EUR and France: des liaisons dangereuses

- **The EUR has once again become a pressure valve of choice for investors fretting about the growing fiscal and political risks in France ahead of the 2027 budget and presidential elections next April and May. We think, however, that factors like the contagion from the OAT selloff to the rest of the EGB market, its impact on the Eurozone financial conditions and ultimately the ECB policy outlook could matter more for the EUR outlook.**

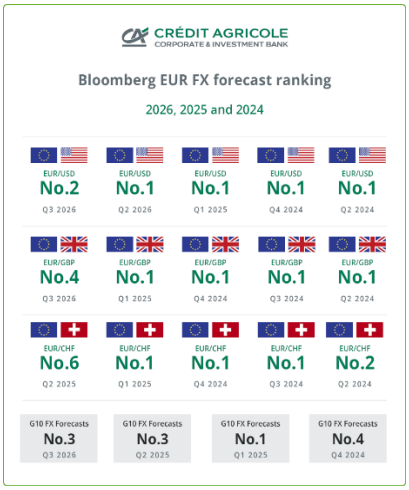
- **Crédit Agricole CIB macro and rate strategists have recently discussed different political scenarios ahead of the 2027 vote and analysed their EGB market impact. We complement their analysis by simulating the EUR impact under the different scenarios. We use the EUR/USD FAST FX model because it allows us to account for any contagion effects or any impact on the ECB policy outlook from the selloff in the OAT market.**

- **Our results suggest that the EUR could recover under several scenarios including our baseline – eg, either an RN or centrist president coupled with either a centrist or RN majority in the legislature – and some more positive outcomes – eg, a centrist president with either a technocrat, centrist or RN government. We see the OAT, BTP and Bono yield spreads to Bunds tighten notably to push EUR/USD back towards 1.17 or higher, consistent with our current EUR/USD forecasts for 2027.**

- **In contrast, should anti-establishment parties to the right or left of the French political spectrum end up controlling both the presidency and the legislature and are able to exercise fiscal restraint, our simulation results point at EUR/USD trading between 1.12 and 1.14. The most EUR-negative outcomes involve a hung parliament accompanied by either policy paralysis or runaway fiscal deficit. We see EUR/USD falling towards 1.05 under these outcomes.**



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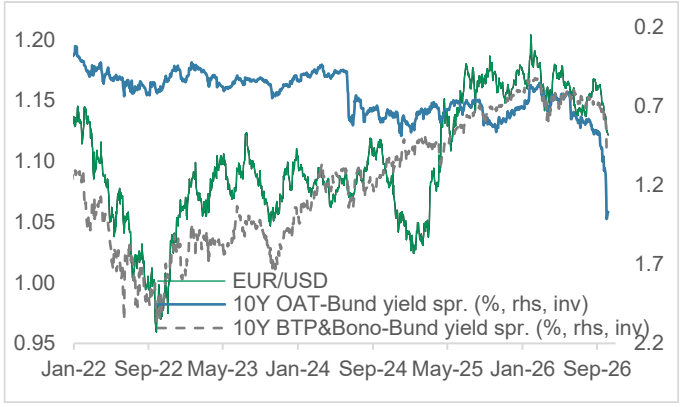
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Contagion and ECB more important than France?

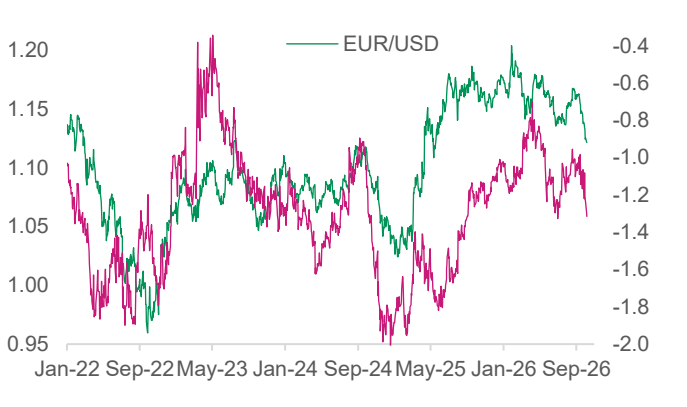
The EUR has once again become a pressure valve of choice for FX investors fretting about the growing fiscal and political risks in France ahead of the 2027 budget and presidential elections next April and May. The start of the French budget process last week acted as a catalyst for the correction in the FX and OAT markets (Figure 1).

Fig 1. EUR/USD vs 10Y OAT-Bund yield and debt-weighted 10Y BTP- & Bono-Bund spread



Source: Crédit Agricole CIB, Bloomberg

Fig 2. EUR/USD vs 2Y EUR-USD rate spread



Source: Crédit Agricole CIB, Bloomberg

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We further saw contagion to the BTP and Bono market intensifying recently. As a result, the debt-market-weighted BTP and Bono yield spread to Bunds hit its widest level in almost three years (Figure 1). We also note that the latter spread has been by far the stronger EUR driver in recent years than the OAT-Bund yield spread. We thus think that the EUR outlook would be driven more by the impact of the French political risks on the EGB market than the OAT market in isolation.

Contagion from the OATs to the rest of the EGB market could tighten Eurozone financial conditions to such an extent that they force the ECB to turn less hawkish. This is what happened when the energy emergency in Europe fuelled fears about a full-blown fiscal crisis in the Eurozone in 2022 (Figure 1). The sharp widening of peripheral spreads to Bunds forced the ECB to remain dovish despite growing inflation threat and this significantly eroded the EUR rate appeal vs the USD (Figure 2).

