230 – 24 June 2024

Investment Institute Macroeconomics

Mind the Crowds!

- New polls with seat projections suggest RN is getting closer to the majority threshold in France, but a hung parliament remains the most plausible outcome.
- France back under EDP is a reminder that fiscal space is non-existent. Using up domestic banks to absorb large public debt supply can be tempting but is ultimately economically toxic as it crowds out private sector funding.

The outcome of the French elections remains highly uncertain. Voting intentions are gravitating towards the three main blocks as those attached to smaller political families probably want to make their vote count, and RN retains its dominant position. More polls providing seat projections put RN closer to the majority threshold, but judging by the surveys, a hung parliament remains (just) the most plausible outcome. A lot will depend on how many qualifying candidates from the historical government parties in third position in the first round will decide to withdraw from the second round to contain the far right.

The announcement by the European Commission that France, along with 7 other member states, is back under "Excessive Deficit Procedure" (EDP) – although it did not have much of an impact on spreads so far – is another occasion to realise that corrective action is needed to avoid a major drift in public debt. This is a blind spot in France's current debate, organised around "moderately spendthrift" and "very spendthrift" proposals from the two political forces leading in the polls. Incidentally, the fact that Italy is again under EDP as well should be a reminder that the "Meloni blueprint", often used to sketch out what could be the economic approach of a RN-led government in France, has not yet been tested for a potentially painful fiscal tightening under close EU monitoring.

French banks' equity prices have improved slightly from their low on 14 June. Fortunately, their exposure to the sovereign is small relative to their Italian counterparts for instance. Yet, before the Great Financial Crisis of 2008, French and Italian banks had very similar levels of exposure. The experience acquired during the "bad old days" of the early 2010s suggests that going the "Italian way" and getting local banks to take up a rising share of local public debt, while understandable from a financial stability point of view, can become economically toxic as this crowds out lending to the private sector and depresses growth on trend. There is domestic space to absorb French debt, but using up this space would still entail a macroeconomic cost.

Latest Messages from the French Polls

The 10-year spread between France and Germany stood last Friday at close at 75basis points (bps), 35bps above the level seen before the announcement of the snap elections and almost unchanged over the week. The magnitude of the contagion effect to the periphery has not changed either. The Italian spread continues to oscillate around 150bps, some 20bps above the pre-announcement level. This suggests that **the decision by the European Commission (EC) to put France and 7 other member states – including Italy – under the Excessive Deficit Procedure had little immediate or direct effect over the market perceptions of these signatures**. This was symmetric: Spain was spared – it was only found in *temporary* breach of the rules – but did not benefit from a particularly favourable treatment by the market (its spread stayed in the 85-90bps range, up 15bps, in which it has been pricing since the announcement).

The move by Brussels was much anticipated. While the response of the national governments to this materialisation of the European disciplinary framework will matter in the months and years ahead (more on this later), **investors did not have to wait for the EC's analysis to understand that corrective fiscal action is needed.** In the case of France, the capacity to deliver such action will of course depend on the outcome of the elections. Candidacies in each of France's 577 constituencies closed on Sunday 16 June, and while polls have probably become more precise as citizens now know about their local choices, they did not necessarily bring that much more clarity.

In Exhibit 1, we look at the latest voting intentions provided by the pollsters which had surveyed public opinion in the days immediately after the announcement of the snap elections by the President. Focusing on these sources helps us to get a sense of how voters are evolving now that alliances have been formed and candidates are known. Indeed, confusion was initially high, since the main centre-right party de facto split, with one component aligning on Rassemblement National (RN), and there could be doubts as to the capacity of the broad left-wing alliance to effectively contain the number of dissident candidacies.

