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Why the French and UK elections matter for investors

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Allison Nathan: In the year of elections, two of Europe's three largest economies are heading to the polls, and investors' reactions couldn't be any more different. France's upcoming parliamentary elections are wreaking havoc on French stocks and bonds, while UK financial markets have been relatively stable as the country gears up for its own general election on July 4th. So what are the markets telling us about the political landscape? And are there risks that are being mispriced?

Sharon Bell: I think the problem with this and the reason that markets are finding it so difficult to price is that there's not a clear path to a great outcome for markets.

Allison Nathan: I'm Allison Nathan, and this is Goldman Sachs Exchanges.

For today's episode, I'm sitting down with my colleagues in Goldman Sachs Research. Sharon Bell is a senior strategist on the European Portfolio Strategy team, and George Cole is the head of European Rates Strategy in the Global Macro and Markets Research Group. They're both joining me remotely from London. Sharon, George, welcome back to the program. Great to see you all.

Sharon Bell: Thank you.

George Cole: Thanks very much.

Allison Nathan: So let's start with the French elections. The snap election called by French President Emmanuel Marcon, which will take place on June 30th with a second round on July 7th, was no doubt a surprise. And I'm not saying it wasn't, but it sent French assets into an absolute tailspin. Sharon, why did the markets react so strongly?

Sharon Bell: You know, I think that there are lots of reasons. I mean, I'd probably put them down into four different buckets. One is the first one, which you've already covered which was the surprise. We've had lots of

elections this year, but this one wasn't expected, first of all.

Secondly, the outcome of this election looks quite uncertain, and markets hate uncertain so I think that's important as well.

But probably thirdly and most importantly, the debt situation in France is pretty worrisome and debt-to-GDP ratio of over 110% and quite a large deficit as well, and the concern is that you'll see more fiscal slippage that you would not get as a coordinated government that will bring that deficit and debt level down over time. So that's a big concern.

And then finally, with my equity hat on, I would say that some of the policies, particularly of the far left and the far right parties in France, would hit company earnings. Discussions of things like, say, potential windfall taxes, for example. So there are lots of reasons, and really though market hates uncertainty.

Allison Nathan: And is there an election outcome that the markets are most concerned about?

Sharon Bell: I think the problem with this and the reason that markets are finding it so difficult to price is that there's not a clear path to a great outcome for markets. The one that they would like most of all, I believe, is the status quo we've currently got. The current sort of government is planning to reduce the deficit in France, and we did have eventually debt-to-GDP in France peaking and coming down.

The other potential outcomes that we might get, for example, a minority far right government or a majority far right government, either of those are much less likely to bring down that debt ratio in France. So there isn't really an outcome that markets are looking at that says, "Yay, this is much better than we expected." And I think even the outcome that we do get over the next few weeks, if it's a minority government or no coalition is formed, you might have further elections only a few months away. So again, that adds an extra layer of uncertainty for markets.

Allison Nathan: In the volatility that we've observed so far, which assets have moved the most?

Sharon Bell: So if I look -- and again, I'm going to focus

on equities here and George can talk a bit more about rates -- but if I look at the French equity market overall, the gains that we saw this year were wiped out really in very little time. And we've seen double digit falls for things like the French small cap indices, domestic stocks in France, banks, and we've also seen sharp falls of infrastructure companies which tend to be quite defensive stocks in France, too.

I mean, European equities, they have had a bit of a setback and particularly relative to the S&P. So if I look relative to the S&P 500, the STOXX 600, which is a broad measure of the European market, that's down 5% relative to the US market in the last couple of weeks.

The impact on global equities, though, has been quite tiny. So I do think this is seen as more a French issue first and then a European issue second.

Allison Nathan: Well, as you said, though, the European equities have been hit a bit. Do you think the markets broadly are overreacting when you think about the moves we've seen in European equities? And then even in French equities?

