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(Un)Resolved

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In the latest round of the European Football Championship, France played out a turgid 0-0 draw with Portugal, while England's draw with Switzerland was marginally more entertaining and did at least provide some goals. Both games went to a penalty shoot-out, so at least there was a conclusive result. The same cannot be said of France's legislative elections, where the country now faces a period of uncertainty and potentially the first hung Parliament under the current constitution. Meanwhile, in the UK general election, the favourite romped home, with most of the entertainment in the race coming from the fight for the lower placings.

Let’s start with France, because it is potentially more impactful for financial markets in the short term. This was another of those election results that has left opinion pollsters with egg on their faces. The hot favourite, at least to win the most seats, was the far-right National Rally party (NR), but they ended up coming third. President Macron’s centrist alliance was expected to be almost wiped out but managed to come in second. The leading group was the hastily assembled combination of far-left wing parties, the New Popular Front (NPF), which, for readers of a certain age, has more than a whiff of Monty Python’s Life of Brian about it.

However, the headline numbers might not be representative. Both the Macron group and the NPF pulled candidates out of three-way constituency contests to ensure that they did not split the vote against NR. Thus, it appears that the clearest message from the result is that, once again, France’s voters have concluded that they are still not in favour of a far-right government, despite NR leader Marine Le Pen’s attempts to improve its brand. And although the NPF’s de facto leader Jean-Luc Melenchon declared himself to be the moral victor and therefore in pole position to lead a new government, it’s not clear that such a popular mandate exists. Which leaves us somewhat in no-man’s land for the moment.

I have commented in previous publications that investors’ first instinct when confronted with a new geopolitical risk is to shoot first and ask questions later, as it were. That happened in this case when the European Parliamentary elections produced an upset owing to the rush of support for NR in France, a result which persuaded President Macron to call a snap election. This would effectively be a referendum on the country’s appetite for a much more radical government, and it was, to some degree, based on the opinion that the European election vote was as much a protest against the current government as support for the alternative. Macron’s gamble was either that the electorate would waver immediately, or, in the case of NR doing well, they would, in the three years before the next Presidential election, prove themselves to be incapable of sound government.

Amazingly, it looks as though Macron’s gamble has paid off, although much might yet depend upon the horse trading that will be required to create a new government. The main options seem to be a centre-left to centre-right grand coalition of national unity, which could, in theory, cobble together a majority, although the potential for internal conflict is there for all to see. Then there could be a “technocratic” government led by a neutral, such as the one that governed Italy recently under former European Central Bank President Mario Draghi, but that looks like a long shot. Perhaps the most likely outcome is a minority government that lurches from one piece of legislation to the next on a case-by-case basis, but that looks equally messy.

From a market perspective, then, what has happened? Following the snap election call, French bonds and equities sold off quite aggressively. The 10-Year government bond (OAT) yield jumped from 3.09% to a peak of 3.34% as investors worried about unsustainably loose fiscal policies being unleashed (now universally known as a “Truss moment”). At the time of writing, the yield has subsided back to 3.22%, and so is still a little elevated to reflect the increased political uncertainty, but nothing to suggest a crisis. Immediately following the European elections, the CAC 40 index of leading French shares fell by 6.5% at its lows (while global equities were generally rising) but is now down 4%. Some of the biggest hits were to banks’ share prices, given their balance sheet exposure to government bonds (rising yields mean falling prices which can lead to investment losses and reduced capital strength). There was also fear of increased taxes on their currently very good profits. Sector leaders Société Générale and BNP were down 16% and 12% at their trough levels, although have since recovered to be -9% and -4% respectively.

And so, it does look as though France has dodged a bullet for now, although there could be weeks of uncertainty ahead as negotiations continue about how to form a government. This is not unusual and so markets should be capable of being patient. But investors would no doubt prefer a government that sits closer to the centre.

There was no such drama in the UK last week, as Sir Keir Starmer's Labour Party cruised to victory. Even so, and despite the huge Parliamentary majority, there are plenty of commentators (and, more understandably, bitter losers) questioning the mandate that it has been given. Low turnout and a low overall share of the vote are being cited as reasons, and there is some validity to those claims. But, in many ways, this was an unusual election, one in which the electorate knew very well what it didn't want – an extension of Conservative government – but wasn't entirely sure what it wanted in its place. As in France, there was a certain amount of tactical voting.

There is also a lingering suspicion that, as might happen in an episode of Scooby Doo, the New Prime Minister is going to have his mask ripped off to reveal that he was Jeremy Corbyn all along. I don't subscribe to that theory, but Labour does need to put a bit more colour onto its bland manifesto in terms of actual policies as opposed to promises and aspirations. Furthermore, we still don't know how everything is going to be paid for, at least assuming there is no magic growth and productivity miracle in the offing. There might be some unpopular tax increases ahead, for example, although not in any of the areas which are off limits, which are Income Tax, National Insurance, Corporation Tax and VAT.

But the key thing is that there is no particular reason to expect UK financial assets to need to price in any sort of political risk premium. Given the fact that our valuation work suggests that UK equities are trading at a discount to other markets, even allowing for stock and sector composition, there might actually be an opportunity to close the gap if we can demonstrate stability and a safe pair of hands. And if Labour's policies begin to gain some traction in terms of growth and productivity, so much the better.

Economic Commentary

FTSE 100 weekly winners

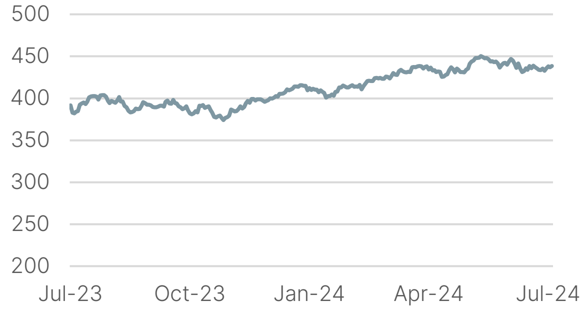
Ocado Group PLC	13.6%
Persimmon Plc	8.3%
Abrdn plc	7.9%
Smith & Nephew plc	7.8%
Taylor Wimpey plc	7.6%
Glencore plc	7.1%
Barratt Developments PLC	6.7%

FTSE 100 weekly losers

JD Sports Fashion Plc	-4.9%
BAE Systems plc	-4.4%
Hikma Pharmaceuticals Plc	-3.9%
CRH public limited company	-3.6%
Ashtead Group plc	-3.2%
InterContinental Hotels Group PLC	-3.2%
Ferguson Plc	-2.8%

FTSE 100 index, past 12 months

EuroStoxx 600 index, past 12 months



S&P 500 index, past 12 months

All data shown in GBP.

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