Markets reprice on the back of French political risk

Politics has moved to the fore in European markets, following the conclusion of the EU parliamentary elections and the shock announcement of French parliamentary elections by President Macron. While much media attention has focused on the rise of the extremes in the European Parliament, the results show the "centre" has broadly held its majority. Taking the three traditional centre groupings together (EPP, Renew, S&D), the combined share of seats is expected to be 56% compared to 59% in the last Parliament. Ursula von der Leyen's EPP party will remain the largest single grouping at 26%, increasing its share from 2019, but Brussels will now enter a period of horse trading over the summer to decide on the key positons in both the Parliament and the European Commission.

Nonetheless, the results in the French and German EU elections highlight growing support for more nationalistic parties in the Eurozone's largest economies, with polls suggesting President Macron's party is set for a heavy defeat in parliamentary elections on June 30th and July 7th. This brings into focus the prospect of a "cohabitation" with Marine le Pen's Rassemblement National (RN) party taking the Prime Minister's office and with it significant control of France's domestic and economic policy. Markets have digested this news by selling off French assets, with the large banks particularly impacted, while the spread between French and German 10-year bonds widened to the highest level since the French elections in 2017. At the same time, the euro has been on the decline, moving lower against both the dollar and sterling during the week.

RN has tempered its Eurozone scepticism in recent years, including calls for "FRexit" from the single currency. However, its economic policies would likely expand the French budget deficit further with its programme of higher public spending and broadly protectionist economic policies, including a "national preference" in public procurement and agricultural policy which rails against EU single market rules. In recent years, Macron's government has struggled to reduce the deficit built up during the pandemic. At 5.5% of GDP in 2023 and forecast to decline only marginally in the coming years, the budget deficit is among the highest in the EU, while public debt is now above 110% of GDP and rising. In this context, attention is now firmly focused on the economic plans of frontrunners RN and the left wing block ahead the elections, and how a cohabitation Government could function during Macron's remaining three years as President.

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