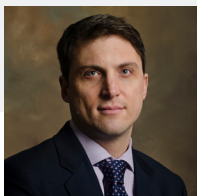




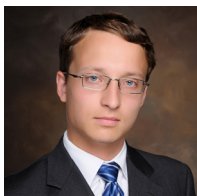
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to inform your decision-making.



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Global Fixed Income **GROWING POPULISM TESTS EUROPE'S BOND MARKETS**

EXECUTIVE SUMMARY

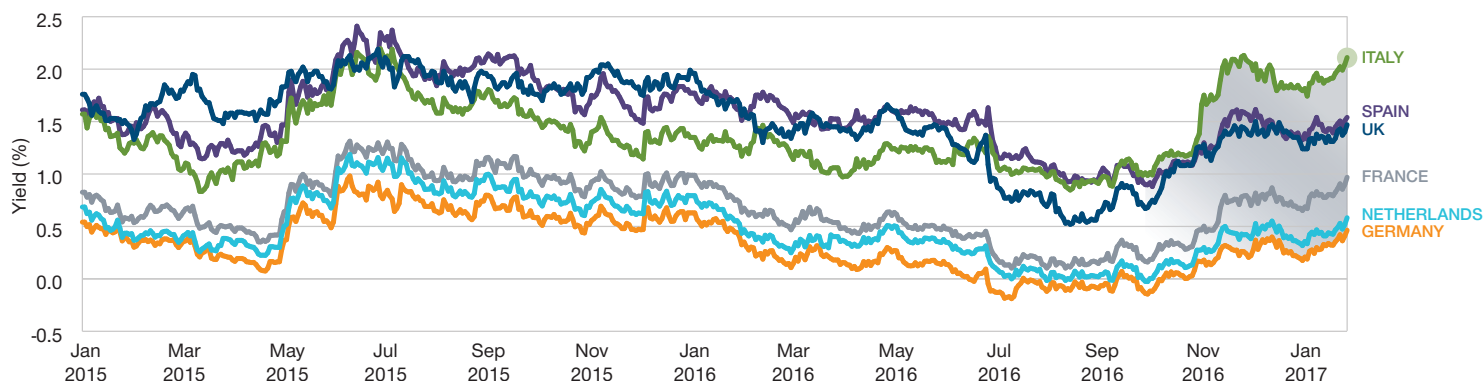
- The extent to which growing “populist” forces could threaten the established order in Europe will be tested this year through a number of events.
- Elections in the Netherlands, France, Germany, and possibly Italy; a planned referendum on Catalan independence from Spain; and the second review of Greece’s bailout program will provide a clearer picture of rising anti-immigration and anti-austerity sentiment.
- While we do not expect a breakup of the eurozone, bond markets have already begun to reprice higher political risk in the currency union ahead of the key risk events, driving bond spreads wider.
- Further volatility can be expected as financial markets seek to determine whether similar forces to those which have led Britain out of the European Union (EU) and delivered Donald Trump to the White House can spring further surprises in mainland Europe.

The extent to which growing “populist” forces could threaten the established order in Europe, disrupting markets in the process, will be tested this year through a number of events. Elections in the Netherlands, France, Germany, and possibly Italy; a planned referendum on Catalan independence from Spain; and the second review of Greece’s bailout program will provide a clearer picture of whether the EU’s attempts to forge greater integration are under threat from rising anti-immigration and anti-austerity sentiment. At the same time, negotiations to clarify the terms of the UK’s exit from the EU will be monitored closely to assess the potential consequences of populist victories in other countries.

Volatility can be expected during the year as financial markets seek to determine whether similar forces to those which have led Britain out of the EU and delivered Donald Trump to the White House can spring further surprises in mainland Europe. Whatever happens, however, we are unlikely to see the breakup of the eurozone—the currency union has many checks and balances to prevent this from occurring. Neither do we currently expect large-scale sell-offs in European financial markets. While the European Central Bank (ECB) will reduce its monthly bond purchases from €80bn to €60bn in March, this will still be enough to exceed annual net issuance by the largest sovereigns, reducing the net supply of government bonds and thus likely preventing any potential rout.

FIGURE 1: European Bond Yields

January 1, 2015, to January 27, 2017



Source: FactSet.

However, bond markets have already begun to reprice higher political risk in the eurozone ahead of the key risk events, driving spreads between European bond yields wider (see Figure 1). And if one of the populist parties defies current polling and actually gains power—and there is recent precedent for poll-defying outcomes—volatility may remain elevated for an extended period. Below we discuss the key risk events of 2017 and assess their potential impact on fixed income markets.

