Focal Point

French elections: a harbinger of new stress?

Authors: Florian Späte and Martin Wolburg

April, 14,2022

Our Focal Point series explores topical issues on macro, markets and investment

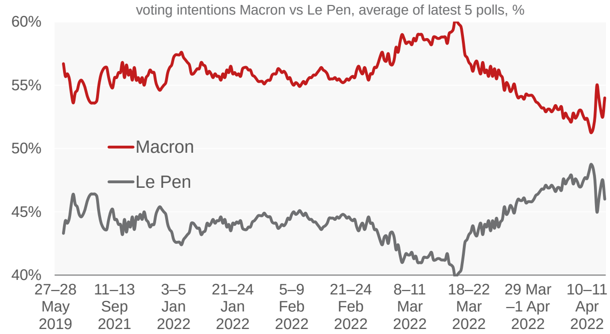
- In the first round of the French Presidential election liberal incumbent Macron (27.8%) received the highest share of votes. As expected, he faces far-right candidate Le Pen in the 2nd round to be held on April 24.
- According to polls Macron will likely remain President, but by a much tighter lead than in 2017. The situation is fluid and there is no unitary support from other succumbed candidates.
- If Le Pen were to become President the reform process would largely stall (e.g. pension age), European projects be hampered and a clash with the EC likely mount. Even if Macron wins, there remains the risk that he loses parliamentary majority in the June 12/19 general elections – so that uncertainty will not be fully removed.
- Euro area financial markets will remain volatile into the run-off election. A second term for Macron would calm markets. On the contrary, the election of Le Pen would lead to a knee-jerk reaction and a lingering high risk premium that would manifest in full should the 'extreme' parties also do well in the forthcoming parliamentary elections.

In the first round of the French Presidential elections on April 10, an accident or a potentially disruptive outcome for markets was avoided. Incumbent President Macron received 27.8% of the votes, clearly beating second-placed far-right candidate Le Pen (23.1%). Polls predict a Macron victory for the April 24 run-off, but his lead over Le Pen has diminished since the mid-March peak. In some polls, a Le Pen victory is still within the margin of statistical error.

Our base case remains a Macron victory. In this case, we would expect no significant lasting effect on financial markets. In contrast, a Le Pen victory would have tremendous longer-term implications. French public finances may deteriorate markedly. On the European level, integration would not only be hampered, but a clash with EU institutions seems likely. It is the latter aspects that would shock markets and may adversely affect Southern EU government bonds. Moreover, French equities but more broadly euro area (EA) ones would come under pressure and the Euro would lose ground against the greenback.

Polls on Macron vs Le Pen

voting intentions Macron vs Le Pen, average of latest 5 polls, %



Source: Wikipedia

Uncertainty ahead of 2nd round to stay high

In the first round, far left and right-wing extremists won a share of 58.0% of the votes altogether amid strong concerns about purchasing power and social protection according to polls. Here, arguably simplistic solutions offered by extreme candidates seem to also appeal to moderate voters.

Latest polls vary considerably. All polls see Macron beating Le Pen. But his lead ranges from 10pp to just 2pp. Although being a tail risk, a Le Pen victory therefore may be in the margin of error. Moreover, Macron's appeal for a 'Republican Front' against the extreme right is shaky. The Socialists, Communists, Greens and the traditional right candidates - that received a joint of 13.5% of the votes – already recommended to support Macron in the second round. But two candidates (Arthaud, 0.6%, and Lassalle, 3.1%) have refused to give any recommendation. And in terms of potential votes, more important candidate Mélenchon, as in 2017, only asked his voters not to vote for Le Pen (i.e. Macron or abstention). In contrast, the far-right candidates Zemmour and Dupont-Aignan (jointly 9.2%) have called for their voters to support Le Pen. The upshot is that uncertainty surrounding the 2nd round of the Presidential elections is significant.

