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French Elections Have the Eurozone in a Tizzy

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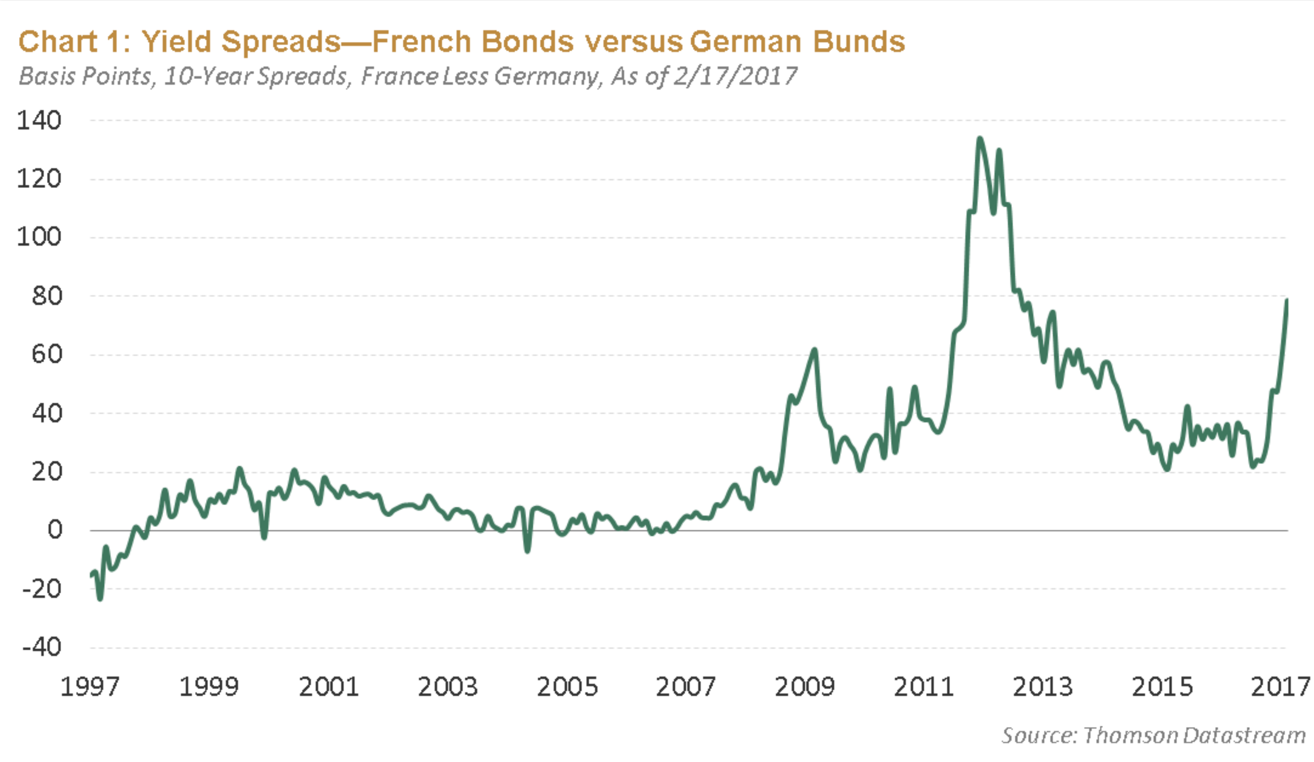
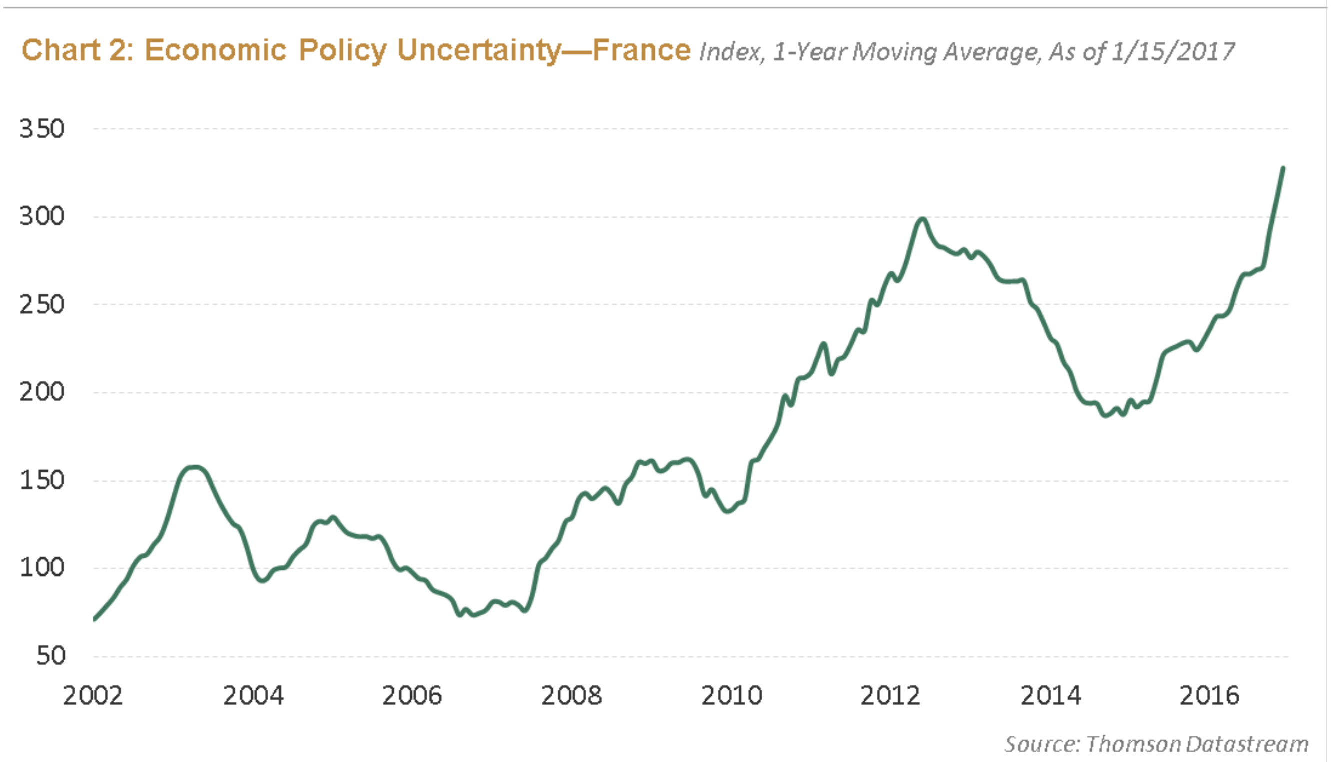
Investors appear to be increasingly worried about several European elections this year, including important votes in the Netherlands and Germany, and possibly Italy. However, the lion's share of their attention has centered on France, where first-round elections are scheduled for April 23. The possibility of a win by the French far-right candidate, Marine Le Pen of the National Front (NL), has investors particularly alarmed. Le Pen's populist platform could challenge the continued viability of the eurozone, a fear that has investors scrambling to hedge against potential French election fallout. Responding to the perceived growing political risks, investors have sought the safety of German bunds at the expense of other bonds across the eurozone. Recently, two-year yields on German bunds have slipped to -0.91%, from -0.65% just a month ago. In general, there has been a broad-based widening of spreads across the eurozone. However, the French yield spreads versus German bunds are now at their widest level since the 2008 Great Financial Crisis. Pushing the election frenzy aside, is the extreme spread widening in French yields solely explained by the risks posed by this year's contentious elections?

