Avoid French government bonds for now; a better buying opportunity may emerge in the months ahead.

Alpine Macro's latest Geopolitical Strategy report, "A 2024 Elections Preview (Part III): France's Too-Clever-By-Half Election" discusses the potential outcomes of the upcoming French legislative elections and analyzes their market implications.

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GEOPOLITICAL STRATEGY

June 19, 2024

A 2024 Elections Preview (Part III): France's Too-Clever-By-Half Election

- President Macron's call for legislative elections is likely to backfire, weakening him.
- Market jitters focus on the risk of a far-right government, but such a government would likely moderate in power. The bigger risk is a far-left dominated government.
- Avoid French government bonds for now; a better buying opportunity may emerge in the months ahead.
- French assets could be attractive, especially if they sell off due to elections, as the main risk of a far-left dominated government will likely be avoided.
- From a political risk perspective, U.K. assets are better positioned than French ones.

In This Report

The European Parliament elections played out as expected[1], with right-wing parties making significant gains. Notably, in France, the far-right French National Rally (RN) gained more than twice the votes of President Emmanuel Macron's liberal Ensemble party (ENS).

Unexpectedly, President Macron then called a snap legislative election. Macron, with three years left in his presidential term and popularity hovering in the 30% range, gambled that an election could rally all other political forces opposed to the far-right RN around him, blunting the threat of an RN government. Alternatively, Macron likely calculated that should the RN win the election, governing France would dent its popularity ahead of the all-important 2027 presidential elections[2], lessening the risk of a Marine Le Pen presidency.

Another factor for Macron calling elections is his lack of a parliamentary majority, which would have made passing a 2025 budget a major hurdle. Failure to pass a budget would have led to the fall of the current Macron-aligned minority government anyway.

1 Alpine Macro Geopolitical Strategy "A 2024 Elections Preview (Part II): Europe's Rightward Drift and The U.S.' Legal Rift" (June 05, 2024).

2 In France's semi-presidential political system, the Prime Minister is appointed by the National Assembly, and his powers do not extend to foreign affairs and national security, which are the preserve of the Presidency.

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Tipping Point In Financial Markets: A Melt-up or Meltdown?

Agenda

08:10 - 08:30 **Opening Remarks : The Shifting Macro Landscape: Opportunities & Risks**
Chen Zhao, Chief Global Strategist

08:30 - 9:30 **Emerging Mega Trends: How Should Investors Be Prepared?**
Ruchir Sharma, Chairman of Rockefeller International and Founder and Chief Investment Officer of Breakout Capital

09:30 - 10:30 **Inflation, Disinflation and Fed Policy: Are We on the Right Path?**
Mike Dooley, Professor Emeritus at University of California, Santa Cruz and Chief Economist at Figure Technologies

10:30 - 10:45 Coffee Break

10:45 - 11:45 **Fireside Chat: Bull Bear Debate**
Francois Trahan, Founding Partner of The Macro Institute Versus
Jim Paulsen, Author of the Paulsen Perspectives research newsletter on Substack

11:45 - 12:30 **The Long and Shorts of U.S. Equities**
Gina Martin Adams, Bloomberg Intelligence Global Director of Portfolio Strategy, Chief Equity Strategist

12:30 - 14:15 **Luncheon Speaker: Biden Vs Trump: How The World Will Be Changed**
Greg Valliere, Chief U.S. Policy Strategist AGF Investments

14:15 - 15:00 **How Is AI Reshaping the Money Management Business?**
Gareth Shepherd, Co-Head of Voya Machine Intelligence (VMI) & Portfolio Manager, Voya Investment Management

15:00 - 15:15 Coffee Break

15:15 - 16:30 **Commodity Panel: Secular Trend, Energy and Prospect of ESG**
Tavi Costa, Partner/Macro Strategist at Crescat Capital
Lenka Martinek, Managing Partner, Sustainable Market Strategies, Nordis Capital
Adam Rozencwajg, Managing Partner, Goehring & Rozencwajg

16:30 - 17:30 **Cocktails & Networking**

Guest Speakers + Alpine Macro Strategists


Ruchir Sharma


Greg Valliere


Mike Dooley


Gareth Shepherd


Francois Trahan


Tavi Costa


Jim Paulsen


Lenka Martinek


Gina Martin Adams


Adam Rozencwajg

Conference Details & Registration: conference.alpinemacro.com | conference@alpinemacro.com | +1 (514) 558-1414

