



French elections: An investor guide

Today we have published our comprehensive multi-asset analysis of the French elections. Six separate reports cover (i) [economic and politics scenarios](#), (ii) [currencies](#), (iii) [government bonds](#), (iv) [French banks](#), (v) [European equities](#) and (vi) [equity derivatives](#). This document summarises these reports and provides an overview of our macro outlook and asset price projections. Please use links on the right of this page to access the in-depth publications.

- Europe is going through its worst existential crisis in sixty years. In such a fragile environment, the French elections can be seen as a battle between pro- and anti-European forces. The final outcome could have fundamental ramifications for the monetary union.
- We do not predict the outcome of the French elections. But instead, analyse scenarios based on indicative probabilities that are a function of (i) current polls and (ii) past polling forecast errors across time and countries. These probabilities suggest that France is more likely to elect a Europe-friendly candidate rather than National Front leader Marine Le Pen.
- Such an outcome would probably trigger a positive reaction by markets. German government yields would likely increase and France's and Italy's spreads narrow. European banks could outperform materially led by the French banks. In this scenario, it is likely that a reformist, pro-European government would be formed. This could represent an opportunity to put the EU and EMU onto a firmer footing, conditional on the outcome of the next German and Italian elections. Conversely, a muddle-through approach is not a sustainable strategy.
- There are still several weeks to go before the election. As markets discovered in 2016, anything can happen – but many clients want to know what might happen if Le Pen were elected. Electing Le Pen would, based on our analysis, deepen the existential crisis for the euro area even before knowing whether the new president would (a) manage to hold a referendum on Europe and (b) win it.
- The macro and multi-asset outlook would depend on the interaction between the Presidential and legislative elections. A President Le Pen would still face material institutional and constitutional hurdles. With Le Pen as a president we see a one-in-three chance of a euro referendum.
- If a euro referendum is called, capital flight, contagion to peripherals and market stress would likely ensue. Government spreads in France would widen above – and in Italy in line with – the respective levels seen during the euro-area sovereign crisis. European equities would fall sharply with a significant spike in implied equity volatility. In this case, we expect the ECB to play a constructive role in avoiding a disintegration of the common currency area in the short run. We assume the ECB would have the implicit support of core country politicians regardless of forthcoming elections.
- If France votes out, however, Europe's non-populist leaders are likely to attempt "one last stand" to save the euro. This requires, in our view, a quantum leap in integration and convergence. The risk is that trading sovereignty and economic convergence via structural reform for greater solidarity would take years, not months. Whether there is enough trust left between core and peripheral countries to achieve this is questionable.

Accompanying documents

France elections:

- [Economic & political scenarios](#)
- [FX](#)
- [Government bonds](#)
- [French banks](#)
- [Equities](#)
- [Equity derivatives](#)



The French elections are crucial for Europe's existential crisis

The French Presidential and legislative elections are not simply about France's next five years. They have grabbed markets' attention because they could have a fundamental impact on the future of Europe.

Europe is going through its worst existential crisis in sixty years. The Great Recession and the euro-area sovereign crisis have opened the doors to the rise of populist and eurosceptic movements. *First*, the UK decided to leave the European Union. *Second*, eurosceptic parties in Italy have *en masse* successfully campaigned for the rejection of the Senate reform in the recent referendum. *Third*, even if recently polls have moved against it, the eurosceptic PVV has significant chances to come first in the [Dutch General election](#) on 15 March. Although we do not expect the PVV to be part of a government, the Netherlands would likely push back at proposals for more European integration.

Pro-European parties are on the defensive. Without greater integration the euro area remains a vulnerable, sub-optimal monetary union, whose survival is exposed to the whim of the cycle. Indeed, the monetary union seems stuck between the political inability to integrate further and fears of growing anti-euro sentiment.

Such an environment magnifies the importance of the French elections. They can be seen as a battle between pro- and anti-European forces.

