24 February 2017

Strategy

The great Le Pen scare – how could markets react afterwards?

Long and difficult road to Frexit even if Le Pen wins

Although data from the euro area this week painted an upbeat picture, with strong manufacturing PMIs and German ifo readings, **French government bonds and the EUR remain under pressure**, as investors' remain focused on the upcoming French presidential election and the risk of a Marine Le Pen win. According to recent polls, it is still most likely that either the independent candidate Emmanuel Macron or the Republican François Fillon will become France's next president (see chart top right). However, there is a significant risk the Front National (FN) candidate Marine Le Pen, who has threatened that France will leave the EU and the euro if she is elected, will win the presidential election. Nevertheless, even if Le Pen is elected, the road to an actual 'Frexit' is long (see *Le Pen – What If? Implications for Euro and Nordic Markets*, 23 February). Whether Le Pen can or will actually hold an EU/euro referendum will depend largely on FN's performance in parliamentary elections in June and support from her chosen prime minister. In our view, it is still questionable whether the public would vote in favour of leaving the EU/euro in such a referendum.

What if? Risk-off and weaker euro if Le Pen is elected president

In terms of short-term market reactions following a Le Pen win (not a 'Frexit', which would have far more severe market implications), we expect the ECB to use its existing QE flexibility to support countries vulnerable to financial spillover, especially in the periphery, whereas support for France could be limited. We expect to see a knee-jerk market reaction with a **broad-based risk-off move** triggering EUR periphery spread widening relative to France, a Bund rally and curve flattening, although the exact spread impact would depend on the ECB response. **For the Nordic markets specifically, we are likely to see safe-haven inflows**, with NGB/SGB/DGB ASW spreads widening.

Market implications if Le Pen wins presidency (base case in brackets)

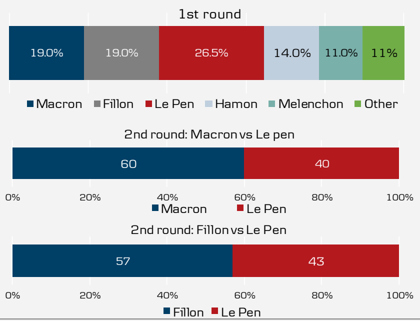
	Central bank response	FX	FI	Credit	Equities
Euro area	ECB uses QE flexibility to support periphery *(No QE tapering in 2017; QE continues also in 2018 with unchanged size)*	EUR/USD down 2-3 figures *(EUR/USD 3M: 1.05)*	Periphery spreads to widen relative to France; Bund rally and curve flattening *(FGBs to rally significantly, more modest rally in periphery)*	Nordic companies and covered bonds to outperform eurozone peers *(EUR credit spreads to remain at the current low level or moderately compress)*	Bearish European equities if FN also wins majority in parliament *(Bullish European equities otherwise)*
DK	FX interventions by DN to limit DKK strength, bar for further rate cut is very high *(No further rate cuts)*	Muted reation in EUR/DKK spot and forwards as DN to cap EUR/DKK downside around 7.4340 *(EUR/DKK 3M: 7.4350)*	DGBs and DMBs to perform vs semi-core; DKK ASW spread to widen *(Spreads on DK FI relative to Euroland to trade with stable range)*		
SE	Additonal support measures if SEK strengthens significantly, f.ex. future hikes postponed, lowering rate path *(End to QE in July; no further rate cuts)*	EUR/SEK to move lower, while USD/SEK should rise *(EUR/SEK 3M: 9.40)*	SGB ASW spreads to widen due to safe-haven inflows *(Minor move in ASW levels; SGB curve to steepen modestly)*		
NO	No further rate cuts *(Monetary policy unchanged)*	EUR/NOK to fall but USD/NOK should bounce *(EUR/NOK 3M: 8.80)*	NGB ASW spreads to widen; flattening of bond and swap curves *(Stable NGB 5Y and 10Y yields; stable ASW spreads in mid-segment, higher long end)*		

Source: Danske Bank Markets

Key points

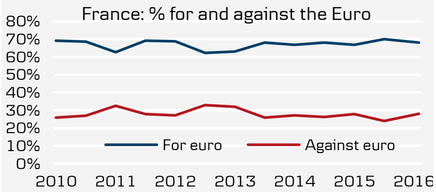
- Holding an EU/euro referendum would be difficult for Le Pen without strong parliamentary backing.
- EUR periphery spread widening if Le Pen wins but ECB to stand ready to ease financial spillovers.
- Nordic FX and FI markets would see safe-haven inflows if Le Pen wins.

