Investment Insights

The French Elections, Explained

BESSEMER TRUST

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Highlights

- The French elections are a key near-term risk event this spring.
- A Le Pen victory would likely result in a sell-off, primarily in European risk assets, and a Macron victory could result in a relief rally.
- Most investors expect a Macron win, but it's not over 'til it's over.
- The outcome may lead the European Central Bank to adjust its current monetary policy framework.
- We are not making tactical changes to portfolios in advance of the elections — though we may add to European equities in the event of a Macron win.

In recent months, we have frequently highlighted the French election as a key binary risk this year. In this *Investment Insights*, we provide a timeline for key events and illustrate the ramifications this election may have for financial markets and Bessemer portfolio positioning.

What to Watch, When to Watch It, and Why it Matters

As we proceed into the second quarter, investors will once again swing their focus back to the political arena with the first round of the French presidential election on April 23, followed shortly thereafter by the second round of voting on May 7. The latest polls continue to show that Marine Le Pen of the National Front Party is neck and neck with Emmanuel Macron of the "En Marche!" party in the first round, while the latter is ahead in the second round polls with approximately 63% of the ballots (Exhibit 1).

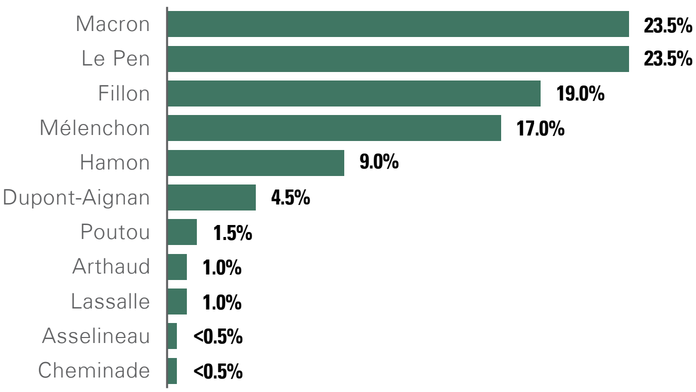
For context, although Le Pen leans to the far left on economic topics, she leans to the far right on most other issues: she is anti-immigration and nationalistic and has promised to restore France's sovereignty on all levels by holding a referendum on France's European Union (EU) membership within six months of being elected. Macron, a former minister of the economy, meanwhile, is viewed as being an independent and centrist candidate.

At this juncture, most investors' base case is that Macron will persevere in the second round due to his ability to attract coalition partners. His platform is largely focused on investment, spending cuts, and tax/labor reform, and we think that he would be unlikely to push for major changes to France's relationship with the EU. While the election momentum has moved in favor of Macron, we note that recent polls have also shown that as many as 43% of French voters remain undecided. Thus, caution is warranted given the unpredictable swing factor of this constituency.

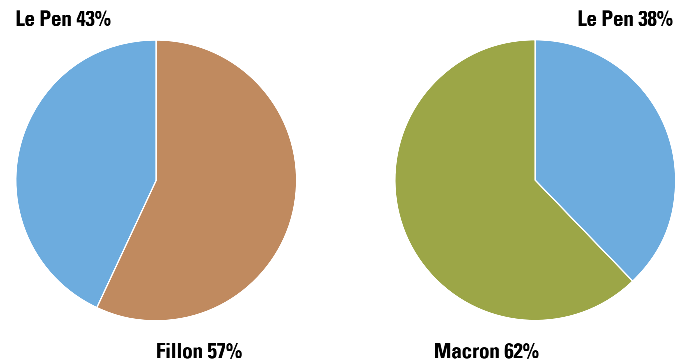
Exhibit 1: French Presidential Election Poll on April 5, 2017

Key Takeaway: In the first round polls, Macron and Le Pen remain neck and neck. In the second round, polls are currently favoring Le Pen's opposition.

1st Round



Hypothetical 2nd Round



As of April 5, 2017. The poll was conducted by Elabe on April 5, 2017. The sample size included 1,041 individuals who represent the French people aged 18 and over and a sub-sample of 995 individuals who intend to vote.

A Macron victory would likely be interpreted as a continuation of the status quo and thus could lead to a relief rally in European assets as investors no longer have to price in the potential economic and political implications of Marine Le Pen's proposed policies. To further illustrate this dynamic, we discuss the potential impacts across the various asset classes and sectors in the section that follows. A Le Pen victory, on the other hand, would likely trigger a risk asset sell-off, centered on European markets, due to the uncertainty her anti-EU platform would likely engender. Le Pen has promised to restore all aspects of France's sovereignty via negotiations with Brussels and a referendum on EU membership, similar to the U.K. referendum on Brexit in June 2016. That said, the analogies with the U.K. stop there. While Britain has its own currency, central bank, and financial regulations, France is a leading constituent of the euro common currency trading block. A Le Pen victory, in our view, would have far more systemic repercussions, as it would raise serious questions about the actual sustainability of the EU itself. How should the euro without France's backing be valued? Would contracts denominated in euros continue to hold? What would the political landscape in Europe look like if a keystone of the region turned inward?

