GENERALI INVESTMENTS

# Focal Point

## French elections: What is at stake?

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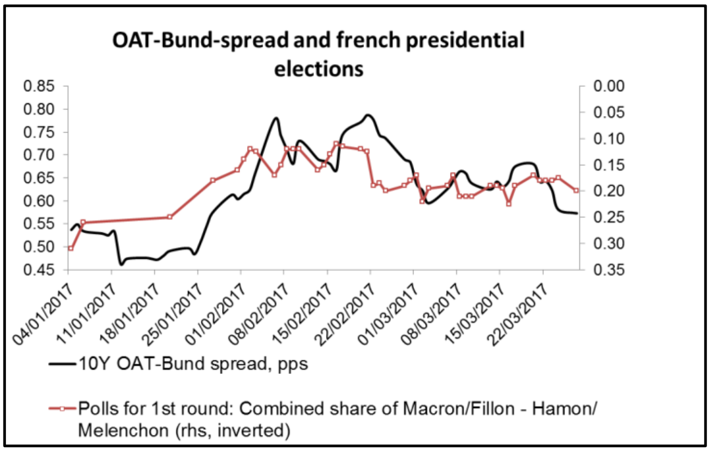
- The upcoming French presidential elections (April 23 and May 7) are in the focus of markets, given the risk that the anti-European candidate Le Pen might lead the country out of the EU.
- However, according to polls a pro-European candidate is ultimately most likely to prevail in the run-off. In this case, financial markets will react positively, with the risk of a EU referendum off the table for now.
- In the less likely event of Le Pen becoming president, markets will get a strong hit. The focus will soon shift towards the parliamentary elections on June 11/18 as the outcome will be crucial for the odds to conduct a EU referendum.
- The hurdles to hold such a referendum are quite high, though. Moreover, polls suggest that the majority of French people (> 60%) would back EU membership, leaving “Frexit” rather a tail risk. If materializing, however, we expect strong and lasting financial market turmoil. Moreover, significant spillovers to global real activity were inevitable.

The election cycle in major European economies has just begun. On March 15, Dutch voters elected a new parliament. The result defied concerns that the extremist and anti-European party would gain the majority of votes. While this has generally been taken with relief, the concern has now shifted to upcoming elections in France.

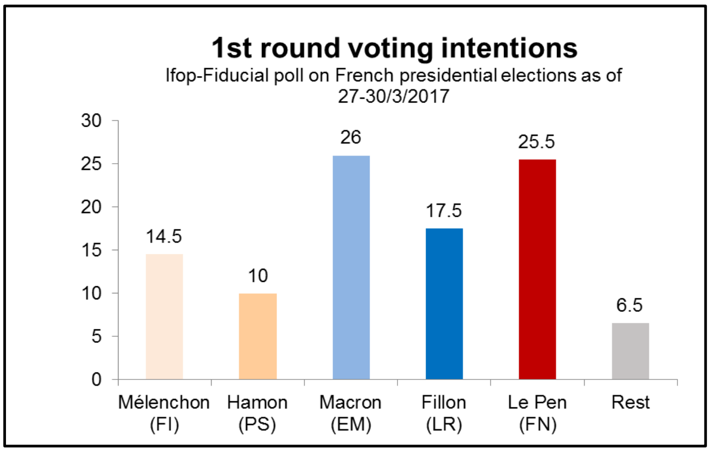
The French presidential elections will take place on April 23 (first round) and May 7 (run-off), followed by parliamentary elections on June 11 (first round) and June 18 (run-off). In France, extreme and Eurosceptic parties are also a cause of concern. On the right end of the spectrum, the Front National (FN) and its presidential candidate Marine Le Pen want to hold a referendum on EU or EMU membership, monetize public debt and pursue a strict anti-immigration policy. On the left end of the spectrum, the communist candidate Mélenchon wants to withdraw from European treaties and the socialist candidate Hamon intends to substantially reshape the EU. What is common to these rather extreme candidates is that, if elected, they would be a danger for the existence of EMU and the EU. Moreover, the programs of these candidates are not very reform-minded and hence do not bode well for the medium term growth outlook of France. In contrast, the programs of the conservative candidate (Fillon) and the moderate candidate (Macron) do not put the existence of EU or EMU into question but strive for growth-friendly economic reforms.

