European Views

French election: likely implications across markets

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- Emmanuel Macron will face Marine Le Pen in the run-off of the Presidential election on May 7, according to exit polls. We maintain our view that mainstream candidate Mr. Macron will likely win the French Presidential election.
- We think the equity market has already largely priced the outcome and concerns about the elections have not prevented European equities and the CAC 40 from performing well on an absolute basis since the beginning of the year (+5% YTD for both).
- We expect today's results to generate some relief for the FTSE MIB, French and Italian banks and a very minor relief for the CAC 40. That said, as this has largely been the central expectation priced into the markets, we would expect any rally to be modest. French domestic stocks and the CAC 40 have not underperformed significantly as of late, and we do not expect them to rally materially following today's results, or after the second round of the election.
- In rates space, French bonds had incorporated some political risk premium, and traded more idiosyncratically. We expect the 10-year OAT-Bund spread to narrow by as much as 15bp on short covering, to around 50-55bp – or within 1 standard standard deviation above our macro-econometric model measure of 'fair value'. We would expect the daily correlation with German Bunds to remain somewhat below the 90% observed since the beginning of the ECB's PSPP on account of residual uncertainties in the run-up to the second round. We would expect a similar re-pricing in intra-EMU spreads in the periphery markets, where BTPs and Bonos spreads to Bunds could go back to trading closer to a range of 170-190bp in the coming weeks (from around 200bp on Friday's close) and 120-130bp (from around 140bp on Friday) respectively. We think that political uncertainty around the Italian political outlook will weigh on BTPs.
- Our FX analysis suggests that a sizeable decrease (to close to 0 percent) in the probability that investors assign to Ms. Le Pen becoming President, or to a break-up of the Euro area, that is close to its lows in July 2014 could push the EUR higher versus the USD and the JPY, pushing EUR/USD close to 1.13.

The views expressed in this research report are for each analyst's area of coverage.

Macron and Le Pen qualify for run-off on May 7

Emmanuel Macron and Marine Le Pen top first round in French Presidential election, on latest projections

Exit polls indicate that the candidate of the centrist political movement *En Marche*! (Onwards!), Emmanuel Macron, and far-right candidate Marine Le Pen have qualified for the second-round run-off of the French Presidential election on May 7.

Exit polls reported by the French media show that Mr. Macron topped the first round, with around 24% of the vote, while Ms. Le Pen came in second place with around 22%.

According to the same exit poll, the results for the other main candidates (who are now eliminated from the Presidential race) are as follows: François Fillon (19.9%), Jean-Luc Mélenchon (19.3%) and Benoît Hamon (6.3%).

Exit polls all broadly point to the same results (at least for the main contenders) and have now been acknowledged by Mr. Fillon and Mr. Hamon, who both said they would support a vote for Mr. Macron in the second round. The final results will be released by the Constitutional Council on Wednesday, April 26 (8pm Paris time) at the latest, and will be available here.

The outcome of the first round of the French Presidential election is broadly consistent with the latest set of opinion polls, which were indicative of a tight race between Ms. Le Pen and Mr. Macron (at close to 23%), followed closely by Mr. Fillon and Mr. Mélenchon (both at close to 20%) – although the momentum behind the latter two candidates had improved of late.

Outlook for the second round on May 7

The run-off vote will take place on May 7. We maintain our view that the mainstream candidate, Mr. Macron, will likely win the French Presidential election.

In the two week-period before the run-off, both Mr. Macron and Ms. Le Pen will resume their campaign. A televised debate between both candidates will be held on May 3 (9pm Paris time).

Polls carried out prior to the outcome of the first round indicate that Mr. Macron has a 25pp lead over Mr. Le Pen. Reflecting France's political realignment between mainstream pro-European and populist Eurosceptic voters, we expect the gap in polls between Mr. Macron and Ms. Le Pen to widen in favour of Mr. Macron in the run-up to the second round. That said, given that (1) mainstream supporters are likely to present a broad united front against the FN in the run-off (dubbed the "*front républicain*"), as already highlighted by the support expressed by Mr. Fillon and Mr. Hamon in favour of Mr. Macron, and (2) left-wing populist supporters are unlikely to cast a vote for the FN because of its perceived extremism, we think it likely that Mr. Macron wins the French Presidency in two weeks' time.