Indeed, the two candidates leading the opinion polls for the first round of the Presidential elections could not have more starkly opposite stances towards Europe. The leader of the National Front Le Pen wants France to exit the monetary union, to bring back the Franc with a potential 20% depreciation and to introduce protectionist measures.¹ The other candidate leading opinion polls, the independent centrist candidate Macron, is campaigning on a clear pro-European message, for example with calls for the creation of a collectively managed euro-area budget.

Our framework

We built a quantitative framework within which we discuss indicative probabilities for various states of the world post election – summarised in Figure 1 – and the potential consequences for asset prices.

The indicative probabilities attached to the scenarios are a function of current French polls combined with (i) the country's past elections – historical polling forecast errors and the December 2015 regional election results – as well as (ii) recent political experiences elsewhere including the US Presidential election, Brexit and Italy's 2016 referendum.

These indicative probabilities are aimed at facilitating the narrative rather than representing Deutsche Bank's predictions of the outcomes of the French elections.

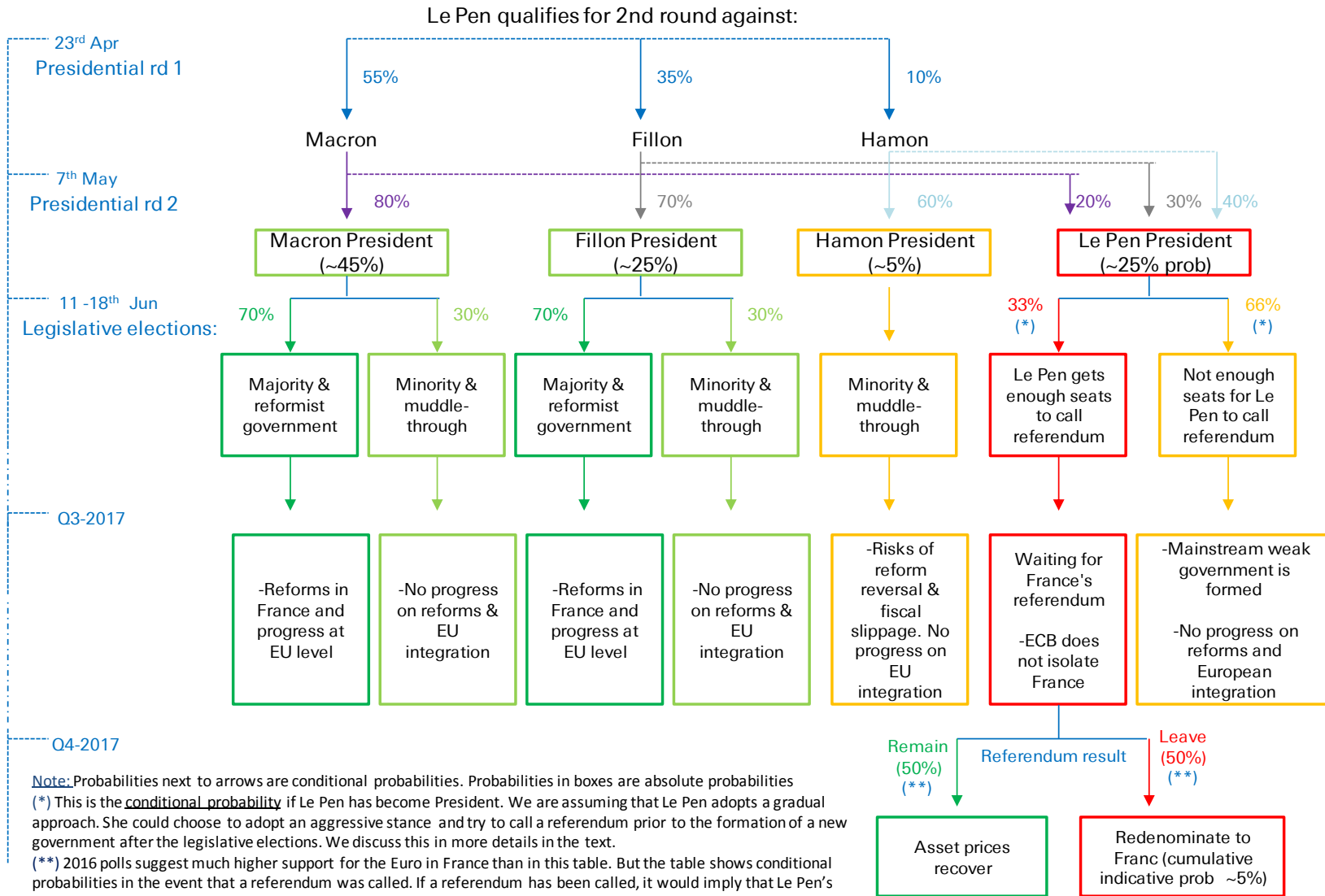
French election dates:

- 23 Apr: Presidential round 1
- 7 May: Presidential round 2
- 11 June: Legislative election round 1
- 18 June: Legislative election round 2

Source: Deutsche Bank

¹ For the main Presidential candidates' programmes see Figure 8 in the Economics & Politics report.

Figure 1: Breaking down the French electoral cycle into potential scenarios with indicative probabilities based on opinion polls and timeline



Source: Deutsche Bank



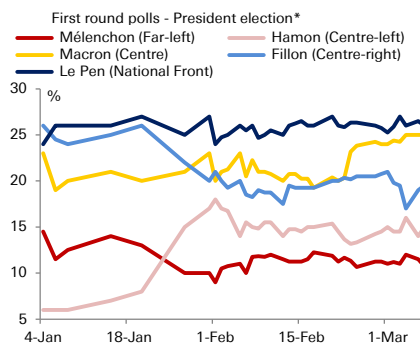


Central case scenario based on polls

Although uncertainty remains high, polls suggest that the central scenario is a victory in the Presidential election by a mainstream candidate (Macron or less likely Fillon). Of course, it would be reckless to be overconfident in such an outcome:

- First, the US Presidential election and the Brexit referendum disproved the wisdom of polls and the market consensus. The polling forecast error was particularly large in the latter case. That said, as shown in Figure 3, even after adjusting current polls for the six-percentage-point forecast error in the UK referendum, Le Pen would still have to close a 15pp gap against Macron. That said, she would have a better chance against centre-right Fillon (Figures 2 and 3).
- Second, while 75% of interviewees planning to vote for Le Pen are certain of their choice, the proportion for Macron is 50%, making his support more vulnerable. That said, we believe that the French two-round electoral system represents a major hurdle for Le Pen which will coalesce centre-right and centre-left voters around a mainstream candidate in the second round. Note that contrary to the experience in the December 2016 Italian referendum, radical-left wing voters are unlikely to join forces with National Front supporters in the second round.

Figure 2: Presidential election first-round polls



Source: * Daily average of all available opinion polls
 Source: Ifop-Fiducial, BVA, OpinionWay, Elabe, Harris Interactive, Cevipof Ipsos-Sopra Steria, Odoxa, Kantar Sofres - OnePoint

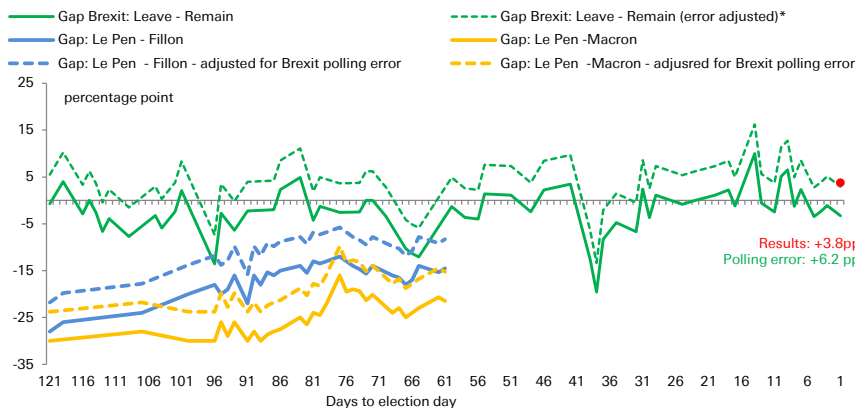
A stable government

The ability of a mainstream candidate to implement his programme will depend on the outcome of the June legislative election. While compromises

are to be expected, we think that it is more likely than not that a reformist, pro-European government can be formed. This would be a positive for the short-term and medium-term outlook of France and Europe:

- We would expect France GDP growth of 1.5% in 2018F (Figure 7). We could ultimately increase our French potential growth estimate of 1.1% by 0.2-0.3pp.
- In the accompanying fixed income report, Deutsche Bank's Abhishek Singhanian would see the 10Y German yields being in the 40bp-50bp range, France-Germany spreads at 40bp and Italy-Germany spreads in the 180-190bp range. Market focus could gradually shift back to Italy. Although the balance of probabilities has moved towards an election in Italy in Q1 2018, the combination of (i) increasing risks of the next election taking place with a *de-facto* proportional system, (ii) extreme political fragmentation and (iii) robust support for the populist parties could lead to an unsavory cocktail.
- At the European level, according to Deutsche Bank equity strategist Sebastian Raedler the Stoxx600 index would be up only modestly relative to current levels. Yet, banks would likely materially outperform the market in this scenario.

Figure 3: Applying the last week's Brexit margin of error to French polls



* Adjusted for average opinion poll estimation error in last week
 Source: Deutsche Bank
 France: Ifop, BVA, Harris Interactive, Kantar Sofres - OnePoint, Elabe, Ifop-Fiducial, Ipsos, OpinionWay
 Brexit - ICM, Panelbase, Survation, ICM, ORB, ComRes, Ipsos MORI, BMG Research, YouGov, YouGov/The Times, TNS, Opinion, Populus/Number Cruncher Politics, Greenberg Quinlan Rosner Research, NATCEN, ORB/Telegraph, Survation/IG Group, Populus



- We think that a Macron (or Fillon) victory would be a favourable outcome for French banks in particular. Deutsche Bank French banks analyst, Flora Benhakoun, estimates that on average French banks have underperformed the broader European banks index by ~5% YTD amid concerns about French political risk and that underperformance would likely unwind.²
- Deutsche Bank equity derivatives strategist, Simon Carter expects equity volatility to return to the “lower volatility regime” discussed in their 2017 outlook, with VSTOXX in the 15-20% range.
- Over the medium term, Macron could represent an opportunity for Europe to put its main entities – EU and EMU – onto a firmer footing. The outcome would be conditional on the next German and Italian elections.

Polls point to a substantial fall in support for centre-right Fillon in the first round to the benefit of Macron. At the second round, Fillon is still seen as defeating Le Pen, but with a decreasing margin. *If the recent trend continues, Fillon’s lead versus Le Pen could fall closer to the average forecast error for the Brexit referendum polls.* If Fillon disproves current polls and becomes President with a stable government, we would expect a market reaction in line with that described above – see graphical summary across scenarios in Figure 6.

An unstable government

If after the legislative election a reformist government under Macron (or Fillon) cannot be formed, *the current policy muddle-through would continue. Such an outcome would likely benefit populist parties.* In our opinion, a muddle-through approach is not a sustainable strategy for the euro area as the next crisis would bring a watershed moment.

That said, the markets will continue to, at least initially, focus on the relief of having dodged potentially highly-disruptive outcomes. Hence, in this case we would expect:

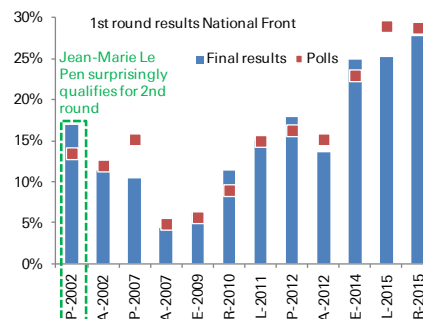
- The French-German spread to be modestly wider by just 20bps.
- French banks to still benefit from the removal of short-term political risk.
- European equities to stay at current levels and equity volatility to not react.

