Quarterly Macro Report

2nd Quarter 2017

Despite the reassuring outcome of the Dutch elections, investors still fret about France's upcoming presidential election. But even in the improbable event of a Le Pen victory, a dreaded Frexit is highly improbable. Meanwhile, the Eurozone's economic outlook has brightened yet again, which even the ECB had to admit.

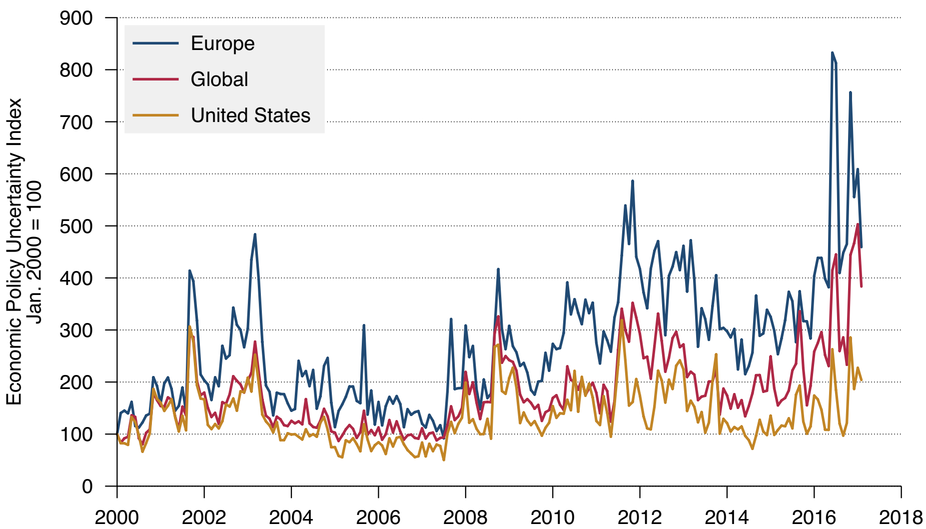
This is the year of important elections in Europe. The Netherlands, France and Germany – three of the five largest European economies – are all holding key elections in 2017. Given the rise of eurosceptic populist parties, some commentators have forecast the imminent demise of the euro and the European Union. And given that 2016's major political events, the US presidential election and the Brexit vote, yielded surprising results after pre-vote polls had suggested different outcomes, a cautious approach to political predications can only be regarded as reasonable. France's election has long been regarded as the true test for Europe, so the pro-European election results in the Netherlands did little to soothe anxiety among investors. We would note that the Dutch election results, while by no means a sure predictor of events elsewhere, may still shed some light on the coming elections.

Dutch pro-European forces win big

Despite right-wing populist Geert Wilders' Party for Freedom gaining five more seats than it won in the previous elections in 2012, pro-European forces have retained a clear majority in the Dutch parliament. Moreover, the large gains of decidedly pro-European parties show that political parties associated with a strong European Union can still win elections.

This outcome may hold an important message for Germany, where the Social Democrats party surged in the polls after Martin Schulz, an unequivocal advocate of a strong European Union, became its candidate for the Chancellor's office. Even if the *Alternative für Deutschland* populist party were to increase its share in September's national elections beyond the 6-percent increase it recently recorded in the regional election in

Fig. 1: Policy uncertainty at unprecedentedly high levels



The well-established Economic Policy Uncertainty Index tracks the frequency of selected keywords in the news media. Although the index has retreated somewhat from its peaks after the Brexit referendum last June, it remains at unprecedentedly high levels, with weeks to go before France holds its presidential and legislative elections.

Source: policyuncertainty.com, Wellershoff & Partners

Saarland, we think the *AfD* will remain on the political fringe. With little or no chance of Germany turning away from the EU, this leaves the French elections as the magnet for investors' worries.

