

MARKET COMMENTARY

Assessing the risks from the French snap elections

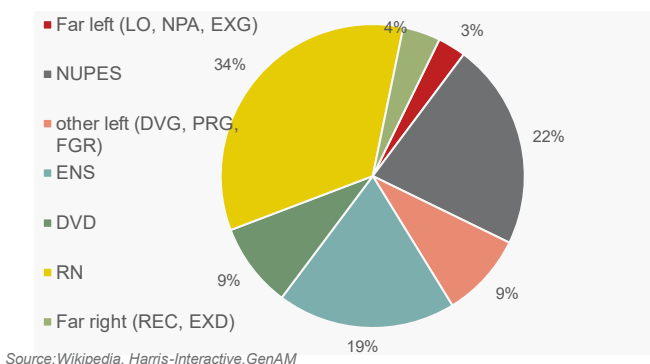
Macro & Market Research

June 13, 2024

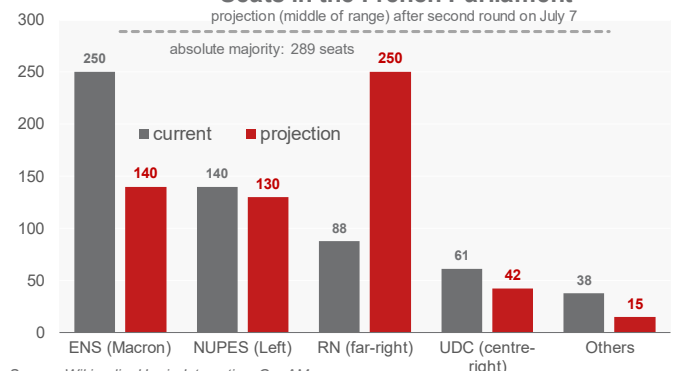
- **President Macron has unexpectedly called for a snap election. The voting system – different from that of the European elections – makes predictions difficult, but it looks like this may backfire, like it did for President Chirac in 1997.**
- **A lack of majority (stalemate) or a RN-led government appear to be the most likely scenarios. We discuss those, as well as four alternatives.**
- **Key market focus will be on fiscal risks. Reassuringly, Le Pen’s ultimate target is to win the 2027 Presidential election, and she will be keen to avoid a repeat of the Salvini and Truss fiscal and market crises. Investors will also fret about the risks of a much slower pace of European integration and wavering support for Ukraine.**
- **In a highly fluid and uncertain environment, market concerns may grow into the first round on 30 June.**

France unexpectedly goes to the ballots: In last weekend’s European elections the right-wing National Rally (RN) party of Marine Le Pen emerged as the winner with 31.4% of the votes, about twice as much votes as President Macron’s Renaissance party (14.6%). In a surprise decision, Macron dissolved the Parliament for snap elections on June 30 (1st round) and July 7 (2nd round). The most similar dissolution, since the launch of the 5th Republic in 1958, is Jacques Chirac’s one in 1997; it was also seen as a tactical manoeuvre, which ended badly with the President losing his large majority in Parliament. Other dissolutions from Charles de Gaulle in 1962 and 1968, or François Mitterrand in 1981 and 1988 were far more justified, and successful. The deadlines for these elections are exceptionally short: this will be the shortest campaign ever, indeed, which will not assuage popular concerns about a dysfunctional democratic life.

Latest poll on first round of election



Seats in the French Parliament



A marked change in the French political landscape ahead: First polls right after the snap election announcement show the right-wing RN becoming strongest again but not achieving an absolute majority, even with a coalition with other far-right parties. RN is projected to fall short of an absolute majority in parliament (235-265 expected vs 289 needed). Conversely, the President's coalition (Ensemble) is set to lose strongly (from 246 to 125-155). Based on these projections we below discuss realistic outcomes. However, the two-round election procedure makes forecasts on seat distributions particularly uncertain. The 577 deputies of the Parliament are directly elected in separate constituencies. In each of them, a candidate must win 50% of the votes, representing at least 25% of the registered voters, to win in the first round. Otherwise, a second ballot among the highest scoring candidates is necessary (most often top 2, sometimes top 3 if they each received votes from at least 12.5% of the registered voters).

