FEATURE ARTICLE: POPULISM ON THE RISE

POPULISM ON THE RISE

It would be easy to look at the upcoming French election and dismiss the likelihood of Marine Le Pen's National Front party winning the election, however, recent important referendums and elections have taught us that we should not dismiss what seems either highly unlikely or impossible. In January 2017, Le Pen asked voters to *'wake up'* and follow the example of their American and British counterparts. By this, she means voting against the establishment, voting against globalisation, and voting for a candidate who will put its country first. The risk lies in whether or not the French listen to her direction.

Following Brexit and the US election, it became evident that populism in prominent countries was on the rise. In the case of Brexit, immigration became the biggest issue at play, and Brits voted predominantly against the influx of immigrants that the country has seen in the past several years. In the United States, Americans voted for reversing globalisation, in the hopes of bringing back jobs that have been lost as the global economy has become more open. What is the sentiment in France that has made Le Pen's party find new traction in recent years? A languishing economy, a persistently high unemployment rate, and repeated terrorist attacks are a few of the big-ticket items that have fuelled voters' demand for change.

But why has just one presidential election garnered so much attention and caused so much worry? Le Pen's protectionist and isolationist platform, including her plans for France to exit the eurozone and bring back the franc, have the potential to be disruptive and damaging beyond France's borders. For one, the European Union is already standing on shaky ground as one of its most important members has just kicked off its own exit negotiations. Could a second country opting to leave the EU be the straw that breaks the camel's back? Could the election of another far-right populist politician spur similar movements in other countries around the world?

In this feature article, we dive into the upcoming French presidential election. We provide an overview of the candidates and their politics at play, as well as why the current economic and country-specific conditions have created the perfect environment for populism to find its footing. We then delve into the knock-on implications of both a Le Pen victory and a loss, the first of which is unlikely but has the potential to have short-term and long-term implications for financial markets, while the latter is more likely to occur and more likely to have a placid outcome. Finally, we address the impact that these scenarios could have on investment strategy.

1.1 The When and Who of the French Presidential Election

The upcoming presidential election in France is being contested by four top candidates: François Fillon of Les Republicans, Benoît Hamon of the Socialist Party, Marine Le Pen of the National Front, and Emmanuel Macron, an independent. The electoral system involves two rounds of voting, the first slated for 23 April. The second round will be on 7 May, in which the top two candidates from the first round face each other in a run-off.

French presidential elections have historically been dominated by two political parties – the conservative Les Republicains and the left-wing Socialist Party. Both have fallen out of favour in the lead-up to the election however, with the former plagued with disapproval of current President Holland and the latter plagued with campaign scandals. So that leaves us with two frontrunners – Macron and Le Pen. Macron was a member of the Socialist Party and held a senior role in Hollande's government. He resigned from his government role in 2016 and founded his own political movement called *En Marche!*, an independent political party which Macron has described as being a progressive organisation of both the left and the right. Macron has a distinctively rosier outlook for France's future involvement in the EU as compared to his competition, having called out his rivals for *'cowardice and hypocrisy'* who claim that the euro and the EU are the root of France's problems.

The other leading candidate, and the one who has undoubtedly drummed up the most media attention, is the leader of the National Front party (FN, acronym based on name of party in French), Marine Le Pen. The FN is a far-right populist and nationalist political party, founded in 1972 to unify the fragmented nationalist movements in the country at the time. The party's first leader was Jean-Marie Le Pen, father of its current leader Marine, and he continued to be the party's leader until he resigned in 2011. Marine Le Pen (Le Pen) has been the leader of the party since his resignation. We briefly discuss the party's rise in popularity in the following section.

