French presidential elections: a mix of hope and fear

Round one of the French presidential elections is now history: Emmanuel Macron eked out a win on points ahead of his main adversary, Marine Le Pen. But the final decision will only come after the return bout on 7 May, where the bookmakers (or as it were, the public opinion polls) are giving clear odds to Emmanuel Macron. The Damocles sword hovers nonetheless – this in the form of a surprise victory by EU/euro-opposed Marine Le Pen and her Front National, an event that could herald-in the breakup of the European sisterhood of states.

France: Marine Le Pen or Emmanuel Macron?

The old-line political parties in France have been relegated to the cheap seats with their candidates. In the first round of the elections, Emmanuel Macron and Marine Le Pen took the lion's share of the initial popular vote. Now comes the runoff election between the two. Opinion pollsters see Macron clearly in the lead, as he most likely can count on left-leaning and conservative voters switching to his camp in the grand finale. For the first time in the history of the Fifth Republic, a runoff election will be held without the inclusion of a Socialist or Gaullist candidate. But even though the research institutes are largely of the same mind, there is no absolute guarantee that Emmanuel Macron will come away the winner. This lesson can be gleaned not only from the unexpected pro-Brexit outcome and the rather ironic election of Donald Trump; it can also be grasped by just doing the maths. In other words, the better Marine Le Pen manages to mobilise her own bloc of voters in the second election, the better her chances of victory are. A simple example: If the Front National can get 90% of its base to actually go to the polls, and voter turnout from the other camps comes in at only 60%, Marine Le Pen wins the day despite what the latest surveys suggest. Moreover, it remains unclear whom the backers of the left-wing populist Jean-Luc Mélenchon will vote for on 7 May. It cannot be ruled out that they ultimately opt for Le Pen. In this scenario, the Front National could come out on top.

A victory by the latter would likely mark the beginning of the end for the EU and hence the currency union as well. Marine Le Pen wants to take France out of the EU or at least achieve a far-reaching reformation of the union. Her election platform foresees not only radical steps to counter the purported "over-foreignisation" of France, but also a massive build-up of the police and military. Many aspects of these plans are incompatible with current EU statutes. For instance, she wants to take the same route as Donald Trump by embracing "intelligent protectionism", which is aimed at combatting alleged unfair competition from abroad. Other declared goals are the reindustrialisation of France and a revitalisation of its agriculture sector. Companies should pay a surtax on the foreign labourers they hire. However, these drastic measures will hardly be capable of garnering a majority of votes when it comes to the runoff election, which is why a Macron victory is considerably more probable.

But Emmanuel Macron also intends to bring a new political style to the Élysée Palace. The independent candidate is not bound by any ideological party discipline, and that has awakened hopes for vast economic reforms. Macron wants to achieve what Spain has already successfully accomplished: an end to the crippling domestic labour disputes. Wages should be negotiated at the industry-specific or, better yet, the company-specific level. Liberal economic legislation should be counterbalanced by a broadening of socio-political requirements. It is entirely possible that, with his political agenda, Macron can make such a new economic policy palatable for the strike-friendly French populace. Reforms in France would send an extremely positive signal that extends far beyond the country's own borders and could bring an end to the otherwise lethargic economic developments in the eurozone.

Economic appraisal

The French economy has largely recovered from the international financial crisis and subsequent sovereign-debt dilemma in the eurozone. After the soft patch encountered in 2012, which was mostly due to the latter crisis, France's GDP has been growing roughly in line with its potential since early 2013. In 2016, the economy expanded at an annual rate of 1.2% and a 1.3% reading could be on the cards for the current year, with domestic demand gradually taking over as the primary driver of growth. The ECB's ultra-accommodative monetary policy is giving a boost to the French economy not just by means of the weaker euro; low interest rates are also spurring credit demand there. Loans to companies and private households have risen significantly since 2014.

