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European political drama takes centre stage

Europe emerged as a key risk to global financial markets this week, as political and economic worries added to trade concerns to form a powerful negative drag on equity markets. Last week's European Parliament elections confirmed a more polarised political spectrum within the bloc, which is expected to translate into both the functionality of the EU and internal politics within the EU member countries. At the same time, the European Central Bank's (ECB) financial stability report published today suggests that increased political uncertainty could exacerbate existing economic weaknesses within the Eurozone, with significant risks which could negatively impact on asset values.

European Elections- "Fragmentation and a shrinking centre"

A new political order appears to be emerging in Europe following the conclusion of European Parliament elections last week. The traditional centre appeared to falter in the hardest-fought European Parliament elections in decades, with centrists losing ground to far-right and Green parties. Turnout was at a two-decade high across the 28 EU member countries in what was seen as a test of nationalist, populist and hard-right influence in the bloc following years of political uncertainty. Populist parties made meaningful gains, however pro-EU parties maintained around two thirds of seats.

These elections have shown that Europe's long-standing duopoly of centre-left and centre-right forces is over. The old politics of slightly socialist and slightly conservative parties working to produce relatively stable national politics has been broken by the polarisation of internal politics which has now translated into the European Parliament level.

In the UK, the newly formed Brexit party (headed by Nigel Farage) and the pro- European Liberal Democrats had the strongest showing, illustrating a clearly polarised electorate on the Brexit issue, while the Conservatives suffered large losses. In France, Marine Le Pen's populist National Rally party gained the most support with 24% of the vote, which is interesting considering that President Macron's party won 21% of the vote, having made EU integration the heart of his presidency. In Germany, Chancellor Merkel's Christian Democratic Union party lost a significant number of seats to the Greens and the far right, as Merkel's heir apparent Annegret Kamp-Karrenbauer oversaw the party's worst ever result in a national election. In Italy, Salvini's far-right league party gained the most support with 34% of the vote, up from 6% back in 2014. Overall, the results reflect the reality of today's world, which has changed vastly since the last election in 2014.

The results have significantly impacted functionality within the European Parliament, leaving the two main parties (the European People's Party and the Socialists & Democrats) without a majority for the first time since 1979. Talks are now in place to form a coalition, with possible parties to form the partnership being the Greens or the ALDE free market liberals. Despite the fragmented nature of the new parliament, it should be relatively easy to strike an agenda that reflects the sentiment of EU citizens, however it is clear that traditional parties must either regroup or be replaced. It will be interesting to see what implications the political polarisation will have on internal politics and the bloc going forward.

Risks in the Eurozone Economy

In its latest Financial Stability Review, the ECB expressed concerns that downside risks to the growth outlook remain prominent, and that weaker growth and a possible escalation of trade tensions with the US could trigger falls in asset prices. The report highlighted that risks to public and private finances have risen over the last 6 months, leaving companies and governments with a high level of debt exposed to a sudden rise in funding costs. Additionally, the central bank warned that although capital adequacy remains strong, banking industry profitability will remain below the levels demanded by investors, not just because of negative interest rates, but due to high cost structures, limited revenue diversification and underperforming legacy assets (bad loans).

The ECB highlighted that given the current risks in the global economy, if downside risks to the Eurozone growth outlook were to materialise, this may cause risks to financial stability. The report outlined four key risks to Europe's financial stability:

- A disorderly increase in risk premiums (bond spreads are widening and US equity valuations are high)
- Debt sustainability issues within companies and governments (the amount of lower-rated corporate debt has doubled over the past 5 years, and government current account deficits are at all-time highs)
- Hampered bank intermediation capacity due to overcrowding and cost inefficiency in the banking sector
- Increased risk taking in the non-bank financial sector as investors go in search of yield, amplifying risks in the financial sector

Overall, weaker than expected growth and a possible escalation of trade tensions with the US, combined with existing US-China trade tensions could trigger a decline in asset values, testing financial stability in the bloc. As the region grapples with slower growth and lower confidence, corporate earnings are likely to become squeezed, affecting the ability of corporates to service their debts. Particular risks lie in the global leveraged loan sector (which has been growing in recent years) as investors go in search of yields in the financial sector, which could pose a significant risk to financial stability. As it stands, according to the central bank, the Eurozone economic recovery has been delayed but not derailed, however as economic conditions worsen, material downside risks to Euro area growth increase.

Overall

With European Parliament elections now over, European leaders are arguing over replacements for the top positions within the European Commission, which is likely to be a key theme in Europe going forward. As political uncertainty increases, economic conditions are likely to become more strained, increasing risks in European financial markets. For now, given the increasing political and economic risks in the area, we retain a low exposure to European assets, with our exposure seeking to benefit from a decline in European equity markets.