Allianz Research | 14 June 2024

What to watch: Snap elections in France, the equity risk premium puzzle, the end of the Fed conundrum?

Ludovic Subran
Chief Economist
ludovic.subran@allianz.com

Jordi Basco Carrera
Lead Investment Strategist
jordi.basco_carrera@allianz.com

Ana Boata
Head of Economic Research
ana.boata@allianz-trade.com

Maxime Darmet
Senior Economist US, France, and UK
maxime.darmet@allianz-trade.com

Eleonore Herfurth
Research assistant
eleonore.herfurth@allianz-trade.com

Executive summary

This week, we look at three critical issues:

- **Snap elections in France: what does it mean for the economy?** President Macron's decision to call for snap elections came as a surprise. The Franco-German 10yr spread has now risen by +21.7bps since the start of the week, the biggest weekly jump in the spread since the height of the sovereign debt crisis in late-2011. According to polls, a *minority* far-right government currently has the highest probability. We continue to believe that it would be short-lived – if happening at all – and that a technocratic/ *Front Républicain* and Macron-backed minority government could be coming in before the end of the year to avoid a hung parliament impasse. Under this scenario, we expect the public deficit to remain close to -5% of GDP by 2026 and growth to be unaffected. Markets would buy the dip. What could go wrong? A far-right government would dent growth by -0.3pp, increase the deficit to -6.5% of GDP by 2026, push OAT spreads at 80 to 100bps, corporate spreads between 110bps higher to 210bps and derail equity markets by -10%. vs pre-election levels. This is both a lot and little, thanks to the ECB put when it comes to markets, and the general resilience (resistance) when it comes to the real economy.
- **The equity risk premium puzzle.** Attractive fixed-income yields are not distracting investors from equity markets despite the expected economic headwinds. While the upward momentum is somewhat justified, the trend defies the conventional wisdom of Equity Risk Premium (ERP) metrics, which suggest investors may be paying an increasingly larger premium – especially in the US, where the ERP currently stands at 0% (compared to 5% in the Eurozone). The continued acceleration of market-based 'perceived ERP' suggests that the equity outperformance may be a self-fulfilling prophecy, reinforcing forward-looking expectations in favour of equities and discouraging investors from rotating into fixed-income positions. Yet, the upcoming policy pivot and its expected effect on the long end of the curve mean that risk-free yields may not be as attractive as they are today for a while.
- **Fed: Will the conundrum of easy financial conditions soon be resolved?** The Fed now projects only one rate cut this year amid still too hot (though easing) inflation. We expect the Fed to start its rate easing cycle in December and have marginally pushed our end-2025 rate forecast to 4%. Although elevated interest rates are pressuring segments of the economy, broad monetary and financial conditions are not as tight as they appear, creating a conundrum for the Fed. We expect liquidity to contract soon as the Fed continues with Quantitative Tightening. Tighter Fed liquidity should start to tighten financial conditions heading into 2025, helping the central bank rein in excessive inflation.

France snap elections: what does it mean for the economy?

European election results aligned with expectations and confirm the centrist pro-European majority continuity. The centrist pro-European majority obtained 63% of votes (or 456 seats, 54 more than the minimum required to form a majority). However, the EU Parliament will become one of the most polarized in EU history as the extreme right increased their share of the vote to almost a quarter of the seats, led by ECR (73) and ID (58). The far-right vote is usually motivated by factors such as purchasing power, immigration, and security. The green transition and the war in Ukraine are the least important worries of the far-right electorate, with 5 to 10% of votes, according to Ipsos polls. The most likely coalition would seem to combine the EPP (189 seats), S&D (135 seats) and Renew (79 seats). The Greens (53 seats) could also join, but with strings and conditions attached. With a grand coalition, the EU legislative process on future policy priorities (defense integration, boosting competitiveness) should not be hampered in the next five-year legislative term. However, the shift to the right in the EU Parliament is likely to have some impact on the policy debate especially on migration and sustainability priorities.