France has also made progress structurally – at least on paper. The French government under President Hollande has adopted various reforms aimed at making the labour market more flexible. For instance, during economically problematic phases, companies now have an easier time derogating from the covenants of wage agreements, both in terms of compensation and working hours. The conditions governing mass layoffs have also been eased, as have those for terminations due to operational redundancies. Today, a company can take these measures if its profitability and revenues have declined for several quarters in succession, or when losses have been incurred over a number of months in a row, or if the company has suffered a severe deterioration of its ability to meet payments. And layoffs are still allowed in conjunction with a restructuring that has become necessary on grounds of competitiveness. So in fact, the French labour market has already become more flexible – however, not enough for the self-proclaimed reformer Macron. If he has his way, further revamps of the past norms will be rubber-stamped by

Parliament. Marine Le Pen, on the other hand, has charted a conservative/nationalistic course for France's future – also in terms of the labour market. In the following section, we offer a brief overview of the major planks in these two political platforms.

Macron: the European

Emmanuel Macron is a declared fan of Europe. Rather than distancing France from Germany, he wants to join Germany in pressing ahead with the full consolidation of Europe.
Here are the key items on his economic agenda:

- Walking-back the 35-hour workweek.
- Additional new approaches to collective bargaining: the massive domestic labour disputes should become a thing of the past; going forward, wages should be negotiated at the industry-specific or, even better, the company-specific level.
- Taking a cue from Germany's Hartz IV reforms, labour policy measures should adhere to the principle of "demand yet empower": continuing education and personal development programmes should be expanded, whereas the unemployed should no longer be permitted to decline every job offer they receive.
- The corporate tax rate should be cut from 33.3 to 25%.

In a nutshell, Macron's reform agenda is based on distinctly laissez-faire elements, but people with poor chances in the job market should be supported more extensively. It is possible that, with such a policy, Macron can bring the strike-predisposed French to the point where they actually welcome a new economic approach.

Marine Le Pen: the go-it-aloner

The Front National's standard-bearer is focused primarily on France's reclaiming "four sovereign rights". Monetary policy, lawmaking, budgetary/economic policy, and territorial determinations should all be put back in the hands of the French government. If the representatives in Brussels fall for the idea that "relinquishment of sovereignty means greater sovereignty for all", a referendum should be held to determine whether France stays in or leaves the EU. If Brussels dismisses such a move, then an EU withdrawal will be ramrodded through. Whatever the case, Le Pen wants to relinquish the euro and revert to a domestic currency, although it should remain possible for large companies to use the European common currency for their business activities.
However, a retreat from the EU and/or the euro would be far from easy. A constitutional amendment would have to be passed by both chambers of Parliament and then receive the blessing of the voting public. It is highly unlikely that these two hurdles would be surmounted. Even though the formal route for leaving the EU is effectively beyond the bounds of possibility, Le Pen could light such a brushfire in her collaboration with other EU member states that it would further weaken the already shaky foundations of the union.

In addition, Le Pen foresees a tax on employment contracts with foreigner workers, and a "social contribution" could be levied on imports – and all of this is being spiced up with the promise of reliefs for low-paid workers and the middle class. As to foreign policy, a withdrawal from NATO is also on Le Pen's agenda.
To put it briefly: a victory by Marine Le Pen would lead to major conflicts within the EU. Although the force of facts could ultimately cause her to take a less radical approach, even a watered-down policy on the part of the Front National would be volatile enough to spark discord with France's neighbours and do lasting damage to the EU. The already recognisable cracks in the walls of Europe would become even larger.

How will the financial markets react?