We do not expect that market participants or others would resolve these questions quickly, and European assets would likely experience a period of heightened volatility as investors try to gain clarity on these issues. Beyond the presidential election, we highlight that in France there are two rounds of legislative voting in June as well, and it is probable that Le Pen's party would maintain a significant minority in those elections. This would maintain her party's position in the national conversation to a certain degree, even if she didn't lead the country. In the event that Le Pen does win, the French political system does limit presidential power to an extent, although we expect financial markets, at least initially, to focus on the perceived probability that the new leader may have some success in her quest for national sovereignty given the tailwinds that a victorious presidential campaign would provide.

Specific to the first and second rounds, the most likely outcome at present is a tight election that features Le Pen and Macron winning the first round, followed by a Macron victory in the second round. A strong win by Le Pen in the first round would be somewhat unexpected and would suggest a higher likelihood that she could win in the second round. This, in turn, would cause some investors to reconsider current positioning in financial markets, and a modest amount of volatility could result. On the other hand, a Macron victory in the first round would be a strong indication that Le Pen's chances of winning in the second round are slim, and thus be interpreted by the market as a signal that the risk event had partially passed, although as both Brexit and the U.S. election have demonstrated, it's not over 'til it's over.

Equity, Currency, and Interest Rate Implications

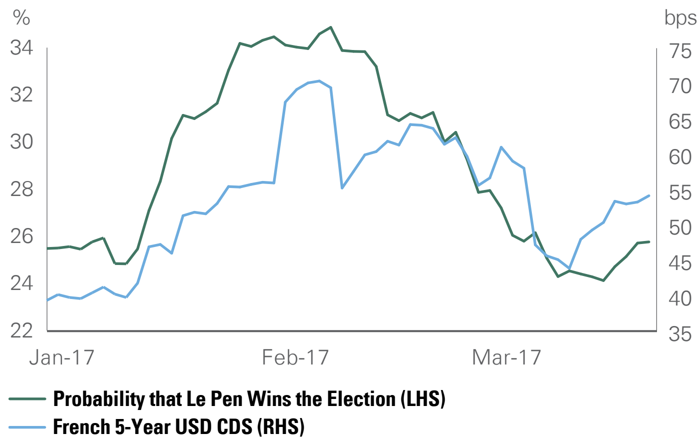
Many factors drive European equity markets and the relative value of the euro, and hence we do not view the movements in these asset classes as a clean read on French political developments. That said, when Le Pen has performed poorly in the polls, the euro has usually appreciated and French equities have generally strengthened, and the reverse has been true when her election probabilities have risen. Because most market participants currently do not expect a Le Pen victory, they are not pricing in large risk premiums in French equity or debt markets.

Although the cost to insure against French sovereign debt has risen modestly over the past several months, it remains far below the levels seen during the European sovereign debt crisis in 2011/2012. There is currently a close relationship between French credit default swap rates, a measure of the country's perceived risk, and the probability of a Le Pen victory (Exhibit 2).

As mentioned, we expect a significant amount of cross-asset volatility to ensue in the event that Le Pen wins convincingly in the first round, or comes out on top in the second round. Equity markets, both in France and globally, would likely experience a significant correction, safe-haven currencies such as the U.S. dollar could appreciate, and Treasury yields could decline notably. European risk assets, particularly European financials, would be particularly hard hit, in our view. Given the somewhat tenuous state of European banks already, this environment would pose an enormous challenge to European policymakers and French/German corporate leadership.

Exhibit 2: French Credit Default Swaps versus Probability of Le Pen Victory

Key Takeaway: A close relationship exists between the cost to insure French debt and the odds of a Le Pen win.