1.2 All This Leads to a Rise in Populism

The issues that France is currently facing – high unemployment, a stagnant economy, high government spending, and frequent terrorist attacks, among others - have had and will continue to have severe political implications. For one, migration has emerged as a major political issue, which has led to a rise in popularity of far-right, populist political parties across the continent. Immigration was a key reason why the Brexit vote turned out the way it did, and is a piece of the Donald Trump puzzle. Such parties (UKIP in the UK, PVV in the Netherlands, National Front in France, etc.) had already seen a resurgence in popularity during the 2011 Euro crisis, due to widespread discontent over poor economic performance and austerity measures which cut government benefits. Add the rise in terrorist attacks to the equation, and Europeans are starting to align themselves more and more with the far-right parties.

Looking at the voting statistics from Brexit and the US referendum, the rise in the popularity of the far-right ideologies was largely driven by the older generation. According to exit polls, 75% of those 24 years of age and younger voted for Britain to stay in the European Union, and 56% voted the same way in the 25-49 age group. Donald Trump's campaign was successful because of his ability to appeal to the older generation of America who felt that they had been left in globalisation's dust.

In France however, far-right populist ideologies have had surprising allure to the country's younger generation. The high youth unemployment rate and the dual labour system that makes it difficult for young people to find permanent work is just one rationale for this trend. Knowing that they are competing against a burgeoning immigrant population in the labour market does not help the matter. In such an environment, the far-right political parties have made quite the impression on France's disillusioned youth.

The anti-immigration sentiment has fuelled the popularity of far-right political parties as well, given that such parties tend to also have anti-EU agendas. The EU's effectiveness at dealing with the immigration and terrorism issues has been called into question time and again, and given that the far-right parties in France are calling for France to leave the EU, it is little wonder why the frustrated and worried French population has been finding more in common with the far-right leaders.

If we then look at Marine Le Pen and her National Front political party, we see that she has been working hard to make her party more appealing to those who have never before leaned that far to the right. The party has a chequered past in terms of its popularity in France, particularly because of her father's racist and xenophobic tendencies that got him into hot water several times. Le Pen has worked hard to distance herself from her political party's racist history, in particular, by expelling her father and other controversial members of the party. The party's platform continues to be very much that of a far-right populist party however, defined by its anti-EU stance, its zero-tolerance approach to law and order, economic protectionism, and opposition to immigration.

Under her father's leadership, the party had become a political outcast, but she has been trying to show that the far-right has a gentler and softer side. She has brought the party back within the range of acceptable political parties to conceivably support, and given the economic landscape in France, it is not surprising that these tactics are working to give her a legitimate chance (although still unlikely) to be the next president of France.

1.3 Scenario Analysis

Le Pen's campaign has garnered a fervent and dedicated base of supporters and it appears as though she could win the most votes in the first round of the election because of the crowded nature of the vote. In the second round however, she will face a much greater obstacle as it is likely that those who voted for the mainstream parties that did not get through the first round will endorse the mainstream party that does (likely to be either Macron or Fillon).

In this section, we discuss the implications of the result of the presidential election by discussing two potential scenarios: Le Pen wins and she gets a parliamentary majority in the June legislative elections and the second being that she does not win. We view the first as the least likely but the most damaging, while the second scenario is the widely expected one with much more muted implications.

1.3.1 Scenario #1 – Le Pen Wins Big

The new French president will be named by early May, but their presumed power in pushing through policies will not be known until after the legislative elections which are slated to take place in June. For Le Pen to have the most success at sticking to her game plan, she will need to have a majority in the National Assembly (the lower house of Parliament), so the FN party will need to win 289 of 577 parliamentary seats. The FN party currently only has two seats in the 348-seat Senate (lower house of Parliament) and given that changes, like those to the constitution, need to be approved by both the upper and lower houses, a majority in the upper house will actually give her a fighting chance. Should she get this majority, it is much more probable that the FN party will be able to push through some of its more controversial policies – including pulling France out of the EU and reintroducing the franc.

Economic Impact

The election of Le Pen will likely spur a great amount of volatility in the short term, given that the implications will be uncertain. The uncertainty will be present not just in France, but across the eurozone as a whole. Consumer confidence would be shaken, in turn causing a slowdown in business investment and consumer spending. The uncertainty would likely drive a massive flight of capital from both France and the eurozone, given that a Le Pen win and a legislative majority would signal an increased likelihood of a fracture in the EU and in the eurozone.

