

FIXED INCOME

European Parliamentary Elections: A Barometer of European Thinking?

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European parliamentary elections don't typically generate international headlines, but with Brexit still unsettled, this time they are front and centre. Our Head of European Fixed Income David Zahn says voters are clearly venting their frustrations, but what is really needed to restore greater investor confidence is some certainty about the path forward.

Normally, we don't consider European parliamentary elections to be an especially significant consideration for financial markets.

But these aren't normal times and we expect a lot of scrutiny of these results.

As expected, far-right populist parties have performed strongly, but don't have a majority in the parliament. Greens have also won more seats.

And while these election results are unlikely to have a direct impact on markets generally, they could act as a barometer of what Europe is thinking. Traditionally, the election of members of the European Parliament (MEPs) is seen as an opportunity for voters to vent their frustration, and we generally see a lot of protest votes. So, we're cautious about reading too much into the results.

Still, whenever an investor can get additional information about sentiment, we think it can be helpful.

We recognise that fixed income investors may be concerned that a significant populist representation in the European Parliament could stifle reform and hinder much-needed growth.

We'd certainly argue that Europe needs reform to get its economy moving and to encourage greater growth potential.

It's important to remember that, other than limiting immigration, there's not a lot the various far-right factions across Europe actually agree on. So, they don't have an agenda to push. But, we do think they have the potential to be disruptive.

Far more powerful than MEPs are the presidents of the various branches of the European bureaucracy. These bodies include: the European Commission, the European Council, the European Parliament and the European Central Bank.

Having a larger share of more extreme parties in the European Parliament may make those appointments, which are due to take place in the coming months, a less smooth process than in the past.

What Role Do UK MEPs Have?

The participation of the United Kingdom in these elections has added further interest. Because of the delay to Brexit, the United Kingdom is electing MEPs, but we don't know for how long those elected will actually serve.

And, we don't know for certain what happens to those seats in the European Parliament once the UK leaves. Do the seats get re-apportioned immediately via by-elections? Before the UK's unexpected re-inclusion in this election, its seats had already been reallocated across a number of other countries.

If by-elections were to occur, the political make-up of the parliament could change again.

In a similar vein, the UK Brexit Party's success could be a real thorn in the side of the European Parliament, at least until the UK leaves. We expect its MEPs to make a lot of noise and to be as disruptive as possible to the parliament.

What Path Now for Brexit?

Theresa May has indicated she will stand down as UK prime minister on June 7.

Much now rests on the identity of her successor.

Given the Brexit Party's strong performance in the European Parliament elections and the anti-EU sentiment among grassroots Tories, we expect the new leader to come from the Eurosceptic wing of the party and to take a harder line on Brexit.

Therefore, we think the chance of a no-deal Brexit has increased significantly.

That no-deal scenario is starting to be reflected in the markets: 10-year gilt yields are down to around 1%, sterling has been on a sustained sell-off versus the euro in recent weeks.

A lot of contenders have already thrown their hats into the ring. We wouldn't expect the new prime minister to be in place until August or September, which gives precious little time for any renegotiation with the European Union—even assuming it would be willing to reopen talks.

We Estimate a 30% to 35% Chance of No-Deal Brexit

Against that background, we'd estimate the chances of no-deal Brexit at 30% to 35%, not because people want it, but simply because there isn't time to put in place a deal to avoid it.

The real question then is the degree to which both sides are able to mitigate the worst effects of a no-deal Brexit.

We've already seen the European authorities indicate they'd like to see some current procedures remain in place until they can negotiate proper replacement agreements. That trend of seeking some quick fixes may intensify because if European growth remains sluggish, the authorities will not want anything that might slow it further.

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