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Global Perspective

President Le Pen: picturing the tail risk

Asset Management

April 2017

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Ever so quietly, amid the noise of the UK delivering its Article 50 letter to the European Council and the boisterousness of French and German electoral politics, Europe's economy has been staging a remarkable recovery.

Investors appear to be penalising Europe based on a perception that its politics are a mess and its economy is mired in a fundamental economic malaise with little hope for improvement. We think it is time to rethink that perception – not least because the data is already refuting it. "European value" in the economy could end up being a bigger investment story than the threat to "European values" in its populist politics.

But we also acknowledge that it is sensible to assess the possibility of a major populist breakthrough. Polls for the French Presidential election have been tightening, raising the very real prospect of Marine Le Pen of the National Front (FN) facing off against Jean-Luc Mélenchon on the far-left in the second round. In this note I sketch out Europe's incipient economic recovery and then discuss perhaps the biggest threat to that recovery: the possibility that Pen ascends to the Presidency of France and successfully implements her campaign promises.

Europe's improving fundamentals

The economic headlines are shown in Figure 1. Real growth in the Eurozone is now at a year-on-year rate close to 2%. In addition, business climate indices show increasing confidence, running well above average levels. Economic data has been beating estimates for a year, now. Purchasing managers' indices show sentiment at its most optimistic in six years, while credit is expanding and unemployment is falling even in the long-suffering periphery of the Eurozone. All of this might have stoked rising consumer prices, but so far core inflation has remained subdued, enabling the European Central Bank (ECB) to maintain its accommodative stance on monetary policy.

It's easy to understand why this gets drowned out by Europe's politics at the moment. They were fragile even before the "Brexit" vote last June. Investors who saw Donald Trump get into the White House have been concerned that populists might enjoy big gains in general elections in the Netherlands and Germany, and that Marine le Pen of the National Front (FN) might even be elected President of France.

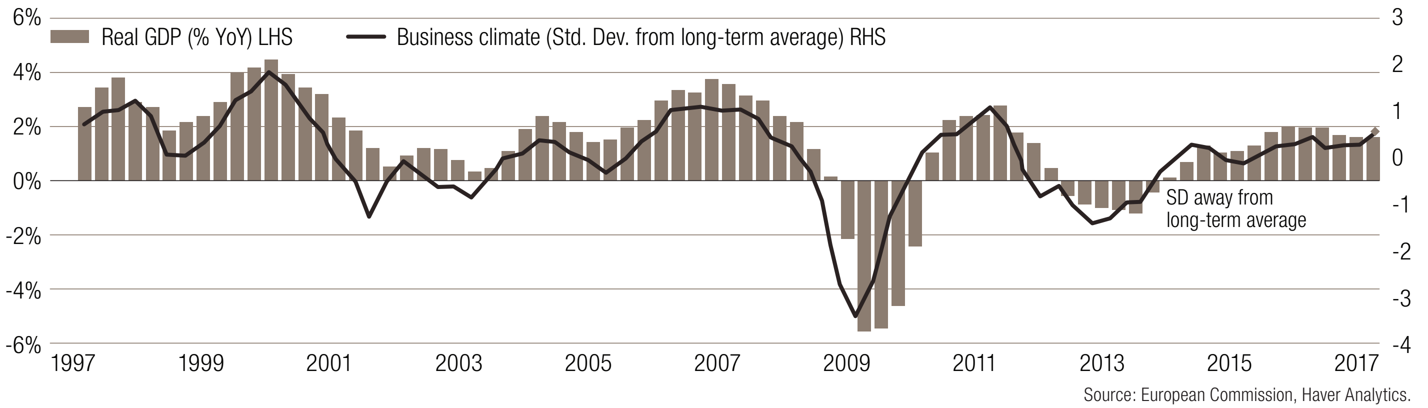
Nerves have been eased a little by the poorer-than-expected showing for the Freedom Party (PVV) in the Netherlands in March, and the way the rise of Martin Schulz of the Social Democrats (SPD) is making Germany's election in September look more like an old-fashioned race between two mainstream parties.

But here we will focus on France. The presidential election is both the most imminent and arguably the most serious threat to European mainstream politics. The consensus is that a victory for Le Pen could pose an existential threat to the Eurozone and even the EU itself. The rise of the far-left candidate Jean-Luc Mélenchon in the latest opinion polls only adds to investors' concerns.