Against this backdrop it does not come as a surprise that markets continuously assess the risk of an extremist becoming France’s next president. While over the past months Le Pen has had a stable share of about one quarter of votes according to polls, an increase in support for the extreme left candidates earlier this year sparked concerns that one of them could make it together with Le Pen in the second round of the elections. In such a case, France would inevitably get a president from the extreme spectrum. The 10-year OAT-Bund spread moved in line with the differential in voting shares between the pro-EU camp (Macron/Fillon) and the Left (Hamon/Mélenchon). It temporarily even soared above 80 bps, the highest level since 2012.




### Victory of a center candidate is base case

That said, as of late, the OAT-Bund spread has moderated again as support for the left candidates eased somewhat according to polls. Moreover, some polls indicate that Macron would in the first round even get more votes than Le Pen. Hence, it seems now very likely that a pro-European candidate enters the second round. Furthermore, in the second round, polls consistently show that both Macron and Fillon would win against Le Pen. In case of the most likely race between Macron and Le Pen, the lead of the former is around 20 pps. While the US election outcome and the Brexit referendum cast doubts about the ability of polls to forecast outcomes, we regard the polls as more reliable this time. The turnout ratio in French elections is traditionally high (average of around 78%) and could even be higher this time given the paramount importance of this election. A high turnout ratio traditionally works in favor of non-extreme candidates. Last, the so called "Republican Front" that also prevailed in the 2015 regional elections will likely ensure that the most promising non-extremist candidate is supported by all non-extremists and not only by the supporters of its party.

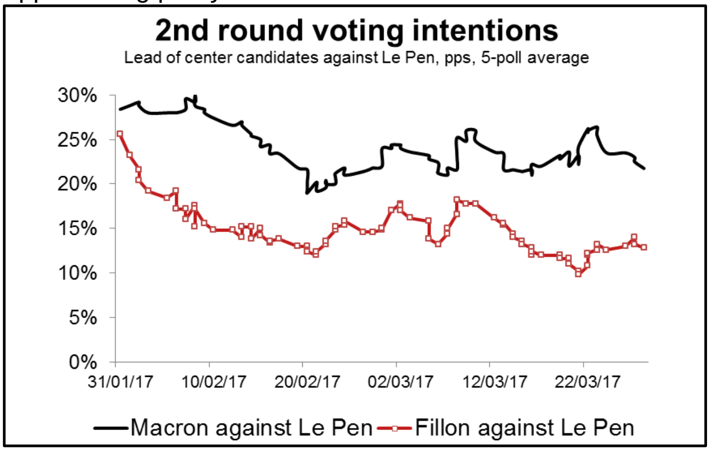



Financial markets are expected to respond with relief to the election of a centrist candidate. Although the 10-year OAT/Bund spread – the relation most in focus of financial markets recently – has already come down from 80 bps to 65 bps, we see some further immediate spread tightening of 10 bps. In case the reform-oriented parties prevail in the parliamentary elections as well, the likelihood of far-reaching reforms increases. Then there will be scope for additonal spread tightening further down the road. Moreover, safe haven flows are likely to be unwound, triggering a modest increase in Bund yields and a (limited) spread tightening of Southern European bonds. What is more, equities will benefit and the euro is forecast to appreciate slightly versus the US-dollar as the political viability of the EU/EMU will be strengthened by a pro-European election outcome.

## Le Pen becoming president a less likely scenario

Having said that, a victory of Le Pen cannot be completely excluded in the second round of the presidential elections. While it is only a risk scenario, Le Pen as the new President and its potential impact on financial markets has to be seriously considered. Given the highly uncertain political, economic and financial environment, it is hardly possible to forecast precisely any financial variable. Hence, any point forecasts can only serve as rough guidelines and should be taken with a pinch of salt.

Subject to these preliminary comments, the election of Le Pen has the potential to trigger severe market disruptions immediately after the second round on May 7. At that point, the probability of a Frexit increases, questioning the viability of the EU/EMU. French OAT yields but also other non-core euro area yields are expected to rise following the presidential elections. The 10-year OAT yield may rise by around 100 bps from current levels. The corresponding safe haven flows will drive down Bund yields strongly and a drop of 10-year Bund yields into negative territory is likely. However, the turmoil will not be limited to government bond markets. Corporate bond spreads will widen (particularly the ones which are not located in euro area core countries), equities will suffer noticeably (with European stocks dropping double-digit) and the US dollar will appreciate versus the euro, with the greenback approaching parity.




