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US Election Implications for Europe: What Many Observers Are Missing

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David Zahn, CFA, FRM
Head of European Fixed Income
Senior Vice President, Portfolio Manager
Franklin Templeton Fixed Income Group®

Global political uncertainly has been plaguing investors around the world for months. With the UK Brexit vote behind us, attention now turns to the US presidential election. In this blog, David Zahn, head of European fixed income, Franklin Templeton Fixed Income Group, looks at the possible implications for international markets as the new incumbent for the White House is revealed. Among other observations, he suggests that should Donald Trump emerge victorious in the November 8 general election, the direction of next year's Brexit negotiations could be altered. Zahn also looks at the latest developments in the planned Italian constitutional referendum.

When I survey the current investment landscape, I'm struck by the fact that two things are driving financial markets today: central bank policies and politics. Of course, over the longer term, macroeconomic fundamentals will continue to be important, but for now they are taking a backseat when it comes to influencing markets.

Investors around the world are keeping a keen eye on the developments in the US presidential election. My experience talking to investors and investment professionals in Europe suggests that the immediate impact of a Donald Trump victory on markets in those regions could be significant, because people are more concerned about what the Republican candidate would do in office given some of his pre-election rhetoric.

It's true that no clear, detailed picture of Trump's policies has emerged, but some observers have interpreted a number of his statements as anti-globalization. He seems also to have hinted that the United States has been too engaged militarily overseas, indicating he might consider scaling back the country's involvement in organizations such as the North Atlantic Treaty Organization (NATO). Both of these positions seem likely to cause concern among Europeans in particular.

I think, generally, observers underestimate the importance of the United States' military support for Europe, notably through NATO. For instance, if Europe had to build up its own military capacity to replace the contribution made by the United States, it would place quite a burden on European states, many of which currently spend a relatively small proportion of gross domestic product (GDP) on defense.

Furthermore, there could be implications for the other big political talking point at the moment: the manner of the United Kingdom's departure from the European Union (EU).

Currently, the United Kingdom is one of the few EU member states to spend 2% of its GDP on defense. So perceived disinterest from an incoming Trump administration in the defense of Europe could prompt EU officials to take a greater interest in ensuring the United Kingdom remains engaged.

Whatever the political landscape in the United States after the November 8 presidential election, it seems likely that the United Kingdom's Brexit negotiations will prove a talking point for investors for months and years to come.

UK Prime Minister Theresa May has indicated she intends to begin the formal uncoupling of the United Kingdom from Europe by invoking Article 50 of the Lisbon Treaty by March 2017. From my perspective, that's a strange choice because it would mean embarking on complicated political negotiations during or very close to major election campaigns in Germany and France.

I would question why a leader would start such a potentially bruising process knowing that two of the most important leaders with whom she will have to negotiate will not be focused on Brexit for at least the following six months, and likely even longer in the event of victory by new administrations looking to implement new domestic agendas.

Equally, I would think it unlikely that anyone running for office in France and Germany would want to give the impression that they would give the United Kingdom negotiators an easy ride, which could mean the Brexit talks get off to a challenging start.

So it seems to me, the probability of a so-called "hard Brexit" has increased. In other words, the United Kingdom giving up full access to the single market and full access of the customs union along with the EU.

I think Brexit without trade agreements in place to mitigate the loss of this access to EU markets would likely be negative for the UK economy, but I also think it would be bad for the European economy because of the level of trade between the two. A European economy that is growing only slowly could ill afford to lose such a trading partner, in our view.

There is already evidence that concerns about the manner of Brexit have been reflected in the strength of sterling: it has tended to fall on headlines suggesting Brexit could be tougher than the UK government hopes. I believe "hard Brexit" could prompt further falls, and that might lead to further monetary policy easing.

Optimists point to the relatively positive UK macroeconomic data since the June 23 vote as evidence that the concern over Brexit has been overplayed, but it's important to remember that nothing has actually happened yet. The United Kingdom remains part of the EU, with all the costs and benefits that membership brings.

With that in mind, we wouldn't have expected the data to deteriorate right away. Markets and businesses know that a change is coming, and that's been reflected in reports of some investment tailing off, but in reality most people are just getting on with their day-to-day lives.

Could We See a "Shy Trumpers" Effect?

The attitude of financial markets ahead of the US presidential election seems to me to be strangely reminiscent of the run-up to the United Kingdom's Brexit vote. Just as markets then seemed to have discounted the possibility of the United Kingdom voting to leave the EU, now it feels as though the markets in general are working on the basis that Hillary Clinton will win and feel the chances of Donald Trump getting the keys to the White House are low—although higher than they were.

While many opinion polls seem to be giving Clinton the edge, experience of recent elections in other parts of the world suggests there may be some under-reporting of Trump's support because supporters of potentially divisive candidates may not want to be so public about their support.

It's a phenomenon familiar in Europe. In Italy it's known as the "Berlusconi Factor," after former Italian Prime Minister Silvio Berlusconi. Typically, the flamboyant Berlusconi would poll poorly in the run-up to general elections, but often went on to do much better than polls would suggest. Similarly in the United Kingdom, so-called "shy Tories," who kept their support for the center-right Conservative Party quiet from pollsters, contributed to the surprise of the 2015 general election, in which the Conservatives secured an unexpected majority against the run of much of the polling.

Investors Await Italian Referendum Outcome

It’s fair to say that global referendums held recently have not proved terribly successful for their organizers. Whether that unhappy tradition continues with the Italian referendum on constitutional reform scheduled to be held on December 4 remains to be seen.

The latest polls suggest that it could be very close, but it seems a large number of people have yet to make up their minds.

I’ve spent some time in Italy recently and the impression I’ve had is that many people are not sure exactly what they’re voting on. One person told me: “We know we’re voting on something that should make the system better, and that should be enough because the current system doesn’t work.”

The potential problem for Italian Prime Minister Matteo Renzi, who called for the referendum, is that voters might make their decision based on their attitude toward his government, in other words a vote of confidence in him.

Renzi had originally indicated he would stand down if he lost the referendum, but now seems to have stepped back from that position, claiming the vote is not about him, but rather about changing the political system. He has said he intends to stay on until 2018 regardless of the vote, but I think that could be untenable for him. If he suffers a significant loss, I think it would be difficult for him to stay.

From an investment standpoint, we would expect Italian bonds to remain under pressure until there is some kind of resolution to this political uncertainty. Currently, we think the risk-reward trade-off leans towards a negative result. In other words, if the vote goes against Renzi we wouldn’t be surprised to see Italian bonds underperform in Europe; on the other hand, we don’t expect much more than a small outperformance if the vote is “yes.”

We expect political noise to become even more of a factor over the coming weeks and months. Political uncertainty has the potential to impact investment sentiment and the global economy so we will continue to monitor the situations closely.

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