

French Election What's different this time?

An insightful analysis prepared by the award-winning Global FX Strategy Team providing opinions on what to expect.

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French Election: What's different this time?

Main points

- On the 23rd of April, French citizens are called to elect their government leader.
- One of the main candidates is Marine Le Pen, who has advocated leaving both the euro and the EU, if she cannot renegotiate some EU rules.
- Although she is expected to do well in the first voting round, she is seen losing the second round, according to polls.
- Even if she wins, holding a referendum on the euro and/or EU membership is not an easy task.
- The biggest market impact is likely to be seen in the euro, European equities, and safe haven assets.

Eurozone's political risk events keep succeeding one another. The bloc's first political risk for this year, the Netherlands election, is now out of the way with "Nexit" being deleted from the financial dictionary. Was this just the calm before the storm though? Now France takes its turn and a new exit pun takes center stage: "Frexit".

On the 23rd of April, French citizens are called to elect their own government leader, but the final outcome is unlikely to be sealed on that day. Unlike the Netherlands, France's presidential election system is a two-round process, and instead of voting for a party, voters are called to select directly the candidate of their preference. In the first round, candidates from all parties are eligible to run. If a candidate manages to gain an absolute majority, which is more than 50% of the total vote, he or she is automatically elected. Otherwise, a second round is held between the two candidates that secured most of the votes in the first round.

The three most popular candidates in this race are Emmanuel Macron, a centrist politician and a former economy minister, Marine Le Pen, the leader of the far-right National Front party, and Francois Fillon, a conservative politician and a former Prime Minister.

So, why is this such a highly anticipated election? Why is this one more important to the investor's eye than the previous ones? For the same reason the Dutch election suddenly became a financial concern. In the past few years, anti-European sentiment has risen sharply within many EU nations, and France is not an exception.

The French Eurosceptic candidate that gathers strong support is Marine Le Pen. There is another Eurosceptic candidate, Jean-Luc Melenchon, but given that he appears less likely to win compared to Le Pen, we will not proceed to an in-depth analysis concerning this possibility. Le Pen has advocated leaving both the euro and the European Union if she cannot renegotiate some of the EU's rules. **Thus, the prospect of her election represents an existential threat to the European project, one much greater than Brexit in our view**, considering that France was among the founding members of the Union and that it is also a member of the Eurozone. With the unexpected decision of the UK to leave the EU and the victory of Donald Trump in the US both still fresh in memory, market participants are paying extra attention to this event, due to the implications that Le Pen's election could hold for the future of European integration.

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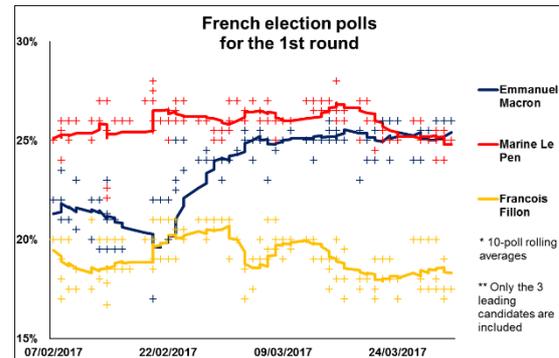
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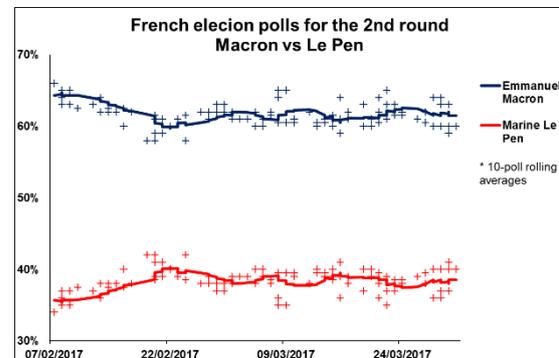
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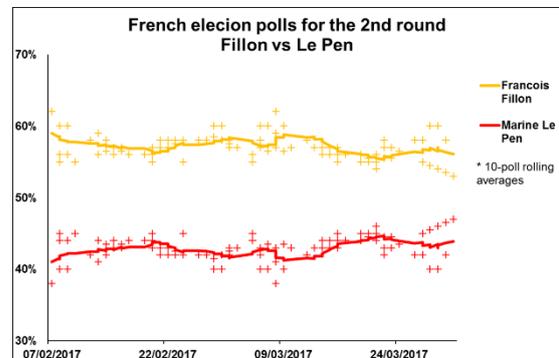
According to the opinion polls, Le Pen is unlikely to get elected as the new French President, but this is what the consensus was for Brexit and Trump a few weeks before the actual votes. Hence, we cannot ignore the possibility of her election and the impact that could have on the financial community. After all, if we were so sure that she is not a threat, why are we writing this report? **The polling history shows that Le Pen was the undisputed favorite for winning the first round back in February.** However, following the announcement of Francois Bayrou that he will not run for President and will instead support Macron, the gap between Le Pen and Macron started to narrow rapidly. **In late March, Macron managed to take the lead.**



One may argue that even if she ends up in the second place, she can still win the second round, which is the decisive one. However, the polls suggest that this is an unlikely scenario regardless of whether she will face Macron or Fillon. In the scenario of her facing Macron, which is the most likely outcome if one trusts opinion polls, Macron is expected to win by 61% to 39%.



Now, in case Fillon is Le Pen's opponent, Fillon is seen as winning via a 56% to 44%. We should not forget to mention though that in both cases the number of undecided voters is non-negligible, particularly in the Le Pen-Fillon story. So, unrealistic as it may be, there is the case of her getting all these votes and being crowned victorious.



