MARKET FLASH

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French elections – what are the potential impacts for the markets in the various scenarios?

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Just over two weeks away from the first round of voting in the French presidential elections, we will endeavor in this report to analyze the various impacts that can be expected for the financial markets in the most credible scenarios that are emerging for investors. These can be split into two main categories, in our view:

• firstly, the "Macron/Fillon" scenario, involving victory for a reformist candidate, which reflects something of a continuity with previous situations;

• secondly, the "Marine Le Pen" scenario, which would be a clear watershed situation as compared to the past 50 years, and would point to France's exit from the euro (and the European Union, due to the treaties currently in force).

1. MACRON/FILLON SCENARIO

There is already a high degree of optimism on the markets on this outcome, but the Macron/Fillon scenario would probably be welcomed nonetheless, as it pushes back the likelihood of France's exit from the Eurozone and the EU, while also providing a broadly credible pro-reform program base:

• **France-Germany yield spread:** expected narrowing to +40-50bps on the 10-year vs. +66bps at this stage; we note that a Fillon victory would probably be more positive for the OAT-Bund spread (+40bps), as he is in favor of more ambitious fiscal consolidation;

• **German interest rates:** the elimination of the uncertainty premium could push the 10-year Bund back to levels of around 0.50%-0.60%, particularly as the ECB could then more swiftly normalize its monetary policy;

• **Interest rates for peripherals:** the spread on the 10-year Italian rate (more than 200bps) could temporarily move closer to the Spanish rate (135bps), but it should rise again as investors begin to focus on forthcoming Italian elections;

• **Inflation in France:** Fillon's program looks slightly inflationary in the short term, with his proposal for a 2-point rise in the VAT rate, but we are likely to see more of a temporary shock on prices than a real inflationary boost, and austerity measures should then dent prices;

• **Eurozone equities:** likely rally of 10-15%, with a premium for French and peripheral markets (Italy, Spain);

• **Euro/dollar:** the euro should resume its slow appreciation trend against the dollar in this scenario, with a target of 1.10-1.15. All will hinge on the ECB's moves after the elections, and also on the Fed, which may start pruning back its balance sheet.

2. LE PEN SCENARIO

Setting aside the widening of the OAT/Bund spread that we have already witnessed (doubled to 66bps since the start of November), the markets have not yet priced in this scenario and investors would therefore enjoy little protection if Le Pen were to become president.

This scenario would raise major uncertainties and concerns, in view of the possibility of a break-up of the Eurozone, which could trigger a real disaster scenario for the European banking system. Stress and volatility would soar, although the likelihood of a National Front victory at the presidential election still remains higher than a true Frexit scenario. In view of the vote counting system, and the varying degrees of popularity of the National Front from one region of France to another, the likelihood of the party gaining a majority of seats in the June legislative elections to then organize a referendum on the euro looks moderate (probably less than 20%) in light of the political, constitutional and legal obstacles. In a scenario where the National Front achieves a majority or a coalition in the National Assembly and could then organize a referendum "for or against the euro", the result would be uncertain as a large majority of French citizens are not in favoring of abandoning the euro at this stage.

However, this scenario would trigger massive investor wariness on French assets due to the perception of a significant increase in risk of a potential redenomination into French francs:

• **France-Germany yield spread:** Brexit gave us an idea of the extent of the risk premium paid in a watershed scenario and so we could expect a depreciation in the value of French debt of around 15-20%, to offset the expected loss in value on the future national currency. This discount is equivalent to a very fast rise in the 10-year rate of around 150-200bps, or more for shorter maturities: based on an OAT-Bund spread of around 50bps on a recurring basis, this suggests a widening in the spread to 200-250bps, which is higher than the figures seen today on Italy. This sharp widening in the OAT-Bund spread could further grow in the event of a landslide victory for the National Front in the legislative elections, if there is sufficient support for a referendum on leaving the Eurozone, and if there is uncertainty on the ECB's attitude. The central bank does not have much leeway to settle the bond markets, such as the moves by the Bank of England after Brexit: a renewed asset purchase program (QE) seems unlikely and OMT programs require a new budget adjustment agreement between the French government and the European Stability Mechanism (ESM), which would probably be impossible in the event of a Le Pen victory. In the event of a break-up of the Eurozone, the OAT-Bund spread could widen to 500bps, which harks back to the peak spreads on the Italian 10-year rate during the 2011-2012 crisis;

• **German interest rates:** the Bund would logically benefit from a flight to quality, which would be further accentuated in the event of a strong likelihood of a return to national currencies, as the Bund would be driven by expectations of the redenomination of German debt into Deutschemarks, which would probably gain considerable value against other currencies. It seems logical to draw a parallel with Swiss rates, which fell into negative territory during the Eurozone crisis, and 10-year German rates could therefore also slide into negative territory.

• **Interest rates for peripherals:** a massive widening in spreads for Spain and Italy looks inevitable, proportionally to the probability of a break-up of the Eurozone, in a similar scenario to the 2011 situation, when spreads for the two countries' 10-year rates to the Bund widened from 175bps to 470bps (Spain) and from 122bps to 552bps (Italy);

• **Inflation in France:** even before a potential Eurozone break-up, mere perception of the risk of a break-up could paralyze major investment decisions and spending on consumer durables. We could also expect a sharp fall in real estate prices (interest rate shock, exit of foreign investment) due to the hefty rise in long-term rates. In the event of a break-up of the Eurozone, devaluation of the new franc would trigger high imported inflation, with consumer prices gaining up to 3-4%, which suggests the materialization of a stagflation scenario.

• **Eurozone equities:** we would probably see a decline of around 10%-15% on the EuroStoxx in the week following the presidential election, with massive sales of banking stocks (-20% to -30%); an accentuation in this drop looks inevitable if the National Front takes a majority in the National Assembly at the legislative elections, if a referendum takes place and of course if Frexit occurs, with in an overall decline of 25-30% in stockmarket indices in the Eurozone in the event that France exits the EU (and -30% to -40% for the CAC 40). These levels are similar to the declines seen on the EuroStoxx 50 during the Eurozone crisis between February and September 2011;

• **Euro/dollar:** we would probably see an instantaneous 5-10% depreciation in the euro against the USD with a gradual acceleration in this decline in the event of a referendum and especially if there were a victory for Frexit (between -15% and -20% overall). The only reference point we have for a period of strong market skepticism on the euro was the 1999-2000 period, when the euro shed close to 30% against the dollar and the yen in the space of a year. However, the dollar’s current relative pricey-ness should safeguard the euro against such a severe decline.

Whatever the scenario, there is a strong risk of ending up with a more dispersed bipartisan system in France, with greater difficulties in creating coherent majorities, coalition governments are not the cultural norm in France. Assessing political risk in the Eurozone requires monitoring this situation very closely.

Lastly, in the event of victory for Marine Le Pen, we should also consider the broader impact that the breakdown of the euro and a systemic crisis affecting a large proportion of the European banking system would have on the world financial markets. Few international investors seem prepared for this scenario, which is reminiscent of the situation triggered by the fall of Lehman Brothers.

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