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Policy Brief

French elections: scenarios and investment implications

13 April 2017

France's election cycle in April-June is taking place in a climate both of high uncertainty in French politics and of a wider populist upsurge that has already produced major shocks in the UK and US. We see only a small chance of another upset in France, but a second-round presidential election featuring the far-right Marine Le Pen is likely to create considerable nervousness for investors. We do not think that a Le Pen win would result in 'Frexit', but it would be an extraordinary shock—for France, for the EU and for markets.

There is a clear dichotomy for markets

France's presidential election on 23 April and 7 May appears essentially a binary question for markets—barring a surprise passage to the second round alongside Le Pen by the far-left candidate, Jean-Luc Mélenchon. On paper, none of the candidates represents the 'status quo' (see Table 1), but for markets there is a clear dichotomy between the business-friendly programmes of the independent centrist Emmanuel Macron or the conservative François Fillon, on the one hand, and the radical proposals of Le Pen and Mélenchon on the other.

However, although attention has focused on the presidential race, the parliamentary election in June is also key to the outlook. Whoever wins, a fragmented parliament will make it challenging to implement their programme. If Macron triumphs, his lack of a parliamentary majority would limit the upside; if Le Pen or Mélenchon win, it might mitigate the downside risks.

We expect a europhile politician to win

Our main scenario, a win for a Europhile politician, could result in a small relief rally on markets. We are well positioned for this outcome, with our overweight in European equities. In the event of a Le Pen win, we would be well served by the protection that we added in March—derivative protection on euro high yield corporate bonds and a call option on gold for discretionary portfolios—as well as our long dollar position and underweight on European bonds.

Table 1: On paper, no status quo candidate

	Jean-Luc Mélenchon	Benoît Hamon	Emmanuel Macron	François Fillon	Marine Le Pen
Voting intentions (1st round; last 3 polls)	18%	9%	23%	19%	24%
Stance & party	Far-left (France Insoumise)	Left (Parti Socialiste)	Centre-left, liberal (En Marche!)	Centre-right, conservative (Les Républicains)	Far-right (Front National)
Europe	Mild eurosceptic (Treaty renegotiation)	Mild europhile (debt relief)	Europhile (€ budget)	Mild europhile (defence)	Strong eurosceptic (Frexit ref)
Immigration	Strongly in favour	Strongly in favour	In favour	Stricter controls (quotas)	Strongly against (caps, controls)
Labour market	Cancel reforms (32-hour week; retirement at 60)	Cancel reforms (support part-time work)	Broad reforms (more flexibility; revamp unemployment insurance)	Radical reforms (end 35-hour week; retirement at 65)	Cancel reforms (more protection; retirement at 60)
Taxes	Fiscal "revolution" (90% max tax rate; 25% corporate tax; scrap CICE)	Progressive rate, higher wealth tax Tax on robots	Broad reform (30% global social tax; CICE & corp tax) €20bn tax cuts	€50bn tax cuts 2% VAT hike	Income (low tranches) & corporate (SME) tax cuts 3% border tax
Public spending	€102bn investment plan €173bn spending (min wage; pensions; etc)	Basic Universal Income (€750; total cost over €300bn)	€60bn cuts €50bn investment plan	€100bn cuts €12bn spending in defence, security, justice	€60bn cuts Boost to low wages & pensions, defence
Civil servants	> +1000K boost to wages	+40K education	-120K	-500K	+50K military
European rules	No 3% deficit Change ECB statutes	No 3% deficit Change ECB statutes	Yes	Yes	No Change CB statutes

Source: Pictet WM - AA&MR, Programmes

Can Le Pen win?

Le Pen remains firmly in the lead on first-round voting intentions, with about 24% support, and is almost certain to reach the second round, if opinion polls are to be trusted. We believe the polls are relatively reliable in France, if only because the Le Pen's National Front (FN) is an established party, in existence for over two decades. Le Pen is most likely to be joined in the second round by Macron. However, this is not certain. The centre-right retains a solid base of support that could see Fillon perform better than polls suggest, and Mélenchon also cannot be ruled out if his recent surge is sustained. Polls suggest that any of these three candidates would comfortably beat Le Pen in the second round.

The participation rate in the second round will be key

Can Le Pen win? Probably only if voter participation collapses. For Le Pen to win in the second round, based on regular turnout of around 80%, she would need an additional 7 to 8 million votes on top of the roughly 11 million votes we think she will win in the first round (already a major advance, bearing in mind that the FN's highest-ever vote was 6.8m in the 2015 regional elections). However, with Macron, Fillon and Mélenchon unlikely, for different reasons, to command widespread enthusiasm among the electorate, participation could be lower—and this would help Le Pen, since FN supporters are relatively likely to vote. If participation drops to 60%, then Le Pen would need less than 3m extra votes.

Another risk is that the electorate is in general quite undecided: around 40% of voters have said that they could still change their minds. So uncertainty is high.

What will be the composition of the next parliament?