Important information: Please see important information at the end of this document.

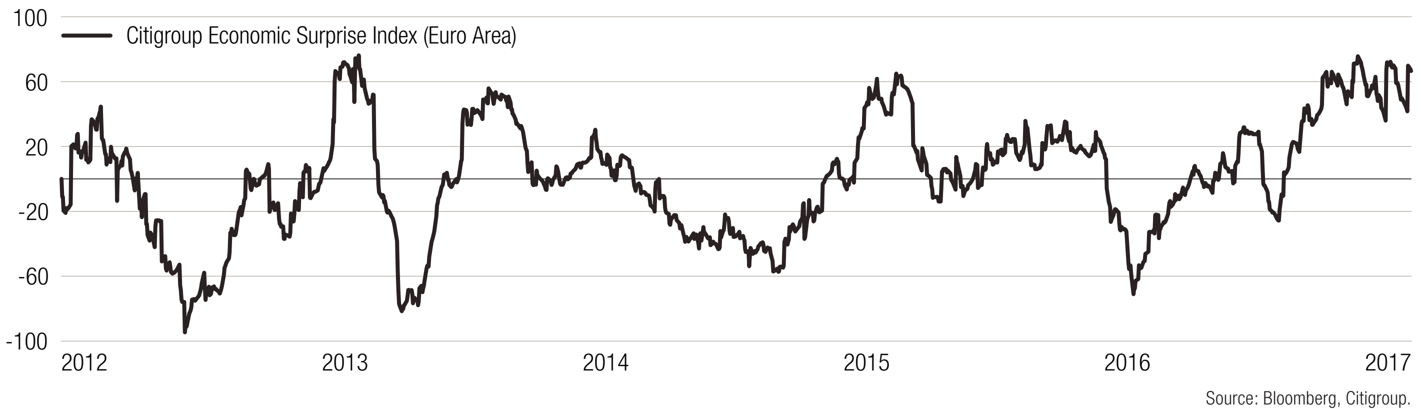
FIG. 1 EUROZONE ECONOMIC FUNDAMENTALS HAVE BEEN IMPROVING

GROWTH AND BUSINESS CLIMATE HAS BEEN PICKING UP…



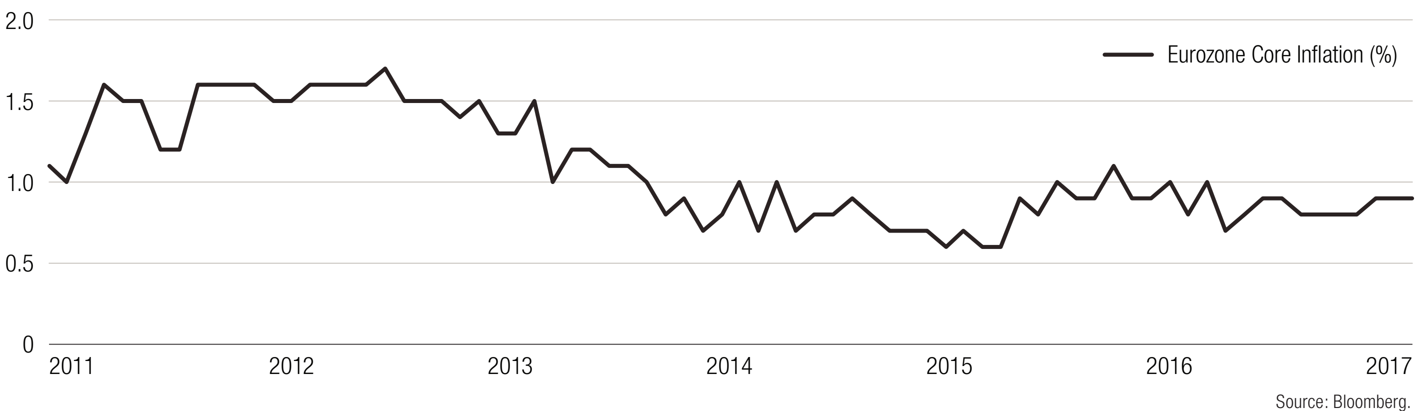
Source: European Commission, Haver Analytics.

… ECONOMIC DATA HAS BEEN BEATING EXPECTATIONS…



Source: Bloomberg, Citigroup.

… BUT INFLATION REMAINS SUBDUED



Source: Bloomberg.