DUTCH VOTE TO KICK OFF THE EU ELECTORAL “SUPERCYCLE”

The Dutch parliamentary election will take place on March 15, 2017, with opinion polls indicating that the far-right, anti-immigration and anti-EU Party for Freedom (PVV), led by Geert Wilders, could become the biggest party in parliament. We do not, however, expect the PVV to be part of the next Dutch government. Although it is leading in the polls, it is unlikely to take more than 25% of the votes and would need to find coalition partners in order to form a government. This will be a very difficult task: While there are other euroskeptic parties, none of them want to leave the EU, and without a governing majority, the PVV will not be able to pass an Advisory Referendum Act, which is a prerequisite for a referendum on membership of the EU and eurozone.

The election is likely to be followed by a prolonged government formation process, probably concluding with the center-right People’s Party for Freedom and Democracy (VVD) forming a coalition with other centrist parties. If this cannot be achieved, further elections are likely, leaving the Netherlands under a caretaker government for an extended period. Given the strength of the economy and government finances, we do not expect any electoral uncertainty to result in a meaningful widening of spreads. However, while the probability of a “Nexit” is negligible, growing euroskepticism in the Netherlands will make the Dutch tougher negotiating partners on broader EU issues such as any future deals with Greece—potentially undermining any future efforts to forge closer EU integration.

FRENCH ELECTION POSES BIGGEST TEST TO EUROZONE

Beginning five weeks after the Dutch election, the French presidential election is widely considered to be the most important political event for the eurozone in 2017. The three main candidates will be François Fillon of the center-right Republican Party; Marine Le Pen of the far-right Front National; and Emmanuel Macron, who will stand for his own En Marche! party on a center-left platform. Benoit Hamon, the Socialist Party’s







candidate, is unlikely to pose a threat to the main candidates.

The first round of the election will be held on April 23. Should no candidate win an overall majority, a runoff election between the top two candidates will be held on May 7. At the time of writing, the vote is expected to go to a second round contested by Macron and Le Pen, which Macron is expected to win by a significant margin—however, the election is still months away, and all three main candidates remain genuine contenders.

A victory for Marine Le Pen, who has called for a wholesale renegotiation of France’s relationship with the EU to reinstate French sovereignty, would be regarded as a major threat to the bloc. While opposition from both houses of the National Assembly would likely prevent Le Pen from tabling a referendum on EU and eurozone membership, her election would nonetheless cast considerable uncertainty over France’s long-term relationship with its EU partners. In particular, a breakdown in France’s relationship with Germany, combined with instability in other member countries, could set in motion the longer-term disintegration of the EU.

In our view, the bond markets have yet to fully price in the political risk stemming from the French election. We expect

FIGURE 2: Key Risk Events in Europe in 2017

Date	Country	Event	Likely Outcome	Adverse Scenario	Importance/Risk
March 15	Netherlands	General Election	The liberal People's Party for Freedom and Democracy loses the election to the Europe Party for Freedom, but gets enough votes to form a coalition with smaller parties.	The PVV performs better than expected and wins 35% of seats, making it very difficult for traditional centrist parties to form a government. Coalition talks fail after prolonged negotiation and new elections are called. The Netherlands enters a period of extremely unstable governments.	 LOW
April 23	France	Presidential Election, First Round	Independent candidate Emmanuel Macron gets 25% to 30% of the votes and secures his place in the second round. The National Front's Marine Le Pen gets about 25% of the votes to face Macron in the second round.	Le Pen performs stronger than expected and wins first round of the elections with 35% of the votes.	 LOW
May 7	France	Presidential Election, Second Round	Macron beats Le Pen with 60% of votes as center-left voters decide to support him in the runoff.	Le Pen surprisingly beats Macron in the runoff to become the next French president. Political instability in France increases dramatically. A hostile relationship between Germany and France marks the beginning of longer-term EU disintegration.	 HIGH
July 17-20	Greece	Bond Repayments	Despite some delays, Greece successfully completes the second program review by the end of the first quarter and receives €6bn in program money. That allows Greece to repay bonds due on July 17 and July 20, avoiding a repeat of the 2015 stress situation.	The Greek government and its creditors fail to reach an agreement on labor market reform and fiscal targets for 2018-2019. Negotiations stay on pause until the end of June due to elections in the Netherlands and France. The government faces liquidity pressures and starts accumulating arrears. Serious concerns about Greece's ability to repay bonds and remain in the eurozone causes volatility in other peripheral markets.	 MEDIUM
July-Sept. 2017	Spain	Catalonia Independence Referendum	Catalonia holds an unofficial referendum on independence. "Yes" wins by a small margin, but the turnout is low (<40%). The referendum result forces the central government to eventually agree to a new status for Catalonia.	Catalonia holds an unofficial referendum on independence and "yes" wins by a reasonable margin (55%+), while turnout exceeds 50%. The Spanish government does not recognize the referendum and does not agree to negotiate with the Catalan authorities. Conflict escalates, potentially leading to freezing fiscal transfers between Catalonia and Spain for an uncertain period of time.	 MEDIUM
August 27-October 22	Germany	General Election	The Christian Democratic Union (CDU) perform worse than in 2013 but poll well enough to maintain the "grand coalition" with the Social Democratic Party (SPD). Angela Merkel remains chancellor. Alternative for Germany becomes the first nationalist party to enter the German Parliament since 1945.	Alternative for Germany performs better than expected and wins 25% of the votes. The CDU underperform and encounter difficulty in forming a coalition with SPD and other parties. Germany enters a protracted government formation process, leaving Europe bereft of strong leadership.	 MEDIUM