Amid a highly fluid situation, we see two likely outcomes, three possible alternatives and a highly unlikely one (chart below shows those outcomes by order of probability, in our very humble opinion). Variations of those scenarios exist, and the outcome remains speculative. Importantly, the Constitution says that the **President cannot call another election for a full 12 months**.

No absolute majority	RN (National Rally) absolute majority	RN & LR dissidents absolute majority	Grand Coalition (Macron, PS, LR)	(Left) Front Populaire (relative) majority	Macron (relative) majority
<ul style="list-style-type: none"> • Most likely • RN most likely the largest group in Parliament, c. 250 • President may pick a PM in civil society • Very hard to run country & pass laws • Key finance law in autumn difficult • Deeper political crisis and new elections in 1 year? 	<ul style="list-style-type: none"> • Unlikely but possible • Proposals imply €100bn (>3% GDP) of unfunded spending, to be watered down. • Macron still has prerogatives (defence, foreign affairs, signs decrees etc.) • Neg. EU integration • Tense cohabitation. Street violence? New elections in 1y? 	<ul style="list-style-type: none"> • Still unlikely, not clear if even possible, given that LR is currently rejecting Ciotti's proposed alliance with RN • Some alignment on security, immigration • Large eco policy diff., fiscally sounder than RN alone • Street violence? • Neg. EU integration. 	<ul style="list-style-type: none"> • Grand national coalition probably Macron's best hope. • Will be hard to make the numbers work, though a relative majority may be possible (if just so). • Not sure LR & PS would accept, given policy differences. • Unstable and ineffective. 	<ul style="list-style-type: none"> • Very unlikely, given that the joint left is polling at around 160 seats • This alliance is very tactical/opportunistic, with very large policy differences – esp. on the economy. • Bearish OATs & CAC. LFI alone most bearish OATs and CAC. 	<ul style="list-style-type: none"> • Highly unlikely, given that the current (relative) majority is set to lose some 100 seats (from 250). • This would be a continuation of the current situation, in an even more politically fragile set-up. • Still dysfunctional.

One of the most likely scenarios sees no absolute majority in Parliament. The right-wing RN will likely win the largest number of seats, but not enough to create an absolute majority. Would President Macron install a non-politician at Matignon (Prime Minister's office)? Maybe, but passing laws, e.g. the budget in autumn, would then prove difficult. Arguably, President Macron, since the spring 2022 general election, could no longer rely on an absolute majority in Parliament. To enact laws, the government had to rely on the support of other MPs (from opposition parties) or Article 49.3, which circumvents the parliamentary vote. The opposition over the past 2 years never agreed on censoring the government with a majority, which would have defeated the 49.3 process and toppled the government. The new composition of the Assembly may make it more difficult to use Article 49.3 – often considered as a democratic artefact – so extensively.

Another possible scenario sees the RN winning an absolute majority, with or without the support of the most radical LR MPs (dissidents). Whether RN needs that partial LR support or not matters (3rd scen. in chart), as their inclusion would likely improve the perception about the upcoming fiscal stance (more responsible). Still, such 'cohabitation' would see repeated clashes between the President and the government. Importantly, the President would retain some prerogatives, e.g. signing decrees, and as such could complicate the life of the government. The latter itself may push for a referendum, e.g. on immigration, which would likely be rejected by the President and/or the Conseil Constitutionnel, deepening the political crisis. The President also predominates when it comes to defence and foreign policy, but the Prime Minister would also sit at the EU Council. In this scenario, investors would fret about international implications, e.g. the support to Ukraine may waver or measures fostering closer integration might be vetoed.

