



French elections: Impact on bond markets

The French spring Presidential and June legislative elections are the next political event attracting investors' attention. Today, we have published our in-depth analysis of this topic and its likely impact on government bond markets, [Economic & political scenarios](#), [FX](#), [French banks](#), [equities](#), [equity derivative](#) and an [executive summary](#) in seven related articles.

- In this section we outline the potential path for French, German and Italian 10Y bond yields following the French elections. The path for bond yields in the scenario of Le Pen winning the presidential election is the most relevant from a risk perspective.
- Since the start of the Eurozone and even in the pre Eurozone period of the early 1990s (post Maastricht) the France-Germany 10Y spread had not been wider than 150bp. However, in the late 1970s/early1980s the spread averaged ~400bp and reached as high as 700bp (despite the existence of the European Monetary System). This was a period which saw considerably higher inflation rates in France compared to Germany. As such it is not dissimilar to elements of the Le Pen programme.
- In the tail risk scenario where France leaves the Eurozone other elements of Le Pen's economic agenda will also become more probable. Therefore, the market might need to price in a reasonable probability of a 1970s/80s high inflation environment in France.
- In the scenarios where Le Pen either loses the referendum or is unable to hold the referendum we would still expect 10Y France-Germany spreads to be wider than current levels given the economic uncertainty and the loss of investor confidence.
- If Le Pen does not win the presidential election in May and given the recent robust data flow in the Eurozone our base case would be for the ECB to indicate a further tapering of their QE programme in H2 2017. We therefore do not expect a significant move lower in French and Italian bond yields even though spreads could tighten from current levels.
- Using indicative probabilities based on opinion polls and the timeline of the election process we arrive at our estimate for 10Y bond yields today. Relative to our estimates current level of 10Y bond yields in Germany are fair while they are too low by 15bp and 45bp for France and Italy respectively.
- The divergence between market levels and our estimates is a result of either the level of yields we are expecting in the various scenarios and/or the indicative probabilities assigned to these scenarios.
- Assigning a 50% lower probability to a Le Pen win and/or a greater tightening in France-Germany and Italy-Germany spreads if Le Pen is unable to hold an EU/Eurozone referendum or loses such a referendum reduces the gap between market levels and our estimates.

Accompanying documents French elections

- [Executive summary](#)
- [Economic and political scenarios](#)
- [FX](#)
- [French banks](#)
- [Equities](#)
- [Equity derivatives](#)



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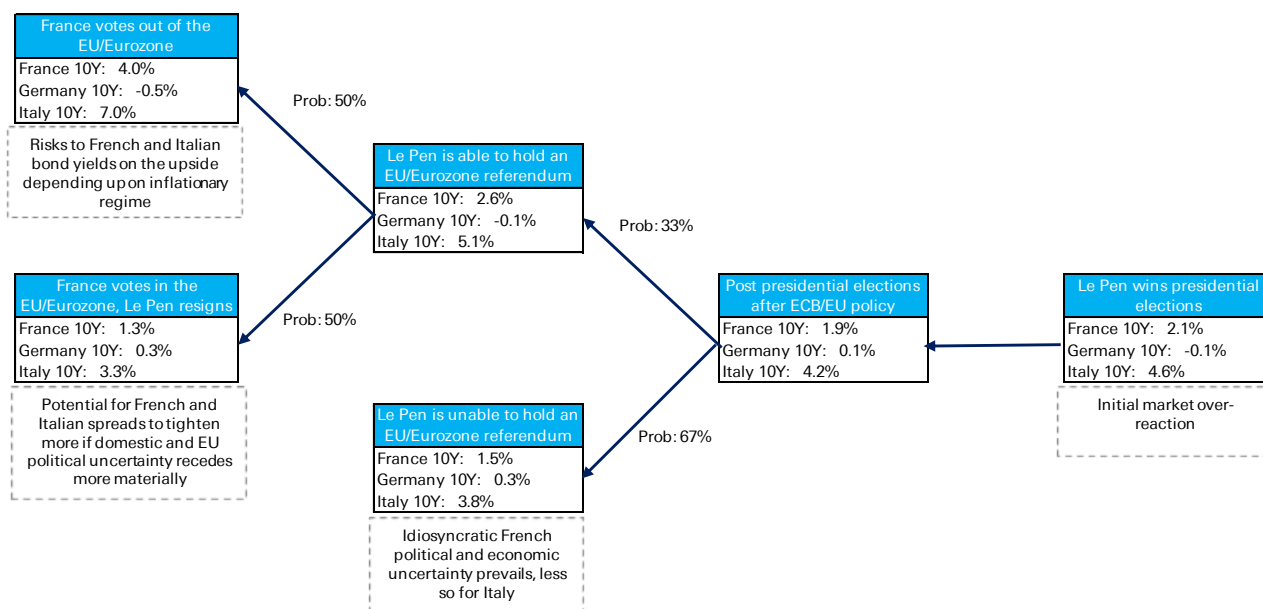
In a separate section we argued that even if the French banking system and Treasury were faced with adverse financing conditions following the French elections they are unlikely to be faced with a liquidity crisis. In this section we outline the potential path for French, German and Italian 10Y bond yields following the French elections.

