

Global Macro Strategy

Markets focus on the French elections

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Global

The recent failings of opinion polls have boosted European risk premia...

The failure of opinion polls to predict the outcome of key recent political events in the last few months (e.g. Brexit vote and the US elections) has led the market to re-price the odds of tail risks materialising well ahead of future such events. This is especially so in the Eurozone, where a number of important political events are coming up.

...driving French election-related risk premia higher across assets

The possibility that Mrs Marine Le Pen, leader of the eurosceptic National Front, is elected as President of the French Republic in May 2017 could raise questions around the future of the Eurozone. Importantly, French spreads vs Bunds have widened far more drastically than those of other Eurozone countries and the EUR has underperformed despite being 6 months away from the French elections and without any polling evidence that Mrs Le Pen is leading the race.

Mr Sarkozy's defeat in the Republican primaries may reduce risks for a while

Former President N. Sarkozy has failed in his bid to be the centre-right's candidate. This is significant as Mr Sarkozy has held the smallest edge over Mrs Le Pen in a hypothetical second round clash in the Presidential elections according to polls. The two remaining candidates are former PMs F. Fillon and A. Juppé. Mr Fillon is in prime position to be the candidate, even as Mr Juppé is enjoying the largest lead in a second round contest with Mrs Le Pen according to polls. Still, these same polls suggest that Mr Fillon also starts with a healthy margin vs Mrs Le Pen ahead of the Presidential election.

At the moment selling EUR/USD downside offers attractive risk-reward...

We think that there is value in selling EUR/USD downside at current levels after the Republican primaries. Although the Italian referendum may still weigh on the EUR in the coming weeks, a lot is already in the price on that front. In addition, the EUR is fundamentally cheap and supported by a very solid current account surplus while the prospect for a US growth boost is increasingly in the price.

...but we are not turning bullish on French spreads yet

On the other hand we are not turning bullish on French spreads to Bunds yet. Political risk remains elevated, polls' reliability has been challenged recently and French spreads remain prone not only to French-specific but also broader political shocks in the Eurozone, the Italian referendum being the next signpost. Instead, we would need to see more attractive levels and wider premia to argue the risk-reward is as appealing.

What might be the impact on French Equities?

If bonds suffer on political risk, French equities are likely to weaken if long run correlations hold. The spread of French yields over Germany has widened out to c.50bps – close to the highest for over 2 years. French equities are negatively correlated to the bond spread (the correlation is -0.6) – less exposed than some other European markets, such as Italy, but still linked. Further political risk from here and a widening bond-spread is likely to be a drag on performance for French equities: relative valuations in France are not cheap enough to absorb a shock, in our view. On the other hand, the pro-cyclical French equity index composition could limit the downside if global growth and reflation remain supportive.

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The market turns proactive around Eurozone political risk

Political risks in the Eurozone have forcefully re-entered the market's radar since the US Presidential elections. With 3 significant political events already having gone the other way from what polls indicated over the last 15 months (namely the Greek referendum last year, the Brexit referendum and most recently the US elections), market participants are now more sensitive to political event risk and also more sceptical of current polling evidence regarding the outcomes.

As a result, in our view the market has already started to re-price the risk premium associated with upcoming political risk events in the Eurozone well ahead of those events. The presidential elections in France in May 2017 is the most notable recent such example. The following observations support this view of ours:

1) While BTPs had been under pressure for the past few months (Figure 1), the recent spread widening has been most pronounced in French government bonds (OATs) both in absolute and relative terms within the European Government Bond (EGB) spread complex. The 10y OAT vs. Bund spread has widened by almost 20bp since the US election to levels last seen during the Greek crisis last summer (Figure 1). Unlike that period, however, the realized bp volatility for the 10y OAT vs Bund spread has skyrocketed since the US election, even relative to weaker EGB credits such as Italy (see Figure 2 and blue bars in Figure 3).

2) Another way to make the same point is by looking at the development of the EGB spread betas relative to the 10y OAT vs. Bund spread. Despite the general spread widening peripheral spreads have moved with a far lower beta compared to the OAT vs. Bund spread since the US elections (see brown bars in Figure 3), even as upcoming political risk events in Italy in particular are imminent.