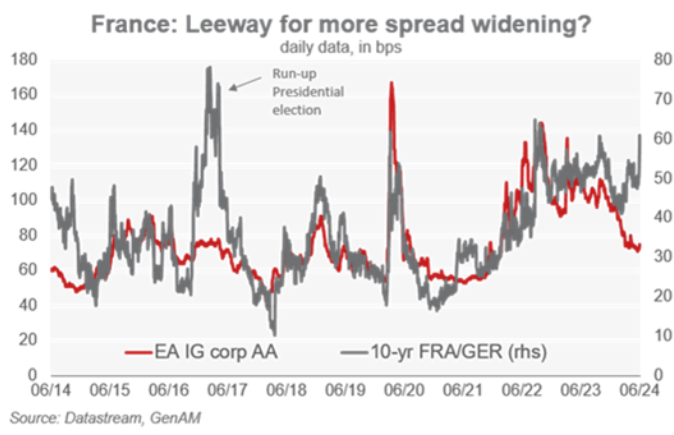
The most market-friendly scenario probably sees Macron's coalition retaining a relative majority (scen 4 above), but this now looks virtually impossible. The **'second best' from a financial market angle** sees a grand coalition comprising Macron's MPs (ENS), the moderate Left (Social Democrats, PS) and the moderate right (Les Républicains, LR, which has just excluded President Ciotti after he proposed a deal with RN). This would keep the RN away from Matignon. This looks numerically difficult, however, and it is not clear whether the traditional left and right (PS and LR) would ever want to engage in such an unnatural coalition, given the large policy differences and the potential political costs into the 2027 Presidential (and probably legislative) elections.

A fifth scenario sees the united left (Front Populaire) winning the largest number of seats, giving them a relative or even a full majority. This currently looks highly unlikely. However the Social Democrats (PS) will get about one third of the constituencies (175) and could benefit in the second round from is left of the so-called ‘front républicain’ (voters’ effort to keep the extremes away from government). Leftist policies would hurt French markets, but the relative heavy weight of the Social Democrats would likely prevent LFI from applying their extremely disruptive programme. This alliance is very unnatural, given the large policy differences within the alliance, hence the political environment would likely remain unstable. Finally, in a sixth but very unlikely scenario Macron and allies would retain a relative majority in a continuation of the current situation.

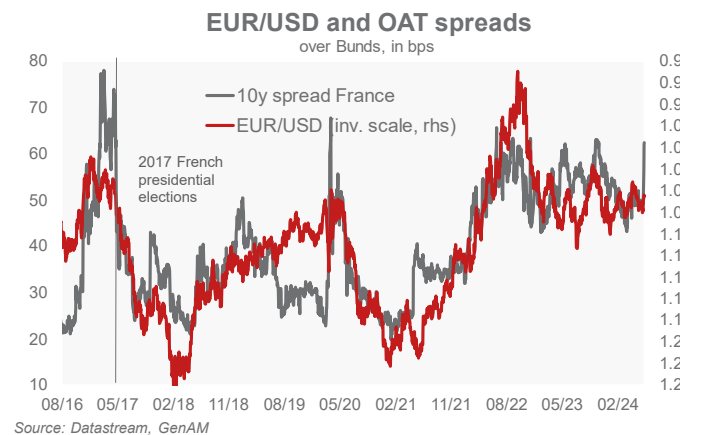
→ **In all, political uncertainty has surged and the risk of political stalemate is significant.** In any case the power of Macron’s own party (Renaissance, formerly known as En Marche) and coalition (ENS or Ensemble, which includes then centrist Modem and moderate-right Horizon) is set to weaken sharply. **Unless a grand coalition keeps the extreme parties away from the government, the chances and speed of a deepening of EU integration will likely fall.**

