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Facing the Fear Premium: Risks and Opportunities in European Politics

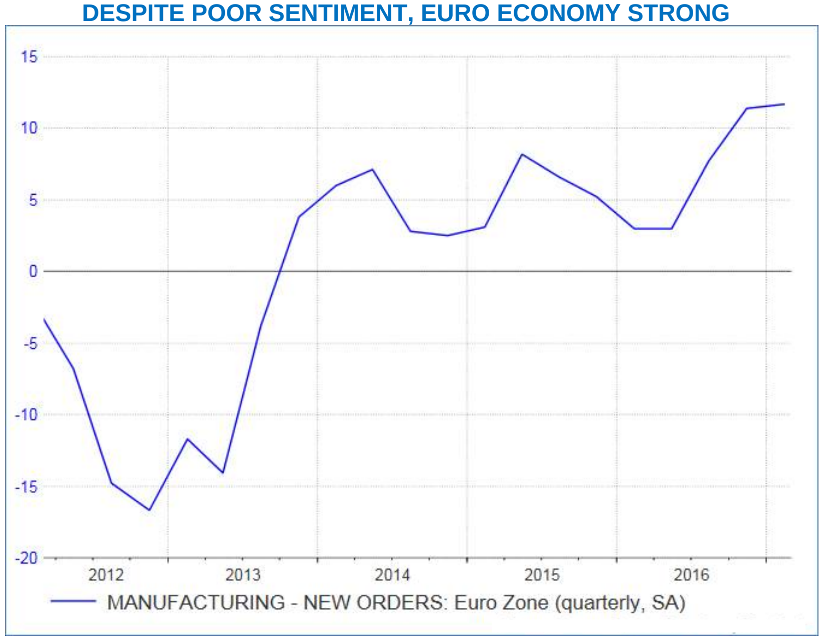
Despite European economic indicators exhibiting strength not seen in the better part of a decade (see *Weekly Chart,* below), equity market sentiment and stock market flows in Europe remain lousy. US-domiciled European ETFs witnessed -$28 billion of net outflows in 2016, almost half of their total assets (*source: Ned Davis Research*). This is in stark contrast to the widespread optimism exhibited in US stock prices and valuation.

This contrast is not due to a differential in corporate fundamentals in Europe vs the US, in our opinion. Our earnings monitor of high-quality, dividend-paying Eurozone multinationals (companies that have a similar return on equity to the S&P 500) suggests that in the last quarter, and indeed in the last few years, corporate earnings at those companies have grown in excess of that of the S&P 500 – yet Eurozone multinationals' price-to-earnings multiples have contracted by 2-3 multiple points over the past three calendar years (*source: Factset Data Systems*). Investors are willing to pay considerably less for a dollar of high-quality Eurozone exporter earnings today than in 2013 or 2014, despite growing earnings and a stronger global growth backdrop. Why?

We believe this disconnect between fundamentals and sentiment in Europe is a reflection of political uncertainty. Investors are openly questioning the viability and future existence of the Eurozone. We acknowledge that exit of a major country from the euro currency union would likely lead to a volatile response in markets; we think it is rational to place a 'fear premium' on this tail risk.

But is this fear premium currently too high? One of our tactical trading rules is "beware the crowd at extremes". We regard the pessimism currently surrounding Europe as extreme. Thus, we see an opportunity for the gap between US and European market sentiment to close, but probably not until there is greater clarity for Europe's politics. Our long-standing belief has been that, while political headlines tends to be 'noise' that can swing near-term market valuation, economic fundamentals drive major longer-term shifts in asset prices. **Therefore, the most important issue for investors here is whether the outcomes of Europe's various elections in 2017 will damage the current positive economic and earnings trajectory. Our current view is 'no' - that the likelihood of the Eurozone splitting apart in the next couple of years is lower than investors fear.** Besides, we might also point out that the two major markets that have experienced the most acute populist upheavals in the past year – the UK and now the US - are also the two markets that have subsequently rallied to all-time highs. So, we believe that investors should caution themselves on being too confident they know the potential direction of the market given various outcomes.

WEEKLY CHART:
DESPITE POOR SENTIMENT, EURO ECONOMY STRONG



Source: Thomson Reuters Datastream, RiverFront. Data last released 2/15/17. Past performance is no guarantee of future results.

While the election slate in Europe is pretty full this year (Netherlands next week, Germany in September, perhaps snap elections in Italy), the French Presidential election (April 23, with runoff round on May 7) will dominate headlines first, and thus is today's focus.

