Economic implications after th...e European Parliament election

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Hello, and welcome to the office Podcast. I'm Taylor Pierce, lead economist of Office Economic and Monetary Policy Institute. Here with me today is Jack renew senior enia Market Strategist. At the end, my Belton will be discussing the economic and financial implications of the recent European Parliamentary elections that took place at the beginning of June. Welcome, Jeff, it's a pleasure to have you.

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Thank you very much. It's a pleasure to speak to you.

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Great. To start off, can you provide an overview of the implications of the European elections that just happened a few weeks ago? Was the outcome expected by markets? Or were there any surprises? Of course, thanks again. So firstly, let's just say when it comes to the outcome of the European Parliament elections themselves, there were no surprises. But of course, it was French president Emmanuel Macron surprise calling of legislative elections in France, which let's just say appended matters to some extent, we know that the implications are still being felt most notably in currency and bond markets. And of course, it's something that we will continue to monitor. So I would say net net, it's something that the market was always looking to perhaps surprise, but not really, in the manner that ultimately unfolded. And I think we are going to have to deal with the implications of not just in the short term, but the important thing is, it actually does prompt them many, many questions about individual Eurozone nations, and the European Union, its entire framework. And I think that will be more important over time.

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Great, thanks. We'll come on to a lot of the issues that you've mentioned. But first, I'd like to know, how did the Euro fare in the wake of the election? And what is your expectation for the euro? Looking ahead, of course, so due to the surprises that we've discussed already, the Euro clearly has softened since the election, and was interesting, the dynamics how things worked out, because in the run up to the election itself, and the fallout of we did have the ECB decision, which was widely known as a quote unquote hawkish cut personally, I don't like that phrase very much. If you want to be hawkish, then don't cut rates. But nonetheless, from the CBS point of view of their decision. Well, from the markets point of view, the ECB decision was ultimately supportive for the euro. And then we saw all of that reverse due to the financial gyrations and it was an environment where we know that many emerging markets have had elections as well. So I think suffice to say markets were in a relatively risk off mood anyway. And it was a question of let me liquidate my positions first and own some dollars are in some safe havens. We've seen the Swiss franc react against the euro as well, that's an interesting additional dynamic as well. So that is what we're seeing so far, and probably the euro will remain under pressure. Now, what I expect from the euro is further declines. But I want to be clear on this, there are many reasons to be bearish on the Euro politics per se, I don't think that is the right one, or I don't think it's the main one, the reason that we've had a very aggressive view on Euro lower this year, for example, being calling for parity. And we still stand by that view, even though heading into the second half of the year, that is looking a bit more optimistic. It's really a question of where the European economy is going. And the European Central Bank, they will react to the economy. And we feel that the European Central Bank is not reacting to the right aspects of the economy in terms of manufacturing, so we can discuss that further on. But it should be due to policy, monetary policy divergence, the Fed, for example, we don't see cutting until September, and that could well be the only cut for this year from their side. So the market is pricing at least one and a half cuts from the ECB, if not more, I'm looking at three to four to be frank. So that's where the misalignment could take place. And that's what what could drive the Euro low and I stand by that view, politics will be secondary or tertiary. It's not going to be a primary driver of Euro lower, though right now. It's sort of heading in the right direction. So I'll take what I can get.

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Okay, thanks for outlining that comprehensive view on the euro and for clarifying that politics are just one factor in there, and perhaps not the most important factor that I'm coming to France. Now. What does the snap election in France mean for markets? So I think markets right now just still digesting things. So we've discussed the impact on the Euro already or the reaction in the euro. I think what we're looking more at right now what the market is focusing on and driving the correlations is what's happening in French bonds. I think there is this