As of April 6, 2017.
Source: Bloomberg

Although the U.K. economy and global risk assets took the Brexit outcome relatively in stride, the same cannot be said for the British pound, which remains roughly 16% lower from just prior to the U.K. referendum. The relatively unique status of the U.K., both in terms of its independent central bank and its separate currency, served to greatly reduce the amount of regional spillover and systemic risk following the referendum outcome. Even then, the U.K. is currently faced with a period of rising inflation that could impede its economic recovery and hamstring British policy makers' ability to navigate the global cross-currents of monetary policy. While the nationalistic bent of Le Pen could be supportive of local equities, as was the case with Brexit (again, in local currency terms) or with Trump's win in the U.S., there are several differences with Le Pen's policies worth highlighting. Le Pen has a leftist, interventionist approach to the economy. A weaker currency, assuming the French franc is eventually adopted, could help French exporters. However, higher taxes on portions of the economy, more labor-friendly policies, and a general lack of pro-growth initiatives make it difficult to see how her victory would support even the French market over a medium-term horizon.

How the European Central Bank May Respond

We expect the European Central Bank (ECB) to vary its policy for the year somewhat, depending on the outcome of the election. Currently, the ECB has maintained an extremely accommodative policy stance to support the continued economic recovery in Europe. If a mainstream candidate like Macron wins the election and European economic fundamentals continue to improve, the ECB may begin to slowly withdraw the extraordinary amount of monetary policy accommodation, much as the Fed did toward the end of 2014. Indeed, the ECB's March meeting minutes released on April 4 noted that it was appropriate to "de-emphasize the sense of urgency" toward taking further actions to support the European economy, which could be interpreted as taking a small step toward discussing ECB monetary policy normalization.

To illustrate just how accommodative the ECB has been, German sovereign bond yields *remain negative* through the seven-year maturity, something that would have been almost unthinkable just five years ago. If the ECB were to begin withdrawing monetary policy accommodation, European sovereign bond yields would likely rise, but it is less clear what the impact on European risk assets would be. If Europe is able to maintain a virtuous growth cycle (like the U.S. has since the Fed began removing accommodation), European equities could continue to perform well. We would expect the euro to strengthen on the back of expectations for higher interest rates in the EU, which could pose a risk to our moderately bullish dollar view for the year.

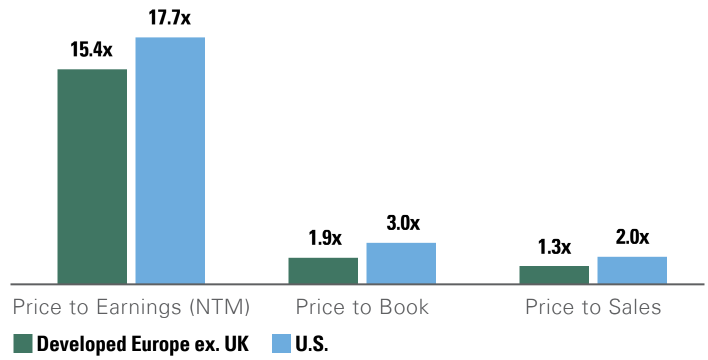
Conversely, if Le Pen wins the election, the resulting financial market volatility and economic uncertainty would almost guarantee a continued accommodative policy stance from the ECB. Additional extraordinary measures would also not be out of the question, although it's unclear exactly what that might look like.

Bessemer Portfolio Positioning

Given our base case of a Macron win, as well as improving global growth dynamics, our portfolios are positioned to be supportive of risk assets over the intermediate term. Bessemer mandates have largely held underweight exposure to Europe over the past 18 months. Our view has been that the U.S. economic backdrop is more conducive to equity market and currency gains, while Europe has been dragged down by structural challenges and political risks.

Exhibit 3: Key Valuation Ratios of European and U.S. Equities

Key Takeaway: European equity valuatons look compelling relative to the U.S.



As of April 7, 2017. Europe ex. UK is measured using MSCI Europe ex. UK; U.S. is measured using MSCI USA. NTM stands for next-twelve-months.

Source: FactSet, MSCI

Economic data in Europe of late has been more encouraging. Meanwhile, European stocks are generally more attractive than their U.S. counterparts on a price-to-earnings, price-to-book, or price-to-sales basis, even when compared to each country's respective history (Exhibit 3). With a Macron win, we are likely to add to European exposure to reduce our underweight position. We caution that the nationalistic and populist sentiment in Europe as a whole is unlikely to subside, and that political risk will continue to serve as a moderate drag for some time, though to a lesser degree once this binary event has passed. In addition, a Macron win might not result in a meaningful, sustained risk asset rally, since an increasing number of investors are already positioned for this outcome.

Given the possibility for unexpected events to take place between the first and second elections which could push voters into the Le Pen camp (especially considering that more than 40% of the French electorate remains undecided), we are wary of making a tactical shift before the election, as binary outcomes are incredibly difficult to predict. Instead, we will wait for a period of clear air and leverage our core strength of combining macroeconomic analysis and bottoms-up stock selection to identify attractive risk/reward opportunities.

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