Our thoughts on how to position around the first round of French elections

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The French Presidential election looks set to be a three-way contest between Marine Le Pen, Emmanuel Macron and Francois Fillon. One of these candidates will be eliminated following the first-round elections on Sunday 23 April, and we foresee three scenarios potentially unfolding.

This article outlines our view on each scenario and provides an asset allocation perspective on how investors might position tactically using short and leverage ETPs and strategically, through our smart beta ETF solutions.

Base case scenario one:
Macron win priced-in into equities—short German Bunds, long Italian BTPs

Macron and Le Pen triumph as Fillon's political assassination undermines hopes for power; Macron remains favourite.

It is widely expected that Macron will prevail in a face-off with Le Pen. Faced with the choice between a divisive political force and a measured, centrist candidate, we believe French voters will vote overwhelmingly in favour for the latter, much like in 2002. Given this widely expected outcome, the relatively wide yield premium of French 10Y OATs and Italian 10Y BTPs over German 10Y Bunds looks overstated, and yields may converge as the status-quo and confidence returns. If Macron continues to build momentum, the easing political risk should enforce a normalisation in European bond yields, trading with tighter spreads to Bunds.

However, investors must also remain cautious as Le Pen's presidential hopes, no matter how remote, cannot be discounted entirely. Unexpected developments, such as another terror attack, could trigger a surge in populist support and nudge undecided voters closer to the far-right. Additionally, Macron's voter base is also not entirely secure with 40% of his voters indicating their voting intention is not yet definitive. New scandals or political mishaps could afford Le Pen greater chances for success.

Possible, but not probable, scenario two:
French OATs at risk—hedge your positions and focus on country-specific equity exposures

Odds on Le Pen victory soar as populist support surges; Macron/Fillon hopes fade.

Le Pen's radical foreign policy and incoherent economic plan threatens the overall stability of the European project and the French economy. This scenario puts equities, peripheral Eurozone government debt and the Euro most at risk, and investors may consider leveraged short positioning as suggested in Figure 1. The risk for a European Union (EU) referendum, debt redenomination (into the French Franc) and nationalisation, while very remote, also cannot be ignored given the impact on sentiment and the speculation this provokes

in markets generally. We believe this will put renewed pressure on French OATs if Le Pen emerges as President.

The resulting flight to safety may compel investors to allocate into safer safe-havens, such as German Bunds or Gold, or to hedge their equity and bond portfolios through inverse (short) exposures.

Longer term, the pressure inflicted on the Euro could present a boon to Eurozone exporters as investors upgrade top and bottom line growth expectations. Country-specific strategies, such as Germany, may offer the best risk-reward opportunity for investors looking to discriminate between European equity exposures—such as avoiding politically sensitive sectors like Utilities and Energy where governments typically hold strategic stakes, in favour of more cyclical sector exposures. WisdomTree's export-tilted strategies may offer an efficient means to play these themes, combining broad baskets of dividend payers with a currency hedged overlay designed to potentially mitigate currency volatility for international investors.

Least likely scenario three:
The market-friendly outcome is bullish equities

Le Pen faces early defeat as Macron and Fillon advance.

Increased risk-on positioning from investors is likely in this scenario. The risks posed to the European project should—at least for the time being—subside with both candidates pushing for greater EU integration and favouring the Euro. Similar to scenario one, the divergence of bond yields in the Eurozone should reverse, as the status quo, for now, will be preserved. Broad Eurozone equity baskets are likely to rally on the back of this, and strategic investors may wish to consider both large and small-cap equity baskets to play the revival in sentiment.

Upbeat risk sentiment may also compel investors to select more concentrated/targeted exposures with higher returns potential, such as Eurozone banks which trade at deeply discounted valuations. Yield curve steepening and the profit opportunity this creates for banks will provide another boost to sentiment in Eurozone equities.

With over 40% of French voters still undecided, the outcome of round one is not a sealed deal. The ongoing political uncertainty may provide plenty of opportunities for investors to position their portfolios using the Boost ETP range and WisdomTree's UCITS ETFs.

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