



Pivotal political week ahead in Europe

As we move into the second half of 2024, the market's lens has shifted from central banks to politics for now, with two pivotal elections taking place in the UK and France this week. While polls suggest the UK election will yield a resounding victory for Labour, the outcome of the French election remains uncertain, with Macron's party trailing both Left and Right blocks after the first round.

Thus, political events could bring increased volatility on European markets in the coming week. In the run-up to the election, the French 10-year bond spread to the German bund, a measure of relative risk of French public debt, widened to the highest level since 2012. However, this has fallen in the aftermath of the 1st round, and the Euro has gained ground against the dollar, as initial analysis suggests the Right will not win a majority in the run-off, with tactical voting may come into play.

With a hung parliament a live possibility, the French political system could be set for a period of deadlock and instability, with neither block able to elect a Prime Minister immediately. In this scenario, Macron may be able to form a Government with elements of the centre-right and left, but this could come at the cost of unwinding of some of his signature policies, including the recent pension age reform.

Whatever the outcome, the next Government's hands will be tied on fiscal policy. Alongside six other countries, France has now entered an excessive deficit procedure (EDP) with the EU Commission,



which will require the Government to present a 4-year plan to bring its deficit down. 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. Analysis of election manifestos suggests the economic plans both Left and Right would expand this deficit further, but markets would likely curtail excessive deficit spending. The Liz Truss 'Mini Budget' highlights the limits of investor appetite to fund fiscal deficits underpinned by incoherent fiscal policy.

Amidst the political noise, the past week has also been marked by relatively dovish commentary from ECB members, including Bank of France President Villeroy stating the "disinflation process is on track" despite a "bumpy" inflation profile. Elsewhere, the Bank of Japan is coming under increasing pressure to hike rates further, as the Yen broke through a 38-year low against the dollar last week, well beyond the levels which spurred a currency intervention by Japanese Government in April.

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