# Investment Strategy Note

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بنك أبوظبي التجاري ADCB

## Should we really worry about Frexit?

**Luciano Jannelli, Ph.D., CFA**
Head Investment Strategy
Tel: +971 (0)2 696 2340
luciano.jannelli@adcb.com

**Wietse Nijenhuis**
Equity Strategist
Tel: +971 (0)2 696 5123
wietse.nijenhuis@adcb.com

**Prerana Seth**
Fixed Income Strategist
Tel: +971 (0)2 696 2878
prerana.seth@adcb.com

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### French election risk has taken unexpected twist, brace for the worst this Sunday, but stay cool over the longer term

*This note is not suggesting that a French populist presidency is the most likely outcome, let alone an inevitability. We are merely advising our clients of the increased probability of a surge in risk come April 23, and its potential implications, bad in the short run, arguably manageable over the medium term.*

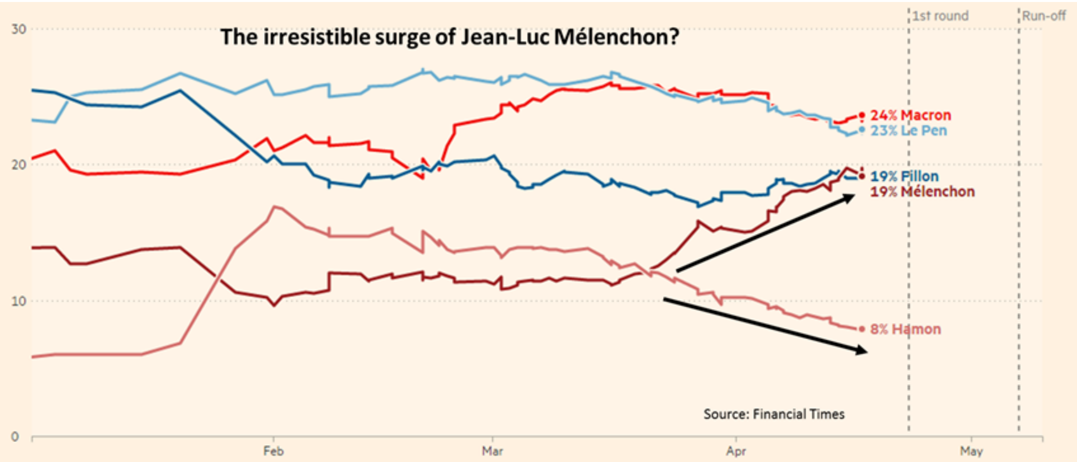
- The first round of the French election this Sunday (April 23) looks suddenly more risky than expected earlier;
- "New" Risk is no longer coming from Mrs. Le Pen, but from the far left candidate Jean-Luc Mélenchon;
- The prospect of Mr. Mélenchon making it to the May 7 runoff, whilst still not the most likely outcome according to the polls, can no longer be excluded;
- Unlike Mrs. Le Pen who is expected to lose with a wide margin in any runoff, Mr. Mélenchon is expected to stand a reasonable chance in all possible runoff scenarios;
- **A Mélenchon runoff participation is not being discounted by the markets. If it were to happen, expect the euro to drop significantly, and global risk assets (in particular equities) to suffer a correction;**
- **Western democracies are showing a remarkable capacity to "cage in" and "moderate" populist politicians (Trump), and possibly also populist ideas (Brexit). Whatever the outcome of the election, it is worthwhile to point out that the French people do not want to leave Europe's single currency, and by a wide margin. Thus the eventual victory of a populist candidate would, yes, trigger a significant market pull-back. Such pullback has anyway been in the air over the last months. It could also constitute an interesting buying opportunity;**
- **We stick to our recommendation for meaningful Treasury and gold portfolio holdings, and remain for now equity neutral.**

## The French populist threat is very much unlike Brexit and Trump, in many ways

Since last summer we have stressed that political risk in Europe was fading since all Euro-zone electorates, with the notable exception of Italy which will go to the polls only in 2018, have become increasingly supportive of the single currency. A lot of that support has to do with the presence of welfare systems which are more absent in the UK and the US, and which have somehow mitigated the impact of globalization on income distribution in the countries concerned. In addition, the breakup of the Euro-zone would arguably be much more frightening for most continental Europeans than Brexit ever was for Britons, or a Trump presidency for Americans. Not surprisingly, the polling gap of Marine Le Pen, hitherto the main French populist candidate, in a runoff scenario with Emmanuel Macron has consistently been above 20%, and above 10% in case François Fillon would make it to the second round. This in no way can be compared with Donald Trump who, yes, surprised to the upside on election day, but whose polling gap versus Hillary Clinton was almost always in the single digit zone, and frequently within the statistical margin of error area.

