FIXED INCOME

Back from the Road Again: Five Things We Learnt from Our European Roadshow

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On a recent European roadshow, David Zahn, Franklin Templeton's head of European Fixed Income, had the chance to meet investors from Germany, France, Italy and Spain. In this article, he sets out some of his takeaway messages from the trip, including a couple of surprises.

Questions About Europe's Growth Trajectory…

A number of investors we spoke to during our recent week-long European tour had questions about Europe's economic resilience going forward.

Eurozone growth has slowed somewhat this year and some people asked us whether we thought this could be the start of a downward trend.

We're more optimistic. We recognise that the eurozone economy is slowing, but we think that's because it can't match last year's strong growth. In 2017, gross domestic product (GDP) growth in Europe was a little above 2.5%. We think this year's GDP growth forecast at just below 2% reflects a more sustainable pace.[1]

It's true that certain of the larger economies are on course for disappointing growth; for example, German growth was negative in the third quarter and Italy has zero growth. However, we consider much of this slowdown to be temporary.

Crucially, the European Central Bank (ECB) seems comfortable with the situation and believes the latest growth figures are within its expectation boundaries.

… But ECB Direction Remains the Main Preoccupation

During our European tour, the main topic of conversation was the future direction of ECB monetary policy.

Our view remains that the ECB will likely maintain its accommodative stance for some time. It has expressed a commitment to stopping new quantitative easing (QE) asset purchases in December this year, but intends to keep reinvesting maturing assets. Furthermore, we do not expect the ECB to begin raising interest rates before 2020, as we've discussed in the past.

However, the ECB's presumed approach raises questions whether it retains enough firepower to deal with any economic bumps in the road in the short to medium term.

Reflecting the concern about Europe's resilience, we fielded a number of questions from investors about the options open to the ECB should the eurozone slip into recession while interest rates across the bloc remain at their historically low levels.

Our expectation would be that the ECB would kick-start its QE programme and begin ramping up purchases again.

There's No Consensus on the Political Situation in Europe

The rise of populism across Europe continues to make headlines, but during our visits with investors, we detected a range of views about its significance. Concern about the importance of populism was less entrenched in France and Germany than in Spain and Italy, where it was a hotter topic of conversation.

In Spain, there was concern about mounting support for the new far-right party Vox, which seems to be adopting a similar approach to the German far-right AfD.

Italy already has a populist government, which seems to be gaining support in opinion polls as it tries to push ahead with its manifesto pledges, including more government spending.

The Italian government's expanded budget plans have fallen foul of the European Commission's spending rules, but we think there should be a resolution in time. As the bloc's third-largest economy, Italy remains a pivotal member of the eurozone. We believe Brussels will likely offer some leeway.

The question is how much volatility we could see between now and the point at which the two sides reach an agreement. We expect Italian assets—particularly Italian government bonds—will go through a period of volatility as we go through this negotiation.

Could Hedging Considerations Make European Assets More Attractive?

Many investors we spoke to on our travels in Europe were concerned about the hedging cost for US dollar investments. European investors pay a significant premium to hedge dollar assets back to euros. That can quickly eat away at any return advantage that US assets might offer compared with European assets.

We'd expect that cost to increase as the US Federal Reserve continues to raise interest rates and the ECB keeps its interest rate unchanged in the short term.

In our experience, most European investors have tended not to run unhedged positions, but this environment might persuade them to reconsider that approach. We might see European investors consider not hedging US dollar-denominated assets and simply take on the dollar risk.

However, we also encountered some European investors who were beginning to question the value of holding US dollar assets. As a result, we could see a resurgence of interest in European assets, and not just from European investors.

There may also be more interest from non-European investors looking to buy European assets and hedge them back into US dollars to take advantage of the exchange rate differential .

European Investors Are Underestimating the Wider Impact of Brexit

We were struck that no one asked any questions about Brexit or the impact of it on the European economy during our trip. There seemed to be a view that Brexit is a problem confined only to the United Kingdom.

Our view is that the implications will likely be much wider reaching. For example, we don't think many people have properly thought through how the departure of the United Kingdom will affect the balance of power in the European parliament.

Eurozone Members Could Hold More Sway

The United Kingdom is due to leave the European Union (EU) on March 29, 2019. Two months later, elections for the European Parliamentary take place.

With the United Kingdom no longer represented in the EU, the proportion of seats in the European parliament countries outside the eurozone hold will be greatly reduced.

As a result, we'd expect the European parliament's attention and interest will be much more euro-focused.

The End of Doctrine of Austerity?

Along similar lines, we may well see a shift in the economic doctrine in Europe after Brexit: there will be few countries supporting fiscal austerity at the European level. Germany, the biggest proponent of economic caution, could quickly find itself isolated in that regard.

So, we might expect to see an expansion of the EU budget and that has long-term implications for the citizens of member states.

Who Could a Hard Brexit Hurt?

In our experience, too many European investors have ignored the implications for economies and markets of a UK-free EU.

It seems clear to us that Brexit will impact Europe harder than many investors currently think. The UK's closest trading partners—Ireland, Germany and the Netherlands—are likely to see their economies hit particularly hard in a way people may not have considered.

We think the impact is likely to be felt even more widely. Were there to be no post-Brexit trading deal between the United Kingdom and EU, the fallout could be much worse.

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What Are the Risks?

All investments involve risks, including possible loss of principal. The value of investments can go down as well as up, and investors may not get back the full amount invested. Bond prices generally move in the opposite direction of interest rates. Thus, as prices of bonds in an investment portfolio adjust to a rise in interest rates, the value of the portfolio may decline. Investments in foreign securities involve special risks including currency fluctuations, economic instability and political developments.

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1. Source: European Central Bank, as of September 2018. There is no assurance that any estimate, forecast or projection will be realised.