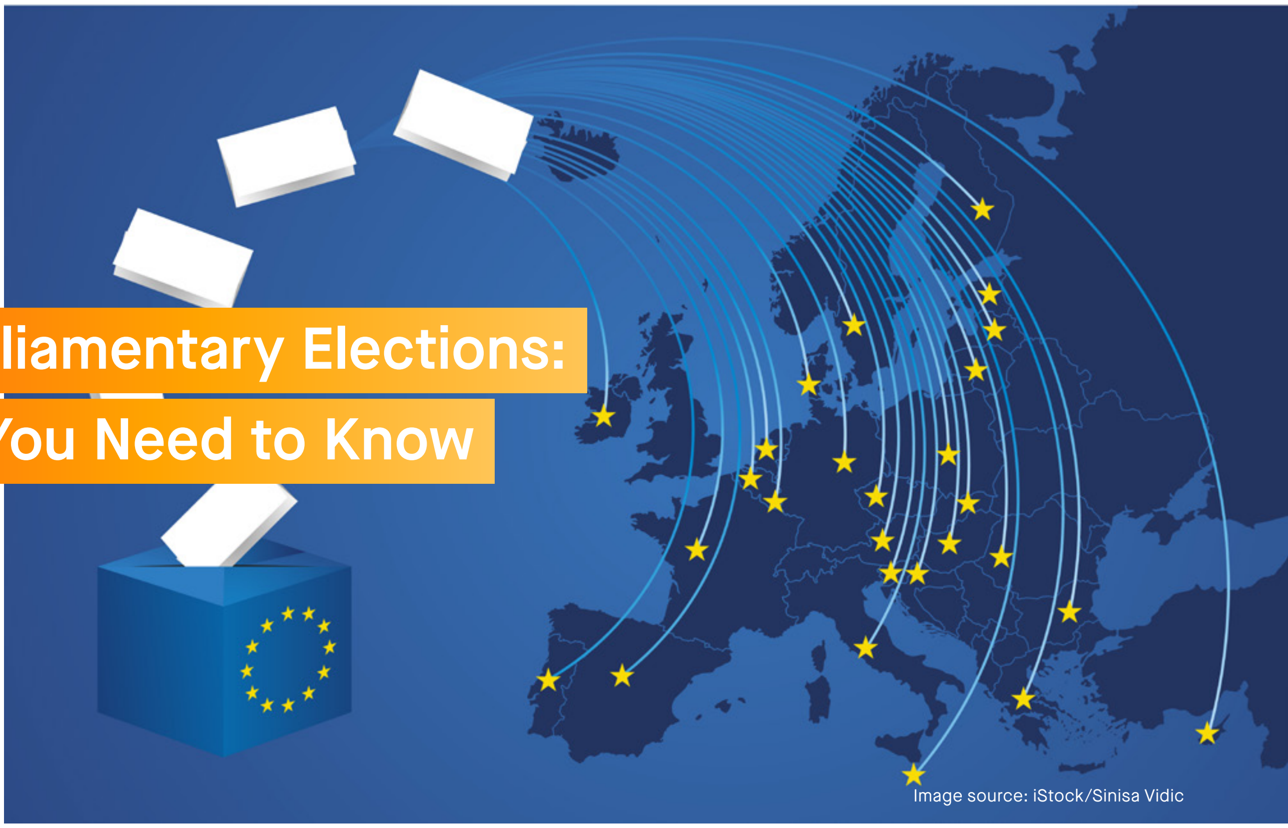
EU Parliamentary Elections: What You Need to Know



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PRIVATE BANKING

The long view

The latest European elections have delivered one main message: voters are increasingly attracted by anti-establishment, populist, far-right parties, that will now hold around 25% of the seats in the European Parliament. In France, this upsurge has even triggered snap national elections.

From an economic standpoint, the short-term impact of this elections might be limited at the European level. However, this dynamic further undermines one guiding principle upon which European economic policies have been built: fiscal orthodoxy.

The recent years have altered the people's perception toward public finances. It had long been generally accepted (even if never very popular) that sound public finances was necessary. But the public spending bonanza of the Covid years, the war in Ukraine and the ensuing inflationary wave have shifted the focus away from public finance sustainability.

In this context, the new EU Parliament, and more importantly most European governments, appear unlikely to implement significant public spending cuts and higher taxes, that may yet be necessary to drive back government deficits toward sustainable levels.

One can therefore expect public debt to continue surging in euro terms in the coming years. It will also likely increase as a percentage of GDP, driven by rising interest payments on public debt due to higher interest rates. A rating agency downgrade looms, as recently experienced by France.