PRIMER ON UPCOMING FRENCH ELECTION – HANDICAPPING THE RESULTS

Excluding fringe participants, the race is down to three (and after this week, maybe two) very different candidates. The first is the far-right Eurosceptic Marine Le Pen of the National Front (FN). Commentators have called her the "female Donald Trump," and one of her first campaign promises is to hold a referendum on Eurozone membership if elected. The center-right Republican, Francois Fillon, carries a message of tough but necessary economic reform, but has been beset by allegations of graft which threaten to end his campaign. In fact, at the time of this writing, rumors abound that Fillon will drop out or be replaced by another Republican. The third is the young newcomer Emmanuel Macron of the centrist *En Marche* movement; he appears to be a pro-Eurozone French liberal in terms of retirement age and pensions, but has also made some vague overtures towards tax and labor policy reform. Le Pen is clearly the candidate that scares the stock market, as French exit from the Eurozone is the tail risk that equity and currency markets fear.

Le Pen has been widely thought to win the first round. However, France's political system makes it highly unlikely that any first round voting will result in an outright victory, which requires more than 50% of the popular vote**; since the 1960s, no French Presidential candidate has won the election in the first round.** The likelihood that Le Pen carries the second round is much less than 50%; according to IFOP polls, Macron is likely to garner 62% of the second round vote, vs just 39% for Le Pen *(source: Bloomberg, March 2nd)*. The reasoning for this goes to the heart of French politics; the first round is often used as a "protest vote", with the electorate typically gravitating towards more centrist candidates in the vote that actually matters.

BUT WHAT IF LE PEN ACTUALLY WINS?

We recognize that anything can happen in ~2 months, especially in an election cycle that's already seen more twists and turns than a subtitled French thriller.* **However, we want to underline that a Le Pen victory does NOT automatically equal French exit from the Eurozone**.

Even if Le Pen wins, we think the path to Eurozone exit for France is still narrow. For instance, it's unlikely that she could actually hold a referendum without rewriting France's constitution. Without a FN majority in Parliament (which will be decided in June and is very unlikely, in our view), such action is difficult to envision. It should also be noted that the French are generally pro-euro; a Eurobarometer survey held in November suggests that almost 70% of the French remain in favor of remaining in the Eurozone. As for risk of conflagration into the European financial system**,** the European Central Bank (ECB) has been consistent that they stand ready to backstop any tightening in financial conditions caused by political turmoil.

RIVERFRONT'S RISK MANAGEMENT DISCIPLINE IN TIMES OF BINARY POLITICAL RISK

Long-time followers of RiverFront's investment philosophy are well-acquainted with our risk management discipline. We will be prepared for multiple outcomes as it relates to the French election. Importantly, RiverFront believes that valuation indicates long-term margin of safety; with developed international stocks approximately 40% below their long-term trend return line on our Price Matters® framework (See our *Outlook 2017* for more on this), we believe many of the adverse political outcomes are already priced into European markets. This may not be true, however, for markets such as the US and the UK, which stand currently near all-time highs.

We believe one of the major reactions in markets to a Le Pen victory would take place in the currency market, with the euro (EUR) likely to weaken significantly in the aftermath. In our Advantage asset allocation portfolios, we are currently hedged against a meaningful portion of exposure to the euro (between 40-50% of our overall euro exposure), in part due to concerns over political headline risk. Also, we think acute euro weakness could prove to be a net positive for the types of high-quality Eurozone multinationals that RiverFront favors. In our view, a major currency devaluation would likely aid competitive positioning and lead to positive earnings revisions, similar to the British experience in mid-2016. This view is dependent, of course, on the global macro-economy holding up even in the face of the increased risk premia associated with a Le Pen win. In our income-oriented portfolios, we are also keeping some 'powder dry' in terms of excess cash, should the market react more dramatically to a Le Pen victory in either round.

**For foreign movie fans, we recommend Gilles Mimouni's* L'Appartement *– a mid-1990s thriller reminiscent of Hitchcock*

Important Disclosure Information (continued)…

Investments in international and emerging markets securities include exposure to risks such as currency fluctuations, foreign taxes and regulations, and the potential for illiquid markets and political instability.

Using a currency hedge or a currency hedged product does not insulate the portfolio against losses.

Technical analysis is based on the study of historical price movements and past trend patterns. There are no assurances that movements or trends can or will be duplicated in the future.

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Weekly Chart: Manufacturing – New Orders, Euro Zone: Industry Survey, Total Manufacturing, New Orders, Business Surveys, Euro Zone, Balance, SA, data via Datastream; Source European Commission/Eurostat; surveys are conducted on a monthly basis in the following areas: manufacturing industry, construction, consumers, retail trade, services and financial services. Some additional questions are asked on a quarterly basis in the surveys in industry, services, financial services, construction and among consumers. Business and consumer surveys provide essential information for economic surveillance, short term forecasting and economic research. Nearly all the questions are of a qualitative nature.