Investec

OUT OF THE ORDINARY

WEEKLY DIGEST | 11 April 2022

France Decides

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When I was appointed to my position at Investec in 2013, I believed that my role as a strategist would be consumed with delving into economic and earnings forecasts as well as the outlook for central bank policy. Indeed, we were just recovering from the first "taper tantrum", when the US Federal Reserve had shocked the market by unveiling plans to stop buying bonds in the secondary market. Little did I realise how much politics (and geopolitics) would come to dominate the investment agenda.

I was only weeks into the job when our Charities team asked me to speak at a conference specifically about the risk to financial markets – mainly UK-focused – and the pound from the Scottish Independence Referendum. Brexit and the election of Donald Trump followed, as well as threats to the future of the euro from Italy. I had to prepare a client letter that we would send out in the event of a Jeremy Corbyn-led Labour Party winning a general election. The war in Ukraine has now raised matters to a whole new level of seriousness and I don't really want to contemplate the consequences of a Chinese invasion of Taiwan.

And yet, amid all these worries equity markets have continued to rise and balanced portfolio investors have made decent returns. If there was ever a "wall of worry" to climb, we have scaled it with aplomb. I was listening to an interview with veteran investor Nick Train at the weekend, in which he commented that the best realisation he ever had as an investor was to be optimistic. The triumph of technology and innovation as well as the ability of companies and consumers to adapt to new forces would seem to bear that out. He is a big advocate of investing for the long term in companies that can compound excess returns on capital, as are we. By the by, in giving retrospective advice to his twenty-year-old younger self, he told him to take up yoga, which I would also recommend.

All of this comes by way of introduction to the political story du jour (ho ho!), which is the French Presidential election. In the light of everything I have already written, it probably won't have an enormous influence on long-term investment outcomes, but it has been moving markets and some investors have been increasing the level of their tail-risk hedges in the event of a victory for the right-wing challenger, Marine Le Pen.

So, what's the story here? This election was not really on many people's radar a few weeks ago, with the incumbent Emmanuel Macron enjoying a comfortable lead in the polls. Indeed, his star even rose a bit higher as a leader during a time of conflict when Russia invaded Ukraine. He had already taken a lead role in the diplomatic attempts to head off the war. But once the shock of war had begun to fade, the shock of rising prices and the threat of a surge of immigrants removed the paper which had been covering existing cracks in France's social order.

We don't have to cast our minds back far to the "Yellow Vest" protests which started in 2018, ignited by a well-intentioned plan to raise fuel duty, but which only served to magnify the gap between rural low-income workers and the metropolitan elite. Now we are seeing painful rises in energy and food prices which are squeezing the finances of the same cohort, and, indeed, those who might be considered better off. It hasn't been difficult for opposition candidates to blame the cost of living crisis on the government and to promise to alleviate it. Madame Le Pen of the right-wing National Rally Party and Jean-Luc Mélenchon of the left-wing La France Insoumise (France Unbowed) Party have been the biggest gainers from the protest against the existing government. There is always the temptation to vote for change owing to the ethereal promise of improvement. In the worst outcomes, this can lead to the election of "strong man" politicians who then find ways to manipulate the system to their own benefit.

At the weekend we had the first round of voting, in which Macron and Le Pen garnered the two highest percentages of votes and thus qualified for the second round on 24 April. At least we now know what the binary choices are. Macron is the known quantity who will try to push on with labour market reforms – including raising the pension age from sixty-two to sixty-five – which is one of his less popular manifesto promises. Investors will be quite happy to see him stay in the Elysée Palace.

Although Le Pen has reined in her more overt right-wing tendencies with respect to race and immigration, she still plans to reduce the freedom of movement within Europe that is currently guaranteed by the Shengen Area agreement. She also wants to assert the primacy of French Law over European Law.