We will first touch on the outcome if Le Pen is able to pull France out of the EU. France is one of the six founding members of the EU, and undoubtedly one of its most important members. With the success of the EU already in question based on its dealing with the European debt crisis and the refugee crisis, it might only take one country to pull out for the EU to break the bloc up completely. The EU can survive without the UK, but can it survive without France? A fracturing of the EU and Eurozone would likely result in economic contraction over the short term. It would be a significant step backwards in terms of the progress spurred by globalisation, and the fractured continent would likely see negative or low growth for some time, at least until there is a better understanding of what a post-EU world looks like.

Advocates of Le Pen's plan believe that the reintroduction of the franc would be unequivocally beneficial to both the French government and French firms. This is because the franc would likely depreciate versus the euro (and other global currencies) as soon as it is introduced, making French goods relatively cheaper and more attractive in international markets. While this is true in the short term, in the long term, for a depreciation of the currency to maintain its positive side effects, inflation needs to be maintained and not allowed to spiral out of control. This will be difficult given that the ECB would no longer be tasked with restraining inflation in France. Without the proper tools to restrain inflation, French producers will then face higher wages and higher input costs, which erode the benefits of the initial currency depreciation.

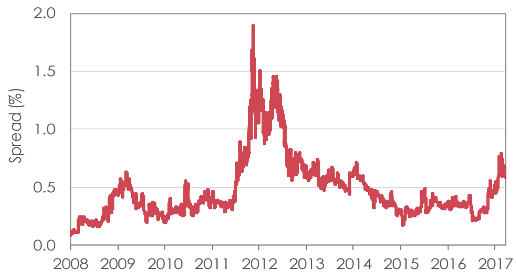
If Le Pen wins big, we would expect the French economy to shrink, become more isolationist, and the government would have more difficulty negotiating on the global stage than if the country continued to be a member of the EU.

Financial Market Impact

A Le Pen victory in May, particularly if it is by a substantial margin, will have the potential to rattle the confidence of investors, even more so if it is followed by a strong showing in the legislative elections come June. Despite a potential Frexit being a long and protracted process, just the thought of it could send financial markets and depositors into a panic. Panicked investors would likely quickly sell off their French assets, as well as other eurozone assets, in the fear of the reintroduction of the franc and the likelihood that the new currency would swiftly depreciate versus the euro and other prominent currencies.

In this risk-off event, French government bond spreads would widen significantly versus German government bonds, which have often been considered safe haven assets. The chart below shows the French 10-year government bond yield spread versus the German 10-year government bond yield. In times of financial market stress, French government bond yields have increased dramatically versus that of German government bonds (this is generally the case for all European government bond yields). In the lead up to the election, we have already seen French government bond yields start to tick up as the anticipation builds. Because of the potential for widespread panic, Germany's safe haven status could even be called into question in this scenario.

Chart 1: 10-Year French Government Bond Yield Spreads over 10-Year German Bunds



Source: Bloomberg, Whitehelm Advisers

In an extreme risk-off event, we would expect the panic to spread beyond France's borders, with Italy the most prone to panic. It is currently the weakest of the prominent EU countries and given that its banking system and its government finances have already come under so much scrutiny, any weakness in neighbouring France would likely extend to Italy. A bank run on the already very vulnerable Italian banks could spell disaster.

But this scenario wouldn't be a surprise in the absence of a response from authorities, so how authorities respond to these events will be critical. The ECB would step in, given that the eurozone's second largest economy would be in dire straits. However, in a scenario of a Frexit, would the ECB purchase French government bonds? Maybe not if they were advancing and likely to exit the Euro and EU. However, the ECB would almost certainly respond to other remaining countries bond yields. In particular, stopping the contagion beyond France would likely be the focus. The ECB could use a similar program as its 2010 Securities Market Program, in which the ECB purchases sovereign debt on the secondary market. This would somewhat contain the stress.

