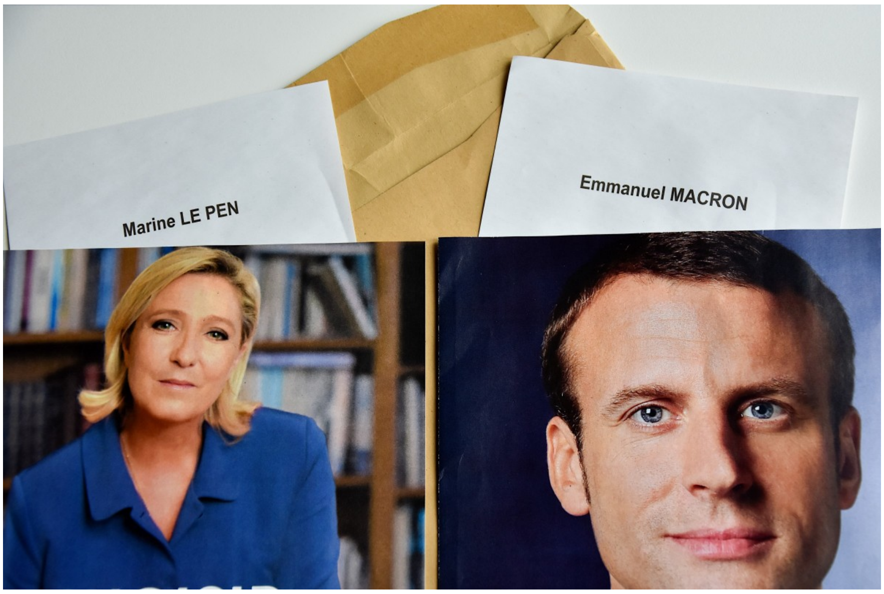
Tensions are mounting in France’s presidential election race

With just a few days to go before voting begins in the first round of the French presidential election, the gap between Marine Le Pen and Emmanuel Macron is narrowing, which is drawing the markets' attention



It's predicted that Marine Le Pen will face Emmanuel Macron in the second round of France's elections on April 24th

A top three for the first round

President Emmanuel Macron is still leading the polls for the first round of France's presidential election, with 26-27% of voting intentions. With the war in Ukraine, we had observed a "rally around the flag" effect and Macron had strongly increased his lead in the polls, reaching 30% at one stage. This lead has melted away and he is back to where he was in the polls before the war. Macron is struggling to make his programme heard, apart from his willingness to implement pension reform, which does not please a large part of the electorate. His position as President has prevented him from really campaigning; his first campaign meeting only came last Saturday. He's also struggling with the cost of living debate. At a time when inflation is rising sharply, this theme has become the French people's top priority.

The far-right candidate Marine Le Pen is in a strong second place, with 21 to 22% of voting intentions, and she has advanced strongly in the polls in recent weeks. In January, she was closer to 17%. This rise is linked with the situation of Eric Zemmour, the polemicist and who also comes from a similar political position. In January and February, he was credited with 15% of voting intentions, but he has since fallen sharply and is now at 10%. A strengthening of the extreme right does not seem to be in place, but rather a shift from Zemmour to Le Pen. Zemmour's candidacy tended to “de-demonise” Le Pen, which helped her a lot because she appeared more moderate. In addition, Marine Le Pen ran a good campaign. Instead of big rallies, she toured towns and villages, showing her ability to connect with ordinary people, which is fundamentally different from Macron. She focused on purchasing power, leaving the others to get lost in broad and comprehensive promises. Her rise as the main challenger perhaps now makes her the default choice for the anti-Macron vote. She benefits from the fact that the French generally don’t tend to warm to their leaders, as illustrated by the fact that no sitting president has been re-elected for two decades.

In third place in the polls is Jean-Luc Mélenchon, with 15% of voting intentions; he's also done well in recent weeks. In January-February, he was closer to 10%. He is seeking to mobilise those who don't normally vote and more left-wingers by highlighting the "useful vote" and insisting that he is the only alternative to a second round similar to what we saw in 2017. His chances of reaching that round are low but not completely zero.

Let's not forget that there is a large number of undecided voters who can swing the vote. Less than 70% of potential voters are certain to vote and abstention could beat the 2002 record. A large abstention could be unfavourable to both Le Pen and Macron. Le Pen voters usually like to protest against the system but might also shun it on election day. Macron voters might think that their candidate will be in the second round anyway and that there is no need to go and vote. As Macron has reminded his supporters, this is how Brexit happened.