French election takes center stage

Marine Le Pen's potential election victory has concerned investors for a while now. This is evident in the interest rate differential between French and German government bonds, which has widened over recent months. But despite the gravity of the issues at stake in France, we think that current market fears are probably overstated for several reasons.

First of all, we think that Le Pen's election prospects are merely modest. Despite her head-to-head race with Emanual Macron in the polls for the first round of the presidential elections, she lags significantly behind both Macron and Francois Fillon in the polling for the decisive run-off vote. But 2016 made it painfully clear that pre-vote polls are subject to substantial error. Thus a potential Le Pen presidency cannot be completely ruled out at this point in time. But even allowing for a Le Pen victory, we are convinced she and her colleagues in the *Front National* would encounter great difficulties pushing their major policies through. What frightens investors most about Le Pen, given her anti-EU and anti-euro policy stances, is the prospect of a French referendum, a *Frexit*, on leaving the EU and abandoning the euro.

But even in the event of a Le Pen victory such a referendum seems quite unlikely, in our opinion. To begin with, Le Pen's *Front National* party currently occupies only two of the National Assembly's 577 seats despite Madame Le Pen receiving almost 18 percent of the vote in 2012's presidential elections. This provides a firm reminder that even if Le Pen were unexpectedly to win the second round, in May, we think it still remains highly unlikely that her party would win enough seats in June's legislative elections to be in a position to pass controversial laws – or even, for that matter, to initiate a referendum on exiting the EU or euro. Finally, there is another factor that should soothe investors' jangled nerves: According to several recent surveys, both the European Union and the common currency enjoy a stable level of acceptance among French voters of around 70 percent.

All in all, we think that concerns about political developments in France and in Europe in general are exaggerated. Depending on the outcome of the French presidential election and, if necessary, the parliamen-