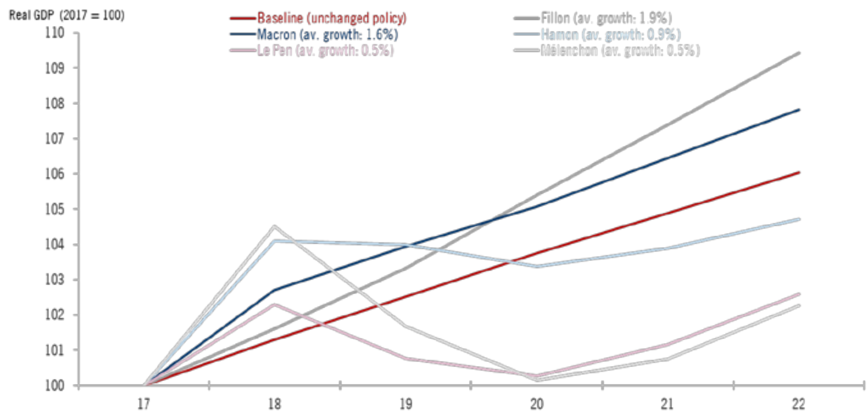
A fragmented parliament is in prospect

Parliamentary elections will be held on 11 and 18 June to replace all 577 members of the lower house (National Assembly). The increasing fragmentation of the electorate points to a large increase in the number of FN seats, from the 2 it holds currently to probably around 60. An FN majority of 290+ seats cannot be entirely ruled out, but a Le Pen victory in the presidential election would likely prompt a rallying under the French concept of a 'Front républicain', with local agreements to ensure that FN candidates are not elected. A fragmented parliament seems likely.

Baseline scenario: A europhile politician wins

Our baseline scenario is that a Europhile politician (most likely Macron or Fillon) wins the presidential election. We project a modest boost to growth (see Chart 1), but implementation of reforms would be challenging, especially for Macron, who has only a fledgling political party and would likely face a fragmented parliament. On the EU, Macron and Fillon both support a strengthening of European monetary union.

Chart 1: Estimated impact on growth of the main candidates' programmes



Risk scenario: Le Pen wins, but 'Frexit' is avoided

There are major obstacles to 'Frexit'

A Le Pen win would be an extraordinary shock, but we think 'Frexit' (French departure from the EU and the euro area) would be avoided, given institutional and political hurdles. EU exit requires a change in the constitution (Art. 89), and Le Pen would face several obstacles:

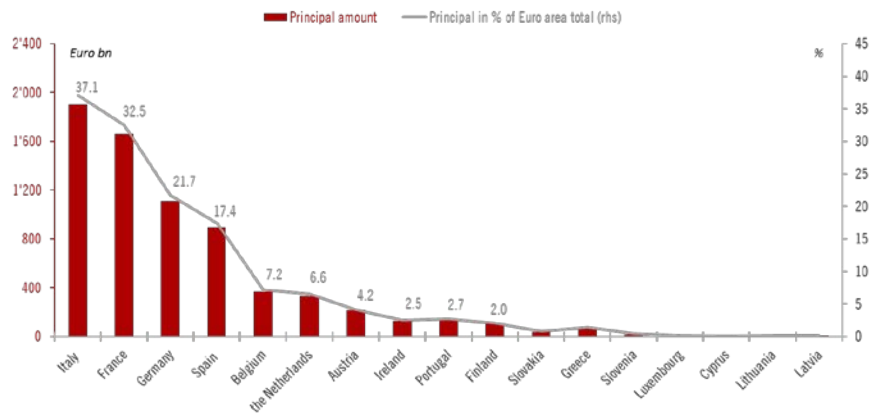
> **Obstacle 1:** probably no majority in parliament, and a de facto veto from the upper house (Senate).

> **Obstacle 2:** ratification would require either a vote in congress, or a referendum; support for the euro among the population has remained stable at close to 70%.

> **Obstacle 3:** the alternative option (Art. 11) has been used several times in the Fifth Republic, but is likely to be deemed unconstitutional if applied to an EU referendum.

> **Obstacle 4:** if a referendum were announced, financial panic would likely favour a 'remain' vote. A return to the franc would cause severe financial and economic disruption. Capital outflows would make controls likely. The banking sector would be under immense pressure. Public debt (around 95% of GDP) could in theory be redenominated for the large part (over 90%) issued under domestic law, but rating agencies would declare a default. Private debt (around 230% of GDP) redenomination would depend on the bilateral exchange rates and the share of contracts settled in domestic vs international law. France is much larger than Greece (its sovereign debt is one-third of the euro area total, compared with less than 2% for Greece; see Chart 2), and the ECB would find it difficult to contain contagion unless it received explicit political backing from the EU Council for more drastic measures.

Chart 2: France's sovereign debt: a major problem



Source: Pictet WM - AA&MR, Datastream

Even without 'Frexit', a Le Pen win would be a huge shock

Nevertheless, even if 'Frexit' were avoided, there would be large negative consequences from a Le Pen win for the French economy, probably including a recession and weaker long-term growth. On Europe, a difficult relationship between France under a Le Pen presidency on the one hand and Germany and many other EU members on the other would severely damage European integration.

Implications of a Le Pen win for markets

Markets would be severely shaken by a Le Pen win. On FX markets, the euro would likely fall by about 6% to 13% against the US dollar on a 1-month horizon, probably taking the EUR/USD below parity (barring a significant rise ahead of the elections).

French equities are fully integrated in European stock markets (one-third of the Euro Stoxx and one-sixth of the Stoxx 600) and a Le Pen victory would create fears not just for France but for Europe as a whole. Short-term volatility levels are inflated, but investors have not hedged aggressively. As a result, depending on the extent of the currency move, a pull-back of between 5% and 15% is possible.

The shock-waves would hit the euro area periphery

In fixed income, there would be contagion to the euro area periphery, and France would lose its semi-core status. Foreign investors could sell off on French government debt. Rising fears of a euro-area break-up would likely push 10-year sovereign bond spreads to about 200bp for France, 250bp for Spain and 300bp for Italy. Assuming that the 10-year Bund yield fell back to 0%, this would translate into 10-year yields of around 2% for French, 2.5% for Spanish and 3.0% for Italian government bonds.

The Wealth Management Investment Committee