The political chasm between the two French presidential candidates could hardly be wider: Emmanuel Macron stands for pro-EU, laissez-faire policies; Marine Le Pen for almost the exact opposite. The behaviour of the financial markets is likely to be correspondingly divergent:

The Emmanuel Macron scenario

An Emmanuel Macron victory would spawn hopes for reforms in France. Whether things ultimately turn out the way he wishes remains to be seen, but alone the prospect of such an occurrence could arouse certain fantasies. The following is a brief overview of what we consider to be the potential reactions:

EUR/USD

The euro could show a slightly positive response to a Macron election win. A bump in EUR/USD to the vicinity of 1.10 is conceivable. However, we are not reckoning with a further significant upside move in the common currency, this due to the likelihood that EUR has already discounted a Macron victory to the greatest extent. As the year progresses, the financial markets will return their focus to the transatlantic yield differential and politics will be placed on the back burner. Further rate hikes by the Fed and continuing leniency on the part of the ECB suggest that EUR/USD will be curious to take a look at the 1.02 mark.

EUR/CHF

The SNB will probably scale down its interventions, seeing as how the worst case failed to materialise and thus the flight of capital into the franc starts to wane. A continuation of the trading range between 1.06 and 1.08 appears to be the most likely scenario.

Yields

In the event of a Macron victory, the ECB would be much more inclined to start tapering its monthly bond purchases than would be the case if Le Pen wins. The yield on 10-year Bunds can be expected to rise by 0.5 %, whilst that on 10-year Confs remains essentially unchanged.

Equity markets:
Even though a win by Macron allays the threat of a Le Pen presidency for another five years, the chances for the French equity market remain modest. Compared to its European counterparts, the CAC 40 is already considered relatively expensive and the projected earnings growth rate of 7% lags that of other countries in the eurozone. Since the start of the year, however, the broad French market has slightly underperformed the STOXX Europe 600. On the other hand, the eurozone as a whole offers a certain degree of upside potential. International investors view the elections in France as a bellwether for the future survival of the eurozone. At the moment, those investors are avoiding crisis-plagued regions, so a resounding "Non!" to Le Pen's uncertain and nationalistic flights of fancy could draw capital back in to the European exchanges. Especially the Continental banks, but also Italian stocks are likely to come away the winners from such a shift. Within France itself, we see potential in certain select stocks. Medium term, though, Macron's reform agenda will have a considerable influence on that potential.

The Marine Le Pen scenario
If the Front National comes out ahead, risk aversion will surge across the globe. Fears for the continued existence of the EU will increase dramatically:

EUR/USD
The worldwide wave of uncertainty would cause a flight to the USD space, in which case we reckon that the greenback could rapidly relocate to the neighbourhood of 0.90 versus EUR.

EUR/CHF
Switzerland as well can be expected to remain in demand as a safe haven. The SNB, despite its increased intervention volumes, would be unable to keep EUR/CHF above the 1.06 level. Our base scenario in the event of a Le Pen victory foresees the franc trading between parity and 1.05 versus the euro.

Yields
The significantly heightened risks surrounding the continued survival of the eurozone would force the ECB to prolong its easy-money policy. This, combined with the strong demand for safety, has the potential to pressure yields on 10-year Bunds back down to practically zero. 10-year Confs would probably be priced with a negative yield of around -0.4%.

Equity markets:
Equity investors are currently not reckoning with a Le Pen presidency. Implied volatility is at an extremely nonchalant level not just in the USA, but also in Europe and France in particular. Given the already generous stock valuations, an unexpected Front National win would hit the financial markets hard, especially the equity markets. In contrast to the impact of the Brexit, a Frexit would severely endanger the European common currency. The weaker euro foreseen in this scenario would of course brighten the outlook for export-oriented companies, but international investors would sit on their hands and avoid the entire eurozone until the dust settles – in which case, heavy selling pressure is almost inevitable.

Summary
The two front-runners for the presidency of France could hardly be more disparate. Emmanuel Macron, a reform-intent liberal, is matched against Marine Le Pen, an outspoken opponent of the EU, in the race for the Élysée Palace. A victory by the Front National would undoubtedly trigger a bad case of nerves in the financial markets. On the other hand, if the favoured Emmanuel Macron comes away the winner, no major price/yield upheavals are likely to result.

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