Waiting for the day after. Implications of the French legislative elections

French Election Watch

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- As first polls stand, the probability that no majority emerges from the election appears significant. One challenge for investors is to avoid overreacting to polls. In addition, we believe political biases can be counterproductive for investment portfolios and investors should focus on the long term.
- We see four potential scenarios, but our main conviction is that France's fiscal situation will remain challenging under EU fiscal rules and put serious constraints on any government's fiscal room.
- We expect political news to continue to affect French government bond yields, mostly those in medium to longer tenors. We think relative value for French government bonds has not changed much recently, as yields of other Eurozone governments have moved in tandem. We see better value for investors in select investment grade bonds from multinational companies that are less exposed to national politics and are offering attractive yields.
- Policy uncertainty is unhelpful for equities in our view. Higher discount rates via potentially higher bond yields and an increased political risk premium is likely to weigh on the French market. The CAC 40's recent underperformance suggests that some of this is already in the price, but we expect there will be little appetite for investors to add risk through this period of uncertainty. Within the French market, we expect financials, utilities and infrastructure stocks to be most vulnerable to policy changes and/or higher bonds yields and credit spreads.
- The impact on the euro so far has been modest. We expect political uncertainty in Europe to have a minor role from here. Only a "Frexit" narrative would bring true generic EUR weakness.

Source: UBS

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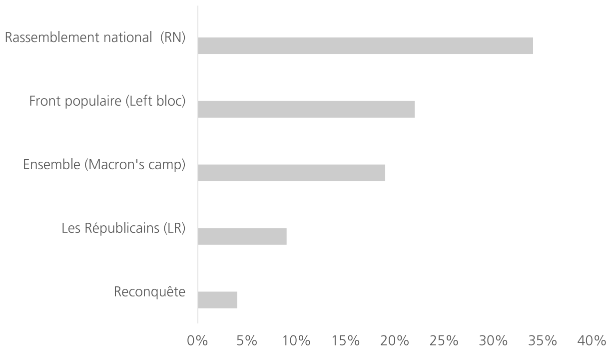
The upcoming legislative elections in France come with a lot of uncertainty as the electoral system, with two rounds of voting, makes results hard to predict. In the first round (taking place on 30 June) typically up to 10 to 15 candidates are listed in each constituency. Only those who obtain more than 12.5% of registered voters' support at the first round qualify for the second round (on 7 July). The candidate that obtains the largest number of votes in the second round wins the seat. It is not uncommon for three to four candidates to make it into the second round. This makes the outcome of the National Assembly election particularly uncertain. As first polls stand, the probability that no majority emerges from the election appears significant. A "cohabitation", a system when the president is from a different political party than most of the members of parliament, would shift legislative power from the president to the prime minister and to his/her camp. However, what seems to be most certain is that the fiscal outlook is unlikely to improve.

A first opinion poll, conducted by Harris interactive, suggests the Rassemblement National (RN) could secure 235 to 265 seats (a significant increase from their current 89 seats). The Macron camp (Ensemble) could win 125 to 155 seats (a decrease from their current 249 seats). The left bloc (Front populaire) could obtain 115 to 145 seats (a slight decrease from their current 153 seats), and Les Républicains (LR) could secure 40 to 55 seats (a decrease from their current 74 seats). The majority in the National Assembly is 289 seats.

Fig. 1: First round intentions vote



Source: Harris interactive, Toluna, as of 11 June 2024

We see four potential scenarios.

1. Rassemblement National "cohabitation" with absolute majority.

In this scenario the Rassemblement National (RN) obtains an absolute majority in the National Assembly. The president of the Republic appoints as prime minister a candidate chosen by the RN. The parliamentary governance of the RN would then be easy, and laws could be adopted comfortably in parliament. However, government dissension and compromises between the two camps (Macron and RN) would prove difficult. In this case, the president would nevertheless keep his reserved domain, remaining responsible for defense and foreign affairs. The RN's program, if implemented as such, would put further strain on the already high budget deficit. In particular, the RN is proposing new spending in favor of pensioners and household purchasing power. These measures would be partially financed by controlling social spending linked to the presence of immigrants or foreigners in France.

