Much Ado About Something

The sheer number of major political risk events this year looked like a major source of potential market volatility, if not real economic crises. The greater concentration seemed to be in Europe. Yet opinion polls suggest the populist insurgence against the establishment might not get any further there. Still, problems within that insurgence are evident in the US, if not the UK. The Trump administration has made no progress in taxes or infrastructure spending, the measures that would stimulate growth. Expectations of a “Trump bump” for the US economy may have to be reduced, while Europe looks less risky, with an economy that is starting to enjoy a growth boost from falling unemployment. Amazing what a difference a few weeks make.

Fiscal disappointment risk is clouding the US outlook
Donald Trump’s election raised the prospect of more business friendly fiscal policies. He promised everything from corporate tax cuts to infrastructure spending and regulatory reform. Sky-high business and consumer confidence surveys show how much is expected of the Republican majority. Yet instead of cutting taxes or starting the infrastructure program, Republicans are prioritizing health care reform, which threatens to drain the new administration’s political capital and the fiscal space available for serious tax cuts. A fiscal disappointment could trigger a sharp correction in economic sentiment and financial markets with negative repercussions for investment and spending decisions. Already, first-quarter GDP growth forecasts have slipped well below 2%. Further setbacks could seriously undermine growth reacceleration.

Dutch elections kick off Europe’s political risk season
Parliamentary elections in the Netherlands could deliver another win for the populist challenge to the political establishment. The hard-right Party for Freedom, led by Geert Wilders, an outspoken Islam-critic and proponent of a Brexit-style EU referendum, has been leading in the polls for much of the last 18 months. Recent polls suggest his support may be waning, but it is still likely that Wilders’ party will win a plurality of votes on 15 March. However, it is equally likely that the Party for Freedom won’t find enough support to form a coalition, and the country could face an extended period without stable government and possibly a new election later in the year. For the markets such instability is less of a risk than the prospect of another EU exit referendum.

A corruption scandal clouds the French election outcome
Center-right presidential candidate Francois Fillon, who was leading opinion polls in early January, has been hit by a corruption scandal and his support has melted away. He seemed the perfect candidate to face Marine Le Pen’s hard-right National Front. Yet in recent weeks, support for centrist Emmanuel Macron has risen sharply. He even took the lead in a few recent polls. Le Pen is still likely to win the first round of Presidential elections in late April. Yet Macron is outpolling her by more than 20 percentage points in polls for the run-off in early May. That’s enough to absorb even the kind of polling error we saw in the Brexit referendum and the Trump election. It seems another French revolution is unlikely.

The German center-left is mounting a challenge
In Germany, the real challenge to the establishment doesn’t come from a left- or right-wing populist party. Germany has both, but neither is likely to gain more than 10%. The challenge to end Chancellor Angela Merkel’s 12-year reign comes from the center-left Social Democrats, newly headed by former European Parliament President Martin Schulz. For most of last year Merkel’s Christian Democratic Union (CDU) had a 10-point lead in the opinion polls. Now, her party is running neck and neck with Schulz’s Social Democratic Party (SPD). A renewal of the current CDU/SPD
cohesion is still the most likely election outcome. The question is who will head that coalition. A loss for Angela Merkel could undermine European stability, but a Schulz chancellorship would make German economic policy more, not less, EU centric.

**Brexit is about to begin in earnest**
The surprise UK referendum result last June sent shockwaves through the markets. Yet sentiment and the macroeconomic assessment quickly returned to normal. After passing several legal and Parliamentary challenges, Prime Minister Theresa May is about to trigger Article 50 of the Lisbon Treaty, which starts the clock on the two-year exit negotiations. The UK government’s decision to go for a “hard Brexit” should make the process much easier. We expect negotiations will vary by sector. Some industries, like manufacturing, will retain full access to the single market. Too many UK jobs are at risk, and the EU is running a profitable goods trade surplus with the UK. On the other side, agriculture will lose access to the EU. Everything else will be somewhere in between.

**China maintains its economic stimulus thrust**
In early March, China’s Premier Li Keqiang delivered his annual government work report to the National People’s Congress. In it, Li set a 6.5% GDP growth target for 2017 but emphasized that the government will “try to do better,” showing confidence that the economy has enough momentum to outperform expectations. This year’s central government budget deficit target remains at 3%, while local governments are allowed to raise borrowing levels, indicating more stimulative fiscal policy. In addition, the focus is shifting from infrastructure spending to including tax cuts and other revenue reductions. That indicates a greater focus on supply-side measures as opposed to classic demand stimulus. The government’s 11 million net new jobs target highlights the growth potential China still offers.

**Sentiment remains bullish – for now**
Global equity markets continued to set new record highs in early March. Since the US presidential elections, the MSCI All Country index is up almost 10% in local currency. Developed markets provided most of the gains, outperforming emerging markets nearly three to one. It’s not simply the Trump effect. European market performance has been on par with the US, while Japan outperformed both. That bullish risk-on sentiment will be tested this month.

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Last updated 6 March 2017.