Exhibit 1 – Concentration towards the three blocks

French polls - voting intentions		Louis Harris	Opinion Way	Ifop	Elabe	Average	Change
RN	Latest	35	35	34	36	35.0	1.8
	Announcement	34	33	35	31	33.3	
FP	Latest	26	27	29	27	27.3	2.3
	Announcement	22	25	25	28	25.0	
ENS	Latest	21	20	22	20	20.8	2.5
	Announcement	19	18	18	18	18.3	
CR	Latest	8	9	6	10	8.3	-1.3
	Announcement	9	10	10.5	8.5	9.5	
Rec+Upf	Latest	3.5	2	2	1.5	2.3	-2.1
	Announcement	4	5	4.5	4	4.4	
DivL+C	Latest	2	2	2	2.5	2.1	-3.6
	Announcement	9	4	5	5	5.8	

Source: Louis Harris, Opinion Way, Ifop, Elabe, AXA IM Research, as of 23 June 2024

We draw two main conclusions. First, **the three main blocks – far right, left-wing, and centrists – are all getting stronger support.** If we take the average of the three pollsters, at the end of last week, the three blocks together attracted 83% of the voting intentions, against 76% immediately after the announcement. Voters normally attached to the smaller political families are gravitating towards the main parties to make their vote count (the French expression for this is "vote utile", literally "useful vote"). The "other left" – i.e., those on the left who refused the alliance with the far-left – and centrists non-aligned with Macron (DivL+C in the table) lost nearly 4 points. Voting intentions for the centre-right (CR in the table) fell as well, as some of their electors are moving to the candidates who allied themselves to RN. Voting intentions for Reconquête (Rec in the table) – another far-right party – also fell as its supporters are probably shifting towards RN.

Second**, the left and the centre are making slightly more progress than the RN which however maintains a comfortable lead**. Voting intentions for the left alliance were initially much lower than the total score of its components in the European elections (32%). It seems that the "Front Populaire" has been able to plug some of that gap, but not all. Some of the socialist supporters have probably shifted to Ensemble, the centrist alliance, which explains much of the improvement there (and gain relative to their poor showing in the European elections). The gains in voting intentions for RN are modest, suggesting that the common candidacies with a component of the centre-right in more than 60 constituencies and rallying Reconquête voters did not bring that much additional support. Yet, **given the likely number of three-way races in the second round, RN's confirmed top position among the three blocks in terms of voting intentions puts them closer to an absolute majority on 7 July.**

Louis Harris Interactive and Elabe are the two traditional pollsters which have already produced two sets of seats projections since the announcement of snap elections. They have both revised up their range for RN, with the upper bound now only 9 seats away from the majority threshold (see Exhibit 2). They have revised also up their forecasts for the number of seats secured by the left alliance – albeit still very far from the majority threshold – and revised down their forecasts for the Centre. Indeed, with a higher turnout, in many cases three rather than just two candidates will qualify for the second round by winning more than 12.5% of the votes of registered voters. This will benefit the RN. Indeed, traditionally, RN's problem in both parliamentary and presidential elections is its difficulty to appeal to enough moderate voters between the two rounds to pass 50%. In 2022, there were only 8 three-way races in the second round of the parliamentary elections. This time, pollsters expect well north of 100 of them. RN's difficulty to extend its reach will be less of a problem. Simply keeping their voters from the first round in many three-way cases will be enough.

Exhibit 2 – RN getting closer

French polls - Seats projections by Louis Harris (note: absolute majority threshold at 289)

	Front populaire (left)	Macron's current majority	Centre-right	Rassemblement National
Louis Harris 9-10 June	*115-145*	*125-155*	*40-55*	*235-265*
Louis Harris 19-20 June	135-165	95-130	30-50	235-280
Elabe 11-12 June	*150-190*	*90-130*	*30-40*	*220-270*
Elabe 19-21 June	150-170	90-110	35-45	250-280
Ifop 18-21 June	180-210	80-110	40-60	200-240
Odoxa 19-20 June	160-210	70-120	10-50	250-300

Sources: Louis Harris, Elabe, Ifop, Odoxa and AXA IM Research, as of 23 June 20

Still, at this stage, **the absence of a clear majority in the National Assembly remains (just) the most plausible scenario**. A difference with the inferences we could draw from the first polls is the diminishing probability to see an alliance between the centre-right and the centrists in the assembly numerically stronger than the left alliance. Even if, as we discussed last week, they could get the support from moderate left socialist deputies, this would make appointing a PM from the centrist group less straightforward. This may be one reason why the latest "talk of town" in Paris is that rather than a political figure, the PM leading a "technical government" could be a technocrat – France aligning itself to the practice often seen in Italy to deal with similar situations.