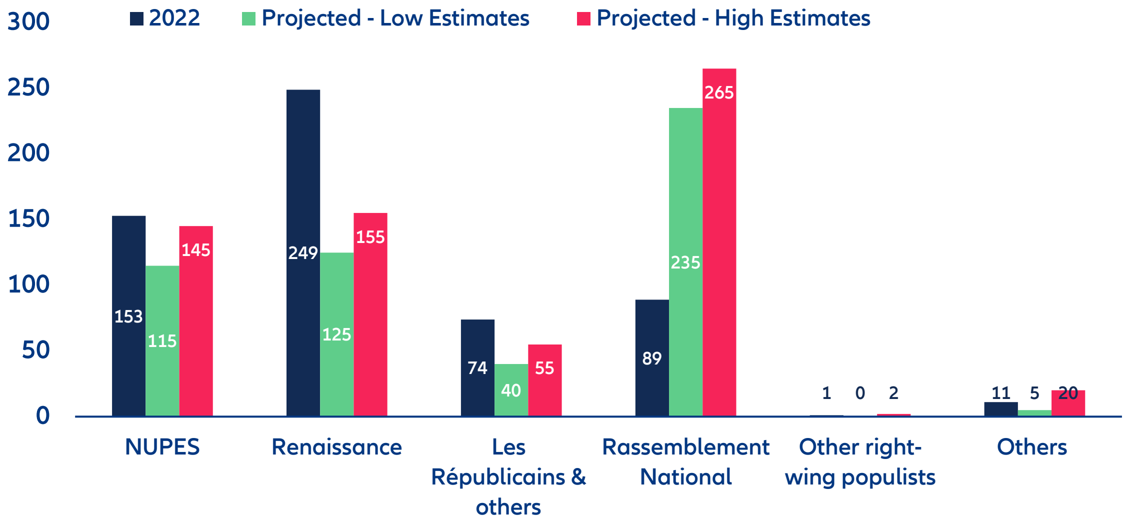
The big surprise came from France with President Macron calling for snap general elections on 30 June and 7 July. As the far-right *Rassemblement National* (RN), Marine Le Pen's party, came first with 31.4% of votes. President Macron decided to trigger Article 12 of the Constitution an hour after the results were known, choosing to dissolve the National Assembly and call for snap elections. Macron's party's poor performance (14.6% of votes), the strong rise of anti-European vote, and a difficult parliamentary situation (with repeated attempts at gathering a majority behind a no-confidence vote) must have motivated this radical move. The French will now have very little time to cast their ballot, the first round will be on 30 June (the 21st day following the dissolution) and the second round on July 7, a couple of weeks before the 2024 Olympic Games.

Markets were taken by surprise, rapidly pricing in a higher uncertainty risk premium on the euro, the French government bond yield, and other risky assets. This reflects heightened concerns about fiscal slippage and the potential for a doom loop scenario. This is not an unknown market reaction as political polarization, especially when voters shift towards extreme positions, tends to lead to increased market volatility due to the uncertain outlook for governance. In numbers, the CAC 40 dropped 2.7%, compared to a 1.7% fall for the Euro Stoxx 50. The euro depreciated by -0.9%, and French sovereign spreads widened by +12 bps, compared to +10bps in Italy and +6bps in Spain (numbers as of June 11, 2024). Despite these developments, market expectations for the ECB have remained unchanged, with just over one more rate cut anticipated in 2024. Since then, markets have partially reversed the initial risk-off rotation. However, French assets still retain approximately 50 to 60% of the initial shock on a structural basis.

The polls (though highly uncertain) point to the potential formation of a minority far-right government as projected seats for RN are 235-265. The first polls for this election (Figure 1) project 235-265 seats for the RN – short of the absolute majority at 289 seats. Macron's party (and allies) is projected to obtain 125-155 seats. LR is projected to win 40-55 seats and Front Populaire 115-145. However, higher participation rates, two-rounds, and certainly some left-over "cordon sanitaire", a very French anti-far-right movement, make the outcome hard to predict. In addition, domestic political alliances keep blurring the lines between a so-called *Front Républicain* and parties deemed extreme: (i) on the one hand, half of the conservative right party *Les Républicains* (LR) is willing to support the *Rassemblement National* (RN); and (ii) on the other hand, the '*Front Populaire,'* managed to gather all left-leaning parties, including the extreme left *France Insoumise*.

We continue to believe such scenario would be short lived (if happening at all) and a hung parliament reality check would push for the formation of a minority, technocratic, *Front Républicain* government (our central scenario). A third scenario, less plausible at this stage, is a minority left government. If the far-right becomes the first coalition in the National Assembly President Macron would likely appoint Jordan Bardella as Prime Minister, the leader of the RN. However, a RN-led government would face stiff opposition of the other groups in the National Assembly. They would probably unite to form a no-confidence vote ('*motion de censure'*) and take down the government. Political deadlock would mean, in our view, that opposition parties (the left, the centre and the moderate LR) would agree to appoint a technocratic government/Front Républicain, yet minority government to run current affairs until the 2027 presidential election. This union would have to compromise with both right-leaning and left-leaning MPs. Fiscal consolidation efforts and structural reforms would be stalled and not much would be expected on the economic policy front.

