French Election Watch

Round one...

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- With first-round voting on Sunday, opinion polls suggest that any two of four candidates could make it to the second round run off. With two candidates running on anti-establishment platforms, the stakes for the economy and markets are high.
- Markets remain alert to the potential for a surprise result, as evidenced by the higher spreads of French over German government bonds. The CAC40 is also trading cautiously. In our Global Tactical Asset Allocation, we maintain a neutral position in Eurozone equities.
- We are still monitoring opinion polls, the campaign trail, and gauges of market anxiety via sovereign bonds and currencies.

Source: Dreamstime

Our view

French voters are heading to the ballot box on Sunday, for what appears one of the most unpredictable elections in recent memory. On the eve of the first round ballot, any two of four candidates have a realistic chance of making it to the second round vote on May 7.

The race is pitched as the establishment (Emmanuel Macron or François Fillon) versus the anti-establishment (Marine Le Pen or Jean-Luc Mélenchon). In our view, the most likely outcome will see an establishment candidate (most likely Macron) facing one of the anti-establishment contenders (most likely Le Pen) in the second round. Under such an outcome, we expect that Macron will become the next president of France. Assuming that Le Pen does not deliver a large upside surprise in terms of vote share, this would most likely lead to a recovery in risk appetite toward French and other European markets.

In our view, the most troubling outcome for investors from Sunday's vote would be if Le Pen and Mélenchon emerged as the first round winners. In our view, there is a low probability of this occurring, but it is possible. Both candidates offer programs for government that are likely to be negative for economic growth. Moreover, the potential for Le Pen to win the presidency will raise the question in investors' minds of France's ongoing membership in the euro and the EU.

Within our Eurozone equity country strategy, we have a neutral rating on the French stock market as long as political uncertainty remains elevated. We maintain our overweight position in the euro versus the US dollar, as the single currency should benefit if either of the mainstream candidates becomes the next president of France.

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Long-term outlook

- The future of Europe, 13 January 2016

Background information

- Eurozone Economic chartset, 10 April

Source: UBS

Opinion polls – and then there were four...

As first round campaigns conclude, four candidates are hovering close to the 20% marker (Fig. 1). Up to now, momentum has been with Mélenchon, and his support looks to be stabilizing near the same level as Fillon's. Interestingly, as voter intentions are firming up, support for the front runners (Le Pen and Macron) has dropped a little. Given the usual margin of error of pollsters' estimates (2–3%), calling the outcome of the first round is extremely challenging. Nevertheless, as things stand, Macron is on course to be the next French president. If he does face Le Pen in the second round, his lead in the opinion polls looks insurmountable (see Fig. 2).

However, undecided voters could still have their say in this election, with a sizable 28% still unsure of their choice for the first round vote (source: IFOP Fiducial). Moreover, the candidates with the strongest support when taking voter certainty into account are Le Pen and Fillon – front runner Macron looks relatively weak in comparison (Fig. 3).

Scenario planning

In our view, there are four probable outcomes to Sundays vote. Markets would react differently to each. We have ordered them according to likelihood as implied by current opinion polls.

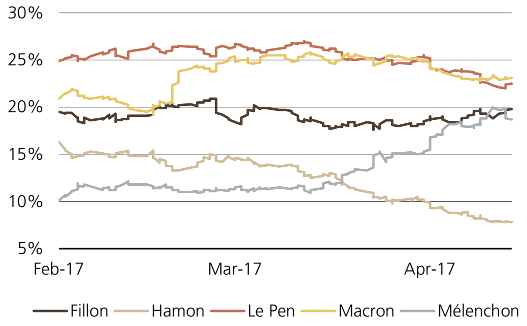
- **Scenario 1: Macron vs Le Pen** – Assuming that Le Pen doesn't deliver a large upside surprise in terms of vote share, this outcome would likely see some recovery in risk appetite given the commanding lead that Macron has in the polls for the second round. Markets will still be alert to the possibility that Le Pen could win, given the nationalist vs internationalist tone that the campaign would then follow.
- **Scenario 2: Fillon vs Le Pen** – As with scenario one, this outcome would likely see a slight recovery in risk appetite, as expectations would be that Le Pen would lose the second round, albeit by a smaller margin. Thus, markets will likely remain on edge.
- **Scenario 3: Fillon vs Macron** – This scenario would likely see a sharp recovery in risk appetite, as the possibility of a anti-establishment candidate becoming president would be removed. Opinion polls suggest Macron will win the second round.
- **Scenario 4: Le Pen vs Mélenchon** – This outcome would likely be considered the worst outcome by investors, as it ensures that an anti-establishment protectionist will become president. We expect that risk appetite would fall, leading to a sell-off in French and Eurozone assets.