Chart 1 European Bond Spreads Widened After The French Election Announcement

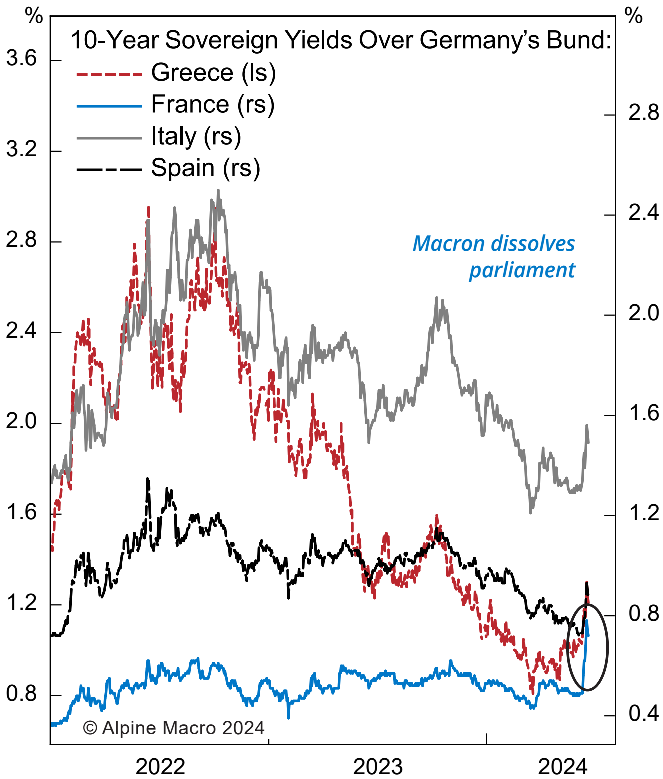
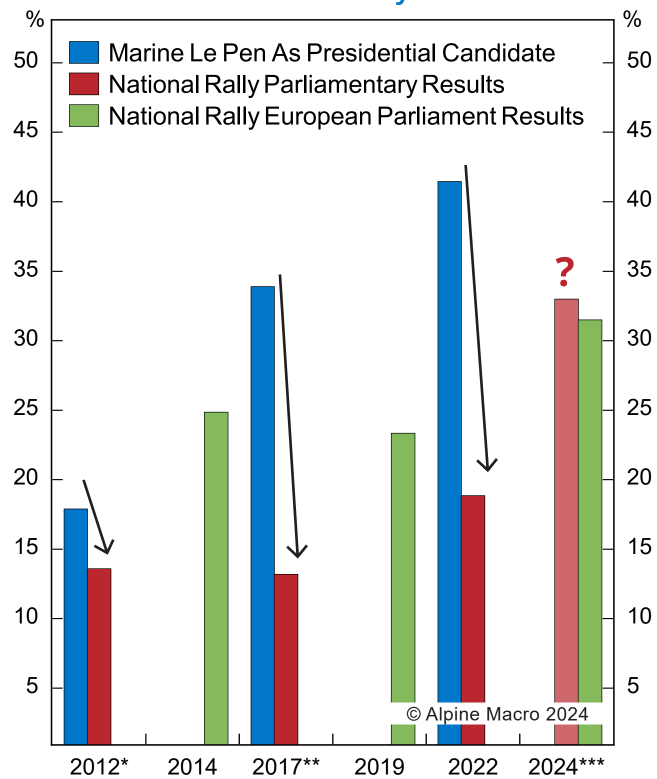


Chart 2 The National Rally Underperforms In Parliamentary Elections



*First round, Le Pen did not make it to the second round
**Second round presidential election results
***2024 Parliamentary data is current RN Polling
Note: National Rally was formerly known as the National Front

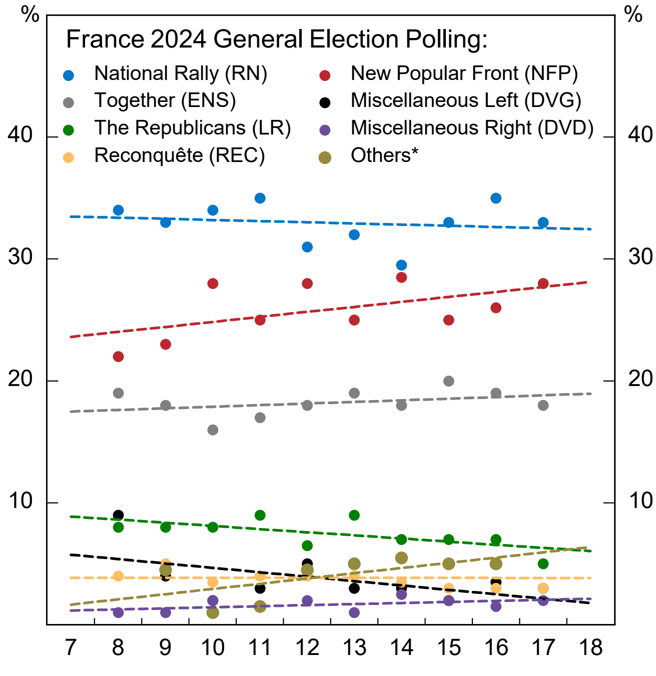
Markets reacted poorly to Macron's decision, selling off largely on the fear of a far-right RN government. The CAC 40 was down by over 6% during the following week, while the spread between French and German 10-year bonds rose by 27bps, on heightened political risk. Panic spread to other European assets, with other government bond spreads widening (**Chart 1**).