A crucial and very uncertain variable in the outcome, irrespective of how voting intentions change in the coming days, will be **the behaviour of candidates coming in third position in the first round with enough votes to qualify for the second round but with little chance to win**. Parties for now are not communicating on this, but in practice there may be a myriad of local decisions in the constituencies rather than a top-down rule dictated by the parties' headquarters, with some tactical withdrawals across moderate centrists, centre-right and socialist candidates, possibly greens, to contain RN's progress. This continues to make seat projections very thorny.

The manifesto war and the fiscal constraint

The debate on the economic platforms of the left alliance and RN which we briefly discussed last week continues. There seems to be a tactical difference between the two. RN has been retreating on its platform from 2022, while the Front Populaire (albeit with some nuances across its components) seems keen to hold on to even the most spectacular or controversial aspects of the manifesto it cobbled up hastily. We suppose that this reflects different strategic goals.

RN already has strong support among blue collars. The party probably calculates it can afford to let go some of its most progressive but expensive economic measures to extend its appeal to more moderate voters in the middle class, as long as it stands firm on its "fundamentals" (immigration and security). There are limits to this approach though and some costly proposals remain, such as the VAT cut on energy consumption – which is also in direct breach of EU rules, since the 2006 directive set up a limitative list of products on which a reduced rate can be levied. On the other side of the spectrum, the left alliance still needs to solidify its traditional base. The French left has been for years facing more and more difficulty in attracting votes from blue-collar workers. College-educated people with fairly low-paying jobs – especially in the public sector – are the heart of its electorate. A lot of the prominent measures in their manifesto would benefit them, e.g., the 10% rise in public service pay, or the overhaul of the income tax system in a much more redistributive direction. The top marginal rate – above 410K per year – would attract a rate of 90% (a doubling from today), and the threshold beyond which taxpayer would start to lose relative to the current setup would stand at about EUR42k per annum. The price the left must pay is that these proposals are weighing heavily on its capacity to attract moderate voters.

In any case, **the ongoing debate between various shades of spendthrift agendas may look surreal given the underlying position of French public finances**. The European Commission's report detailing the reasons why France has – once again – been placed under the Excessive Deficit Procedure is edifying (link here). A point which we think is worth highlighting is the Commission's Debt Sustainability Analysis (DSA), which presents a "no policy change" trajectory for public debt, i.e., assuming that the member state's structural deficit (the deficit corrected for one-offs and the impact of cyclical conditions) does not change from its current level over the next 10 years. France would see its debt rise to almost 140% of GDP by 2034 (see Exhibit 3). Incidentally, the graph helps to understand why Spain was spared by the European Commission: even without additional efforts, Spain would stabilise its debt ratio. Finally, the graph also suggests that **the "Meloni blueprint", increasingly used in the market to sketch out what could be the policies of a RN-led government in France, has not yet been tested for a sustained, painful fiscal adjustment**. If the current fiscal stance is not corrected and Italy fails to reap the benefits of the current flow of funds from Brussels to lift trend growth, public debt, in the Commission's DSA, would reach 168% of GDP in 2034.

