MAERKI BAUMANN & CO. AG

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La Peine

"Political risk" is a term one encounters in many a financial publication at the moment. It is now only a couple of months until the French presidential election, which has the potential to unleash major turbulence in the financial markets. In the Netherlands, parliamentary elections will take place on 15 March. We hold the view that the Dutch populists, although gains for them may be well come, will not stir up investors' emotions. We expect this to be different in France. There are any number of candidates in the first round of this election (scheduled for 23 April), but only a handful of them has the potential to make it through to the second round (7 May). One of these is the representative of the Front National (FN), Marine Le Pen. The word chosen for the title of this commentary – which shares the same root as the English word "pain" – reflects what we believe will be the consequences for markets in the event of her being elected.

Le Pen's electoral manifesto unveiled at the beginning of February, which was entitled "Au nom du peuple", makes us fear the worst: a French exit from the EU, an end to central bank independence with the aim of financing government spending while at the same time demanding cuts in the budget deficit, introducing "intelligent protectionism", lowering the French retirement age, and increasing expenditure on security services and the military – all of these policies look tailor-made for destabilising France's economic situation. The fact that the yield spread between French and German government bonds has widened in recent months is no surprise. And yet these spreads are much narrower than they were in 2012, when there were common fears that the eurozone would break up.

To put it bluntly, the election of Marine Le Pen would lead to significant financial market turbulence, particularly in Europe. Indeed, in the event of a run-off between the Socialist Benoît Hamon and Marine Le Pen in the second round, European markets would experience a black day as early as 24 April, the Monday following the first round of the election (not to mention a sharp devaluation of the euro). This risk scenario could become reality if the far-left candidate Jean-Luc Mélenchon were to withdraw from the race in favour of Hamon prior to the first round. In the latest polls, this pair enjoy a combined voting share of around 24%, meaning that any deal would give rise to the very real danger of a final round involving the two poles of the French political spectrum. Because as things stand, it looks highly unlikely that Mme Le Pen will be ousted from her leading position in the polls, in which she enjoys a stable approval rating of around 25%. Even the news that Mélenchon was stepping down in favour of Hamon could act as a short-term sell signal for European stocks.

That said, we are convinced that – despite Brexit and the election of Donald Trump – the world is not in for a further surprise in the shape of the election of the FN representative as President of the French Republic. This mainly because French electoral law is based on the majority principle over two rounds, and the past has shown that the number of FN voters over the last two decades has remained quite stable at around 5 to 7 million. Given an electorate of more than 40 million and a typically high turnout of more than 70% in presidential elections, victory in the second round would appear to be beyond Le Pen. Another reason for doubting the validity of comparisons with

Brexit and Trump's victory is the fact that both these polls pointed to a much closer outcome than the current polls for the upcoming French election.

So if not Le Pen, then who? We are expecting the former Minister of the Economy, Emmanuel Macron, to reach the second round and the run-off against Le Pen, not least thanks to the extremely vocal support he enjoys from the centrist François Bayrou, who himself enjoys the support of 5% of the electorate. Whether or not François Fillon, a former Prime Minister during the presidency of Nicolas Sarkozy, can shake off the weight of preliminary investigations into his alleged fictional employment of family members is something we doubt. In our view, the election of Macron would be very positive news, with the potential to give European markets a significant boost. Although any expectations of rapid structural reforms would probably be misplaced, market attention could shift from fears of continued stagnation towards hopes of a break-up of obsolete structures. Given the low current valuation of eurozone equities, this would trigger handsome price rises. Our positioning already exhibits an overweighting of eurozone equities, but as things stand this overweighting is only modest in view of the prevailing risks. These risks are not limited to France, as there is plenty of potential for worrying newsflow from other member states of the eurozone too – notably Italy.

Specifically, there is a very real chance of Italy holding national elections early, i.e. before the end of this year. Here there has been a marked fall in approval ratings of the single European currency project: only 41% of Italians polled last October saw the euro as a good thing, with 47% believing the opposite. Compare this with the end of 2012, when 54% of Italians were in favour of the single currency, and 37% against. In the event of a breakaway of the left wing of the social-democratic Partito Democratico, the majority constellation in the lower house of the Italian parliament would become even more fragmented, resulting in a development that could end very turbulently: Italy's exit from the eurozone. That would make the Greek crisis look like a picnic, and would also make the dramatic scaling-down of risk positions in investor portfolios appear a matter of urgency.

Conclusion
The elections in France have the potential to boost risk aversion in the financial markets significantly. In our view, the worst electoral run-off scenario for the financial markets would be a choice between a representative of the left and a representative of the far right of the political spectrum. We view a French exit from the EU as highly improbable, as the institutional parameters that apply in France represent a major hurdle on their own. On the other hand, even the outcome of the first round on 23 April, which will whittle the field down to just two candidates in the run-off two weeks later, could trigger euphoric price rises on the part of eurozone equities, as well as giving a major boost to the single currency. However, a very active investment strategy will be the order of the day in 2017 too, i.e. we recommend regular profit-taking in the wake of price gains.

Project Europe will be exposed to regular crises of one kind or another over the next few years. But the greatest worry in this respect, even if it is not making the headlines at the moment, remains Italy. So who knows if one of our next investment commentaries will be titled "careless chirping", in this case relating to the leader of the Five-Star Movement, Beppe Grillo...

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