PICTET WEALTH MANAGEMENT

France: high-stakes election

Hope for the best, prepare for the worst

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SUMMARY

- The European elections will likely have a bigger impact at the national than the European level, where the centrist grand coalition will retain its majority. The main priorities of the next Commission should remain broadly unchanged centred around enhancing the EU strategic autonomy and competitiveness.
- In France, the risks are high for the upcoming legislative elections to result in an unstable cohabitation government. An immediate threat for the market would be the next budget including controversial measures that could weigh on public finances and fuel inflation risks.
- The fragile state of French public finances along with the large share of foreign holdings of government bonds may fuel volatility in the bond market in coming weeks, although rating agencies are unlikely to take further action until we get more clarity on the political and fiscal fronts.

A SHOCK AT THE NATIONAL LEVEL MORE THAN AT THE EUROPEAN LEVEL

At the European level, the 6-9 June elections were in line with opinion poll expectations and did not result in a major shift in the balance of power. The far-right parties made significant gains in the number of seats they won. However, they failed to gain a blocking minority in parliament. At the same time, the incumbent grand coalition of centre-right, centre-left and liberals retained an absolute majority of seats in Parliament, albeit a smaller one than before. The next Commission should therefore be able to rely on this enlarged centre and continue the work of the outgoing von der Leyen Commission. Its main priorities will be the strategic autonomy of the Union and strengthening the competitiveness of the European economy.

Ursula von der Leyen remains the frontrunner for a second term at the Commission, although her nomination is by no means a foregone conclusion. As the nomination vote in the Parliament is secret, MEPs do not always follow the voting instructions and disagreements are common. Moreover, with the weakening of Olaf Scholz in Germany and Emmanuel Macron in France after the vote, the choice of the European Council, which initially nominates the candidate for Commission President, could fall to a figure seen as more consensual and more likely to take over from a weakened Franco-German couple.

In both Germany and France, the elections resulted in a significant defeat for the incumbent majorities: in Germany, Olaf Scholz's coalition lost to the conservatives and the AfD; in France, the Renaissance coalition lost heavily to the far-right National Rally. Against this background, and to everyone's surprise, Emmanuel Macron decided last night to dissolve the National Assembly, the lower house of parliament, and to call early general elections for 30 June and 7 July, raising the risk of a "cohabitation" between the incumbent president and a prime minister from another party, possibly from the far-right *Rassemblement National* (RN).

FRENCH ELECTIONS: WHY THEY ARE DIFFERENT, AND WHY THEY MATTER

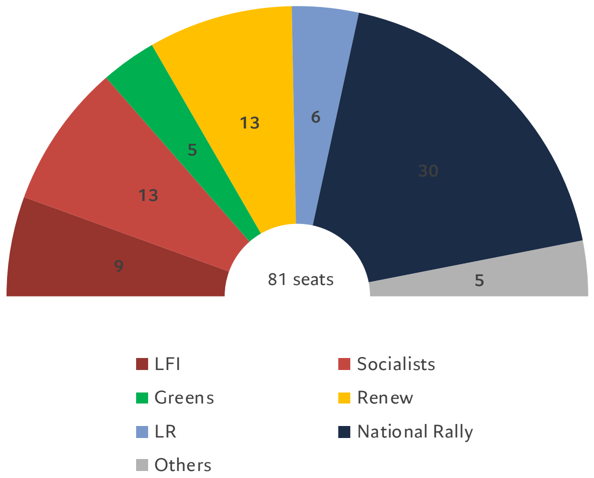
The specific modalities of the French parliamentary elections make them more complicated to forecast. In a nutshell, **the far-right is in the lead, but anything looks possible in terms of the composition of the next government, with crucial alliances to be made in between the two rounds on 30 June and 7 July**.

The President can only dissolve the National Assembly once a year. Under the fifth Republic, the assembly has been dissolved five times, either in the middle of a crisis (e.g., Charles de Gaulle in 1962 following a *motion de censure*) or because the parliamentary majority was different from the President's (e.g. François Mitterrand in 1981 and 1988, when the elected President, whose term was still seven years compared with five years for the deputies of the Assembly, was facing a parliamentary majority from the opposition). The last time it was used was by Jacques Chirac in 1997, which led to the success of the opposition party forming **a so-called cohabitation government, significantly reducing the power of the President.** Macron's dissolution is different as he still has a government working on a (slim) majority in parliament, but he made this surprise decision in order to give the French population the choice to renew the Assembly and "clarify" the situation.

There are various interpretations of Macron's motivations and strategy. Many observers including Olivier Blanchard have argued that making the RN face their responsibilities would expose the economic risks of their programme, either leading to a defeat today, or in the next presidential election in 2027 once the population realised they were not fit for power. This is questionable and risky as a strategy; at the very least the failure of the RN is not a given, especially after they have had a long time to prepare for actual responsibilities. In Italy, Giorgia Meloni managed to make further gains in the European election.