Of course, other scenarios are possible, for example, Mélenchon could replace Le Pen in scenarios 1 and 2. If so, we foresee that market reaction would be broadly similar to that described above. Once the candidates are know, it is also likely that attention will turn to the forthcoming National Assembly elections, as support here will be needed for the president to implement their program.

The economy, the EU and the single currency

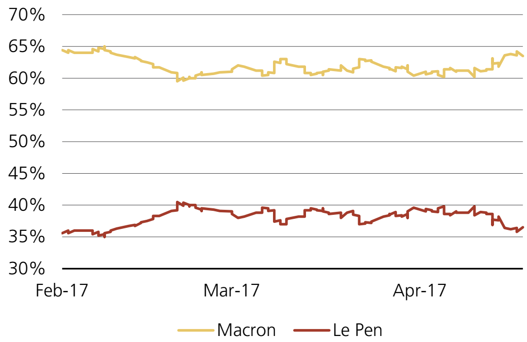
In Table 1 we summarize the main features of the leading candidates' manifestos. Of course, the new president, to implement his or her economic program, will need the support of the French National Assembly. So, even if Le Pen or Mélenchon were to win, each is unlikely to realize all of the contentious aspects of her/his agenda, since parliamentary backing will likely be lacking. To a lesser extent, insufficient Assembly support could also thwart Macron from achieving some of his aims, as he also is unlikely to have a parliamentary majority if he becomes president.

Fig. 1: Any one of four candidates could make it to the second round
Assorted opinion polls, five-poll moving average



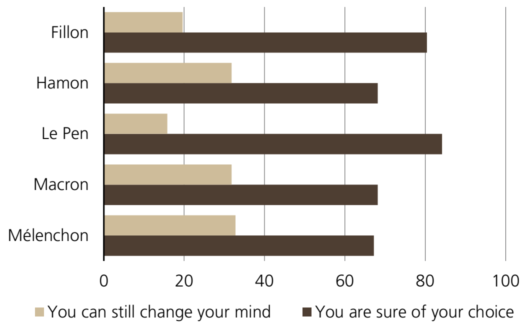
Source: Various polling agencies, UBS, as of April 2017

Fig. 2: Macron could inflict a heavy defeat on Le Pen in the second round
Assorted opinion polls, five-poll moving average



Source: Various polling agencies, UBS, as of April 2017

Fig. 3: Macron's support base is not as firm as Le Pen's or Fillon's
Five-poll moving average



Source: Ifop Fiducial, UBS, as of April 2017

Table 1 – Summary of main manifesto points of the five leading candidates

Candidate	François Fillon	Benoît Hamon	Marine Le Pen	Emmanuel Macron	Jean-Luc Mélenchon
Party	Les Républicains	Parti Socialiste	Front National	En Marche!	La France insoumise
Likely share of first round vote (based on opinion polls)	18-20%	8-10%	23-25%	23-25%	18-20%
Economy	Introduce a number of reforms aimed at boosting the growth potential of the economy. Lay off 500,000 public sector workers.	Introduce a universal basic income. Strong focus on protecting worker's rights.	Oppose free trade deals. Advance measures to promote French workers and companies (tax on foreign workers, awarding public sector contracts, FDI restrictions).	Reduce public sector spending and headcount by 120,000 over five years. Boost competitiveness through training, apprenticeships and more labor market mobility.	Maintain current public spending. Increase minimum wage by 16%. "Definancialize" the economy; reverse some nationalizations.
Budget deficit	Deficit widening in the short-term, target 0% by end of term (2022).	Respect the 3% deficit threshold.	Abandon the Stability and Growth Pact; target a deficit of 1.3% by 2022.	Remain within the Stability and Growth Pact; gradually cut deficit to 1% by 2022.	Ignore the 3% deficit target.
Labour market	Reform the 35-hour work week and introduce more flexibility into the labor market. Increase the retirement age.	Reduce 35-hour work week to 32. Maintain current retirement age.	Open to flexibility on the 35-hour week at the industry level. Lower retirement age to 60.	Tackle unemployment (7% by 2022) with labor market reforms and a focus on training. Maintain 35-hour week.	Lower retirement age to 60. Set maximum salary for CEOs at 20x the lowest. More power to employees and unions.
Taxation	Increase VAT by 2%. Tax cuts to the tune of €50bn in order to bring down the unemployment rate.	Increase number of tax bands. Tax robots.	A number of efforts to reduce taxation for low earners and SME's. All measures look to be unfunded.	Cut corporate tax rate to 25% over the presidential term from 33% currently.	Introduce more tax bands, 100% marginal tax rate for salaries above EUR 400,000. Tax on financial transactions.
Europe, EU, and the euro	Europhile, but less so than the current president. Strong message on security and refugees may put him at odds with EU partners.	Europhile, most likely to support further EU integration.	Euroskeptic. Wants to hold a referendum to leave the single currency and reform or leave the EU.	Europhile, wants to create a EUR 50bn public investment fund. Will aim to reform fiscal and budget rules.	Wants to reform the EU; favors ending the independence of the ECB and pulling out of free trade deals.
Other	Under investigation about payments made to his wife and other family members. Voter base looks stable; likely reached the low point in the opinion polls.	Reject CETA and TAFTA trade deals.	Leader of the populist Front National. Manifesto is more centrist than 2012 to appeal to a wider range of voters. Has the most consistent support base for the first round.	Independent candidate. Lacks party infrastructure, so voters may question if he can govern effectively without parliamentary support.	Surprised in the TV debates, attracting a lot of support with his hard-left, anti-establishment views. He is now seen as a contender for the second round.

