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Asset Management

Should politics matter for European investors?

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“We are merely reminding ourselves that human decisions affecting the future, whether personal or political or economic, cannot depend on strict mathematical expectation, since the basis for making such calculations does not exist.” **John Maynard Keynes**

Spare a thought for medieval bankers (not a sentiment expressed every day.) The litany of issues facing this nascent class of professionals makes today’s political and economic environment seem positively benign.

The first deposit banks contended with wars – an ostensibly daily occurrence at the time – religious schisms, coin shortages, and rogue bankers. Such was the need to provide a stable environment that local politicians stepped in to regulate the sector. The resulting punishments meted out were rather daunting: a law was passed in Barcelona in 1321 which forced bankers who had become insolvent or gone bankrupt to ‘be held for a year on bread and water until all accounts were satisfied’. If this failed then the next stage was execution, as so happened to the unfortunate Francesc Castello, who was beheaded in front of his own bank in 1360.

Or take the first financial conglomerates originating from Florence in the 14th and 15th centuries. To navigate the political carnage of the age, the Peruzzi and Bardi companies combined huge merchant businesses spanning different European countries with increasingly powerful banking segments. Vastly successful, they ultimately fell due to a difficult political and economic environment, but in the case of the Peruzzi company, also due to the large loans extended to King Edward III who defaulted due to his lavish lifestyle and the financing of his wars with France. Finally, take the Medici bank, the first modern holding company, spread over different countries to diversify its risk. The bank also faced rival families, who in one case stabbed to death Giuliano de’ Medici during a church service, yet more defaulting monarchs in Edward IV, and ultimately the invasion of Florence by the French.

These various businesses demonstrate that there are lessons beyond never lending to a monarch, which is repeatedly shown to be a terrible business decision. A criticism or fear often levelled at European equities is that the political landscape is prone to shift. Business, it is often said, hates uncertainty. But there is another element embedded in this assumption, which is that investing in European stocks is a proxy for the corollary of European political results, namely economic performance.

However, as is becoming far better known, such stocks are rarely good proxies for domestic performance, as European companies generate more of their revenue from overseas than other major regions: over 55% of revenues are generated abroad, compared with 29% for the US, 47% for Japan and 26% for EM countries[1].

Emerging markets are of particular importance, contributing 30% of total European revenues as of 2023, followed by North America at 22%. Given that Europe is predominately an export economy, it should follow that around 60% of the cost base is located inside Developed Europe, much higher than the revenues derived from the region[2]. The UK has an even more pronounced bias, with only circa 29% of UK PLC's revenue derived from the UK, again with emerging markets the most important contributor. In some ways, this shouldn't be a surprise; European companies, many of them several hundred years old, have a rich history of selling their products and services in emerging markets. Heineken made its first steps into South America in 1883[3], while the first soaps from the precursor to Unilever landed in India in 1895[4].

The above goes some way to explain the seemingly counterintuitive spectacle of the FTSE 100, CAC 40, and DAX all hitting record highs during 2024 when the underlying economies have at best flatlined, or in the case of Germany, experienced a recession. A European large-cap company's listing location, or 'country of risk', rarely aligns with its revenue profile. To that end, the argument that Europe is less a proxy for domestic political machinations or economic performance, but rather one exposed to the future path of the global economy, and geopolitical events, seems more apposite. To some extent this – superficially at least – would suggest that European investors shouldn't worry that much about the continent's political movements.

However, it would be remiss of any analyst or commentator not to scrutinise whether this time may well be different, and there are a number of elements that may well give investors pause for thought. The first is how the last few years have undoubtedly seen a shift in public interventions in the European economy – and indeed that of many advanced economies – following the various crises of 2008, sovereign debt, and the pandemic. This has marked a re-entry of the state into the business and economic landscape far beyond simple regulation and, more pertinently, not along a traditional Keynesian line of configuring investment through links between public and private actors within a specific framework.

As advanced economy debt levels continue to rise and the use of off-balance sheet tools continue to proliferate, state interventionism (whether politically or economically driven or perhaps a combination of the two) as a risk to business (both positive and negative) is likely to grow.

The second component is a direct input into the wave of state interventionism mentioned above: the shifting concerns and desires of voters within Europe and how their voting decisions will shape elected officials. Again, there are signs that the current electoral cycle is different.

For most recent European elections, dividing lines have lain across issues of left versus right, and often correspondingly pro versus anti EU. This is no longer the case. A recent report[5] from the European Council on Foreign Relations has shed light on how these neat dividing lines no longer exist, and that voters are increasingly falling into five groups that are concerned with events that have warped the European psyche in the last few years:

- The climate emergency
- The migration crisis
- Economic turmoil
- The war in Ukraine
- The Covid-19 pandemic

The extent that these concerns are felt varies, subject to the individual country: Germany is particularly concerned with migration given the events of 2015, Eastern European countries are more concerned with Russia's invasion of Ukraine given their own nascent post-soviet liberalism, and France and Denmark are more concerned with the climate emergency.

All five of these apprehensions have 'mobilising potentials', but it is how different political parties react to the amalgamation of the concerns and are effective at producing proposed solutions to the issues that will shape how elections will turn out. As the electorate has become more issue-orientated rather than ideologically aligned with segments of the political spectrum, this may go some way to explaining the rather scattergun success of far-right parties across the continent, as many have campaigned on individual issues such as the economy and migration rather than a broader ideological creed. This is perhaps best shown in the Dutch parliamentary elections in November last year.

[1] Morgan Stanley, Global Exposure Guide, 2023.
[2] Ibid.
[3] Heineken, 2024.
[4] The Economic Times, 2011.
[5] *A Crisis of One's Own: the Politics of Trauma in Europe's Election Year*, European Council on Foreign Relations, January 2024.

While the increased polarisation of the electoral psyche may not in and of itself appear to affect investors, there is a final component which, when combined with these shifts in electoral concerns, may well define political risk for investors for the next few decades. Geopolitical volatility on a global level is increasing[6].

> **"As political volatility increases, investors may look back at the disinflationary free-trade wielding past decades as their halcyon days."**

The age of US primacy is over; whether or not one agrees with the views that Samuel P. Huntington espoused in his 'Clash of Civilisations' argument, the rise of a China-led rebuttal to the unidirectional influence of the west, as well as the end of the peace dividend as war rears its head once more in Europe and elsewhere, is reshaping geopolitics in a way not seen since the end of the Cold War. A result of this is a fractious choice for policymakers between efficiency and self-sufficiency. As political volatility increases, investors may look back at the disinflationary free-trade wielding past decades as their halcyon days.

So, to answer our own question as to whether politics should matter for European investors? The answer, as always, is nuanced. Yes, investors should be cognisant of political change and the potential impacts. But closer examination shows that unlike other regions, European businesses by their very nature have shown a resistance to domestic political upheaval through the geographical diversity of their business models.

Whether or not this can continue, as geopolitical volatility increases and the possibility of deglobalisation grows, will remain to be seen. However, in the meantime, investors should perhaps recognise that high quality European companies with revenue exposure to large portions of the globe, may prove a wise place to be in a world of flux. The medieval bankers of centuries past would no doubt have agreed with them.

[6] EIU, Investors and the new era for geopolitics, 2024.

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