Any French government after 7 July will have to deal with these realities. Of course, one could argue that the Commission is too pessimistic with its assumptions for France's GDP growth rate by the end of the decade (it falls back to 0.5%), but that is the result of the kind of potential growth the country would achieve without lifting productivity, in a context of slower contribution from labour supply in an ageing society. In any case, at least for 2024, **the uncertainty triggered by the snap elections is already having an impact on economic activity**, and hence tax receipts. The French composite PMI index fell further in contraction territory in June to 48.2 from 48.9 in May, a 4-month low. To quote directly from Markit, the survey source, *"the overall strength of business confidence slipped below its historical average to its lowest since the start of the year. In some instances, companies expressed uncertainty towards the upcoming election result, as well as more broad geopolitical risks".*

True, much as the sovereign spread has stabilised last week, French banks' equity price has rebounded slightly from a trough on 14 June, up 1.9% as of last Friday for the average of the three banks in the CAC40. Yet, when compared with the level before the announcement of the snap elections, the decline remains significant: 12.3%. We mentioned last week the findings of a Banque de France study which concluded to a visible impact of a decline in banks' equity value on lending appetite. This matters particularly in France since the country exhibits one of the highest debt ratios of the corporate sector (c.150% of GDP), and contrary to the trend at work in the rest of the Euro area where disintermediation continues, banks have recently taken up a higher share of this burden.

Still, the magnitude of the transmission from pressure on the sovereign funding costs to banks should be a function of the banks' exposure to government bonds, and from that point of view, French banks are in a relatively good position. In Q1 2024, sovereign bonds stood at 2.4% of French banks' total assets, against 12% for their Italian counterparts**. The so-called doom-loop between the sovereign and the banks is still far-away in France (see Exhibit 4). Yet, we think we should be wary of "boiling frog" phenomenon if the fiscal slippage continues,** and banks are increasingly called up to absorb an excessive supply of government bonds.

Exhibit 3 – The EC's DSA is edifying

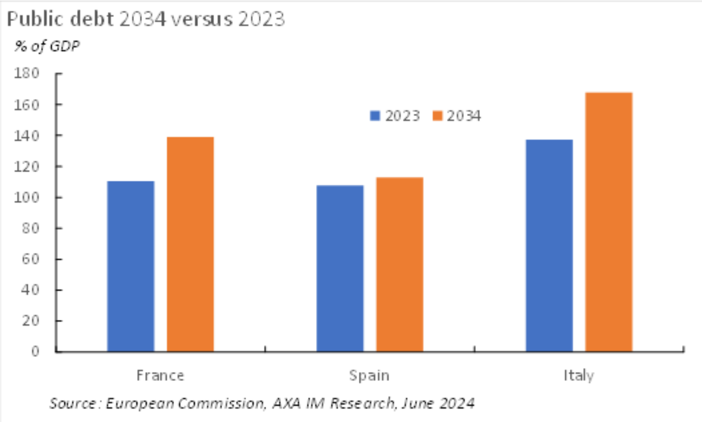
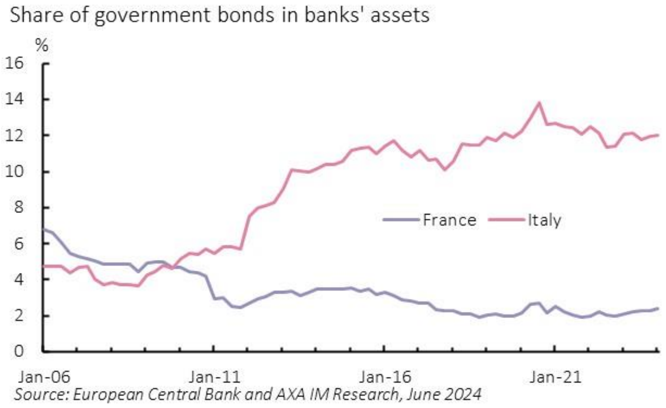


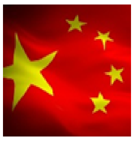
Exhibit 4 – Some space, but do you want to go there?



