12/ The political cycle: Will the winds of change keep on blowing over France?

"Political language is designed to make lies sound truthful and murder respectable, and to give an appearance of solidity to pure wind" G. Orwell

For the past 10 months, the political cycle of elections has come with its elements of surprises, where mass manipulation through the media and polls have failed. The populations of England and the US have turned against their elite systems and have expressed their vote of discontent in a way that was unexpected by the media and the establishment. This has led to results for the English referendum and the US election that were far out of the consensus. One reason behind this gap might be that our world and political order has started to shift, with the old order (the one of the past 25 years) falling apart and a new world starting to shape up on the back of a generational shift. In many ways, this is reminding us of these transition periods described in the World of Yesterday by S. Zweig, where an old order is disappearing and a new one is shaping up.
On the political side, the changes are drastic. However, if we look at the capital markets' reaction to them, it seems that those elections have created an increase of volatility through market corrections or set backs in equities and commodities, but have not derailed the underlying reflation trend which at that time was progressing fairly unnoticed (see graph on this page). The surprised Brexit vote lead to a sharp equity sell offs (minus 10% from April to June in the Footsie 100 and 5% in the S&P500), a 20% collapse in Sterling and a bond rally of 10% (US10y) on the news. Yet, it also proved to mark the low point of interest rates and triggered a spike in Gold which created the high point of the gold market for 2016. Nevertheless, thereafter, the early existing trends of reflation reasserted themselves. Similarly, the Trump election created a correction in equity markets, a short spike in gold and a small fall in rates, only to be followed by a strong risk-on period, where equities rallied, rates rose while Gold, Yen and volatility collapsed.

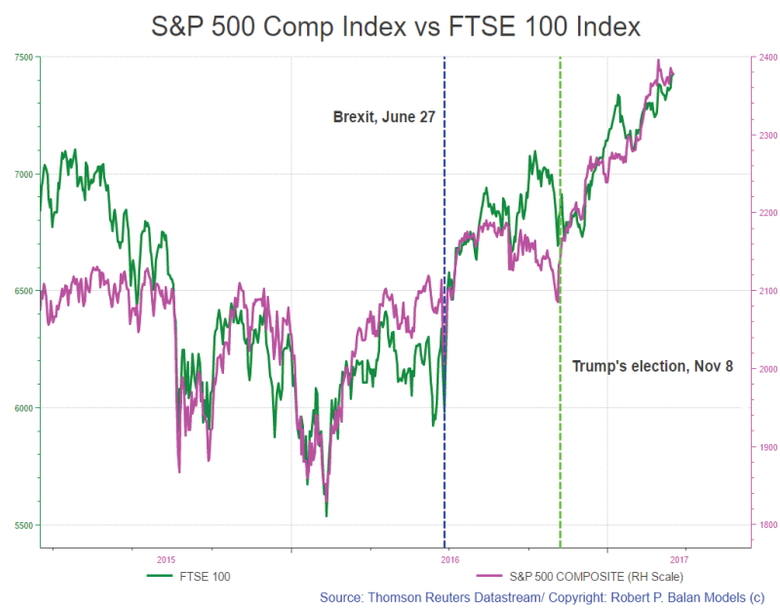
Today with the markets having adjusted significantly following the Trump election, our task is to try to evaluate if in this context, there is room for surprise in the French election, which once again could create a sharp pricing adjustment in many asset prices.

Now, if we look at the current set up for the French election, some concerning elements have started to build as we approach the vote period which will take place in 2 stages: on the 23 rd of April to determine the last 2 contenders for a final round and on the 7th of May to decide between them. At this stage, 3 candidates (with various probabilities) stand a clear chance to be France's next president: Marine Le Pen from the National Front party, Francois Fillon, an ex prime minister from les Républicains, the conservative party equivalent in France, and Emmanuel Macron, the ex-economy and finance minister of the socialist president Hollande, who created a new political movement ("En Marche"), an initiative meant to detach himself from the poor legacy of the current socialist government.

As market participants, our main concern has always been to establish where the consensus is, and from there, what are the probabilities for results to come out away from this consensus as well as try to estimate their impact on asset prices.

As this is written, and dialoguing with many of our correspondents in France, the clear consensus is that Marine Le Pen would win the first round only to be defeated without any doubt in the second round by either Mr Macron or Mr Fillon. This situation is very close to the situation to the Brexit or Clinton/Trump perception before the election. The Opinion way/ Orpi polling institutes (17th of March) are considering that Mrs Le Pen would receive 28% of vote, Mr Macron would gather 25% and Mr Fillon 20% in the first round. For the second round, Mrs Le Pen would lose 41%/59% vs Mr Macron and 45%/55% vs Mr Fillon. In a way, the consensus is a repeat of the 2002 election results where Mrs Le Pen's father, Mr Jean-Marie Le Pen contended Mr Jacques Chirac in the second round. Mr Chirac easily won with a 82.21% vs 17.79% vote.

However, during the last 15 years the spirit of the times has changed a lot and today, the winds of discontent are fed by poor growth (see first graph on next page) due to the failed socialist policies, high unemployment level due to lack of structural reforms (see second graph on next page), high debt, poor political leadership, heavy taxation, distrust of the political class



and worries about immigration and terrorists issues. Those issues are feeding the discontent vote and the key question is how much of this will translate into votes for this election.

Two factors, which are also key to account for at this stage, are that according to polls, 30% of voters remained undecided, while 75% of Le Pen supporters say they would not change their minds. Only 51% of potential voters for Macron said the same.

Situation with the candidates: Mr Fillon is representing conservative values, but he is embroiled in a scandal over allegations that his wife was paid for an allegedly fictitious job. This is clearly a political coup which was meant to affect the candidate and shift voters to Mr Macron and Mrs Le Pen. Mr Macron is a young candidate (39) with limited political experience who has never been elected before. He is pure product of the establishment (ENA education) backed by media and banking lobbies, a pure fabrication. He is a kind of French Tony Blair 20 years too late who thinks this election could be won with the 3rd way. Mrs Le Pen is a national front party candidate known for her clear anti-immigration and anti-Europe positions, opposed to free trade and autarky and seems to be gathering a significant part of the protest vote.

However, it is important to remember that while this presidential election is battled in 2 stages, the governing organisation of the country is fought out in 3 stages with the election of the national assembly coming a few weeks later on the 11th and 18th of June.

The markets have so far been focused on the all-important presidential election but the answer might come with the national assembly. The current political fragmentation and election system make it likely that moderate parties remain those with the majority. And if Mrs Le Pen were to be elected, her actions would be constrained as she would not have control of the assembly. This would also probably apply to Mr Macron. So, at worst at this stage, what might happen is that the electorate might rock the boat but will not sink the ship. Hence , a Le Pen victory would translate into sharp short term corrective moves for the French and global equities markets and particularly for the banking sector. Euro crosses would also suffer, particularly versus the yen and swiss franc. The OAT Bund spread would fly, along with Gold. We believe these sharps moves would be of short term nature and that past the initial shock, the global macro forces of reflation and global growth acceleration might reassert themselves and provide support for global risk assets for the second part of 2017.