3) The relative and absolute beneficiary in this entire episode has been Spain. The 10y SPGB vs. Bund spread was relatively well-behaved in the most recent EGB spread widening. It displayed the lowest increase in realised vol as well as the biggest drop in the beta relative to French spreads, indicating the strongest resilience in the EGB compound. This supports our [positive view on SPGBs](#) on the back of better fundamentals and more stable politics relative to its EGB peers.

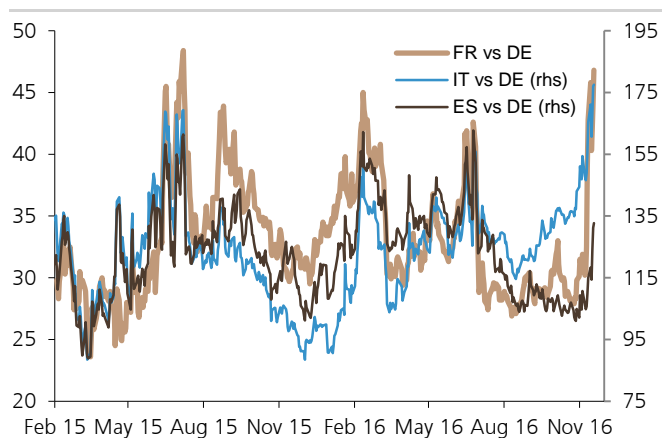
Markets are more sensitive to political risk after the recent failings of opinion polls...

... and have started re-pricing the risk premia linked with important upcoming events in the Eurozone

Post US-election spread widening has been focused on France, not Italy...

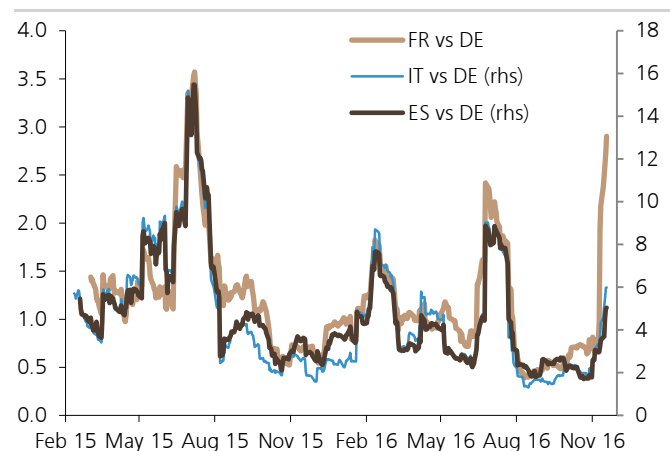
...with Spain the clear outperformer

Figure 1: 10y EGB yield spreads against Germany have widened substantially since the US elections



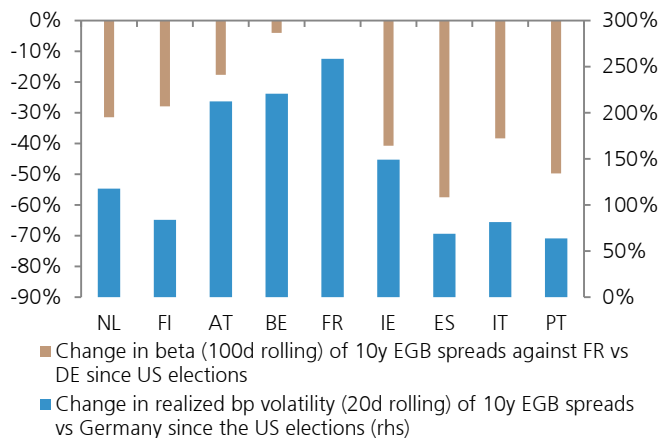
Source: Bloomberg, UBS

Figure 2: Daily realized bp vol (20 day rolling) of 10y EGB spreads against Germany has also spiked



