Eurozone Equity Markets Face Political Headwinds

Eurozone equity markets have had a difficult year thus far, losing some 13.2% as of November 28, as measured by the iShares MSCI Eurozone ETF, EZU. While a slowing economy and a 6% weakening of the euro offer a partial explanation of the US-dollar return from these markets, a number of political uncertainties appear to have been more important causes.

These uncertainties include the outcome of the Brexit process, Italy’s budget conflict with the European Union (EU), trade war concerns, and the recent political turmoil in France and on the Zone’s eastern border, with the dangerous escalation of tensions between Russia and Ukraine. As the year end approaches, these headwinds to investor market sentiment have not eased.

With time running very short, there remains great uncertainty about Brexit. The EU governments have agreed to the draft agreement between the EU and the UK that provides the terms of the UK’s withdrawal from the EU and have indicated that they are not open to making any changes in it. Prime Minister May now has the very difficult task of seeking the approval of the UK House of Commons (one of the two houses of Parliament), which will vote on the subject on December 11. May now finds it necessary to argue against her past statements that no deal is better than a bad deal. She has emphasized that this is the best deal the UK can obtain and would be much better than exiting without a deal next March. However, there is great opposition to the deal from both May's Conservative Party and from opposition-party MPs, including those strongly intent on leaving the EU, on the one hand, and those strongly preferring to remain in the EU, on the other. The deal, as structured, falls in the middle ground, not fully satisfactory to anyone; but a no-deal break would clearly be very damaging to both the UK and the EU. The Bank of England just released their analysis which indicates a no deal Brexit (a "disorderly Brexit") would lead to a recession worse than the financial crisis. That possibility may lead some to reluctantly vote for the deal or to abstain. Nonetheless, it appears likely the Commons vote will be negative, if the vote is on the current text. It now appears there will be amendments to that text before the vote. What then will follow is highly uncertain.

Rejection by the House of Commons would leave the government with 21 days to put forward a further revised plan, which would go to a second vote in Commons. Any changes in the original draft agreement would require reopening negotiations with the EU. One amendment suggested as a solution adds a sunset provision to the so-called backstop provision in order to remove the possibility that the UK would be locked into the backstop customs union indefinitely. The most-mentioned proposal for a more extensive renegotiation of the deal is the "Norway option," which would involve the UK's joining the European Free Trade Association. But that option has a number of drawbacks: the UK would still have to make payments to the EU, would still have to find a solution to the Irish border issue, and would not gain control over migration.

A Commons' rejection on December 11 could also very well trigger a challenge to Prime Minister May's leadership, which could lead to a new Tory Prime Minister. There might also be a general election, which could possibly bring in a Labour government. Labour has had unclear views as to which way to move on Brexit but clearly intends to pursue policies strongly opposed by business. The likely second vote in Commons, either on the current deal again or on a revised arrangement, if affirmative, would then see the measure taken up by the European Parliament. A simple majority there would lead to consideration by the European Council, where approval requires the affirmative votes of 20 countries representing at least 65% of the population.

Should the second vote in the UK Parliament be negative or the agreement be rejected by the EU, the UK would likely exit the EU with no deal on March 29, 2019. But that outcome is not the only possibility. The EU could agree to extend the time limit and continue negotiations despite having said they would not do so. The UK could decide to hold a second referendum on Brexit, a step more likely should the Labour Party come into power following a general election. Another possibility would be a new referendum after the UK exits the EU. A positive vote on rejoining the EU would require agreement by the EU, which would be possible if an exit deal had finally been approved but very unlikely for many years in the case of a no-deal BREXIT. In view of all the various possible outcomes, uncertainty is weighing heavily on investor sentiment.

The budget stand-off between the new Italian government and the EU has escalated. The EU has announced that Italy’s proposed budget is in “particularly serious non-compliance” with previous commitments and EU regulations. This pronouncement signals the likely beginning of the EU’s formal enforcement process, which can lead to large financial penalties. There are reports that the Italian government is beginning to yield a bit on its budget, which may provide some room for Brussels to reach an agreement that avoids the most severe outcome.

The Bank of Italy has issued a warning that the rising bond yields caused by the government's expansive spending plans could threaten the stability of Italy's banks and insurers as well as add billions to the interest on Italy's debt. Moody's has cut Italy's local and foreign currency ratings to Baa3 from Baa2. Foreign investors are shedding Italian bonds, while Italian retail investors do not appear eager to increase their participation in the government's debt raising. The high interest rates and developing strains on the banks certainly will not help the Italian economy, the Eurozone's third largest, to reverse the slowdown that has developed over the course of this year.

Trade uncertainties have had an impact on economies around the globe, hampering global economic growth. For the Eurozone economies, the uncertainties include those related to Brexit, to the US–EU trade conflicts, and to the widespread effects of the US–China trade war that have already emerged. The IHS Market Eurozone PMI for October, which showed that the Eurozone's economic growth had slowed to its lowest pace in over two years, cited "an export-led slowdown, linked to growing trade tensions and tariffs." The IHS Markit Flash Eurozone PMI for November then indicated that growth had dropped further to near a four-year low. It cites a further fall in new export orders across manufacturing and services. The drop in exports was the largest seen in the four-year history of this indicator.

The political difficulties of French President Macron do not yet appear to have seriously affected the French economy, which continues to grow at above-trend rates. His business-friendly economic reforms are a plus there. Spain's economy also is recording firmer gains in activity. In contrast, the growth of the German economy, the Eurozone's largest, slumped to a five-month low in October, and Italy's growth turned negative in October for the first time since 2014.

Relative equity market performances year-to-date reflect these differences in economic activity. The iShares MSCI Germany ETF, EWG, is down 17.5%; and the iShares MSCI Italy ETF, EWI, is down 15.9%; while the iShares MSCI France ETF, EWQ, is down only 9.4%; and the iShares MSCI Spain ETF, EWP, is down 11.5%. A sustained recovery in the Eurozone markets would be possible should trade tensions ease. A final agreement between the UK and the EU on the terms of the UK's withdrawal from the EU would also provide a substantial boost for these markets. In the current highly uncertain situation, caution and close monitoring of developments are warranted.

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Sources: BBC.com, Financial Times, Bloomberg, New York Times, The Economist

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