PERSPECTIVES

French Election Result: Macron Wins, But Can He Deliver?

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There were no surprises as French voters elected Emmanuel Macron as their new president after the second round of voting. Franklin Templeton's investment professionals share their thoughts on the prospects of a Macron presidency and suggest it might not be plain sailing for the self-styled political outsider.

New President Will Need Support to Implement His Agenda

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For once the polls have proven correct.

Even before the first round of voting, Emmanuel Macron had been installed as the favorite for the French presidency and so his victory had largely been priced into the markets.

But as we look longer term, I think it's significant to note that Macron is a real political outsider. While Marine Le Pen and the far-left candidate Jean-Luc Melenchon both presented themselves as outside the system during the first round of the campaign, both are seasoned political veterans. Macron really isn't. He's never held a senior political office and has no real political party behind him. His political movement is only a year old.

In our view, the immediate question is whether Macron can build a parliamentary majority to support the implementation of his reform program.

Keep in mind that we have French parliamentary elections due to take place on June 11 and 18, and we expect the outcome of those votes to play a big role in Macron's ability to deliver on his election promises.

Our expectation is that the June elections are likely to produce a largely fragmented parliament. At the outset of the presidential elections, there were four candidates representing very different parts of the political spectrum who accounted for around 20% of the votes each. We'd expect that split to be reflected in the composition of the new French assembly.

As a result, Macron is likely to have to negotiate with all sides to implement his proposed reforms, but perhaps particularly with broadly center-right Republicans.

Much-Needed Reform on the Horizon?

France has always been seen as a laggard in terms of economic and labor reforms in Europe.

In our eyes, the chaotic French labor market in particular is ripe for reform. Unemployment is at unacceptably high levels, partly due to the strict employment rules that make it difficult for businesses to shed staff. As a result, businesses are reluctant to take on new employees.

In order to implement labor reforms, Macron is going to have to take on the French unions and reduce their political power, which is immense and which has been accumulated over decades of French political infighting.

We think these reforms are very important in France, and could prove positive not just for the French economy and the French equity market, but also for Europe in general.

We'd expect to see some stiff resistance from the unions, including some very noisy and visible national strikes. But we'd consider that to be a necessary step for the French economy. And if Macron is able to achieve some success with labor reform, I think we could see operating margins in France rising higher, unemployment going lower and the overall prospects for gross domestic product (GDP) growth improving.

Investor Attention Turns to Macron's Ability to Govern

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While we're expecting a positive reaction from the financial markets to Emmanuel Macron's presidential victory, such a rally will likely be mitigated by the expectations of rising interest rates and a renewed focus on the challenges Macron will face. We saw a partial rally in French equity markets after Macron's first round success, and we feel now investors' attention may turn to his ability to govern after a difficult campaign.

In the longer term, we expect the Macron administration will likely position itself as a continuation of the previous government of Francois Hollande, yet with a more pro-investment and slightly more right-wing leaning.

Although Macron is a relative political newcomer, the nature of French politics means he will likely need to appoint some more established political figures, from mainstream parties to his administration.

With Macron having no significant, established political party behind him, we expect those parties whose candidates fell short in the first round of the presidential campaign to push hard for parliamentary seats in the June parliamentary elections in a bid to win influence.

Right-wing party Les Republicains in particular performed better than its center-left rival Parti Socialiste in the presidential first round and is likely to be keen to secure a stronger position when negotiating with Macron for key government positions.

We think the political flavor of the coalition Macron builds will be important. While the new president has a more pro-business agenda than his predecessor Hollande, he might be significantly constrained in his social and economic reforms if he needs the support of both mainstream right-wing and left-wing parties.

Possibly Beneficiaries

From an investment perspective, assuming Macron is able to build support and implement the central tenets of his reform agenda, we'd expect the main beneficiaries could be stocks with an exposure to clean energy, research and development (R&D), technology, health care and infrastructure projects.

In addition, we see Macron's victory as likely positive for stocks depending on French macro improvement (particularly cyclical value stocks), and for all stocks that would benefit from a possible corporate tax cut. Last but not least, Macron's victory will likely have a positive effect on the European periphery, with cyclical stocks benefiting the most.

A Positive Outcome for Eurozone Equities

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European markets were largely pricing in the victory of Emmanuel Macron, and voters delivered. But the result of the French presidential election is important not just for France, but for the wider eurozone too.

A victory for Marine Le Pen would have raised the possibility for a French vote to leave the European Union (EU). A potential "Frexit" scenario would undoubtedly hurt confidence in European equities.

We think Macron's victory is positive for France and positive for the eurozone. From an investment standpoint, we think this result could prove positive for shares of banking, insurance and potentially energy companies in the region.

On the other hand, the Macron victory is likely to be less positive for companies we'd consider to be lower-growth. Additionally, we believe the more defensive sectors of the equity market such as consumer staples could underperform, along with some telecommunication companies and utilities, where returns are heavily regulated.

Eurozone Growth on Track?

Our working assumption is that the eurozone will hold together and Macron's strong pro-European credentials should help support that assumption.

With the election behind us, our attention now shifts to the growing breadth of the internal eurozone recovery, helped by a Macron-led France. Some of the lead eurozone indicators, including industrial production and purchasing manager indexes (PMI), have been very strong in the first quarter of 2017.

We're hoping to see a continuation of mild inflation and, in time, would expect to see an appropriate response from the European Central Bank in the form of scaling back quantitative easing and ultimately a rise in interest rates.

Rising oil prices caused a headline spike in eurozone inflation at the beginning of this year, which has washed through the system. Inflation is now falling back to a more normal core inflation number of around 1%. Still, we'd look for core inflation in the eurozone to continue rising up to the level we're seeing in Germany of 2.2%.

Longer-term Questions Remain for French Bonds

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Emmanuel Macron's widely predicted victory should be positively received by markets, at least in the short term.

From a fixed-income perspective, we'd expect French government bonds to experience a further relief rally, although the victory had largely been priced in after the first round of voting.

However, very quickly, we expect pressure to build on Macron to outline exactly how he intends to govern. So far we have only a very rough sketch of what he's planning to do.

Much will depend on the results of June's National Assembly elections, and particularly whether he can garner support from rival parties.

Our feeling is that in government, Macron could be a little further left on the political spectrum than some commentators had originally expected.

Certainly we've not seen anything in his manifesto so far that would suggest he could bring down France's deficit significantly, nor stem its rising debt to GDP.

That is not good for long-term French fundamentals. But over the medium term, we'd expect French government bonds could probably begin to sell off once people finally synthesize the full implications of the Macron victory.

At the moment, politics are driving the markets. Once investors see through that, I think there could be an underperformance in French government bonds.

French government bonds currently trade on a similar level with that of German bunds, and yet they are not similar. France has a large current account deficit, a significant budget deficit and high debt to GDP. In time we think investors will come to realize that, on fundamentals, French government bonds should be trading much further out.

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Special risks are associated with foreign investing, including currency fluctuations, economic instability and political developments. Any further exits from the EU, or a belief that such exits will occur, may cause additional market disruption globally and introduce new legal and regulatory uncertainties.