Source: UBS as of April 2017

Navigating the markets

Favorable economic conditions and exceedingly loose monetary policy support European equity markets, in our view. But the political uncertainty ahead of the French presidential election is likely to serve as a drag.

We believe Le Pen has a 40% chance of becoming President. The likelihood of a Frexit is much lower, at 10–20%, in our view, due to parliamentary and constitutional hurdles as well as broad public support for the EU and Eurozone (opinion polls suggest 60–70% of voters favor the euro).

Still, a Le Pen win would likely rattle European equity markets, given her attitude toward EU membership. Regardless of the legal complexities involved in holding a referendum and the small likelihood of the public voting to exit the Eurozone, investors will probably worry that a Le Pen presidency would trigger an existential crisis for the EU and the euro.

With this in mind, we have a neutral recommendation on French shares within our Eurozone equity country strategy. We still like the French stock market fundamentally, but French equities are unlikely to outperform in the short term with political uncertainty high. Note that CIO's Eurozone country preferences are not implemented in our global tactical asset allocation. (*For more information, please see Investing in Europe: Gaulish strife, 30 March*).

As for the currency markets, if Le Pen or Mélenchon were to emerge as the next French president, European asset risk premiums are likely to rise and the euro's rebound will be curtailed. However, under Macron or Fillon, we would expect a rapid decline in the yield spread between France and Germany and a strong rebound in the euro. The Swiss franc is the obvious winner when French politics turn extreme. However, our base case is a relaxation of European politics and therefore a depreciation of the CHF and a reduced need for SNB intervention. We therefore expect EURCHF to rise after the elections.

One currency cross that we believe can outperform under either scenario is EURSEK. The Swedish krona seems to be the sleeping beauty of G10 currencies. Sweden is enjoying the strongest economic growth of all the G10 countries, coming increasingly close to overheating. In our view, the strong fundamentals supporting the SEK should see it outperform irrespective of the outcome of the French elections.