The least likely scenario

Based on the indicative probabilities described above, the least-likely scenario appears to be a victory of the Socialist candidate Hamon. His chances could modestly increase in the highly unlikely event of an alliance with the radical-left candidate Melenchon. *But in this scenario, we would also increase the likelihood of a Le Pen victory at the second round.*

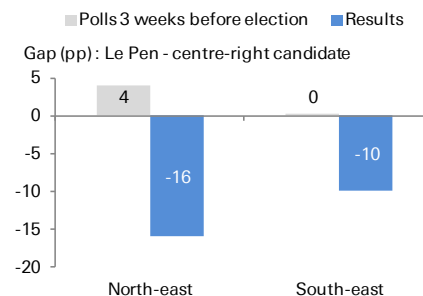
If Hamon were to become President, in the first couple of years we would expect tensions with Europe on fiscal policy and risks of reform reversals to be then followed by more centrist policies.

Figure 4: Pollsters careful in measuring National Front support



Note: P-Presidential elections, A-National Assembly elections, E-European elections, R-Regional elections, L-Local elections. We use the average of the last 5 available polls prior to the vote. Source: Deutsche bank, Ifops, Sofres, BVA, OpinionWay, Ipsos, Elabe, Harris interactive

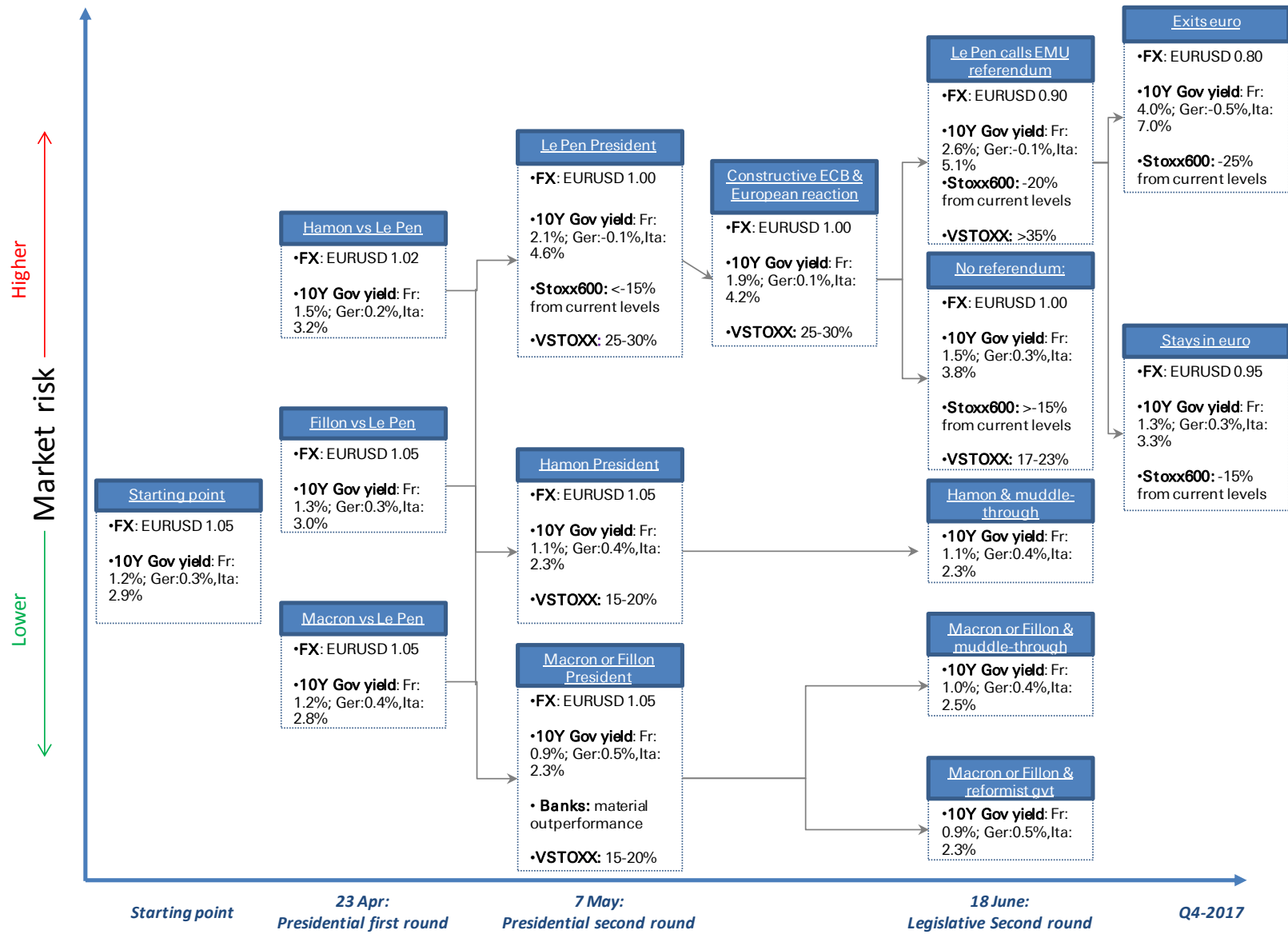
Figure 5: In 2015 regional elections, polls suggested a National Front win in two regions. It won none.