Figure 1: Projected National Assembly seats June-July 2024 election out of the total of 578 seats



Sources: Harris, Allianz Research

We estimate the GDP and public finances impact of two scenarios: RN minority government, and a technocratic-*Front Républicain* (still minority government for Macron's party). To do so, we estimate the fiscal impulse, the bond market impact and the equity market impact, with the latter two shocks affecting financial conditions and private agents' confidence. In our pre-election baseline, we expected French growth at +1.3% in 2025 and +1.2% in 2026, equity market to rise +10%, and government interest rates to drop below 2.5% by end-2025. The results of the three scenarios are summarized in Figure 3.

The RN's economic platform entails a net fiscal cost (debt-funded) of around 0.7% GDP or EUR18bn (excluding the unwinding of the pension reform and the nationalization of highway) based on more realistic assumptions on revenues. Their pledges include various social spending and tax cuts, such as a cut to the VAT on energy products, new healthcare spending, reductions in production tax income tax and social contributions cuts (see Figure 2). The nationalization of the national highways would entail a very large cost of EUR40-50bn but has been ruled out by the Party in the next legislature. An unwinding of the pension reform would cost a lot to the public finances, but more the burden would materialize on the medium-term. On the revenue side, the RN plans to fund these measures through the privatization of public broadcasting, reducing the French cash transfer to the EU, savings on state operations, lowering benefits for immigrants or a clamp down on tax & social evasion. New spending and tax cut measures have been evaluated at EUR56bn (in 2022 euros), excluding the cost of unwinding the pension reform and the nationalization of highways, vs around EUR48bn of revenues raised. However, receipts look very challenging. Privatizing public broadcasting would face stiff opposition and likely strong pushback from unions. The clampdown on tax & social evasion also appears ambitious[1] and uncertain as well as the savings on immigration[2]. We would deem EUR38bn of revenue raised as more realistic. In total, we estimate a RN-led government would deliver around +0.7% of GDP (EUR18bn) of net fiscal easing.

We estimate the GDP and public finances impact of two scenarios: RN minority government, and a technocratic-*Front Républicain* (still minority government for Macron's party). To do so, we estimate the fiscal impulse, the bond market impact and the equity market impact, with the latter two shocks affecting financial conditions and private agents' confidence. In our pre-election baseline, we expected French growth at +1.3% in 2025 and +1.2% in

[1]*They are at the top of estimates.*

[2]*Some measures could be challenged by the French constitutional courts.*

2026, equity market to rise +10%, and government interest rates to drop below 2.5% by end-2025. The results of the three scenarios are summarized in Figure 3.

Figure 2: Selected economic measures of Rassemblement national (RN)

Spending	Estimated amount (EUR)	Receipts	Estimated amount (EUR)
Pension reform: restore full retirement at age 60 with 40 years of service and increase the minimum pension*	17bn	Privatize public broadcasting TV/radio	4bn
Income tax exemption for under 30-yr old	3.7bn	Cut back on NGO funding	2-4 bn
Exempt from employer's contributions increases of 10% in salaries below 3 Smic	10.5bn	Savings on immigration*	16bn
Exempt corporate tax for self-employed below 30 for first 5 years	<3bn	Clamp down on tax & social evasion	15bn
Reduction in production tax	9.6 bn	Savings on local government operating costs	5bn
Reduction of VAT from 20% to 5.5% on fuel, electricity, gas and heating oil	10.3bn	Reduction of EU transfer	5bn
Nationalize highways*	40 - 50bn	Reduction of green subsidies	5bn
Urgency plan on medical care	20bn		
Total	**114-124 bn**	**Total**	**52-54**

**Probably excluded from the next RN-led government ** e.g. Removal of Universal Healthcare*

Sources: Rassemblement national, Institut Montaigne, various, Allianz Research

Figure 3: Macro-economic impact of government scenarios

	Pre-election baseline			Technocratic-*Front Républicain* (still minority government for Macron's party)			Majority RN government		
	GDP growth	Fiscal deficit	Public debt	GDP growth	Fiscal deficit	Public debt	GDP growth	Fiscal deficit	Public debt
2024	0.9	-5.1	111.7	0.9	-5.1	111.8	0.8	-5.2	111.7
2025	1.3	-4.3	112.6	1.3	-4.8	113.2	1.0	-5.8	114.6
2026	1.2	-3.9	113.0	1.2	-4.8	114.4	1.2	-6.4	117.4

Sources: Oxford Economic, Allianz Research. Note: the majority RN government scenario does not include the cost of nationalization of highways and the unwinding of the pension reform.