The key point is that her policies would reverse the direction of travel we have seen in terms of unity amongst leading EU countries, a unity that was crucial in the creation of the €750bn European Recovery Fund to help the region recover from the pandemic. And with Germany having recently shifted to the left by creating a ruling coalition led by Olaf Scholz of the Social Democrats, there would be a much bigger ideological divide between Europe's two largest and most influential economies.

Last week's opinion polls for the second round showed an average 52.5% to 47.5% split in favour of Macron, but this is uncomfortably close to parity and a far cry from the 66% to 34% outcome of 2017's election. I remember that the geopolitical commentator John Hulsman said then during a conference that I hosted with him that Le Pen would get a lot closer in 2022 and probably win in 2027. He's on track so far.

The risk to markets has been seen in the fact that French equities have underperformed wider European indices, and that the yields of French OAT bonds have risen faster than those of German Bunds. More worryingly, perhaps, the yields of the bonds of more highly indebted peripheral countries such as Italy, Portugal and Spain have also risen faster. Support from Brussels and the European Central Bank might be less forthcoming in a more fractured European Union. The worst-case scenario would be a rerun of the euro crisis. Thus, the euro has also been a relatively weak currency.

Our central view, and that of the market, is that Macron will prevail. The fact that Jean-Luc Mélenchon, who polled a surprisingly high 22% in the first round, has told his supporters not to vote for Le Pen is helpful. Valérie Pécresse, the centre-right candidate (who polled 4.8%) has endorsed Macron. Perhaps the biggest risk in the second round is voter apathy, where a highly motivated Le Pen supporter base is fully mobilised against a complacent Macron camp. I'm sure the whips will be out. We will know the result by the time I pen the next Weekly Digest after the Easter break.

Finally, though, I might observe that it is unlikely that the growing support we have seen for more radical political leaders will subside soon. There are some very deep fault lines running through most of Western society, with highly indebted governments not well placed to fix them. The gap between the "haves" and the "have nots" appears to have widened, certainly at the extremes, and closing it is going to be a painful process for many. Meanwhile, should we be entering a period of secular commodity price inflation, as predicted by several respected economists, things are only going the get more difficult. And all this while trying to exit the pandemic and manage climate change, not to mention the challenge of a China/Russia-led schism in the global geopolitical order. No single politician or political party will be able to deal with that agenda, but the chances of a unified approach seem limited too.

No doubt there are plenty more things to worry about ahead. But let's take Mr Train's advice and remain optimistic about human ingenuity and the ability of great companies to continue to churn out returns over the years. In the meantime, I wish you a restful Easter long weekend, which I think we can all look forward to after such a tough start to the year on so many fronts.

Economic Commentary

FTSE 100 weekly winners

AstraZeneca PLC	8.5%
GlaxoSmithKline plc	7.4%
Berkeley Group Holdings plc	6.6%
National Grid plc	5.4%
Ocado Group PLC	5.4%
London Stock Exchange Group plc	5.2%
SSE plc	4.9%

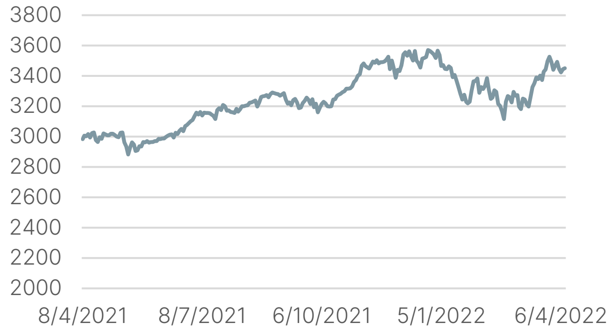
FTSE 100 weekly losers

Smurfit Kappa Group Plc	-9.9%
Intermediate Capital Group plc	-7.5%
Entain PLC	-6.3%
Mondi plc	-6.1%
Lloyds Banking Group plc	-5.9%
Polymetal International Plc	-5.9%
International Consolidated Airlines Group SA	-5.7%

FTSE 100 index, past 12 months

EuroStoxx 600 index, past 12 months

S&P 500 index, past 12 months



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