We consider three outcomes for the presidential elections. In all three scenarios we assume that Le Pen makes it into the second round of the presidential election. Indicative probabilities based on opinion polls would suggest a victory for a centrist candidate. The less likely scenario would be a win for Le Pen while the least likely scenario is a win for the socialist candidate Hamon. From a market perspective we expect limited differentiation in the scenarios where a centrist candidate or a socialist candidate wins. The potential path for bond yields in the scenario of Le Pen winning the presidential election is probably the most relevant from a risk perspective.

Le Pen wins presidential elections

In assessing the path for 10Y yields in such a scenario it is easier to work backwards from the potential level of 10Y yields in each possible end-state. We work backwards as shown in Figure 1 below

Figure 1: Working backwards for bond yield forecasts if Le Pen wins presidential elections with indicative probabilities based on opinion polls and timeline of elections



Source: Deutsche Bank



- We forecast yields for both a yes and no vote if an EU/euro referendum is held
- Using these yields and the probability of each outcome we forecast the level of yields to be reached upon the announcement of the referendum
- We forecast yields for the scenario where Le Pen wins the presidential election but is unable to call a referendum
- Using the level of yields in case a referendum is called and if a referendum is not called and the probability of each scenario we forecast yields in case of a Le Pen presidential win
- We price in a slight over-reaction of bond yields – lower for Germany and higher for France & Germany - in the immediate aftermath of the Le Pen presidential win relative to the probability weighted yields mentioned above. This is because we expect the market to be nervous about the potential ECB and EU leaders' response to Le Pen's presidency. However, we do not expect the ECB to precipitate the crisis by limiting liquidity access to French banks and/or imposition of capital controls by any of the core Eurozone countries. Therefore, this initial over-reaction would be corrected between the French presidential and the parliamentary elections.

EU/Euro referendum: In or Out

France votes to leave the EU/Eurozone

German yields

If the euro is retained by only the core northern European countries such as Germany, Netherlands, Austria etc. the expected appreciation of this currency relative to the currencies of the other countries along with the flight to quality flows could result in a strong demand for German govt. debt. While these could cause a very large decline in 10Y German bond yields the market will have to price in a central bank which is less likely to maintain policy rates at extremely low levels. In the initial aftermath of the referendum result we forecast 10Y German bond yields at -0.5% which would be below the lows seen in the summer of 2016. However, following the departure of France and other peripheral countries and the establishment of an effectively new central bank German 10Y bond yields could move up considerably higher.

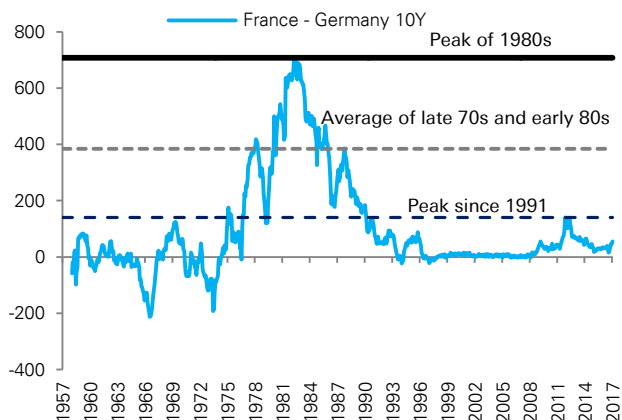
French yields

Since the start of the Eurozone the widest level of France-Germany 10Y has been 150bp (excluding some short-lived spikes) during the sovereign debt crisis of 2011-12. Even in the pre Eurozone period of the early 1990s (following the Maastricht Treaty in 1992) before the convergence trade had gathered strong momentum the spread had not been wider than 150bp. This might suggest that even in the scenario of France leaving the Eurozone the spread might not widen to more than 150bp. However, it must be noted that over this period inflation in France was not significantly higher than that in Germany and in fact inflation was higher in Germany in the early 1990s on account of the German reunification.