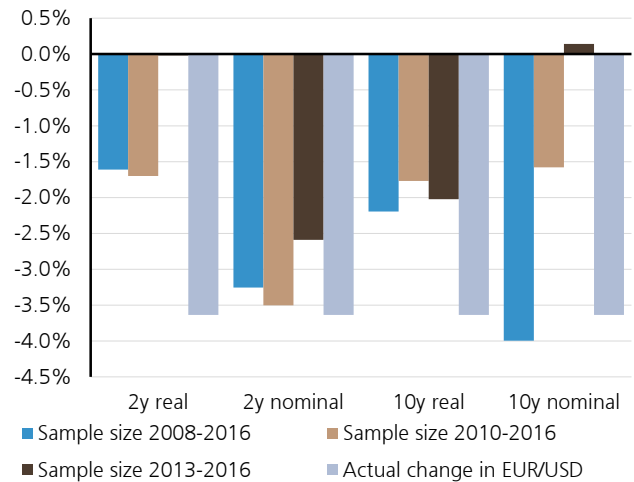
Source: Bloomberg, UBS

Figure 3: Mostly a French risk: OAT vs. Bund spread volatility spikes as the sensitivity of other EGBs spreads to French spreads falls



Source: Bloomberg, UBS

Figure 4: The fall in EUR/USD is 1-2% larger than implied by most measures of rate differentials and the 10y BTP spread to Bunds, also pointing to elevated political risk



Source: Bloomberg, UBS

4) Interestingly, the EUR has also been trading poorly since the US elections. In fact, EUR/USD has fallen by 1-2% more than what most measures of interest rate differentials and the widening in Italian spreads would justify across a range of sampling periods (Figure 4). This adds to the evidence that the risks around the French elections have also weighed on the currency recently over and above the [prospect of US reflation](#) and the Italian referendum.

The EUR has also underperformed during that time

The French Presidential election as a catalyst for changes to the Eurozone's current status quo

The renewed focus in the upcoming Presidential election in France in May 2017 stems from the possibility that Mrs Marine Le Pen, leader of the increasingly popular eurosceptic National Front, could be elected as President of the French Republic. The potential mix of the eurosceptic Mrs Le Pen at the helm of the second largest economy in the Eurozone is enough to revive existential questions regarding the future of the Eurozone that have been essentially dormant since the ECB introduced its OMT programme back in 2012.

Indeed, Mrs Le Pen's National Front in its [programme](#) demands renegotiation of France's membership in the European Union in favour of more sovereignty of the nation state. It also wants to set France's net contribution to the EU budget to zero and reintroduce its own monetary policy, i.e. leave the euro, and has promised a referendum to that effect if elected.

Next year's French elections are in the market's radar...

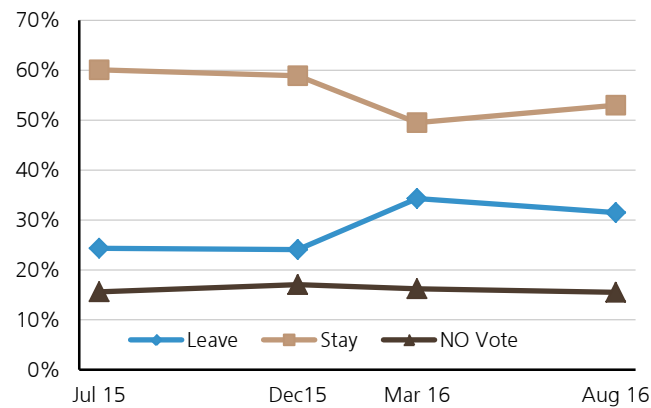
... due to the possibility that a eurosceptic President may be elected

Polling evidence on such a hypothetical referendum is scant, as the topic has not been formally entertained in French politics outside Mrs Le Pen's proclamations. The few surveys available point to an advantage for a Remain outcome, which however is not as high as one may expect for a country as central to the European project as France (Figure 5). More broadly, and with better data availability, the EU's perception in France according to the latest Eurobarometer is quite weak, with just over 35% of respondents having a positive view of the EU and negative attitudes surging closer to 30% from around 20% a year ago (Figure 6).