We were surprised last week by the focus in the market commentariat on the bond auction organised – as scheduled – by the Treasury which was presented as the first "test" of France's attractiveness after the announcement of the snap elections. The auction went well, with bids at roughly 2.5 times the amount collected by the Treasury, but if we mobilise our memory of the "peripheral crisis" of 2011-2012, auctions usually go quite smoothly even in times of stress. The issue is not there**. Italy provides a good example of how gradually a local national system can become overly exposed to its sovereign**. Usually, foreign investors are the first to stop investing in a "problem country". They can be replaced by local banks which have a vested interest in keeping their sovereign afloat to avoid being engulfed in a systemic crisis – all the more since the capital charge they incur on those assets is small. When the European sovereign crisis struck, the exposure of Italian banks to sovereign bonds was on par with their French counterparts, at about 5% of their total assets. By the end of the crisis, the ratio had tripled. Ultimately, this was not a bad decision from a financial stability point of view, but it contributed to the stagnation of the Italian economy in those years, as banks' capacity to lend to the private sector was increasingly crowded out by lending to the government. We are not there, not at all, but down the road, **this is often how strong countries start struggling when fiscal policy is not under control: not necessarily a "sudden stop", but a slow-grinding exhaustion of economic dynamics.**

The British counter-example

A few weeks ago, when surveying the coming British elections, we used the title "boring is making a welcome return". Now that the main parties have issued their manifestos, the contrast with France is even starker. Our colleague Gabriella Dickens has just issued a thorough paper on the proposals and their challenges (see link here). In the economic realm we have two versions of mainstream policies facing each other, with only nuances between them. The fact that whoever comes to power after 4 July will have the smallest fiscal headroom – i.e., distance from the existing rules – of any modern government is clearly having an impact on the parties' ambitions. It may be that the UK's brush with populist policies since the Brexit referendum in 2016 – with scary consequences in the autumn of 2022 – is acting as a powerful vaccine.

Country/Region	What we focused on last week	What we will focus on in next weeks
	• Retail sales (May) +0.1% (control +0.4%), Apr revised to -0.2% (from 0.0%) & -0.5% (-0.3%) control • Housing starts (May) -5.5% after +4.9% Apr; permits -3.8% from -3.0%. NAHB survey (Jun) +43, from +45 • Philly & Empire surveys (Jun) down 3.2pt and up 9.9pt respectively, both remain subdued. • Industrial output (May) +0.9%mom, mfg +0.9%	• PCE inflation (May) soft headline and core (0.0%mom and 0.1%) expected after CPI and PPI reports. • GDP (Q1, f) second revision, currently 1.3% (saar) • Conf Bd consumer conf (Jun) watch expectations component for further weakening after Michigan • Philly Fed servs (Jun) has been subdued • New home sales (May) volatile but soft this last 12m
	• Headline HICP (May) was confirmed at 2.6%, core at 2.9%. Recreation/tourism prices stay dynamics • June flash PMIs were weaker than anticipated, led by Fr and Ge. Fr is back in contraction terr with political turmoil already impacting the outlook, Ge slightly better but only with Svcs at 53.5. Losses in ZEW and INSEE surveys were more muted • Latest Fr polls: RN: 34%; NFP: 27.5%, Renaiss :20%	• Ifo (Jun) to provide another survey on current Ge activity after weaker flash PMI • German retail sales (May) • European Commission surveys (Jun) • Flash HICP in Belgium, France, Spain and Italy (June) • First round of the French general elections on Sunday 30 June.
	• CPI inflation (May) fell to 2.0%. Services inflation dropped to 5.7%, above expectations 5.5%. • BoE kept Bank Rate unch at 5.25%. Voting split unch at 7-2. Some of 7 said “finely balanced” call. • Retail sales (May) 2.9%mom, Apr rev’d up to -1.8%	• CBI Industrial Trends total orders likely up at -20 in Jun, from -33 in May • Final GDP for Q1 likely revised down slightly at 0.5%qoq, from 0.6%
	• Machinery orders down by 2.9% mom in Apr. • Trade deficit widened in May to ¥1.2bn • CPI (May) 2.8% (2.5% Apr), core, core 2.1% (2.4%). • Services PMI (Jun, p) dropped to 49.8, 27-month low	• BoJ Summary of Opinions. • Unemp. rate likely unch at 2.6% • Tokyo CPI likely up at 2.3% in June, from 2.2% in May. Core at 1.8%, from 1.7%.
	• Retail sales (May) rose by 3.7%yoy (Apr: 2.3%) • FAI (May) edged down to 4.0%yoy ytd, (Apr: 4.2%) • IP (May) softened to 5.6%yoy, from 6.7% in April • Housing price (May) down by 3.9%yoy (Apr: -3.1%) • LPR 1Y and 5Y unchanged at 3.45% and 3.95%	• 17-24 June: FDI (May) • 27 June: Industrial profit (Jan-May) • 30 June: NBS PMI for mfg and non-mfg (Jun)
	• CB: Brazil (10.5%) & Indonesia (6.25%) stood on hold. Chile cut -25bps to 5.75% & Hungary -25bps to 7.0% • Inflation (May) remained stable at 5.2%yoy in South Africa	• CB: Turkey (50%) & Philippines (6.5%) are expected to stay on hold. Mexico to cut -25bps to 10.75%, Czechia -25bps to 5.0% & Colombia -50bps to 11.25% • CPI in Malaysia (May) & Poland (June) • May industrial production in Chile, Korea & Thailand