The elections are scheduled for June 30 and July 7. Parliament is elected in two rounds, where candidates that poll over 12.5% of the votes in the first round (if nobody gets 50%) advance to the second round. This system has historically favored centrist parties, as moderate voters tend to vote tactically in the second round to shut out radical candidates. For example, the RN has always underperformed in legislative elections (relative to its presidential and European Parliament results) due to tactical voting (**Chart 2**). This is what Macron is gambling on.

Macron may have calculated that centrist parties will prevail. Yet, it seems his gamble may be misfiring. The most extreme parties are polling extremely well, while the centrist/liberal parties are unpopular. Polling shows that the RN is ahead with over 30% of the votes, while a coalition of left to extreme left parties, quickly assembled after Macron called elections, the New Popular Front (NFP), is polling in second place (**Chart 3**). Macron clearly did not expect a strong far-left coalition.

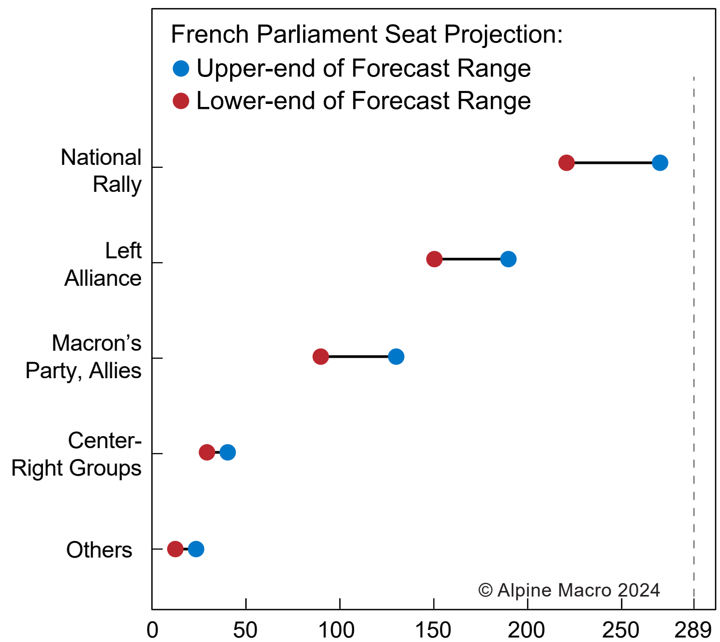
Most estimates are that the RN will win most seats in parliament (**Chart 4**), falling just short of a

Chart 3 The RN And The NFP Lead In Polling



*Includes PA, DVC, DSV, REG, DIV
Source: Ifop, Opinion way, Cluster17, Harris-Interactive

Chart 4 Can The RN Reach The 289 Seats For A Majority?



Note: Online poll of 1502 people conducted June 11-12, 2024; source: Elabe

majority, with the NFP coming in second, ahead of the pro-Macron and other centrist parties. However, given the tactical voting in the second round of the elections, there is significant uncertainty about this outcome.

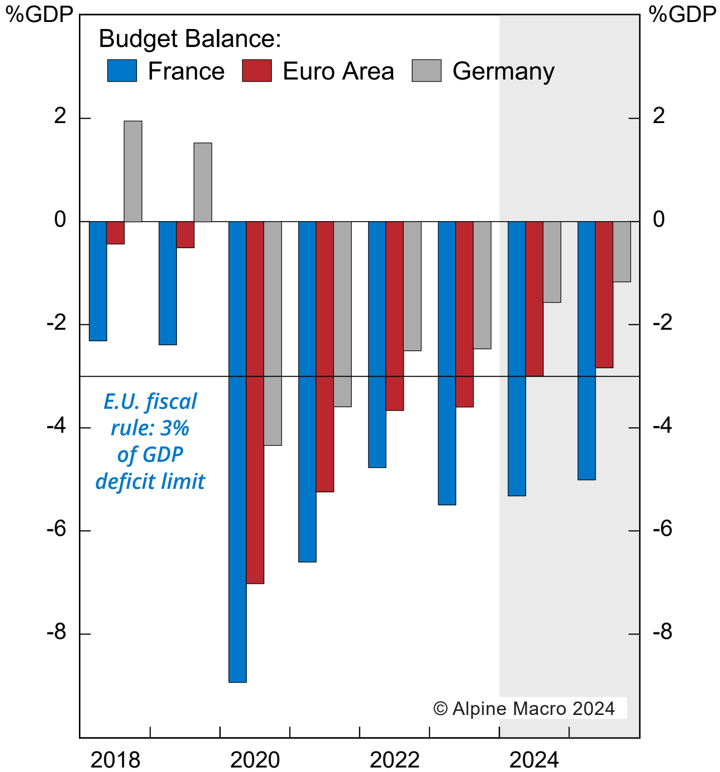
What is at stake? The main risks are around fiscal policymaking, decided by the parliament and the Prime Minister. Despite the markets' reaction, there is no risk of a Frexit, as was the case in 2017 if Marine Le Pen had won the presidency.

