EU elections: Challenging the status quo

Published 25 June 2019

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Contrary to expectations, the populists' backlash was thwarted successfully at last week's European Union (EU) parliamentary elections. European parliamentary elections rarely garner much attention however this time round the uncertainty over Brexit has helped draw significant attention to the EU elections. Bucking a 40-year downward trend, voter participation across Europe rose to 51% for the first time since 1994 compared to 43% in 2014. The strong participation helped temper the result for the populist parties who tend to benefit from a low turnout. The fight against climate change and the opposition to mass migration were the two dominant theme's that garnered the most support from voters at the EU elections in 2019. The Green party (pro-climate protection) outperformed their poll predictions in almost every EU country.

Figure 1: EU election results (26 May 2019) – number of seats and change from outgoing parliament

Source: European Parliament

A fragmented Pro-European majority

While the far-right populist parties and liberal pro-EU parties both gained ground, in aggregate populist parties performed worse than they did four years ago with their vote share declining from 30% to 25%. Eurosceptic populist parties gained dominance in France, Italy, Poland and Hungary while they under-performed polls in Germany, the Netherlands and Spain. The traditional centre-left Progressive Alliance of Socialist and Democrats (S&D) and centre-right European People's Party (EPP) parties, which have dominated the EU since 1979, lost their majority in the EU elections, giving way to a more divided pro-EU bloc. The well-established close collaboration between the EPP and S&D will now need to accommodate the policy priorities of the parties grouped in the Alliance of Liberals and Democrats for Europe (ALDE) and Green parties, paving the way for a slowdown in legislative procedures over the new five-year institutional cycle. Populism appeared to be a bigger threat in countries struggling with an economic recovery such as Italy and France. Italy's far right League party emerged as the strongest claimant to the leadership among Europe's populists. The League party secured 34.3% versus 17.1% votes for Five Star Movement, marking a sharp reversal of the 2018 election result. France's far-right, nationalist leader Marine Le Pen's National Rally party recorded a strong 23.5% of votes (albeit below the party's 2014 results), narrowly edging out President Emmanuel Macron.

Implication on Brexit

In the United Kingdom where voter participation was far lower at 37% (just over half of the Brexit referendum 72% in 2016), the hard-line, anti-EU Brexit Party led by Nigel Farage captured first place with 31.7% of the votes, reflecting the frustration with the incumbent Conservative party and the main opposition Labor party. The pro-remain parties such as the Liberal Democratic (Lib Dem) party (at 18.5% of votes) and the Green party (at 11.1% of votes) also scored well in the election. However, the results have left the political situation more polarised with 38% in the remain camp and 37% in the leave camp (excluding the votes earned by Labor and Conservatives). Prime minister May's successor is unlikely to make much progress in negotiating alternatives to the current withdrawal agreement in the run up to the 31 October deadline. This makes the extension of the 31 October Brexit deadline inevitable and tricky as it will be contingent on the unanimous consent of all 27 EU countries. Looking ahead, the possibility of a general election is certainly growing and with this the tail risks of a “no deal” and “no Brexit” have increased considerably. In order to claw back the votes won by Lib Dem and Green party, Labor is likely to shift its stance to the remain camp, thereby supporting a second referendum and raising the odds of no Brexit. However, a conservative led government would increase the possibility of a no-deal scenario. Our base case would be for a general election before year end and a second referendum by Q1 of 2020 as it would require more legislation.

Changing of the guards in 2019

The European election results helped remove one source of uncertainty of a broad populist and nationalist anti-EU surge. Populist parties have dropped their agenda of leaving the EU and are more focussed on changing the system from within. However, there remain political uncertainties ahead as the nomination process for the leadership of many EU institutions unfolds over the next six months, ending in November 2019. Every five years, when the incumbent European political cycle gives way to the new one, the president of the European Council, European Commission and the representative of the Union for foreign affairs and security policy are re-elected. In addition, as Mario Draghi's term is set to expire on October 31, the post of European Central Bank presidency over an 8-year term is also up for renewal. The upcoming European council meeting on June 20-21 should provide more clarity on the nominations. The EU will be faced with a tough balancing act by taking into consideration gender, political affiliation and geography when it fills its top jobs. The European elections broadly revealed that populist parties appeal had limits especially at a time of heightened geopolitical risks. With the looming risk of further trade disruptions, it is imperative for pro-EU forces to consolidate their vision and remain unified to shield them from external shocks.

Taking advantage of the market developments

We believe investors are overpricing the risks of a global recession as they see no end in sight to the US-China trade war. President Trump is now threatening Mexico and India with tariffs. Amidst this current backdrop, Europe in our opinion appears relatively shielded as its automakers were granted a 180-day (mid-November) extension to the deadline on tariffs. The US Congress is likely to approve an EU trade deal provided it includes some agricultural concessions. The EU has indicated that it is open to increasing the scope of the agreement on the condition that they achieve a mutually beneficial trade agreement. There has been a modest recovery in the macro data in Europe. Economic growth in the Eurozone was stronger than expected in Q1 2019 as GDP rose 0.4% versus 0.2% over the prior quarter. Monetary trends in the Eurozone have improved evident from the 4.7% acceleration of eurozone M3 growth in April. The European Commission's index of Economic Sentiment improved in May to 105.1 versus 103.9 in April marking the first monthly increase after 10 consecutive months of decline. European earnings momentum (tracked by companies on the EuroStoxx 600 Index) improved in Q1 2019 and consensus estimates point to higher growth in Europe this year compared to the US for the first time since the financial crisis. Amidst the backdrop of low yields, European equities today are one of the few asset pools yielding more (4% versus 3.4%) than their 30 -year average bond yields. European companies balance sheets remain underleveraged and the free cash flow cover appears reasonable at 1.38x providing enough evidence that they are unlikely to cut dividends any time soon. We believe the case for Europe has become even stronger amidst this heightened geopolitical low yielding environment.

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