Under a technocratic government the growth outlook would barely be affected but the public deficit will remain close to 5% of GDP. Under this scenario, we think that political deadlock would mean a slightly tight fiscal stance to assuage markets (0.2% of GDP per year), compared to our expectation of 0.7% of GDP in 2025 and 0.5% of GDP in 2026 under the Attal government. Structural reforms started under the Attal government (such as the unemployment benefit reform) would be stopped. Interest rates on French bonds would fall slightly below 3%, equity prices rise by 7%. GDP growth would barely change from the pre-election baseline. This is because tighter financing conditions would be offset by a less tight fiscal stance. However, public deficits would be barely reduced to only -4.8% of GDP by 2026 (after -5.5% in 2023) against -3.9% of GDP in our pre-election baseline.

Under a RN government the French risk premium will surge. It would be France's Salvini moment. GDP growth would drop to +1% in 2025 (-0.3 p.p. relative to pre-election) despite the fiscal expansion. Public deficits would

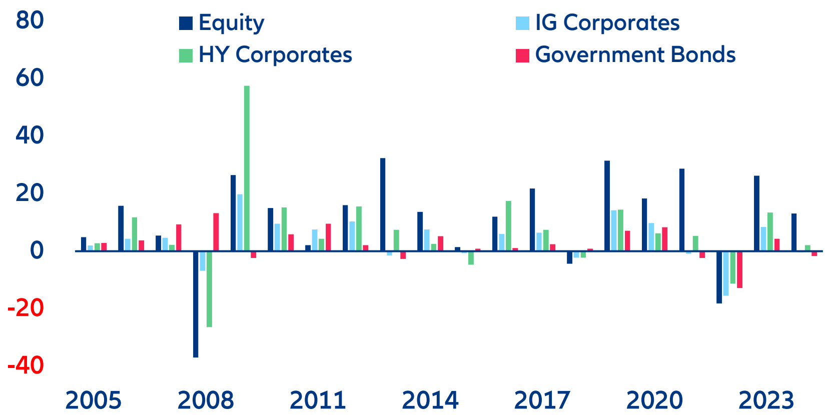
rise around -6.4% of GDP by 2026 and the debt-to-GDP ratio would climb above 117%. Historical precedents like Italy's 2018 elections show a realistic benchmark for what could happen if France decides to shift to the far-right. In Italy, the far-right Lega's coalition with the Five Star Movement led to political uncertainty, widening BTP spreads, and a 20% drop in equity markets. Similar market volatility could happen in France if the far-right gains significant power. While the situation in France is somewhat unique, it bears similarities to Italy in 2018. Drawing from the Italian scenario, if Marine Le Pen's party were to gain structural control of France's national assembly, it is estimated that the resulting "right-wing" shift could cause a +50 basis point widening in 10-year French government bond spreads. This would likely be a reaction to heightened risks of fiscal slippage and increased intra-European tensions. Please note the dampening effect of the ECB which should not be underestimated in calming markets down.

Not all fiscal spending boost growth and not all revenue-raising measures hurt growth. We remove the reduction of the EU transfer and the receipts from privatization of public broadcasting TV/radio on the revenue side as these items do not affect economic activity. In total, under a majority RN government, the fiscal expansion would be around 1% of GDP (EUR 27bn). Under this scenario, we would expect interest rates to climb to 3.5% by 2025 and stay above 3% in 2026 as financial markets react negatively to the fiscal costs. Equity prices would drop by 10% by the end of 2024 and remain weak through 2026. Our estimates show that GDP growth would be 1% in 2025 (-0.3 p.p. lower than projected pre-election) because the growth-boosting effect of the fiscal expansion is more than offset by tighter financing conditions and lower confidence hitting private spending. The public deficits would climb to around 6.4% of GDP by 2026 (EUR 199bn) because of lower growth, higher interest expenses, and higher fiscal spending. The debt-to-GDP ratio would rise above 117% of GDP.

The equity risk premium puzzle

Attractive fixed-income yields are not distracting investors from equity markets. Except for 2022 – when all asset classes suffered stagflation – equity markets have delivered above-average returns since 2020. The trend looks set to continue in 2024 despite economic headwinds. Interestingly, this is also the case in a risk-adjusted context. Sharpe ratios[3] indicate that equities continue to exhibit the highest risk-adjusted returns among all US liquid asset classes, outperforming their fixed-income counterparts (Figure 4 & 5).