Such a move from the ECB would be critical in limiting the downside. The fragility of the European banking system with increasing interest rates would cause big problems for European banks, given that there would be a decline in deposits and much higher refinancing costs. As credit agencies start downgrading the banks, the ECB's refinancing operations would exclude the downgraded banks because of their poor collateral quality (unless changed). Failing banks and higher interest rates would be damaging at the government debt level as well given that France's debt to GDP level currently stands at 100%. If the country were to default on its debt, it would no longer be able to borrow in international financial markets.

It is important to note that this is not the only possible outcome should Le Pen win big in May and June. Le Pen has promised that she would arrange an *'orderly'* exit from the EU to make sure that France, and the broader EU, do not crumble in this scenario, however financial markets could react well before Le Pen is even given the chance to make sure the exit is orderly. And given the extreme implications of an ugly Frexit, authorities are likely to do everything possible to manage an unwind as best as they can. Only time will tell how successful they will be in this endeavour.

1.3.2 Scenario #2– Le Pen Does Not Win

At this point in time, the outcome of the scenario of 'if not Le Pen, then who' is still uncertain. However, as we discussed in the first half of this feature article, the candidate currently looking to have the best shot at the French presidency is Emmanuel Macron. Macron has found himself as the leading candidate primarily because of the difficulty that his contenders have faced on the campaign trail. Nevertheless, Macron has been able to appeal to both the left and the right and at least some part of his platform seems to appeal to everyone. He has advocated for significant economic reforms, he is pro-Europe, pro-immigration, and pro-globalisation.

While on paper his campaign is appealing, he and his supporters are likely to meet resistance soon after he becomes president. Because Macron formed a new political party, he does not have the backing in Parliament that other candidates have. He has never fielded candidates for election, so it will be difficult, likely impossible, for him to get a legislative majority. Regardless of the winner of this election, one likely outcome is that the Parliament will be highly fragmented, which will make it difficult for the next president to push through their proposed policies.

Macron has campaigned on an ambitious platform, that includes €60 billion of spending cuts and low interest borrowing, to fund a €50 billion public investment program and €20 billion of tax cuts. The tax cuts would be shared between both individuals and corporations. While promising on paper, the current state of the French economy will create headwinds for even the most ambitious of proposed policies (all of this assuming that he has the backing of Parliament, which at this point appears unlikely). Furthermore, Macron has been compared to Hollande, in part because of the fact that he recently worked for Hollande as the Minister of the Economy, which does not bode well considering the latter has been deemed the most disliked French president in history (notwithstanding the clear need for a smaller government and deregulation of the labour market).

Economic Impact

Likely, the outcome of this scenario will be status quo for French domestic affairs. In France, presidents have a relatively great amount of control over foreign affairs, in terms of being able to decide to go to war, ratify treaties, and negotiate with foreign powers. Yet, on the domestic front, so much needs to be approved by the upper and lower houses, and without a majority, it is likely that the French economy will get stuck in neutral. That said, this scenario would be viewed as a positive when it comes to the geopolitical implications.

Under Macron's leadership, it is likely that France will try to improve the relationship between France and the EU, given his pro-EU and pro-globalisation platform. Relations between France and Germany, the two EU superpowers, could improve and enhanced cooperation would open up the door to improved efficiency within the soon to be 27-member bloc.

Financial Market Impact

It is likely that any outcome in which Le Pen does not win would result in a modest rally for European equity markets. Investors will breathe a sigh of relief in knowing that the French people prefer improving the country's relationship with the EU, rather than dismantling it. Given France's prominent position in the bloc, a vote against Le Pen would be, in part, a vote for making the union stronger.

1.4 Impact on Investment Strategy

In this section, we discuss what such an election and the potential implications of it have on investment strategy, from the perspective of Australian superannuation funds in particular.

