



FLASH

2017 French presidential election

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2017 FRENCH PRESIDENTIAL ELECTION: WITH THE RACE NOW OFFICIALLY ON FOR THE ÉLYSÉE PALACE, LA FRANÇAISE TAKES THE OPPORTUNITY TO SUMMARISE ITS MANAGEMENT STRATEGY IN THIS UNPRECEDENTED ELECTORAL CLIMATE.

A black swan circles the campaign: the risk of a victory for an extreme-wing party...

The black swan, in the theory developed by philosopher Nassim Nicholas Taleb, represents an event the probability of which is extremely low but for which the consequences, were this event to occur, would be significant.

As things stand, this is exactly how we view the possibility of the victory of an extreme-wing party in the French presidential election to be held in April/May. None of the surveys currently predict the victory of an extreme-wing party in France. However, such an event would have both a major immediate and medium-term impact, as it would lay the foundations for a collapse of the euro zone. In our view, this has two implications: this extreme scenario cannot be ignored; but it cannot dictate the focus of our management strategy either.

... but at the same time, a fundamentally favourable economic climate

It is important to recall that our relatively positive core scenario is based on a synchronised improvement in the global economy. This can be seen in the strong performance of flash and leading growth indicators (PMI, consumer confidence) throughout the world, including emerging markets. In the United States, this trend is driven by an already strong job market, which contributes to the rebound in inflation towards a level close to the Federal Reserve's target of 2%.

This fact fully justifies the recent 0.25% hike in key interest rates announced by the Fed which marks the normalisation of its monetary policy, albeit with a certain level of caution maintained. On the other side of the Atlantic, we expect the European Central Bank to follow suit and a gradual moving away from non-conventional measures, with a time lag of around two years.

This favourable trend encourages us to look forward to riskier assets

Thanks to this strong trend over recent quarters, deflation fears are subsiding. Taking a position in line with our core scenario means limiting duration risk and, on the contrary, increasing the share of equities, high-yield credit and financial subordinates. The current economic climate encourages greater risk taking within our portfolios, deliberately placing them in an uncomfortable position in the event of a major market shock, the onset of this infamous black swan...

What are the potential impacts on the markets in the event an extreme-wing candidate is elected?

To solve this difficult equation, we must first carry out stress tests on our portfolios, considering the main consequences such an event would have.

Firstly, we would see a major impact on French interest rates, which could climb to 3%: the spread with German rates would widen even more rapidly in that it is likely that the latter would serve as a defensive investment and could fall to 0%.

Moreover, the euro would come under pressure and, in our view, could depreciate 10% against the dollar and even more against sterling, due to an increase in the perception of a risk of the euro zone collapsing.

The CAC 40 could fall by 20%, triggered by a more significant fall in banking stocks (of around 30%) and the Italian market would follow a similar trend.

Assets such as residential property and financial subordinates would also be affected, by both a drop in valuation and a liquidity crisis.

Finally, volatility would obviously fly off the scale.

What portfolio investment decisions to favour in this binary situation?

Having made this observation, the first step for us is to move away from our core scenario and trim down our exposure each time the risk of loss, in the adverse scenario, exceeds the tolerance level which we have set for each portfolio. This position is even more justified in that the return on risk has been good in recent months: it will allow us to draw profit from a share of the performance of recent weeks.

The second approach which we have started to implement includes introducing a portfolio protection strategy, through the purchase of highly out-of-the-money puts for example: providing efficient mechanical protection in the event of a major market slump (10% or more) at a relatively low cost, thanks to volatility which, for the moment, remains weak.

These protection strategies are obviously implemented on a case-by-case basis, according to the risk tolerance of each strategy/investor; they are made to measure.

We will keep you regularly updated on this subject between now and the second round of the election in May and will keep you informed of our view of the situation and any changes in our portfolio management strategies. The teams at La Française are always available to answer any questions you may have regarding your investments.

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