EDMOND
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ARE FRANCE'S ELECTIONS RISKY?

Unlike 2017, the second round of the French presidential elections appears on the surface to present fewer issues: Emmanuel Macron is now the candidate of continuity while Marine Le Pen is no longer arguing for Frexit. Moreover, it looks likely that neither would be able to secure a majority in the National Assembly. We might as a result be tempted to skim though each candidate's electoral programmes as both would have to compromise to get a working parliamentary majority, supposing that a majority could be formed. So should investors ignore France's elections?

ARE THE CANDIDATE'S ECONOMIC PROGRAMMES EVEN RELEVANT?

Both promise to make substantial changes and their manifestos have a number of measures in common, like reducing production taxes and death duties and scrapping TV licences. However, Marine Le Pen's plan to nationalise motorways sets her apart. The measure would obviously have a big impact on the companies concerned. And the spending needed to roll out her measures would seriously impact government finances already thrown off balance by recent stimulus packages. As for Emmanuel Macron, his promise to cut taxes would be partly offset by pension reform.

France's deficit was running at 6.5% of GDP in 2021 so there is no budgetary leeway. With the ECB winding down its liquidity support, government finances will now play a bigger part in bond spread dynamics. That said, we do not expect markets to overreact, at least initially: these are after all election promises and they are bound to be adjusted when a new parliamentary majority is formed. In short, macroeconomic issues are not what we are currently focusing on.

THE POSITION ON EUROPE COULD MAKE ALL THE DIFFERENCE

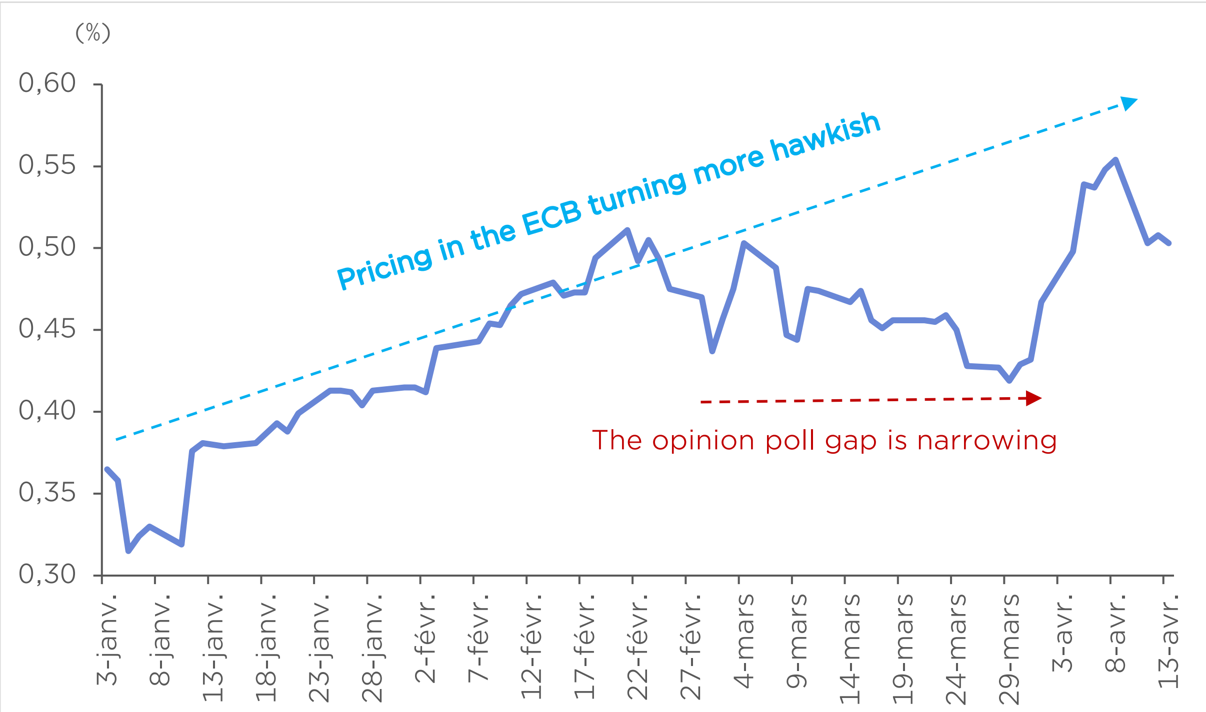
Marine Le Pen's campaign has not given much space to European questions but parts of her manifesto raise questions: reintroducing border controls, slashing France's financial contributions to the European Commission and ending the primacy of European Union law over French law go against the European Union's processes.

But let's suppose that Marine Le Pen is elected president and gets a working parliamentary majority to put these proposals to EU countries. There is almost no chance that a majority of EU countries would accept them and even those who did would not be entirely in agreement. Hungary and Poland, for example, are the most favourable to reinstating the primacy of national over EU law but the most opposed to cuts in financial contributions to Brussels. In this particular case, European institutions, which are the single currency's bedrock, could be paralysed. A win for Marine Le Pen would also drive up volatility both on French government bonds and sovereign debt in peripheral countries like Italy. German Bund premiums would rise further until the risk of paralysis abated.

MARKET REACTIONS

There is currently quite a narrow opinion poll gap between the two contenders but French OAT/German Bund spreads are, for the moment, only half as wide as in 2017 when there was more uncertainty over both finalists. As for equity markets, the CAC 40 had one or two trading sessions which were more volatile than elsewhere in Europe.

OAT-Bund spread since January 1st 2022



Source: Bloomberg; Edmond de Rothschild Asset Management. Data at 13/04/2022.

Any return of European political risk which is not yet discounted in markets hinges on Marine Le Pen

- (i) winning,
- (ii) getting a parliamentary majority to form a government and then
- (iii) sticking to her objectives concerning Europe.

There are so many ‘ifs” here that the probability of this scenario is low.

In the meantime, we have reduced exposure to French and peripheral country debt in our portfolios. Even without political risk, pressure on the ECB to tighten further could still cause spreads with Germany to widen.

Benjamin Melman, Global CIO Asset Management

GLOSSARY

• Investment Grade: bonds rated as high quality by rating agencies.

• High Yield: corporate bonds with a higher default risk than investment grade bonds but which pay out higher coupons.

• Senior debt benefits from specific guarantees. Its repayment takes priority over other debts, known as subordinated debt.

• Debt is considered to be subordinated when its redemption depends on the earlier payment of other creditors. To offset the higher risk, subordinated Senior debt has priority over other debt instruments.

• Tier 2 / Tier 3 : subordinated debt segment.

• Duration: the average life of a bond discounted for all interest and capital flows.

• The spread is the difference between the actuarial rate of return on a bond and the rate of return on a risk-free loan with the same maturity.

• The so-called "Value" stocks are considered to be undervalued.

• Markit publishes the Main iTraxx index (125 leading European stocks), the HiVol (30 highly volatile stocks), and the Xover (CrossOver, 40 liquid and speculative stocks), as well as indices for Asia and the Pacific.

• EBITDA: Earnings before Interest, Taxes, Depreciation, and Amortization.

• Quantitative easing describes unorthodox monetary policy from a central bank in exceptional economic conditions.

• Stress Test: a process which simulates extreme but possible economic and financial conditions so as to assess any impact on banks and measure their resilience to these events.

• The PMI, for "Purchasing Manager's Index", is an indicator of the economic state of a sector.

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