Source: Deutsche bank, BVA-Presse régionale "Elections régionales 2015, intentions de vote par région", sample size 1043 and 914, 17-23 Nov 2015, A Zulfikarpasic

² The accompanying French banking sector report argues that the best way to be positioned on French banks is through pair trades.

Figure 6: Summarising market outcomes across different scenarios



Source: Deutsche Bank





The high-impact scenario: Le Pen becomes President

The macro and cross-asset outlook will depend on the interaction between the Presidential and legislative elections. A President Le Pen would still face material institutional and constitutional hurdles to apply most of her proposals. That said, just electing Le Pen would deepen the existential crisis for the euro area even before knowing whether the new President will (a) manage to hold a referendum on Europe and (b) win it.

Avenues to call a referendum

Will Le Pen be able to call for a referendum on France's euro-area membership? There are two main direct routes:

- Less likely – Aggressive acceleration: Le Pen could try to call a referendum prior to the June legislative elections. She would appoint a PM who would in turn propose the referendum and organise a special meeting of Parliament to debate it. A vote is not necessary, only a debate is required. That approach effectively removes the Parliamentary hurdle. That said, the Constitutional Court needs to approve the organizational decrees. Constitutional experts are split on whether the Court would oppose such an aggressive move. Note that if Le Pen were to be elected, she is likely to do so thanks to low participation in the Presidential election second round.
- Our central case scenario is that Le Pen will take a gradual approach. We would expect her to avoid (i) an immediate institutional crisis and (ii) large protests in order to maximize the National Front's chances at the June legislative elections. **In this scenario, Le Pen's key hurdle would be to gain the support of a fifth of parliamentarians in the joint session of the Upper and Lower Houses (Article 11 of the French Constitution). To do so she would need to gain at least 150 MPs out of 577 seats at the June election for the Lower House.** According to our estimates, such an outcome requires a swing in support for the National Front equivalent to about a victory with 55% of the vote in favour of Le Pen in the Presidential election.³

Under the scenario where Le Pen has won the Presidential election, we assign a 1/3 probability to the National Front getting at least 150 seats based on the 2015 regional election adjusted by Le Pen's surprise Presidential victory.

In the opposite scenario where Le Pen remains President but she does not manage to trigger a euro referendum (after the legislative election), spreads versus Germany should narrow after the initial reaction but we would expect them to remain above current levels with German 10Y yields at 0.25%, France-Germany 10Y spreads at 125bp and Italy-Germany spreads at 350bp. We would expect the Stoxx600 to be about 15% below current levels with VSTOXX in the 17-23% range.