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irrespective of the outcome of the legislative elections, it feels like that from a fiscal point of view, there is not much that is going to be done about France's increasing debt burden. But let's be frank here, France is not alone. Many, many countries in the Eurozone, they face similar issues. Italy has been a perennial case, for example. And if we are going to look at debt sustainability, the UK is in a problematic position, and also the US and but the US Treasury market is still seen as the ultimate safe haven. So I think it's just the suddenness of this development, which has upended things. And the one other thing I would like to highlight looking at our custodial flow data, we are the world's largest custodian, about a quarter of our assets are based in the EMEA region. Of course, not all of it is in the euro zone, or the core eurozone, sovereign debt markets. But we like to think that we really capture these flows very, very well. And our clients, especially our cross border clients, headed into the European election period, heavily overweight, or 80s, especially relative to all the other core years in markets as well. So just from a positioning point of view, there was always going to be some pressure, we look at flow monitors for mean reversion purposes, if everyone owns a particular asset, then even if the outcomes are positive, maybe some profit taking will take place as well. So I think it's a confluence of factors, the suddenness of the result, and plus the positioning, which has driven the reaction that we've seen. Now up ahead, of course, the next two weeks or so heading into the elections, we're not going to prejudge things. And let's see, even when we get the result, we can sense that maybe campaign language will be very different in terms of when you actually achieve a certain degree of high office and you and you have to execute your power, then things can be dragged more towards the center or more mainstream approach. So that is entirely possible as well. So right now, I've attributed much more of the price action, especially in French bonds, and also in elsewhere, potentially, to the suddenness of the decision, and over positioning. And of course, we'll be monitoring other markets, such as Spain, and Italy as well. But overall, I'm not too concerned about Eurozone bonds, full stop for the next two years or so as we come up to the next budgetary cycle. And this really brings us to the point about yours and governance and this Hamiltonian moment which we are BMI, of course, very, very attached to given the gentleman who founded our bank 240 years ago, right. So you know, net net. If this does, let's just say swerved perhaps Europe away from thinking more about joint issuance, which we did see during the pandemic, but that was, of course, an emergency situation, then maybe it could lead to some degree of reassessment. But in the short term over the next two to three years, because we have those backstops because we have the NG EU program and the joint issuance, which underpins that I really wouldn't be too concerned about European bonds. So again, European assets, you can worry about them. But on the sovereign side, your politics, perhaps that should be should not be at the forefront. I have concerns for the time being.

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Right, we'll come to the European or Pan European kind of financing mechanisms and during issuance in a second, but I wonder if you wanted to comment briefly, you mentioned Spain and Italy as other countries you're watching. Do you have any views on what have you seen in spreads of member state government bonds, they're waiting there, you said you're not worried. But any anything, you're particularly keeping an eye on there. So compared to the movements in OTs, for example, New Zealand bond OS and btps are probably much more manageable. So we've even seen Greece, for example, announcing that they want to repay early, I believe 8 billion euros worth of ESM assistance from the prior bailout programs. So that does show that there is quite a bit of dispersion in terms of how European sovereigns are performing. And considering Spain and Italy, would these concerns have been well documented, and there has been a backstop where we have seen flows, sovereign sonar, joint resources being directed to these countries, again, looking at spreads looking at the positioning, I'm not too concerned at this point, out of all the supposedly Southern European at risk nations, Spain did see some stronger buying. So if I want to draw the parallel with France, for example, you want to identify the markets, which were relatively over positioned, heading into the European Parliament elections, I would probably put Spain sort of in that category offered better yield maybe liquidity on a relative basis strong as well. That's why people bought into these bonds, right, because they provided the value, but net net, I don't think that's really on the market's radar right now. So apart from the marginal positioning adjustments, it really is about asset allocation rather than any political or fiscal risk. Yeah, that makes sense. So going back to the Hamiltonian moment that you mentioned, what is your conclusion based on the election results? What is your outlook for deeper fiscal integration at the EU level? And do you think that the risk premia on highly indebted European economies

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sovereign debt, will they will there be implications there? So we must look at things on an absolute and relative basis across all facets of the results in here. I think it's good to take a step back, move away from Paris, and let's look a Strausberg. Right, the European Parliament results, did it result in too much of a change, or the focus shifted from Madame vana lions future towards President macrons. And future, right. Whereas if we look at the European Parliament results, it really is, as you were right. And that's only one pillar of the European Union's broader governance. So so. And as we saw during the negotiation process for NG II, during the pandemic phase, there were points at which the group of countries known as the approval for they did drive a hard bargain your whether it was being loans grants, and in the end, we got a hybrid of things, I think those same positions that we had four years ago, will remain in place. So it's pretty much the status quo. I think where the market needs a dose of reality, perhaps was anticipating that it was the first step towards gradual integration, fiscal integration, such that by the time we got to the next multi year financial framework for the European Union, somehow that that Hamiltonian moment would arrive by default, that was never going to be the case, again, we saw how hard it was four years ago, we saw how hard reaching those agreements for the Greek bailout or for other bailouts, and during the last sovereign debt crisis, how difficult they were. So I anticipate the next two to three years will be difficult as we run up against those deadlines. But I'm also quite confident that Europe will find a way. And one thing, I think investors outside of the eurozone and outside of the European Union, especially those based in Asia, and across the bond, they realized that the purpose of the European Union, the purpose of political integration, the purpose of financial integration, and the creation of the Euro zone, the history behind it, and how strongly attached the European ideal was to these countries, you know, beyond simple spreads and financial framework, I think markets actually led to strong less than 12 years ago. And it'll be important not to forget those lessons. So ultimately, I am optimistic. And but I also admit that the journey there, of course, there will be bumps in the road.