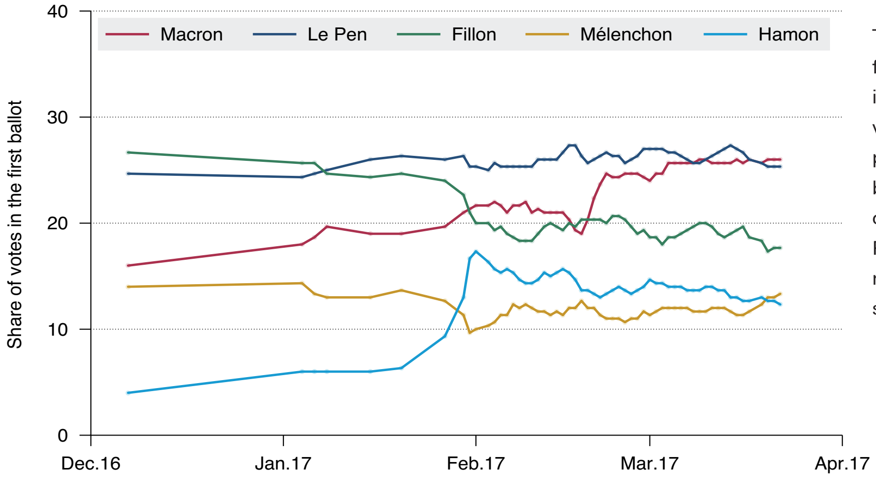
Table 1: Macro economic estimates

	Real GDP growth in %						Inflation in %					
	2015	2016	2017P	2018P	2017Δ	2018Δ	2015	2016	2017P	2018P	2017Δ	2018Δ
USA	2.6	1.6	2.0	1.5	-0.3	-0.9	0.1	1.3	2.4	2.5	-0.1	0.2
Euro area	1.9	1.7	1.6	1.5	0.0	-0.0	0.0	0.2	1.5	1.8	-0.1	0.4
Germany	1.5	1.8	1.8	1.5	0.4	-0.1	0.2	0.5	1.6	2.0	-0.2	0.3
France	1.2	1.1	1.5	1.2	0.2	-0.2	0.1	0.2	1.4	1.8	0.1	0.5
Italy	0.7	1.0	1.2	1.0	0.4	0.1	0.0	-0.1	1.0	1.5	-0.1	0.3
Spain	3.2	3.4	2.5	2.0	0.1	-0.1	-0.5	-0.2	1.5	1.5	-0.7	-0.0
United Kingdom	2.2	1.8	1.0	1.4	-0.5	0.1	0.0	0.7	2.5	2.5	-0.9	-0.8
Switzerland	0.8	1.5	1.5	1.5	0.0	-0.2	-1.1	-0.4	0.5	1.0	0.1	0.4
Japan	1.3	0.8	0.8	0.5	-0.4	-0.5	0.8	-0.1	0.0	0.5	-0.7	-0.5
Brasil	-3.8	-3.3	1.8	1.5	1.1	-0.9	9.0	8.7	6.0	6.0	1.1	1.3
China	6.9	6.7	6.4	5.5	-0.1	-0.6	1.4	2.0	2.8	2.5	0.5	0.3
India	7.6	7.5	7.5	7.0	0.7	-0.4	4.9	4.9	5.0	5.0	0.3	0.1
Russia	-3.7	-0.7	1.0	1.0	-0.1	-0.5	15.5	7.1	5.0	4.0	0.2	-0.5
World (PPP)	2.6	2.4	2.6	2.4	-	-	2.8	2.9	2.7	2.7	-	-

E Estimates Wellershoff & Partners Δ Deviation from consensus economic forecasts

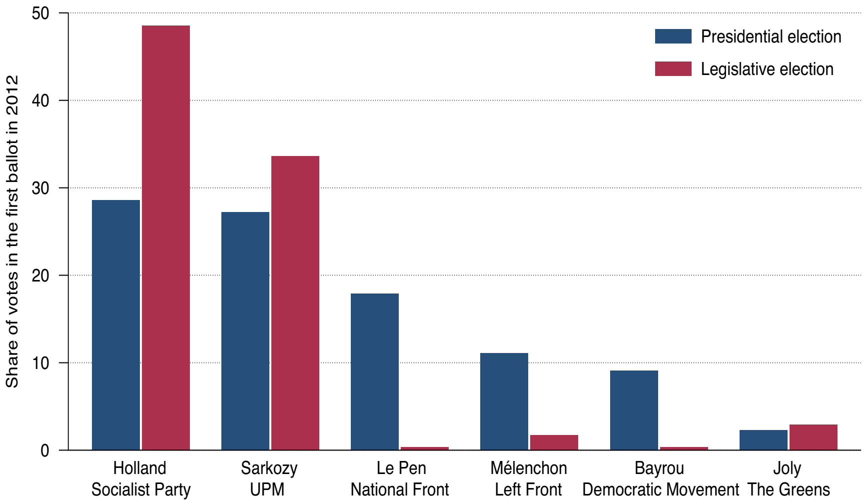
Source: Consensus Economics, Thomson Reuters Datastream, Wellershoff & Partners

Fig. 2: Polls indicate head-to-head race in the first round of France's presidential election



