CIO PERSPECTIVES

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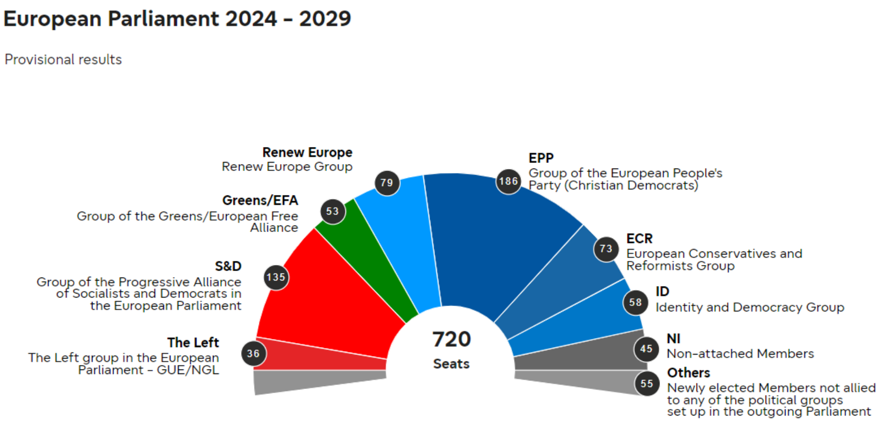
EU and French elections: markets are nervous, but not panicking

2024 was shaping up to be a crucial year in terms of elections, since 80% of the world's population has been or will be called upon to vote this year. This weekend's European elections brought their share of surprises. At a European level, the European People's Party (EPP, centre-right) came out on top, but Europe's far right made a historic breakthrough, with the Green Group one of the big losers. After India and Mexico, it is France that is the focus of investors' attention after the surprise announcement of snap parliamentary elections by the President of the Republic Emmanuel Macron.

A French problem, rather than a European one

The rise of the far right at European level is no real surprise in itself, as there is no blocking minority within the European Parliament that could prevent it from functioning properly. As such, Ursula von der Leyen is still well placed to continue her mandate at the head of the European Commission, which would reassure and restore visibility and continuity to European policy. So, it was the results in France and the announcement of snap parliamentary elections that created a surprise and a shockwave on the financial markets, both equity and rates. The National Rally (RN) received 31.5% of the votes, twice as much as Emmanuel Macron's party, with the Socialist Party coming in at third with 14% of the vote.

This surprise announcement to dissolve the National Assembly is seen as bold but also uncertain. Elections will be held in two rounds, on 30 June and 7 July, to elect 577 members of parliament, with a majority of 289 being required. This political uncertainty is therefore worrying the financial markets for two reasons: firstly, concerns about a possible cohabitation and, hence, President Macron's ability to continue his reform programme, and secondly, in the event of a victory for the RN, concerns about the budgetary drift of the French State. As a reminder, France's rating was downgraded by S&P to AA- barely ten days ago, against a backdrop of budgetary drift.



Source: European Parliament.

Tensions over French debt

The financial markets reacted negatively to this announcement and immediately punished all European debt, particularly French and Italian. The lack of visibility over the future parliament and the consequences for fiscal policy were at the heart of this reaction. Italian debt is also suffering, with the market anticipating a potential tightening of policy by the current far-right government in the event of a French coalition. On the bond markets, yields 10-year OAT bonds (French government bonds) returned in two days to their highest level since November 2023 at 3.25%. The spread between German and French debt has widened by around 0.15% in 2 days. This tension is real, but the absolute level remains moderate. We are a long way from the tensions of 2017, when the spread peaked at 0.80%, or even 1.90% at the height of the sovereign debt crisis in 2011.

The ratio of public debt to gross domestic product (GDP) is over 110.6% and is expected to continue to deteriorate to 114% by 2027. France has not generated a primary budget surplus (i.e. tax revenues in excess of expenditure excluding interest charges) since 2001. The financial markets are thus worried about a new budgetary drift, and an additional cost of debt, which would have a snowball effect with a higher interest rate for refinancing leading to an even higher budget deficit for the French government. On today's date, the average rate paid by the French State on its debt is 1.6%, which is still low in absolute terms, given that spending on the cost of the debt represents 10.9% of the French budget. To put this into perspective, the interest burden represents 13% of the State expenditure of the United States of America, i.e. the third budget item.

CAC 40 falls sharply on opening day

The benchmark French stock market index CAC 40 lost as much as 2.4% at the start of trading on Monday - one of the biggest intraday falls in a year - to finish at -1.35%. French banks that lost the most ground, due to their exposure to the pressure on interest rates and hence the potential premium to be paid on the financial markets. Domestic stocks in sectors such as construction and transport were also targeted. However, this index is anything but domestic: only 15% of CAC 40 sales are generated in France. Differentiation is therefore essential, but the use of futures markets to sell the stock market index independently of its composition can lead to major movements.

To watch in the coming weeks

It is difficult to predict the outcome of the forthcoming elections, but an absolute majority of the RN appears be an extreme scenario. However, if this were to happen, it would not be well received by the financial markets, because the economic programme remains vague. The rhetoric of leaving the European Union and abandoning the euro are no longer on the agenda, and the budgetary drift is strongly criticised, but the perception of foreign investors will be strongly affected, seeing a government that lacks experience to lead the country. In the event of a relative majority (somewhat similar to the Italian situation), this configuration is not ideal from a financial point of view, as it would mean a halt to the reforms under way and a deterioration of public finance.

In the short term, tensions will persist over French debt, the sectors most exposed to the domestic economy and the euro. But as with any situation of tension, opportunities may open up for long-term investors. Europe's economy has improved this year, with the Euro Area GDP recently revised to 0.7 % for 2024, inflation has fallen faster than expected even if tensions persist, and the European Central Bank was able to cut rates last week. This environment has led us to view small and mid-caps more favourably, after 3 years of underperformance. Volatility in this segment could therefore offer new investment opportunities, and we will be keeping a close eye on developments in over the coming weeks. Overall, the European markets are still under-owned by international investors, so a withdrawal of these investors would have a more limited impact in our view. We remain positive on the dollar, which remains the safe-haven asset in times of uncertainty and offers a very positive carry rate against the euro.

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