The Rhyme and Some Reasons

1. ***The Political Risk***. Clearly there is substantial angst over the prospects of the National Front winning the French presidency. That conclusion is readily apparent from the dramatic spike in spreads, as French bond yields rose from a low of 0.10% to 1.07% currently, with the spread widening to 80 basis points over German bunds. The rise in spreads (see Chart 1) appears to be matched by heightened economic policy uncertainty in France (see Chart 2). Le Pen is running on an anti-EU platform, with the goal of taking France out of the EU and off the euro. Recent polls show Le Pen leading in the first round on April 23, but losing the presidential election in the May 7 second round to either Emmanuel Macron, the former economy minister in the Valls government, or Francois Fillon, the prime minister under Nicolas Sarkozy. The unexpected outcomes of both Brexit and the U.S. presidential election have unnerved investors. However, there is a greater risk of a populist winning in the Netherlands, as Geert Wilders, head of the far-right Party for Freedom, leads in recent polling. Yet, we have not seen a similar widening of Dutch spreads, even though this election takes place on March 15. Furthermore, analysts speculate that the Netherlands could take a while to form a government, which should presumably heighten political risk. Are we ignoring other forces that could explain the broad spread widening in some eurozone bond yields?





2. *Other Reasons.* France appears to be unique in the amount of spread widening that has occurred, even though there is a wide consensus that Le Pen cannot win a second round, and that French voters generally favor remaining on the euro. The Dutch spread has widened, but is only a bit over 30 basis points, compared to 80 basis points in French spreads relative to German bunds. Using a simple assumption, one

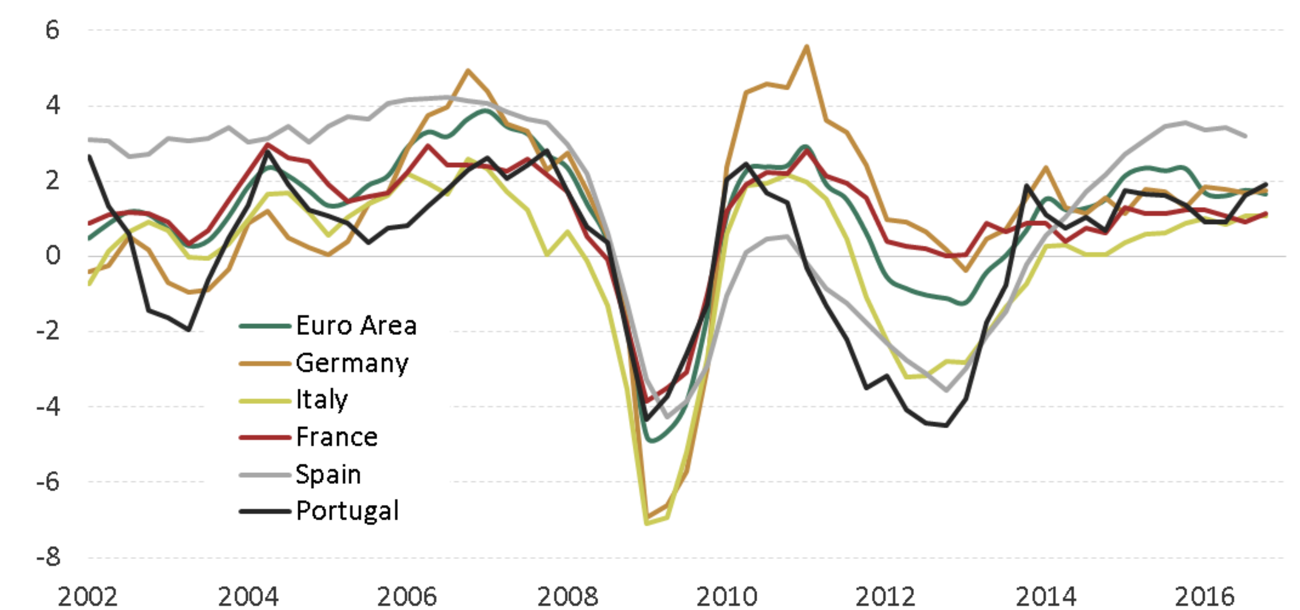
could allocate 50 basis points of the total 80 basis points of widening to France's political factor, but what might explain the additional 30 basis points? First, take a look at Spanish spreads (see Chart 3), which show some widening but a relatively well-behaved relationship with German bunds.