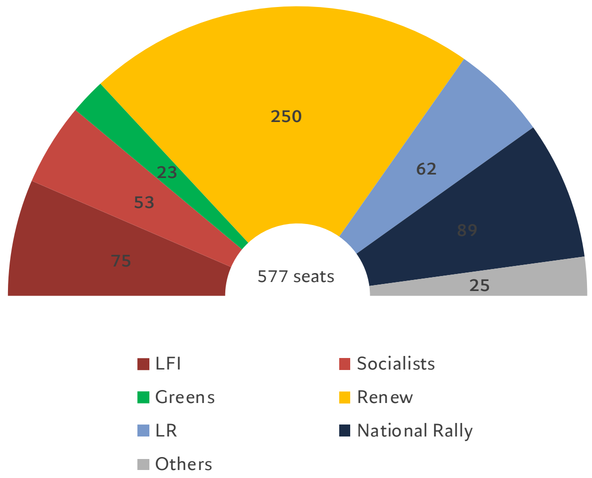
Another interpretation could be that Macron believes he can gather a wider, more eclectic majority resulting from a so-called *Front Républicain* pushing centre-right and centre-left parties to get together after the election. That is equally uncertain given the political fatigue that several years of such threats have fuelled, but this is where the specificities of the parliamentary elections matter.

Chart 1: France's seats in the European parliament



Source: Pictet Wealth Management, European parliament, as of 10 June 2024

Chart 2: composition of the French parliament



Source: Pictet Wealth Management, French National Assembly, as of June 2024

Indeed, **the legislative election will be held based on a two-round system to elect 577 deputies for five years**. 289 seats are needed for an absolute majority. The next President will likely be elected with the soon-to-be-formed new Assembly, which he may decide to dissolve again, but that's another story. After the first round on 30 June, any candidate with more than 12.5% of the votes will be qualified for the second round, meaning there can be three or even four candidates left. In the second round on 7 July, the candidate with the most votes is elected.

This is why the negotiations and potential alliances made in between the two rounds are so important: they can make all the difference and favour candidates who wouldn't be elected based on a single-round, proportional voting systems. This is how in 2017, Macron's party got 28% of the votes but a majority of 308 seats. In 2022, the presidential party got 26% of the votes but only 245 seats, short of an absolute majority. The Left bloc got 26% (and 131 seats) while the far-right RN got 19% (and 89 seats).

The negotiations between left-wing parties forming the so-called Nupes alliance will drive their strategy in between the two rounds depending on the results of the first round. The same is true for the conservative party *Les Républicains*, which got fewer votes in recent elections but could nonetheless influence the results if they were to change their strategy vis-à-vis the RN in some constituencies.

The latest polls projecting the composition of the French parliament date back to December 2023, with the RN expected to come first with 28% of the votes, and within touching distance of a majority in terms of seats (243-305 vs the 289 threshold). With less than three weeks to go until the first round, one can reasonably expect that the RN will remain in the lead, but things could still change in terms of the final outcome. **A crucial driver of the election will be the participation rate**. In the 2022 election, turnout was 47.5% in the first round (the lowest ever), and 46.2% in the second round. We would expect participation to rise substantially in the upcoming election, with RN most likely to lose some ground relative to the voting share they got in the European election.

HOPE FOR THE BEST, PREPARE FOR THE WORST…

In conclusion, there are various moving parts that can influence both the result of the election and the impact on the economy and the markets. **Turnout and potential alliances among parties will be crucial going into the vote.** Still, the risk is high to get a cohabitation government led by the 28-year old RN president, Jordan Bardella. This would fuel political, social, and economic uncertainty, although the President of the Republic would retain considerable power including in terms of foreign affairs. Moreover, both the President and the Senate, the upper house of the parliament still controlled by the conservatives and the centrist parties, could make the government's tasks more difficult by blocking some policy initiatives.

If the far-right were to be part of the next government, the immediate risk would be that important decisions will be very difficult to make, **starting with the budget and a number of very controversial measures** that the RN has been pushing for some time and that **could weigh on public finances while fuelling inflation risks**. These measures would include higher social spending to boost wages and pensions, but also some targeted tax cuts. The market would likely reprice higher the risk of another rating downgrade amid concerns over longer-term debt sustainability.

Last but not least, even though the RN abandoned their proposal to exit the EU some time ago, **it remains deeply Eurosceptic and would likely oppose several European integration policies**, trying to undermine European institutions and possibly reduce France's support for Ukraine. Either way, the weakening of the German-Franco couple risks putting Europe itself in a weaker position at the worst possible time, ahead of the November election in the US.

… INCLUDING HIGHER VOLATILITY

For all the uncertainty, the French government bond market has been relatively well-behaved so far, with the spread between the 10-year French government bond (*Obligation assimilables du Trésor*, or OAT) and its German counterpart widening only by 5 bps, to about 54 bps this morning. With a yield of 3.2%, the 10-year OAT offers yields below Spain, Portugal and Italy's 10-year government bonds, in part because the French government debt retains a higher rating (see *Chart 3*).

When assessing the impact that snap elections could have on French OATs we would divide between the stabilising factors and the destabilising ones. Among the stabilising factors, we would highlight the following three:

1. an **elevated credit rating**;
2. a **large and liquid debt market**;
3. the large share of **European Central Bank's (ECB) holdings of OATs**.