However, going further back in the late 1970s/early 1980s we do see the France-Germany 10Y spread at considerably higher levels - averaging ~400bp and reaching as high as 700bp (Figure 2). This occurred despite the existence of the European Monetary System which was meant to prevent large fluctuations of currencies relative to each others. This was a period which saw considerably higher inflation rates in France compared to Germany and saw a significant increase in the share of government in the economy (Figure 3).

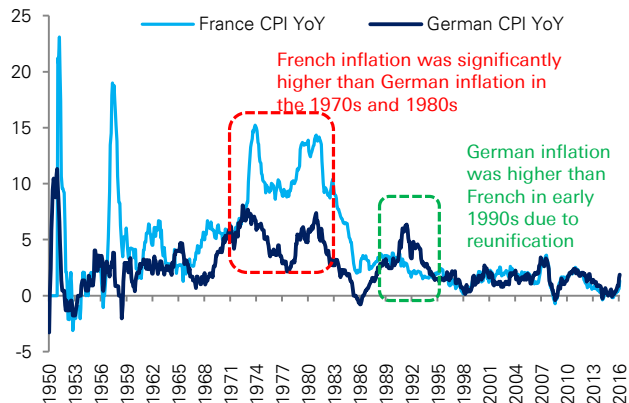


Figure 2: France-Germany 10Y spreads were considerably wider in the late 70s and early 80s...



Source: Deutsche Bank, Haver Analytics

Figure 3: ... when French inflation was considerably higher than German inflation in the 1980s



Source: Deutsche Bank, Haver Analytics

In the tail scenario where France leaves the Eurozone other elements of Le Pen’s agenda including ending the Banque de France’s independence, central bank financing of budget deficits, inflation of around 3% and protectionist measures will also become more probable. Such an environment could result in a dis-anchoring of inflation expectations and the market might need to price in a reasonable probability of a 1970/80 high inflation environment if France votes to leave the EU/Eurozone.

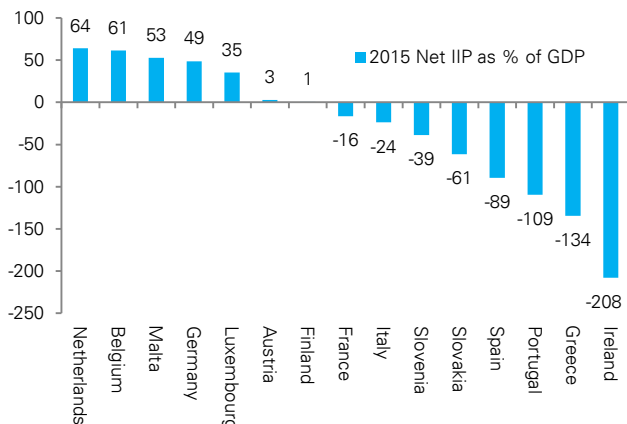
In addition to the depreciation of the euro leading up to such an event our FX strategists expect the new French Franc to depreciate by an additional 10% (trade weighted basis). The combined effect of these is a 25pp price level shock which by itself could warrant about 250bp (25% over 10 years) widening in the France-Germany 10Y spread.

Given the reasonably elevated debt/GDP ratio of 97.5% (Figure 5) and negative net international investment position of -16% of GDP (Figure 4) we would expect a significant reduction in holdings by international investors.

Assuming an average of the peak spread of 150bp in the 1990s and 700bp in the 1970s/80s we would expect the France-Germany 10Y spread to be about 425bp and we forecast 10Y French yields at ~4%.