France's fiscal outlook is already challenging, as reflected by S&P's one-notch downgrade to AA- last month. France's budget deficit is -5.5% of GDP, below the E.U.'s -3% limit, and seems likely to stay there (**Chart 5**). The public debt is also very high for a developed economy, the third highest in the eurozone, at 112% of GDP, almost double the E.U.'s 60% guideline (**Chart 6**). France will be subject to the E.U.'s Excessive Deficit Procedure (EDP) from 2025 and will be required to further cut spending. The current government has promised to reduce the fiscal deficit by 1% per year until 2028, but even that will be challenging, especially as GDP growth is middling (**Chart 7**).

Investor fears center around an RN-led government or a government dominated by the NFP, either of which could be fiscally expansionist, as both the far-right and the far-left call for significant increases in social spending. However, we think markets are overreacting to the possibility of an RN government while underestimating the risks associated with a broad coalition government dominated by the far-left NFP.

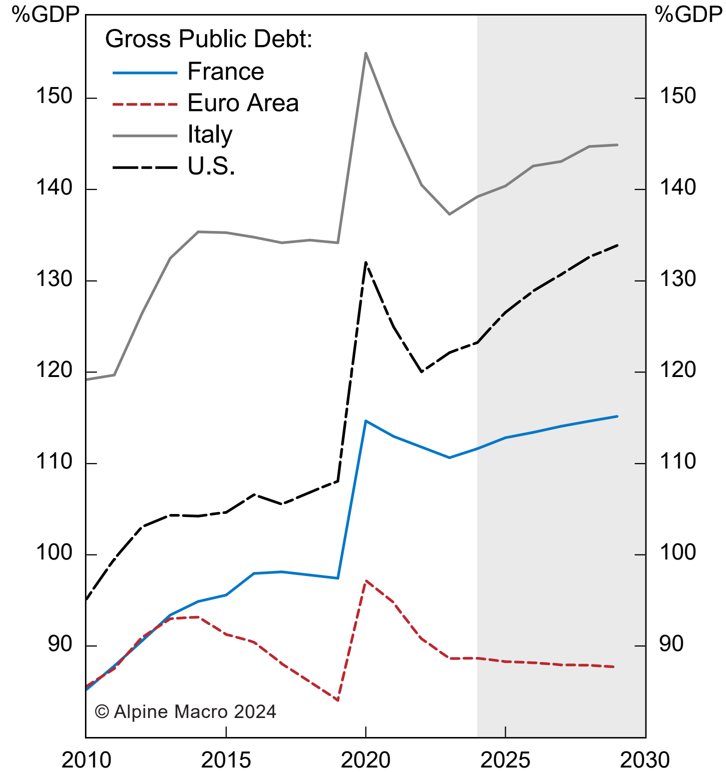
Looking at the elections, we see three broad scenarios, summarized in **Table 1** and detailed below.