France retains an elevated average credit rating (between AA and AA-), in part thanks to the strength of its institutions and to the diversity and dynamism of its economy. Although S&P recently downgraded France to AA-, all the rating agencies have a stable outlook on the country, and we don't expect them to take further action until we get more clarity on the political and fiscal outlook.

The French government bond market is the second largest in the euro area after Italy's. With an amount outstanding of EUR2.33 trn (against EUR1.87 trn for Germany), it offers by far the most highly rated and liquid sovereign bond market in the euro area.

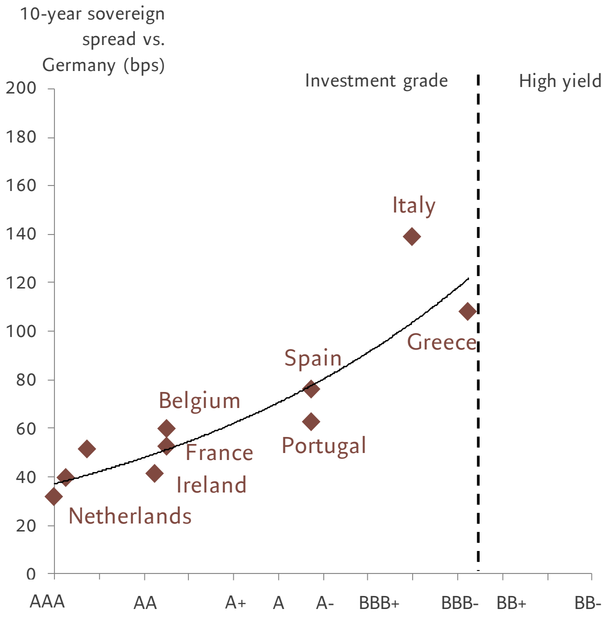
Moreover, the ECB holds approximately 21% of the French government bonds outstanding (see *Chart 4*). Although it is gradually decreasing its presence by reducing the reinvestments of maturing bonds in both its Asset Purchase Programme (APP) and Pandemic Emergency Purchase Programme (PEPP), we do not expect this process to quickly reduce ECB's share.

Among the destabilising factors, we would highlight the following two:

1. the **large non-residents holdings**;
2. the **elevated public debt-to-GDP ratio**.

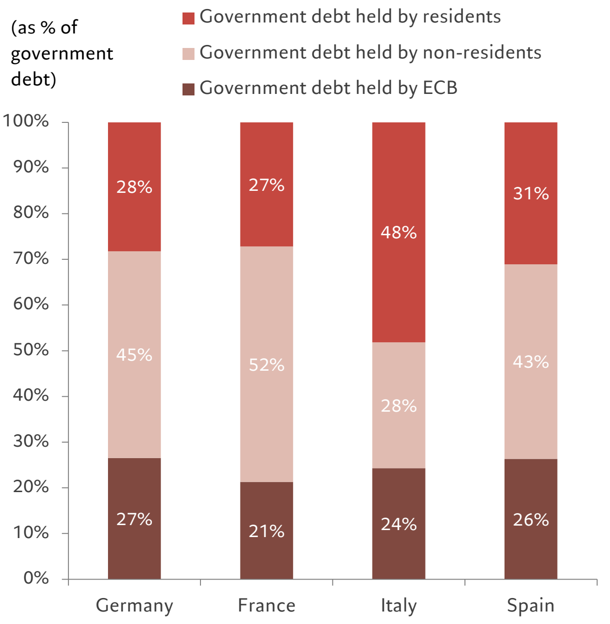
Similarly to Germany, the French government debt is primarily held by foreigners (with a share of 52%), with 31% in the hands of non-euro area investors. A large victory of the RN could lead some foreign investors to reduce their holdings, given the political uncertainty that would ensue up to the next presidential elections. As examples, both the European debt crisis in 2011-2012 and the formation of a far-right government in Italy in 2022 have had similar effects.

Chart 3: Euro sovereign spread and country rating*



Source: Pictet Wealth Management, Bloomberg Finance, L.P., 10.06.2024 (*Average country credit rating based on S&P Global, Fitch Ratings, Moody's and DBRS)

Chart 4: Euro area government debt holders



Source: Pictet Wealth Management, ECB, L.P., 31.12.2023

France's public-debt-to-GDP ratio, at 111%, is one of the highest in the euro area. Contrary to its peers, French indebtedness has not fallen materially along with the economic recovery post-covid and is unlikely to do so according to the government's current projections. A new governing coalition in the parliament could have an influence on the fiscal trajectory, so we will know more after the elections.

Weighting between the stabilising and destabilising factors, we do not expect a material reaction of French government bonds. Political uncertainty could definitely lead to further spread widening between the 10-year French and German sovereign bond yields, but we believe that the 10-year French spread is unlikely to move above 80 bps given the stabilising factors we have mentioned above. As such, for now, **we maintain our year-end forecast of 60 bps, while bracing for higher volatility this summer**.

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