Sharon Bell: Yeah, it's a good question, given that the move that we've had. For the CAC 40 companies, which is the blue chip index in France, the actual exposure to France in terms of sales for those stocks is quite small. It's about 15% of their sales exposure. I sometimes think it works better to flip the other way around and think that 85% of these companies' exposures is outside of France itself. So arguably, the moves which we've seen year-to-date wiping out the progress that the CAC 40 had made, does seem quite harsh relative to the fact this is a very international index. But that being said, I do think the uncertainty is extremely high, investors are nervous, and the CAC 40 had been a good performer in recent years with a relatively high valuation. So given all of that, I don't think the market move is all that extreme. I think there's been pockets that might have been a bit extreme relative to, say, direct earnings impact. But given the sort of higher risk premium that we have, I'm not surprised to see this type of move.

Allison Nathan: Interesting. And George, if you look at the bond market, French 10-year government bond yields have surged relative to German bunds to the widest levels

we've seen in recent years. So what are the markets, the bond markets, telling us about this situation?

George Cole: We do know that the European bond markets price in relative credit worthiness via these credit spreads, so the level of yields, typically benchmarked against the strongest credit, Germany, give you some sense about, you know, the market's concern about the ability to finance future debt, confidence in future fiscal trajectories and so on. And they move around with the fundamentals. So if growth is weaker or a government plans to spend more, you typically find these credit spreads widening.

Now, what we've seen is about a 30 basis point -- maybe depending upon the day, maybe slightly more -- credit spread widening between France and Germany. That sounds maybe small relative to the sort of credit spread widening we've seen in other European markets over the several years, but this really is quite a big move for France. It's akin to the move we saw ahead of the 2017 French presidential election, which again was a fairly notable widening. And so what it is really telling us is that the market is concerned that ultimately, either because of a general rise in the level of uncertainty about any future

government's capacity to improve the fiscal path, or the possibility of electoral outcomes where you have significant spending that is on top of the current fiscal trajectory, which as Sharon mentioned is already a source of some concern for markets, that really has left us in a fairly net negative position.

We either learn that spreads probably struggle to recover the levels that we saw before the European elections simply because the outcome worsens for the French President Macron, even in perhaps a situation of a hung parliament, for example, if he had a diminished relative majority, or we learn that actually a government comes in with a more expansionary fiscal program. And so the market is wrestling with that risk.

It's also interesting to note we've seen a bid for German bonds, and so it's not just been a rise in French yields. What we've also seen is that spread has widened because German yields have fallen. And although French yields have been creeping back up, that actually tempers the overall yield move for French bonds because ultimately the credit spread can widen not only because French yields go up and German yields go down and so actually insulate the

overall level of yields in France.

Allison Nathan: And George, you said that there's actually a bid for German bunds. Flight to safety, I assume. Are there other assets that are particularly vulnerable or going to benefit in the bond market?

George Cole: Yeah, well, I think that this is really the key thing that we are looking out for is the extent to which stresses or repricing of credit spreads in France spills over into other markets. We've seen in previous episodes of course, you know, generalized spread moves in Europe. For example, think about Italy and Spain and Portugal. When you see, you know, a weakening of credit spread in one market, you often find that there are spillovers to the other markets, and so that is a key thing that the market has really got its eye on.

The world does look a little bit different to where we were perhaps a decade or so ago. We now have additional measures, for example, at the ECB or the EU-wide level that reduce tail risk. The ECB has its transmission protection instrument, which is a kind of backstop facility to buy bonds if stresses emerge. We know that at the EU

level there are additional fiscal pooling measures through the recovery fund that supports Southern European economies. And so in that sense, we perhaps don't have the same vulnerabilities as in the past.