In this context, we expect the ECB to maintain its existing refinancing facilities (namely the fixed-rate full allotment (FRFA) and the emergency liquidity provision (ELA) via the

Bank of France) in the coming weeks, to sustain market functioning and continuity of pricing in the systematically relevant market segments. In the face of a politically-induced spread widening, this is also likely to be accommodated through its asset-purchase programmes, as long as it proves to be temporary.

Huw Pill, Alain Durré and **Pierre Vernet**

Equities - the result was mainly priced

In our view, today's results for the first round of the French presidential election and the higher than expected turnout are likely to be received positively by market participants.

1. Expect limited market upside

We expect European equities to remain broadly flat during the two rounds of the election given that the outcome of the first round corresponds to what was broadly expected, and given that the probability of Ms. Le Pen winning the election cannot be completely ruled out.

While we think Emmanuel Macron will win the presidential election on 7 May, we think this outcome has the potential to lift European equities only slightly (about +2%-3%), given our view that very little 'election risk premium' has been discounted in European equities (unlike in the bond and the equity derivatives markets).

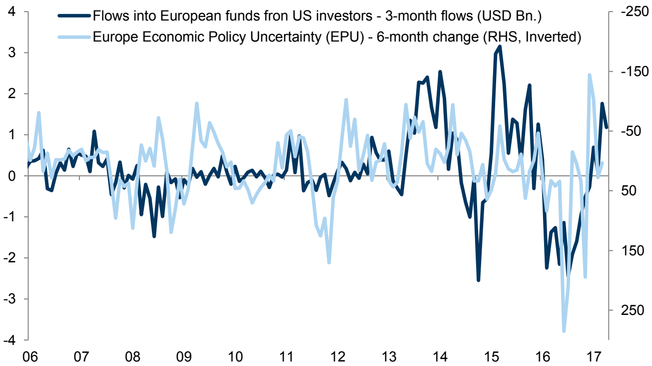
The French election has not prevented **European equities and the CAC 40 from performing well on an absolute basis since the beginning of the year (+5% YTD for both).** Likewise, the performance of European equities versus the US has reflected pretty accurately the positive moves in fundamentals. **Europe has seen inflows from US investors (after a year of selling in 2016) and has started to outperform the US.**

Since the beginning of the year, the equity risk premium has declined by 40bp in Europe, while it has risen by 50bp in the US. Strong global and local economic data since the end of Q4 2016 have benefited Europe relatively more, reducing the tail risk from deflation, while recent uncertainty regarding the policies of President Trump and future Fed rate hikes have reflated the US ERP. If a tail risk event in European elections had been fully priced in, we think the equity risk premium and economic policy uncertainty spread between Europe and the US would not have tightened in favour of Europe to this extent.

As we have shown previously, inflows from US investors into European equities and the performance of European equities versus the US tend to correlate well with the relative uncertainty differential that prevails between the two regions. The two charts below show no disconnect in these historical relationships.

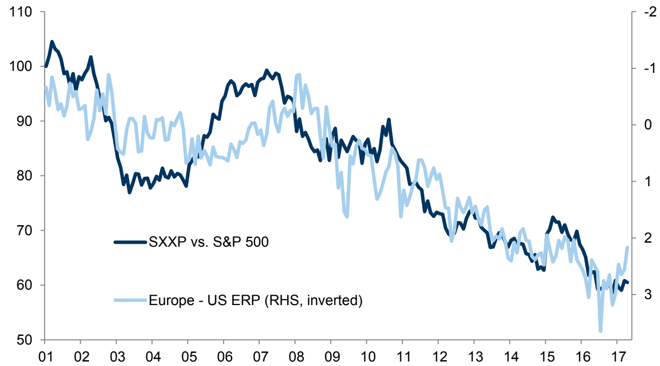
Exhibit 1: After a full year of selling in 2016, European equities have benefited from positive inflows from US investors

The Economic Policy Uncertainty index tracks the number of articles with policy-relevant terms such as uncertain or economy in major newspapers



Source: TIC, EPU, Goldman Sachs Global Investment Research

Exhibit 2: The SXXP has started to outperform the S&P 500 as the equity risk premium has fallen relatively more in Europe than in the US