## High hurdles for a referendum in France

With a new President Le Pen the key question is whether and when she will be able to hold a referendum. Here, it is crucial whether a referendum on EU (Art. 89 of the French Constitution) or EMU (Art. 11) membership shall be conducted. In the case of EMU membership she might even use a fast track procedure (her Prime Minister would propose a referendum according to Art. 11) and to initiate it between the presidential and the general election. As the parliament does not meet in this period, he could not be dismissed by a no-confidence vote. The approval of the Constitutional Court would then remain the only hurdle. More generally, taking such a far-reaching decision like an exit from EMU by means of a referendum is unprecedented and it remains a distinct possibility that the Constitutional Court does not allow it. However, going this way probably reduces the FN's appeal to more moderate supporters in the general elections which would make governing extremely difficult for her. All other ways to conduct a referendum require strong support from the parliament. In case of a referendum on EU membership even both chambers of parliament need to vote in favor of an identical proposition.

With the FN currently having only two deputies in the National Assembly, the June elections are crucial. In case Le Pen becomes president, she obviously did much better than suggested by the polls. Simulations suggest that a share of at least 56% of the votes in the second round of the presidential elections would be needed to secure a sufficient number of FN parliamentarians in order to trigger a referendum. In addition, the Republican Front will come to the fore again thereby reducing the chances of a landslide FN victory in the parliamentary elections.

Last, a referendum would also have to be won. According to a poll from the Bertelsmann Foundation (Aug. 2016) about 60% of the French people would still vote in favor of staying in the EU. Likewise, 72% of French polled by Elabe in early March were opposed to ditching the euro and returning to a national currency. All in all, while one cannot rule out a referendum in case of a President Le Pen, the hurdles for doing so and then also succeeding in the referendum are still high.

In case the referendum will be held but the French people reject it and opt for staying in the EU/EMU, financial markets would react positively. However, as Le Pen would remain president and would continue to pursue anti-European politics, the corresponding rebound of financial markets is expected to be limited.

## If worse comes to worst, …

… the French people follow Le Pen and vote for a Frexit. However, the probability of such a scenario is rather low. Polled investors (Sentix) assign a probability of 8% to a Frexit – a number which we still regard as somewhat too high. As France is the second biggest country in the EU and together with Germany traditionally a driver of European integration, a Frexit would call into question the complete European project. Even focusing only on the immediate (say up to three months) economic and financial consequences, the impact can hardly be overestimated.

The redenomination risk would result in a huge capital flight which would not be confined to France but would spill over to other countries. The uncertainty over the value of a new French currency is likely to create a huge risk aversion which would affect all industrialized countries. While risky assets would suffer strongly and even government bonds outside a narrowly confined euro area core may fall strongly, safe haven flows would particularly support German Bunds.

Bund yields may decrease strongly, with 10-year Bund yields falling to a new historical low (between -0.5% and -1.0%). In contrast, peripheral bonds may come under pressure and the historical peaks in government bond spreads marked during the debt crisis could be reached again. In case of France, the expected depreciation of the new currency (by assumed 15%) may be priced immediately. Additionally, the swing in the economic policy may trigger a higher risk premium. Hence, the OAT-Bund spread may clearly exceed the historical highs. Taking the second half of the 80s of the last century as a reference point may result in 10-year OAT yields of around 4.0%. European equities are likely to fall almost back to the levels of 2011 and the euro may probably get close to the historical low (0.83 EURUSD) marked in 2001 again.

These indications do not consider yet a break-up of the EMU although a collapse of the euro into several currency blocs is a realistic scenario further down the road. What is more, an expected implosion of the euro and a Lehman-like hit to confidence may trigger turbulences on financial markets comparable to the years 2008/2009. Ultimately, it would induce a global recession in the quarters to come.

## Conclusion

The forthcoming French elections have kept financial markets on their toes. Given the high share of undecided voters, the election of a center candidate is not a done deal yet.

However, the base case remains the election of Emanuel Macron as the new president given current polls as well as the institutional setting in France.

Financial markets would receive this with relief and are likely to respond friendly. The sustainability of the resulting price increase of financial assets would also depend on Macron's ability to implement structural reforms. This in turn is contingent on the outcome of the general elections in June.

# Imprint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