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OBSERVATIONS

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French politics—set for a reshuffle

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In 2016, two major political events defined the investment landscape and dominated investor sentiment. First, the UK voted to leave the European Union (EU), then Donald Trump stunned the world by becoming the 45th president of the US.

Since these unexpected events, investors have become increasingly focussed on negative scenarios. As we approach the French presidential election, a win from far-right National Front leader, Marine Le Pen, may pose a further threat to market stability. In this article, we look at how the French election process works, potential outcomes of the election, and what it means for investors.

The path to presidency

In France, presidential elections occur every five years, with the elected president permitted to spend no more than two terms in office. There are two stages to the election process:

- **Stage one**—a standard popular vote takes place, and if a candidate receives at least 50% of this vote they become president. This year, this vote is scheduled to take place on 23 April.
- **Stage two**—if no candidate receives an absolute majority in the iniatial round of voting, a second round (known as the 'run-off') is held two weeks later. This is scheduled for 7 May. During the run-off the two highest-scoring candidates go head-to-head. The reason for this is to ensure the elected president receives a majority vote.

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The powers of the president

Compared with many other European political systems, the French president has a strong influence over the country and the economy, outranking all other political positions, including the prime minister he or she elects after becoming president.

While the policies of the president are very important, the support of his or her prime minister is key. This is because the prime minister is responsible for the day-to-day running of the country, and without his or her support, the president will find it difficult to enact change.

In electing a prime minister, the president must appoint an individual who has a majority within the parliamentary assembly. This means that the president may be forced to elect someone with opposing political views, which would greatly diminish the president's power. In a situation such as this, the president and prime minister are said to be in 'co-habitation', and it is this aspect of the French political system that is crucial in determining the impact of the upcoming presidential election.

The political landscape in France is set for a reshuffle

The encumbent president, Francois Hollande, will not be running for re-election, and the front-runners for election this time around have mandates for change which range from moderate to extreme. The impact these changes could have on financial markets range from extemely negative (where there is a heightened risk of the EU breaking up) to positive (if the French economy can be revived by structural reform).

The impact these changes could have on financial markets range from extremely negative to positive

The main candidates for the upcoming election are Marine Le Pen, Leader of the French National Front party, independent candidate Emmanuel Macron, and Republican party candidate Francois Fillon.

Marine Le Pen—French National Front party

Marine Le Pen is the leader of the French National Front party and daughter of former leader and party founder Jean-Marie Le Pen. It is a long-standing extreme right-wing political party—strongly traditionalist, anti-immigration and Euro-sceptic.

Under Marine's leadership the party has enjoyed a period of strength, partly because of the party's softer image with her at the helm and her steps to distance the party from its traditional racist and xenophobic image.

Le Pen's key polices involve a massive reduction in legal immigration, a tougher law and order stance (particularly in relation to Islamic fundamentalists), and the promise to hold a referendum on EU membership. The aim of the latter is to regain monetary, legislative, territorial and economic sovereignty. In terms of reform, the party's policies are strongly traditional, and they have a focus on maintaining long-standing benefits such as the 35-hour working week and the retirement age.

Emmanuel Macron—independent candidate

Running as an independent, Emmanuel Macron is a centrist who is pro-European and pro-business. He recently served as Economic Minister in President Hollande's administration—but has sought to downplay this link. As a newcomer to politics, he has never held an elected position. He was initially given little hope of success and was criticised for not having the policy details to back his political ambitions. His policies around key issues focus strongly on international co-operation, particularly ties within the EU, and on economic and labour market reform. With aims to cut public spending and to implement policies to boost business, he is seen as a progressive candiate aiming to use structural reform to boost economic growth.

Francois Fillon—Republican party

Francois Fillon was formerly Prime Minister under President Nicolas Sarkozy, and rose to prominence with a shock victory in his party's primary election in late 2016. His popularity in the polls has dropped since allegations emerged that he had paid salaries to his wife and children for jobs that were alledged to be fake. This investigation is ongoing.