Upcoming events	US:	Tue: Case-Shiller HPI (Apr), FHFA HPI (Apr), Conference board consumer confidence (Jun); Wed: New home sales (May); Thu: Durable goods order (May, p), GDP (Q1), Goods trade balance (May), Weekly jobless claims (22 Jun), Wholesale inventories (May, p), Pending home sales (May); Fri: 1st head-to-head debate between Joe Biden and Donald Trump, PCE price index (May), Personal income & spending (May), Chicago PMI (Jun), Michigan consumer sentiment & inflation expectation (Jun)
	Euro Area:	Mon: Ge Ifo business climate index (Jun); Tue: Sp GDP (Q1); Thu: Ez M3 money supply (May), Ez Business confidence (Jun), It ISTAT business & consumer confidence (Jun); Fri: Ge Unemp (Jun), Fr,It,Sp HICP (Jun, p); Sun: First round of French National Assembly Election
	UK:	Mon: CBI Industrial Trends survey (Jun); Wed: CBI Distributive Trends survey (Jun), 2nd head-to-head debate between Rishi Sunak & Keir Starmer; Thu: BoE publishes Financial Stability Report; Fri: GDP (Q1), Private consumption & business investment (Q1), Current account (Q1), Nationwide HPI (Jun)
	Japan:	Tue: Leading index (Apr); Fri: Unemp (May), Industrial production (May, p), Housing starts (May)
	China:	Thu: Industrial profits (May); Sun: Official mfg & non-mfg PMI (Jun)

Our Research is available online: www.axa-im.com/investment-institute

About AXA Investment Managers

AXA Investment Managers (AXA IM) is a leading global asset manager offering a diverse range of global investment opportunities in both alternative and traditional asset classes. Through our products we aim to diversify and grow portfolios, while delivering long-term investment performance and value for clients.

AXA IM manages approximately €844 billion in assets, of which €480 billion are categorised ESG-integrated, sustainable or impact as at the end of December 2023. We are committed to reaching net zero greenhouse gas emissions by 2050 across all eligible assets, and to integrating ESG principles across our business, from stock selection to our corporate actions and culture.

Part of the AXA Group, a worldwide leader in insurance and asset management, AXA IM employed over 2,700 employees and operates from 23 offices in 18 countries globally at end of December 2023

Visit our website: http://www.axa-im.com
Follow us on Twitter: @AXAIM & @AXAIM_UK
Follow us on LinkedIn: https://www.linkedin.com/company/axa-investment-managers
Visit our media centre: www.axa-im.com/en/media-centre