The EU's perception in France remains fairly weak

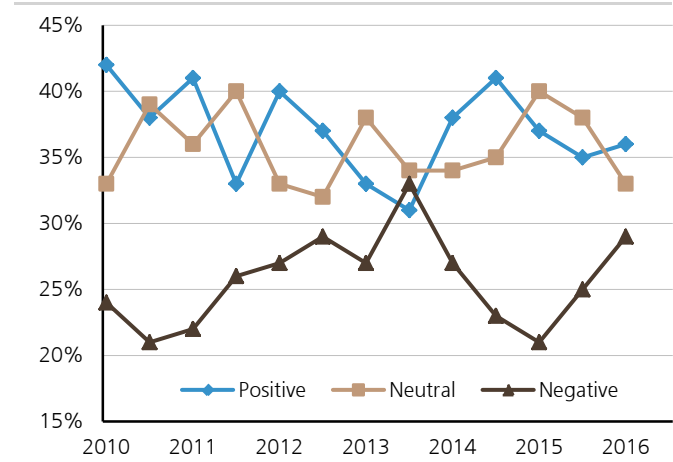
Figure 5: Polling evidence on a hypothetical referendum on EU membership for France points to generally weak support for Remain of just over 50%

Imagine there is a referendum and you could decide whether your country stays as a member of the EU. How would you vote?



Source: Bertelsmann Stiftung – [eupinions](#) are periodic EU-wide surveys by Bertelsmann Stiftung, a German think tank

Figure 6: The EU's image in France has taken yet another downturn in the last year



Source: Eurobarometer, UBS

Legal steps required for a French referendum on EU membership

It is also worth reviewing the various legal steps required to hold a referendum on EU membership in France. According to the French constitution (Article 11) a referendum can be initiated by the President on a proposal by the Government or by parliament (one-fifth of members of parliament, supported by one tenth of voters enrolled in the electoral register). Hence, this increases the importance of the French legislative elections, due to take place in June 2017. In case of a co-habitation, for example, it would obviously be more difficult for the President to push through such a referendum. The most recent opinion poll available on the legislative elections indicates that although the National Front would indeed be expected to make significant gains vs 2012, it would be nowhere near majority in the National Assembly (Figure 7).

However, even if a referendum on euro membership were possible, there remains considerable legal uncertainty as to the options available for Eurozone members to actually leave the common currency (but stay members of the EU, as Mrs Le Pen's programme suggests), given that EMU membership is linked to EU membership (unless the treaties were amended in a way that grants opt-out clauses retroactively).

The Republican primaries may put risks to rest for a while

The first round of the Republican primaries has already offered some clarity with regards to the Presidential elections in May and is likely to reduce near-term uncertainty.

More specifically, former president Nicolas Sarkozy failed to secure a place in this coming Sunday's run-off. Instead, Francois Fillon, a former PM under Mr Sarkozy, won 44% of the preliminary vote and is set to face another former PM, Alain Juppé. With Mr Sarkozy now officially backing Mr Fillon, he is very likely to be the Republicans' candidate by next Sunday.

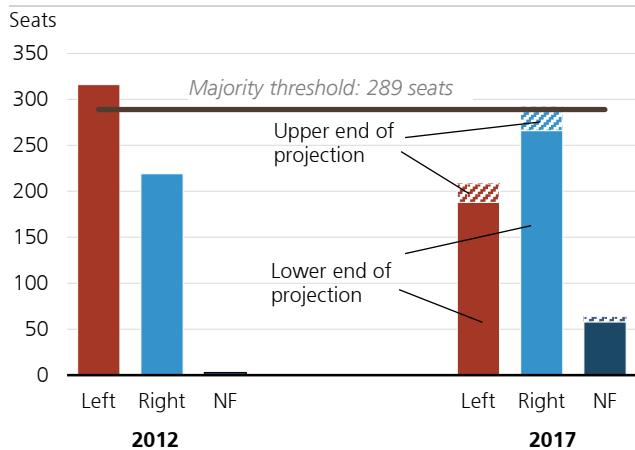
Parliament needs to authorise a referendum on EU membership

Mr Sarkozy has failed in his bid to be the centre-right's candidate

The elimination of Mr Sarkozy is significant on its own. According to polls, Mr Sarkozy has held the smallest edge over Mrs Le Pen in a hypothetical second round clash in the Presidential elections in May (Figure 8). Although Mrs Le Pen did not participate in the second round of the election in 2012, her enhanced popularity combined with the unpopularity of the likely candidates from the Socialist party imply that she is very likely to be one of the two competitors in the second round. This, in turn, makes the choice of her likely opponent from the centre-right critical.