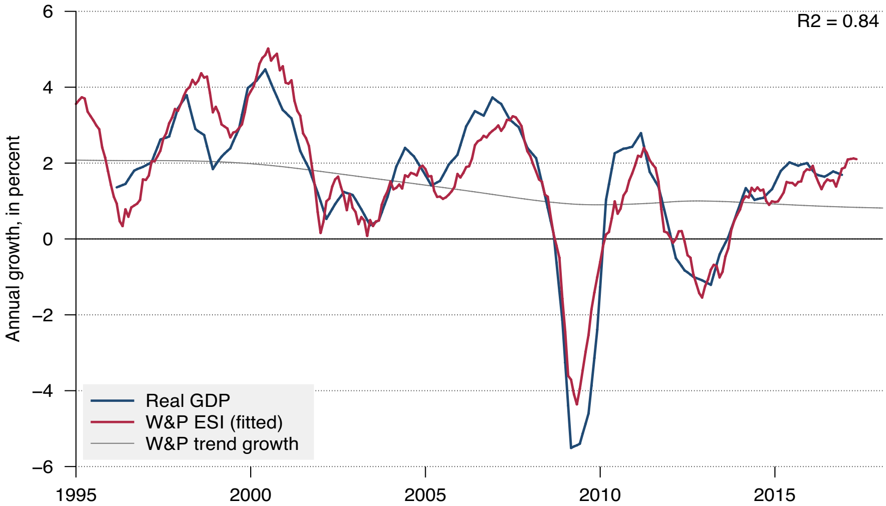
The results on the left are calculated from various opinion polls conducted in the past 14 days. The first round of voting is on April 23 and the latest polls still show a head-to-head contest between the Socialist Emmanuel Macron and far-right populist Marine Le Pen. But polls for the decisive second round of voting, on May 7, clearly show Macron defeating Le Pen.

Fig. 3: The gap between votes and victories in France's 2012 presidential and legislative elections



The large discrepancies in France's last presidential and legislative elections, in 2012, result from the country's majority voting system, which allows parties to strike deals before the second round of voting. While Marine Le Pen received almost 18 percent of the presidential vote in 2012, her party won only two of 577 seats in the French National Assembly in the legislative election. Meanwhile, the Socialists and the UPM (Union for a Popular Movement) increased their shares.

Fig. 4: Eurozone's economic outlook continues to brighten



In a challenging environment in 2016 the Eurozone's economy showed remarkable resilience. The current year-over-year GDP growth rate of 1.7 percent lies well above its trend growth rate of 0.9 percent, confirming the region's rapid recovery. Moreover, Wellershoff & Partners' survey-based economic sentiment indicator is pointing to another round of economic growth in the 1st quarter of 2017, which would make it the Eurozone's 16th consecutive quarter of economic expansion, a performance record that not even the US economy can match.

Source: Elabe, Harris, Ifop-Fiducial, Ipsos, OpinionWay, Thomson Reuters Datastream, Wellershoff & Partners tary elections in June, these worries should fade. Then, once anxieties evaporate about an imminent EU break-up or the abandonment of the euro, investors' attention may finally focus on Europe's economic rather than its political developments.

The Eurozone's bright economic outlook

The Eurozone's bright economic outlook has been a bit under-reported, we think. In the 4th quarter of 2016 the Eurozone's GDP expanded yet again, this time by 0.4 percent quarter-over-quarter, as fast a growth rate as the US economy achieved for the quarter. Moreover, Wellershoff & Partners' survey-based economic sentiment indicator for the Eurozone is pointing to another round of economic growth in the 1st quarter of 2017.

