France: A market-friendly result which will help reduce the European risk premium

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The essential thing needed to line European markets up for a positive reaction to the result of the first round of France's presidential election yesterday was confirmation that one of the two main market-friendly candidates made it through to the second round of the election which takes place on 7 May. As predicted by the opinion polls, this has duly happened. Market-friendly centrist reformer Emmanuel Macron will face far anti-European right-winger Marine Le Pen.

The nightmare for the markets, a run-off between Le Pen and hard left-winger Jean-Luc Mélenchon, will not happen. Forget Frexit. Forget a major assault on the Euro project. The narrowness of the result in yesterday's election result is not what matters from here. The French start over again with the second round vote and there is every reason to believe that margin of victory for Macron will be far larger than a cursory glance at the first round results might lead one to assume.

Opinion polls before yesterday's result have consistently pointed towards something like a 60-64%: 36-40% vote in Macron's favour, should he face Le Pen in the second round. Initial polls yesterday repeated this. What the French call 'le front républicain', i.e. basically make sure the Front National represented by Le Pen doesn't win, is, once again, seemingly swinging into action.

In the immediate aftermath of yesterday's vote, defeated first round candidates of significance have come out in favour of Macron for the second round. Particularly important for Macron must be the endorsement of him by right-of-centre François Fillon, who made it clear in his speech acknowledging defeat that abstaining in the second round is not an option. Other senior figures of Les Républicains like Alain Juppé have also come out for Macron, as has the socialist party candidate Hamon and former prime minister Valls.

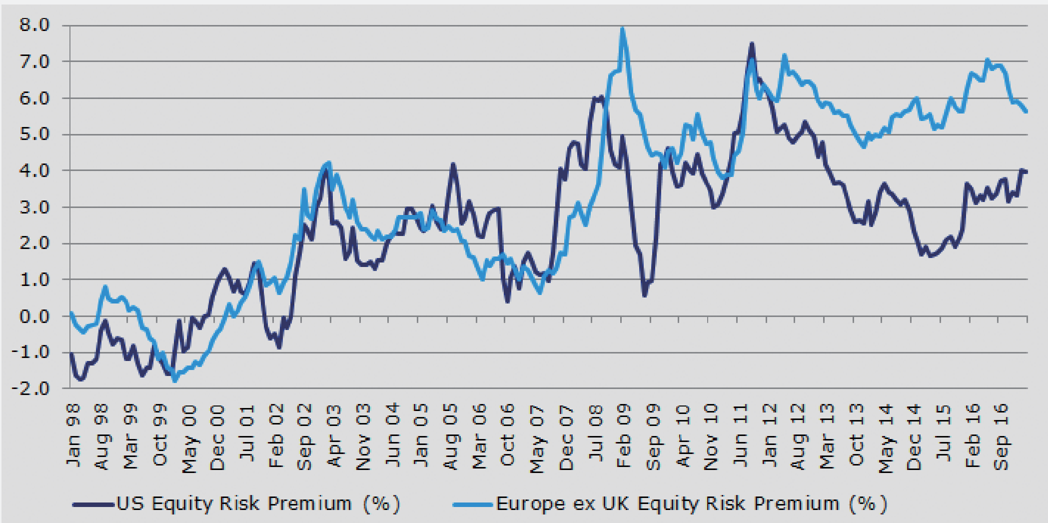
So, why does all this matter? We should end up with a centrist French president with a reform agenda, who is a committed pro-European and supporter of the Euro. No market disruption. No reason for the (we suspect) many international investors who have a downer on Europe for political reasons to get more negative, in fact quite the contrary.

A Macron presidency should also be a lot easier for the Germans to work with constructively. Less downside risk from European politics may also nudge the ECB a little closer to modifying its monetary policy in the coming months, let's see. Assuming Macron wins the second round, he does nonetheless have challenges to face: he has limited experience of high office and no established political party at his beck and call. He also needs to be able to work with a newly constituted French parliament after June's legislative elections and formal or informal coalition-building will doubtless keep journalists very busy then.

But aren't there more countries in Continental Europe with more elections just around the corner? Well yes, that's what happens in democracies. Viewed from today, Germany's elections this autumn look pretty unproblematic from a financial market perspective. Italy is one for next year, but it is worth remembering that the country's (very) proportional system of parliamentary representation is likely to make it hard to allow radicals any real power.

With one more political hurdle cleared, we believe it is now logical that we start to see Europe's high equity risk premium, which has been in place since the financial crisis (see figure 1), finally begin to moderate. There is no evidence that Europe is succumbing to a wave of radical politics.

Figure 1: European equity risk premium is still close to crisis high



Source: Bernstein as at 31 March 2017. Equity risk premium is defined as the 10 year average nominal earnings yield from MSCI Europe ex UK/MSCI US minus market cap weighted 10 year real bond yield for Europe ex UK countries.

Meanwhile an economic recovery is underway, inflation is returning (direction is more important here than absolute level) and European corporates are in good shape. Europe, for all its manifold faults, deserves to be regarded better than its risk premium implies. It's an over-used phrase, but our portfolios are by and large at the 'risk on' end of the spectrum and given valuations, trends in corporate earnings, the economy and politics, we are still happy to be positioned in this way.

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