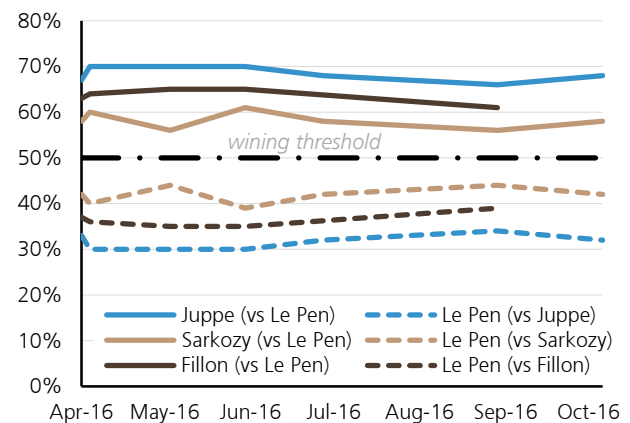
Mr Sarkozy had held the smallest edge over Mrs Le Pen in polls

Figure 7: Polls suggest that the National Front would be nowhere near majority in the National Assembly



Source: Opinion Way, UBS

Figure 8: A. Juppé is polling better than F. Fillon in a 2nd round run-off with M. Le Pen, with N. Sarkozy third-best



Source: UBS, BVA, IFOP

Of the remaining two opponents for the centre-right berth, Mr Juppé is enjoying the largest lead in a second round contest with Mrs Le Pen according to polls (Figure 8). His more centrist profile arguably appeals to the centre-left and left-wing voters whose support will be required in the second round.

The Republican run-off will be between F. Fillon and A. Juppé

Polling evidence for Mr Fillon, on the other hand, is more scant as he was an outsider until very recently. The latest poll including a run-off between Mr Fillon and Mrs Le Pen goes back to September, in which Mr Fillon was seen winning the run-off by a 61-39% margin (Figure 7). In general, polls suggest Mr Fillon is occupying the middle ground between Mr Sarkozy and Mr Juppé in terms of their prospects against Mrs Le Pen, which means that he also starts with a healthy margin vs Mrs Le Pen ahead of the Presidential election.

It is worth noting, however, that Mr Fillon's agenda includes reform plans such as cutting public expenditure, raising the VAT and increasing working time. If implemented, such reforms could provide some upside to the French longer-run growth potential. Politically speaking, however, it could be also argued that it is harder to attract the left-wing voters with the same ease as Mr Juppé.

Looking ahead, we should get more clarity about the candidates from the other parties over the coming weeks. The Socialist party primaries will be held on January 22 and 29. President Hollande has not yet announced whether he will run again as a candidate with current PM Manuel Valls being the likely alternative. Former economy minister Emmanuel Macron, who is running on a reform-agenda and positions himself as a candidate outside the established parties, is also a contender in the presidential elections. However opinion polls so far suggest his chances to go through to the second round are slim.

We should get more clarity about the other candidates in the coming weeks

What to do

In [Will the EUR par the US dollar?](#) we argued that a centre-right candidate with high approval rates vs Mrs Le Pen would reduce near-term uncertainty with regards to the French Presidential election, as the market's focus would likely shift away from that stress point in the short-term. Mr Fillon seems to satisfy this description based on his polling performance to-date, although this judgement is subject to continuous reflection as more polling evidence comes in over the coming months.

That said, the Republican primaries were only one of two imminent political events weighing on Eurozone markets since the US elections. The upcoming Italian referendum on 4 December remains an important risk event ahead.

With one of the two key signposts cleared, we think that there is value in [selling EUR/USD downside at current levels](#). Clearly, the Italian referendum may still weigh on the EUR in the coming weeks. That said a lot is already in the price on that front, as evidenced by the protracted widening of Italian spreads over the last few months and elevated EUR/USD vols. In addition, the EUR is fundamentally cheap and supported by a very solid current account surplus while the prospect for a US growth boost is increasingly in the price. Overall, we see the risk reward in selling EUR/USD downside as relatively attractive.

In rates space, on the other hand, while the re-tightening of the OAT vs Bund spread could gain some traction over the near-term (coming from extreme levels), the most recent political developments are not sufficient to give an all clear for an outperformance of OATs within the EGB spread complex. Political risk remains elevated, polls' reliability has been challenged recently and OATs (in particular against Bunds) remain prone not only to French-specific but also broader political shocks, with the Italian referendum being the next signpost. Consequently, we would not engage in OAT vs. Bunds tighteners nor in beta adjusted OAT outperformance trades against EGB peers on strategic grounds at this stage.