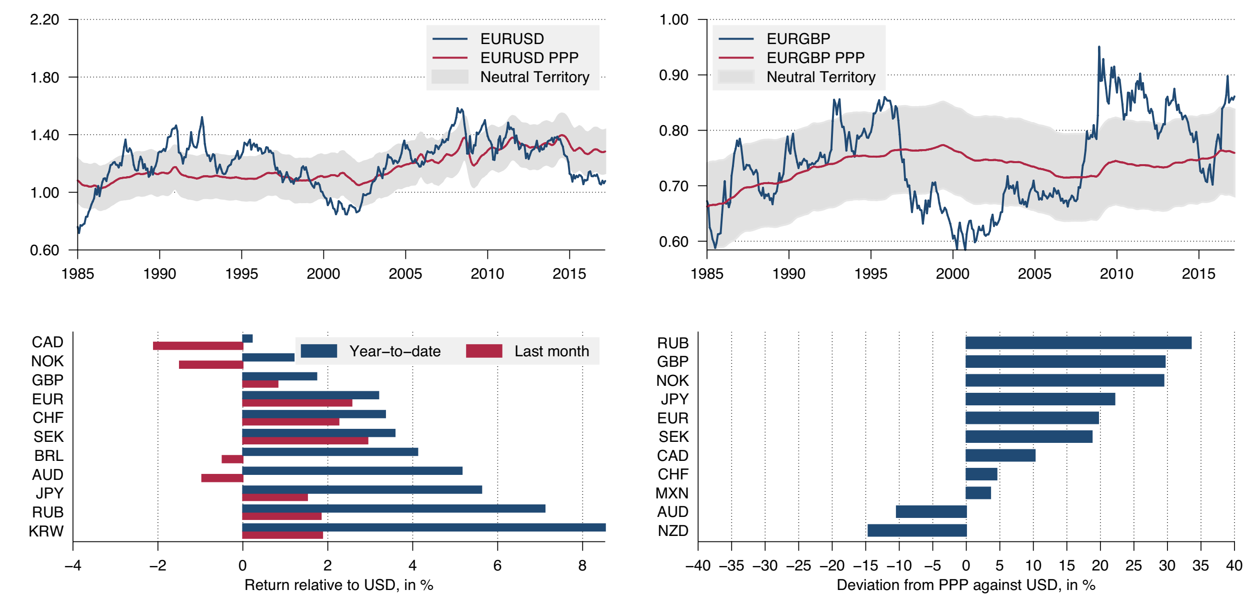
That the economies of the Eurozone's member states are doing well has recently, and rather surprisingly, even been confirmed by Mario Draghi, the president of the European Central Bank. At the ECB's most recent official press conference, in mid-March, after years of warnings about low growth rates and deflation in Europe, Draghi painted an upbeat picture of the Eurozone's economic outlook for the coming two years.

Admittedly, the decision not to expand a financing tool for European banks with the cryptic name TLTRO cannot be regarded as a departure from the ECB's overall expansionary monetary policy yet. But together with Draghi's comments it can perhaps be seen as a first step. And indeed, as soon as political uncertainties have declined, as we expect them to, we think it will be increasingly difficult for the ECB to justify its ongoing quantitative easing program. After Eurozone inflation rates surged to 2 percent, Germany's representatives in particular – with an eye toward their country's elections in September – will make sure that the discussion about how to end the ECB's quantitative easing program will be initiated sooner rather than later.

A stronger euro ahead?

As worries about the Eurozone's political uncertainties begin to fade, investors' attention could shift to the Eurozone's promising economic outlook and the growing prospects of a sooner rather than later tightening of the ECB's monetary policy. This could in turn lead to a quite drastic reassessment of currency valuations, with capital flowing back into the euro. Thus, the substantial deviation in the EURUSD exchange rate in terms of purchasing power parity, currently at around 14 percent, may be set to narrow later this year.//

Fig. 5: FX performance and valuations



PPP estimates based on producer price indices

Source: Thomson Reuters Datastream, Wellershoff & Partners

Disclaimer

About us

Perpetual Wealth AG is a wealth management boutique offering financial and family office services to a sophisticated international clientele. Perpetual Wealth AG is a member of Aquila & Co., which is regulated by FINMA (Swiss Financial Market Supervisory Authority) as a security dealer and as a bank. Perpetual Wealth AG is a member of SAAM, Swiss Association of Asset Managers, and FINMA regulated with regards to Anti-Money-Laundering regulations.

Wellershoff & Partners Ltd is an independent consulting and research company that focuses on global economics, financial markets and comprehensive risk management. The internationally operating consultancy was founded in 2009 and is based in Zurich.

Imprint

Published by // Wellershoff & Partners Ltd., Zurich
Authors // Felix Brill, Markus Schmieder
Concept // Wellershoff & Partners Ltd., Zurich
Design // Feinmass Kommunikationsdesign, Lucerne

Editorial deadline: March 29, 2017