Poll still shows Le Pen losing second round run-off (19-22 February)



Source: Ifop Fiducial, Danske Bank Markets

The French are not too euro sceptic



Source: European Commission Eurobarometer, Danske Bank Markets

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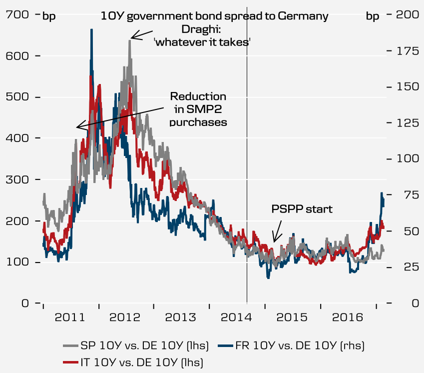
In FX markets, we would expect the EUR to weaken versus other major currencies and EUR/USD to settle 2-3 figures lower. In our view, the GBP could be one of the top performers if Le Pen wins the election, due to an increase in the EUR risk premium and a decline in the Brexit risk premium priced on GBP. However, we remain **cautiously bullish on SEK and NOK versus EUR**. In the case of a Le Pen win, Nordic currencies such as the SEK and NOK could even strengthen further to the EUR driven by safe-haven inflows. Should the SEK strengthen too rapidly, we could see additional easing measures from the Riksbank (such as lowering the rate path or postponing future rate hikes and an end to QE in July, as we currently expect) but we do not expect a Le Pen win to trigger easier monetary policy in Norway, as Norges Bank has shifted its short-term mandate focus towards financial stability. **The reaction in EUR/DKK spot and forward markets, on the other hand, should be more muted** as Danmark's Nationalbank would use FX interventions to cap EUR/DKK downside around 7.4340, although in our view the bar for further rate cuts is very high.

While we expect European credit spreads to remain at the current low level in our base case, we think **Nordic companies and covered bonds could outperform their eurozone peers** if Le Pen wins the presidency, as exposure to France and the French economy is fairly limited.

The medium-term move in equity markets on a Le Pen win would depend on whether FN is able to secure a majority in parliamentary elections in June. In this scenario, we recommend being underweight equities as well as cyclicals and financials in Portugal, Italy, Ireland, Greece and Spain. On the other hand, should FN be unable to secure a majority despite a Le Pen win, we think the environment could be bullish for euro area equities as well as cyclicals and financials due to the possibility of more expansionary fiscal policy.

Spread impact depending on ECB response



Source: Macrobond Financial, Danske Bank Markets

Global market views

Asset class	Main factors
Equities	
Overweight stocks short and medium term	The reflation trade with cyclicals outperforming defensives is still in play as the underlying EPS and GDP growth trends are still intact.
Underweight developed markets, overweight emerging markets Overweight US, Japan, Nordics and Russia/Eastern Europe; underweight Europe and LatAm; neutral on China	The very communicative new president in the US is not able to offset this. In our view, his policy agenda is still about growth.
Bond market	
German/Scandi yields – set to stay low for now, higher on a 12M horizon	For now German yields are kept low by political uncertainty and a very tight repo situation. Later in the year, the political risk picture should improve and, as the economy is improving, the ECB tapering discussion should return to the market.
EU curve – set to steepen 2Y10Y	ECB to keep a tight leash at the short end of the curve. Hence, the curve 2Y10Y is set to steepen. We see no rate hike in the US before June but the risk is skewed towards three hikes this year.
US-euro spread – stable	
Peripheral spreads – tightening but clear risk factors to watch	Economic recovery and QE should mean further tightening but politics (French Presidential election), banking recapitalisation plans and a potential new move higher in eurozone yields remain clear risk factors. Periphery spreads often widen when core yields move higher.
Credit spreads – neutral	
FX	
EUR/USD – lower over coming months, then higher	USD set to remain supported by Trump and the Fed in the near term. EUR/USD to head higher beyond 3M .
EUR/GBP – higher in coming months	Short-term risk skewed on the upside on 'hard' Brexit risks. Longer term, we expect EUR/GBP to settle in the 0.83-0.88 range.
USD/JPY – short-term risks skewed on the upside	USD/JPY set to remain supported near term by relative monetary policy and risk appetite.
EUR/SEK – range near term, gradually lower medium term	Gradually lower on relative fundamentals and valuation in 2017 but near-term potential limited.
EUR/NOK – gradually lower	Cross set to move lower on valuation and growth, real rate differentials normalising. Technical picture is near-term supportive.
Commodities	
Oil price – range bound	OPEC cuts almost fully implemented, US crude stocks are still growing
Metal prices – volatile before Trump's speech, slight upside potential	Underlying support from consolidation in mining industry, recovery in global manufacturing and US fiscal spending.
Gold price – headed lower on stronger USD	Rising yields and USD keeping a lid on the gold price; support from political uncertainty.
Agriculturals – rising again	Attention has turned to *La Niña* weather risks over the winter, consolidation seen in some parts of the market.

Source: Danske Bank Markets

Disclosures

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None.

Date of first publication

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