Even in our base case of a Macron victory on April 24, uncertainty about French politics will not subside quickly. The parliamentary election will take place on June 12/19. His coalition (LREM and MoDem) currently holds a clear majority (of 350/577seats) in the National Assembly. Macron's reform momentum faced resistance when in came to the crucial issue of pensions and the labour market and the pandemic brought it to a halt. To resume the reform process, he needs a strong backing in parliament. This makes the general election result at least equally important as the Presidential one. Traditionally, extremist parties perform less strongly there because of lacking local roots. But protest votes may break the post-presidential wave usually seen during the general elections. Key concerns of the voters - not least deteriorating purchasing power –are unlikely to vanish soon. Macron's party (LREM) might not receive the strong support won in 2017 (308 seats). A wider coalition government may yet again force him to water down his reform ambitions. Against this backdrop it will be key to watch whether the extreme left (e.g. France Insoumine, Communist Party and Greens) and/or the extreme right (Le Pen, Zemmour, Dupont-Aignan) each manage to join forces for the June election. The higher the share of extremes in the National Assembly the more difficult it will in the end be for Macron to tackle reforms.

On the other hand, in the risk case of a victory Le Pen would probably need to substantially compromise on her programme. Generally, the President would have even less room for manoeuvre in case of a so-called cohabitation meaning no majority in parliament. Given the complexity of the political situation, in March the French policy uncertainty index surged to the highest level since April 2017, when the last Presidential election took place.

Le Pen victory bad for public finances and the EU

Le Pen victory would largely stop the resumption of the reform process. Most importantly, she would not address the crucial pension issue - leaving the retirement age basically unchanged at 62 – and the unemployment insurance scheme. On the other hand, her programme implies much more spending than Macron's. Purchasing power support measures sum up to about € 50 bn per year vs about € 25 bn for Macron. As a result, if not blocked by parliament, until the 2027 election, the French debt-to-GDP ratio would probably rise to around 150% by then, up from 114.6% in 2021, while in case of a Macron victory it may recede somewhat.

Key features of electoral programmes

	Macron	Le Pen
EU	Invest.for defence and green trans. not subj. to SGP	National law shall prevail over EU rules
Reforms	Lift retirement age to 65, consolidate pension schemes, reform unemp. Insurance	No change of retirement age (of 62), reduction in some cases to 60
Fiscal policy	Annual military spending +50 bn by 27, inv. In future sectors	Annual military spending +55 bn by 27, no cut in publ. employment
Taxes	Cut prod. taxes and SSC	Fiscal support for families, reduction of energy taxes
Energy	Carbon neutrality by 2050, expansion of renewables, in favour of new nuclear power plants	Against expansion of wind turbines, supports new nuclear power plants

A Le Pen victory would also have significantly negative repercussions for the EU. While she has given up the Frexit-goal, her rhetoric suggests that France would no longer foster EU integration. The pledge that national law shall prevail over EU law would make a clash with EU institutions and rulings very likely, especially on the Stability and Growth Pact. Her nationalistic perspective would unsettle European projects in the areas of defence, energy and the green transition. In addition, the achievement of the EU's ambitious goal to become climate neutral by 2050 would be at risk – Le

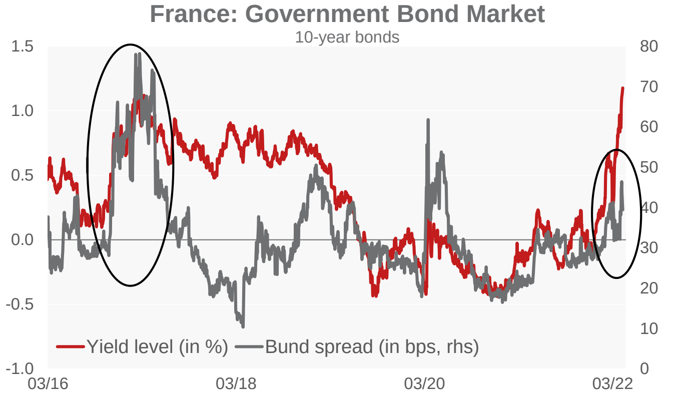
Pen has ambitious plans for nuclear energy and hydrogen, but opposed to subsiding renewable energy. Also, a more pro-Russian stance could derail the unified EU approach to the Russian invasion in Ukraine. If worse comes to worse – i.e. her victory being followed by a surge of the extreme parties at the general election –,EU and EMU break-up concerns may rise again.

Election of Le Pen a burden for financial markets

Financial markets reacted with relief to Macron's solid performance in the first round of the Presidential election. Particularly French OATs retraced half of the sizeable recent spread widening versus Bunds. Equities and corporate bonds were also able to recover somewhat, whereas the Euro did not profit sustainably.