Political Risk and French Equities

What does the widening OAT-Bund spread mean for Equities?

If the mechanism of higher political risk comes mainly through the bond market, how does this impact French equities? The spread of French yields over Germany has widened out to c.50bps – close to the highest for over 2 years. French equities are negatively correlated to the bond spread (the correlation is -0.6) – less exposed than some other European markets, such as Italy, but still linked.

Looking back over time, there has been a relationship between the CAC 40 and the inverse of the OAT-Bund spread. If this widens further from here it would likely point to weaker equity performance.

The first round of the Republican primaries has reduced uncertainty

The next risk event in the short-term is the Italian referendum

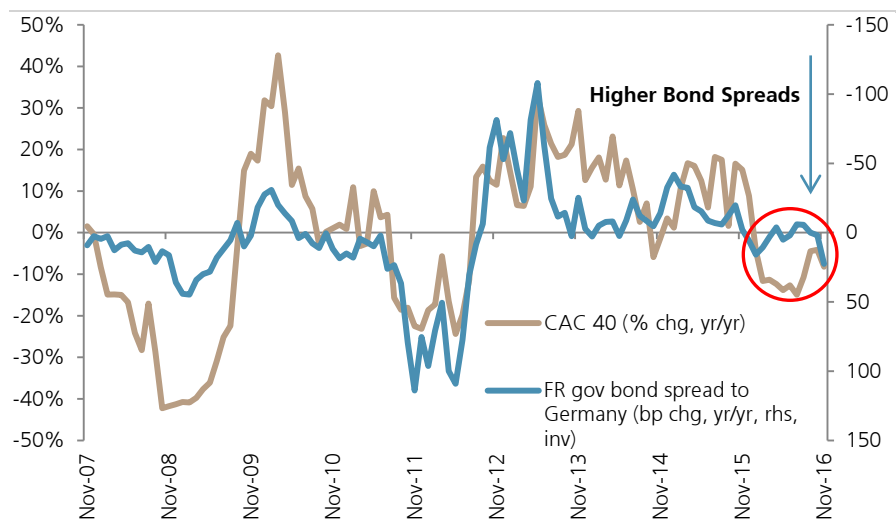
The risk-reward in selling EUR/USD downside is relatively attractive

But we are not turning bullish on French spreads yet

What does political risk mean for French Equities?

Wider French-German bond spreads are negative for the CAC 40...

Figure 9: French Equities vs. Bond Spreads (Inverted)



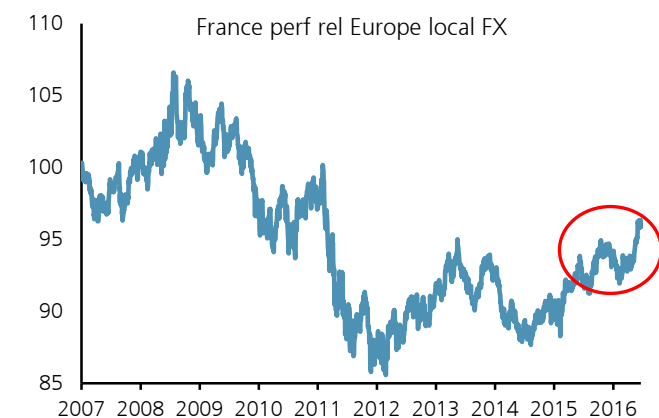
Source: Thomson Datastream, UBS European Equity Strategy

Performance: close to in line over a decade, outperformed in last year...

Over the last decade, France has performed more or less in line with the wider European market - underperforming from 2009 to mid-2012 during the Eurozone crisis and then outperforming since. But zooming in on the most recent period over the last year shows outperformance with the cyclicals running in the last 2 months and then a small pullback since the US Elections.