However, we do have a situation where, if there is a substantial challenge to fiscal discipline coming out of the next French government, there is maybe the potential for that to have knock-on effects to other economies. So what we are noticing is that, although we are looking at the move in French bonds as probably being reasonably large given the potential for the next government to undertake an expansionary fiscal plan, it does look like the market is still quite calm about the implications for other economies. It's not clear that that is wrong, but it's also something that makes us a little bit wary about stepping in, for example, to buy these other markets just here.

Allison Nathan: Right. So it's not clear that the market is right is I think what I'm hearing you say. But if we take a step back for a moment, I recall heading into this year there was so much focus on how expensive the US market had gotten after a period of US exceptionalism for several years and growing optimism that the investment flows into

the US would start to redirect towards areas elsewhere such as Europe. Has this ongoing political uncertainty in a core member like France upended that narrative?

Sharon Bell: Yeah, this is a great question and a real problem for Europe. You know, if we dial back the clock about a month ago, I think the main conversation I was having with global investors was the concern that, although, yes, absolutely, the US has got its exceptionalism, you're already well pricing that in the case of the US. So the S&P was very expensive and the Mag 7 in the US are such a dominant part of the index. You're very concentrated in your exposure if you're investing in the US. So there was a kind of view that, "Well, maybe we should look at Europe." And they looked at Europe and they found that activity was improving, interest rates were coming down in front of the Fed, very helpful, and that valuations were a lot lower. And although the European equity market is quite concentrated, too, it's not as concentrated as in the US and not just in that one sector either.

So, you know, tick, tick, tick, you felt that Europe offered some value and some cyclical improvement. I still think it

does, but I think this has obviously added to uncertainty. And really, if I look at investment flows in Europe, in the last two years, we have had constant outflows from global investors into Europe. And really ever since Russia invaded Ukraine, we've seen those consistent outflows. And they were starting to come back in. As I said, in the month ago or so, you were starting to see investors' interest in Europe for those elements I mentioned before.

But this really has shone a light, I would say, on the structural problems Europe has. So the structural problems were always there, but you were willing to overlook them for the cyclical upside I just mentioned. The structural problems being a lack of growth, lack of productivity, lack of investment, all of that I would put under the label of lack of growth. And then the debt level that's already accumulated in Europe. So those two problems and I think those structural issues which are very difficult to resolve, this French election has really shone a light on those particular problematic issues.

Allison Nathan: And if we do see the outcome that the market fears -- a far right majority taking hold of the government -- and we see the fiscal expansion that the

market is concerned about, that's ultimately inflationary, in which case will that complicate the monetary policy mission going forward?

George Cole: Yeah. So I think this is the really interesting issue for the European economies. It can be very challenging to undertake a unilateral fiscal expansion that actually does have the impact on growth and inflation that you'd want, right? That you want this to be better for growth. The reason is that credit spread because, if that credit spread widens enough, then actually this is detrimental to growth. We've got a situation where the market is worried about fiscal risks, and the net impact for the economy may not be positive. It may be that ultimately credit spreads or absolute yield levels rise so much that actually it has a contractionary effect on the economy.

Again, that may be not quite where we are, however, that I think is the really important thing to remember. The growth benefits from looser fiscal policy can be taken back by that widening in the credit spread. And that's why I think ultimately the ECB will be very, very focused on transmission because ultimately you're right, inflation is too high and, if you were to see, for example, a cooperative,

coordinated fiscal expansion at the EU level or the area-wide level, that would be much more inflationary. But if you saw one country unilaterally attempting to undertake a big fiscal expansion, that actually could have the opposite effect if the financial condition's tightening via wider spreads undoes the impact of that better growth.

So I think it's a little more complicit than to say the impact would be net inflationary because, ultimately, the market will give you a signal about whether or not that fiscal policy is tenable. I think for that reason, you know, it does suggest that the incentive for any incoming government, even the absolute majority of National Rally, would be to moderate the fiscal program compared to a situation that would see a very significant and negative market reaction. But again, the market obviously has widened because it just doesn't know what is likely to come next.

