

ECONOMICS: EUROPEAN PERSPECTIVES

# FRENCH PRESIDENTIAL ELECTION: THE ONE TO WATCH

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Victory for Marine Le Pen at the French presidential election is a low probability, very high impact event that could pose an existential threat to the euro and European Union (EU). In such a scenario, we would expect French bonds to come under heavy selling pressure. We would also expect peripheral bond markets to sell off, the euro to weaken and Bund yields to fall, perhaps sharply.

The approaching French presidential election is by far the biggest risk event on this year's European political calendar. Uncertainty has increased in recent weeks, but the probability that National Front leader Marine Le Pen will win has not risen materially, in our view, and should therefore still be regarded as a relatively low probability event. That said, an extreme right-wing president of France would rock Europe to its core, so it's a scenario that needs to be taken very seriously.

### The Run-up to May 7

The presidential election consists of two rounds of voting. The first takes place on April 23, with the two best-placed candidates advancing to a head-to-head contest on May 7. In recent weeks, opinion polls have consistently shown that Le Pen is likely to win the first round of voting. Unless something changes, we should therefore regard the probability of her progressing to the second round as being very high (i.e. around 90%).

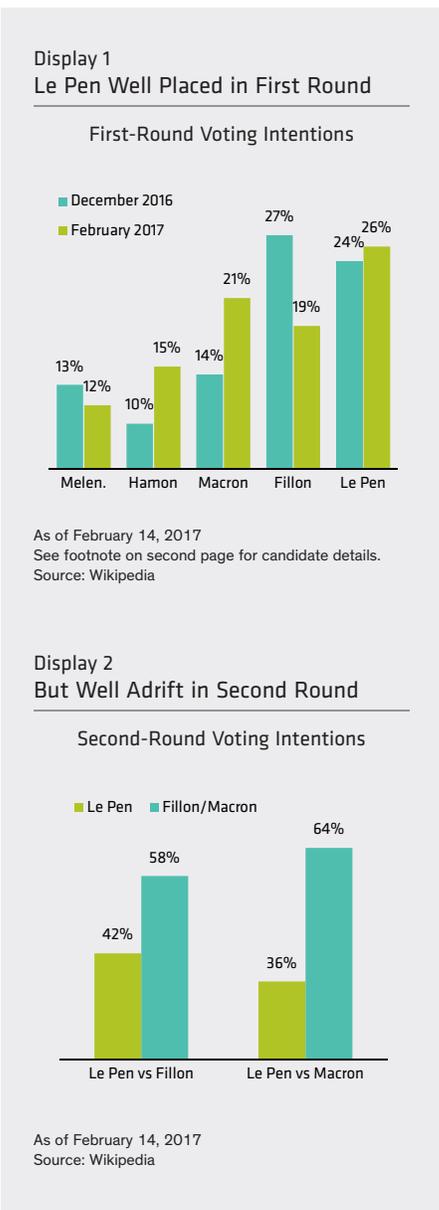
It's more difficult to know who will join her there. Until recently, the favorite was center-right Republican party candidate Francois Fillon. However, Fillon's prospects have been hurt by claims that he made

illicit payments to his wife—to the extent that he may be forced to withdraw and make way for an alternative Republican candidate. So far, the main beneficiary of Fillon's travails has been centrist candidate Emmanuel Macron, who now occupies second place in the opinion polls.

Fillon's rapid fall from grace should, however, serve as a reminder not to take too much for granted at this stage. With just six points separating Macron and Benoit Hamon, the Socialist party candidate (*Display 1*), a lot could change between now and polling day.

In our view, a number of key questions will help determine the election outcome: Will Macron, who has not previously stood for public office, stand up to the rigors of an election campaign? Will another centrist candidate stand? Will the Republican party replace Fillon with a different candidate? And will Hamon improve his prospects by entering an electoral pact with left-wing Jean-Luc Melenchon?

While all the indications are that Marine Le Pen will top the first-round vote, her prospects of winning the second round look more remote. Recent opinion polls



suggest that Fillon would beat Le Pen by 15-20 points and that Macron would beat her by almost 30 points (*Display 2, previous page*). At present, there are no polling data for a Le Pen/Hamon runoff, though that would probably be a closer contest.

