

Asset Allocation

This month's topic

French Presidential Election: taking stock of the situation and decrypting current issues

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French elections are a major concern for the financial markets because they are emblematic of current trends: the rise of far-right (or respectively extreme left) parties in the EMU core countries (respectively peripheral countries), the growing rejection of the establishment, protectionist temptations, hostility towards Europe and / or towards the European institutions, the fight against inequalities, the debate on the sharing of added value (employees vs. shareholders)... The election of an anti-European candidate or the election of a candidate who wants to reform Europe or leave the EU in the event of failure to reform it (as advocated for example by Marine le Pen or Jean-Luc Mélenchon) is currently perceived as a vote in the continuity of the Brexit and the election of D. Trump in the United States.

This is not at all our central scenario, but it seems legitimate that risk premiums (spreads against Germany, volatility, CDS ...) remain at high level until we see more clearly the outcome. Let us also recall, and it is very important, that Brexit votes and American elections took place on a single round: the one who is won the first round had been elected. This is not at all the case of the French elections, where the second round is likely to drastically rebuff the cards. **The winner of the first round has no assurance of being the winner in the second round: the game of alliances and voice transfers always makes the difference.** One of the objectives of this note is to explain all of this in detail, and to present the scenarios involved.

Let us recall that four electoral deadlines are converging:

- The presidential elections (on Sunday 23 April and Sunday 7 May 2017)
- The general elections (Sunday June 11th and Sunday June 18th), to replace 577 members of Parliament.

The candidates for the French presidential election

There are currently more than 50 people, who seriously or somewhat more "fanciful", said they want to stand for the presidential election. But this is not so simple, because each of them must gather the necessary sponsorships. In order to run, a candidate must have 500 signatures of elected representatives from at least 30 different departments (with a maximum of 50 signatures (10% signatures) per department). Only elected representatives can lend their support to an application, that is to say mayors (NB: there are 36,000 communes in France), deputies, senators, European parliamentarians, regional councilors, general councilors, the members of the Corsican Assembly and the Overseas Assemblies. In total, there are potentially more than 47,000 sponsors. The list of 500 supporters must be provided by 17 March at 6:00 PM at the latest. As for each presidential election, only a dozen people will be official candidates, some not getting the required sponsorships, others withdrawing to the advantage of candidates better placed.

Among the various personalities who officially declared their candidacy, eight of them completed their quest and obtained the 500 necessary supports. As of March 14, in alphabetical order, they are:

Nathalie ARTHAUD, official candidate of "Lutte Ouvrière", extreme left (0.56% of votes in the first round of the presidential election of 2012), 46 years old.

The essential

French elections are a major concern for the financial markets because they are emblematic of current trends: the rise of far-right (or extreme left) parties in the EMU core countries (peripheral countries), The growing rejection of the establishment, protectionist temptations, hostility towards Europe and / or the European institutions, the fight against inequalities, the debate on the sharing of added value (employees vs. shareholders) ...

The very fact that it is possible to contemplate the election of an anti-European candidate or who wants to reform Europe or leave the EU is likely to generate uncertainty, volatility and damage to the financial markets (weakness of the euro, increasing interest rate spreads against Germany, a rise in CDS levels ...). Note that exiting EU is complex, while a Frexit would seriously damage (destroy) the European construction. This is not our scenario, but we must admit that before the election results, the likelihood of seeing stress disappear is virtually nil.



French elections represent a major concern for the financial markets because they are emblematic of current trends



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François ASSELINEAU, founder of the Union Populaire Républicaine (UPR), general delegate for economic intelligence at the Ministry of the Economy and Finance between 2004 and 2006, 59 years old.

Nicolas DUPONT-AIGNAN, candidate of the party “Debout La France” (1.79% of the votes in the first round of the presidential election of 2012), 55 years old.

François FILLON, official candidate of the party “Les Républicains”, former Prime Minister (2007-2012), former Minister of Higher Education and Research, former Minister of Information Technology and Post, former Minister of Social Affairs, former Minister of Education (under the presidencies of Jacques Chirac and Nicolas Sarkozy), 62 years old.

Benoît HAMON, official candidate of the “Socialist Party”, former minister responsible for social economy and solidarity, former Minister of Education (under the presidency of François Hollande), 49 years old.