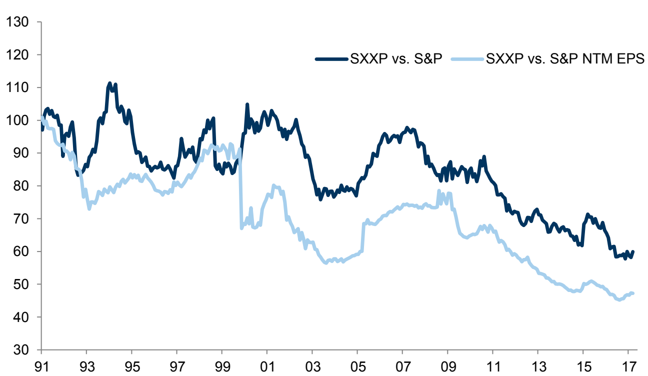


Source: Datastream, Goldman Sachs Global Investment Research

There is also evidence that European equities have moved in line with economic fundamental data, as they have recently started to outperform the US when earnings expectations have started to rise more rapidly in Europe than in the US (see Exhibit 3).

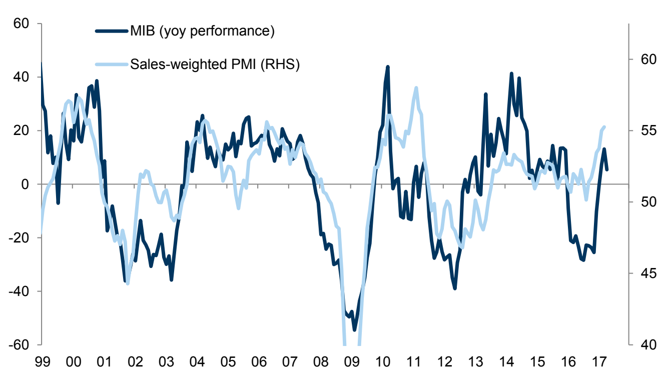
Another way to compare the performance of European equities with fundamental data is to look at the year-on-year performance of equities and PMIs. Exhibit 4 below shows that even Italian equities, which we consider to be the most sensitive to French election risk, have moved in line with the PMIs (weighted according to the geographical sales exposure of the FTSE MIB).

Exhibit 3: The recent outperformance of European equities is consistent with the relative improvement in profit growth in Europe versus the US



Source: Datastream, Goldman Sachs Global Investment Research

Exhibit 4: The FTSE MIB seems in line with PMIs

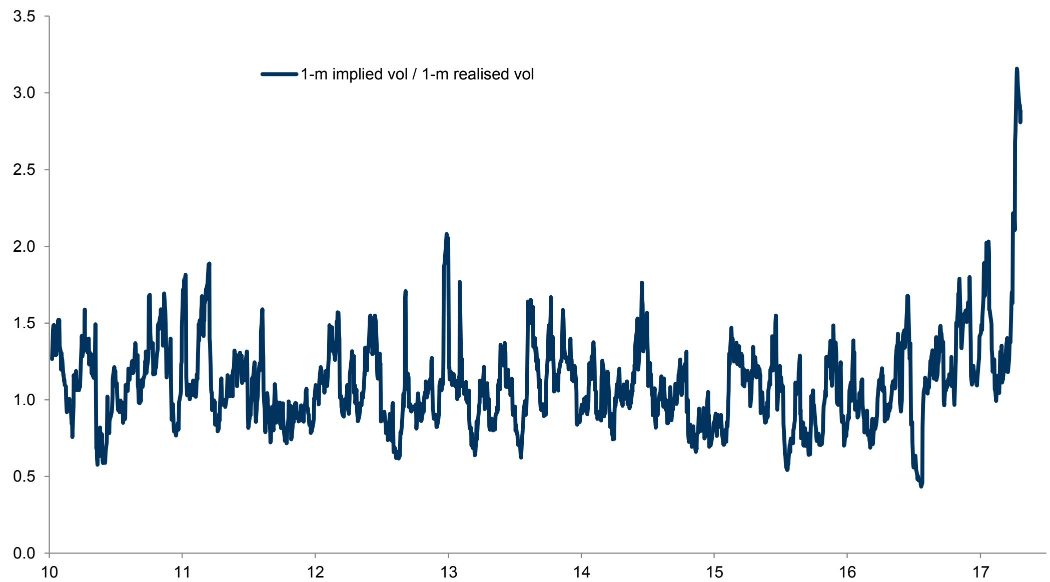


Source: Haver Analytics, Goldman Sachs Global Investment Research

In the event Ms. Le Pen is elected in the second round (not our base case), European equities would be particularly vulnerable given how little this scenario seems to have been discounted.