Chart 3: Yield Spreads—Spanish Bonds versus German Bunds

Basis Points, 10-Year Spreads, Spain Less Germany, As of 2/17/2017

Source: Thomson Datastream

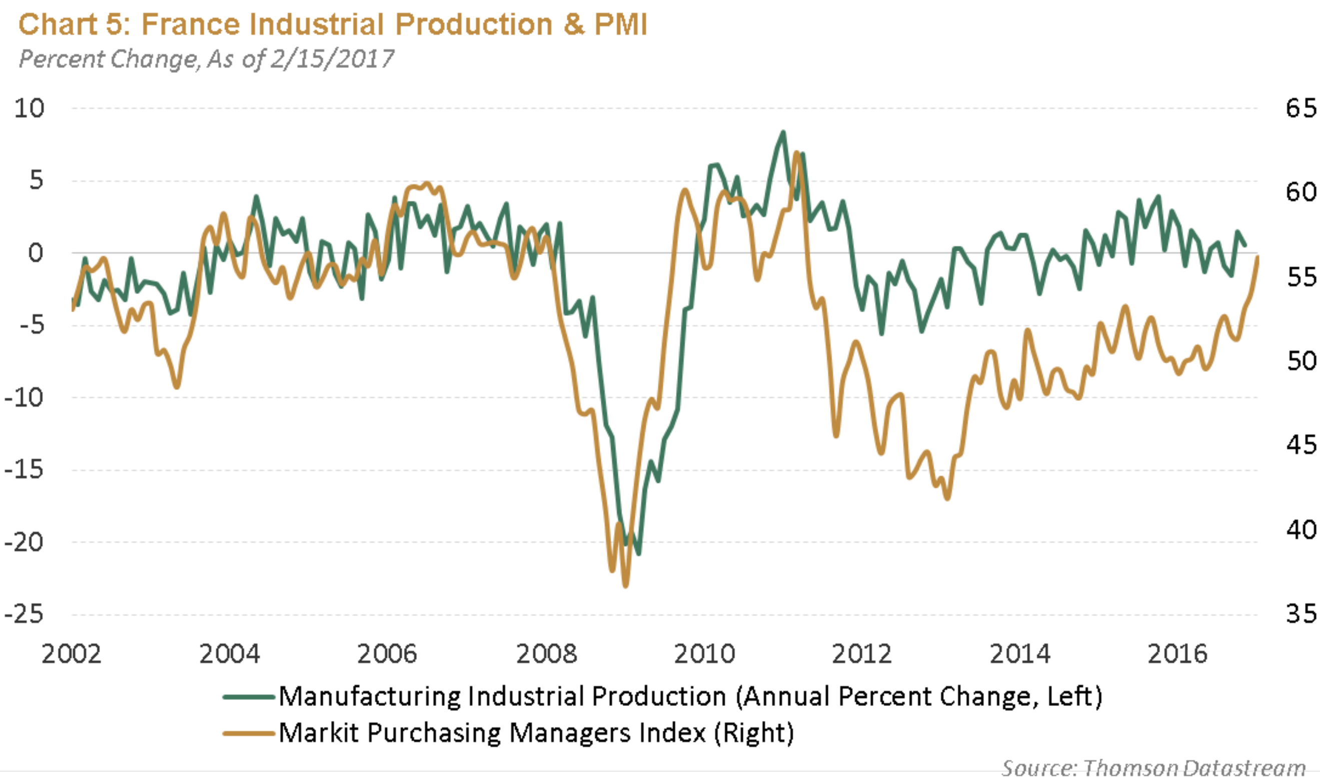
Chart 4: Euro Area GDP *4-Quarter Percent Changes, As of 12/31/2016*