Paradoxically, inflation both drives and results from fiscal overspending. Accommodative fiscal policies are likely to sustain inflationary pressures by keeping final demand firm and preventing downward adjustments in prices after the surge of 2021/22. This may lead to persisting inflationary pressures that will further reinforce the appeal of populist policies and may force the European Central Bank (ECB) to maintain rates at a "high" level.

In this sense, last Sunday's results may signal a continuing long-term trend of escalating public deficits and debt, rising inflation, and increasing interest rates. It's not entirely surprising that a growing portion of the population is supporting these economic policies. Inflation can be a powerful and tempting way to reallocate wealth, away from creditors and capital owners, and toward debtors and workers provided wages rise in parallel of prices. Unfortunately, history has shown that the long-term economic consequences of such dynamic are always dire.

European equities: reasons to be fearful, reasons to be cheerful

The European election results show that the world is becoming more fragmented after decades of globalization. To counteract the negative impact on growth, we resort to increased government spending. This leads to higher inflation and more regulation.

While this backdrop is less favourable for asset prices, equities remain attractive in this low growth and inflationary environment. Effectively, as long as we avoid outright deflation, corporate profits are geared to nominal growth and therefore provide a hedge against inflation. In addition, contrary to debt that we have plenty and we keep issuing, high quality equities are getting scarcer as the concentration of profit is increasing and the corporate share buy-backs are reducing the supply.

As the world is getting more fragmented, it is important to look at businesses that can adapt to this new environment. This means businesses that are more local or regional and/or with very strong competitive advantages. On the other hand, investors should be cautious investing in heavily regulated industries as visibility may decrease.

Fixed income: OAT spreads on the rise while credit spreads remain well behaved

One of the main lessons from the recent European elections is that higher interest rates are here to stay for the foreseeable future. The initial market reaction was an increase in interest rates across European countries, with 10-year EUR government yields rising by an average of 10 basis points (bps). France, in particular, saw a significant impact after the announcement of snap elections, with its 10-year OAT yield increasing by nearly 20 bps to reach a yearly high.

While government bonds were notably affected, the credit market remained relatively stable. The iTraxx Europe Main index, which tracks investment-grade European credit, only rose by 2 bps. The iTraxx XOVER index, which tracks high-yield European companies, increased by 5 bps, remaining well-contained. The only sector that saw a notable decline was AT1 bonds, the most subordinated part of a bank's capital structure after equity, which dropped by 0.6% over two trading sessions.

This situation calls for caution. Potential rating downgrades for France could put more pressure on government bonds, especially as major investors, like those in Japan, find more attractive opportunities in their domestic markets. We have been underweight on fixed income for some time now, especially on long-term government bonds, due to the inverted yield curve, negative term premium, high interest rate volatility, and large supply. We continue to hold this position.

Additionally, political risk is a major concern in 2024, with many elections happening around the world. Given the current political uncertainty, recent credit rating downgrades, and the possibility of more downgrades, along with fiscal policies under a new government, we prefer to avoid OATs for now. The increased risk and volatility in France's fixed income market make OATs less attractive.

Forex: Euro is (again) under pressure

As the consequences of the rise in anti-establishment parties will only be felt over the medium-to-long run in the economy, the initial reaction to the European elections was rather muted on Forex markets. The modest decline in the EUR/USD and EUR/CHF exchange rate (-0.6% in the following two days) may rather be linked to the uncertainty created by France's snap elections than by the EU level election results.

Over the medium term, an environment of higher inflation and rising public debt is certainly negative for any currency and the euro will be no exception. However, as inflation and public debt dynamics are not specific to Europe, but rather a global trend among most developed economies, other currencies will also face similar headwinds in the future. In the US, fiscal policy is likely to remain expansive regardless of who wins the next Presidential election, which could weaken the US dollar's fundamentals under the next Administration.

As such, exchange rates between currencies may not be the best barometer of the impact of those long-term economic trends, except for the rare economies that don't give in to the siren calls of rising public debt and inflation (Switzerland being the best example). Gold is likely to be a better gauge of the erosion in currencies' value caused by this trend. The yellow metal was up +1.6% versus the euro in the two days following the European elections.

For the time being, we continue to hold a negative view on the EUR vs USD. Political uncertainty in Europe adds to the existing dynamic of rate differentials between the ECB and the Fed, as the ECB has started to cut rates ahead of its US counterpart.

We also continue to hold a positive view on Gold, for the diversification that it brings in portfolios and for the hedge it can offer, precisely when inflation and public deficits become more structural.

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