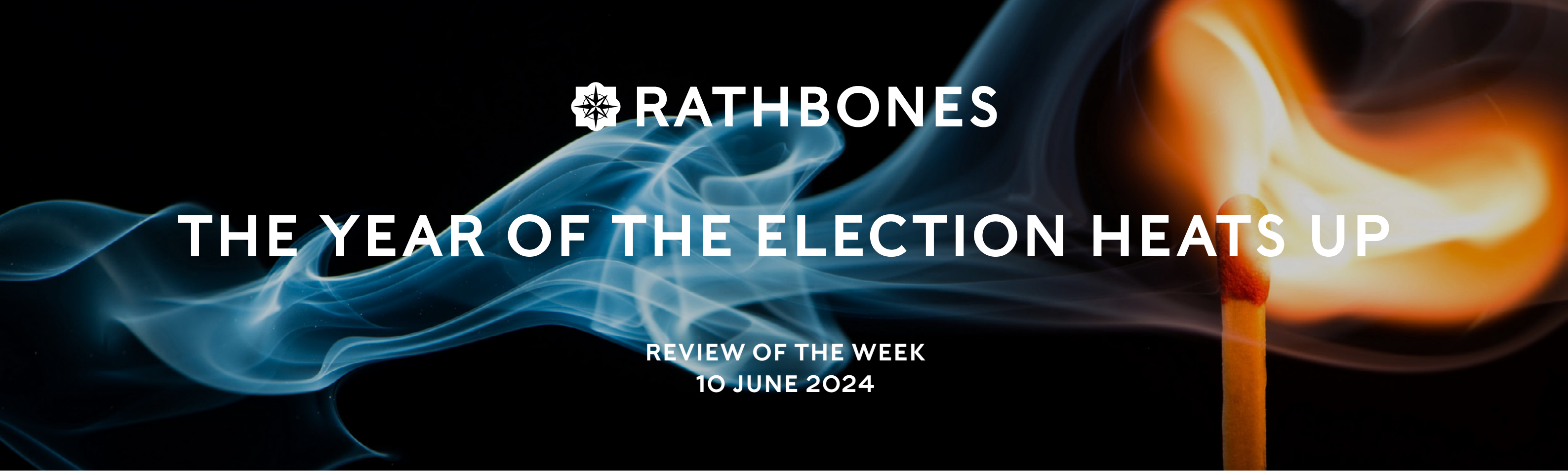

RATHBONES

THE YEAR OF THE ELECTION HEATS UP

REVIEW OF THE WEEK
10 JUNE 2024

THE YEAR OF THE ELECTION IS ALREADY PROVIDING WARNING SIGNS TO EXPECT THE UNEXPECTED. EVEN WHEN OUTCOMES AREN'T A HUGE SURPRISE, PAINFUL (IF TEMPORARY) PITFALLS MAY LIE AHEAD.

Politicking is really heating up. No, not here in the UK where the election campaign may have turned more testy, but things are largely shock-free. It's elsewhere that voter expectations are getting burned.

Remember this is the Year of the Election. About 40% of the world's population will elect new leaders before 2024 comes to a close. Last week's big news was the surprise outcome of India's parliamentary polls. Prime Minister Narendra Modi secured a third term, but his Bharatiya Janata Party (BJP) failed to win an outright parliamentary majority. That humbling forced Modi to forge a coalition government for the first time since he took power a decade ago (more on that later).

And this week kicks off with a really huge shock after France's President Emmanuel Macron decided yesterday to call snap parliamentary elections.

Macron rolls the dice

Macron opted to dissolve parliament following the crushing defeat of his centrist Renaissance party at the hands of Marine Le Pen's far-right populist National Rally (RN) in European Union (EU) elections over the weekend.

The centre-right European People's Party clung on to its position as the largest single group in the EU parliament, but – as expected – far-right populists made sizeable gains in France and Germany in particular. German Chancellor Olaf Scholz's centre-left Social Democrats were soundly trounced by the far-right Alternative for Germany (AfD) and they dropped to third place. And the coalition that supports Macron (five parties altogether, including Renaissance) won less than half the votes cast for RN.

Macron has taken a mighty big gamble by calling National Assembly elections in the hope French voters baulk at the prospect of a RN government. France will go to the polls for two rounds of voting on 30 June and 7 July (the Sundays before and after the UK's elections). If Macron's gamble backfires and RN wins a majority in the National Assembly, the prime minister's job would likely go to Le Pen's 28-year-old protégé Jordan Bardella. And President Macron would be forced to see out the last three years of his presidency in what the French call a *cohabitation* with the RN. It's unlikely to be a cosy living arrangement.

