EUROPE: INVESTING IN PERIODS OF POTENTIAL POLITICAL CHANGE

Dominic Wallington – Head, European Equities & Senior Portfolio Manager,
RBC Global Asset Management (UK) Limited

"Everything needs to change so everything can stay the same"

Giuseppe Tomasi di Lampedusa – The Leopard

Recently we were asked for our thoughts on political developments in Europe. Our custom is generally to invoke the stock-market aphorism "stocks are not the market and the market is not the economy" when talking to investors in our funds. Another way of making the same point is to say "listen to the businesses, not to the headlines." Too much equity-investor time is taken up looking at the ever-changing macro and trying to fit portfolios into world views that tend to be difficult to discern and to time. Our team's approach is built on an understanding that it is the job of corporate-management teams to mediate and offset the external problems that find their way into the news. Also, many of the businesses that we look at are highly international and not particularly affected by local economics or politics. There are always tensions between the prerogatives of government and business interests, but the political assumption for more than a generation has been that the best way to help the economy is to help the companies within it.

All of these things tend to add up to the business environment exhibiting a stability that astonishes those who look at the news and market movements. We practice an educated agnosticism towards the idea that big events are relevant to investment but sometimes we need to turn our attention to unfolding themes.

In the U.K. and the U.S., we have witnessed political events that demonstrate the remarkable flexibility of democracy. Subsequently, markets are generally at higher levels and so, yet again, it has appeared to be wise not to react to big macro events. As a whole, business growth and profitability have not been affected by Brexit and Trump and the market has recognised this. Our concern is that we believe similar political changes could occur in Europe and for similar reasons. The difference is that, in our view, the EU possesses less dexterity to deal with change than the U.K. and the U.S. Democracy can operate at a national level, but the technocratic body that is the EU might not be able to accommodate the change that results.

The new energy in European politics may prove fragmentary, with individual countries seeking greater sovereignty in response to the demands of their domestic populations. At the same time, there may be a growing understanding that European integration has stalled, perhaps terminally. While predictions are very difficult to make, our conclusion is that there are clear risks to the EU project and that the process is unlikely to follow a linear chain of events. The forces currently rippling across the intricate intersection of politics and markets are, nevertheless, long term in nature and need to be thought about.

If events unfold in this way – and there is the potential that to do so doesn't require populist parties taking power but merely garnering levels of support that surprise market participants – parts of the long-lived EU Institutional framework could be at risk. The implications of this would be more substantial than those associated with the changes that have recently taken place in the U.K. and the U.S.

The constancy of change is a given, and this universal theme has been recognized in many of the world's religious texts and great works of art. What is important is acceptance and incorporation of this fact. If Europe does see political change, then it is possible that it will be accompanied by policy that is reflationary in nature, especially in Southern Europe. Investors may anticipate this and we may therefore ultimately witness a more extended style change in European equity markets towards weaker, more lowly rated companies. The thinking will be that the operating environment will become easier for them. This would not necessarily work to our advantage because we tend to invest in the companies that excel in any environment.

We believe, however, that the companies we specialize in are the best at coping with the more generalized issue of change, irrespective of how it might manifest itself. It could be economic, political, structural or technological. The quality of management teams in these types of companies tends to be very good but they also generally exhibit built-in sustainable advantages that make them more robust. LVMH is not the same company as the one founded by Louis Vuitton in 1854, but the longevity of the brand is very instructive in terms of understanding how LVMH might fare if the European political landscape does change. Having survived the Long Depression of 1873-1890 and numerous political changes and wars both in the 19th century and, most substantially, in the 20th century, the brand and the group have prospered on the global stage. Whatever happens to the political landscape in Europe, LVMH will continue. If change does come to Europe we shall not be surprised by it but, having anticipated its possibility, we will still respond by listening to the businesses and not watching the headlines.

Global Asset Management