Chart 5 France's Budget Deficit Will Stay High



Note: Shading denotes projections; source: European Commission

Chart 6 France's Debt/GDP Ratio

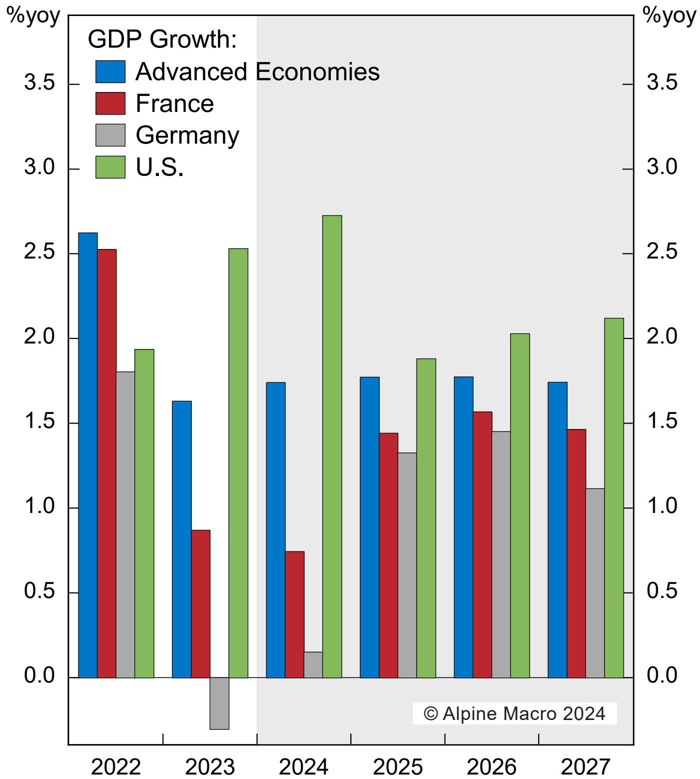


Note: Shading denotes projections; source: IMF

Table 1 The French Legislative Elections: Potential Outcomes And Impact

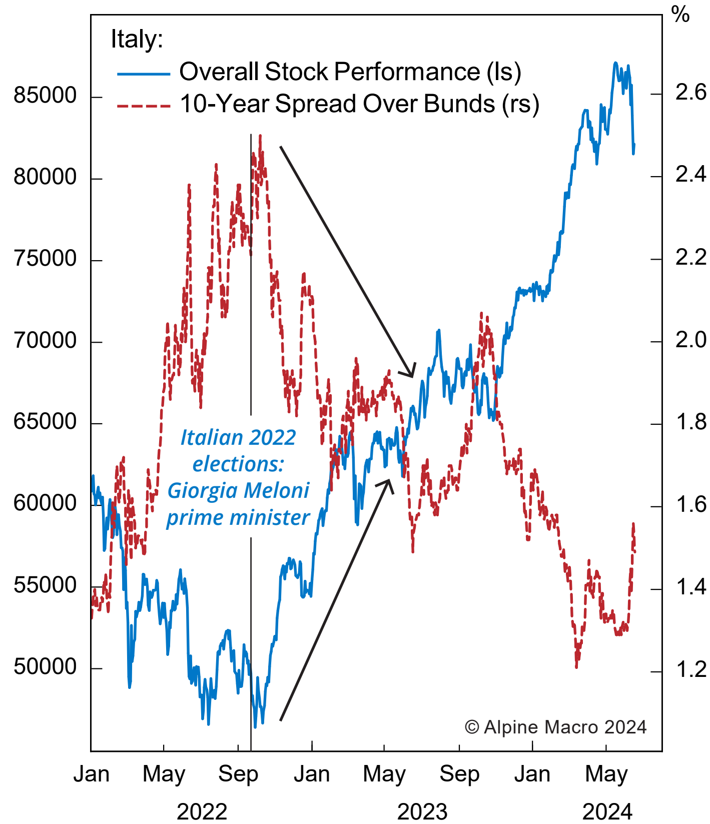
Scenarios	Likelihood	Immediate Market Reaction	Fiscal Policy	Government Bond Impact	Equities Impact	Currency Impact
1. RN-led government (a majority or in a coalition)	40%	Negative to neutral	Neutral	Negative at least initially	Negative initially, washes out over time	Short-term volatility
2. Centrist/ Macronist coalition government	30%	Positive	Neutral	Positive, relief rally	Positive, relief rally	Neutral to positive
3. An NFP-dominated left-wing coalition	30%	Negative	Negative	Negative	Negative	Short-term volatility

Chart 7 French GDP Growth Is Middling



Note: Shading denotes projections; source: IMF

Chart 8 Italy 2022: Meloni's Moderate Governance Boosts Markets



Scenario 1: An RN-led Government (40%)

The RN may win a slight majority, or enough seats to form a coalition with factions of other right-wing parties. We do not think there would be a dramatic difference between the RN governing with a majority or in coalition.

Why? Because once in power, the RN will likely moderate its far-right and populist stances, especially on fiscal issues, like Italy's Giorgia Meloni did after winning the 2022 elections. Markets sold off before Meloni's victory (**Chart 8**), but political risk diminished as her government pursued market-friendly policies. The RN leadership, including Marine Le Pen and the likely RN Prime Minister Jordan Bardella, are likely to follow a similar path, and are signalling moderation.

While the RN favors fiscally expansionary measures such as increased social spending and cutting VAT, it is aware that any fiscal expansion could lead to a bond sell-off and damage its popularity. Ultimately, the RN and Marine Le Pen aim for the French Presidency in 2027 and are thus incentivized to provide stability and govern from the center — meaning exercising more fiscal restraint than expected.

Scenario 2: Centrist/ Macronist Coalition Government (30%)

It is possible that Macron did not miscalculate, and that his ENS party, along with other centrist parties, gain a tenuous majority. It is also plausible that the NFP coalition splinters, with the Socialists and possibly the Greens joining Macron's governing coalition.

What has Macron gained in this case? Very little. The new parliament would be fractious, and his party the ENS, will not have a majority. The best outcome for Macron will thus be the current status quo, or something somewhat more chaotic. This is why Macron's snap election call is likely too clever by half.

Yet such an outcome would be welcomed by markets, leading to a relief rally in bonds and equities. A Macronist governing coalition would continue moderate fiscal consolidation, and debt metrics would likely improve, albeit slightly. France's sovereign credit ratings would likely be most stable under this scenario.