We do not think that the relation with European Union (EU) and other partners will dramatically change. Many investors are concerned about a potential "Frexit", but we need to consider that Macron would retain constitutional powers over Europe, foreign policy and defense and that the party no longer wants to leave the EU and the Eurozone. The RN aims to limit the free movement of migrants by carrying out national border controls and dialing back EU climate rules.

2. Rassemblement National "cohabitation" with relative majority.

The second scenario would see the RN obtain a relative majority in the National Assembly (the RN would be the largest party in the National Assembly but with less than 289 seats). The president of the Republic would then appoint as prime minister a candidate chosen by the RN. In this context, the RN would encounter the same difficulties in forming an absolute majority as Macron's camp, which currently only has a relative majority in the Assembly. France would then enter a political deadlock, marked by the ungovernability of a relative parliamentary majority and a complicated cohabitation.

As mentioned above, our expectation is that the RN would try to propose new spending in favor of pensioners and household purchasing power, but in the absence of an absolute majority it would be difficult to make any important changes on pension reforms and immigration. As the focus on household purchasing power is common to other parties, the RN could lower the value-added tax on energy and fuel and fund it with a tax on financial assets. Proposals such as a slash to toll fees on motorways by renationalizing them, and to privatize public broadcasting and scrapping the TV license fee would be difficult to implement.

3. Front Populaire "cohabitation" with relative majority.

The third scenario looks unlikely at this stage. It would see the union of the left, the Front populaire (LFI-La France insoumise, Parti Socialiste, Ecologistes, Parti Communiste) win a relative majority in the National Assembly (the coalition would be the largest party in the National Assembly but with less than 289 seats). The president of the Republic would then appoint a prime minister from the Popular Front, thus initiating a period of cohabitation. The union of the left would face the same difficulties as the presidential majority in the Assembly, amplified by the disagreements inherent in cohabitation and the internal dissension between the different parties in this coalition.

The union of the left just published its manifesto. Its first proposals suggest a government from this union would undo the recent pensions and unemployment reforms, increase the minimum wage, and not engage in fiscal consolidation. The union proposes significant new spending in favor of pensioners and purchasing power. These measures would be partially financed by an increase in corporate taxation and taxes on financial assets.

4. Renaissance 2.0.

Another scenario would see Macron's presidential camp maintain its relative majority in the National Assembly. In this case, the presidential camp would find itself in the same situation as before: it would have to continue to deal with the different parties to pass laws in the National Assembly or seek to forge alliances to obtain a coalition with an absolute majority.

In this scenario, Macron's new government would likely propose new spending in favor of household purchasing power and the competitiveness of companies. These measures would be partially financed by a labor reform already discussed before the EU elections and savings made on the operating expenses of local authorities, also already discussed.

What should we expect on financial markets?

Sovereign debt: we expect political news to continue to affect French government bond yields, mostly those in medium to longer tenors

Whoever emerges as winner(s) from the upcoming elections will need to face the Excessive Deficit Procedure of the EU, given the French budget deficit is significantly ahead of the 3% threshold envisaged for member countries. It is yet unclear to what extent this procedure can alter the fiscal plans of a new government or even entice it to take measures reducing the structural fiscal imbalance. When it comes to the credit rating outlook for France (Aa2/AA-), the future political leadership and its ultimate fiscal plans will be key determinants. We already had a deteriorating issuer credit outlook on France before the recent events, expecting rating cuts by one notch over the next 12 to 24 months. Higher deficits than currently anticipated could lead to earlier and also to more cuts, taking France down into the A category. The upside risk to this view would be a new government that is very responsive to deficit reduction pressure from the EU, which could stabilize ratings at current levels.

