FRENCH ELECTION WON'T HELP THE ECONOMY

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> The financial market is increasingly being challenged by geopolitical risks where France is the next stop though the election won't bring a solution to the fundamental economic problems.

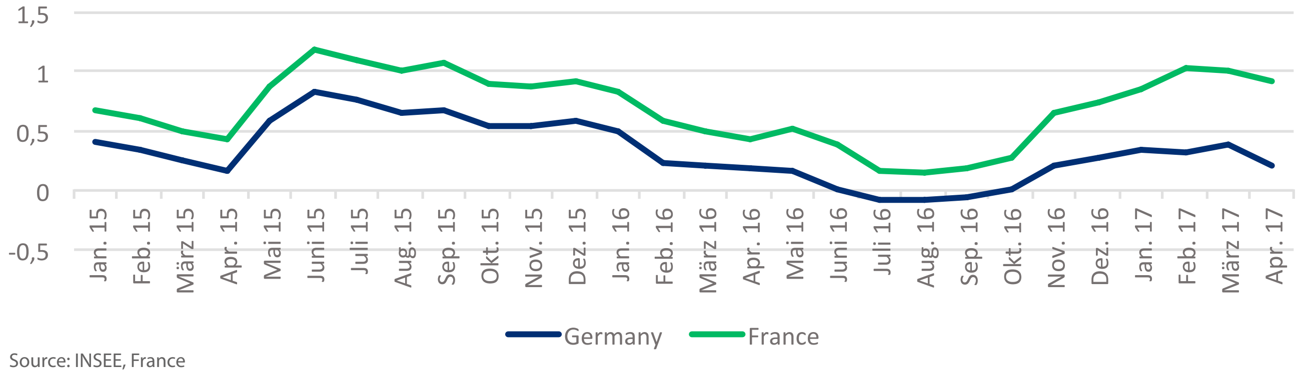
In the week before Easter, the Asian financial markets began to worry about the upcoming presidential election in France. Clearly, geopolitical developments generally remain as an increasing risk factor in the financial markets. The market nervousness created by this French presidential election is unusually huge, and with good reason.

Based on my insight of professional investors right now, it is clear that a growing number have hedged their portfolios against a dropping euro, or alternatively the exposure towards the euro has been outright reduced. During the same period, some investors have sold out of French government bonds, or in other ways reduced the risk in this asset class. Graphic one shows the yields of German and French 10-year government bonds, which confirms the picture with a widening spread. The concern in the financial market is of course, that Marine Le Pen from Front National, against expectations, wins the election. About 2½ weeks ago the foreign exchange market explored a sharp rise in the price of currency options giving the right to sell euros against U.S. dollars.
The price difference between options with the right to sell euros against dollars compared to the right to buy euros against dollars (risk-reversals) has not been bigger since the market fear of a Euro collapse back in 2011. This applies to contracts with a maturity of one month and the development happened precisely when the one month contract covered both election rounds in the upcoming French presidential election. All these hedges should have push the euro down against the greenback, but on the contrary, there has been a slight uptrend in the EUR / USD exchange rate throughout that period.

Other forces are at least as strong or stronger in the transatlantic currency game. Personally, I very much focus on the messages from Washington D.C. about the future direction of the U.S. dollar. The U.S. Treasury Secretary Mnuchin persistently insures the financial markets about a strong dollar policy, but President Trump is clearly of another opinion right now – so far Mr. Mnuchin has defended his territory. I consider this internal discussion in The White House significantly more important for the EUR/USD exchange rate than the French presidential election. But it does not change the fact that the election in France is a short-term risk to the financial markets and the risk also has a certain complexity.