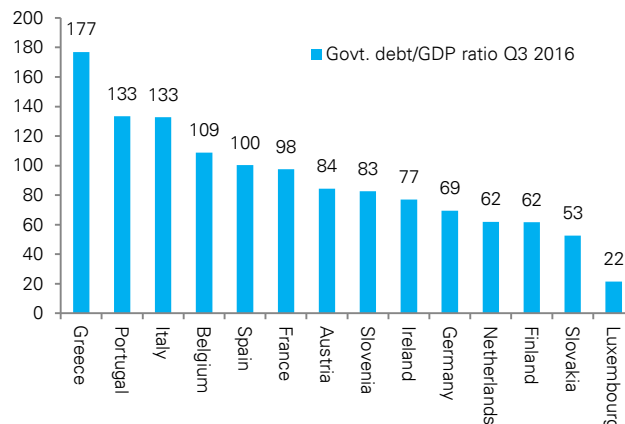


Figure 4: France’s negative net IIP exposes it to behaviour of international investors



Source: Deutsche Bank, IMF, Haver Analytics

Figure 5: France’s gov. debt ratio is also reasonably elevated



Source: Deutsche Bank, Eurostat, Haver Analytics

Italian yields

With France voting to leave the Eurozone the market will very quickly price in an exit for Italy. Even though our FX strategists forecast a relatively similar depreciation and cumulative price shock in Italy compared to France the much higher level of debt/GDP in Italy will probably result in a bigger impact on Italian yields. We would expect Italian 10Y bond yields to trade at least around 7% (similar to levels seen in 2011-12) in the immediate aftermath of the referendum result. There is the possibility of Italian bond yields trading well above the 7% level if the market prices an immediate restructuring of the Italian gov. debt and/or a regime shift like France with a loss of independence of the central bank, risk of fiscal dominance and dis-anchoring of inflation expectations.

Figure 6: Bond yield forecasts on the path to France leaving the Eurozone

	10Y Germany	10Y France	10Y Italy
Le Pen wins presidential elections	-0.1%	2.1%	4.6%
Le Pen calls referendum	-0.1%	2.6%	5.1%
France leaves the Eurozone	-0.5%	4.0%	7.0%

Source: Deutsche Bank

France votes to stay in the EU/Eurozone, Le Pen resigns

If France votes to stay in the euro/EU referendum Le Pen’s position as president might become untenable and she might resign. However, this is unlikely to result in a complete normalisation of yields, for France as well as Germany and Italy, towards current or early January levels.

If Le Pen is able to call a referendum we expect the ECB to increase the pace of QE back up to EUR 80bn and despite the referendum result the ECB is unlikely to announce a tapering of their QE programme in the near-term. This is likely to prevent Bund yields from normalising and we expect 10Y bund yields at ~0.25% (i.e. not much higher than the average levels seen since the start of QE in March 2015).

France-Germany 10Y spreads will probably be wider than the current level of ~65bp given the damage to investor (in particular international investors) confidence. As a reference point we think that the level of the France-Germany 10Y spread at the time of Draghi’s “whatever it takes speech” of 100bp would be a reasonable level for the spread to tighten in the near-term. Over the



medium-term depending on the subsequent political developments in France and the EU more broadly there could be scope for a further tightening of spreads.

It could be argued that Le Pen's ability to organize a referendum will imply that the market will remain wary of the likelihood of a similar referendum being organized in Italy. However, the likely economic damage seen in France as a result of the referendum could reduce the likelihood of a strong support for a similar referendum in Italy. We expect the current ratio of Italy-Germany vs. France-Germany spreads of 3:1 to persist and thus expect Italy-Germany 10Y spread to be around 300bp in this scenario.

Announcement of the referendum

Indicatively we assign equal probability to the outcome of the EU/euro referendum if it is held. Applying the 50% probability to each scenario we would expect the level of 10Y yields in France, Germany and Italy to be 2.63%, -0.13% and 5.38% respectively prior to the referendum.

After the parliamentary elections: Referendum or no referendum

No referendum

If Le Pen is unable to organize a referendum we would expect the level of yields to be broadly similar relative to the scenario where a referendum has been called and the vote has been in favour of staying in the euro.

However, as Le Pen would remain president, the risk of a referendum being organized would not have disappeared and policy uncertainty would prevail. This leads us to expect greater impact on French yields with 10Y France-Germany spreads at ~125bp.

