France

- National Rally (NR) fears overblown with historic number of ‘triangulares’ (3-way runoff races) and news of cooperation between Macron’s centrist coalition and NFP (Nouveau Front Populaire, the leftist alliance) will cause NR to fall short
- A base case where all parties receive roughly around the same seats skewed towards the NFP, but not enough for a single majority, foreshadows (a) gridlock as Mélenchon has publically ruled out negotiations with Macron’s centre to form a government and possible new elections (b) this is simply a negotiation tactic and they will form a government, or (c) the NR and centre form a government together
    (a) Mélenchon’s party has the momentum and surprise factor that in recent days propulsed them to the expected largest bloc due to fears of the National Rally; though he could keep the government formation in gridlock by holding the coalition with the centre aloof and possibly envisioning new elections under a gridlocked government pushing the NFP to a majority off the back of continued momentum; this is unlikely to transpire, however, as a primary motive behind its surge was the dropping of 3rd place triangulare candidates and a momentous increase in voter turnout *against* the NR, which was seen as a threat due to projections of it reaching the brink of a majority and dissatisfaction with the only other alternative - the centre that has ruled in recent years over covid and inflation. Either this gridlock will persist, possibly resulting in new elections because of a misperception of the momentum on the part of Mélenchon, which most likely would not continue, or some sort of compromise must occur. If the alternative is NFP having an absolute majority, gridlock is likely marginally better for markets and bond yields, and Macron could try to cooperate with either side and secure his party as the important make-or-break in parliament - though, this seems unlikely given the lack of cooperation between the blocks and the result will still be negative, most likely with the left and right wing blocs trying to break the centre, rather than align with it
    (b) If the end is a compromise, this will be positive, but it seems unlikely given Mélenchon’s track record and personality and his recent rhetoric. A NFP-led French government would likely be worse for markets than a NR one, because their policy proposals on the economy promote aggressive spending, reduction of the retirement age, etc. that would enlarge the deficit significantly, hold inflation higher, and weaken the fiscal position of the French government - borrowing rates higher - and controversial international politics like the recognition of Palestine and lack of concern towards Ukraine or NATO, alongside the unpredictable and somewhat dictatorial personality of Mélenechon, may bring enhanced political risks
    (c) The alternative to gridlock and new elections and a NFP-centre government is for the centre to form a government with the NR against the NFP. This would be a seemingly strange choice considering that Macron brought his bloc in alliance with the NFP during the elections (having 3rd place candidates of either party drop out in triangulares), though his rhetoric was timid in confirming it and was likely spurred into reality due to polls showing the NR near an absolute majority

The result of our analyses points to a base case of continued gridlock and a hung parliament in France which, though not as bad for markets as a NFP absolute majority, still will hang on governing stability and add to political risks and uncertainty. The upside is that large and reckless spending or policy packages proposed by the left and to a lesser extent the right will likely not make it through, but this also means unresolved fiscal issues and no progress on reforms (even a rollback of Macron's pro-business reforms). This means continued high borrowing costs demanded by investors, but unlikely for sudden significant further increases until the situation evolves.

French bond spreads to Germany should tighten given hung parliament and lower fiscal spendings, and the reversal of the flight to quality, but remain elevated and not return to pre-election levels in the near future. Volatility in bonds, the euro, and stocks will remain elevated but go down over time broken up by possible spikes on pivotal points that give more information on adjusting the likelihood of our different cases. France in general was sold off because of general political risks but the sell-off on individual equities that show good fundamentals and quality has likely been excessive so there are opportunities there. French equities have already been the worst performers among major European indexes since the call of the election and are likely to remain constrained.

The growing debt and fiscal issues would not fade given a hung parliament and political gridlock; average borrowing costs will continue to rise over time and a buy on the comedown from the immediate selloff is good long-term French government debt's exposure to regional shocks can be expected to rise and mirror Italy's, and sharp changes in sentiment are important for French GBs given 50% foreign ownership, including a big component of Japanese institutions seeking secure EU sovereign debt (which may decline either as Japan emerges out of its low-rate environment and as other European options become more relatively attractive - opportunity for a spread trade depending on views of other EU countries).

Finally, the overall economic debt risk contribution of France to the eurozone will decrease given a hung parliament, narrowing yield spreads of problematic countries like Italy, Greece, Portugal, and others to Bunds. However, political risk can rise given the NFP's positions and the uncertainty around the future of the government.