Will Europe Continue Down the Populist Path?

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- The Brexit vote and Donald Trump's unexpected 2016 election victory have kicked off a wave of pro-nationalist sentiment across the globe.
- With several key eurozone countries facing elections in 2017, leading economists and investors envision a possible reshuffling (and even a potential demise) of the European Union.
- Volatility typically accompanies political transitions; investors should review their objectives and adjust accordingly.

Planting the Seeds of Populism

The world has entered the middle age of its third industrial revolution. This era, which began around 1970, has seen technology shift from mechanical to digital, resulting in increased economic growth, wider global trade and higher standards of living for many people. But the digital transition has not occurred without problems; namely, pronounced income inequality and generally higher unemployment in certain segments of the population. Many lower- and mid-level blue-collar workers in mature economies have struggled with declining wages or loss of jobs due to both globalization and digitalization.

The current Middle-East refugee crisis and immigration issues further stoke the populist fire. Workers in developed countries are concerned that immigrants will take their jobs for less pay. The influx of foreigners has also fostered a low-level fear of terrorism.

A Popular Strategy Worldwide

The resulting anger, fear and desire to regain control were the primary drivers of the strong populist sentiment that led to Brexit and the election of Donald Trump. Now that the populist floodgates have been opened, it could continue its global sweep in the upcoming elections of several key developed European countries.

Italy held a constitutional referendum in early December 2016, resulting in the resignation of center-left Prime Minister Matteo Renzi and emboldening the already-ascendent Five Star Movement, a nationalist party that wants to take Italy out of the eurozone. In mid-February, Renzi stepped down as leader of the ruling Democratic Party, increasing the chances of an earlier-than-expected election in September that will determine the new leadership in the country.

Nexit, or the possibility that the Netherlands will exit from the EU, is also on the radar. Populist Geert Wilders (who has been referred to as a Dutch Trump) and his far-right Freedom Party could win the largest number of seats in the Dutch government on March 15. Along with another populist party known as For The Netherlands, the Freedom Party has called for a referendum on leaving the EU. Nexit could be a difficult proposition, however, as both chambers of Dutch Parliament must agree on changing a law that was established in 2015 pertaining to referendums; the law only allows the public to vote on new legislation and treaties.

Frexit, or France's departure from the EU, is possible this spring, as polls suggest that pro-nationalist candidate Marine Le Pen is likely to win the first round of elections on April 23. Le Pen claims the euro is responsible for France's high unemployment rate and has promised to pull the country out of the EU if elected. In the event that no candidate takes a majority of votes in the first round, a run-off between the top two candidates will be held on May 7. Current polls show Le Pen being soundly defeated by center-leftist Emmanuel Macron in the run-off; however, polls don't always tell the full story, as demonstrated by Trump's surprise victory and Brexit, both of which had been considered unlikely outcomes. In the event that Le Pen does take the presidency, her nationalist platform will face an uphill battle, as only two of the 577-member National Assembly represent her National Front party.

Grexit — the original inspiration of the EU "-exit" moniker — is again looking like a worrisome possibility. Germany, Greece's largest creditor, recently put fresh pressure on the country to meet the conditions set forth in its bailout package. According to German finance minister Wolfgang Schaeuble, Greece — where financial troubles first reached crisis proportions in 2010 — could be forced out of the eurozone if it fails to implement economic reform after a third installment of a $91 billion[1] bailout from the EU. Greek Prime Minister Alexis Tsipras recently agreed to lower the threshold of tax-free income and amend its pension system, effective by January 1, 2019 (pending Greek parliamentary approval in March 2017); promises that until now, Tsipras refused to make.

[1] In U.S. dollars

Dexit — or Germany's departure from the EU — would be the nail in the eurozone's coffin. Founded in 2013, the anti-euro Alternative für Deutschland (AfD) party, spent the last half of 2016 growing in popularity, as Chancellor Angela Merkel's open welcome to refugees upset many Germans and bolstered the country's nationalist movement. However, recent polls show that AfD has hit its lowest level of popularity in seven months. Meanwhile, the center-left Social Democrats party (SPD), which gained traction after Martin Schulz assumed its chairman position in January looks to be the most credible challenge to Merkel's September reelection at the moment.

As each successive EU member state experiences a populist uprising, governments in other eurozone countries are likely to be influenced by their agendas, and may even borrow from them.

The advance of populism in Europe will also have a ripple effect on currencies, capital markets and industry — not just in the respective EU member state, but worldwide. European companies that do business globally could underperform against companies that are based in, and mostly deal with, domestic consumers. Increased tariffs and trade barriers stand to hurt global companies by reducing their profitability. A combination of low relative corporate profitability and an accommodative European Central Bank could continue to weaken the value of the euro. Uncertainty around economic policy would likely create volatility across most asset classes.

Surviving the Patriotic Spring

So how should investors navigate a world marked by political volatility?

First, disregard opinion polls. Brexit and Trump's election are two huge examples of polls that got it wrong.

Second, ignore predictions of instantaneous economic catastrophe. Many predicted that Brexit would surely destroy the U.K. economy in short order. The reality was much less bleak: although the first month following the referendum was quite dismal, U.K. manufacturing rebounded in August with its largest increase in twenty-five years. British consumers largely shrugged off the Leave vote: economic growth climbed by 0.7% in the fourth quarter and 2% for the year ending December 31 due to record-breaking household spending.

Third, diversify your portfolio across and within different asset classes to manage risk and to avoid putting all your eggs in one basket. Investors who are particularly risk-averse should consider allocating a portion of their portfolios to lower-volatility equity strategies and other asset classes that have historically exhibited low-volatility characteristics.

Lastly, remember that what goes down often comes back up — eventually. Most global markets plummeted the day after Trump won the U.S. presidential election. U.S. stocks saw deep losses overnight on November 8; but within three months, the S&P 500 Index, the Dow Jones Industrial Average, the NASDAQ Composite and the Russell 2000 Index reached all-time record highs. In Canada, the S&P/TSX composite index reached a new record-high close in early February. MSCI's World Index, which tracks equities in 23 developed countries, rose by 0.8% by late January, hitting a 19-month high. After plunging to a four-month low one week after Trump's November election, the MSCI Emerging Markets Index (which is heavily weighted in China and South Korea) jumped 12%.

As always, investors should carefully consider all investment options and select investments based on their individual objectives.

Index Definitions

The MSCI World Index is a free-float-adjusted market capitalization weighted index that is designed to measure the equity market performance of developed markets. The MSCI World Index consists of the following 23 developed market country indexes: Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Hong Kong, Ireland, Israel, Italy, Japan, Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland, the U.K., and the U.S.

The S&P/TSX Composite Index is the headline index for the Canadian equity market and contains stocks of the largest companies on the Toronto Stock Exchange (TSX).

The Dow Jones Industrial Average is a price-weighted average of 30 significant stocks traded on the New York Stock Exchange (NYSE) and the NASDAQ.

The Russell 2000 Index includes 2,000 small-cap U.S. equity names and is used to measure the activity of the U.S. small-cap equity market.

The S&P 500 Index is a capitalization-weighted index made up of 500 widely-held large-cap U.S. stocks in the industrials, transportation, utilities and financials sectors.

The MSCI Emerging Markets Index is a free-float-adjusted market-capitalization-weighted index designed to measure the performance of global emerging-market equities.