The most likely scenario has long been a victory for Le Pen in the first round and afterwards the majority of votes go to the independent Macron in the second round. But the financial markets are quite challenged as the voters move incredibly much all the time. In the beginning of January, Francois Fillon from the Republicans lost his lead over Le Pen. During the same period Macron has managed to match Le Pen in the opinion polls and just since March the left-wing candidate Mélenchon from La France insoumise is close to 20 pct. in some polls. In addition, only one week away from the first election round up and nearly one third of the voters were still unsure if they would vote. Such a large proportion of undecided voters have not been seen since 2002, and some electoral researchers point out that a low turnout probably is an advan-

10-YEAR GOVERNMENT YIELDS IN GERMANY AND FRANCE



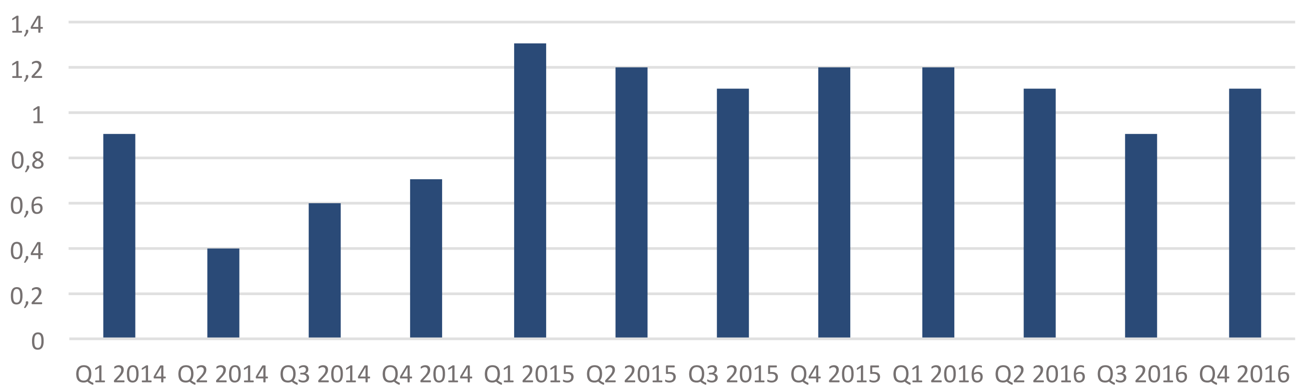
Source: INSEE, France

tage for Le Pen because her party's voters are more engaged. It is the Le Pen scenario that wins investors financial insurance bets which is a clear indication that the possibility of a Le Pen victory is not ruled out. During the period, since investors have insured or reduced their risks, they have also been safeguarded against a further risk- that Mélenchon will win his way into the Elysée Palace. This is probably the least likely outcome, but the interesting fact is that currently more than 40 pct. of the French voters support a candidate whose dissatisfaction with the euro and / or the EU is a significant parameter in the election campaign. This division among the voters will be a challenge for the future president regardless who it will be. However, there is an even greater challenge which is France's economic situation and outlook.

As graphic two shows, the GDP growth rate in France is stuck around one pct. for years, and in addition, the country is known for its notorious budget deficit for decades. Since the financial crisis, the government in Paris has exceeded the EU Commission's limit of the annual budget deficit at 3 pct. of GDP. However the deficit in 2016 at least only was minus 3.4 pct. The deficit is still too high and it underlines that a part of the modest GDP growth is simply caused by excessive public spending. At the same time, unemployment is solidified around 10 pct. and the youth unemployment rate has been 24 pct. for a number of years.
The incoming president inherits all these economic headaches too. The current likely winner, Macron, has presented the most thought-out solutions concerning the French deadbeat economy. His prerequisites in the economic sphere are of course good, as he was minister for economic affairs until 30th August last year. He retired to become a presidential candidate. However, it does not change the fact that the task will be extremely difficult because it is an uphill battle. Another example is that the government debt that last year reached 96 pct. of GDP - hence a hopelessly indebted country without economic growth and high unemployment. When Macron was a member of the government, he was considered a rebel. Among other things because he said the unthinkable- that the weekly working hours should be increased in France.

Should Macron win the presidential election, the investors will respond positively by buying euros and French treasury bonds again. Any new president should obviously carry out deep economic reforms where Macron's desire for longer weekly working hours is just a ripple on the surface. However, economic reforms immediately pose a risk of negative GDP growth, and just the dream of increasing the weekly working hours probably triggers major strikes throughout France. These big and basic challenges are naturally not solved by a presidential election and I recommend investors to focus much more on these issues – it certainly reduces the desire to buy back the French treasury bonds.

FRENCH GDP GROWTH (YEAR-ON-YEAR)



Source: INSEE, France

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