FIXED INCOME **FOCUS**

Could the French Presidential elections affect sovereign markets?

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Fixed Income Focus represents the viewpoint of the Global Fixed Income team at LGIM.

2016 wasn't a great year for the political pundits. With France heading to the polls shortly, could another political surprise be in store? And what could this mean for European debt markets?

FRANCE MOVES INTO THE POLITICAL LIMELIGHT

Having failed to predict both Brexit and Trump in 2016, confidence in political polls is low. The pollsters haven't exactly got off to the best of starts in 2017 either, having not foreseen the results of the French Republican and Socialist Party candidate selections. However, investors have little else to help them gauge elections results, and tension is mounting as France now moves into the limelight.

Much has been said about the rise of the far right across Europe. The French Presidential elections are of particular interest, with far right candidate Marine Le Pen commanding a healthy lead in the polls for the first round on 23 April.

However, the French system means a second round vote round on 7 May is highly likely. This is when the top two candidates will go head-to-head, and here her chances look weaker.

FRONT NATIONAL'S ODDS OF ELECTION ARE SHORTENING

Front National made it to the second round of the election in 2002 when it was run by her father, Jean-Marie Le Pen. Despite strong momentum going into the

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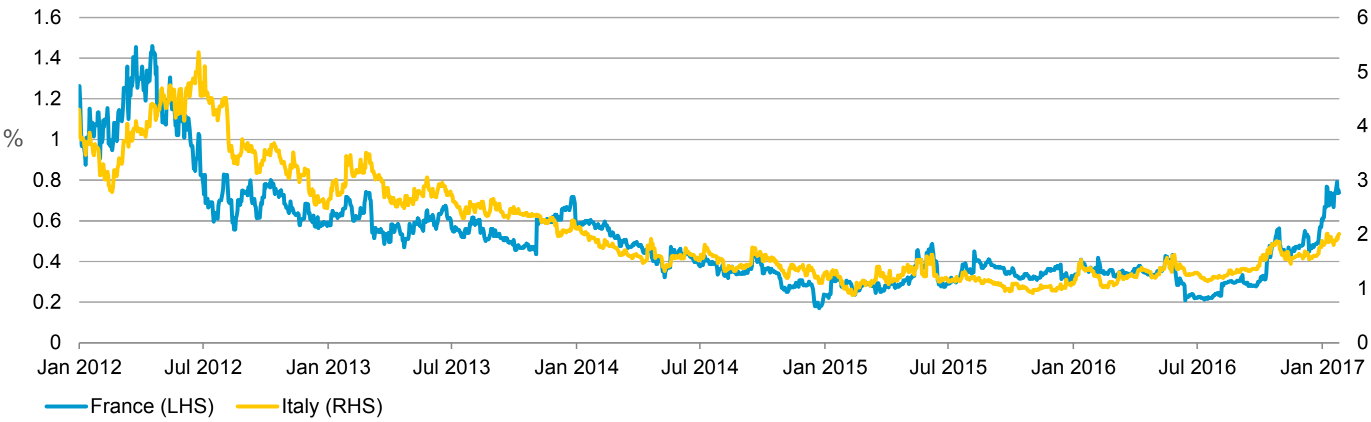
Figure 1 – Charting moves in French and Italian sovereign spreads



Source: Bloomberg as at 24 February 2017

first round, he was heavily defeated in the second round, losing to Jacque Chirac by 82% to 18%, having gained very little ground from the first round as supporters of other candidates rallied around Chirac. Despite Marine Le Pen moderating some of the party's strong lines which put the electorate off in 2002, the expectation is that a similar swing will prevent her becoming president in 2017.

Indeed, head-to-head polls have Le Pen losing the second round to either independent candidate Emmanuel Macron or conservative François Fillon, her two main rivals, albeit by a much lower margin than her father at around 60% to 40%. And what is more, this margin has been falling in recent polls.

To complicate matters further, a potential tie-up between far-left Socialist Party member Benoît Hamon and left-wing candidate Jean-Luc Melenchon is a distinct possibility which could catapult Hamon into the second round versus Le Pen. While there is plenty of common ground in their economic programmes, there are also areas where Hamon and Melenchon differ greatly, not least on Eurozone membership, with Hamon seeking greater European integration while Melenchon is pursuing significant reforms. A partnership is by no means a formality therefore, but it is an eventuality that the market is now beginning to consider seriously. Although there are as yet no head-to-head polls for a run-off between Le Pen and Hamon, we believe that this is likely to be the scenario in which Le Pen's chances are greatest.

WHAT COULD A LE PEN VICTORY MEAN FOR MARKETS?

With a referendum on Eurozone membership at the heart of her manifesto, we believe that a Marine Le Pen victory could be the most disruptive outcome for markets.

There are three possible routes to a French referendum. The first of these requires the support of a Parliamentary majority, which seems unlikely given that the June legislative election is projected to deliver a hung Parliament. However, both the second and third options are plausible. The second route only requires support from one-fifth of Parliament (and one-tenth of voters), while the third allows the President to circumvent Parliament and propose a referendum to the people directly. Considering that Le Pen would have needed in excess of 50% of the votes to win the Presidency, it seems highly likely that a referendum would indeed take place in the event of her victory.

With France holding a key position at the heart of the Eurozone, and with the Brexit vote fresh in people's minds, a higher probability of a referendum is likely to cause significant widening of sovereign spreads in France, as well as across all Eurozone sovereigns. Such a strong challenge to the euro project would be likely to hurt the most highly indebted and uncompetitive member states due to the risk of a return to individual currencies. Italy looks particularly vulnerable in this regard.

In recent weeks, spreads between the bonds of peripheral and core European countries have widened to levels not seen since 2014.

With the European Central Bank's (ECB) quantitative easing programme reaching its practical limits, and with outright monetary transactions as yet untested (and unlikely to be activated until the 'transition mechanism' between the ECB's purchases and the broader economy is negatively impacted) the path of least resistance appears to be for even wider spreads. It's also possible that Italian sovereign risk could underperform French risk, given how much the huge Italian government bond market relies on central bank support.

While a Le Pen Presidency is not our base case, it is not a stretch to believe polls currently under-represent the probability of this outcome. Indeed, with the pollsters having got things so wrong in 2016, we see the market continuing to put pressure on European sovereign spreads as we head into the first round of the French Presidential elections in April. As a result, in our global rates portfolio we are underweight peripheral markets, with a particular focus on Italy.

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