RN currently holds only 88 out of the 577 seats in the French parliament compared with 159 for Macron's Renaissance. It's likely to gain more seats in the upcoming polls, but winning another 201 to obtain a majority looks remote. The most likely outcome seems another coalition led by Macron.

Macron's announcement has triggered an immediate sell-off in French stocks and bonds which, in turn, has dragged down Europe-wide indices. Hardly surprising. We all know markets get rattled by political uncertainty. But elections almost always *resolve* that uncertainty. History shows that markets will usually look through even the most dramatic political outcomes, provided their direct economic implications are limited.

France provides one of the few exceptions to this rule when François Mitterrand and his 'deep red' variety of socialism took charge of the Elysée Palace back in the early 1980s. But even then capital markets showed how good they are at adjusting and moving on: after 1983, when Mitterrand tacked just a little back towards the centre – his *tournant de la rigeur*, as the French put it – France's stock market managed to keep pace with other markets in non-socialist countries.

Our analysis suggests that elections rarely change pre-existing market trends, which are typically determined by factors outside governments' direct control, unless they bring in radically different economic models. And that's not something we see happening in developed economies this year.

… as Modi scrapes another win

In developing nations, elections more frequently alter the course of economies and capital markets, often because their institutions are more malleable and their economies more susceptible to spiking inflation. Three recent elections in big developing economies have been making waves over the last few weeks. In India, Mexico and South Africa, stocks sold off and currencies weakened as the results rolled in, even though the outcomes themselves weren't huge surprises.

The most notable market-mover was India's mammoth general elections, in which a staggering 642 million people cast their votes. The coalition led by Modi's BJP had long been expected to win a third term (voting began way back in April given the considerable logistical challenges involved in the world's biggest elections). Exit polls last week then suggested Modi was set for a landslide victory that might enable him to enact important business-friendly reforms.

In the event, the vote turned out to be much closer than these polls had suggested. The BJP-led coalition secured enough seats to form a government, but came in short of a 272-seat majority on its own.

Investors in Indian stocks who had bid up their already pretty rich prices to record highs in expectation of a Modi landslide began to sell them as they realised they'd badly miscalculated the scope of his victory. That triggered a savage sell-off in Indian stocks. They've now recouped these losses, but the sell-off is a salutary reminder that, **as we explained last month**, an awful lot of good news tends to be priced into Indian stocks. That leaves their prices particularly vulnerable to sharp corrections when the unexpected happens.

Central bank divergence

Outside politics, this week's main event will be the US Federal Reserve (Fed)'s June interest rate decision, alongside its updated projections for the path of rates, inflation and economic growth. Before markets open on Wednesday, we'll get May's consumer price inflation (CPI) data. A significantly hotter or cooler reading than expected could see some volatile repositioning, especially in bonds, ahead of the Fed's announcements in the afternoon.

With the market pricing in a near certainty of no move on rates, the Fed's 'dot plot' – which shows how each voting and non-voting member of the policy committee think rates will be adjusted over the next three years – will be the main focus. Markets are now fully pricing in only one quarter-point cut from the Fed in 2024 and the odds of a September quarter-point cut has dropped to 50/50.

At the beginning of this year, Fed was widely expected to be the first major central bank to cut rates. That would have upheld a tradition in place more or less ever since the Second World War whereby the Fed has always tended to cut rates before its global peers. The tradition was upended in 2011 when the European Central Bank (ECB) unexpectedly cut rates in a bid to ease the eurozone sovereign debt crisis and the Fed kept rates unchanged. There was another break with tradition in 2013 when the ECB again slashed rates as the Fed stayed on hold. But these divergences are vanishingly rare.

So it's understandable that there's a certain amount of nervousness about last week's decisions by the ECB and the Bank of Canada to leapfrog the Fed and cut rates by a quarter-point well before it does. (The Swiss National Bank and the Riksbank, Sweden's central bank, both cut earlier this year.)

Divergence from Fed monetary policy does not come without risks for the ECB. In particular, how might an early ECB rate cut impact on the exchange rate between the euro and the US dollar?

All other things being equal, it should weaken the single currency. That would make the price of exports from the eurozone to the US more competitive, but it would also push up the price of imports – particularly energy, which is priced in dollars. And that might risk stoking EU inflation uncomfortably higher. Could the ECB yet regret its bold move, particularly since eurozone inflation is already quite a bit above the bank's 2% target rate? It's a risk, but a calculated one that concurs with our assessment of the likely path of the economy from here.

If you have any questions or comments, or if there's anything you would like to see covered here, please get in touch by emailing **review@rathbones.com**. We'd love to hear from you.

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