If 2016 was the year that introduced the concept of populism, 2017 will be the year that sees its consequences and implementation. With Trump's presidency in its infancy and the British government now closing in on activating Brexit, investors are also focusing on mainland Europe, which is facing a year of potential major political upheaval. In this piece, we focus on the ramifications of a changing political landscape in the Eurozone in a year of elections in France, Germany and the Netherlands.

Marine Le Pen—"On behalf of the people"

We have spoken of European uncertainty for before; making no secret of the fact that we are concerned about the fragility of the Union, the strength of the currency and impact of weak sentiment on the Eurozone's long-term growth trajectory.

The Greek debt situation is stealing the headlines at present; however, of far greater importance is the possibility that the growing populist feeling that has taken hold in the UK and US may also take hold in mainland Europe, with this year's elections taking centre stage.

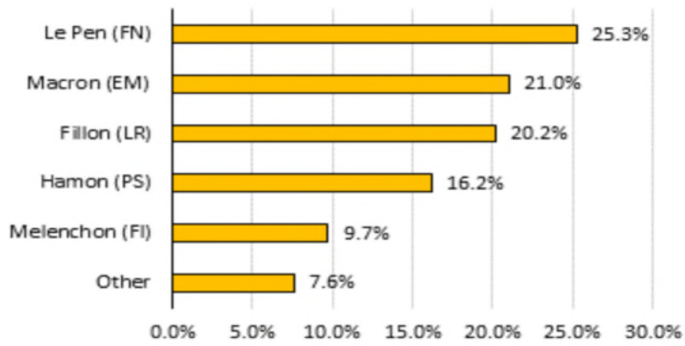
We've already seen the first stirrings of this populist movement after a ground-breaking reform bill was rejected by the Italian public last year. Having proposed the bill, Prime Minister Matteo Renzi resigned when it failed, potentially paving the way for the Five Star Movement (an anti-EU party) to form a new government.

France's far right National Front party leader, Marine Le Pen, welcomed the Italian referendum as an anti-austerity signal to France. She said: "After the Greek referendum, after Brexit, this Italian 'No' adds a new people to the list of those who would like to turn their backs on absurd European policies which are plunging the continent into poverty."

After the bill was rejected, the positive reaction from markets was surprising. Given that a large Eurozone member state had taken a small but very definitive step towards anti-EU leadership the magnitude of the move in the Euro STOXX 50 index, rising more than 5% in the days that followed, was greater than anticipated. Whilst this may not be an accurate indicator that investors are relieved to see populism sweeping the globe, this along with the Trump effect does at least show that markets are temporarily unconcerned by the rise of the populist movement. Yet unsurprisingly many see the growth of populism as a real threat to the stability of the European Union.

The French Election

On 23rd April, the French will head to the polls in the first of two voting rounds to elect their next president. One name at the forefront of this election, synonymous with anti-EU rhetoric and populist support, is Marine Le Pen. Although once perhaps dismissed as an unlikely candidate, Le Pen has gained ground over the past couple of years. More recently the corruption allegations concerning her main rival, Francois Fillon, have led to Le Pen taking a lead over her competitors in the first-round polls. Although the second-round polls indicate that Le Pen's supporters won't carry her over the line, the situation is reminiscent of the e-mail scandal surrounding Hillary Clinton in the latter weeks of the US presidential campaign. Fears abound of history repeating itself.



Le Pen has a clear lead over her rivals, almost certainly placing her in the second round of voting, in which only the two most popular candidates will then compete.

We know from recent experience that neither opinion polls or bookmakers' odds provide a reliable barometer for predicting the results of elections. As such we have to consider that there is a real possibility of another populist leader taking charge in a key member state of the EU and the markets are starting to factor this in. We believe that Le Pen has a very good chance of winning. French voters will know that the markets have risen sharply rather than plummeting (as predicted) since Trump took office. Also, the UK economy is seemingly in rude health post-Brexit (at least for now) and this will bolster Le Pen's case that Frexit (??!) will be good for the French economy.

Since the new year, French 10-year bond yields have risen 50% to circa 1%. Yields rising mean that investors are selling these bonds and this is an indication that markets expect a difficult road ahead for the French economy. This is hardly surprising, given the rhetoric from Le Pen. If she does win the election, she will certainly recommend an EU membership referendum.

In the midst of Brexit this is likely to destabilise previous positive sentiment towards EU equities and for this reason, among others, we are very cautious about the region.

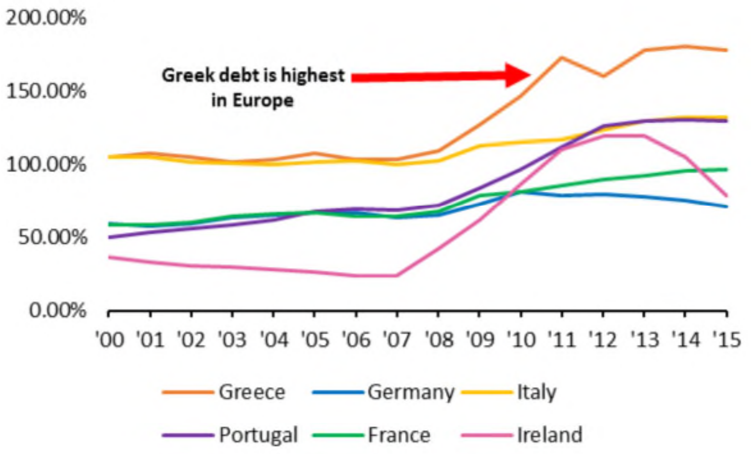
The German Election

Later in the year, on 24th September, the German people will also vote in their federal elections.