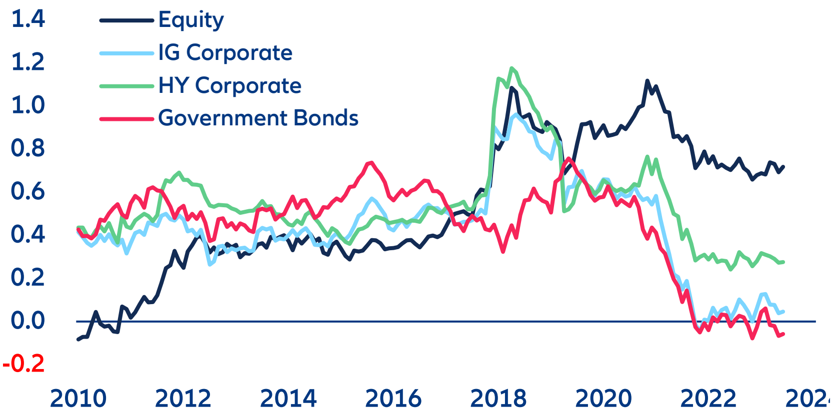
Figure 4: US yearly total return performance (in %)



Sources: LSEG Datastream, Allianz Research

[3] The Sharpe Ratio measures the risk-adjusted return by comparing excess returns to their standard deviation.

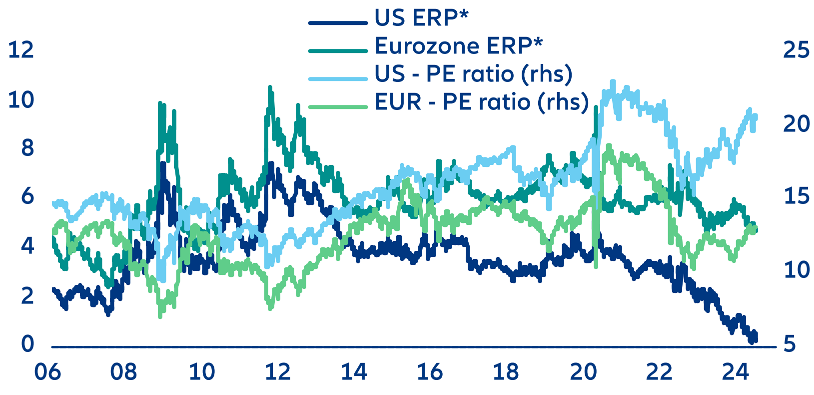
Figure 5: US assets Sharpe ratio (10y rolling – monthly returns)



Sources: LSEG Datastream, Allianz Research

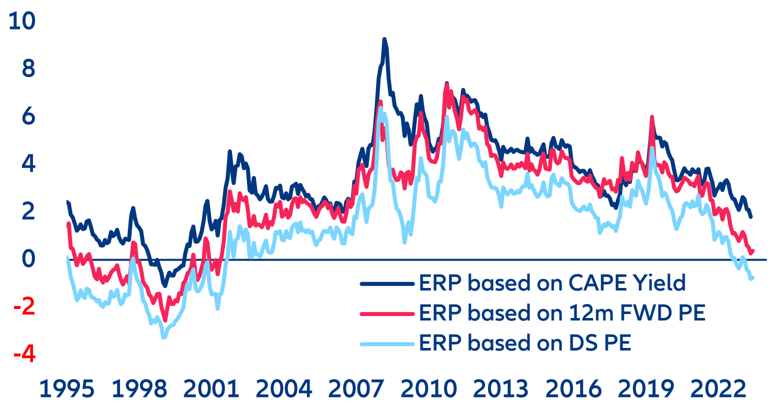
The upward momentum is somewhat justified, but the trend defies the conventional wisdom of Equity Risk Premium (ERP) metrics, which suggest investors may be paying an increasingly larger premium, especially in the US. Strong earnings resilience is evident across the board, and thematic trends such as artificial intelligence, reshoring, defence and the climate transition continue to drive upward revisions in earnings and pricing expectations. In the US, the ERP, defined as the difference between the earnings yield (the inverse of the Price-Earnings ratio using 12-month forward earnings) and the risk-free rate (ten-year government bond yield), is currently 0%. This suggests that investors in the US are receiving minimal additional returns for equity risk compared to government bonds. In contrast, in the Eurozone, the ERP is around 5%, indicating a higher compensation for risk. This disparity is further highlighted by the high PE ratio in the US (~21x) compared to Europe (~13x), making US equities appear more expensive relative to their government bond and transatlantic counterparts (Figure 6). Other metrics confirm that the current trend is defying conventional wisdom. The renowned Shiller cyclically adjusted PE ratio indicates a US equity risk premium above 1%, a historically tight compensation comparable to the period following the 2000s dot-com bubble (Figure 7). In the Eurozone, various metrics suggest that the equity risk premium ranges between 3% and 5%, still offering a compelling argument for equities over government bonds, although not near historical highs (Figure 8).

