The Silver Bullet

Don’t Fret about Frexit

Hey now, baby
Get into my big black car
Hey now, baby
Get into my big black car
I want to just show you
What my politics are
– Cream, Politician (1968)

After Brexit and Trump, investors have entered 2017 cautiously and are not willing to take any chances on Europe’s upcoming elections.

There are indeed reasons to worry. Anti-Euro candidates Marine Le Pen in France and Geert Wilders in the Netherlands have been topping the polls until recently. Meanwhile, the UK is preparing to start its divorce negotiations with the EU. Greece faces a big debt redemption in July, while its debt negotiations have stalled.

Complexity and political uncertainty are high, but fundamentals are strong and European institutions have untapped ammunition. Hedging eurozone break-up, buying bunds at negative yields and shorting the Euro are popular trades now. But beyond the populist rhetoric, there is often little substance: Europe has been limping along for years without breaking up. Soon investors could find themselves into a positive scenario they’re unprepared for.

2017: A year full of political events

Source: Algebris (UK) Limited. *Yellow = already took place, Blue = future events, Red = European high risk

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Our Base-case: A Macron Victory

The French presidential election operates on a two-round system: should no candidate win a majority in the first round on the 23rd of April – the most likely scenario – then the top two candidates will enter a run-off election to be held on the 7th of May.

The top three contenders are populist Le Pen, reformist Macron and republican Fillon. Recent polls have shown a strong lead for Emmanuel Macron, previously the underdog. The game-changer for Macron was both the endorsement by Francois Bayrou, a notable centre-right potential candidate, as well as the scandal engulfing Fillon’s candidacy. So far, Mr Fillon has pledged to stay in the race, despite allegations of corruption. We estimate the following final outcomes:

- **72% probability**: Macron wins
- **19% probability**: Fillon wins
- **8% probability**: Le Pen wins

While Ms Le Pen is the most likely candidate to enter the second round based on current polls, she actually stands a very low overall chance of winning. This is because the centre and centre-right vote, currently split between Mr Fillon and Mr Macron, is then likely to converge. We estimate only a 15% probability of her beating Fillon and 6% probability of beating Macron in the second round. Our analysis uses a Monte Carlo approach, correcting for poll bias and simulating tail risk, as explained below.

There’s also a fourth scenario: should centre-left candidates Mélenchon and Hamon decide to form a leftist alliance, there could be greater uncertainty over who will be facing Le Pen in the second round. However, so far both Mélenchon and Hamon have ruled out this possibility given their fundamentally different views on EU issues.

We estimate a low chance of Le Pen winning, and an even lower chance of Euro redenomination

*Estimated from a Monte Carlo simulation based on Eurobarometer Survey data for France (2010-2016) on the question “whether you are for the Euro or against the Euro”:

  *an average of 60% for “For the Euro” (towards lower end of past polls) and a standard deviation of 12% (5x of 2010-2016 poll standard deviation).
What Happens if Le Pen Wins?

Even if Ms Le Pen wins, redenomination risk is low. In the FN’s Les 144 engagements présidentiels, Le Pen details her ambitions to target 2% GDP growth by 2018 partly through tax cuts to SMEs and individuals in lower-income brackets. More importantly, she also plans to renegotiate EU membership and to break the single-market with a tax on imports.

We see a very low probability (14%) of Le Pen progressing on her Euro-exit agenda, even in the unlikely event of her winning both rounds of elections. For Le Pen to deliver on Frexit, she will need approval from France’s bi-cameral parliament. France’s parliament is split between the Assemblée Nationale and the Sénat. In theory, both houses need to pass legislation for it to become law, but in practice the final decision rests with the Assemblée Nationale. However, Le Pen’s FN party currently only has 2 of the 577 deputies in the Assemblée Nationale. The next elections for the Assemblée Nationale will take place on the 11th and 18th of June, but the latest poll suggests that FN is only likely to get 58-64 seats, still far short of a majority. Additionally, FN has no deputies in the Sénat. Only a third of Sénat deputies are up for re-election every three years. This means the earliest the FN could control the Sénat is after three years, in 2020.

Markets currently overestimate the risk of currency redenomination. If we assume that French debt in local currency would be worth around 20 cents below its German equivalent, then market prices imply a 5% probability of redenomination: the 1% yield differential in 2-year French vs German bonds is roughly equal to 5% probability times a 20% loss given Frexit. Instead, we estimate a 1% probability of redenomination on French sovereign debt (8% probability of Le Pen winning elections, times a 14% probability of a referendum winning).