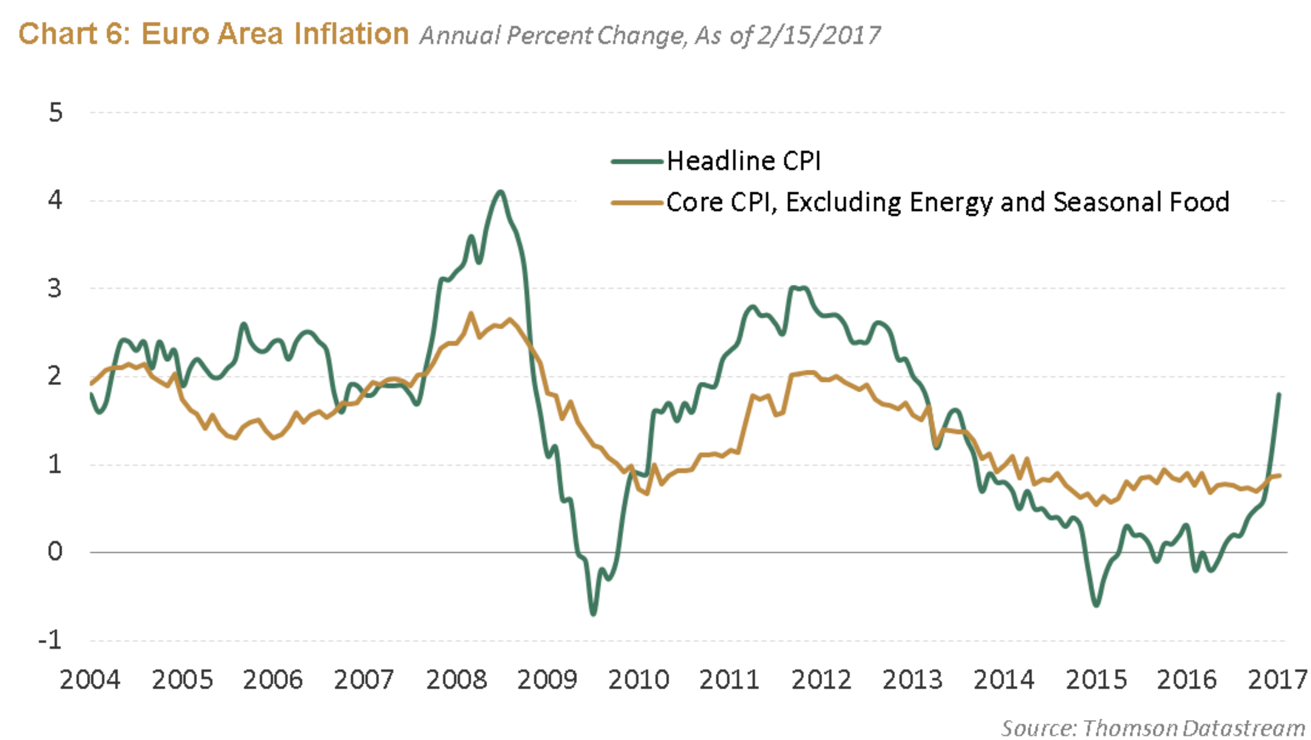


Source: Thomson Datastream

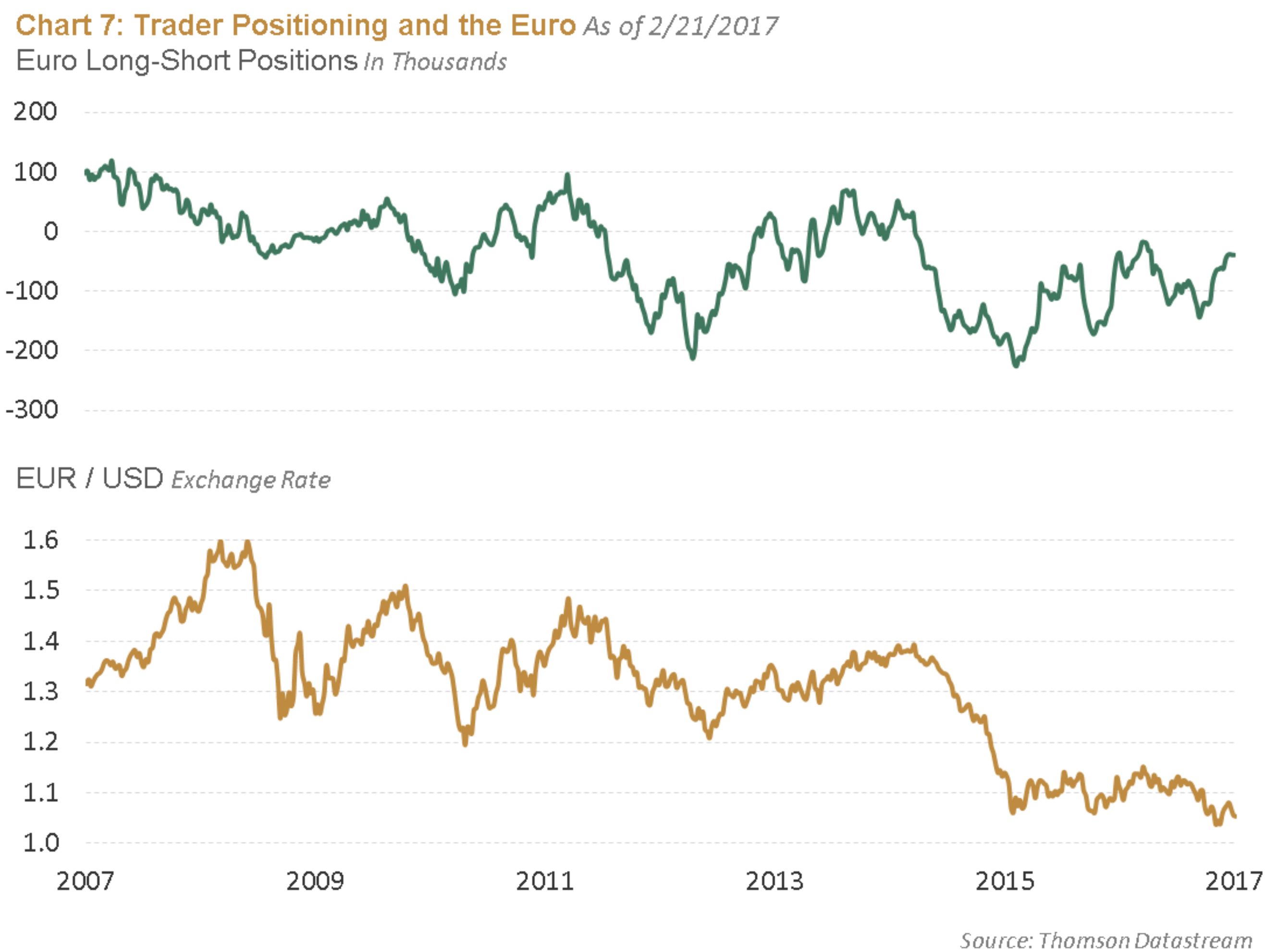
Looking across the eurozone suggests that a better economic outlook may be partially contributing to the spread widening (see Chart 4). Gross domestic product (GDP) seems to be doing better across the region.

