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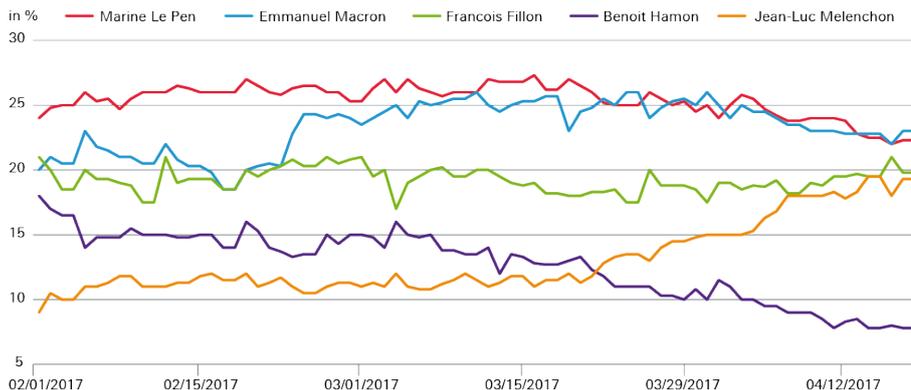
Finally, France votes

Macron looks well on track to win the presidency. But don't bet on it. There are plenty of wild cards.

Much has happened in the weeks since our last analysis of the French presidential elections. Very little has changed in terms of the likely outcome.

Like pretty much everyone else, we continue to see a run-off between the pro-European, socially liberal Emmanuel Macron and far-right Marine Le Pen as our base case. For the past month, the two have been in a statistical dead heat, currently at around 22% to 24% in public polling. The next two candidates are now close behind. Former right-wing Prime Minister François Fillon is currently at around 20%. Far-left firebrand Jean-Luc Mélenchon has been rapidly catching up.

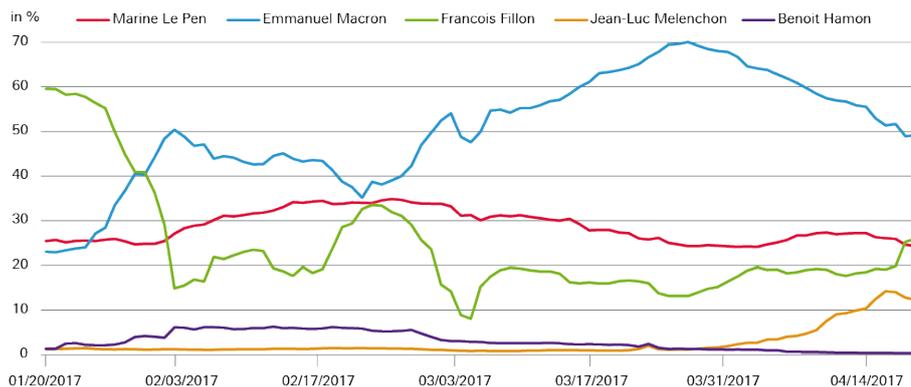
1st round average election polls



Sources: OpinionWay/Orpi, IFOP/Paris Match, Harris Interactive, Kantar Public, BVA, Bloomberg Finance L.P., Deutsche Asset Management Investment GmbH, as of 4/18/17

Given the slight but very consistent lead of Macron and Le Pen as the top-two candidates, statistical simulations based on polling data still suggest a fairly high likelihood they will face each other in the second round on May 7. Data from betting sites show a similar picture.

Average implied probability of winning



Sources: Oddchecker, Bloomberg Finance L.P., Deutsche Asset Management Investment GmbH, as of 4/18/17

Stefan Kreuzkamp
Chief Investment Officer



In a nutshell

- Like pretty much everyone else, our base case assumes a run-off between Marine Le Pen and Emmanuel Macron
- In that case, markets are likely to immediately price in the increased chances of the Eurozone surviving
- There are plenty of wild cards, though. Uncertainty is unusually high

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Not quite a done deal – yet

Of course, the trouble with such simulations is that they are only as good as the data fed into them. France has never seen an election quite like this one – with neither the traditional left-wing nor the traditional right-wing candidate among the top-two contenders. Modelling any regional differences in turn-out correctly has probably become more difficult. It may also prove more consequential, this time around, given big gaps in the voting preferences between rural and urban voters in particular. Finally, the fact that all public polls have been so consistent in terms of Le Pen's and Macron's relative strength, for so long, is itself slightly troubling. It could reflect pollsters tweaking their methodology to get close to what their colleagues are predicting – increasing the risk of all of them getting it wrong for the first round.

Election-day surprises in terms of which two candidates qualify would not be all that surprising. The gap between the top-four candidates is both small and shrinking. For example, Mélenchon's momentum might win him some additional, last-minute support at the expense of other left-wing candidates lagging far behind. (In 2012, Mélenchon underperformed his polling data, largely because of last-minute switches in favor of François Hollande, the eventual President. This time around, a similar bandwagon effect could work in the opposite direction.) Meanwhile Fillon has been under a cloud of scandal. Perhaps this has caused some voters to shy away from revealing their voting intentions to pollsters.

