European elections and political reactions: what is the impact on the financial markets

Didier Bouvignies
General Partner, CIO

While the shockwave of the French President's dissolution of the National Assembly came as a surprise on the evening of the European elections, political reactions were swift to follow. What are the consequences of this unexpected situation for the financial markets? Didier Bouvignies share his outlook, General Partner and CIO.

A redrawn French political map, but not at European level

A paradox emerges from the results of the European elections held on June 9: while the polling institutes' estimates were right on the whole, no major upheaval in the composition of the European Parliament is to be expected. Although the far-right parties made progress, Identity and Democracy won only nine seats, while the European Conservatives and Reformists took only four. The centrist Renew party and the Greens/EFA lost twenty and eighteen seats respectively. However, it seems highly likely that the grand coalition (Socialist, centrist and EPP) will remain the only European political force capable of forming a majority, thus favoring Ursula Von der Leyen's re-election. The radical right-wing parties, for their part, are not in a position to form a blocking minority.

A swift political response in France

The real surprise of these elections remains the collapse of the ruling parties in the two largest countries of the Union. In France, the Macronist (liberal) list achieved less than half the score of the Rassemblement National (far-right), while in Germany, the SPD (social-democrat) led by Olaf Scholz came only third, behind the AfD (far-right) and well ahead of the CDU/CSU (right). This electoral setback prompted the French President to dissolve the National Assembly and call new parliamentary elections for June 30 and July 7. The German Chancellor, for his part, seems to have chosen not to go down this road, ruling out the risk, for the time being, of an early election in Germany.

The motivations behind this decision are difficult to pin down, especially as it took most analysts by surprise. However, it's safe to assume that, faced with a resounding defeat and the risk of a motion of censure when the government votes on its plan to under-index pensions in line with inflation this autumn, the French President preferred to take the initiative and remain “master of the clocks”. This decision, as surprising as it is risky, masks as much the hope of winning as the desire to make voters face up to their responsibilities, or even to confront the Rassemblement National with its inconsistencies, in order to put it to the test of power.

While it's always difficult to make political predictions, given the current state of affairs, what scenarios are conceivable? An absolute Renaissance majority seems unlikely, while a relative majority would mean a return to square one. More likely, the Rassemblement National would win a majority, probably not absolute, but certainly relative. In either of these last two scenarios, the French would be faced with a fourth cohabitation in it’s Fifth Republic. However, the composition of the latter would be unprecedented, and would raise questions about the way Marine Le Pen's party would exercise power.

In such a scenario, the President would retain control over international affairs, but would not be able to oppose the projects of a government supported by the National Assembly domestically. He would then have only a few technical elements at his disposal to delay the implementation of decisions. The formation of a relative majority for the Rassemblement National could also lead to an unstable coalition, with a fragile parliament forced to negotiate on a case-by-case basis according to the projects put forward by the ministers. Such a situation would offer limited visibility, and would resemble the situation encountered under the French Fourth Republic.

On the other hand, in the event of an absolute majority, the Rassemblement National's economic policy may give cause for concern. Even if Marine Le Pen's party has abandoned its most radical positions, notably exiting the euro, its program appears to be more inspired by inflationary, unfunded measures, such as support for purchasing power, price controls, wage increases exempt from social charges and various taxes. However, once in power, can the Rassemblement National follow the example of Giorgia Meloni in Italy? At European Union level, although the pro-Von Der Leyen coalition alliance remains in the majority in the European Parliament, it is likely that, as we have been sensing for several months, the more protectionist and less environmentalist trend will strengthen.

What impact will this have on markets?

Financial markets don't usually play politics, and when they do, they usually get it wrong (cf. the Gulf War in 1990, *Brexit* and the election of D. Trump in 2016, the Russian-Ukrainian conflict in 2022). However, this geopolitical context generates uncertainties that investors do not appreciate. The vagueness surrounding the policy of the second largest country in the Eurozone is widening the spread[1] between French and German rates, but also with Italy and Spain. The rise in the 10-year OAT[2], taking the spread with the German 10-year to 60 basis points[3], seems justified by the aforementioned uncertainty and its hitherto low level in view of budgetary imbalances. Nevertheless, these spreads remain very moderate compared to those observed in 2011-2012 during the Eurozone debt crisis. While this political uncertainty is likely to have a moderate impact on French growth, it could also complicate monetary policy decisions. While the ECB has been claiming for several months that it is "data dependent", the Central bank is also "political dependent".

However, it seems unlikely that this tremor in France will spread to all markets in the Zone. Naturally, the latter have not failed to react, mainly through the sectors potentially impacted by the Rassemblement National's political program. Among banking stocks, Société Générale and BNP Paribas are now facing fears of new taxes on profits, and both stocks suffered from significant drop in the aftermath of the elections, pushing them into negative territory year to date. This situation contrasts with the sector's good performance within the Zone year to date. More generally, the French political context has led to a significant underperformance of the CAC 40 over the past two months, reducing the index's performance excluding dividends to 3.4% year to date, compared with nearly 10% for the Euro Stoxx 50[2].

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(1) Yield spread between a bond and an equivalent maturity considered "risk-free".
(2) Obligations Assimilables du Trésor: French government bonds with maturities ranging from 2 years to 50 years.
(3) Source: Bloomberg, 11/06/2024.
(4) Data dependent.
(5) Policy dependent.

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France

29, Avenue de Messine
75008 Paris
+33 1 40 74 40 74

Belgium – Netherlands – Luxembourg

Rue de la Régence 52
1000 Bruxelles
+32 2 627 77 30

Switzerland

Rothschild & Co Bank AG
Rue de la Corraterie 6
1204 Genève
+41 22 818 59 00

Italy

Passaggio Centrale 3
20 123 Milano
+39 02 7244 31

Germany - Austria

Börsenstraße 2 - 4
Frankfurt am Main 60313
+49 69 299 8840

Spain

Paseo de la Castellana 40 bis
28046 Madrid
+39 02 7244 31

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