

French election gridlock and its implications on the markets

9 July 2024

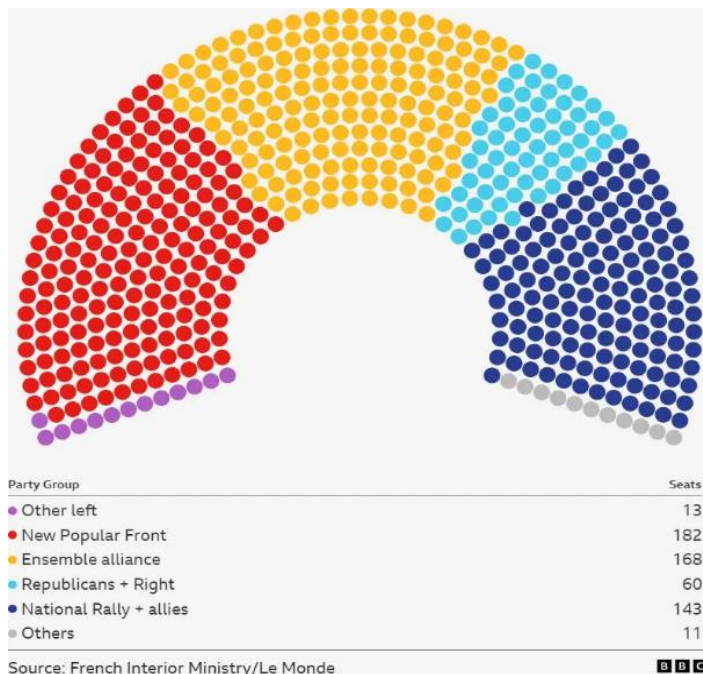
Overview

- Second round results of the French legislative election surprised markets, with the left-wing coalition securing the most seats
- There is no clear majority, with the parliament split across three major political groups
- Expect near-term market relief, as the most acute tail risks are now reduced
- That said, a political gridlock heightens volatility against uncertain fiscal outlook

Results - A divided parliament with no majority

Second round results of the French legislative election held on 7 July 2024 took the market by surprise, with the left-wing coalition (New Popular Front, NPF) unexpectedly coming in first with around 182 seats, though falling short to secure an absolute majority. President Macron's Ensemble centrist coalition trailed behind at 168 seats, while Marine Le Pen's far-right (National Rally, RN) came in third with 143 seats - which is well below expectations. Coupled with a high participation rate, the tactical voting by the left and centre political parties to block the far-right had succeeded, resulting in a hung Parliament

France National Assembly elections 2024 Breakdown of seats



Source: BBC News, "What just happened in France's shock election?", 8 July 2024

Political implications - High uncertainty remains

With that, the worst outcome of a far right or far left majority has been averted, removing risks of any radical spending plans. While this may be a short-term relief to markets, no clear relative majority will likely result in a prolonged period of political and market uncertainty, given the low visibility of how a new government would look like. Indeed, in a gridlocked situation, it will be challenging for any policies and/or programs to be implemented.

Fiscal outlook in focus - Potential ballooning deficit

The stand-out performance of the NPF has stirred worries given its aggressive fiscal stance on both spending and taxation, with plans including raising minimum wage, boosting housing subsidies and reversing pension reforms. This will strain the budget of a highly-indebted France, and clash with EU's restrictive fiscal rules. That said, given a divided parliament, it is still unclear which policies and/or programs could be passed.

France has not had a primary balance surplus in 20 years; its deficit made up 5.5% of GDP in 2023 and is expected to remain elevated at 5.3% in 2024. Meaningful improvements to structural deficits are necessary over the next few years in order to comply with EU rules. The European Commission had recently recommended for France to be placed under an Excessive Deficit Procedure (EDP). In that regard, if the political gridlock drags on, there are risks that fiscal consolidation plans may backslide and further rating downgrades could arise. Should Macron step down as President, it would lead to new presidential elections and another fresh bout of volatility.

Market implications - What to expect?

Rates: The knee-jerk movements since Macron's call for a snap election have been partially reversed. We expect OATs-Bund spread to recover to 50-60bp from 80bp wide. This is below the 150bp seen during the peripheral European crisis, and the ~78bp during COVID-19.

FX: While EURUSD traded higher on the results, EUR upside looks capped in the short term, without any meaningful catalyst in sight. While uncertainty leading up to the elections had bolstered safe-haven demand, we see limited upside for the Yen and Swiss Franc now.

Equities: We expect some stabilisation but no major breakout. Notably, French banks are down meaningfully since early June given their holdings in OATS and high domestic exposure. We believe that the magnitude of the sell-off already reflects election uncertainty while long-term fundamental sector outlook remains constructive. As Macron is still going to take charge of foreign policy, we see limited contagion to the rest of Europe.

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