Fillon comes from western France, whichis known to be traditionally conservative. While his foreign policies are softer than Le Pen's, he is also promising tougher border controls and stricter regulation of Islam. While Fillon is not a supporter of Europe, his policies focus on reform rather than an outright exit. He promises to sack 500,000 government officials and cut EUR 100 billion from the budget. He has also targeted the 35-hour week and retirement age, and is proposing tax cuts for business and the wealthy in an attempt to boost economic growth.

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A run-off is almost certain to take place

It's highly unlikely that any candidate will win via an outright majority in the first round of voting. As such, a run-off is almost certain to take place.

Polling indicates that Le Pen is likely to make it to the run-off—with either Macron or Fillon her opponent. As at 10 April, polling shows that Macron and Le Pen are jointly leading the field, and Fillon is currently in third place having weakened significantly in the wake of his family's payments scandal.

While Le Pen appears well-placed to progress beyond the first round of voting, current polling shows that the run-off would likely see her opponent (whoever that may be) pick up the anti-right-wing vote, and this could lead to a heavy defeat for Le Pen. This scenario would be similar to her father's experience in 2002 when he was heavily defeated by Jacques Chirac in the run-off vote. However, as we have seen from the UK referendum and the most recent US presidential election, anything is possible in politics. In this case, we believe there are three likely outcomes:

Scenario 1—Marine Le Pen becomes president

If Le Pen becomes president, it's extremely unlikely she will be able to nominate a supportive prime minister. This means it's highly unlikely she will be able to implement her policies and push for a referendum for France to leave the EU. Even if she did call a referendum, the public would be voting to leave at a time when UK economic growth is expected to slow as a result of its departure from the EU. Although Le Pen looks likely to make it to the run-off, according to most polls, she's around 10% behind at this stage. We believe that the chance of Le Pen becoming president is the least likely of the three scenarios.

What it means for investors

This scenario would be the most disruptive for financial markets as it could potentially lead to the break-up of the EU. If Le Pen were to reach the run-off, then we're likely to see greater market volatility and more risk priced into markets. The potential for Le Pen to call a referendum appears limited—but if she becomes president, then political stability and confidence in Europe will be impacted.

Scenario 2—Macron or Fillon becomes president

The most likely outcome is that Macron or Fillon beats Le Pen in the run-off. Attention would then turn to the parliamentary election in June. A Macron or Fillon victory, combined with a supportive prime minister, would be a positive result for France and Europe as a whole. We would expect to see an improvement in French GDP via labour market reform and increased productivity.

What it means for investors

We think that European equities are beginning to look attractive

We expect that a victory for either Macron or Fillon following the run-off would provide relief for equity markets. This is because there would be a reduced risk of the EU breaking up. The prospect of increased productivity and growth from structural reform would also be positive for France and Europe as a whole. The French economy has suffered from a period of low productivity growth. In recent years it has lagged other major European economies such as Germany.

Scenario 3—Macron or Fillon are in co-habitation

If either Macron or Fillon become president, but their respective parties fail to gain a majority in the parliamentary election, they would be forced to nominate a prime minister from another party. This would make it difficult to push through any proposed policy changes.

What it means for investors

While this scenario would be beneficial for markets in that there would be a reduced risk of the EU breaking up, there is little likelihood there would be significant structural reform in France. This means that productivity would continue to lag Germany and economic growth would struggle to gain significant momentum.

Our long-term view on European equities

We think that European equities are beginning to look attractive. This is because valuations are signficiantly below long-term averages and don't appear to be in sync with the current economic environment. Also, after almost a decade of corporate profit declines, the most recent profit reporting season showed the first earnings growth in six years where a net 20% of companies beat their earnings estimates. Going forward, we believe that corporate earnings could be in for a period of sustainable growth, supported by improving economic data in Europe, expanding credit growth, falling unemployment, and a weaker Euro currency.

As the probability of Le Pen becoming president is very low, we believe that too much risk is being priced into the market. However, we recommend maintaining a neutral position in the near term until the election result is clear and we can remove political risk. We don't believe the current risk/reward trade-off warrants taking risk into the election—but we recommend that investors be prepared to allocate to select European equities if the election passes without incident.