Scenario 3: An NFP-Dominated Left-Wing Coalition (30%)

Probably the worst-case market scenario is a coalition government between the NFP and Macron's ENS, with the NFP in the dominant role (i.e., choosing the Prime Minister), following NFP outperformance. The NFP is largely dominated by the extreme left France Unbowed Party (LFI) and includes the Communists, Greens, plus the more moderate Socialists.

An NFP government would be fiscally expansionist, aiming to undo Macron's pension and labor reforms, raise social spending, and impose significant taxes on corporations and the financial sector. Macron would struggle to blunt these moves, and fiscal consolidation would be implausible.

This scenario would create significant uncertainty and more risks than an RN government. While the RN has moderated in recent years to become more palatable to centrist voters, most of the parties in the NFP have radicalized.

Market Implications

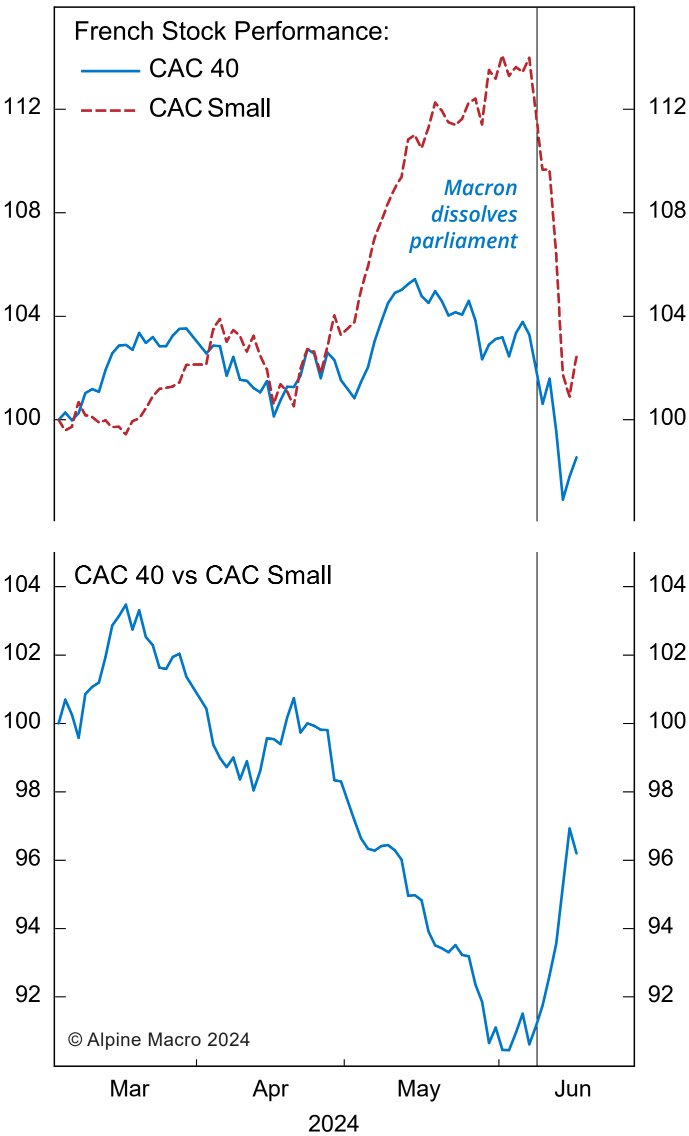
Until the election results and the next government fiscal policies are known, French sovereign bonds could remain volatile, and are best avoided for now. At a minimum, uncertainty could last until late July-August. That said, we think that bond market volatility will diminish afterwards, as our two scenarios of either an RN government that chooses to govern in a more fiscally moderate fashion (40%), or a centrist/Macronist parliamentary majority (30%) add up to a relatively neutral fiscal baseline.

However, bond spreads could further widen on an RN victory, as markets fear the RN could choose to govern in a fiscally irresponsible manner (and this is indeed a risk also to our call). We think this risk is quite small, and thus such fear-driven sell-off may be in fact a contrarian opportunity to buy into French government bonds. One thing to watch is whether the RN credibly signals adherence to fiscal probity (e.g. credible cabinet appointments, etc).

An NFP-dominated government would pose the main risk to the fiscal outlook, with likely longer-term negative consequences for French assets.