We estimate that the equity derivatives market is pricing a 5% absolute move for the SX5E for the election. Based on our assumption that it reflects a 20% probability of Ms. Le Pen being elected, it implies a 12% downside move for the SX5E and a 15%-16% downside move for the FTSE MIB and the CAC 40 if this scenario were to materialise. As we argued in a previous note, we think the FTSE MIB would be affected to a greater extent than the CAC 40. (See details of the implications of the election of Ms. Le Pen in *Frexit: what should you expect for European equities*, 15 March 2017.)

Exhibit 5: Implied volatility has never been as high vs.realised
Implied (1m ATM) vs. realized (1m) SX5E volatility

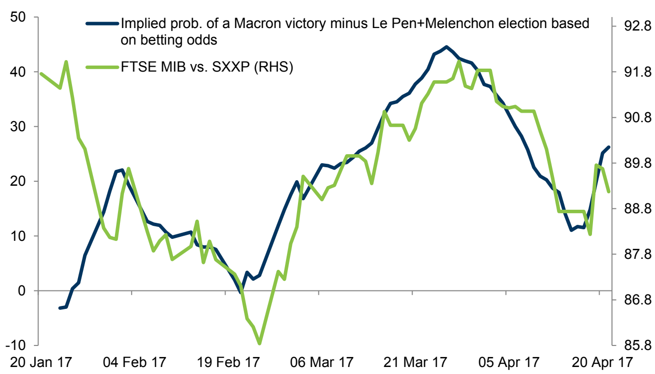


Source: Goldman Sachs, Goldman Sachs Global Investment Research

2. Below the market surface: expect Euro area risk assets to modestly outperform

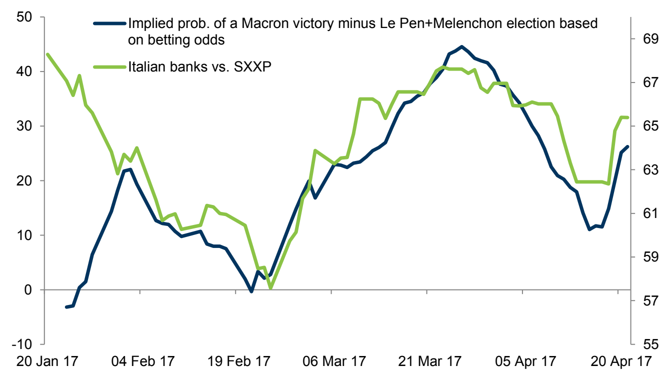
As we argued in *Frexit: what should you expect for European equities?* 15 March 2017, we think that Euro area risk assets have been the most sensitive to developments in the French electoral campaign. **Hence, we expect today's results to generate some relief for the FTSE MIB, French and Italian banks and a very minor relief for the CAC 40. That said, as this has largely been the central expectation priced into the markets, we would expect any rally to be modest.** The two charts below show the extent to which these stocks have been sensitive to bookmakers' odds during the election campaign.

Exhibit 6: The FTSE MIB has been very sensitive to developments in the French electoral campaign...



