FRENCH ELECTION HAS INVESTORS ON KNIFE'S EDGE, WITH FUTURE OF EU IN THE BALANCE

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The French presidential elections represent the greatest source of uncertainty for markets this year.
As a founding member of the European Union, the risk of the French electing a president who favors separation from the bloc amounts to a true existential threat for the European project. The risk posed is much more severe than that from Brexit, because the UK – already something of a reluctant partner – has its own currency, while France is a member of the euro.

Jean-Luc Mélenchon and Marine Le Pen, two of the four leading candidates, favor an exit from or dramatic renegotiation with the EU. Should either win the keys to the Élysée Palace and follow through on their threats of a Frexit, support for the EU across the continent would likely fracture, making its continued existence untenable.

The situation is made more difficult by a lack of visibility on the ultimate outcome after two rounds of voting – the first on April 23, followed by a runoff between the top two candidates in May 7, should no clear winner emerge from the first round.

Four of the eleven candidates are polling within margins of error of each other. Moreover, polling is volatile, with candidates rising and falling quickly and regularly. There is also a general distrust of the polls given surprise outcomes in last year's British referendum and the U.S. presidential election, while one-third of respondents are claiming they haven't chosen a candidate or will abstain in the first round. And because there are two rounds, tactical voting makes it difficult to judge the ultimate outcome.

AS A RESULT, MARKETS ARE ON A PRECIPICE

Investors have turned cautious, as reflected in the strength in safe haven assets such as German and Japanese government debt, the yen and low-volatility equities, and weakness in more volatile asset classes such as financials, energy, industrials, peripheral debt and French sovereign bonds.

A victory for Le Pen or Mélenchon, of the extreme right and left wings respectively, could trigger a significant sell-off from current levels, while a win for independent centrist Emmanuel Macron or center-right candidate François Fillon should spur a significant rally in riskier assets.

The impact of a Le Pen or Mélenchon victory is likely to have a dramatic negative impact on risk assets not only in France but globally, because both advocate for a return to more rigid forms of economic management. That is viewed as making France uncompetitive, which could spur recession and debt runs. Further, concern about the increased likelihood of Frexit and a return of the franc are likely triggers for bank runs, capital controls and credit losses, potentially destabilizing France and Europe, and leading to global contagion. With confidence still not back at pre-2008-09 levels, the resurgence in financial markets and the real global economy may be reversed.

However, a win for the more moderate Macron or Fillon could spur a significant rally in risk assets globally as both favor reforms aimed at improving France's competitiveness and growth. This would remove uncertainty over the future of the EU and likely create greater euro-area growth.

So while most polls think Macron is the likely victor, the uncertainty is great. A market-favorable outcome – a win for Macron or Fillon – could result in a strong run, as happened following Donald Trump's victory in the U.S. election, while victory for Le Pen or Mélenchon will likely be worse than Brexit given the increased risk such a result would have for the continued existence of the EU.

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