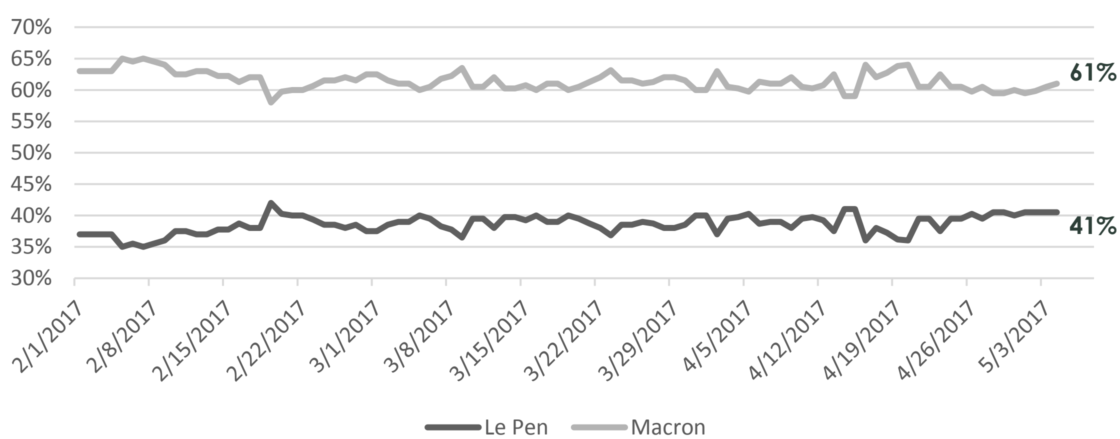
MACRON VS. THE COALITION OF THE UNWILLING: IT'S EHE TIME

By: Jeff Weniger

This weekend's French presidential election loss by the National Front's Marine Le Pen was never much in question. As recently as last week, the victorious Emmanuel Macron was the prohibitive favorite, priced at 1 to 10 odds. Brexit was a much closer race; "Leave" was trailing by only 2 points in referendum-day polls.[1] With similar margins, Hillary Clinton led 48.2% to 46.1%[2] in final polling, with Donald Trump ahead by 3 points in a major survey.[3]

The chart below shows why the French vote was not comparable: Macron's margin was of the landslide variety for months.

Bloomberg Composite Poll-of-Polls, French Presidential Election



Source: Bloomberg, 2/1/17 to 5/4/17.

Here's a Better Analogy

Macron hope = Trump hope.

"Trump risk" on November 7 turned into "Trumpflation" by November 9. Same guy, same platform, completely different investment theses. Why? The bull market needed a story, so it came up with one. The rise in the euro to more than CAD$1.50 from $1.38 in February also needed a story: "Macron-flation."

One of Macron's problems is that, like Trump's dilemma, he will find that upending the status quo requires a bold legislature. Trump struggles even with his own party, let alone the opposition Democrats. This poses a problem for the ascendant euro: Macron-induced economic revitalization may prove fleeting because it relies on a conciliatory Coalition of the Unwilling: The National Assembly, France's parliament.

1 Financial Times poll-of-polls, as of June 23, 2016, the day of the Brexit vote.
2 Real Clear Politics Poll Average, Final.
3 LA Times/USC Tracking Poll, 11/1/16–11/7/16. Election was 11/8/16.

Macron is about to meet the conflict of his life as he marches headfirst into confrontation with the opposition.

The Euro's Roadblock

Once a Socialist Party rising star, Macron had to scramble to save his career because he was associated with president Francois Hollande, whose approval rating at one point sank to 4%, just ahead of the bubonic plague.
So he put together En Marche!, his new left-of-center party comprising disillusioned Socialists who wanted to cast non-Le Pen protest votes. But he needs collective togetherness in the National Assembly, not protest votes. Elections are next month.

Remember, the euro rally coincided with anticipation of Macron's victory. The euro bulls have embraced a theme of nascent French dynamism spurred by his tax cuts and government streamlining, but the thesis is contingent on Macron's proposals passing parliament's Coalition of the Unwilling.

He must cobble together a ragtag group of Socialists and Greens to fall in line, even though many members of parliament are steaming from the political battles just waged by multiple players. He can ask for support from pro-business Republicans, but that cadre wants to claw back its base, many of whom left permanently for Le Pen's anti-establishment message. Le Pen's Euroskepticism ruffled feathers in the 7th arrondissement, but there are millions of votes elsewhere that Republicans may want to court by snubbing Macron.

The new president has his work cut out for him, yet the strong-euro thesis relies on France catching enough sustainable inflation and economic resilience to prompt the European Central Bank (ECB) to end its €60 billion-per-month bond purchase program. If the plan doesn't come together perfectly, expect the ECB to sit on its hands for longer than expected, spelling trouble for EUR as 2017 ages.

Let's Get Real: France Needs EUR Weakness

The French budget deficit was 3.4% last year and the Street is looking for a 3%+ deficit in 2017, another in a long line of Maastricht Treaty violations dating to the Lehman collapse.

How can France square up its finances? Not by growing out of it; the country's $2.4 trillion gross domestic product (GDP) expanded at an annualized 0.8% in the first quarter. Cut the military? Certainly not in the face of its obligations to its terror-prone former colonies. Certainly not with Paris serving as ground zero for European terrorism. Certainly not when a look across the Atlantic finds Trump holding NATO allies' feet to the fire in the war on terror. Macron can't touch pensions or hike taxes; labor reform prospects are tenuous at best.

The investing public is hanging its hat on ECB president Mario Draghi observing some soon-to-emerge economic sparkle that will allow him to end the bond purchase program. We will believe it when we see it.

EHE: There for the Taking

The WisdomTree Europe Hedged Equity Index ETF (EHE) could alleviate the headache and additional volatility that comes from bearing equity and foreign exchange risk at the same time. By allowing investors to distance themselves from the euro's fortunes, WisdomTree allows asset allocators to de-emphasize currency risk and European politics.

Furthermore, clear monetary policy divergence that makes hedging the euro particularly interesting at this moment is unfolding: the U.S. Federal Reserve (Fed) is hiking interest rates and the Street expects the Bank of Canada to follow suit by 2018, while the ECB may have to taper down its massive bond purchase program before it even thinks about increasing its deeply negative short-term rates. The yawning gap in interest rate differentials between Canada and Europe in turn suggests an intriguing level of interest income embedded in the forward contracts that EHE uses to hedge the euro. This rate is 1.3%, and growing. Unhedged strategies typically have no such embedded interest rate boost.

If we are right about Macron's star fading, investors will need to take a long look in the mirror and ask whether they want to deal with the euro headache right now. EHE may be of interest, especially if National Assembly elections start taking headlines.