French sovereign spreads to widen as the vote draws nearer, particularly if Le Pen is doing well in the polls. If Le Pen pulls off the ultimate surprise and wins, we expect significant widening in non-German core and peripheral spreads, although probably not reaching the stress levels of 2011-2012 given ongoing ECB bond purchases. On the other hand, a Fillon or Macron victory would be perceived positively by the markets, causing a significant tightening of spreads.

MERKEL'S "GRAND COALITION" LIKELY TO WEAKEN

Although we expect Chancellor Angela Merkel to win in September, the campaign will probably be the toughest of the four she has contested as her popularity has fallen on the back of her welcoming stance toward migrants. By contrast, the right-wing Alternative for Germany (AfD) party has received a boost in the polls due to its anti-immigration policies and currently has around 15% support—putting it in line to put the first far-right members into the German parliament since 1945.

A strong showing by the AfD will make it more difficult for Merkel to form a coalition, potentially leading to a prolonged negotiating period. AfD's success will come at the expense of both Merkel's Christian Democratic Union (CDU) and the center-left Social Democratic Party (SPD), resulting in more direct competition and reduced cooperation between them. That said, it is almost certain that a strong performance from the AfD would result in a continuation of the "grand coalition" of the CDU and SPD, albeit a more precarious incarnation.

We believe that Italian spreads are currently pricing in most of the risks in Italy, and we do not expect them to widen significantly. However, from here, the possibility of spread widening between Italian debt and Spanish and French debt may offer an opportunity to adopt a small overweight position in Italy against Spain or France.

After the election, Germany will continue to play a leading role within the EU, but its stance on certain issues may harden. In particular, Germany's current policy of supporting weaker eurozone members such as Greece may come under question if Merkel lacks strong parliamentary backing. As the eurozone's major risk-free asset, bunds will likely benefit from rising political tensions, with periphery spreads widening.

REFORM COULD BRING EARLY ITALIAN ELECTION

After two years of relative stability, the political environment in Italy has become volatile again. In December, Prime Minister Matteo Renzi resigned after he lost a referendum on constitutional reform by a wide margin. On January 25, the Italian Constitutional Court ruled that part of the existing electoral law was invalid, potentially opening the way for early elections this year. In a written verdict, the court rejected the idea that national elections could be held over two rounds but agreed that any party that took at least 40% of the vote should win an automatic parliamentary majority.

The court said the amended law could now be used immediately if elections were called. A vote is not scheduled until early 2018, but former Prime Minister Matteo Renzi, who still heads the ruling Democratic Party (PD), has said he wants a ballot held as soon as possible. The possibility of this occurring hinges

on whether the PD decides to try to push through further changes to the electoral system—possibly scrapping the 40% rule—before it invites the country back to the polling booths. We believe there is a reasonably strong chance of an election in Italy this summer. The populist, anti-euro Five Star Movement (M5S) has been polling at around 30%, neck-and-neck with the PD. While it is possible that M5S could become the largest party after an election, it is unlikely to pass the 40% mark and lacks obvious coalition partners. It is more likely that the PD would form a coalition with the center-right Forza Italia, with further support from smaller centrist parties, to keep M5S out of power.

Even if M5S were able to form a government, it is unlikely that Italy would leave the eurozone. Although the party is anti-euro, it still wants to keep Italy in the EU, which would be legally impossible if it departed the currency union. Moreover, a referendum on eurozone membership is illegal under the Italian constitution and changing the constitution would be a very complicated process. We believe that Italian spreads are currently pricing in most of the risks in Italy, and we do not expect them to widen significantly. However, from here, the possibility of spread narrowing between Italian debt and Spanish and French debt may offer an opportunity to adopt a small overweight position in Italy against Spain or France (see Figure 1, page 2).

CATALONIAN INDEPENDENCE ISSUE REARS ITS HEAD AGAIN

Although the conservative Popular Party finally managed to form a new government in Spain in late October 2016, political uncertainty in the country remains high. The new government, led by Prime Minister Mariano Rajoy, lacks a clear parliamentary majority, requiring it to seek ad hoc support for every bill it wants to pass. It has already faced difficulties in passing the 2017 budget, and the challenges ahead may be even greater. For these reasons, it is unlikely that the government will serve its full term, meaning that another general election in Spain could be held within the next year or so.