Even France is showing some improvement. Industrial production has picked up, and the Purchasing Managers Index (PMI) points to further expansion going forward in France (see Chart 5). Possibly, a portion of the French spread widening is attributable to an expectation of better economic growth.





Inflation in the eurozone appears to be picking up as well (see Chart 6). That could be another force impacting spreads, in addition to the better growth expectation. This most recent pickup in inflation can be traced to base effects and the recent rise in energy prices. While core inflation has not yet started to accelerate, it is likely only a matter of time. Existing productive capacity is being increasingly utilized, as the French manufacturing capacity utilization rates continue to move higher. The output gap across the eurozone is narrowing, and the unemployment rate has fallen from 12.1% in May 2013 to 9.6%, still high, but sharply lower. The improving economic outlook and expected higher inflation could put the European Central Bank (ECB) closer to tapering its quantitative easing program further, once events, like the French elections, are in the rear-view mirror. Realistically, if a Le Pen win and eventual French exit from the EU were in the offing, shouldn't the euro have traded through $1.00 by now? Instead, traders appear to be reducing short euro positions, and the euro is bouncing along the lower portion of its recent trading range (see Chart 7).



Conclusion

Interest rate spreads in the eurozone have clearly widened. In particular, French spreads have experienced a dramatic widening, which has led to a singular focus on the upcoming French elections as the prime mover. Indeed, the financial press has discussed the French election hedging that is ongoing in the markets. Obviously, there is much concern over a Le Pen victory and what that may mean for the future of France's position in the EU. However, it is important to put these concerns in perspective. Even if Le Pen does win, she would still require support in the National Assembly and the Senate. Currently, the National Front holds just two seats in each of these two chambers. Elections for these two chambers will be held on June 11 and June 18. In all likelihood, the

National Front would not garner sufficient seats to govern, necessitating the forming of a coalition. Moreover, other eurozone spreads have widened even in countries without elections this year, such as Spain. Is it possible that wider spreads are at least partly driven by macroeconomic factors? Certainly, France's spread widening owes part of this widening to its political uncertainty—but just part. Political risks aside, the general widening appears to be the result of an improving economic outlook, higher inflation, and the prospects for a gradual reduction of ECB support.

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