Macron: Reforming France and strengthening the EU. A potential victory for Macron would likely be the best scenario for France and for Europe, in our view, given his strong pro-reform and pro-EU agenda. His key proposals, while ambitious to pass, include the creation of a Eurozone budget administered by a common Minister of Economy and Finance, commitment to meeting EU deficit targets, a €50bn investment plan and reforms to the job markets (see table below).

### Emmanuel Macron’s Key Proposals

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<tr>
<th>Europe</th>
<th>Investment Plan</th>
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<td>“Europe is an essential achievement.”</td>
<td>- To launch a major investment plan of €50bn over five years (€15bn to ecological transition, €15bn to skills, €5bn to agriculture, €5bn to health, €5bn to transport and local amenities, €5bn to modernisation of public administration</td>
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<td>- To create a budget for the Eurozone with 3 functions (investment for the future, emergency financial assistance and response to economic crises)</td>
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<td>- To create a post of Eurozone Minister of Economy and Finance, who will be responsible for the Eurozone budget</td>
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<td>- To create a European Defence Fund that will finance common military equipment and joint military R&amp;D</td>
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<td>- To strengthen the European Border Police, establish a permanent European Defense Headquarter, create a European Security Council and reform the European carbon market</td>
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- To support private investment

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<th>Employment/ Businesses</th>
<th>Public Finances</th>
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<td>- To lower workers’ social contributions while making it easier to increase working hours in companies</td>
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<td>- To create a universal unemployment benefits programme, but under which unemployed individuals would not be able to receive benefits if they turn down more than two job offers</td>
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<td>- To introduce a ceiling and floor for labour compensation for dismissal without real and serious causes</td>
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<td>- To facilitate the hiring of low-skilled employees</td>
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<td>- Universal retirement rules for all</td>
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- To reduce budget deficit and meet EU targets (deficit not exceeding 3% GDP by 2017 and structural deficit at -0.5% GDP by 2022) |
| - To cut 120,000 public sector jobs |

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<th>Others</th>
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<td>- To tackle nepotism by making it illegal for MPs to employ family members as parliamentary assistants</td>
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<td>- To fight conflicts of interest by banning MPs from serving as consultants and from sitting on company boards</td>
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Source: Algebris (UK) Limited, En Marche!
In addition, a Macron victory combined with a potential Merkel-Schulz coalition in Germany could lead to a strong Franco-German coalition, paving the way for European integration and much-needed fiscal stimulus.

**Fillon: the alternative positive scenario.** Mr Fillon’s campaign has run on the promise of challenging the French “software”. His agenda includes revising the 35 hour work week, rewriting the entire 3000 page labour code, firing 500,000 government employees and getting rid of the wealth tax. While less radical than Macron’s promise to further European integration, Fillon’s programme should still be positively received by markets.

**Conclusions: There’s Growth at the End of the Political Minefield**

1. **Our base-case scenario for France is that Macron wins in the second round on May 7th.** This could lead to a very positive scenario for Europe, with Macron partnering with Merkel or Schulz in Germany to form a strong Franco-German coalition. This may result in greater fiscal spending as well as a focus on long-term European integration projects.

2. **We think markets are over-pricing the chance of a Le Pen victory and currency redenomination risks.** In our view, even if Le Pen is elected, her party will not control the Assemblée National nor the Sénat. In addition, even if there is a referendum on EU membership or on the Euro, we estimate a low probability of passing a Frexit vote (14%).

3. **2017 has been seen as a political minefield for European investors, but the potential bombs are being defused one by one:** Le Pen is unlikely to win in France. In the Netherlands, Geert Wilders has seen a decline in recent polls and will likely have limited control on parliament even if he wins. In Germany, both leading candidates are pro-Europe and could form an alliance post elections, increasing public spending on infrastructure and defence. In Italy, Mr Renzi is running to lead the Democratic party and planning a come-back. Populism has its economic roots in rising inequality and disenfranchisement. While the US and UK have outgrown Europe over the past decades, they also rank highest for inequality. As we wrote in the Financial Times last month, Europe’s social safety net and welfare policies could now turn from weaknesses into strengths.

4. **There’s growth and reflation at the end of the political minefield.** Strong macro data and a recovery in corporate fundamentals make Europe a good investment after the political dust settles. Growth data is solid, inflation is normalising, investment is coming back to periphery countries which implemented reforms and banks are starting to lend again (The Silver Bullet | Don’t Give up on Europe). We see value in European risk assets in the infrastructure, energy, defence and financial sectors.

I’m a political man
And I practice what I preach
I’m a political man
And I practice what I preach
So don’t deny me, baby
Not while you’re in my reach

I support the left
Though I’m leaning, leaning to the right
I support the left
Though I’m leaning to the right
But I’m just not there
When it’s coming to a fight
– Cream, Politician (1968)
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Additional reading:
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