Relatively new techniques using online data such as site visits, internet searches and social-media sentiment also hint at a race in flux. Surveys collected by Odoxa/Dentsu Consulting alongside traditional polling underline Mélenchon's strength (with the largest number of visitors to his site and YouTube channel, as well as excellent readings on several social-media metrics). Another composite measure of online buzz, published by Filteris, has consistently shown Fillon in a stronger and Macron in a much weaker position than the polls would suggest. Keep in mind though that such measures only have a very limited track record as predictive tools. (In the case of Filteris, the methodology is a closely guarded secret, making it hard to assess its validity.) They may also be subject to biases and deliberate manipulation, for example of the sort Russia has been accused of in both French and last year's U.S. elections.

Our base case: President Macron

Take it all together, and we still expect Le Pen and Macron to end up on top. In part, this is because there is just as much potential for polling errors working in their favor, or for the perceived front runners gaining traction in the final days before the first round (as has tended to be the case in several previous presidential elections).

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2nd round average election polls: Macron vs. Le Pen



Sources: OpinionWay/Orpi, IFOP/Paris Match, Bloomberg Finance L.P., Deutsche Asset Management Investment GmbH, as of 4/18/17

Assuming there is a Le Pen and Macron match-up, Macron's second-round prospects appear to be better than they were a month ago. A political newcomer, he has largely avoided major missteps and cut an increasingly confident figure. His polling lead in second-round match-ups with Le Pen has been steady, at around 20%. Beneath the headline margin, two key details in the polling data are particularly revealing:

- First, the number of Macron voters no longer ready to change their mind has steadily risen in recent weeks, and now frequently exceeds that of Le Pen voters in second-round match-ups.
- And second, a persistent majority of French voters well above 50% do not want to see Le Pen's Front National (FN) in government. They neither expect nor want Le Pen to win. Indeed, the figure on the various versions of this later question ("Who would you like to win the presidency?") has been persistently at or below 20% for Le Pen. Even among some of her own sympathizers, a vote for Le Pen remains more of a protest gesture than a governing mandate.

Against this backdrop, our base case is that markets will price in the prospect of a Macron presidency immediately after the first round, fairly independently of the precise results. Spreads between French and German government bonds should swiftly shrink to close to where they were before markets began to worry about the potential of Le Pen taking France out of the Eurozone. The euro should get a moderate boost. Sentiment in equity markets should also benefit, but the potential immediate upside is likely to be limited. There appears little Le Pen risk priced in. Macron's reform agenda should eventually provide further upside for French equities and may also improve sentiment towards Europe more broadly. However, Macron's ability to effectively govern will critically depend on the results of the parliamentary elections on June 11, with a runoff on June 18.

In our view, it will be critical to analyze the first-round presidential election results for pointers on how Macron's movement "En Marche" might do at the parliamentary elections. In particular watch out whether Macron has been able to expand his appeal beyond urban strongholds.

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Wild Cards: Mélenchon and Fillon

Alas, there are now plenty of wild cards, because of Mélenchon and Fillon. Either of them now has fairly plausible paths into the second round. Much more so than even a week ago.

Mélenchon in particular is becoming credible, and could well make it into the run-off if his momentum continues. From a market perspective, we would consider that problematic in many ways:

- First, and most obviously, his economic proposals would be troublesome news for the French economy, if he actually won and was able to enact them. From a broader European perspective, the immediate fall-out may be more limited. Fears of the Eurozone breaking up would recede, particularly if Mélenchon making it into the run-off coincides with Le Pen getting knocked out in the first round. Relief on that may not last. Over the longer term, France under a president Mélenchon would certainly change the debate, and eventually policies in other countries too.
- Second, just reaching the second round would be an accomplishment, even if he is then beaten by either Fillon or Macron. It would drag the rest of the debate away from the reform proposals of Fillon or Macron. Even if either of those were to beat Mélenchon, they would probably secure a much weaker mandate. A president Fillon or Macron narrowly beating Mélenchon would also have less momentum heading into the parliamentary elections. Prospects for liberalizing rigid French labor laws would recede. Facing Mélenchon, Fillon in particular would probably trim his proposals on cutting public-sector jobs, spending and taxes.
- Third, it is highly uncertain whether polling can be trusted. There is relatively little data on such a match-up, deemed highly implausible even a few weeks ago. French political history suggests voters might be inclined to take a more sceptical view on Mélenchon, as they take a closer look at his proposals.
- Fourth, and for what they are may be worth, the limited polling we have had shows Macron consistently beating Mélenchon, but Mélenchon up to 20% ahead of Fillon. However, this probably overstates the certainty. Fillon could still win and Macron could still lose.
- Fifth, of course, is the worst-case scenario we have previously discussed. If both Fillon and Macron get knocked out, and Mélenchon ends up facing Le Pen, markets would get very nervous on the Eurozone's survival prospects between the two rounds.