What happens if Le Pen has enough support to call a euro referendum?

If Le Pen manages to call a euro referendum via Article 11 of the French Constitution, the conditional probability of France exiting the euro area would likely become a 50-50 call. In the period before such a referendum:

³ There is a possibility that Le Pen could first go for the above described gradual approach to maximize her chances at the June election but in the case of defeat she could then reverse to an aggressive strategy. She could create an institutional crisis by insisting in appointing a hard-core eurosceptic PM and consequently dissolve the Parliament. As France waits for a new parliamentary election her PM would stay and could propose a referendum. Alternatively Le Pen could promote an electoral reform towards a proportional system, which could give the National Front enough representation to trigger a euro referendum – see box 2 on page 11 in the Economics & Politics report.



- Capital flight and market stress are likely to ensue. We would expect French GDP to enter a recession.
- The market reaction would be extremely negative with contagion to the peripheral countries. French-German spreads would reach 270bps with Italian spreads at 520bps, the 10Y German yields would fall below zero (-0.1%).
- The euro could depreciate by nearly 10% against the USD. The Stoxx600 index would decline by around 20% relative to current levels and equity volatility would reach the scale of the 2011/12 Eurozone crisis (VSTOXX >35%).

However, we would expect France and the euro area to avoid capital controls:

- Le Pen would politically have little incentive to proactively call for capital controls. She would have a greater chance of winning a euro referendum if she can prove that “Europe” *de facto* imposed capital controls as this would strengthen her case for regaining monetary sovereignty.
- The ECB would likely play a constructive role in avoiding a disintegration of the common currency area in the short run. We assume that the ECB will have the implicit support of core country politicians.
- Based on their collateral buffers, we think that the French banking system would be able to sustain the stress while waiting for the referendum – this is explored further in the French banks report. Together with the insurance sector, it should also be able to support the gross financing needs of the French government over the May-December period.

If we are wrong, capital controls would lead to significant contagion and a sharp deleveraging, severely damaging the French and euro-area economy.

What happens if France votes to remain in the euro area?

In the scenario where Le Pen loses a euro referendum in Q4 2017 we would expect a partial recovery in asset prices.

- We would expect the 10Y German yield at 0.25%, i.e. close to the average levels seen since the start of the ECB’s QE programme. The French and Italian 10Y government spreads versus Germany could narrow to 100bp and 300bp respectively.
- The Stoxx600 index would regain some of the lost ground but still be down nearly 15% relative to current levels.

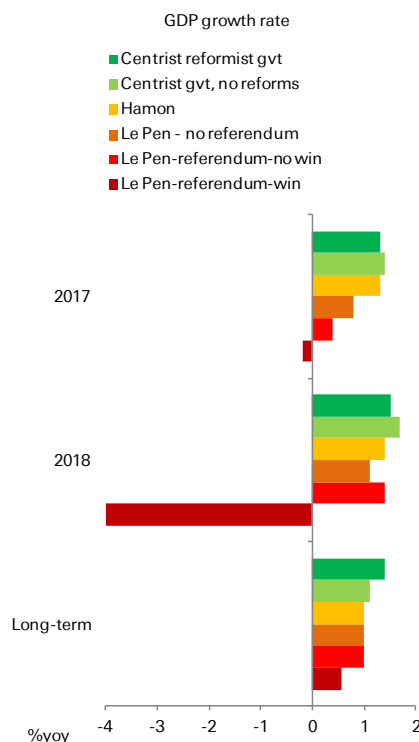
Note that in this case, we project modestly tighter spreads than in the scenario where Le Pen remains President but is unable to call a referendum. It is true that in the former scenario Le Pen must have *ex-ante* captured a larger political support than in the latter one. However, *ex-post* the evidence of the economic damage caused by the attempt to exit the euro area would, in our opinion, decrease support for eurosceptic parties in France and Italy.