Higher risk of fiscal profligacy clouds rating outlook: French public finances are already not in a good shape. The fiscal deficit was at 5.5% in 2023 and is according to the EC set to recede to 5.0% by 2025 only, while the debt ratio is forecast to advance from 110.6% in 2023 to 113.8% by 2025. Deteriorated fiscal metrics were the key reason why S&P recently downgraded France from AA to AA-. Any new government will face further fiscal consolidation needs to make the budget compliant with the updated EU rules (see below). While the fiscal plans of the future government are highly speculative, we fear that horse trading to overcome policy differences would ultimately result in increased spending. Moody’s (whose rating is one notch above Fitch and S&P’s equivalent score) already **warned** about this risk, explicitly stating that currently stable outlook and eventually the rating itself may well be cut to negative on worsening debt metrics. Looking further ahead, if the medium-term public finance outlook were to deteriorate lastingly, further rating actions could come on the table. **Fitch** also raised some concerns.

A clash with European rules? As the Stability and Growth Pact is no longer suspended and France missed the objectives, an Excessive Deficit Procedure (EDP) will highly likely be launched. This will add pressures on French politics and be carefully watched by other governments with excessive deficits. Defection by a core country like France would significantly complicate the enforcement of the new fiscal rules. In autumn the 2025 budget will be discussed and submitted to the EC. While the European



Source: Datastream, GenAM



Source: Datastream, GenAM

Commission has been awarded higher discretion in assessing national consolidation plans, it will have little appetite to approve insufficient proposals, leaving scope for fresh tensions between the EC and a new French government into autumn, especially in case of a cohabitation.

Government bonds: In response to the announcement of snap elections, the OAT/Bund spread has widened by up to 15 bps across all maturities. The 10-year OAT/Bund spread is currently at 61 bps, the highest level since October 2023. This means that the underperformance observed over several months, not only against Bunds, has recently accelerated. E.g., the 10-year OAT/Bono spread had already narrowed by 20 bps to 25 bps since February (currently 18 bps). This reflects, among other things, the challenging fiscal situation of France described above.

Political uncertainty will remain high in the run-up to the elections and may even increase further, given the fluid situation. Accordingly, **we see scope for the 10-year OAT/Bund spread to widen somewhat further.** The 2017 Presidential election campaign period can be seen as a reference here. At that time, the spread peaked at over 75 bps (see chart). Arguably, markets then worried

about the risk of 'Frexit', which has since been removed from the RN's manifesto. But public debt and bond yields are now much more elevated, making debt sustainability concerns more serious.

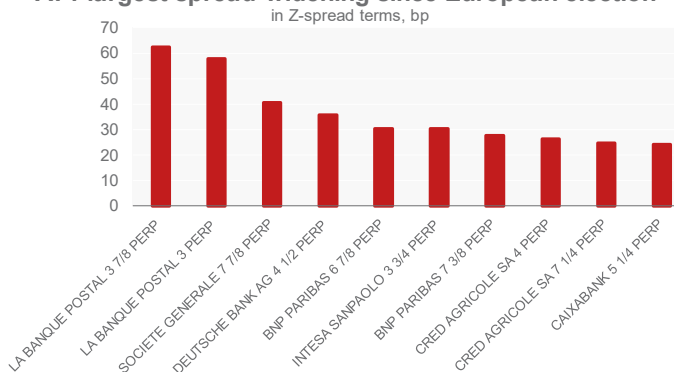
The further spread development will be largely determined by the majority in the new parliament. Should President Macron succeed in forming a government without the RN, expect a spread narrowing. However, the tightening would likely be limited, as the implementation of structural reforms and the necessary fiscal consolidation will continue to present challenges. We do not forecast a return to the OAT/Bund spread that existed prior to the European elections.