Figure 6: US and Eurozone Equity Risk Premium (ERP)



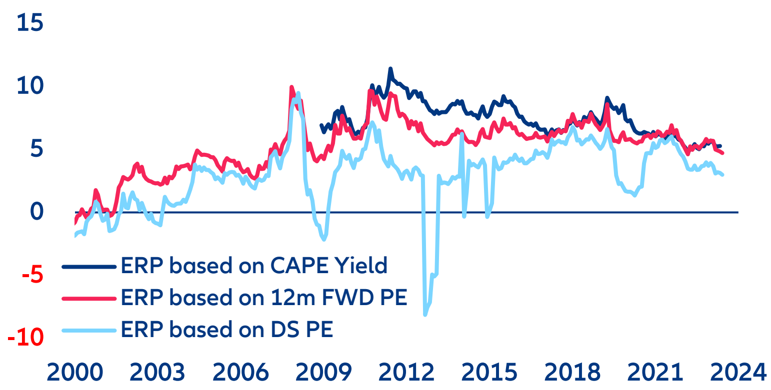
Sources: I/B/E/S, LSEG Datastream, Allianz Research

Figure 7: US (S&P 500) Equity Risk Premium (ERP)



Sources: I/B/E/S, LSEG Datastream, Allianz Research. Note: CAPE: Shiller Cyclically Adjusted PE ratio, DS represents the LSEG Datastream sourced coincident PE ratio.

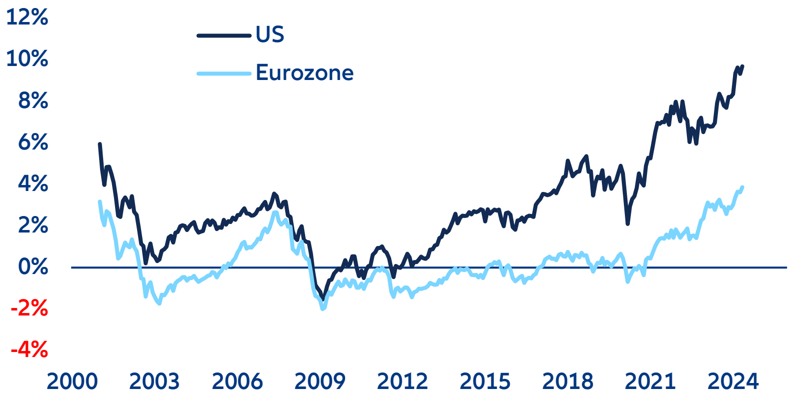
Figure 8: Eurozone (Eurostoxx 300) Equity Risk Premium (ERP)



Sources: I/B/E/S, LSEG Datastream, Allianz Research. Note: CAPE: Shiller Cyclically Adjusted PE ratio, DS represents the LSEG Datastream sourced coincident PE ratio.

Ultimately, the market-based ERP suggests that the current equity outperformance may be a significant self-fulfilling prophecy. By focusing on an adaptive metric for the total return of equities versus government bonds, it becomes clear that the perceived equity risk premium continues to accelerate, reaching its highest point in the US and the Eurozone since the dotcom bubble. Assuming this metric is a reliable indicator of forward-looking expectations, it is reasonable to argue that, despite equity price dynamics drifting from fundamental valuations, the ongoing outperformance of equities compared to bonds reinforces forward-looking expectations in favour of equities. This trend discourages market participants from rotating into fixed-income positions as the opportunity cost of shifting amid the recent market rally can be perceived as too high, preventing a fundamental rotation based on fundamental relative attractiveness (Figure 9). In this scenario, despite the unattractive valuation of equities compared to government fixed income, equity markets might still find support due to strong earnings resilience and thematic trends such as artificial intelligence, reshoring, defence and the climate transition. These factors could lead to a fundamentally based increase in the ERP, potentially sustaining the year-to-date positive equity performance. However, it is worth noting that the upcoming policy pivot and its expected effect on the long end of the curve will mean that risk-free yields may not be as attractive as they are today for a while.