Marine LE PEN, candidate of the “Front National” (17.90% of the votes in the first round of the presidential election of 2012), far right, 48 years old.

Emmanuel MACRON, Movement “En Marche!”, Former minister of the economy of François Hollande, 38 years old.

Jean-Luc MELENCHON, president of the party “The left party” recently renamed “France insoumise” (arrived 4th in the first round of the presidential election of 2012 with 11.1% of the votes), former minister delegate to the Professional education of Lionel Jospin, 65 years old.

In total, only 5 candidates are likely to win over 10% of votes in the first round of presidential elections: Marine Le Pen and François Fillon for the right, Benoît Hamon, Emmanuel Macron and Jean-Luc Mélenchon for the left.

For the right-wing parties, François Fillon (whose candidacy is currently complicated) and Marine Le Pen are irreconcilable on many subjects, not least of which Europe, protectionism, immigration policy, and any alliance for a second round of elections is impossible.

The case of the left is even more complex: with three candidates to date plus two other candidates of the ultra-left, it is the most fragmented part of the political landscape. There will, however, be three major candidates, representing three relatively traditional political streams:

- **Supporters of the “big bang”**, represented by the extreme left and advocating radical changes. This big bang is represented by Jean-Luc Mélenchon, but also by other candidates like Philippe Poutou or Nathalie Arthaud;
- **Proponents of the welfare state**, whose measures quickly end up burdening the major financial and budgetary equilibriums. It was clearly the political cornerstone of François Mitterrand and François Hollande, and it is the way also of Benoît Hamon for the 2017 presidential election;
- **Supporters of competitiveness, both of companies and governments.** This trend has always existed and it has always been a minority for decades. It is embodied today by Emmanuel Macron, who reminds us of the intellectual turn of the German SPD party in 1959 which considered that *“the market as much as possible, and the state as much as necessary”* had to be the proper target. Many left-wing voters who, on the contrary, want a more marked left-turn on the part of the Socialist Party, do not recognize themselves in this political programme, which they consider to be in some respects close to the programme of the François Fillon conservative right. Macron also reminds of Tony Blair (former British Labor Prime Minister) who tended to consider that *“the economy is neither right nor left ... there is just what works and what does not”*.

Beyond these divisions, we must be clear: **the challenge of all the national elections to come (in the Netherlands, in Italy, in France and in Germany) lies in the sustainability of European integration.** Among all the candidates of the French presidential election, only Marine Le Pen (Front National, at the far right of the national chessboard, and Jean-Luc Mélenchon (“France Insoumise”, close to the extreme left of the political spectrum) are openly hostile to Europe or, more exactly, to the European institutions as they are currently



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Right-left: important - and often irreconcilable - divisions within both of them



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organized. Both candidates consider they have to leave Europe if it is not possible to change it. As for the other candidates, either they come from openly pro-European parties like François Fillon (Party of Republicans (conservative right) and Benoît Hamon (Socialist Party, “classical” left), or their movement is based on the will to participate in the European Union (Emmanuel Macron, “En Marche!”, a center-left and center-right movement since its association with François Bayrou (MODEM)). It is true that the two Euro-skeptical / anti-European parties (both supporting a big bang scenario) currently collect 40% of the voting intentions (slightly less than 30% for Marine Le Pen, just over 10% for Jean-Luc Mélenchon), but their association is totally impossible.

As regard the current polls, the risk Mélenchon represent to Europe is currently much lower than the risk Le Pen, but we do not bet at all on these risk scenarios. However, it is certain that the seizure of power by the Front National party (Marine Le Pen) would make the case for Frexit possible (exit of France from the European Union). Mrs Le Pen is indeed considering reforming the EU or leaving the EU one of her main battles: she has clearly announced that if France is not able to change, over a period of 6 months, the economic policy, the immigration policy ... then she would proceed, as promised, to a referendum on the exit of the EU. Here comes a key question: are the French people ready to send their country on the way out of the EU? Not sure, in fact, but there is no doubt that this risk (the “Frexit”) will continue to have an impact on the EU and more specifically on EMU: the fragility of the euro, the rise in spreads in peripheral countries (including France) against Germany would be the main consequences... We do not believe in such a scenario, with France exiting EU and EMU and with Mrs Le Pen being elected. In Germany, both Angela Merkel and Martin Schulz (former President of the European Parliament) are supporters of Europe, as are also Emmanuel Macron and François Fillon in France, two candidates who, to date, have the greatest chance of gaining the elections. But before this happens, the financial markets will have to face three critical situations:

- First, they will have to live with the prospect of seeing the extreme right party emerge at the top of the first round of presidential elections. According to the surveys, Marine Le Pen, at the time of writing, would lead Emmanuel Macron (Movement “En Marche!”, moderate left), François Fillon (conservative right) and Benoît Hamon (Socialist party), and Jean-Luc Mélenchon (Left) with respective scores of 27%, 24%, 20%, 14% and 13% respectively (Opinion Way, March 14, 2017).
- Then, through the play of transfers of votes at the second round of the presidential elections, and according to the current polls, they should live the elimination of Marine Le Pen in the second round of the presidential elections It should be noted that, due to the transfers of votes and the ability of the right-wing parties to withdraw for the left-wing parties, and vice-versa, French voters have so far eliminated the extreme right of most elections, national, regional, municipal elections also ... It is said that in elections the French chose with their hearts in the first round and with their minds in the second. Marine Le Pen is expected to be defeated by both E. Macron (40% vs. 60%) and F. Fillon (43% vs. 57%), and the difference is statistically significant.
- Finally, it will be necessary that the newly elected president (presumably E. Macron (leading polls) or F. Fillon) attracts the voters to obtain a presidential majority in the legislative elections, the only way to have a stable government. The two candidates are clearly pro-European and their election would mean the emergence of a strong Franco-German axis and governments capable of carrying out reforms. The right-wing candidate will benefit from the support of all his camp (the right wing), which is not really the case with E. Macron, judged by many socialist voters as a sort of “dissident.” He is now perceived as a centrist, witnessed by his recent alliance with MODEM François Bayrou, centrist candidate of the last three presidential elections (2002, 2007 (when he finished 3rd in the first round with almost 19% of the votes) and 2012). In the event of Macron’s victory, the perceived risk would be to find himself with a president without support of a homogeneous party, which would be complicated. Such a situation would be highly probable with Marine Le Pen and Emmanuel Macron (except for the massive and unconditional rallying of

“ The two Euro-skeptical / anti-European parties would currently collect 40% of the vote’s intentions ”

“ In Germany, both Angela Merkel and Martin Schulz are pro Europeans, as are also Emmanuel Macron and François Fillon in France ”

“ Nearly one in two voters is still ready to change its mind ”

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the Socialist deputies), quite high with Benoît Hamon, and not negligible with Francois Fillon. The risk, ultimately, would be to have a country politically at a standstill.

What to think about polls? Are they really unavoidable... but unreliable? Some indispensable reading grids

Since the British referendum and even more since the election of Donald Trump to the presidency of the United States, it has become normal to criticize polls and polling institutes. Some observers reject them, others speak only of this. How should one judge opinion polls?

When we look at the results of a poll, we obviously have to look first at the **methodology** used.

The **sample** chosen must be representative of the population on the basis of gender, age, socio-professional categories, geographical situation ... The larger the sample, the higher the confidence zone and vice versa. The **margin of error** is also an important criterion. We all know that the lower the sample, the higher the margin of error. In other words, when a poll gives an advance of 1% or 1.5% between two candidates, it is actually zero given the statistical margin of error. Thus, for a sample of 1500 people, a 10% voting intention is in fact between 8.5% and 11.5%, and a 30% voting intention is between 27.7% and 32.3%. This greatly undermines the credibility of the gaps published in the surveys. In other words, the gap between F. Fillon and E. Macron is currently insignificant should we refer to some polls: whether one or the other is elected would in no way alter the credibility of the polls. The **timing** of a poll is also crucial. Voting intentions fell sharply following the Penelopegate, and then went back, as Macron's voting intentions made a (slight) leap after the agreement with F. Bayrou. Strong and low-key events drive the results of the surveys. To look at them in their dynamics has more sense than to consider them as a photograph at the instant t. Comparing polls also makes little sense: looking at the dynamics of each polling institute is more appropriate.

