Philequity Corner (May 1, 2017)
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French Connection

One may think we are writing about the 1971 Oscar Awardee for Best Picture with the same title, French Connection. However, what we are actually writing about is the connection between Philippine capital markets and the French elections. Though this was not given much attention by Filipino investors, hedge funds and institutions the world over were glued to their screens as they awaited the results.

What's the connection?

Despite the lack of coverage here, what happened in France affected markets worldwide. In fact, one of the possible results could have led to a severe downturn, or at the very least a sharp correction, for global equities, including Philippine stocks. If you are wondering what the connection is between French elections and the Philippine stock market is, we have listed them below.

1. **Growth concerns allayed**
   We have explained in previous articles that economic growth in the US, Japan and China have brought about renewed confidence. With the Eurozone's growth still quite fragile, the entry of centrist and political newcomer Emmanuel Macron in the 1st round of French elections last April 23 caused the markets to heave a sigh of relief. The worry was a run-off between extreme right Marine Le Pen and extreme left Jean-Luc Melenchon because both candidates have economically disastrous programs which might cause growth to stagnate once again. Not only will this affect France and the Eurozone, but it might drag down global growth as well. With one of the major global growth risks now removed, equity investors have one less risk to worry about.

2. **Bullish global stock markets were instrumental to the PSEi's upswing**
   Strength in stock markets worldwide was one of the main reasons that the PSEi was able to break out of its long consolidation between 7,200 and 7,400 (see *PSE Index breaks out after long consolidation*, 10 April 2017). Prior to the 1st round of French elections, the rally in global stocks took a pause as investors awaited the outcome of the elections. As investors derisked their portfolios, the French stock market lost 3%, European indices lost more than 2%, US equity markets fell 3.5% from their highs and US 10-year bond yields fell from 2.6% to 2.2%.

   However, right after the election results came in, the French stock market gained 4% and Europe as a whole was up more than 2%. With stock markets across the globe resuming their upswing, the Philippine stock market was brought higher with them.

3. **Political uncertainty removed**
   After a month of uncertainty, scandals, rebounds and late surges, markets were relieved that the worst case scenario did not come to pass. Markets hate political uncertainty, as was seen during the Brexit referendum. Since Macron survived the first round, it lowered uncertainty significantly and global equities rallied as a result.

4. **Euro strength lifted most currencies**

In the run-up to the 1st round of French elections, the euro had been stuck in a consolidation as markets remained tentative. Then, the day after French elections, it rose 1.4% against the dollar. The strength of the euro was crucial because euro weakness would have caused the US dollar to strengthen, affecting currencies worldwide, which may cause the Philippine peso to weaken again. Instead, the euro lifted most currencies around the world. In fact, the Philippine peso is one of the beneficiaries of the outcome of French elections.

Worst case scenario avoided

In contrast to the Macron-Le Pen matchup which was welcomed by markets, a victory by Melenchon would have been greeted with much apprehension. One of his campaign promises was to implement a 100% tax on the rich, which caused grave concern for businessmen and investors. The worry was a worst case scenario where the extreme left Melenchon faces off against extreme right Le Pen in the 2nd round of elections – two very unfavourable candidates. This is mainly because both candidates favour France's exit from the Eurozone. Note that France is one of the 6 founding members of the European Union and even has veto power in the United Nations Security Council. If France exits the EU, it would deal a serious blow to stability in the region. Fortunately, Melenchon failed to make it to the top 2, avoiding the worst case scenario from happening.

Pollsters finally got it right

Though most pollsters had predicted this outcome, investors and analysts had every right to be skeptical because previous polls got it all wrong. Looking back at the Brexit referendum, practically everyone expected the status quo to win. Instead, we are now faced with the UK's eventual exit from the Eurozone. The most notable mistake though would be Donald Trump's victory over Hillary Clinton. Despite trailing in most polls, Trump went on to win the electoral colleges by a sizeable margin. This time though, to the relief of market participants and analysts, the pollsters finally got it right.

Macron – the next French president?

A former member of the Socialist party, Macron was an unlikely candidate for President. A former investment banker, he chose to run as an independent by forming a new political party, "En Marche!". Despite this, he garnered support not only within France but also from other countries. German Chancellor Angela Merkel, European Commission President Jean-Claude Juncker, former US President Barack Obama and foreign ministers from different countries all voiced their support for Macron. WIth 23.9% of the vote in the first round, pollsters are predicting that Macron will be marching forward towards the French presidency.

Nobody likes Le Pen

Even more fortunate for markets is that it seems nobody likes Le Pen, especially her opponents. Right-wing candidate Francois Fillon of the Les Republicains party called on his supporters to vote for Macron in the 2nd round. Another defeated candidate, Benoit Hamon of the Socialist party, also asked his voters to give their support to Macron, saying that "he could tell the difference between political opponents and opponents of the Republic." Former French Prime Minister Manuel Valls, a partymate of Hamon's also gave his support to Macron to ensure Le Pen did not win power.

Macron victory bullish for stocks

With Macron being perceived as pro-Europe and pro-business, his strong showing in the 1st round is favourable to the stock market. Moreover, polls show that Macron has a significant lead over Le Pen going into the 2nd round of French presidential elections on May 7. If the polls are right and Macron does win, one can expect a bullish reaction from the stock market.

Political upheaval

Seeing the victory of Trump and our own President, Rodrigo Duterte, it seems that the political landscape is changing dramatically. Unconventional leaders are gaining support at the expense of previously well-established political parties which are losing their foothold. In France's case, this election was the first time in French modern political history that the two pillars of the political arena, the Socialist party and the Les Republicains, were both eliminated in the 1st round of the elections. Whether we like it or not, this wave of political change is expected to generate political upheaval in the years to come.

Risk on!

With the worst case scenario now behind us, fears of the EU disintegrating, global growth slowing down, and the US dollar strengthening on the back of euro weakness have been minimized. Now, investors can focus on corporate earnings results and put their efforts into stockpicking. Thus, from "risk off" mode, markets went back to their "risk on" orientation. Bonds and gold fell as investors shifted back into equities. Global equities rebounded, with the Nasdaq making a new all-time high, hitting 6,000 for the first time in history. The PSEi itself has rebounded from the lows of December and is now at a 6-month high. Not only is our stock market looking better, but this recent breakout above 7,700 also confirms our call that we have seen the low in this correction phase last December (see *Santa Arrives Late*, 9 January 2017). With the political uncertainty of French elections removed, this is one less obstacle in the path of the PSEi back to its all-time high of 8,137.

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