We expect Italian spreads to be moderately tighter relative to the 3:1 ratio for Italian vs. French spreads given the more idiosyncratic political concerns driving the widening of France-Germany spreads. We expect 10Y Italy-Germany spreads at ~350bp.

For 10Y Bund yields we forecast the same level of yield of ~0.25% as in the scenario where France stays in the Eurozone following the referendum.

After the parliamentary elections

Based on the probabilities that one would assign to Le Pen being able to organize an EU/euro referendum (indicatively we assign 33% probability to a referendum being organized) we arrive at 10Y bond yields following Le Pen's win at the presidential elections for France, Germany and Italy at 1.86%, 0.12% and 4.17% respectively.

Figure 7: Bond yield forecasts if Le Pen wins but is either unable to call an EU/euro referendum or loses the referendum

	10Y Germany	10Y France	10Y Italy
Le Pen wins presidential election	-0.1%	2.1%	4.6%
Le Pen is unable to call referendum	0.3%	1.5%	3.8%
Le Pen calls referendum but loses	0.3%	1.3%	3.3%

Source: Deutsche Bank



Post presidential but pre parliamentary elections

We expect the market to initially overreact following a Le Pen win in the presidential elections and before the parliamentary elections in June. This is because immediately after the presidential elections the market might be concerned about the response from the ECB and other EU policy makers. The market will not be able to ignore the risk that the ECB imposes some restrictions on the liquidity provision to French banks and/or limits the Target2 balances.

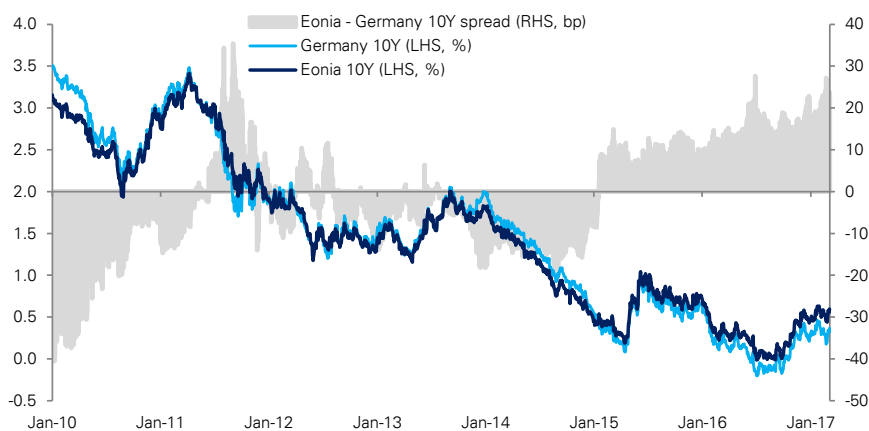
The risk of such outcomes leads us to forecast lower German yields (-0.1%) and higher French and Italian yields (2.1% and 4.6%) immediately after the presidential elections relative to the probability weighted yields mentioned above. However, these yield levels should then correct towards the probability weighted outcomes once the conciliatory ECB and EU policy response expected by our economists is seen.

Le Pen does not win presidential elections

If Le Pen does not win the presidential election in May some of the recent decline in core yields and the widening in semi-core and periphery spreads should be unwound. In addition, given the recent robust data flow in the Eurozone our base case would be for the ECB to indicate a further tapering of their QE programme in H2 2017. Both these factors would argue for higher German yields while the impact on French and Italian spreads would be in opposing directions. We would not expect French and Italian spreads to tighten back towards the levels seen in the summer of 2016.

In this scenario we would expect German 10Y yields to move higher towards 50bp in the near-term which would be consistent with our outlook forecast of 10Y German bond yields in the 80-90bp range by year-end. The risk to Bund yields is to the upside given the significant richening of Bunds vs. Eonia since the start of ECB QE (Figure 8) although the timing of this normalisation remains difficult to anticipate. There is further upside to Bund yields if we see greater economic integration and co-operation in the Eurozone following the French and the subsequent German elections.