Appendix

Terms and Abbreviations

Term / Abbreviation	Description / Definition	Term / Abbreviation	Description / Definition
1H, 2H, etc. or 1H11, 2H11, etc.	First half, second half, etc. or first half 2011, second half 2011, etc.	1Q, 2Q, etc. or 1Q11, 2Q11, etc.	First quarter, second quarter, etc. or first quarter 2011, second quarter 2011, etc.
2011E, 2012E, etc.	2011 estimate, 2012 estimate, etc.	A	actual i.e. 2010A
ADR	American depositary receipt	ARPU	Average Revenue Per User
AUM	Assets under management = total value of own and third-party assets managed	Avg.	average
bn	Billion	bp or bps	Basis point or basis points (100 bps = 1 percentage point)
BVPS	Book value per share = shareholders' equity divided by the number of shares	CAGR	Compound annual growth rate
Cant Inc/Capita	Cantonal income per capita (Switzerland only)	Capex	Capital expenditures
CF	Cash flow	CFO	1) Cash flow from operations, 2) Chief financial officer
Cons.	Consensus	Core Tier 1 Ratio	Tier 1 capital minus tier 1 hybrid securities
Cost/Inc Ratio (%)	Costs as a percentage of income	CPI	Consumer price index
CR	Combined ratio = ratio of claims and expenses as a percentage of premiums (for insurance companies)	CY	Calendar year
DCF	Discounted cash flow	DDM	Dividend discount model
Dividend Yield (%)	Dividend per share divided by price per share	DPS	Dividend per share
E	expected i.e. 2011E	EBIT	Earnings before interest and taxes
EBIT Margin (%)	EBIT divided by revenues	EBITDA	Earnings before interest, taxes, depreciation and amortization
EBITDA Margin (%)	EBITDA divided by revenues	EBITDA/Net Interest	EBITDA divided by net interest expense
EBITDAR	Earnings before interest, taxes, depreciation, amortization and rental expense	EFVR	Estimated fair value range
EmV	Embedded value = net asset value + present value of forecasted future profits (for life insurers)	EPS	Earnings per share
Equity Ratio (%)	Shareholders' equity divided by total assets	EV	Enterprise value = market value of equity, preferred equity, outstanding net debt and minorities
FCF	Free cash flow = cash a company generates above outlays required to maintain/expand its asset base	FCF Yield (%)	Free cash flow divided by market capitalization
FFO	Funds from operations	FY	Fiscal year / financial year
GDP	Gross domestic product	Gross Margin (%)	Gross profit divided by revenues
H	half year	h/h	Half-year over half-year; half on half
hist av.	Historical average	Interbank Ratio	Interbank deposits due from banks divided by interbank deposits due to banks
Interest Coverage	Ratio that expresses the number of times interest expenses are covered by earnings	Interest exp	Interest expense
ISIN	International securities identification number	K	One thousand
LLP/Net Int Inc (%)	Loan loss provisions divided by net interest income	LLR/Gross Loans (%)	Loan loss reserves divided by gross loans
LPR	Least Preferred: The stock is expected to both underperform the relevant benchmark and depreciate in absolute terms.	Market cap	Number of all shares of a company (at the end of the quarter) times closing price
m/m	Month-over-month; month on month	mn or m	Million
M and A	Merger and Acquisition	MP	Marketperform: The stocks expected performance is in line with the sector benchmark
MPR	Most Preferred: The stock is expected to both outperform the relevant benchmark and appreciate in absolute terms.	n.a.	Not available or not applicable
NAV	Net asset value	Net Debt	Short- and long-term interest-bearing debt minus cash and cash equivalents
Net DPS	Net dividends per share	NIM or Net Int Margin (%)	Net interest income divided by average interest-bearing assets
Net Margin (%)	Net income dividend by revenues	NV	Neutral View: The stock is expected to neither outperform nor underperform the relevant benchmark nor significantly appreciate or depreciate in absolute terms.
n.m. or NM	Not meaningful	NPL	Non-performing loans

Appendix

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OP	Outperform: The stocks is expected to outperform the sector benchmark	Op Margin (%)	Operating income divided by revenues
p.a.	Per annum (per year)	P/BV	Price to book value
P/E or PE	Price to earnings / Price Earnings Ratio	P/E Relative	P/E relative to the market
P/EmV	Price to embedded value	PEG Ratio	P/E ratio divided by earnings growth
PPI	Producer price index	Prim Bal/Cur Rev (%)	Primary balance divided by current revenue (total revenue minus capital revenue)
Profit Margin (%)	Net income divided by revenues	q/q or QQQ	Quarter-over-quarter; quarter on quarter
R and D	Research and development	ROA (%)	Return on assets
ROAE (%)	Return on average equity	ROCE (%)	Return on capital employed = EBIT divided by difference between total assets & current liabilities
ROE (%)	Return on equity	ROIC (%) or ROI	Return on invested capital
Shares o/s	Shares outstanding	Solvency Ratio (%)	Ratio of shareholders' equity to net premiums written (for insurance companies)
sotp or SOTP	Sum of the parts	Tax Burden Index	Swiss tax index; 100 = average tax burden of all cantons
tgt	Target	Tier 1 Ratio (%)	Tier 1 capital divided by risk-weighted assets; describes a bank's capital adequacy
tn	Trillion	UP	Underperform: The stock is expected to underperform the sector benchmark
Valor	Swiss company identifier	WACC	Weighted average cost of capital
CIO	UBS WM Chief Investment Office	x	multiple / multiplicator
y/y or YOY	Year-over-year; year on year	yr	Year
YTD	Year-to-date		

Appendix

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