The Spanish government's long-standing dispute with Catalonia looks set to come into focus again this year. Catalonia, one of the richest regions in Spain, claims that it pays more money to the central government than it receives in fiscal transfers. The unwillingness of the Spanish government to review the current arrangement has frustrated the Catalan authorities, which may call an independence referendum as early as July if polls indicate an increase in support for breaking away from Spain. Even if such a referendum were held and the vote was a "yes," it would be unlikely to result in Catalonia becoming an independent state as there is no legal mechanism through which this could occur. It would, however, increase tensions between Catalonia and the Spanish government, potentially resulting in an abrupt cessation of financial flows between the two.

Given current expensive valuations, Spain is one of the best places to be short on European periphery debt. Spanish debt has been trading below Italy, but in our view the market is underpricing political risk in Spain. As such, we believe spreads between Italy and Spain could narrow in the medium term.

SECOND BAILOUT REVIEW LOOMS FOR GREECE

The Greek government completed its first bailout program review in May 2016. Since then it has remained in the second review process, the completion of which has been delayed several times amid disputes over labor market reform and fiscal conditionality for the 2018–2019 budgets. As things stand, we expect the review to be completed before the end of the first quarter.

This should pave the way for an extra €6 billion funding disbursement, which should be enough to enable Greece to repay bonds maturing in July.

However, the window for a deal between Greece and its creditors is closing fast. The election of Donald Trump as U.S. president could negatively impact the U.S. position on International Monetary Fund (IMF) financing in the eurozone, which in turn could make it more difficult to strike an agreement between Greece, the IMF, and the EU—particularly given existing disagreements between the EU and the IMF on the sustainability of Greek debt. As key elections are taking place in Europe over the next few months, Greece is unlikely to be on top of the European political agenda; if the second bailout review is not completed before the end of the first quarter, the situation could be pushed back until July, raising concerns about Greece's ability to repay its debt to the ECB and remain in the eurozone. If not resolved by early July, there could be a repeat of the volatility in peripheral markets that occurred in the summer of 2015.

MAY HINTS AT HARD BREXIT

While the events previously discussed take place, negotiations over the terms of the UK's exit from the EU will begin in earnest. On January 24, the UK Supreme Court ruled that the ruling conservative government must seek the approval of Parliament before triggering Article 50. In reality, this is unlikely to delay the process as

Overall, we expect European spreads to be volatile in 2017, most likely rising in the first half of the year and calming down after the German election in September—assuming none of the negative outcomes described materialize. If one or more of these negative outcomes do occur, spreads could remain elevated for much longer.

parliament is almost certain to approve the legislation, leaving Prime Minister Theresa May on track to deliver on her promise to trigger Article 50 in March. Arguably more significant than the Supreme Court's decision was May's speech to diplomats a week before, in which she clarified the government's position on its negotiations with the EU over a post-Brexit trading deal. While clearly stating that she wanted the UK to have as much access as possible to European markets, May also strongly reaffirmed the need for Britain to retain full control over immigration—directly in conflict with one of the key tenets of the EU—increasing the possibility of a “hard” Brexit.

Even more important than May's comments on migration was her assertion that “no deal” with the EU would be better than a “bad deal.” To publicly state that Britain would be comfortable with having no trade deal with the EU post-Brexit was a bold move—and raised questions about what a post-Brexit arrangement would be in the absence of a formal agreement.

While May's speech provided some clarity over the UK government's approach, it raised more questions than it provided answers on what Brexit will mean in practice. And while the UK economy has performed stronger than expected in recent months, inflation is rising and the Bank of England's bond purchase program is about to come to

an end very soon, removing a key prop from the UK sovereign bond market. As such, UK gilts should be treated with caution for the foreseeable future. Sterling too looks vulnerable to further downward adjustments.

VOLATILE SPREADS NECESSITATE CAUTIOUS APPROACH

Overall, we expect European spreads to be volatile in 2017, most likely rising in the first half of the year and calming down after the German election in September—assuming none of the negative outcomes described materialize. If one or more of these negative outcomes do occur, spreads could remain elevated for much longer. However, it is unlikely that spreads will reach stress levels similar to those of 2011–2012 as the ECB is likely to respond to significantly heightened volatility in peripheral markets with further quantitative easing.

In this environment, it may pay to trade peripheral markets on the neutral/short side in the first half of the year, potentially switching to a long position in the second half of the year if political risk is perceived to have fallen. Within the eurozone, politically stable countries such as Slovenia, Cyprus and Ireland currently offer the lowest level of risk and therefore the most attractive opportunities on the long side. By contrast, France and Spain, where we believe the level of risk to be greater than is currently priced in by markets, may offer interesting shorting opportunities.

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