We expect volatility to remain high into the second round on April 24.

The market reaction to the run-off election is likely to be uneven. A victory of Macron would eliminate a tail risk but price action would likely be muted, and more so as a parliamentary majority is by no means guaranteed in the June elections. However, in a knee-jerk reaction French corporate bonds will still likely make up some ground and the risk premium on French government bonds will also fall moderately if Macron prevails (a noticeable equity reaction is more unlikely as there has been not underperformance of French equities recently).



Source:Datastream, GIAM calculations

On the contrary, a major reaction on financial markets is to be expected if Le Pen gets her way. The market movements in the run-up to the first rounds were only a glimpse of what is to be expected in this case. Above all, French OATs would come under pressure. The comparison with the 2017 election (see chart above) indicates that the recent widening was rather moderate. The spread widening in 2017 occurred in the run up to the first round and priced just the *probability* of a Le Pen victory. Accordingly, it can be argued that the increase in the risk premium in 2017 should rather be seen as a lower limit of a possible spread widening in case of an *actual win* by Le Pen. While Le Pen softened her stance on the EU financial markets would still price her euro-sceptical attitude with a higher risk premium (this will hurt particularly EA non-core government bonds). This applies even more as the potential implementation of the fiscal plans would be accompanied by a worsening of public finances (see above). Depending on the majority in parliament in June, the spread widening may be sustainable and significant. However, as Le Pen will not be able to implement her complete agenda, we do not expect that French OAT spreads will skyrocket. E.g., we do not forecast that French government spreads widen to the Spanish spread level (in a worst-case scenario we expect 10-year OAT/Bund spread to widen towards 80 bps). This applies even more as the recent strong correlation indicates that other non-core bonds would also come under pressure, e.g. BTPs.

The blow to the European integration process would also weigh on EA credits versus US credits. French issuers account for more than 20% of the overall index. As financials are more exposed to systemic risks, we would expect an underperformance of financials versus non-financials. Moreover, the weak performance of OATs in case of a Le Pen victory would also weigh on French financials (and on EA non-core financials in general). Additionally, French renewable energy producers would suffer an increase in risk premiums.

The fall in the CAC40 would be sizeable if Le Pen moved to the Palais de l'Élysée and in general the EA risk premium would linger at high levels for longer. As with corporate bonds, shares from the financial sector would come under pressure (immediately and more so later in case Le Pen performs strongly in the general elections in June). This adds to the headwinds emanating from the Ukraine war causing a strong economic and sentiment deterioration and reinforces our cautious stance on cyclical sectors as well. Given the volatile environment and considering looming risks, we prefer US and UK equities versus EA ones for the time being.

The EUR/USD has become much more susceptible to OAT spreads over recent weeks. A Macron victory would bring mild relief for the EUR, which is burdened by the economic fallout from the Russian war in Ukraine. A Le Pen victory would likely raise the risk premium on the single currency markedly and more lastingly, driving the EUR/USD closer to 1.05.

IMPRINT

Issued by: **Generali Insurance Asset Management S.p.A.**
Società di gestione del risparmio, Research Department

Head of Research:

Head of Macro & Market Research: **Dr. Thomas Hempell, CFA**

Team:

Elisabeth Assmuth | Research Operations

Elisa Belgacem | Senior Credit Strategist

Radomír Jáč | GI CEE Chief Economist

Jakub Krátký | GI CEE Financial Analyst

Michele Morganti | Head of Insurance & AM Research, Senior Equity Strategist

Vladimir Oleinikov, CFA | Senior Quantitative Analyst

Dr. Martin Pohl | GI CEE Economist

Dr. Thorsten Runde| Senior Quantitative Analyst

Dr. Christoph Siepmann | Senior Economist

Dr. Florian Späte, CIIA | Senior Bond Strategist

Guillaume Tresca | Senior Emerging Market Strategist

Dr. Martin Wolburg, CIIA | Senior Economist

Paolo Zanghieri, PhD | Senior Economist

"Edited by the Macro & Market Research Team. The team of 14 analysts based in Paris, Cologne, Trieste, Milan and Prague runs qualitative and quantitative analysis on macroeconomic and financial issues. The team translates macro and quant views into investment ideas that feed into the investment process."