Enter Jean-Luc Mélenchon.

The peculiar French voting system, combined with the current political polarization in the country, means that Le Pen and Mélenchon could make it to the second round ballot, even if together they don't obtain half of the country's votes. What is most frightening is the recent surge of Mélenchon in the polls. And whilst it might be reassuring that this surge has coincided with the demise of the socialist candidate Benoît Hamon, it should be pointed out that the political differences between Mélenchon and Hamon are not that big. A further migration from Mr. Hamon's electoral basin could be sufficient to push Mélenchon in the runoff.




There is, unfortunately, another significant difference between Brexit and Trump on one hand, and a populist Eurosceptic French presidency on the other hand. Indeed, in hindsight one could argue that Brexit was a "trading opportunity", whilst Trump was a "game changer". Neither event resulted in a major risk-off episode, with the Brexit correction lasting a few days, and the Trump correction no more than a few hours. In this note we argue that Mr. Mélenchon making it to the second round ballot, especially if in the company of Mrs. Le Pen (a much less likely winner in any runoff), could easily lead to a much heavier market correction than we saw in the aftermath of the Brexit vote (or in the immediate aftermath of the Trump election). A French president who would want to seriously renegotiate the EU Treaties (Mélenchon ) or invoke a euro referendum (Le Pen), without necessarily pursuing further market reforms and deregulation whilst potentially erecting trade barriers (both Mélenchon and Le Pen), appears on the face of it something much more dramatic than Brexit or Trump. This is so because it would have the potential to jeopardize the long-standing Franco-German relationship on which the European Union has been built. Speculation about all that could potentially lead to much more significant market reactions.

**But populism across all western democracies is getting caged in, France likely to fall in place too, worst case scenario is probably a buying opportunity**

France is, however, similar to the US and the UK in that it is a mature democracy with a still very wealthy society (although arguably with a bit more of a revolutionary political spirit compared to the Anglo-Saxons!). Over the last months, we have seen how easily US Courts have been able to put a check on Mr. Trump's most controversial executive orders, and how the US Congress has not allowed the repeal of the Affordable Care Act that that would have left a significant number of Americans without health coverage. At the same time, and whatever the implications in terms of a "softer" or "harder" Brexit, Mrs. May decision to call a new election is also a clear move to reassert parliament's prerogatives over a political agenda that seemed to had been captured a bit too much by the hardline winners of the Brexit referendum. Would one not have expected just that from the world's oldest parliamentary democracy? France has of course its own political system, but in France too there are checks and balances: the President has to cope with a Parliament that must approve the government and budgetary laws and, guess what, neither the Front National nor the followers of Mr. Mélenchon are ever likely to gain control over parliament. As such, it is reasonable to assume that the market's reaction in case Mélenchon (with or without Mrs. Le Pen) would move to the second round, would be excessive, and thus a buying opportunity.

| Four possible electoral outcomes | Expected immediate market reaction | Degree of surprise / broader implications |
|---|---|---|
| Macron – Fillon | Euro: up<br>Yields: up<br>Spreads: down<br>Equities: brief and moderate rally | Not expected by the market: this scenario would give a boost to Euro-zone confidence |
| Macron – Le Pen | Euro: stable to up<br>Yields: stable<br>Spreads: stable<br>Equities: stable | Expected by the market. Macron should easily beat Le Pen in the May 7 runoff |
| Le Pen – Fillon | Euro: stable to down<br>Yields: down<br>Spreads: up<br>Equities: stable to down | Not expected by the market: this scenario would increase Le Pen chances, thus boost uncertainty, thus volatility until May 7 runoff |
| Le Pen - Mélenchon | Euro: sharply down<br>Yields: down<br>Spreads: jump<br>Equities: down | Big market surprise: we would argue that the French institutions would over time "cage in" the populist presidency, such that markets would rebound soon, and this could be a good buying opportunity |

## Sources

*All information in this report has been obtained from the following sources except where indicated otherwise:*

1. *Bloomberg*
2. *Wall Street Journal*
3. *RTTNews*
4. *Reuters*
5. *Gulfbase*
6. *Zawya*

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