Sharon Bell: I think that's such a good point as well because we've had some incarnations of populist governments in the last few years that didn't turn out to be as negative for markets as perhaps investors feared beforehand. And of course, that is an upside risk here that you do is a majority or even a minority government which

is National Rally. And yet they're perhaps not as extreme in their policies as many investors worry about.

Allison Nathan: Interesting. Let's turn to the UK election on July 4th, where the outcome seems potentially more certain and markets have reacted less strongly. Sharon, what issues are at stake there?

Sharon Bell: Yeah. So at the equities, the UK election I would say is less worrisome. And I think less worrisome than what we've been talking about with respect to France in two senses. First of all, the polling data is pointing to a clear lead for the Labour Party, so the outcome feels a lot less uncertain. And the second is that the space for being radical on policy is much more limited as both of the main parties in the UK, the current government under the Conservative Party or the Labour Party that is in the lead in the polls, both of them are promising to keep within quite tight fiscal rules. And given that, there isn't a lot of space for huge surprises of the nature that will potentially spook the markets. So I see it as much less of a risk event.

Allison Nathan: George, do you agree?

George Cole: Yeah. I mean, I think that when we look at the macro implications for the various plausible outcomes under the current party plans, we really don't get a particularly widespread on things like growth, inflation, the deficit. It's not as if there are no differences, and perhaps you could imagine the market thinking and trying to price and understand, for example, differences in the composition of the deficit. Is it more taxation, more spending? Or is it less on both? Is the margin of the governing majority going to have some impact on the way that the market reacts? All of that is possible, but I think that's kind of second order to the point that Sharon made, that ultimately it feels like the overall uncertainty around this election -- not just for the outcome itself but the implications for macroeconomic policy on the far side -- is likely to be a bit smaller this time.

Allison Nathan: But always seems like as soon as we get comfortable about the amount of uncertainty and assume something will be more certain, we're surprised. And political uncertainty has of course been a key feature of the UK. I'm thinking back to the 2022 LDI crisis. Brexit, still maybe that was a moment where we expected some volatility and a tremendous amount of uncertainty, yet it

was still somewhat of a shocker. So are there any risks in the UK that are being mispriced or underestimated, George?

George Cole: That's a really good question, and I think that you are absolutely right in listing the events of the recent decade and looking at the levels of uncertainty, were they market pricing in terms of volatility priced into markets? Looking at the big shifts in asset pricing that we have seen, of course that uncertainty has had huge impacts on UK markets, on sterling, and on the real economy itself.

I think in some sense, the freshness of the 2022 LDI crisis means I am more confident to say that those risks have diminished simply because I do think again, just having that in the recent history itself, constrains the kind of political possibilities in a way because the costs of that event were just so significant that ultimately it does push toward more moderate policies and I think has really made it clear that taking excessive fiscal risks is quite an unwise thing to do, again, in the current moment when yields are high, inflation is high, the central banks are finding it difficult to provide a lot of relief by cutting rates. And so

it's not to say, of course, that fiscal risks have disappeared. They are still of course there for the UK. But it does look like at least in terms of the political consensus it's moved to a much more moderate position.

Maybe I can mention one other thing, which is that we've very clearly seen the UK move to a relatively hard form of Brexit, introducing a lot of friction with the trading relationship with Europe. I think it's interesting to consider the possibility that maybe that doesn't worsen from here and in fact may even improve. And so in a sense, could it be that the risk that is mispriced, could it be a positive one? I mean, that seems something that might seem a long shot and probably is a more long-term question for the UK, given the current political reality.

But I think that the situation where the UK seeks to improve what has been a really poor productivity performance by loosening the supply side of the economy, moving closer to its nearest trading partner, not reversing Brexit necessarily but maybe taking measures to reduce trade frictions or enter into various reciprocal agreements.

