MACRON VS. THE COALITION OF THE UNWILLING: IT'S HEDJ TIME

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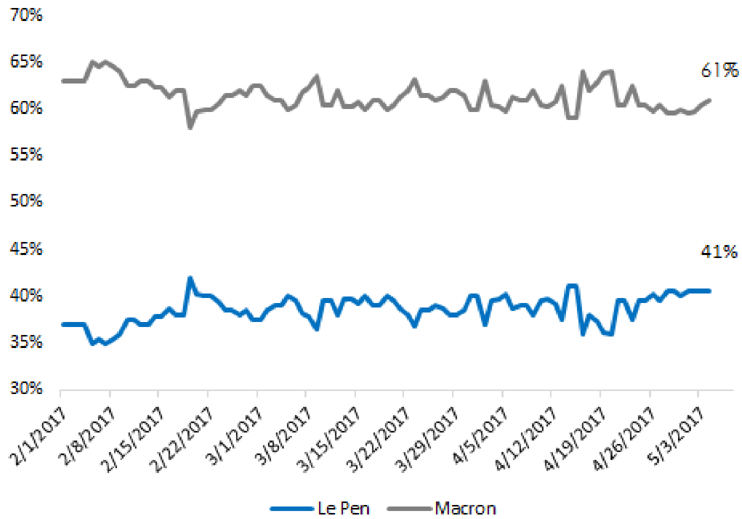
This weekend's French presidential election loss by the National Front's Marine Le Pen was never much in question.

As recently as last week, the victorious Emmanuel Macron was the prohibitive favorite, priced at 1-to-10 odds. Brexit was a much closer race; "Leave" was trailing by only 2 points in referendum-day polls.[1] With similar margins, Hillary Clinton led Donald Trump 48.2% to 46.1%[2] in final polling, with Trump ahead by 3 points in a major survey.[3]

The chart below shows why the French vote was not comparable: Macron's margin was of the landslide variety for months.

Bloomberg Composite Poll of Polls, French Presidential Election



Source: Bloomberg, 2/1/17–5/3/17.

Here's a Better Analogy

Macron hope = Trump hope.

"Trump risk" on November 7 turned into "Trumpflation" by November 9. Same guy, same platform, completely different investment theses. Why? The bull market needed a story, so it came up with one.

The euro's 5-cent move to $1.09 in the last five months also needs a story: "Macronflation."

One of Macron's problems is that, like Trump's dilemma, he will find that upending the status quo requires a bold legislature. Trump struggles even with his own party, let alone the opposition Democrats. This poses a problem for the ascendant euro: Macron-induced economic revitalization may prove fleeting because it relies on a conciliatory Coalition of the Unwilling: The National Assembly, France's parliament.

Macron is about to meet the conflict of his life as he marches headfirst into confrontation with the opposition.

The Euro's Roadblock

Once a Socialist Party rising star, Macron had to scramble to save his career because he was associated with president Francois Hollande, whose approval rating at one point sank to 4%, just ahead of the bubonic plague.

So he put together *En Marche!*, his new left-of-center party comprising disillusioned Socialists who wanted to cast non-Le Pen protest votes. But he needs collective togetherness in the National Assembly, not protest votes. Elections are next month.

Remember, the euro rally coincided with anticipation of Macron's victory. The euro bulls have embraced a theme of nascent French dynamism spurred by his tax cuts and government streamlining, but the thesis is contingent on Macron's proposals passing parliament's Coalition of the Unwilling.

Macron must cobble together a ragtag group of Socialists and Greens to fall in line, even though many members of parliament are steaming from the political battles just waged by Macron. He can ask for support from pro-business Republicans, but that cadre wants to claw back its base, many of whom left permanently for Le Pen's anti-establishment message. Le Pen's Euroskepticism ruffled feathers in the 7th arrondissement, but there are millions of votes elsewhere that Republicans may want to court by snubbing Macron.

The new president has his work cut out for him, yet the strong-euro thesis relies on France catching enough sustainable in flation and economic resilience to prompt the European Central Bank (ECB) to end its €60 billion-per-month bond purchase program. If the plan doesn't come together perfectly, expect the ECB to sit on its hands for longer than expected, spelling trouble for EUR as 2017 ages.

Let's Get Real: France Needs EUR Parity

The French budget deficit was 3.4% last year, and the Street is looking for a 3%+ deficit in 2017, another in a long line of Maastricht Treaty violations dating to the Lehman collapse.

How can France square up its finances? Not by growing out of it; the country's $2.4 trillion gross domestic product (GDP) expanded at an annualized 0.8% in the first quarter. Cut the military? Certainly not in the face of its obligations to its terror-prone former colonies. Certainly not with Paris serving as ground zero for European terrorism. Certainly not when a look across the Atlantic finds Trump holding NATO allies' feet to the fire in the war on terror. Macron can't touch pensions or hike taxes; labor reform prospects are tenuous at best.

The investing public is hanging its hat on ECB president Mario Draghi observing some soon-to-emerge economic sparkle that will allow him to end the bond purchase program. We will believe it when we see it.

HEDJ: There for the Taking

The WisdomTree Europe Hedged Equity ETF (HEDJ) could alleviate the headache and additional volatility that comes from bearing stock and forex risk at the same time. By allowing investors to distance themselves from the euro's fortunes, WisdomTree allows asset allocators to de-emphasize currency risk and European politics.

Furthermore, clear monetary policy divergence that makes hedging the euro particularly interesting at this moment is unfolding: the U.S. Federal Reserve (Fed) is hiking interest rates and removing accommodation, while the ECB may have to taper down its massive bond purchase program before it thinks about increasing its deeply negative short-term rates. The yawning gap in interest rate differentials between the U.S. and Europe in turn suggests an intriguing level of interest income embedded in the forward contracts that HEDJ uses to hedge the euro. This rate is more than 1% today, and growing. Unhedged strategies typically have no such embedded interest rate boost.

If we are right about Macron's star fading, investors will need to take a long look in the mirror and ask whether they want to deal with the euro headache right now. HEDJ may be of interest, especially if National Assembly elections start taking headlines.

[1]Financial Times poll of polls, as of 6/23/16, the day of the Brexit vote.

[2]Real Clear Politics Poll Average, Final.

[3]LA Times/USC Tracking Poll, 11/1/16–11/7/16. Election was 11/8/16.

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DEFINITIONS

Brexit : an abbreviation of "British exit" that mirrors the term Grexit. It refers to the possibility that Britain will withdraw from the European Unio.

Bullish : a position that benefits when asset prices rise.

Inflation : Characterized by rising price levels.

Maastricht Treaty : the original treaty that established the formation and rules of the European Union and the eur.

Volatility : A measure of the dispersion of actual returns around a particular average level. .

Foreign Exchange (FOREX, FX) : The exchange of one currency for another, or the conversion of one currency into another currency.

Monetary policy : Actions of a central bank or other regulatory committee that determine the size and rate of growth of the money supply, which in turn affects interest rates.

Hedge : Making an investment to reduce the risk of adverse price movements in an asset. Normally, a hedge consists of taking an offsetting position in a related security, such as a futures contract.

Interest rates : The rate at which interest is paid by a borrower for the use of money.

Tapering : A shift in monetary policy by which the Federal Reserve would begin decreasing the amount of bonds it purchases.

Forward contracts : Agreements to buy or sell a specific currency at a future date at an agreed upon rate.