

Should we really worry about Frexit?

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.

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

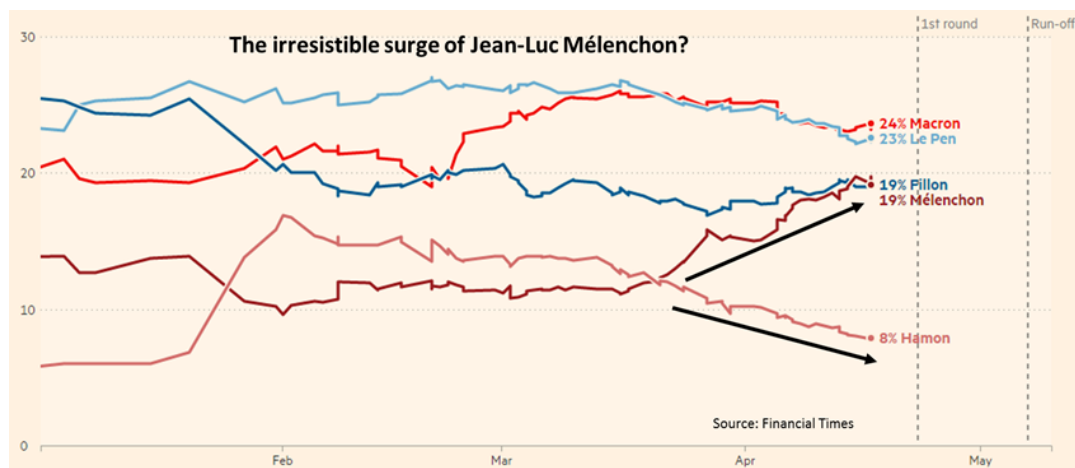
Visit our [Investment Strategy Webpage](#) to read our other reports.

Investment Strategy Note

20 April 2017

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

Investment Strategy Note

20 April 2017

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 Yields: up Spreads: down 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 Yields: stable Spreads: stable Equities: stable	Expected by the market. Macron should easily beat Le Pen in the May 7 runoff
Le Pen – Fillon	Euro: stable to down Yields: down Spreads: up 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 Yields: down Spreads: jump 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

Investment Strategy Note

20 April 2017



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

Disclaimer

This publication is intended for general information purposes only. It should not be construed as an offer, recommendation or solicitation to purchase or dispose of any securities or to enter in any transaction or adopt any hedging, trading or investment strategy. Neither this publication nor anything contained herein shall form the basis of any contract or commitment whatsoever. Distribution of this publication does not oblige Abu Dhabi Commercial Bank PJSC ("ADCB") to enter into any transaction.

The content of this publication should not be considered legal, regulatory, credit, tax or accounting advice. Anyone proposing to rely on or use the information contained in the publication should independently verify and check the accuracy, completeness, reliability and suitability of the information and should obtain independent and specific advice from appropriate professionals or experts regarding information contained in this publication.

Information contained herein is based on various sources, including but not limited to public information, annual reports and statistical data that ADCB considers accurate and reliable. However, ADCB makes no representation or warranty as to the accuracy or completeness of any statement made in or in connection with this publication and accepts no responsibility whatsoever for any loss or damage caused by any act or omission taken as a result of the information contained in this publication. This publication is intended for qualified customers of ADCB.

Charts, graphs and related data or information provided in this publication are intended to serve for illustrative purposes only. The information contained in this publication is prepared as of a particular date and time and will not reflect subsequent changes in the market or changes in any other factors relevant to their determination. All statements as to future matters are not guaranteed to be accurate. ADCB expressly disclaims any obligation to update or revise any forward looking statements to reflect new information, events or circumstances after the date of this publication or to reflect the occurrence of unanticipated events.

ADCB does and may at any time solicit or provide commercial banking, investment banking, credit, advisory or other services to the companies covered in its publications. As a result, recipients of this publication should be aware that any or all of the foregoing services may at time give rise to a conflict of interest that could affect the objectivity of this publication.

Past performance does not guarantee future results. Investment products are not bank deposits and are not guaranteed by ADCB. They are subject to investment risks, including possible loss of principal amount invested. Please refer to ADCB's Terms and Conditions for Investment Services.

This publication is being furnished to you solely for your information and neither it nor any part of it may be used, forwarded, disclosed, distributed or delivered to anyone else. You may not copy, reproduce, display, modify or create derivative works from any data or information contained in this publication.