Figure 9: Market-based smoothed ERP



Sources: LSEG Datastream, E. Barthalon (2014), Allianz Research. Note: The smoothed ERP is derived from a self-updating dynamic exponential smoothing method.

Fed: Will the conundrum of easy financial conditions soon be resolved?

The Fed, in a cautious move, now expects only one rate cut this year amid still too hot (though easing) inflation. As widely expected, the FOMC decided to keep the target range of the Federal funds rate at 5.25-5.5%. The median FOMC projection shows only one 25bp rate cut this year against three expected in March. For the end of 2025, they pushed up their forecast slightly, to 4-4.25%. Despite inflation slipping a bit more than expected in May (at +3.3% over the past 12 months, vs. +3.4% in April), underlying price pressures remain too elevated for the Fed's liking. The May payroll report indicated strong wage growth, with average hourly earnings increasing by +0.4% m/m, or +4.1% y/y (from +3.9%). This is too high for the Fed's liking in the context of a still strong, though easing, labor market. Despite the slight rise in the unemployment rate from 3.9% to 4%, the labor market still looks healthy, with initial jobless claims and the layoff rate remaining at very low levels. The vacancy-to-unemployment (V/U) ratio – an indicator of labor market tightness closely watched by the Fed – was cooling at 1.2 in April (from 1.3) but is still above its pre-pandemic level. A simple empirical Phillips curve relating labor market slack to inflation suggests that the V/U ratio needs to fall below one for inflation to settle consistently around 2%.

We now expect the Fed to start its rate easing cycle in December. We have marginally pushed up our end-2025 rate forecast to 4%. We noted in a previous report[4] that inflation does not look like normalizing before Q4-2024. By cutting interest rates in September, the Fed risks moving too early amid still loose financial conditions (see below). Besides, a September rate cut, in an environment of still elevated GDP growth and inflation above 2%, could backfire on the Fed if it gets politicized ahead of the November election. Candidate Trump has repeatedly accused the Fed of preparing a rate cut to boost Biden's re-election prospects before the election.

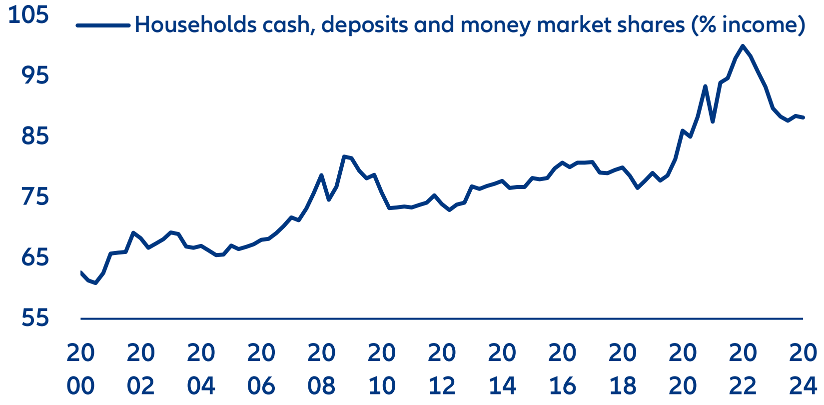
Elevated interest rates are affecting some segments of the economy ... Segments sensitive to interest rates are undoubtedly suffering from elevated funding rates. For instance, in the residential market, existing home sales remain rock bottom while new construction has stalled since the beginning of 2024. Low-income households also feel the pinch of high interest rates on consumer credit. The delinquency rate on consumer loans reached 2.7% in Q1 2024, the highest since early 2012.

... but broad monetary and financial conditions are not as tight as they appear, creating a conundrum for the Fed. The monetary base (an indicator of liquidity that consists of the currency in circulation plus banks' deposits held at the Fed) is almost 70% above its end-2019 pre-pandemic level, or 43% in inflation-adjusted terms. It has even *accelerated* since early 2023, partly because of the injection of fresh liquidity by the Fed into the banking system in

[4] What to watch I May 16, 2024 (allianz.com)

March-April 2023 during the regional banking crisis. As a result, lending standards from the financial sector to private agents are not as tight as often assumed. While the SLOOS survey on banks' lending standards still shows many banks tightening credit supply, the NFIB survey indicates that the number of SMEs reporting tighter loan standards has not increased so much. This is because lending from non-bank financial institutions has stepped up. Additionally, households are still flush with liquid assets[5], equivalent to over 88% of their disposable income, against 75-78% in the five years before the pandemic (Figure 10). This still leaves room for households to continue to spend by digging further into their pockets.