Figure 8: Significant scope for tightening of Eonia – Germany spreads if Le Pen does not win and ECB is expected to taper ECB QE



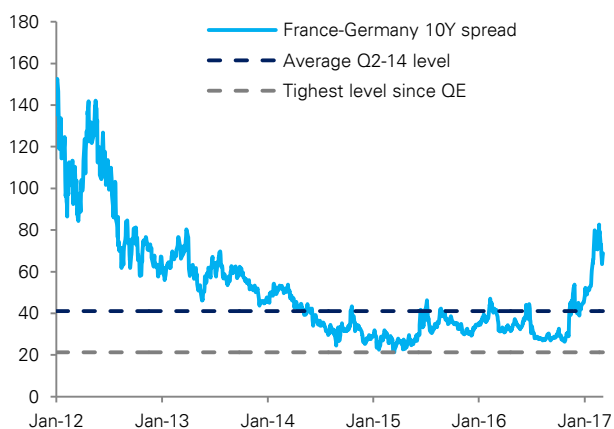
Source: Deutsche Bank, Bloomberg Finance LP



In Q2-2014 when QE was not expected by the markets the 10Y France-Germany spread averaged around 40bp (Figure 9) which is tighter than current levels. In a scenario where a centrist President backed by a reasonably strong government is in place we would expect the 10Y France-Germany spread to tighten back towards 40bp. If however, we have a centrist President backed by weak coalition government and/or a socialist President we would expect the 10Y France-Germany spread to remain at current levels in the 60-70bp range.

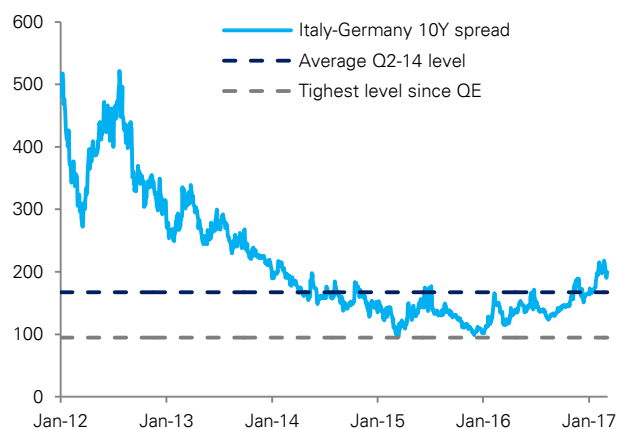
In this scenario we would not expect 10Y Italy-Germany spreads to tighten materially given Italy's domestic political problems and divergence in their medium-term growth prospects relative to the rest of the Eurozone. Combined with the prospect of ECB tapering we expect Italian spreads in the 180-200bp range (Figure 10).

Figure 9: France-Germany 10Y spread was ~40bp in a pre QE world



Source: Deutsche Bank, Bloomberg Finance LP

Figure 10: Italy-Germany spread has potentially less room to tighten in a QE free world



Source: Deutsche Bank, Bloomberg Finance LP

Figure 11: Bond yield forecasts if Le Pen does not win presidential elections

	10Y Germany	10Y France	10Y Italy
Hamon wins presidential election	0.40%	1.10%	2.30%
Macron or Fillon wins presidential election	0.47%	0.93%	2.30%

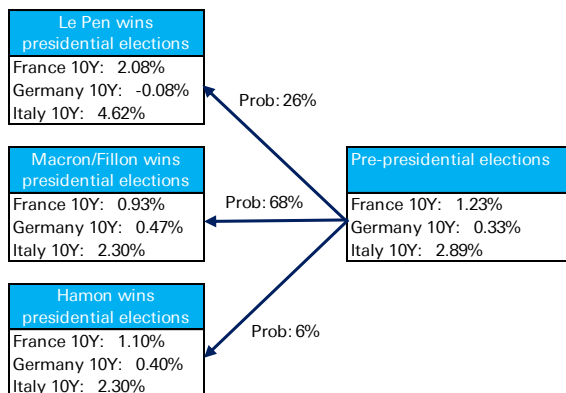
Source: Deutsche Bank

Estimates for yield levels today and sensitivity analysis

Using indicative probabilities assigned to the various outcomes of the presidential elections based on polls we are able to arrive at our estimate for 10Y bond yields today. We find that relative to our estimates today's levels of 10Y bond yields in Germany are fair while 10Y bond yields in France and Italy should be higher by ~15bp and ~45bp respectively (Figure 12 and Figure 13). Needless to say the divergence between market levels and our estimates is a result of either the level of yields we are expecting in the various scenarios or the probabilities assigned to these scenarios.