Sharon Bell: And I would argue, within equities, that sort

of upside risk, upside potential is not superpriced either. If I look at, say, FTSE 100, the big cap index in the UK, it trades on roughly half the valuation of the S&P and many would argue rightly so because it doesn't have the exposure to tech. But it is one of the cheapest indices globally.

And if I look at, say, the FTSE 250, which is midcap index which is much more UK exposed, that is also trading on a similar valuation. And it's close to the lows of its valuation range in the last 20 years. So this shows you the market's already pricing a lot of the weaker structural problems in the UK and not so much of the potential upside risk that George talked about.

Allison Nathan: But it seems kind of ironic to me that, just as the UK may be getting to a place where it could start to strengthen its relationship with the euro area again, the euro area again seems to be very much in question. I mean, correct me if I'm wrong, but I'm hearing more and more concern about the fragmentation of the euro area than I've heard in quite some time. So as a leaving question, let me just ask you: What are you watching in terms of the signs of growing risk in the euro area?

George Cole: So very clearly, as I mentioned before, watching the credit spreads there is a very clear way to see is the market pricing this as a localized domestic issue for France? Or is it broadening out and seeing spillovers into other sovereign markets and being priced as a more generalized, if you like, systemic risk in Europe? It's a reasonable question to ask. How can France have a serious issue, for example, around fiscal policy or credit spreads without it being a European issue, just given how important France is to the broader euro area and the EU as a whole? And I think that that is a perfectly reasonable point to make.

And so in a sense, I do think watching this relatively calm response that we've seen in other sovereign bond markets is absolutely key. And to the extent that that begins to broaden out, it would be a sign that maybe the market is starting to connect the dots and say that, whether it's because of potential changes to fiscal rules, whether it's because of potential implications for 2027 presidential election in France, there might be broader risks than just something you see on the French domestic political front.

And then of course, I do think, for the broader economy, is this something that will be a negative for French growth? Will it be a broader tightening in financial conditions that will weaken the economy? Because what we do know is that euro area fragmentation risk, as you mentioned, we have seen that that really comes to the fore when growth is particularly weak. And at the moment, what we have seen is that there has been some signs of a cyclical upswing. We know that the European consumer will benefit from lower inflation, lower energy prices. That should be a tailwind to growth. But if you were to see a financial conditions tightening short circuit that and move the euro area into a weaker period of growth, that of course increases those risks.

I would say that, again -- and I think I mentioned earlier -- the world is different post pandemic. We do have additional backstops in the euro area that curtail some of the fragmentation risk that we've seen in the past. Again, that might be one of the reasons why the market is a little more relaxed this time beyond the French bond market, but that of course bears close watching. And I think what is clear is that we certainly haven't seen moves in sovereign bond markets that would warrant some intervention with

those backstops from the ECB. That of course would be a lot further away in terms of spread widening.

Allison Nathan: So watch the outcome of the French election, of course. Watch for any spillover risk into other regional bond markets and the economy more broadly. And in the UK, let's see. Let's see if we're in for another political surprise or if we and the markets are right, that we're going to have more of a benign outcome and hopefully a bit more of a positive trajectory in terms of the relationship between the UK and Europe. And we'll see what it brings for the economy and markets.

George Cole: Absolutely. I think one thing I would say is just we're four for four for interesting elections so far. If you think across emerging markets, the EU election, which again, threw out the surprise of the French, and of course we've got some big ones to come.

Allison Nathan: Sharon, George, thanks so much for joining us.

Sharon Bell: That's great. Thank you.

George Cole: Thanks very much.

Allison Nathan: This episode of Goldman Sachs Exchanges was recorded on Thursday, June 20th, 2024. I'm your host, Allison Nathan. If you enjoyed this show, we hope you subscribe on your platform of choice and tune in next week for another episode. And if you want more insights from Goldman Sachs, make sure to visit GS.com and sign up for Briefings, a weekly newsletter from Goldman Sachs about trends shaping markets, industries, and the global economy. Thank you for listening.

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