What happens if France votes to exit the euro area?

In the tail scenario where France leaves the euro area, other elements of Le Pen’s economic agenda – Bank of France to finance budget deficits, no free-trade agreements, tax on employment of foreigners – will also become more probable.

- The market might price in a reasonable probability of a 1980s style high inflation environment in France. While since the early 1990s the France-Germany 10Y spread has not been wider than 150bp, in the 1980s the spread averaged 400bp with peaks as high as 700bp. Hence, in the scenario of France exiting the euro area the French 10Y yields could be around 4%. Contagion would push down German yields to -0.5% and Italian 10Y yields up to 7.0%. The spread between Italy and Germany

Figure 7: French GDP projections under the key scenarios



Source: Deutsche Bank



would then be 250bp above the peak seen during the euro-area sovereign crisis.

- European equities would be further impacted negatively with the Stoxx600 index falling further, down 25% relative to current levels. The sharp currency depreciation would only partially offset the domestic economic fallout.

A last-stand of the remaining EMU countries is unlikely to succeed

In the tail-risk event of France exiting the monetary union, Europe’s non-populist leaders are likely to attempt “one last stand” to save the euro.

That said, the only way to sustain the single currency in the long-run is through a quantum leap in integration and convergence. Even if there is political willingness for fiscal integration in core countries, without France these countries would probably not have enough resources to support the periphery. Peripherals would have to swiftly implement deep structural reforms that lead to a convergence with core countries – first of all Italy.

Europe has probably left it too late to credibly achieve this quantum leap and get to the appropriate depth and balance between greater solidarity and loss of sovereignty in the face of an immediate shock such as France’s exit. There is probably not enough trust left between core and peripheral countries. We think that, at best, a hard core of Northern euro-area member states could retain a common currency.

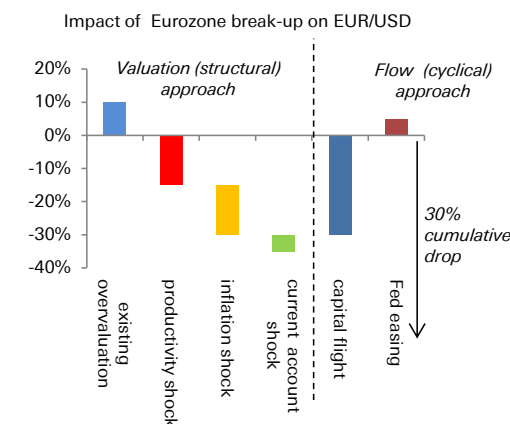
FX impact of a euro-area break up

On the FX side we have focused on the extreme tail risk of France exiting and of euro-area break-up. Under very conservative assumptions, Deutsche Bank FX strategists Robin Winkler and George Saravelos estimated that ex-ante the EUR/USD exchange rate would depreciate by 25-30% to 80-75 cents. Legacy currencies may fall even further after the event.

A capital flows approach would suggest that EUR/USD would depreciate by 30% before the break-up assuming reserve re-allocation. An alternative valuation framework accounting for the negative productivity and inflation shocks would suggest a 25% depreciation. A powerful Fed response could provide an offset of 5-10%.

Some currencies such as the Deutschmark could regain some of the lost ground post break-up. That said, relative to the current shadow FX rate all currencies would end up depreciating against the US dollar, with a cumulative depreciation ranging from 10% in Germany to 70% in Greece and Portugal. France and Italy could experience a depreciation in the upper-middle levels of this range. Our assumption here is that there is a significant negative productivity shock. Our estimates are highly sensitive to the degree of capital outflows as well as to the size of the productivity and inflation shocks that materialize.

Figure 8: Impact of Eurozone breakup on EUR/USD



Source: Deutsche Bank

The authors of this report wishes to acknowledge the contribution made by Kuhumita Bhattacharya and Baqar Zaidi in preparation of this report



Appendix 1

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