Now, if Le Pen doesn't make it to the second round, it is doubtful whether a Macron-Fillon standoff would have an impact in the financial world, in our view.

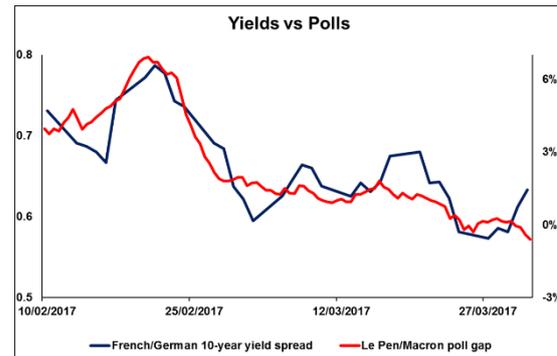
Even though it's unlikely to happen, in the scenario that she does get elected, can Le Pen actually hold a referendum on the euro and/or EU membership? That would largely depend on how well Le Pen's party does in the elections for the lower house of parliament, the National Assembly, which will follow this presidential race. These elections also consist of two rounds that will take place on the 11th and the 18th of June respectively. They are extremely important because whoever controls parliament can cause a government to fall through a motion of no confidence, as well as propose, approve, or block referendums.

It is critical to bear in mind that under French law, a referendum on the euro is much easier to hold compared to a "Frexit" referendum on EU membership. A referendum on the euro may be organized on the initiative of 20% of parliament members and the support of 10% of the registered voters. Alternatively, the Prime Minister, who the President appoints, could simply propose it. However, the

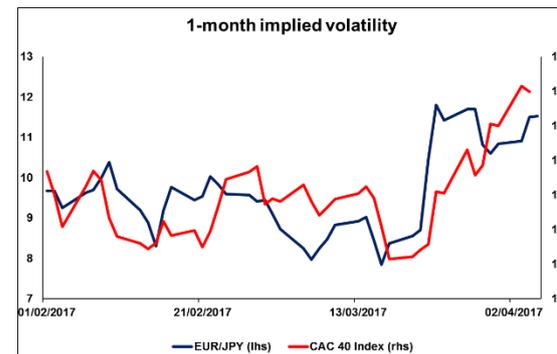
Prime Minister's appointment needs to be approved by parliament first, making it highly unlikely that Le Pen will get her pick without controlling the National Assembly. It is also worth noting that the few opinion polls that have been conducted on this issue show almost three quarters of the electorate wanting to keep the common currency.

On the other hand, a referendum on EU membership is a much more complicated matter, as the Constitution would need to be changed before holding one. Both chambers of parliament would need to approve the constitutional amendments, and only then can a "Frexit" referendum be held. This is almost impossible in our view, considering that Le Pen's party currently holds just 2 out of the 577 seats in the lower house of parliament, and 2 out of the 348 seats in the upper house, the Senate.

Now that we've explained the election background, let's discuss how this race is likely to affect the markets. Investors have already been paying attention to the polling battle and this is visible on this graph. Here, we can see that while the Le Pen/Macron gap is narrowing, the spread between the French and German 10-year government bond yields is shrinking as well. **This means that the risk premium added due to the possibility of Le Pen being elected decreases, as Macron becomes more likely to win the election.**



Turning to the FX market, the euro is the currency that is likely to feel the election heat the most. A Le Pen victory could cause the euro to sink in our view as investors will likely price in a much greater risk of European disintegration and are thus likely to begin dumping European assets. EUR/USD is possible to fall back below the psychological zone of 1.0500, a move that could pave the way towards the lows of January, near 1.0360. A win by either Macron or Fillon could signal that the European status quo continues, and is likely to lead to a relief bounce in the common currency. **Having said these, we should note that the risks surrounding the euro's reaction from this election are likely asymmetric, with a potential Le Pen win generating a much bigger negative response than the corresponding relief bounce in case she loses.** We believe this is the case because as we have already noted, she is unlikely to win the election according to opinion polls, and thus her victory could take markets by surprise, much like Brexit.



Considering its status as a safe haven asset, JPY could respond too. We expect a Le Pen victory to lead to increased demand for this currency, as investors flee the euro and seek shelter elsewhere. **In particular, we expect EUR/JPY to be the biggest loser from a potential Le Pen win.** Likewise, we would expect it to be the biggest beneficiary if anyone else is elected as political risk diminishes and market participants turn back to European assets, while decreasing their exposure to safe havens.

Much like the yen, gold's safe-haven status could cause it to surge as well in case Le Pen and the National Front claim success. It could tumble if Macron or Fillon emerge victorious.

With regards to equities, we expect stock indices to move in similar fashion to the euro. Specifically, to plunge if Le Pen wins, and to experience a relief bounce if Macron or Fillon win. Such effects may be

more evident in European stock indices compared to foreign indices as European nations could be directly influenced by the outcome of this election. **Of course, all eyes will be on the CAC 40, the main French equity index, as it will probably be the prime mover.**

Conclusion

Even though it could have a very significant market impact if it materializes, **a Le Pen win is a low probability scenario with what opinion polls suggest. The biggest risk to this view would be a high percentage of the undecided voters choosing to support Le Pen**, though that seems unlikely as well if one considers her poor performances in the debates. Even if she manages to win, the road to referendums on the euro and/or EU membership is long and filled with obstacles. Furthermore, it is doubtful whether the French public would even support such a referendum, as the few recent opinion polls show overwhelming support towards the euro for example.

The most likely scenario for us is the one where Le Pen makes it to the second voting round, but loses to Macron. The biggest market impact in that scenario would probably be seen in the euro and French stocks, which are both likely to rebound as political risk dissipates.

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