In the run-up to the elections, we expect political news to continue to affect French government bond yields, mostly those in medium to longer tenors. Short-dated bonds are unlikely to be much affected by politics and will rather reflect the outlook for the ECB's interest rate path. We think relative value for French government bonds has not changed much recently, as yields of other Eurozone governments have moved in tandem. We see better value for investors in select investment grade bonds from multinational companies that are less exposed to national politics and are offering attractive yields.

Fig.2 French spreads should remain wide for now

Spread between the 10 year OAT and the Bund

Source : Refinitiv datastream, UBS, as of 14 June 2024

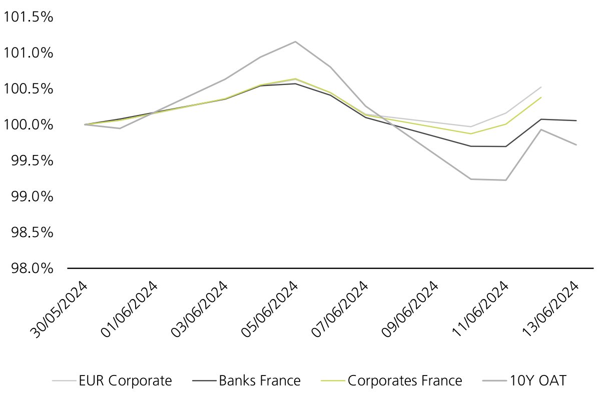
In the absence of (unexpected) political chaos, we think in the run-up to the elections risk premiums for French bonds should remain in a fairly contained range of around 20–30 bps around the current level of 68 basis points over 10-year German Bunds (Fig. 2). As said above, as long as valuations of other investment alternatives move along with French spreads, we don't see why investors should expose themselves to the wide range of uncertainties surrounding the French debt trajectory.

French fixed income corporate sector: we don't think the French election will be a major turning point for French corporate bonds

It is not uncommon for the French corporate sector to exhibit less return volatility than French sovereign debt government during election cycles. This pattern has been seen in recent days. While French corporate bonds have underperformed the wider EUR IG space, they have recouped some of the underperformance in recent sessions and have performed better than OATs. It is difficult to make any predictions so long as details on political manifestos remain unavailable. However, continued volatility in French sovereign debt would likely also continue to demand a premium on corporates in general—presenting challenges for traditional summer carry trades. As a result of their systemic exposure, banks have lagged the most in the past days and subordinated bank paper will likely remain among the most exposed segments in the weeks ahead. Given the close link to the government and the exposure to the country's energy policies, utilities and their hybrids may also prove softer at times.

However, we are not overly alarmed at this stage. In contrast to the French state, the corporates we cover generally boast strong balance sheets and many are well diversified and generate significant revenues outside the country. They are also not facing the same issuance challenges and market technical headwinds as their government does, and we note that national energy champion, EDF, recently managed to place EUR 3bn in a multi-tranche bond deal at reasonable conditions with an order book that was 3–5x oversubscribed. As such, we don't think the French election will be a major turning point for French corporate bonds. Should further significant weakness occur, we would likely view it as a buying opportunity. In the absence of major policy shifts we would expect spread underperformance to revert over the longer run as the election dust settles.

Fig.3 French corporate bonds should be less volatile than government bonds
Bond indices



Souce: Bloomberg, Iboxx, as of 13 June 2024

Equity strategy: policy uncertainty is unhelpful for equities in our view
Higher discount rates via potentially higher bond yields and an increased political risk premium are likely to weigh on the French market. The CAC 40's recent underperformance suggests that some of this is already in the price, but we expect there will be little appetite for investors to add risk through this period of uncertainty. There are also implications for the wider European market given one of the positive cases for European equities was linked to potential inflows from foreign investors, which would have helped close Europe's valuation gap to other developed markets, but the return of political uncertainty is likely to keep foreign investors away until we get more clarity.