Brexit, Trump… Le Pen?

Markets seem uncertain how to respond to the possibility of a Le Pen presidency. At the height of the Eurozone crisis in 2011-12, market pricing was notably globalised. With regard to the current risks, it has remained fragmented.

The spread between French and German government bonds has widened and experienced heightened volatility, but that political risk has not been reflected in other asset markets: the VIX Index of implied volatility in US equities, and even the VSTOXX Index of implied volatility in European equities, are subdued; a rally in emerging markets has been gathering steam; and even the euro has been resilient, losing only 2% of its value, on a trade-weighted basis, over recent weeks.

This is a puzzle, given that a Le Pen victory would certainly have ramifications far beyond France and its bond market. The FN's policies include taking France out of the Eurozone and introducing a new national currency, holding a referendum on EU membership and revoking the independence of the French central bank.

The puzzle is probably explained by the fact that this potential high-impact event has a much lower probability than the Brexit and Trump votes to which it is often compared. Those were one-off, binary, winner-takes-all contests which were always too close to call. The complexities of elections in Europe make them very different.

In France, the Presidential election has two stages. Le Pen may win the first round on 23 April, but polling suggests she will need an extremely large swing of voters from the far left, or substantial voter abstention, to overcome the coalescence of votes around her opponent on 7 May.

How powerful would President Le Pen be?

Le Pen making it to the second round but then being heavily defeated is our base scenario. Nonetheless, for investors, arguably the important question is what might happen should Le Pen become President, and in what sequence, rather than what probability we should attach to the event.

There is a chance that she will follow the Syriza playbook and step back from her party's more extreme positions once the potential costs become clear. The market could play an important disciplining role here. However, we think it is much safer to assume that she will try to press ahead with her manifesto.

What power will she have to do so? Getting a referendum on EU membership looks like a tall order. The French constitution would need to be amended using Article 89, requiring a majority in both houses of parliament – and the parliamentary elections in June are unlikely to deliver that. It may be possible to invoke Article 11 to hold a referendum on the matter of euro membership, and this would require the support of only one-fifth of the parliament, together with one-tenth of eligible voters in petition (currently deemed to be 4.5 million signatures) – a much less stringent hurdle than the terms of Article 89. However, the Constitutional Council would have to assess the legality of this move. There is also the small matter of persuading a nation of savers to ditch the euro and redenominate their pension funds in risky new francs – whose peg to the euro will almost certainly come under immediate and sustained attack.

In short, a threat to EU membership appears to be off the table for the foreseeable future. The threat to euro membership could be off the table by June, or even sooner should the FN recognise the concerns of this nation of savers. Even the worst-case scenario of Le Pen pressing ahead with her plan to leave the single currency would see that plan subjected to many months of political and legal wrangling, as the constitutional court would have to rule on the legality of any proposed referendum before it can even take place.

Potential market fallout: look to 2011-12 for clues

But of course, financial markets wouldn't wait for a court ruling before reacting. How might they meet a victory for Le Pen? We think the euro crisis of 2011-12 is the best place to look for an indication: we have studied the peak-to-trough returns of various asset markets during that episode (Table 1), and we think the ranking order of which assets sustain the most damage (if not the magnitude of that damage) is likely to be very similar. Indeed, as the probability of a Le Pen victory has receded over recent weeks we have seen this pecking order become evident, in reverse – European assets have outperformed their global peers and Eurozone spreads have tightened.

Overall, in equities we see European banks as most exposed to a Le Pen victory, followed by broad European equities. In the rates space, we anticipate spread widening in the Eurozone periphery (including France), with safe-haven demand for US, Swiss and Japanese bonds.

When it comes to the magnitude of the move, we are assuming a beta of 0.6-0.7 relative to the 2011-12 losses, with the peak-to-trough move taking place over a period of three-to-six months. We assume a slightly dampened move to reflect the high level of liquidity that the ECB has put into the system since the earlier crisis, coupled with backstops in the form of the European Stability Mechanism (ESM) and the potential deployment of Outright Monetary Transactions (OMT). In principle, these measures would reduce the risk of a funding crunch in the Eurozone banking sector.

We also think that the hit to the euro itself is likely to be lower than in 2011-12, when it dropped by 19%, partly due to its lower starting levels (EUR-USD was at 1.45-plus then, versus 1.07 today), and partly due to redenomination risk. In the event of Le Pen taking France out of the single currency, the legacy euro would be dominated more by the (stronger) German currency.