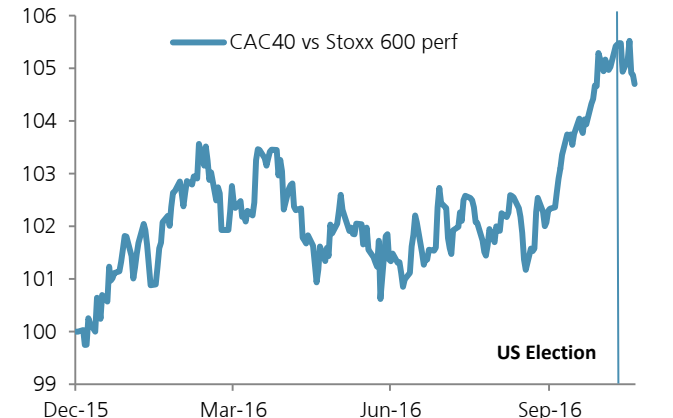
France has performed close to in line with Europe over the last decade...but outperformed in last 12m

Figure 10: LONG RUN: France perf rel Europe (4% down since 07)



Source: Thomson Datastream, UBS European Equity Strategy

Figure 11: SHORT RUN: France gave back some relative performance post US-Election...



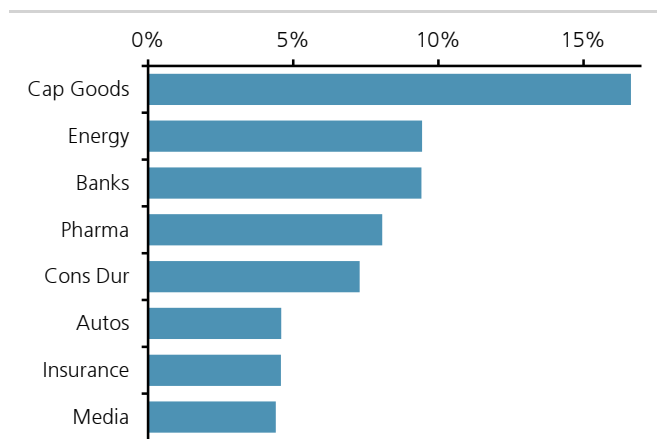
Source: Thomson Datastream, UBS European Equity Strategy

France: Country DNA...pro-cyclical...

France is pro-cyclical in the sector make-up: the largest sector is Cap Goods (17% of the index) and the market as a whole is 9% underweight defensives relative to Europe. This should be supportive if the tone of the market remains reflationary and may offset some of the drag from rising bond yields. In our Outlook document we highlighted that much of the move to date had been in inflation breakevens rather than real yields. And right now European equities are positively correlated to rising bond yields (*please see: [Outlook 2017: No More Excuses...](#) 15 November 2016*).

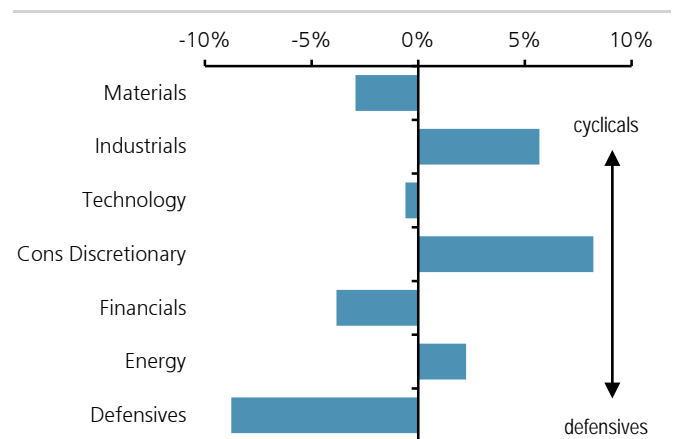
France is pro-cyclical – biggest sector weight is Cap Goods (17% of index)

Figure 12: France: Largest sectors (% of market)



Source: Thomson Datastream, UBS European Equity Strategy

Figure 13: France: Sector make-up relative to Europe



Source: Thomson Datastream, UBS European Equity Strategy

What about valuations?