Within the French market, we expect the financials, utilities and infrastructure stocks to be most vulnerable to policy changes and/or higher bonds yields and credit spreads. This has been reflected in the market moves this week, with some of the most vulnerable stocks falling around 10% since the snap election was called. On the other side, stocks exposed to domestic consumption, such as retailers, could benefit from potential new policies aimed at supporting household consumption. There are also many globally exposed businesses in the CAC 40 which typically generate less than 15% of sales from France. These businesses should see limited direct impact from new policies, so any sell-off related to risk-off sentiment could present selective buying opportunities at some stage. So far, these stocks have been relatively resilient, typically down less than 5% since the announcement.

Financials (Sacha Holderegger and Thomas Parmentier). The implication for banks depends on whether the election outcomes will impact economic growth, potentially leading to reduced bank lending and deteriorating asset quality, and higher taxes to address the growing budget deficit. Although French banks have diversified sovereign debt portfolios, increased credit spreads would negatively affect their capital levels. Additionally, there is a risk that Livret A rates might remain higher for longer, further delaying the recovery in French retail. Regardless of the outcome, while French banks are not expensive in a sector context, we remain cautious due to the risk of a political deadlock. For insurance, we believe that taxes on share buybacks are a potential negative. Any change on the French debt rating could also impact asset quality and therefore solvency ratios and potential capital returns.

Toll road operators (Alex Stiehler). The RN party stated in its 2022 party manifesto that it would like to nationalize French toll roads and then implement a tariff cut (-15%). The infrastructure names materially corrected after the election. Based on UBS Research estimates the market currently values Eiffage's and Vinci's toll road business at around zero. In our view, this reaction looks overdone. The government has the option in the contract with the firms to buy back the concession at fair market value. It is also important to note that the maturity of the concession is relatively short: Eiffage (2035-2036 for most assets) and Vinci (2032-2034 for most assets). Therefore, the longer it takes (most likely a multi-year process), it reduces the risk, as the firms will convert the net present value of the concessions into cash through dividends. The risk to this view is that the new government speeds up the process and buys back the concession in a short period of time.

Utilities (Carsten Schufter). A government's energy policy influences a utility's strategy. This is true of all countries, but of France in particular. In 2022, the French state renationalized Europe's largest electricity producer, EDF, to pursue its political goals (expansion of nuclear energy, favorable electricity tariffs). Nuclear energy has been of enormous importance in France for decades. A French government that does not consider the importance of nuclear energy as an economic factor and means of decarbonization therefore seems highly unlikely, in our view. However, there are differences in the extent to which the expansion of renewable energies is being promoted. The outcome of the elections is likely to have an impact on Engie and Veolia in particular. Engie is probably more impacted by this election and political risk on tariffs, investments, etc., should not be underestimated.

Consumer (Thomas Parmentier). We expect limited impact on luxury brands at first, as they make 90% of their revenues outside of France. However, a more protectionist government could lead to tariff increases with China (for example electrified vehicles) and there is a possibility than retaliation could affect luxury goods, as we have seen in the past with cognac. On retailers and consumer staples, everything else equal, a government increasing salaries and pensions could help consumption at lower-end segments.

In the FX market, macro dynamics matter more than political shifts

Political uncertainty has been weighing on the euro amid the recent European parliamentary elections and the upcoming elections in France. The impact so far has been modest. High frequency news flow out of the US were more important. While political uncertainty in Europe will linger, the impact will likely play a minor role from here, as short-term policies are unlikely to change quickly (the focus here is fiscal and external relations). Only a "Frexit" narrative would bring true generic EUR weakness, in our view. However, a small EUR risk premium should remain in an environment of poor economic growth in the old continent.

What does that mean? EURUSD could easily test 1.05 or dip below it. Speculative accounts are still EUR long versus the USD. These positions can be reduced. Given political uncertainties in Europe, other European currencies should have an easier task to gain ground versus the EUR. In short, the GBP stays well bid versus the EUR, the NOK and SEK can recover more and EURCHF could trade more quickly to the lower side of recent ranges. The EUR finds a top and weakens in TWI terms.

UBS CIO risk views

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