Markets

French Stocks Rise as Traders See Safety in Political Gridlock

- Rise of left-wing coalition comes as a surprise in election
- Investors had expected the far-right to take the most seats

France looks headed for political instability after a surprise win by a left-wing coalition in Sunday's legislative election offered no party a path to claim the majority needed to govern. Caroline Connan explains what comes next. *Source: Bloomberg*

By Alice Gledhill and Julien Ponthus
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The lack of any clear winner in the French elections is being viewed with some relief by investors, who speculated that there's unlikely to be any major policy changes while the government is deadlocked.

French stocks advaced on Monday alongside a broad advance in the European market, while bonds and the euro posted small moves. While benchmark bond spreads are still wider than before the election, a reflection of the persistent worry over the country's debt burden, they've tightened recently as it looks unlikely that the far right or far left will be able to push through their big spending plans.

The CAC 40 Index gained 0.4%, rebounding from an early slump. French bonds were little changed, with the 10-year yield at 3.2%. The euro steadied after a seven-day advance, trading near 1.084 against the dollar.

"It's unlikely radical reforms will come through," said Alexandre Hezez, chief investment officer at Group Richelieu. "Because there likely won't be any structural reforms on spending either, the wide spread on French debt will be maintained. But for other assets classes, it's the scenario which triggers fewer changes."

Read: Surprise Win for Left in French Vote Leaves Investors on Edge

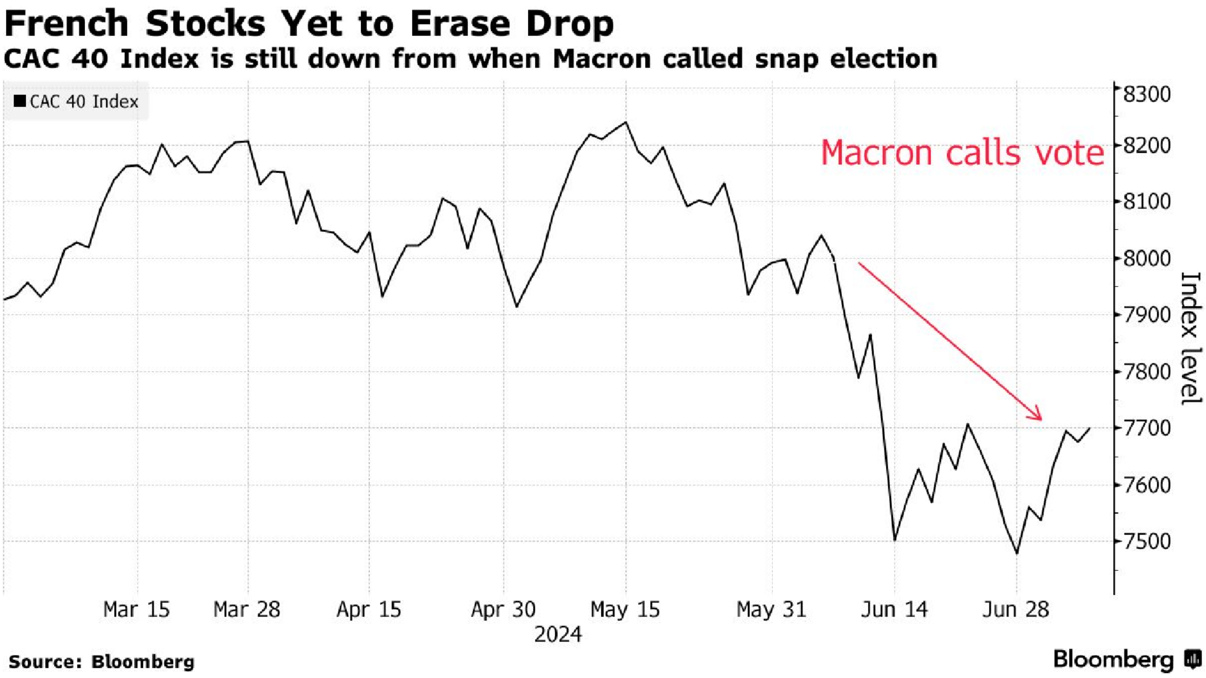
With Sunday's final round of voting showing that the nation is heading for an extended period of political wrangling, investors are trying to make sense of the potential outcomes. While a left-wing alliance will have the biggest presence in the lower house, it's short of the number needed for overall control. President Emmanuel Macron's group was second with Marine Le Pen's National Rally trailing in third place.

Money managers have spent the last week or so fretting over a Le Pen-dominated government, but the left's success is still a concern for investors because it amounts to a fresh dose of uncertainty in the euro-area's second-largest economy.

Still, the left alliance lacks an absolute majority – limiting how much it can do – and some strategists suggested a hung parliament would be a positive outcome for investors.

The gap between 10-year French and German yields, a measure of credit risk, sits at around 65 basis points, below levels seen at the height of the market rout last month.

"If there is no government capable of taking action, it might not be so bad, as the reforms would not be rolled back and no tax giveaways would be handed out," said Edgar Walk, chief economist at Metzler.



Read more: France Set for Political Gridlock After Left-Wing Election Win

The New Popular Front – which includes the Socialists and far-left France Unbowed – won 178 seats in the National Assembly, according to data compiled by the Interior Ministry. Marine Le Pen's National Rally, which pollsters last week had seen winning the election, came third with 143, while President Emmanuel Macron's centrist alliance notched up 156.

French markets plunged into a tailspin in June, wiping out billions of euros from stocks and bonds as Macron's snap poll prompted concern that the far-right would take power. But over the past week, traders pared a chunk of those losses as opinion polls indicated that the National Rally would fall short of an outright majority. France's CAC 40 Index last week erased about half of the losses it endured in the aftermath of Macron's announcement.

> **What Our Strategists Are Saying...**
> "The contours of the next government are far from clear. That is an outcome the nation's bonds won't like – a prospect that will pressure its yield spreads. The key question for the markets will be who the prime minister will be, how well they can work with the far left to enact legislation, and most importantly what that will mean for France's fiscal rectitude."
>
> – Ven Ram, cross-asset strategist

An absolute majority for the left was identified by investors as the scenario they were most concerned about in the days ahead of the first round of votes. But that possibility was discounted after Le Pen's National Rally convincingly won the first round. Among its pledges, the left coalition wants to reverse seven years of pro-business reform and hike the minimum wage.

The Institut Montaigne estimates that the New Popular Front's campaign pledges would require nearly €179 billion ($194 billion) in extra funds per year.

France is already grappling with a budget deficit that at 5.5% far exceeds the 3% of economic output allowed under European Union rules. The International Monetary Fund predicts that – without further measures – debt would rise to 112% of economic output in 2024, and increase by about 1.5 percentage points a year over the medium-term.

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S&P Global Ratings downgraded France in late May, highlighting the French government's missed goals in plans to restrain the budget deficit after huge spending during the Covid pandemic and energy crisis.

Vincent Juvyns, global market strategist at J.P. Morgan Asset Management, said tensions were likely with reforms spearheaded by Macron now in doubt, potentially hurting the value of French bonds versus their peers.

"Markets may demand a higher spread as long as the new government hasn't clarified its fiscal position," he said. "The European Commission and rating agencies are expecting 20 to 30 billions of cuts but the government will actually have to deal with a party which want to increase spending by 120 billion."
– With assistance from Vassilis Karamanis, Verena Sepp, and Greg Ritchie