TABLE 1 PEAK-TO-TROUGH LOSSES IN EQUITY MARKETS DURING THE 2011-12 EUROZONE CRISIS

TICKER	NAME	PEAK	TROUGH	CHANGE (%)
MXEU0BK Index	MSCI Europe/Banks	71.89	36.52	-49.20%
MXUS0BK Index	MSCI US Banks	50.09	33.13	-33.86%
MXEF Index	MSCI EM	1206.49	831.22	-31.10%
TPX Index	TOPIX Index (Tokyo)	973.6	706.08	-27.48%
M7EU Index	MSCI Europe NR	132.96	102.71	-22.75%
SPX Index	S&P 500 Index	1353.22	1099.23	-18.77%

Source: Bloomberg.

TARGET 2 balances: real risk to the Monetary Union

However, beyond the mark-to-market and investment risks, the spectre of a French exit from the euro has to be understood using the prism of TARGET 2 balances. TARGET 2 is the interbank settlement system for the Eurozone. Currently, France has a TARGET 2 balance close to zero, while Germany is a creditor and the Eurozone periphery a debtor. While unsettled balances have been rising recently, this has been on the back of shifts in inter-country balance-of-payment trends, rather than the capital outflows that fed the more toxic shift in balances during 2011-12.

The key risk here is of significant toxic shifts in TARGET 2 balances in the event of a Le Pen victory being met with capital outflows from France and the Eurozone periphery, in expectation of broader Eurozone upheaval. Based on the 2011-12 scenario, Germany would likely become an even bigger creditor to the system as capital flees the "weaker" countries. But this assumes that Germany will not interfere with shifts in its TARGET 2 unsettled balance. In reality, political questions will certainly be asked before Germany decides to increase its credit to other Eurozone countries if it is clear that one of those countries, France, intends to leave the eurosystem, potentially leaving Germany with a significant fiscal loss on its claims. Were Germany to freeze the TARGET 2 system the single currency union would cease to exist even before a referendum on France's membership takes place – highlighting the importance of expectations in this situation.

Any toxic shift in the TARGET 2 balances that are ultimately financed by Germany through the ECB would begin with a funding crunch among Eurozone banks. Therefore it is important to estimate the potential magnitude of such a funding crunch.

In a March 2017 research note, "French elections: potential implications for French banks," Deutsche Bank attempted to quantify the potential funding loss that could be experienced by the French banking system during this period of uncertainty by applying the losses experienced by Spanish, Irish and Greek banks during the sovereign debt crisis. To take into account differences in the funding profile of these banking systems, the paper focuses on funding that is deemed vulnerable, such as overnight and short-term deposits (redeemable at notice, or term deposits with maturity less than one year); external liabilities from outside the Eurozone; and debt securities with maturity less than one year. By this measure, the French banking system has EUR 2.7 trillion of vulnerable funding out of EUR 4.0 trillion of total funding, or 68%.

One has to conclude that, while it will be difficult for Le Pen to implement her campaign promises even if she wins the election in May, it is the expectation of major Eurozone upheaval, rather than the reality itself, which makes the scenario of a Le Pen victory significantly more complicated and dangerous for risky assets than was the case after the Trump and Brexit surprises.

Conclusion: these are tail risks

In the end, we feel that the scenarios drawn out above are tail risks, not a base case. Moreover, the most extreme of those risks will not be realised or reflected in asset prices immediately but rather over a period of many months, simply because of the constitutional and political obstacles that lie before them. The only thing that is for certain is this will be a path-dependent process with strong role played by expectations of markets, individuals and governments.

It is sensible for investors to start thinking about what the sustained, medium-term impact of a Le Pen victory might be, in French government bond markets and European bank assets, not least because these assets are not pricing in that victory today. Should that victory occur, it will be sensible to start considering some of the worst-case scenarios.

Our base case scenario has Le Pen losing in the second round of voting for the presidency, consistent with current polls. This would not miraculously lift the cloud of populism that currently hangs over the political scene, but alongside the disappointing results for the PVV in March and the more recent trends in Germany, it could signal that Europe has at least dodged a bad storm. It may be some time before we feel the sun shining on our faces again – but do not be surprised to see the market's attention redirected rather quickly to Europe's hidden strengths and visibly improving prospects.

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