FIXED INCOME

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, he believes many investors are underappreciating the long-term implications for Europe of the biggest political uncertainty for the region—Brexit.

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Hear more from David Zahn in our latest "Talking Markets" podcast.

After a year in which politics dominated the European investment agenda, we expect 2018 to bring more focus on economic fundamentals.

However, looking further out, we see politics returning to the agenda as the full implications of the departure of the United Kingdom from the European Union (EU) reveal themselves.

In particular, we see Brexit having a significant impact on the balance of power in the trading bloc and on the way it operates.

The election of Emmanuel Macron as French president and the re-election of Angela Merkel as German chancellor—both proponents of further European integration—suggests to us that political leadership for the EU is probably more stable than it has been for many years.

So in 2018, at least, we think politics will take a backseat and markets will be more focused on the European Central Bank's (ECB's) monetary policy course, as well as the macro economy.

Our view is the growth story in Europe is generally positive, although there are reasons to be cautious. Some regions are weaker than others and inflation across the eurozone remains well below the ECB's 2% target level—all of which continues to justify the ECB's continued accommodative stance. We'd expect the ECB to extend its quantitative easing (QE) programme slightly beyond its current September timeframe.

Equally, we don't expect to see the ECB start raising interest rates until well after QE is completed. So we're looking at 2020-2021 before eurozone interest rates begin to rise.

On the other hand, we expect the composition of the ECB could change over the next 18 months. Mario Draghi's tenure as ECB president is due to end in October 2019, with several other members of the ECB governing council also expected to step down over the next year.

Taking all of these considerations into account, we'd expect bonds in Europe will probably be range-bound for the year. Yields may rise slightly higher than they are now, but we wouldn't expect to see any substantial increase without inflation coming back much more strongly not just in Europe, but outside as well.

However, we do see some potential pockets of opportunity in certain European currencies—notably the Norwegian krona and Swedish krone—which have sold off quite a bit recently.

Brexit Threatens to Shift Balance of EU Power Longer-Term

For all the current bluster, we believe there will eventually be some kind of Brexit deal between the United Kingdom and the EU.

Certain parts of Europe—notably Ireland and Germany—could potentially be hit quite hard if the United Kingdom were to leave the EU without a deal. So we think those parts of Europe will likely be focused on making sure there is some type of deal, although not necessarily the best deal for all sides.

But longer term, we think the United Kingdom's departure from the EU may start to reveal differences of attitude amongst different factions within the trading bloc. And, it may bring about a switch in the balance of power in the European Parliament towards eurozone countries.

Countries such as Germany and France want to have a more integrated EU, while others, for example in Central Europe, favour a looser grouping that offers them trading benefits while allowing greater control over their sovereignty.

Under European Parliament rules, a vote or veto needs 67% support to pass. Currently eurozone countries represent around 70% of the votes in the European Parliament, with non-eurozone countries, including the United Kingdom, representing the remaining 30%.

So currently, dissention from just one eurozone country could scupper a vote. But after the departure of the United Kingdom, which represents 12% of European Parliament votes, the voice of non-euro countries will have less force.

We think this could mean the EU becoming much more of a euro club. Those countries that have not adopted the euro may have to rethink their position if they want to have a say in the future of the bloc.

On a similar note, the United Kingdom has tended to take a more economically austere approach to the EU budget, often voting with other mainly northern European member states (including Germany) against spending increases.

Once the United Kingdom leaves, countries in favour of more EU spending may find themselves in the majority, with the potential to succeed in votes even in the face of possible German opposition.

We think that too could create some different dynamics in the trading bloc, although probably not in the immediate future. Still, we think European politicians will already be starting to plot their approach to this changing situation, and it's something we think should be on the watchlist for investors.

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