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And you stole my phrase, I was going to say you sound optimistic, but there will be bumps in the road for deeper and deeper integration financially, fiscally. So thanks for that. Just to zoom out a little bit and ask a question on trade. We saw the European introduction of tariffs on Chinese electric vehicles last week, which is higher than many were predicting, I think it's fair to say, what do you think will be the implications for Europe's economy of a more protectionist European Parliament? Especially in some of those key sectors, like manufacturing? Of course. So after Turkey announced their 40% tariffs on Chinese New Energy vehicles, and given Turkey's customs union status with the European Union, I thought, yeah, that was kind of the direction that the EU would go, though, we know that there there is significant differentiation in between manufacturers. And I think Europe will need to think about the European car manufacturers based in China who re export their own products and back to Europe, for example. So this is a complicated process. But having said that, at the end of the day of terrorists, what do they achieve? And I really think it's in the eye of the beholder. But the problem right now, I think, for Europe, and going back to my earlier point, why I think the ECB needs to cut rates more is because manufacturing sector has been contracting for so long, and Europe lacks an industrial policy. Now we can quibble about the nature of US industrial policy and Chinese industrial policy, the first principles, they have an industrial policy, and Europe because of its very nature and the need for consensus amongst member states. That's why things tend to a bit slower. So now that this has been put forward, I think the important thing is okay, we have protections now within Europe against an onslaught of Chinese EVs, whether they will rise or decline in exports. I think that secondary, if let's say tariffs, has bought Europe some time and space, what are you going to do with that time and space? That is important? So will individual countries or at an EU level redouble efforts to increase productivity to find the competitive edge that European manufacturers not just in vehicles, but across manufacturing that they had in the past, which generated strong revenue growth for some of the exporting nations? Will they be able to use this opportunity to innovate and boost productivity and boost trend growth? Or is it going to lapse and we maintain the status quo because the status quo cannot be maintained? And I think that's something that Europe realizes, and we're waiting for Mr. dragees report along those lines, of course, I'm sure he's going to be in high demand across many different facets over the next few weeks or months or so. And again, it's about using this window, to really think about reform to think about the

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Next level of competitiveness for the European Union and also industrial policy and also energy policy, right? Are we going to have a broader debate about taxonomy of renewables? Are we really going to think about nuclear again, in particular? Is there a case to revisit the entire green framework? Right. So all of these are valid questions and that Europe needs to discuss. But of course, there's a lot on the table. And here is where individual countries come in. So if they may not align in terms of what they think that the future holds, for green policy for energy policy, etc, etc, that's where things tend to perhaps get bogged down a bit. But net net, I think we've seen comments from from China this week already saying that this is really not going to change their strategy. And I think the best when it comes to China, and its export policy, it's incumbent upon us to encourage Beijing and I think Beijing is realizing this as well, to have diversified growth as well. Any country just relying on exports, I don't think that is going to be sustainable over the medium to longer term. And as we head into the third plenum in July, in Beijing feels like that there is going to be more resources and directed towards the household that can only be beneficial for Europe, because we still know that Europe has a lot of high value added manufacturing, you know, beer, from handbags, and to precision instruments, so that the Chinese household will use directly or indirectly as well. So I think there are many places, there are many areas where accords can be reached and at the same time.

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Great, thanks. So it sounds like the tariffs could be beneficial to Europe, if they then facilitate a more comprehensive industrial policy. So So just on that, I would never characterize tariffs as beneficial per se, because, by definition, in the short term, they may well actually raise prices for households and in a cost of living crisis that we're seeing all over the world right now. And maybe there will be unintended consequences as well. So that's why I would encourage you European policymakers to think carefully I think what with new new energy vehicles

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with EVs, that's something that Europe will Well, that's something that households will naturally absorb, you know, it's a long standing process. We are worried about trade conflict configuration, right? If it actually starts to shift into staples into more everyday items, with a faster transmission into

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into headline inflation, for example, that can be more of a problem. But yes, as you said, it does provide some breathing space for Europe to develop industrial policy. But that's where, by definition, if you need an agreement of multiple member states, it's much harder to find that kind of an agreement compared to one country, achieving its own goals and coming up to a decision relatively quickly.

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The green agenda, and I was wondering if you had any what your expectations are on the results of the European elections on the EU's agenda, to transition to a sustainable economy, sustainable financing. And just to wrap up that you had other major markets, topics or major impacts to the European economy as a result of the election?

