EDMOND DE ROTHSCHILD

# SPECIAL FLASH: LIKE A SENSE OF DÉJÀ VU

**Nabil Milali, Portfolio Manager/Multi-Asset & Overlay Strategist**

The political divide within the National Assembly left little doubt about the fate of the Bayrou government, and even though the latter wanted to believe in it until the end, the vote of confidence ultimately resulted in failure, hastening his resignation and the fall of his government. France thus finds itself in the same situation as last year after Mr. Barnier's departure and is expected to experience its 5th Prime Minister in three years, signaling the significant political instability characterizing the country since the beginning of E. Macron's second term. Faced with an unprecedented tripartition of the political landscape under the Fifth Republic, the president now has three options before him, which we present here in order of most to least likely according to us:

1) **The Appointment of a New Prime Minister**: This is the option we favor at this stage, as do financial markets and the President's close associates. While mentioning G. Darmanin, S. Lecornu, or C. Vautrin as potential candidates, these hypotheses have lost credibility because the political equation can no longer be resolved without the Socialist Party due to the intransigence of the National Rally. Therefore, E. Macron has every incentive to turn towards the left side of the assembly, whether by appointing a party figure like O. Faure or a personality likely to gain the PS's approval, such as the economy minister E. Lombard or former minister J.L Borloo. In this case, the new Prime Minister would have equally narrow margins as F. Bayrou, significantly limiting his capacity to vote on an ambitious public deficit reduction text. In any case, a new budget must be presented no later than 70 days before the end of the year, i.e. October 13, which should prompt Emmanuel Macron to appoint someone fairly quickly. The difficulty in finding a compromise in the current National Assembly configuration is expected to lead to broadly renewing the former budget, resulting in only modest improvement in the public deficit. Nevertheless, investors might choose to see the glass half-full and applaud the absence of additional slippage in budget balances, which would translate into a stabilization of the OAT-Bund spread and a temporary increase in the attractiveness of French stocks as political uncertainty dissipates. However, France would only once again postpone the delicate issue of public finances (cf. infra), which will return to the forefront next year, awaiting a true clarification by 2027 at the latest.

2) **Dissolution of the National Assembly**: Although this option was unavailable to him following the Barnier government's fall at the end of 2024, it now falls within the options available to the president. Without being the majority, the probability of this scenario is non-negligible given the profound political divides within the political class, now compounded by a social protest movement starting on September 10. In the case of strong mobilization, E. Macron might choose to hand back power to the citizens by calling new elections, hoping for a clearer majority to emerge this time.

This scenario is certainly what the National Rally hopes for, threatening to censor any new Prime Minister regardless of his political orientation. M. Le Pen indeed sees an opportunity in the current political situation to access power. On one hand, polls place her in a very advantageous position against a fractured New Popular Front likely not to present common candidates in all constituencies, such that high first-round results could result in larger seat projections than the 2024 legislative elections. On the other hand, the judicial Damocles sword hovers above M. Le Pen, with the risk of a long ineligibility period if her conviction is upheld on appeal (new trial starting January 2026), which might compel her to do everything possible to ensure the next Prime Minister comes from her camp to eliminate the disqualification penalty for convicted elected officials, thus paving her way for a 2027 presidential candidacy. Nevertheless, despite RN's ambitions, polls continue to suggest that the party's progress would not be sufficient to grant it an absolute majority, even considering an alliance with The Republicans, suggesting it would be unable to apply a high-spending program. While a dissolution would likely constitute an unpleasant surprise for financial markets, possibly leading to a significant widening of the French spread and underperformance of the CAC 40 compared to its European peers, the impact should remain contained. Furthermore, we estimate that contagion to other European rates and the euro would stay generally limited.

3) **A Presidential Resignation**: This is very unlikely at this stage but cannot be entirely excluded, especially since it is a demand from a segment of the September 10 protest movement. It is also a goal of France Insoumise, refusing any compromise, even if a left-leaning Prime Minister is appointed, to force E. Macron to acknowledge the institutional blockage and step down before the end of his term. This scenario would certainly be the least favorable for French assets since the risk of victory by extremes would be significant, which could lead to a marked widening of the French spread, likely reaching new highs. In this scenario, the risk of contagion with euro depreciation and tensions in the credit market would be palpable. Indeed, investors' fear would not be insufficient efforts to reduce the budget deficit but rather that it might deteriorate again as these political parties' programs forecast a significant increase in public spending without real savings measures, not to mention their willingness to engage in a standoff with Brussels. Nevertheless, the likelihood of E. Macron's resignation remains very low, as he himself recently indicated he would see his term through to the end.

Whichever outcome of the current political crisis, the probability of a significant public finances reform will remain low, so much so that financial markets themselves seem resigned and might settle for a scenario where the budget deficit does not deteriorate further. Yet, without being catastrophic, the situation is worrisome as France diverges from the rest of the Eurozone with the largest budget deficit (-5.8% in 2024; -5.4% expected in 2025 vs a EZ average around -3%) and public debt on an upward trajectory (113% in 2024 and 117% expected in 2025). This deterioration in budget balances is mainly explained by a decline in tax revenues due to tax cuts granted to households (-1.6 pts since 2017) and businesses (-0.8 pts), which has not been offset by a reduction in public spending (returned to 2017 levels after a pandemic peak). While many parties agree on the need to reduce public spending, which currently represents 57% of GDP (vs 50% average for the Eurozone), it remains difficult to find a majority for measures that would bring the primary deficit below the debtstabilizing level. Indeed, decomposing this spending surplus compared to the rest of the continent (7 ppt), most of it stems from the pension system (2.2 ppt) and health care (1.5 ppt), two politically explosive subjects that parties seek to avoid, prompting them to propose only marginal deficit adjustments. It thus stands to reason that the status quo should persist unless pressure from the European Commission and especially from financial markets intensifies, in which case more challenging choices will necessarily have to be made, likely following new legislative or presidential elections.



EDMOND DE ROTHSCHILD ASSET MANAGEMENT (FRANCE)

47, rue du Faubourg Saint-Honoré 75401 Paris Cedex 08

Société anonyme governed by an executive board and a supervisory board with capital of 11.033.769 euros

AMF Registration number GP 04000015

332.652.536 R.C.S. Paris