Source: Bloomberg, Datastream, Goldman Sachs Global Investment Research

Exhibit 7: ... as have Italian banks

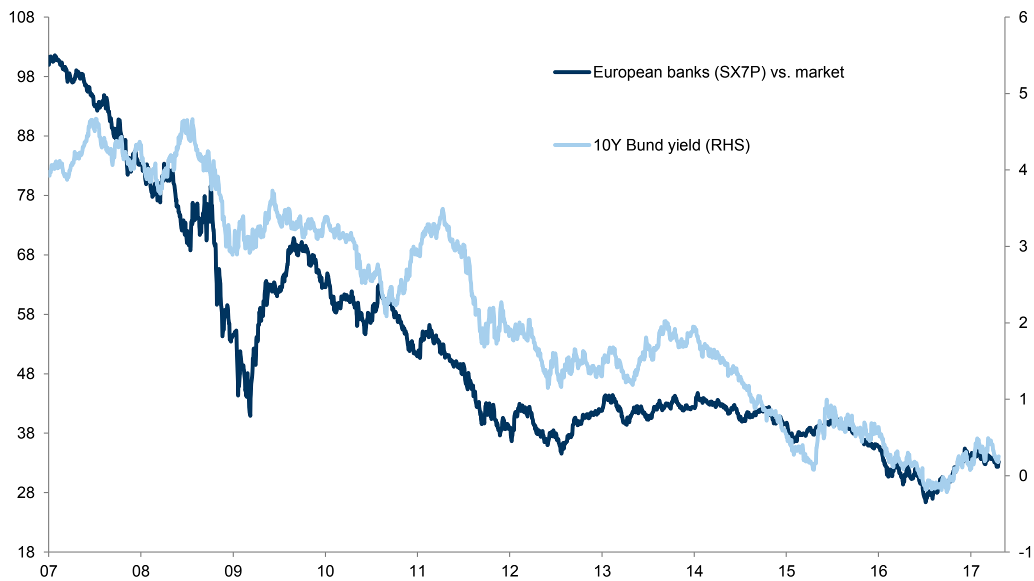


Source: Bloomberg, Datastream, Goldman Sachs Global Investment Research

Although the performance of broad European banks has not closely tracked developments in the French electoral campaign, we still expect a small positive reaction for Banks on an absolute basis, as tail risk uncertainty decreases (as was the case after the Dutch election). Italian and French banks should be the main beneficiaries of today's results (e.g., BNP and Unicredit, both Buy-rated by our analysts), particularly if bond yields rise and sovereign spreads narrow.

However, not all the underperformance of Banks since the beginning of the year owes to election risks. As shown in the chart below, the performance of Banks remains closely dependent on interest rates. Of course, part of the fall in German bond yields has been driven by the election uncertainty premium, provoking a flight to quality into German assets, but it has also reflected the unwinding of reflationary hopes. In conclusion, we think that if **the tail risk of the election of a Eurosceptic candidate such as Ms. Le Pen were completely removed, this would only modestly lift European banks.**

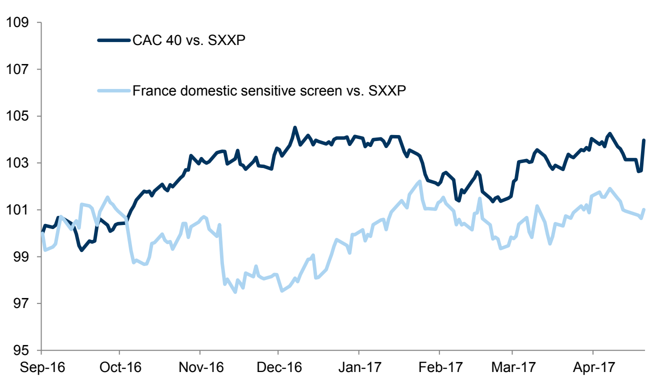
Exhibit 8: European banks have been mainly dependent on the evolution of bond yields



Source: Datastream, Goldman Sachs Global Investment Research

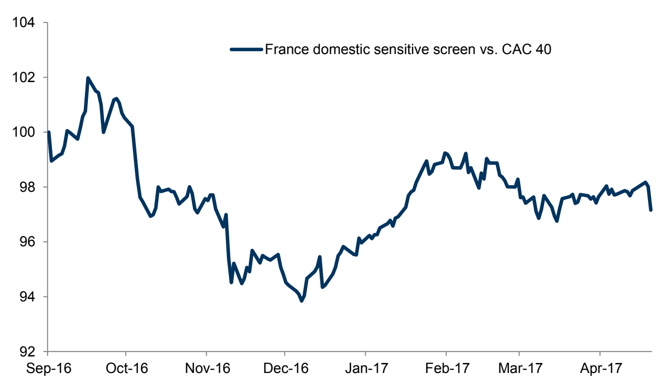
French domestic stocks and the CAC 40 have not underperformed significantly as of late and we do not expect them to rally materially following today's results, or after the second round of the election. As we have highlighted in a previous note, the CAC 40 has strong international exposure and a reasonably supportive sector composition, notably in comparison with the FTSE MIB. In addition, the French economy is likely to be more resilient than the periphery economies in the event France leaves the Euro area (which would heighten the probability of a Euro area break-up).

Exhibit 9: The CAC 40 and French domestic stocks have not underperformed significantly



Source: Datasatream, Goldman Sachs, Goldman Sachs Global Investment Research

Exhibit 10: French domestic stocks have not underperformed the CAC 40 to any significant extent



Source: Goldman Sachs, Goldman Sachs Global Investment Research

Lilia Peytavin and **Peter Oppenheimer**

Rates - Bund yields should return to January levels

Since January, the country-specific risk premium priced in OATs and in other periphery markets saw a strong increase, which we have discussed here and here.