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Of course, so looking at the ultimate goals for the green transition of the So, as I said earlier, the makeup of the European Parliament, I don't think that has changed materially relative to the prior composition. So I think it's a question of as you were, now, whether as you were itself is optimal. I think that is a different debate altogether. And I think in terms of the green agenda that seems to have gone off the ball a bit globally. And I just go back to the point about a question whether you will have more conflict between domestic agendas, and overall European Union agendas, and that could really inhibit policymaking. Again, the status quo is unsustainable. That's what the draggy review, I really want some to highlight that, having said that, I do think that the broader direction coalition govern. So we are seeing that all over. So if it that that could generate the potential possibilities for a broader discussion, if we have these big tent governments. So there will always be scope for sustainability. And I think there will be popular demand in that direction as well. But when it comes down to I would say financial market. So that's where so one is their broader investor demand for that. And here, I think it's less of a political issue. We'd like to make it out to be a political issue. But I think it's more of an interest rate issue. If you can own US Treasury debt, the tenure of close to 5%, then you can package whatever product that you want, doesn't have to be green, you can do anything else. cash equivalents, for example. I think it's going to be very, very difficult to supersede the dollar

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In your asset allocation. So that's why we're looking at the US right now. And as much as we think that the dollar faces strong valuation issues and the like, and this actually pertains to some of the other topics that we're talking about, that almost isn't any alternative, and here's where I've sent to European policymakers will have quite a large degree of frustration, why is there a sudden fiscal focus on France on Europe, and that the US always seemingly gets a free pass us has debts, debt sustainability, metrics are not great either. But at the same time, it is still considered the world's reserve assets. If you look at Asian reserve managers, which surely the conflicts are very, very closely, our dollars are still comprise the bulk of our holdings. And that isn't going to change anytime soon, China's pushing for an alternative, but very, very slowly, but China itself is still very much exposed up to $1. So that's why that sustainability that's more urgent in a euro zone context, but just going back to green finance, or green issuance, as interest rates do come down, I do think they will come down over time, it's just going to take a lot longer than we can probably the market expected at the beginning of the year, for example, we were looking at a Fed cut in March. And now that's been pushed to September, this high for longer environment led to the US I think will inhibit financing, to all other asset classes, maybe tech and AI related segments. That is a bit of an outlier right now. But looking at all other metrics, you will need us nominal rates us real rates to fall significantly before I think interest on a marginal basis and can start to emerge in other areas. And it is what it is what it is as allocation on a risk adjusted basis, it just favors being long us cash on one end. And long US equities on the other end a bit of a barbell approach and probably us duration, as well. So I think that's just something we have to live with. That means financial conditions are going to be tighter in Europe in a global context. But they're going to be just as tight if not even more so in emerging markets, right. So we're not seeing enough flow into those areas, either. But there will be an environment where markets find that they really are more than overweight US assets across the board and a massive rotation will be needed. And that's where for those who are best prepared to have a framework to capture those flows to often or an alternative, they will do best. So the impetus right now is for European policymakers on a nation state level on an EU level to anticipate that flow coming through to anticipate the search for alternatives outside of this US centric environment that we've had over the last few years and benefit accordingly. Because the financing is there, we just need a trigger out of the FOMC out of the US. That's gonna come later than expected. But it will come and you need to be ready for that. And what I do fear is that either due to the status quo, or disagreements between nation states and European Parliament or the broader EU level, then Europe is not ready for that, then I'm afraid, then the funds will be absorbed elsewhere, perhaps will most likely actually for sustainability for green efforts as well. There's a lot being done in emerging markets for that. So and it's something that Europe will need to recognize the face of competition across the board.

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Great, yeah, that's such a comprehensive answer. Thank you for that. And just, as you mentioned, we do hear, do a lot of

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analysis of central bank reserve currencies and assets. In our survey this year, global public investment survey of central bank reserve managers found that the US dollar is the currency with the highest net demand over a one to two year period, which is in line with what you just explained. And this is due to cyclical factors, like higher rates in the US and a positive outlook for us, for the US economy.

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Well, I don't know if you had any less

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concluding remarks, otherwise, we can wrap it up here.

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Oh, no. That's that's pretty much it. I'll just say it has been an interesting year politically. And we have several more political events coming through. And I think the European elections have shown always expect the unexpected. I know, it's an old cliche. But again, markets were surprised, not by where they thought they would be surprised, but by reactions of individual policymakers. So I think this does underscore the case, even in financial markets, the decisions of individuals matter. And I think that will be a good

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point of guidance. So let's just say for more votes to come further down the line this year and beyond.

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Yep, that makes sense. Well, thank you so much, Jeff. It's been a pleasure. Thank you as well to our listeners, be sure to check out our other podcasts wherever podcasts are available. Thank you.

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