Although matters in Germany appear to be less extreme, with Angela Merkel looking likely to secure another term in office, there has been a surge in support for the Socialist Democratic Party and the far-right Alternative for Germany party, which brings even more anti-EU feeling to the table. Populist sentiment has risen through the migrant debate in Germany and this has paved the way for different schools of political thought to gain ground.

If further protectionist voices are heard in the Bundestag, it may be the case that the economic interest gap widens between peripheral economies in the EU and the powerhouse of Germany. If that happens it would be easier for anti-EU (read, anti-German) feelings to proliferate in those economies, thus weakening the union further and creating a less favourable environment for European stocks.

To put this into context using Greece as an example, Greek debt stands at over double the EU average as a percentage of GDP. The last thing a more protectionist German government will want to encourage is further support for Greece at a time when the IMF are backing away from the problem.



European debt as a percentage of GDP – Since the 2008 crash, Greek debt has hit alarming highs compared to its peers.

The Dutch Election

In a similar vein to Germany, there has been a rise in populist support in the Netherlands due to immigration concerns and an aversion to the 'propping up' of peripheral EU economies. This means a likely victory in the polls for the People's Party for Freedom and Democracy (PVV), led by Geert Wilders, on March 15th. He is an anti-Islamist with a penchant for controversial and inflammatory rhetoric…

"We have imported a monster and this monster is called Islam"

"*The less Islam, the better. It is as simple as that."*

"Islam is the Trojan Horse in Europe. If we do not stop Islamification now, Eurabia and Netherabia will just be a matter of time."

Although his party is likely to win the election, it is unlikely that Wilders will become Prime Minister as all opposition parties have publicly declared that they will not form a coalition with the PVV.

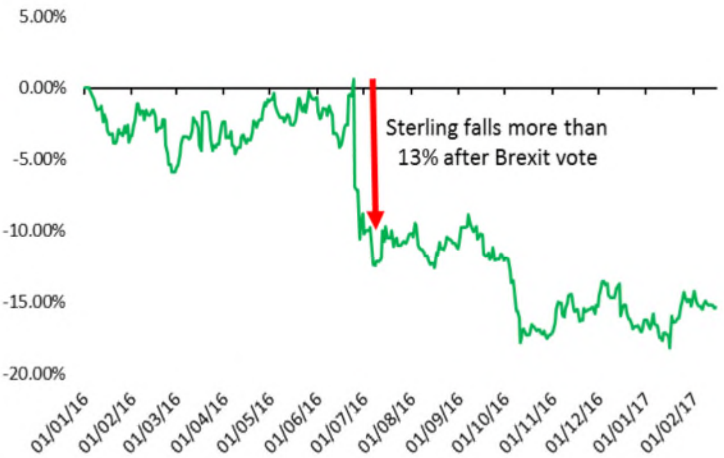
What is concerning from an EU standpoint is that if a coalition is formed after this election it is likely to comprise of many small parties, creating an unstable majority to oppose Wilders' very large minority. As with the German government, this would increase the influence of anti-EU sentiment in European seats of power.

A Weaker Euro

Markets have taken all of this in their stride thus far but we feel it is the euro that will feel the greatest impact of the perceived fragility of the Eurozone. A Le Pen victory and a tilt to the right for other nations post-election could drag the single currency down, particularly against the US dollar. The movement of the euro against the US dollar, having weakened from relative highs in May 2016, serves as a warning for investors.

Whilst a weaker euro means cheaper exports and helps encourage tourism, it also indicates a lack of investor confidence in the longer term. If we see signs of political tensions in Europe, the euro may fall further, damaging euro-exposed investment performance in the process.

If we look back to how sterling behaved post-Brexit we saw the exchange rate plummet -13.2% over two weeks with no significant recovery yet . Whilst the effect on the euro may not be as extreme, this is a foreboding sign all the same.



Sterling vs US Dollar in face of Brexit

Support has been growing for protectionism and it will continue to challenge the landscape of European governments far into the future. If we see immediate and significant steps made by populist movements across Europe in 2017 market volatility is likely to follow.

It is difficult to predict the outcome of such events (see Brexit and Trump for examples!) but the warning signs are there for all to see. There might be some fantastic, opportunist gains to be achieved by investing in European equities but we feel that the risks of investing now greatly outweigh the potential returns. We prefer to invest in other markets such as the US, which will still perform well if other major economies continue to grow yet be partially insulated from the uncertainty caused by political upheaval in Europe. Of course the US has its own problems (!) but a protectionist and tax cutting president should at least pave the way for US growth in the short-term. The same cannot be said with any certainty for the Eurozone.