Le Pen is mightier than the sword, but not Emmanuel Macron

French Presidential election update

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EMMANUEL MACRON WINS THE FRENCH PRESIDENCY

In a largely anticipated result, Emmanuel Macron has won the French presidential election. The contest has been one of the most closely watched political and market-relevant events in Europe, and the most hotly contested French election in recent history. But with a winning margin of 66% vs Marine Le Pen's 34%, Macron's victory is decisive. Turnout was relatively low by French standards at 74%.

However, there is more French politics to come. Macron will formally become the French president on 14 May. The focus will then swiftly move on to the legislative elections on 11 and 18 June. As the head of the relatively new En Marche movement, Macron still faces a challenge from the established parties in terms of getting a majority.

In turn, this will impact his ability to pass legislation and make the reforms he promises. Without a working majority in parliament, Macron will be forced to work alongside a Prime Minister from a different political party and compromise with his/her domestic policy agenda.

MACRON'S KEY POLICIES

Amongst the key measures Macron has campaigned on are:

- Reduce the deficit by €60bn
- Cut 120,000 public sector jobs
- Boost competitiveness through a €50bn investment plan
- Lower household and corporation taxes
- Promoting a common euro area budget and finance minister

EUROPEAN RISKS REMAIN

Although Macron was the most pro-European amongst the main candidates, this vote should not be mistaken as a ringing endorsement for the EU. 49% of all those who

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voted in the first round of the election did so for parties explicitly in favour of leaving the euro and/or the EU.

Moreover, the rest of 2017's European election calendar still has much to offer in terms of event risk. The German election in September is the next key milestone. The relationship between France and Germany will determine the future of Europe and how Macron and his German counterpart work together to address the rise in populism, the challenges of immigration and structural weaknesses, will be high on the agenda.

Then it is Italy's turn where a general election has to be held by May 2018. Italian political risk should not be underestimated given the strength of support for the anti-establishment Five Star Movement.

MARKET REACTION MUTED

The euro was initially higher on the news that Marine Le Pen will not be the next resident of the Elysee Palace. However, as this result was widely anticipated, the market reaction has been fairly muted.

Market stress about the prospects for a destabilising outcome peaked several weeks ago just prior to the first round of voting. The clearest market barometer of this risk has been in the excess spread of French government bond yields over equivalent maturity German government bond yields. That has retraced from 80bps (prior to the first round) back to the 20-40bp range that has characterised the last three years.

Looking ahead, equity markets can return to focusing on the more mundane issue of earnings prospects. On that front, recent news has been encouraging with the long-term underperformance of European earnings finally having come to an end.

On the euro itself, we remain quite negative given the lingering political risks (especially in Italy) and the likely widening in the interest rate differential between Europe and the US. We continue to think it is appropriate to hedge European currency risk.

However, the most pressing challenges in the months ahead may well be in European fixed income markets. On our estimates, the European Central Bank is on its way to owning nearly a quarter of the sovereign and non-financial corporate bond markets. The prospect of slowing down the pace of those purchases (i.e. tapering) has the greatest potential to disrupt the markets in the second half of the year.

The last 12 months has clearly demonstrated that politics matters for financial markets. However, the clearer lesson from the last 12 years is that you ignore central banks at your peril.

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