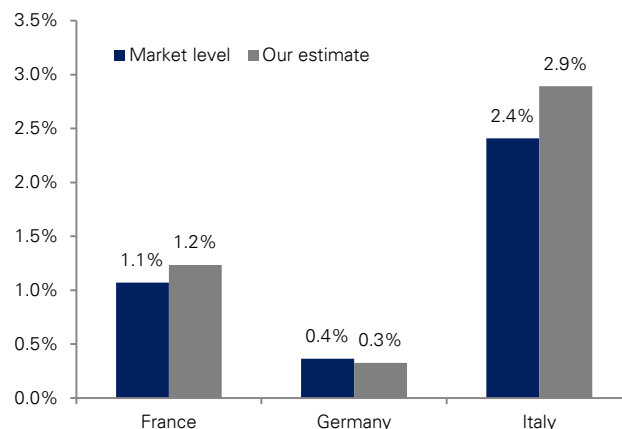


Figure 12: Estimating yield levels pre-presidential elections



Source: Deutsche Bank

Figure 13: By our estimates French and Italian bond yields should be higher than current market levels



Source: Deutsche Bank, Bloomberg Finance LP

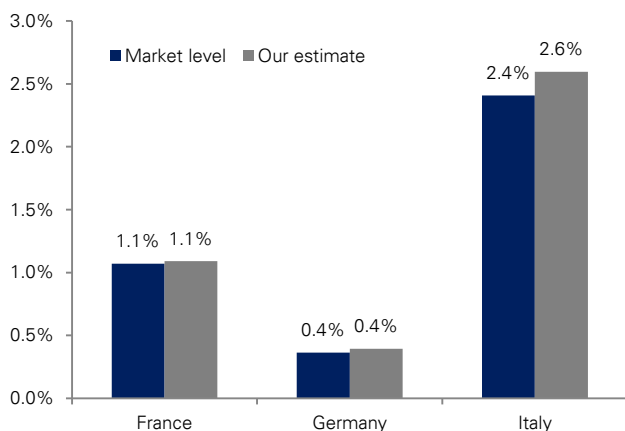
Sensitivity to probability of Le Pen winning

Our indicative probabilities imply slightly more than 25% chance for Le Pen to win the presidential elections. If we were to reduce her probability of winning against each candidate by 50% we find our estimates for French and German bonds yields are broadly in line with current market levels but we continue to estimate slightly higher yields for Italian bonds (Figure 14).

Sensitivity to yield levels in scenario

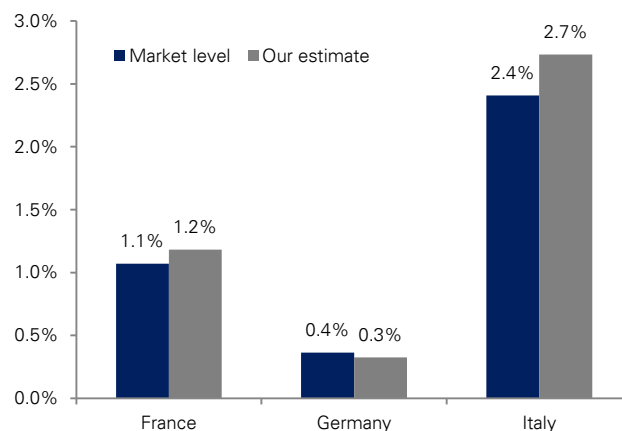
In our analysis, even in a scenario where Le Pen loses the referendum or is unable to call a referendum the France-Germany spread remains reasonable wide at 100bp and 125bp respectively. Similarly the Italy-Germany 10Y spread remains reasonably wide at 300bp and 350bp in these two scenarios. If instead we get an additional tightening in spreads by 25bp for France-Germany and 75bp for Italy-Germany spreads in each of these cases we would see reasonable convergence between our estimates and current market levels (Figure 15).

Figure 14: The gap between our estimate and market levels narrows if probability of Le Pen winning is reduced by 50% vs. all candidates



Source: Deutsche Bank, Bloomberg Finance LP

Figure 15: The gap between our estimate and market levels narrows if we assume a greater tightening in scenarios where Le Pen loses the referendum or is unable to call one



Source: Deutsche Bank, Bloomberg Finance LP



Appendix 1

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