The **security of voting** must also be taken into account, as this is undoubtedly a crucial criterion. To put it simply, this is the percentage of respondents who say they are sure of their choice. Traditionally, some candidates have a vague base of voters, and the farther the deadline, the lower the security of voting. However, important differences between the candidates can already be highlighted. For example, 52% of Mélenchon's potential electorate recently admitted to being able to change their mind, a percentage similar to that of Benoît Hamon. For Emmanuel Macron, this percentage was even larger, at 58%. Only two candidates had a solid foundation: Marine Le Pen (23%) and François Fillon (28%). In other words, while the percentage of voting intentions of these last two candidates has little risk to decline (except in case of a sudden and negative event), Macron's was theoretically more at risk. This obviously did not augur the ability to attract additional voting intentions, or to the security of vote to rise... which precisely occurred. Three other criteria may complement the analysis: the **wish of victory**, the **victory prognosis**, the **feeling that a candidate would - or would not - be a good candidate**, which may at the last moment attract the undecided or the versatile voters. According to the polls, 28% of the French consider that Marine Le Pen has the "presidential stature", against 45% for E. Macron.

Conclusion

The French elections revive fears about the Eurozone, but these fears seem largely exaggerated. Bet on an improvement in spreads against bund (and in particular the spread OAT-Bund) and sovereign CDS after the elections. In the meantime, adopting a wait-and-see attitude (with a negative bias to France and other peripheral countries) still seems to be the best strategy.

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“ French elections revive fears about the Eurozone, but these fears seem exaggerated ”

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Asset allocation

Summary tables

Asset allocation: multi-class outlooks and convictions								
	1 month-change	---	--	-	0	+	++	+++
Equities/gov. bonds	→						□	
Corp. bonds/gov. bonds	→						□	
Equities/corp. bonds	→					□		
Duration	→				□			
Corporate bonds	→					□		
Oil	→					□		
Gold	→				□			
Cash EUR	→			□				
Cash USD	→					□		

Asset allocation: relative outlooks and convictions by major asset class									
		1 month-change	---	--	-	0	+	++	+++
Equities	US equities	→							
	Japanese equities	→				□			
	Euro equities	→					□		
	UK equities	→				□			
	Pacific excl. Japan	↘				□			
	EMG equities	→				□			
Gov. Bonds	US bonds, short	→		□					
	US bonds, long	→		□					
	Euro core, short	→			□				
	Euro core, long	→				□			
	Euro peripherals	→				□			
	UK bonds	→			□				
	Japanese bonds	→			□				
Corp. Bonds	US IG	→					□		
	US HY	→					□		
	EURO IG	→					□		
	Euro HY	→					□		
	EMG debt hard currencies	→				□			
	EMG local debt	→			□				
FX	USD	→					□		
	EUR	→			□				
	JPY	→				□			
	GBP	→				□			

The table above represents an investment horizon of six to 12 months. The changes reflect the outlooks expressed at our most recent investment committee meeting. The different lines provide relative outlooks for each major asset class and absolute outlooks for forex and commodities. The outlooks, changes in outlooks and opinions on the asset classes reflect the expected direction (+/-) and the strength of the convictions (+/+/+). They are independent of the constraints and considerations concerning the construction of portfolios.

Macro Hedging Strategies

	one-month change	0	+	++	+++	
Long US Treasuries	→		□			The economic risk is declining, with economic indicators rather reassuring in the United States, Asia and Europe. The French leading indicators are well oriented, but the political risk remains. The Fed will tighten its monetary policy in March, but this is largely expected and does not augur a real change in pace in rate hikes. The US corporate tax reduction is expected to further mitigate the risk on growth. The US Treasuries, the US dollar (and GBP, NOK and SEK) appear as good alternatives to European political risk and potential difficulties in the euro area.
Long Bunds	→	□				
Long USD	→		□			
Long JPY	→	□				
Long volatility	→		□			
Long cash USD	→		□			
Long Gold	→		□			
Long US TIPS	→		□			

The table above represents a short investment horizon of one to three months. The changes (column 2) reflect the outlooks expressed at our most recent investment committee meeting. The lines express our aversion to risk and our macro-hedging strategies. They should be viewed in relation to the asset allocation tables. A negative outlook in terms of asset allocation will not lead to hedging. A temporarily negative outlook (negative in the short term but positive in the medium term) may lead us to protect the portfolio, without affecting our long-term outlooks. The application of the strategy is expressed by a position (+), and the scale of the position is expressed by a graded scale (+/+/+). These strategies are independent of the constraints and considerations concerning the construction of the initial portfolio subject to protection. These are overlay positions.

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