The gap is closing for the second round

The most likely outcome is, therefore, a Macron-Le Pen run-off (an 89% chance, according to The Economist). In the polls, the gap between the two has narrowed sharply in recent weeks, reaching 3 points (51.5% for Macron, 48.5% Le Pen), which is within the margin of error. Other polls give him a lead of 6 points, others even more. But in any case, it's closer than the 2017 second round, where Macron won 66% of the vote against 34% for Le Pen. This is partly due to the fact that some voters, and in particular those on the harder left, are saying they would rather stay home than vote for Macron again, even if it makes Le Pen the president.

Nevertheless, current polls do not say everything about the second round. First of all, the voting intentions will depend on the voting instructions given by the candidates eliminated in the first round. There are some uncertainties, especially on the posture of Mélenchon. Moreover, the second round campaigns are partly about choosing a worthy president of the Republic and not only about voting against the old one. That could be detrimental to Le Pen.

We can't exclude a Le Pen victory

Finally, the debate between the final two candidates could have an important impact, as in 2017. It is dangerous for Le Pen, especially because of her previous sympathies for Russia's Vladimir Putin, a subject that is somewhat forgotten but will undoubtedly return after the first round. But the debate is potentially also dangerous for Macron because he will surely be attacked on the cost of living problems. The opposition is already preparing evidence to portray him as “the president of the rich”.

In the end, a Macron victory still seems much more likely, but given the state of the polls, we can't completely exclude a Le Pen victory. The next three weeks will be very eventful. Also, it’s worthwhile remembering that the presidential election will be followed by the legislative elections on 12 and 19 June, which will determine the parliamentary majority and whether the President-elect will actually be able to implement his programme. At the moment, the chances of Marine Le Pen obtaining a parliamentary majority are extremely low.

The return of Frexit?

Given Le Pen's " anti-EU " stance, the markets are a bit nervous about the narrowing gap between the two main contenders given her "anti-EU" stance. Even if she no longer talks about “Frexit” in her programme, she wants to put in place measures that mount to a disguised break with the European Union. In particular, she talks about fraud prevention, which is accompanied by border controls. She wants to hire 20,000 customs officers to control goods entering France from neighbouring countries, effectively challenging the foundations of the European single market.

She also wants to withhold France's payments to the EU budget, and questions the supremacy of EU law, among other things. All these measures are incompatible with being a member of the EU, so it can be considered a Frexit in disguise. This could be a threat to Europe's political stability and cohesion, affecting the economic outlook.

Rate impact: Spreads are rising

The market’s reassessment of risks surrounding the elections has seen growing pressure on French sovereign bond spreads over Bunds. The 10Y spread has risen to above 50bp, levels where the spread has previously lingered briefly at the onset of the pandemic. Before that, higher levels were last seen at the 2017 presidential elections, with spreads in the area of 60-80bp.

Widening pressure on spreads is currently exacerbated by the ECB’s growing desire to normalise monetary policy and in particular the phasing out of net asset purchases. The Pandemic Emergency Purchase Programme (PEPP) has already ceased net buying as of April. It was the most flexible tool the ECB had at hand to lean against market fragmentation. The regular purchase programme still stands ready with a slated purchase volume of €40bn for this month, but its public sector share is more closely tied to the ECB’s capital key split between jurisdictions. And for comparison in 2017 the ECB was buying at a pace of €80bn per month in the run-up to the first election round, then reducing volumes to €60bn in April that year.

Given the inflation backdrop faced by the ECB right now, the bar to intervene in markets should also be higher. We would thus not exclude the 10Y spread of French government bonds over Bunds to widen above 60bp between election rounds, especially when overall market volatility remains high and investors already demanding extra compensation for holding duration.

FX impact: Add French politics to the Euro’s other challenges

For several months the FX options market has been pricing extra EUR/USD volatility around the French election event risk. In fact, EUR/USD volatility for Monday, 25 April is priced at about two and a half times normal levels. The recent narrowing in opinion polls suggests the options market was right to be concerned.

FX traders recall the events of early 2017 when EUR/USD was languishing in a 1.05-1.08 range ahead of both Dutch and French elections. While Frexit is less of a risk today than it was back in 2017, concerns of a Le Pen victory and what it would mean for the unity of EU policy response are just adding another bearish layer for EUR/USD.

Currently, this FX pair is trading close to the lows of the year on expectations for front-loaded Fed policy tightening and the negative terms of trade shock being experienced by the Eurozone on the back of the war in Ukraine. Our base case assumes that EUR/USD starts to trade out a 1.05-1.10 range into the summer months. A strong performance from Le Pen in the first round and a surprise win in the second would see EUR/USD trade 1.05 sooner rather than later.

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