic of Brexit. I guess, a lot of the focus, particularly in the UK, has been on the implications for the UK. I know you take a slightly different view. Tell us a little bit about how you are eyeing up the Brexit negotiations and what the implications may be for investors and for Europe generally?

David Zahn: For the negotiations, I think they will end up forging something and will get some type of deal, and we'll get a transition period of a couple of years and then we'll get some type of trade agreement. But the real question becomes, how do they deal with the Irish border? It's difficult to see the solution because you don't want to hard border between Northern Ireland and Ireland, but you don't want to hard border between Northern Ireland and the rest of the UK. So the only real way to do is keep the whole UK in the entire trading block, which then doesn't mean you really kind of have left. So I think that that will be the linchpin, if you will, of the negotiations of how do we deal with that, and I think dealing with that is going to be quite difficult.

I think people really have underestimated that if the UK were to leave [the EU] with a no deal at all and no transition period—and so it just left in March 2019—this would impact Europe as well. Places like Ireland would be hit very hard; places like Germany would also be hit quite hard. I think there are different parts of Europe that will be quite focused on making sure there is some type of deal, maybe not the best deal, but there will be some type of deal. Also, I think it will reveal some of the splits within Europe that you have in some countries such as Germany or France that want to have a more integrated Europe. And, basically, if you are in the eurozone, you're all coming together closer and closer and some of those are more outside, more in Central Europe, that said, "well, we want to kind of have a looser grouping where we get some benefits but we still have more of our own sovereignty." I think that split will be quite interesting to see exactly which countries fall into which camp.

I think one of the important points people haven't been focused on as much is what happens to the voting situation within the EU Parliament once the UK leaves. We have to remember that the UK has 12% of the votes in the EU Parliament, and, if you look at euro countries which are about 70% of the votes, and the non-euro countries which have about 30% of the votes, you need 67% in order to pass any legislation. So if you are at 30% for the non-euro countries, you only need to pull across one or two small countries in the eurozone to basically block legislation that you don't like. However, once the UK leaves and as 12% votes just disappear, it means that actually the eurozone countries will have a formal majority and even if one or two small countries that don't really like the legislation go over to the non-euro countries, it will still pass. So I think it means that countries that are non-euro countries within the EU will have a smaller say within the Parliament. I think that's important because it means, how will policy be driven forward?

Number two, Germany and the UK actually used to vote quite a bit together—both quite pragmatic—as have some other groups and again they are very close to that 67% block and tended to be more fiscally austere countries that used to kind of be in that block. So the Netherlands, Germany, etc. But now that the UK is leaving with the 12% vote, it actually means the other countries that tend to spend a bit more will actually have the overriding votes to push through legislation. I think this means that the way Europe functions, it will become much more of a euro club and if you are not in it, well, you are going to have join or you just won't have any say in what's happening. As well, I think it may be much more focused on countries that tend to maybe spend a bit more rather than be more austere. I think that could create some friction within Europe, and I think that's something people haven't really looked at as much. That's kind of for 2019, 2020, but people will already start to be plotting that, how does that work?

Richard Banks: So, some significant longer-term implications for Europe and eurozone in general.

David Zahn: Yeah, I think it's more kind of 2019, 2020, but still, I think people will start to realize that this does change the makeup and does change how the EU functions because many people in the EU will say the UK has been a bit of a thorn in the side for some time and this will actually be alleviated and they will be able to pass the type of laws that they wanted to pass for some time, even though I think that many of them could have longer-term ramifications.

Richard Banks: We've talked about a number of the big ticket agenda items for 2018. Is there anything less high-profile that you've got your eye on?

David Zahn: I think that there are a lot of little things going on in Europe. What's going on in Poland and Hungary with having the anti-immigration stance and how do they stack up against the EU, I think that will be interesting to watch. I don't think it will necessarily be a major event, but if more people start to come over to their side, that could change policy.

I think it's important that Greece is growing, they have had three consecutive quarters of positive growth, which is something they have not had in the last six or seven years or so. I think that again shows the economy is starting to heal and I think that's positive, it's a longer-term story but I think that's good.

I also think the Catalonian situation [in Spain] is going to continue to rumble along, and I think that will create constitutional issues for Spain to have to deal with, and that probably will affect some of the inward investment into Catalonia assuredly but also Spain in general. I think these [issues] might have some longer-term ramifications. These are all little things that I think that if one of them flares up and become slightly bigger, they could have a bigger impact. But at the moment, I think there are more smaller issues that we should be aware of but not get too focused on because actually on the longer-term investment horizon, they are not really as crucial to some of the larger issues we have already talked about.

Richard Banks: David, thank you very much. That's all we've got time for on this edition of Talking Markets with Franklin Templeton. If you've enjoyed hearing from David and want more insights from our wide range of on-the-ground investment professionals, check out our archive of previous episodes and subscribe on iTunes, GooglePlay, or just about any other major podcast provider.

So until next time, goodbye.

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