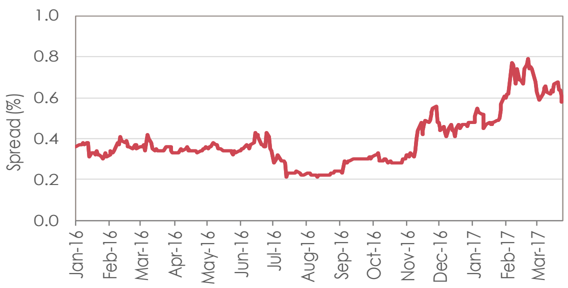
Debt Markets

In anticipation of the upcoming election, investors are already demanding a higher premium for holding French debt, as seen by the increasing spread between French government bond yields and German government bond yields. Following the Brexit outcome and the election of Donald Trump, investors became more aware that populism was finding its footing in the developed world, and France was vulnerable to the same fate. So what happens if that same outcome materialises in France over the coming months?

In the case of Le Pen winning the election, we would expect financial markets to swiftly move to a 'risk-off' environment, much like what was seen in the hours following the US election result, and in the hours and days following Brexit. Given the magnitude of this election, we would expect the risk-off phase to last much longer than it did following Brexit and the US election.

Typically, in risk-off environments, investors choose safety over uncertainty, buying up government bonds because of their perceived safe haven status. In the short term, this could very well be the case, particularly for German government bonds (bunds) given their positioning as Europe's ultimate safe haven investment. The demand for bunds would decrease their yield and increase their price, however wariness regarding the new French government could send French government bond yields up, widening the spread between French and German government bond yields. Because the implications of such a result would likely unfold over the long term, the yield curve for French government bonds would steepen, given that the longer-dated bonds are more exposed to credit risk and long-term investor unease.

Chart 2: French vs German 10-Year Government Bond Yields, 2016 - 2017



Source: Bloomberg, Whitehelm Advisers

Given that 60% of bonds issued by the French government are held by foreign investors, the implications of a big Le Pen victory cannot be overlooked. Before there was any worry about the outcome of the presidential election, French government bondholders would likely not have given much thought to the currency risk associated with the bonds. If the bonds are redenominated into francs following a Frexit (which would be possible for the 80% of government bonds that were issued under domestic law), the bondholders would be exposed to significant currency risk, particularly given that the franc would be expected to depreciate versus the euro immediately following its reintroduction. Authorities are alive to this risk and would want to transition in an as orderly path as possible. That said, liquidity of derivative markets for hedging franc exposures would likely be very small and sporadic, leading to challenges in hedging, as well as higher costs.

Government bonds would not be the only worry for debt markets if Le Pen managed to have France leave the eurozone. With the reintroduction of the franc, the French private sector may face significant difficulty in being able to service their euro-denominated debt. Of approximately €1 trillion euros of French corporate bonds that are currently outstanding, more than 50% is governed by foreign laws, and hence would not automatically be redenominated in francs, but would stay in euros instead. If the franc were to depreciate, French firms could face significant difficulty in being able to afford financing its euro-denominated debt.

Bondholders who bought credit default insurance, through the credit default swaps market, are also unlikely to get paid out if the redenomination occurs. As per definitions from the International Swaps and Derivatives Association (ISDA), conversion from euros into another currency does not necessarily constitute a restructuring or a default if the redenomination is as a result of direction from the government (which it would be in this case).

Equity Markets

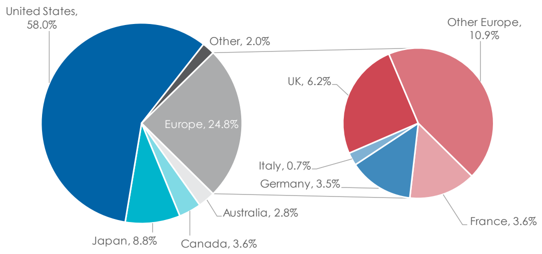
If Le Pen wins the second round of the election on 7 May, it is likely that we will see a sell-off in equity markets. Looking back on the US election and Brexit, we were anticipating a much longer sell-off in terms of duration than what actually happened. That said, given the broader implications of a Le Pen victory in terms of the future of the EU and the eurozone, we would anticipate that the sell-off following a Le Pen victory would be longer and more severe.