It is challenging to anticipate the government bond spread impact of an RN-led government, given that the party has never governed at national level. However, it has previously expressed support for tax cuts and spending increases. The 2022 manifesto – which has yet to be updated – is estimated to include some €100bn of unfunded spending (>3% GDP), though this would surely be watered down. Already Jordan Bardella, who is running for Prime Minister position, has started to pedal back on the promise to unwind the pension reform. **Marine Le Pen's ambition is to win the 2027 Presidential Election, and she will be keen to avoid a fiscal crisis like Italy's Salvini and the UK's Truss.** A coalition with LR dissidents would also imply a more responsible fiscal policy. Still, a RN-led government would give rise to concerns among investors and pave the way for a further increase in spreads – notwithstanding the hopes of a market-friendly outcome similar to that of the government led by Meloni in Italy.

The announcement of snap elections also has implications for other euro area bond markets. Spreads of EA non-core bonds versus Bunds have also widened since the weekend results. However, the spillovers have been limited, as the snap elections are largely seen as a country-specific matter. Yet with market uncertainty likely to continue at least until the elections, we see leeway for a further moderate spread widening for Southern European bonds (albeit with a lower beta to OATs than usual).

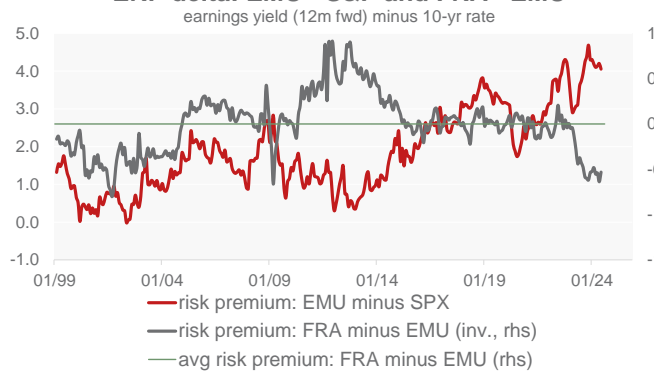
FX: The EUR initially suffered following Macron's snap election announcement, extending last week's losses in the wake of the strong US labour market report, but EUR/USD is now little changed from last week's close after lower US CPI numbers. Compared to the strong widening in French OAT spreads, this seems a muted reaction (see chart). That said, even in the 2017 election campaign, when Ms. Le Pen mulled a Frexit and OAT spreads widened to 80bp, the EUR/USD impact proved relatively contained.

AT1 largest spread widening since European election



Source: Bloomberg, GenAM own calculations

ERP delta: EMU - S&P and FRA - EMU



Source: Datastream, GenAM calculations

We neither expect a deep EUR sell-off over the next weeks, but amid the current environment, notably the ECB leading the Fed in the easing cycle, the **risks are tilted to some further dips in the EUR/USD.**

Credit: In credit markets we have seen so far a very moderate risk off reaction with more pronounced spread widening observed on subordinated bonds issued either by French banks or utilities. Going forward we expect moderate pressure to remain on those players but we remain constructive on the asset class.

Equities: Over the last month, the MSCI France index has lost 5%, of which 2.5% since the EU election results and Macron's call for a snap election. Investors may be reconsidering the EU reform process, keeping the EMU equity risk premium (ERP) over the US at a very high level. The French stock index offers a weaker earnings momentum and a lower ERP than the EMU index. This ERP gap is also lower than its historical average (France is thus "expensive" vs. EMU). The French ERP vs. EMU could rise by at least 0.5% to reach the historical norm. This would represent a relative underperformance of 5% vs. EMU. French financials, energy and materials look expensive relative to EU peers, thus potentially more vulnerable. Conversely, business services, food retail and telecoms look cheap relative to EMU.

EM: France is systemic for Europe, but not globally. The impact on global markets and EM assets in particular should be minimal. Almost 80% of EM external debt is labelled in USD and the main EM issuers are out of the CEE region. The external debt asset class is mainly driven by USD investors. We do not see impacts on local debt. At the regional level, even for the CEE, the consequences should be marginal. A good template is the 2017 French Presidential elections when OAT/Bund spread widened, but CEE countries were barely affected. If anything, dips in EUR/USD may have some limited and temporary effects on CEE FX.

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