Figure 10: Households' cash, deposits and money market shares (% income)



Sources: LSEG Datastream, Allianz Research

We expect liquidity to start contracting as soon as the Fed continues with Quantitative Tightening (QT). The Fed began downsizing its bloated balance sheet in mid-2022 by reducing its Treasury and mortgage-backed securities holdings. Usually, there is a close connection between the Fed's securities holdings and monetary base growth (Figure 11). However, this time, the expected result has been delayed because of the 2023 injection of liquidity by the Fed and technical reasons linked to the rapid outflows from the reverse repo facility[6]. With the normalization of the reserve repo facility, the run-down of the Fed's asset holdings will soon start to exert downward pressure on bank reserves and the monetary base, which should start dropping in early Q4 2024.

Figure 11: Monetary base & Fed' securities holdings

Sources: LSEG Datastream, Allianz Research

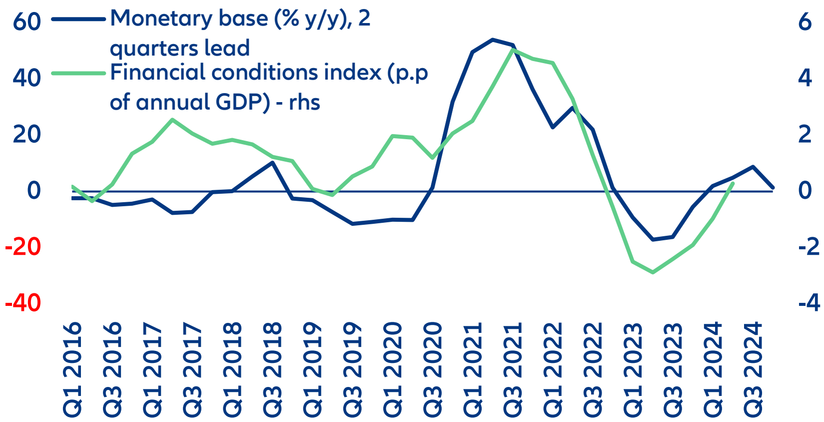
---

[5] Cash, deposits and money market shares.

[6] Money market funds have withdrawn liquidity from the facility to soak up the new bond issuances of US Treasuries in the place of banks. Hence, banks' reserves at the Fed have not decreased (quite the opposite), pushing up the monetary base.

Tighter Fed liquidity should start to tighten financial conditions heading into 2025, helping the central bank rein in excessive inflation. The growth of the monetary base moves in tandem with our in-house financial condition index[7], with the former leading the latter by around two quarters (Figure 12). This suggests that the drop of the monetary base in early Q4 2024 that we forecast should start to tighten financial conditions by early/mid 2025. This is probably what the Fed is striving for as it seeks to moderate economic growth and inflation.

Figure 12: Monetary base & financial conditions index



Sources: LSEG Datastream, Allianz Research

[7] *Our FCI encompasses corporate bond yields, the stock market index and house prices (all in real terms).*

These assessments are, as always, subject to the disclaimer provided below.

FORWARD-LOOKING STATEMENTS

The statements contained herein may include prospects, statements of future expectations and other forward-looking statements that are based on management's current views and assumptions and involve known and unknown risks and uncertainties. Actual results, performance or events may differ materially from those expressed or implied in such forward-looking statements.

Such deviations may arise due to, without limitation, (i) changes of the general economic conditions and competitive situation, particularly in the Allianz Group's core business and core markets, (ii) performance of financial markets (particularly market volatility, liquidity and credit events), (iii) frequency and severity of insured loss events, including from natural catastrophes, and the development of loss expenses, (iv) mortality and morbidity levels and trends, (v) persistency levels, (vi) particularly in the banking business, the extent of credit defaults, (vii) interest rate levels, (viii) currency exchange rates including the EUR/USD exchange rate, (ix) changes in laws and regulations, including tax regulations, (x) the impact of acquisitions, including related integration issues, and reorganization measures, and (xi) general competitive factors, in each case on a local, regional, national and/or global basis. Many of these factors may be more likely to occur, or more pronounced, as a result of terrorist activities and their consequences.

NO DUTY TO UPDATE

The company assumes no obligation to update any information or forward-looking statement contained herein, save for any information required to be disclosed by law.

Allianz Trade is the trademark used to designate a range of services provided by Euler Hermes.