The 10-year OAT Bund spread closed on Friday around 70bp, or two standard deviations too wide relative to our measure of macro fair value. On account of tonight's result, we would expect the spread to narrow to around 50-55bp, and Bund yields to rise towards 30bp.

We expect some election uncertainty to continue to be priced into EMU spreads in the period to the second round, and French bonds to continue to trade more idiosyncratically than has been the case since the start of QE.

We would expect a similar re-pricing in intra-EMU spreads in the periphery markets, where BTPs and Bonos spreads to Bunds could go back to trading closer to a range of 170-190bp in coming weeks (from around 200bp on Friday's close) and 120-130bp (from around 140bp on Friday) respectively. We think that political uncertainty around the Italian political outlook will weigh on BTPs.

Francesco Garzarelli, Alexander Demyanets* and **Matteo Crimella****

**Alexander is a senior economist in the Interest Rates Strategy team. ** Matteo is an intern in the Global Macro and Markets Team*

FX - a modest positive for the Euro

So far in FX space, the initial market reaction has been positive, with EUR/USD at 1.09, from 1.0708 as of Friday's closing. Going into the second round, our Economists' base case remains that Ms. Le Pen is unlikely to be able to broaden her base sufficiently to become the next President. That said, from here on, markets will be focusing on Ms. Le Pen's campaign rhetoric and on the polls. In order to improve her chances of being elected, Ms. Le Pen is likely to soften her anti-Euro stance to appeal to more moderate voters. We expect the currency to strengthen if uncertainty around a possible break-up of the Euro area is priced out. On the other hand, if Ms. Le Pen campaigns on an anti-Euro platform, the pressure on the currency will remain until the second-round election removes this uncertainty.

In our *FX Views*, "The Euro and Frexit" we quantified the impact on the Euro crosses versus G10 currencies due to changes in the probability of Ms. Le Pen becoming President and to the probability that investors assign to a break-up of the Euro area. First, we quantify the impact of a 10pp decrease in the odds of a Le Pen presidency on the various Euro crosses and find that, among the G-10 crosses, EUR/USD would increase the most (about 2%) and EUR/NOK the least (about 0.5%), while EUR/SEK would show a slight depreciation. Should the probability investors assign to Ms. Le Pen becoming President become very negligible (close to 0%), EUR/USD could appreciate by around 5%, reaching around 1.13. We do not find any statistically significant effect of a change in the odds of a Le Pen presidency on the EUR/CEE crosses (HUF, PLN, RON, CZK), with the estimated betas being very small.

Second, we estimate the betas of different EUR crosses to changes in the Sentix indicator, which measures the probability that investors assign to a break-up of the Euro area over the next 12 months. On our estimates, a reduction in break-up risk to 10% would lead to a slight appreciation of the EUR versus the major G10 currencies. The indicator has declined from 25% in February to 18% in March and a 10% decline would put it closer to its lows (7%) in July 2014. In our view, it is unlikely that investors will completely price out Euro area break-up risk given the rise of Eurosceptic parties in other members of the monetary union. Once again, we do not find any statistically significant effect on EUR/CEE crosses (HUF, PLN, RON, CZK), with the estimated betas being very small. This may simply reflect the close ties of these economies to the Euro area and the fact that CEE central banks have adjusted policy in the past to prevent sharp changes to their currencies.

In summary, our analysis suggests that a decrease in the probability that investors assign to Ms. Le Pen becoming President or to a break-up of the Euro area that is close to its lows in July 2014 could push the EUR higher versus the USD and the JPY, pushing EUR/USD close to 1.13. That said, how positive and persistent the market reaction will be after the election will depend on other factors, including the economic and inflation outlook and communication from the ECB at this week meeting and other central banks on the near-term policy stance. Political uncertainty and the threat of a break-up of the Euro area will remain a latent risk that is likely to resurface at times, with the next pressure point being the Italian elections, which are likely to take place in 2018Q1.

Silvia Ardagna & Rohan Khanna

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Reg AC

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We, Huw Pill, Francesco Garzarelli, Silvia Ardagna, Alain Durré and Pierre Vernet, hereby certify that all of the views expressed in this report accurately reflect our personal views, which have not been influenced by considerations of the firm's business or client relationships.

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