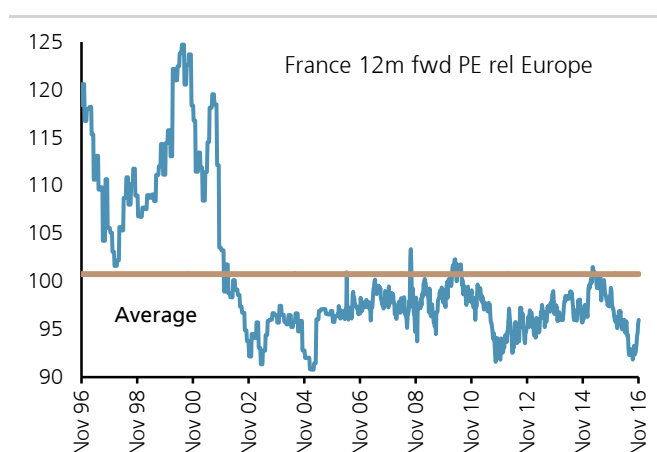
Valuations appear slightly cheap to neutral. P/E multiples relative to Europe are c.5% cheap vs. their long-run average. And this is on earnings that are down close to in line with the wider European market. French earnings are down 26% from their 2007 peak, Europe is down 29%. The P/BV relative is also somewhat attractive, but the relative dividend yield is in line with history.

Relative Valuations: neutral to slightly cheap

For more details please see the section on "Profit Black Holes" in our recent report: [Europe differs to World = 4 unique buy ideas](#), 15 November 2016.

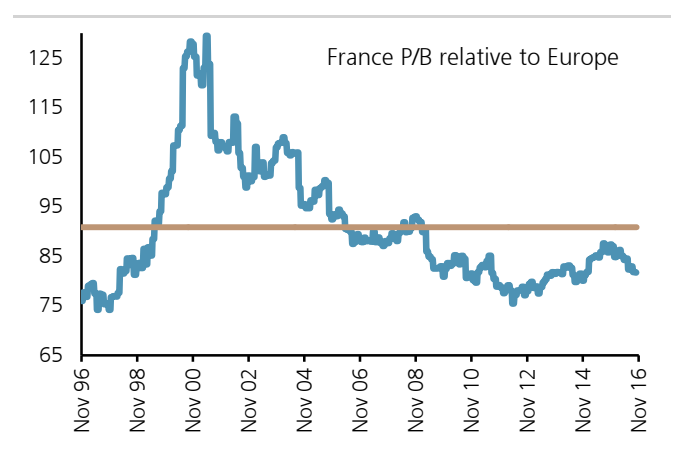
Conclusion: Further political risk from here and a widening bond-spread is likely to be a drag on performance for French equities. Although less exposed to bond spreads than some other European markets, such as Italy, there is still a link and relative valuations in France are not cheap enough to absorb a shock. The pro-cyclical mix may help offset somewhat if the global reflation trade continues.

Figure 14: France PE rel Europe vs History



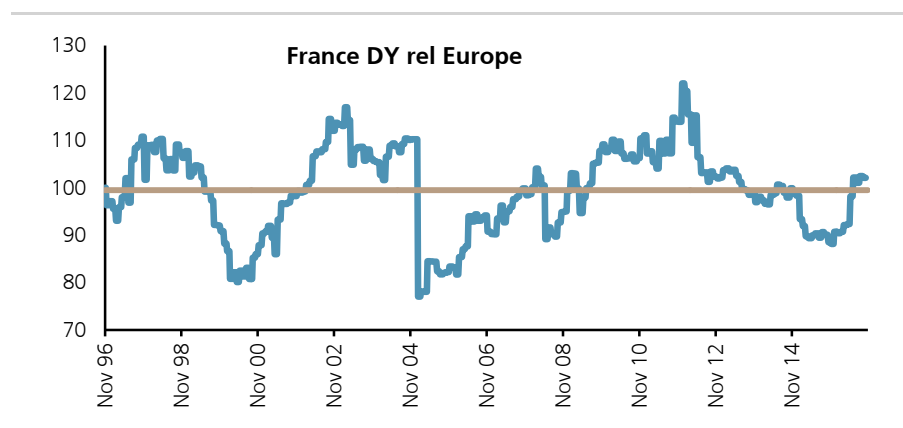
Source: Thomson Datastream, UBS European Equity Strategy

Figure 15: France PB rel Europe vs History



Source: Thomson Datastream, UBS European Equity Strategy

Figure 16: France DY rel Europe



Source: Thomson Datastream, UBS European Equity Strategy

Valuation Method and Risk Statement

Risks of multi-asset investing include but are not limited to market risk, credit risk, interest rate risk, and foreign exchange risk. Correlations of returns among different asset classes may deviate from historical patterns. Geopolitical events and policy shocks pose risks that can reduce asset returns. Valuations may be adversely affected during times of high market volatility, thin liquidity, and economic dislocation.

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