**Blog 16/02/17 – Are Europe’s Political Risks Greater Than Markets Think?**

A month before the Dutch vote, should the markets be more worried about Europe’s political risks? True, five year CDS spreads, the classic worry-ometer, have widened a little but they remain well below 2011-12 levels. So let’s play devil’s advocate.

**Conventional Wisdom.** Harvard economist JK Galbraith coined the phrase “conventional wisdom” 60 years ago to describe commonplace beliefs which are acceptable and comfortable. Here is today’s conventional wisdom in six easy stages:

* The three key threats are Geert Wilders in the Netherlands, Marine Le Pen in France and Alternative fur Deutschland in Germany
* Geert Wilders will win the most votes but will not win power. The likely outcome is a five or six party coalition led by the current prime minister, Mark Rutte.
* Marine Le Pen will win the first round of presidential voting but lose the crucial, second round no matter who she faces.
* AfD is only polling around 12% of the vote compared with 30% for Martin Schulz’s SPD and 33% for Angela Merkel’s CDU and has little chance of doing much better
* In practice, a bigger problem for European markets is the ECB and its QE programme
* And, finally, there were big political shocks last year, namely Brexit and Trump, but the markets rode them without trouble

**Unconventional Wisdom.** Let’s see if we can dent that narrative. We agree that Wilders will not be the next Dutch PM. Moreover, Merkel and Schulz are strong favourites and will see off Frauke Petry. Thus, we should focus upon Marine Le Pen.

Le Pen, 48, is at the height of her political powers whereas Francois Fillon is fighting a corruption scandal and Emmanuel Macron, 39, is relatively inexperienced. In fact, she called Macron “my ideal opponent”: he is affluent, young, liberal and cosmopolitan.

She has abandoned some of Front National’s more extreme policies such as the death penalty and focuses upon globalisation, the ruling elite and the EU. What is the French for “take back control”?

Like Trump, she is a charismatic candidate facing some bland opponents. She is a good television performer; she appeals to the younger generation; and she is a campaigner with a cause. No one thought Donald Trump would win; no one thinks Marine Le Pen will. And if Le Pen does win, she has promised an EU referendum within six months.

However, she faces two big obstacles. First, high disapproval ratings among non-Front National supporters – a case of Anyone But Marine for many people. Second, the EU gets high approval ratings among French voters, by 60% against 28%, which makes her anti-EU message a tough sell.

**Investment Conclusion.** The French election is a binary event – a Macron win would be good for French assets; a Le Pen win would be bad. Thus, assigning probabilities to outcomes is not that helpful. Perhaps the best long only strategy is to ride the rally for now but to head for the exit if Marine Le Pen’s second round polls versus Macron move decisively above 40%,