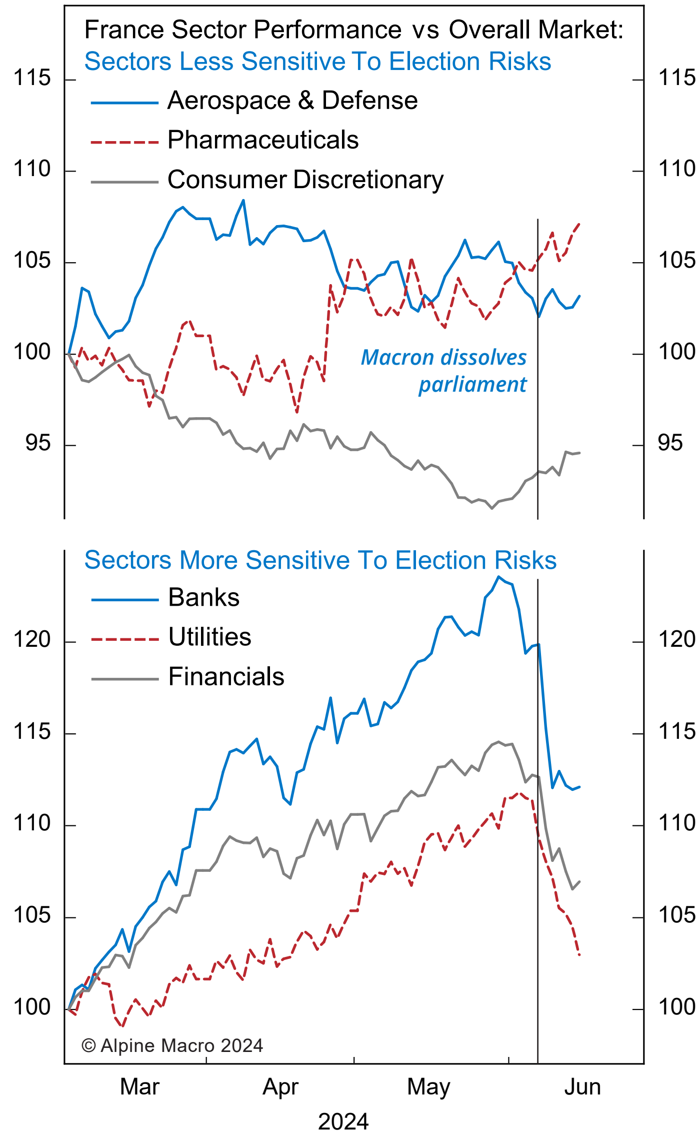
While there are some concerns, the euro is unlikely to materially depreciate significantly due to France's elections. The bigger risk is if a French fiscal crisis occurs (e.g. a Liz Truss-style event) and

Chart 9 Global Revenue Shields Some Firms From Election Risks



Note: Series are rebased to March 2024=100; source: Euronext

Chart 10 Different Sectors Have Different Sensitivities To Electoral Risks

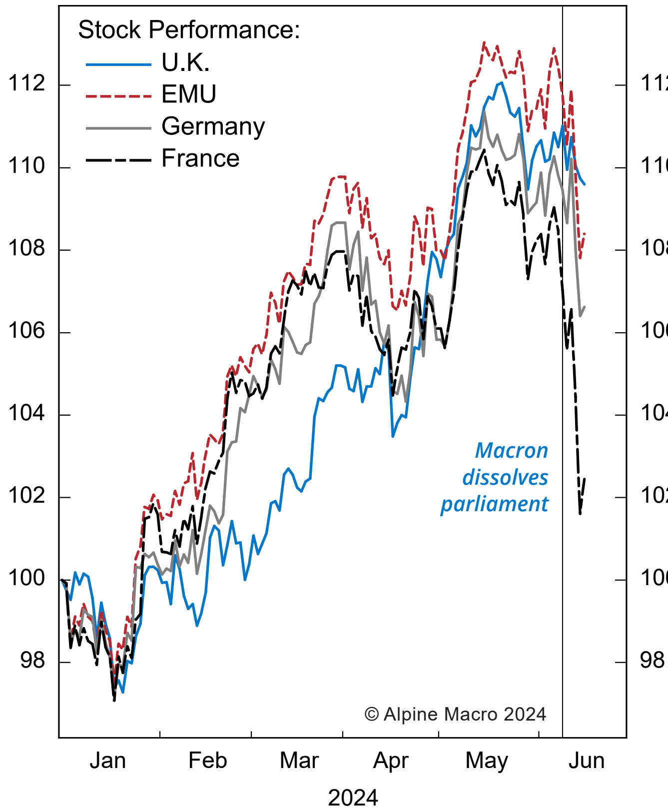


Note: All series are rebased to March 2024=100

then impacts other eurozone members. In such a scenario, the ECB would likely intervene and buy sovereign assets, limiting the sell-off of French bonds and broader contagion, though significant market volatility could occur.