Over the longer term, share prices are dependent on corporate earnings. Le Pen believes that by taking France out of the eurozone, she will be increasing the competitiveness of French firms on international markets, and in turn, boosting their profitability. This would be beneficial for the French share market, however, more than just the price of French exports determines the profitability of companies. The balance sheet imbalances that may arise if the franc is reintroduced and it depreciates versus the euro will be just one of the factors that could detract from corporate earnings. We would expect a Le Pen presidency to dampen the performance of French businesses, hindering share market returns.

If a Le Pen induced share market sell-off is localised to France, global equity investors (including Australian superannuation plans) would be relatively unscathed. France makes up less than 4% of the index, while the United States accounts for almost 60% of the index. Given that the outlook for the US continues to be strong, a sell-off in the French share market may be offset by strength in the American one.

However, the weakness in share markets could extend well beyond France's borders, and given that Europe makes up about 25% of the MSCI World Index, this could spell much greater pain for global equity investors. However, well diversified superannuation plans should be well protected from the headwinds in Europe.

Chart 3: Geographic Breakdown of MSCI World Index, as of March 2017



Source: Bloomberg, Whitehelm Advisers

It is important to remember here that while this extreme downside scenario for financial markets is plausible, it is unlikely given Le Pen's likelihood of winning is also unlikely. As support for Macron is building in the lead up to the election (including the defection of several key politicians from the Socialist Party to Macron's), the chance of a muted, 'business as usual' response is the most likely scenario. As learned from Brexit and the US election however, it is important to consider the possibilities, because even the far-fetched can happen. This brings us to our final section, in which we discuss the late 2017 federal election in Germany, in which powerhouse Angela Merkel is facing stiffer competition than she has in recent elections.

1.5 Conclusion

It has been a quick change of the world order. A year ago, Brits voting to leave the European Union seemed like it could never happen. Even more far-fetched was the idea that Donald Trump would be the president of the United States. Yet, 2016 was a year in which populism found its footing, people voted against establishment, against globalisation, and for change. The implications of both votes are still largely unknown given that the British government only just triggered the EU exit clause and Trump has yet to pass any of his proposed policies. If the French election was in two years rather than in a week, perhaps the French would have a better understanding of the implications of trying to turn back the clock on globalisation, by seeing the effect that it has had in the UK, in America, and globally.

Instead, French people are going to the polls knowing that they have a structurally challenged labour market. Many are voting knowing that they live in a state of fear as a result of the increasing frequency of terrorism-related attacks. They are also heading to the polls while seeing and feeling the effects of the migration crisis that the EU has historically had difficulty dealing with over the past several years. So when a political party who has had trouble appealing to mainstream voters has based its campaign on targeting all three of these issues, it is no wonder that there is concern that a far-right, populist leader may be the next president of France, whether this be in 2017, or in the next election.

As we have discussed throughout this feature article, we view Marine Le Pen being the victor of the upcoming French presidential election in April and May as a tail risk – unlikely but likely extremely damaging if it occurs. Leaving the EU and replacing the euro with the franc would not be good for the French economy, in the short or long term. But the implications would be felt well beyond France's borders. It could not only give other populist parties around the world a voice as they try to get their own movements off the ground, but it could trigger a full dismantling of the European Union.

Political elections are carrying significant weight as of late in terms of the impact that they can have on financial markets, and the series of European elections in 2017 are no different. We will continue to keep a watchful eye on further developments, particularly to gauge whether or not Brexit and Trump were two independent events, or if they are harbingers of what is to come around the world.

This feature article is a condensed version of a more in-depth article. If you are interested in accessing the longer-form version, contact Nicole McMillan at Nicole.McMillan@WhitehelmCapital.com.