Before considering scenarios and probabilities, it's worth asking how much faith we should place in French opinion polls? Recent experience from other countries suggests the need for caution. However, the National Front is not an unknown quantity (as far back as 1988, it captured 14% of the first-round vote), its polling has been remarkably stable in recent weeks and there is no evidence that opinion polls systemically understate its electoral support: in the last five presidential/National Assembly elections, opinion polls have understated National Front support twice and overstated it three times (with a range of +/- 3%). In addition, it's worth noting that opinion polls just before the second round of the last two presidential elections were very accurate.

### Main Scenarios

It's certainly possible that opinion polls are sending us a false steer about the chances of Marine Le Pen winning the second-round vote. But until we see some evidence of this, or signs of a shift in public opinion, we're inclined to think that the odds are stacked against her. So while we attach a probability of 90% to Le Pen reaching the second round, we put the probability of her actually winning the election at 15-20%. With the campaign barely under way, we think Macron and Fillon (or an alternative centre-right candidate) are equally likely to win and assign probabilities of 35-40% to both. Hamon, by contrast, is the clear outsider, with a probability of 5-10% (though this would rise if Melanchon were to withdraw).

For financial markets, there probably isn't a great deal to choose between a Macron or Fillon victory: both have reformist agendas and a victory for either would lead to a modest relief rally. The same would not be true for Hamon, who is from the left-wing

of the Socialist party and whose program includes a commitment to roll back past reforms and plans to introduce a shorter working week and guaranteed minimum income. The extent to which he could actually implement these policies would depend upon the composition of the next parliament, which won't be decided until legislative elections in June (and there have been no recent opinion polls for this). But even in a best-case scenario, the resultant uncertainty and policy gridlock would not set a favorable backdrop for French asset prices.

A Le Pen victory would be of a different order of magnitude altogether. While some aspects of the National Front's populist agenda are being echoed in other countries—i.e. increased protectionism, stricter controls on immigration—Le Pen also wants to regain monetary, legislative, territorial and fiscal sovereignty from the EU (i.e. quit the euro, withdraw from the Schengen Agreement, restrict the free movement of people and abandon the Stability Pact). And if this couldn't be achieved via negotiation—and it's a pretty safe bet that it couldn't—Le Pen has promised to call a referendum on EU membership.

Some observers have, rightly, pointed out that it would be very difficult for Le Pen to achieve these aims without a parliamentary majority (which she has little to no hope of achieving). But that's hardly the point. We're not talking about Greece or the UK here, but a eurosceptic president of France—one half of the Franco-German axis that has driven postwar European integration. At best, a Le Pen victory would plunge the EU and its decision-making processes into chaos; at worst, it could mark the beginning of the end.

### Market Implications

It's for this reason that we would expect the reaction to a Le Pen victory to be severe. Over the years, French bonds have derived considerable support from the implicit assumption that France is so important for European economic and political integration that Germany will, in

Display 3  
Bond Market Vulnerable

French less German 10-Year Yield Spread



As of February 14, 2017  
Source: Bloomberg

extremis, always ride to its rescue (the same assumption helped support the French franc when other currencies floundered during the ERM crisis in the early 1990s). As a result, French bonds have acted as a slightly higher-yielding proxy for Bunds, and the yield differential between the two countries has been lower than a strict interpretation of French fundamentals would warrant. In our view, a Le Pen victory would shatter this illusion and push the yield spread sharply higher (*Display 3*).

Nor would the rest of the euro area escape unscathed. However difficult it would be for Le Pen to achieve her aims, there is no doubt that a National Front victory on May 7 would lead investors to price in a higher probability of euro-area breakup. And this would push peripheral yields higher, the euro lower and 10-year Bund yields back to, or perhaps below, zero.

It's a fair bet that the European Central Bank wouldn't stand idly by, but it's hard to see Mario Draghi's "whatever it takes to preserve the euro" pledge being quite as effective with the president of France actively pushing in the opposite direction. As we said at the outset, a Le Pen victory is a low probability event, but one that would have very profound implications. ■

Candidates from left to right: Jean-Luc Melenchon (Left), Benoit Hamon (Center-Left), Emmanuel Macron (Centrist), Francois Fillon (Center-Right), Marine Le Pen (Extreme Right). Note that the December reading for Benoit Hamon is for the leading Socialist candidate at the time, Manuel Valls, as Hamon was not then regarded as a viable candidate by most polling organizations.

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