As for Fillon:

- Markets would certainly welcome a Fillon and Macron match-up. This would represent a strong and positive mandate for the sort of measures France has desperately needed for decades.
- Unfortunately, it is probably also the least likely of the lot. Unlike Mélenchon, Fillon has shown limited signs of momentum, nor are the obvious sources of significant gains

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at the expense of also-run candidates. To get to a Macron vs. Fillon duel, you probably need to assume that throughout the campaign, the polls significantly understated Fillon's support, while at the same time overstating Le Pen's. The former looks unlikely, but possible. The latter looks extremely implausible.

Le Pen could still win

A Le Pen victory is still possible, even if we get the Le Pen and Macron match-up we described in our base case. There is a risk of markets getting ahead of themselves, in immediately discounting the prospect of Le Pen winning. This risk looks fairly manageable. Her most plausible path to the Elysee Palace would be more by accident than by design.

This reflects the opposition of a majority of French voters to FN rule. Based on current data, her winning against Macron would probably require a combination of low turnout, as well as last-minute missteps on Macron's part or damaging leaks. Perhaps the biggest danger might paradoxically be Macron continuing to show poll strength, as well as a strong Macron showing in the first round. If a Macron win is seen as highly likely, this might reduce turnout among his potential supporters, in particular among voters who only see him as the lesser of two evils.

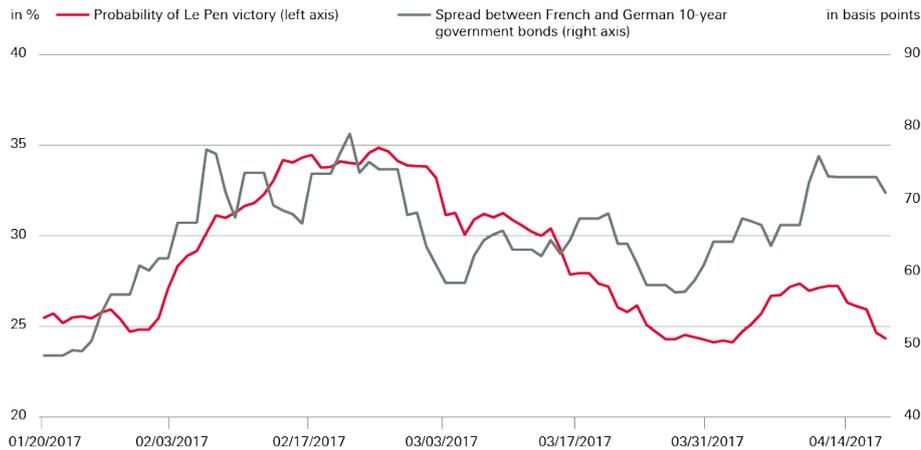
Due to the vagaries of French electoral law, an upset Le Pen victory largely thanks to better turnout among her supports, would be very unlikely to be repeated in the parliamentary elections. Instead, surprised voters might well use this opportunity to put strong parliamentary checks on Le Pen's ability to enact any of her proposals. In the month until then, a narrowly victorious Le Pen would also have strong incentives to tune down her rhetoric on the euro further – potentially reassuring markets, as well as voters. We will have more to say on this, once we get past the first round. Suffice to say here that there would probably be a very volatile initial reaction immediately after Le Pen winning, followed by a quick recovery, as it becomes clearer that her scope for manoeuvre following a narrow and surprising win could prove very limited indeed.

The spread between French and German government bonds has risen much more sharply in recent weeks than the strength of the previous correlation would imply.

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Likelihood of Le Pen victory & spread France vs. Germany



Sources: Oddchecker, Bloomberg Finance L.P., Deutsche Asset Management Investment GmbH, as of 4/18/17

The parliamentary calculus would be different, by contrast, if Le Pen wins the presidency in a high-turnout election where both sides mobilize. Based on the data so far, this looks highly unlikely. If it does happen, we would expect to see some early signs of this well before the second round of voting. Either Le Pen would need to significantly outperform her polling numbers in the first round - which would hint at large, systematic biases in public polls and naturally reduce our and market confidence in her second-round poll numbers. Or, alternatively, we would need to see significant movement in her numbers between the two rounds. That's possible, of course, but the gap is large and the window of opportunity very short. The flip-side is that a decisive Le Pen win would also augur very well for her party's prospects at the parliamentary elections. It would also plunge the established parties of the center right into further chaos. Add Fillon being not just beaten but humiliated in the first round of the presidential elections by coming in fourth behind Mélenchon, and the prospects of the Eurozone surviving Le Pen's terms in its current form would look exceedingly dim. Markets certainly appear uneasy.

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Glossary

Eurozone

The Eurozone is formed of 19 European Union member states that have adopted the euro as their common currency and sole legal tender.

Front National (FN)

The National Front (Front National, FN) is a far-right political party in France, founded in 1972 by ultra-nationalist Jean-Marie Le Pen and currently led by his daughter, Marine Le Pen.

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