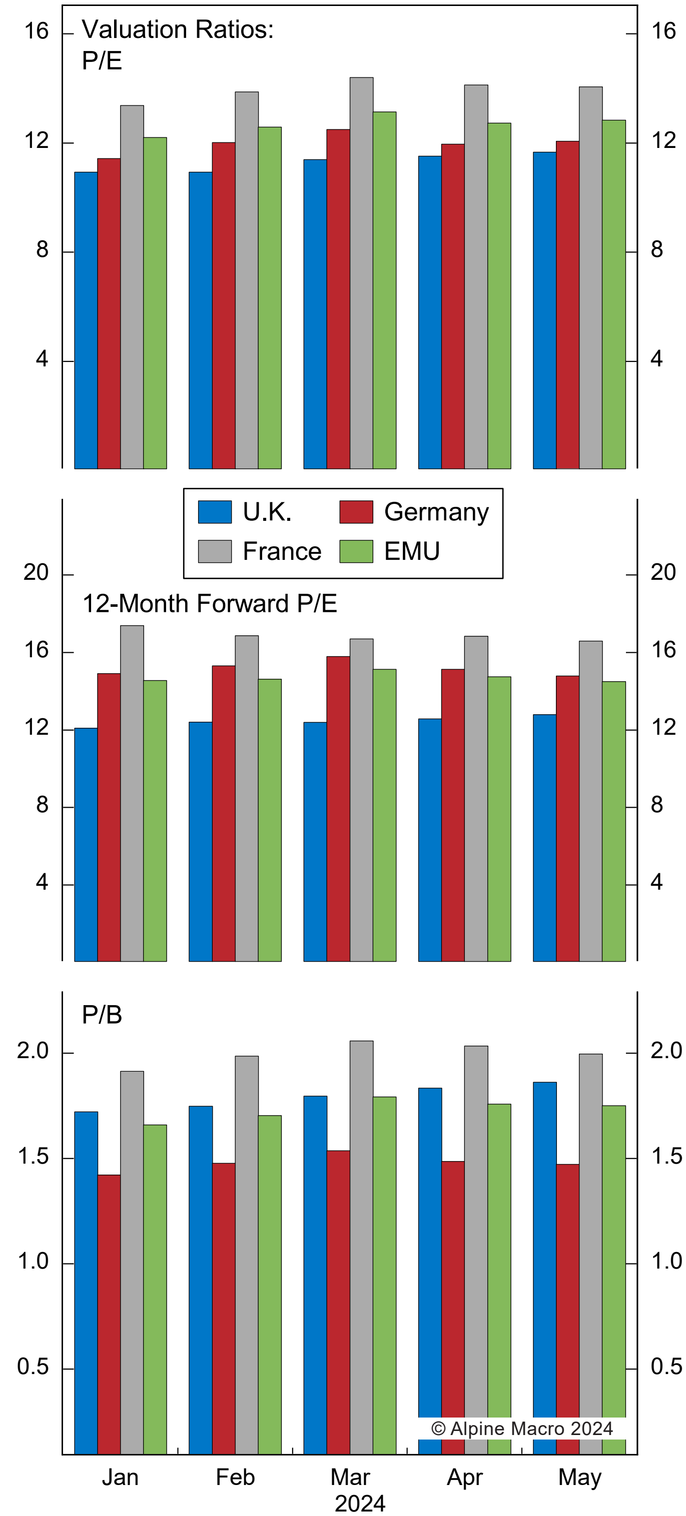
Equities relatively insensitive to electoral risks could provide opportunities. For example, the CAC 40 has declined due to the snap elections decision, and political risks are arguably priced in. The CAC 40 represents companies that get about 85% of their revenues from abroad, so it is relatively immune to domestic political risks. **Chart 9** shows that post-election announcement, the CAC 40 relatively outperformed the more domestic-oriented CAC Small index, which has higher exposure to election risks.

Chart 11 U.K. Equities Perform Well, Less Exposed To Eurozone Political Risks



Note: All series are rebased to Jan 2024=100; source: MSCI Large, Mid & Small cap

Chart 12 U.K. Equities Are Also Cheaper Than French Ones



From a sectoral perspective, different equities also have different sensitivities to electoral risks, creating some opportunities. Most French equities declined after Macron's election announcement, but relative to the benchmark index, aerospace & defense, consumer discretionary, and pharma & biotech appreciated (**Chart 10**, top panel). Consumer discretionary would benefit from all political parties' preference for increasing household wealth and spending. Aerospace & defense, and pharma are export-oriented sectors where France is competitive and there is global demand.

Conversely, utilities, financials, and banking stocks declined relative to the benchmark index due to their larger exposure to government regulation and policymaking. Financial and banking stocks are also declining on fears of fiscal deterioration and further sovereign downgrades (**Chart 10**, bottom panel).

A tactical, politically-driven safety trade before the French election would be to buy U.K. stocks (**Chart 11**). These are cheap relative to French equities (**Chart 12**). Politically, the U.K. Labour Party is likely to win the July 4 parliamentary elections, providing political stability and is signaling a pro-growth, market-friendly policy set. This should favor U.K. equities over French ones, at least through early July[3].

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3 The next GPS report will be on the U.K. elections

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