The strong, the stable and the chaotic
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Franco-German relations are reinvigorated while the UK election race heats up

With financial markets awaiting US payroll data due later today, political developments in Europe have grabbed most of the investor attention in the past several days. In Italy, an agreement between the major parties with respect to electoral reform appears to open the door to elections later this year and this has led to questions with respect to risks associated with the sovereign. However, these risks are overstated in our opinion. The compromise on a Germanic style proportional representation election system without any bonus allocation to the largest party suggests that a coalition government is an extremely likely outcome to any vote that takes place in the foreseeable future. In this context, even if the 5 Star Movement are the largest single party, their influence will be blunted and given their unorthodox approach, a grand coalition of the centre left and the centre right seems a more plausible outcome in our view. Just as important though, we would highlight that the position of the 5 Star Party, which once campaigned on a very Eurosceptic platform, has evolved very substantially in the course of recent months and we very much doubt there will be any push towards a referendum on Italian EU membership in any case. Indeed, it has been interesting that even in France the extreme Front National has dropped Frexit as a policy objective after Le Pen's recent failing in the polls. As with Syriza in Greece, we are seeing how populist parties are reining back their hostility towards Brussels and the single currency at a time when the growth outlook across the region appears to be brightening. Consequently, we do not see a path that would lead to Ital-exit as a result of Italian polls and consequently view investors who are viewing the upcoming vote as an opportunity to speculate on the demise of the Bloc as naïve in their understanding of the situation.

The broader backdrop in the eurozone appears supportive, with political risk declining and the economic outlook improving, whilst policy makers continue to maintain an accommodative stance. The upcoming European Central Bank (ECB) meeting should see an upgrade in growth forecasts and a neutralisation in the balance of risks. However, a taper announcement is not likely before September in our view and for the time being, the ECB remains at pains to paint a dovish picture. Visits with policy makers in Berlin this week also suggested to us that renewed European integration may be coming back onto the agenda as we move through this year. It was interesting to see Merkel turn her back on the US and UK following the recent G7 summit and look inwards towards the EU. We could envisage renewed discussion regarding a pathway towards greater budgetary co-ordination and steps towards pooling sovereignty on common Eurobonds coming back onto the agenda as the Franco-German axis is reinvigorated following the recent Macron election. We also sense that the EU will be an increasing focus for Merkel in her coming term (assuming she wins re-election as now seems likely), given that the German economy is booming and that she seems to have achieved most of her domestic ambitions.

Indeed, it is interesting to contrast the politics of the strong and stable eurozone with the volatile and chaotic backdrop witnessed in the UK. With the UK election less than one week away, the assumption that Theresa May would cruise towards a substantially increased Parliamentary majority has been called into question by opinion polls suggesting that the race may be much closer. Certainly, it seems that Jeremy Corbyn has connected much better with younger voters and is winning the battle on social media, even if the traditional media remains openly hostile towards the socialist stance of the Labour leader. Theresa May's recent policy U-turns and refusal to participate in TV debates have played badly for a politician wanting to communicate a message of strength and stability. Although a hung Parliament remains more of a risk scenario than a central case at next week's vote, we would highlight that there is a range of possible outcomes given how political allegiance appears to be shifting at a national level. With financial markets relatively complacent with respect to the outcome, there is a risk that Gilts and the Pound see a nasty move weaker, should there be a surprise outcome.

Elsewhere, in the US, economic data have continued to paint a picture of a healthy economy but modest inflation during the past week. We expect the Federal Reserve (Fed) to raise rates later this month and keep the trajectory of the dot plot unchanged and although this may be more hawkish than markets expect, the backdrop of an accommodative combination of fiscal and monetary policy can help risk assets continue to rally against the backdrop of modest volatility. In FX markets, the Chinese renminbi has been one of the strongest performers over the week with authorities pushing the daily fixing stronger – perhaps wanting to disavow last week's Moody's downgrade. We believe that this move will be temporary in nature and that the People's Bank of China will allow the currency to weaken versus its basket in order to support growth at a time when policy tightening has started to drag on economic activity.

As we look ahead, low-flation seems to be an increasingly dominant theme expressed by investors against a very benign global backdrop. This should continue to favour carry trades in our view, though we disagree with the notion that the absence of higher inflation will stop the Fed from hiking. Monetary policy operates with lags and the central bank is aware of several important one-off factors, which have pulled recent inflation numbers lower. However, if wages can continue to trend modestly higher and inflation surveys continue to suggest that future price rises will be consistent with the central bank's mandate, then there is no reason not to expect the Fed to continue to normalise rates and to indicate a trajectory consistent with prior FOMC meetings. It is possible that the Fed, which is ultimately more assertive than the market expects will represent the biggest challenge ahead to the carry trade going forward, though aside from this it seems that low volatility conditions can persist for longer.

In contrast to the settled global outlook, developments in the UK seem more unpredictable. It is interesting to reflect writing in this weekly commentary six months ago, whether Jeremy Corbyn would be in 10 Downing Street in 2017, and it is perhaps even more remarkable that an election campaign, which started with a 20 point gap between the Conservative and Labour Parties is now becoming an exciting race at all. Theresa may well win a large and increased Parliamentary majority, yet it is intriguing to wonder how markets might react and how events might unfold, were we to see a Labour/SNP coalition with Jezza in number 10 and Alex Salmond as Foreign Minister overseeing Brexit negotiations. Maybe the return of 'House of Cards' on Netflix has us fantasising interesting plot twists and turns, yet in the UK right now, anything feels possible…

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