We have seen investors paring back their ECB rate hike expectations due to the latest tightening of Eurozone financial conditions. That said, the Eurozone economy remains resilient, and the ECB continues to focus on containing inflation. The bank further has tools to deal with any potential spike in sovereign credit risks. As a result, the EUR-USD rate spread has dipped but has not collapsed (Figure 2). Given the close correlation between the ECB relative rate outlook and EUR/USD, we expect that a continuation of the recent policy normalisation in the Eurozone would offer some support to the EUR.

In summary, **we are cautious on the EUR from current levels but doubt that a repeat of the aggressive 2022 sell-off is on the cards**:

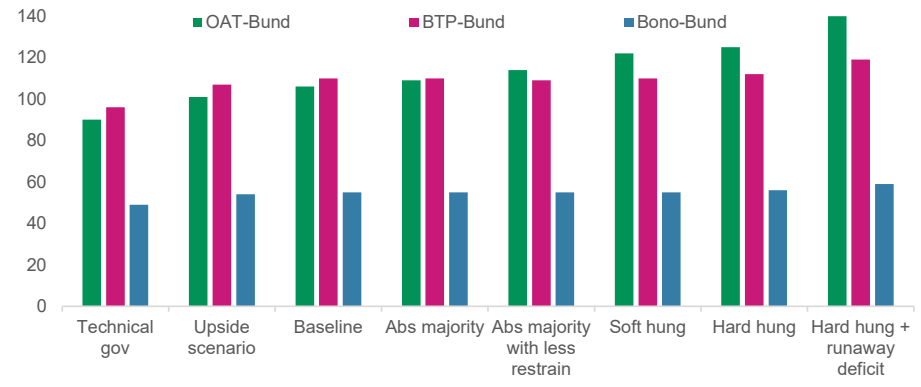
1. **The Eurozone economy shows considerable resilience, supported by robust domestic demand.**
2. **It remains to be seen whether the contagion from the OAT sell-off would intensify significantly further, in a blow to the EUR.**
3. **The ECB is very focused on containing inflation, and its hikes support the EUR rate appeal.**

The downside risks to our EUR outlook would grow, however, if the EGB market sell-off escalates and thus tightens European financial conditions, limiting the ECB's ability to hike too aggressively.

Election scenarios and their EGB market impact

The French fiscal and political outlook will remain a key driver of the EUR outlook in the next 6-9M. Crédit Agricole CIB macro and rate strategists have recently discussed the different political scenarios ahead of the election and analysed their bond market impact. We show the expected levels for 10Y OAT-Bund, BTP-Bund and Bono-Bund yield spreads as of the end of Q327 in Figure 3.

Fig 3. Q327 indicative 10Y spreads under different scenarios (Q327, bp)



Source: Crédit Agricole CIB

Our macro and rate strategists consider a base case of a centrist President and an RN majority in the National Assembly or an RN president and a centrist majority in the legislature. They also construct several additional scenarios that are meant to

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cover a wide range of positive and negative outcomes and their impact on the OAT as well as the BTP and Bono markets. Among these, the most positive outcomes involve a centrist president with either a technocrat government or a centrist majority in the National Assembly (Figure 3).

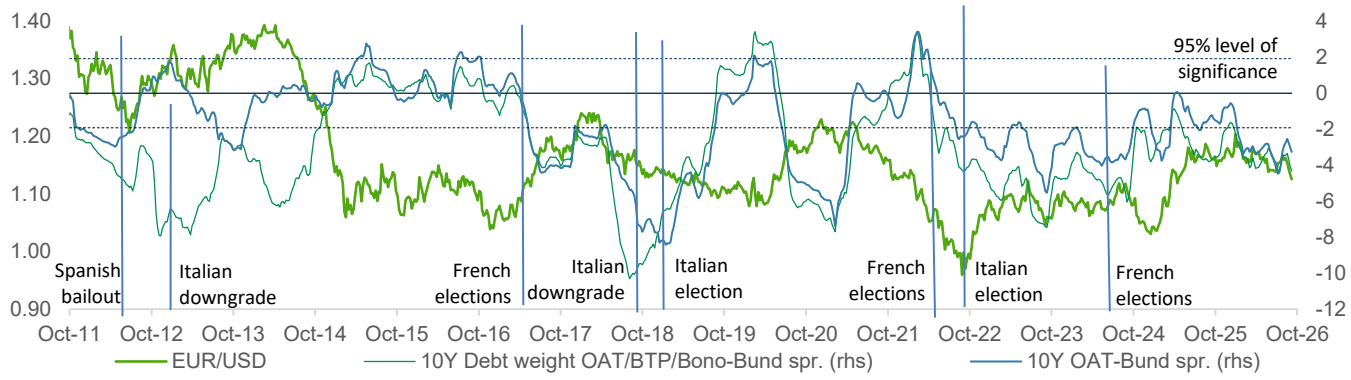
In contrast, the scenario with the most negative EGB impact would come from either an 'absolute majority with less fiscal restraint' or a 'hard hung parliament with runaway fiscal deficit' that would involve parties on the left of the political spectrum who are in charge of either the presidency or the legislature, or both. It is also worth highlighting that a hung parliament or absolute majority involving RN is expected to be less negative for the EGB markets (Figure 3).

Simulating the EUR/USD impact

In this section, we complement the analysis of our macro and rate strategists by looking at the FX market impact from the potential outcomes from the 2027 vote and the different configurations of political parties that it may entail. To this end, we use the forecasts from our rate strategy colleagues about the impact of the different election outcomes on the 10Y OAT yield spread over Bunds. We further consider a potential contagion to the rest of the EGB market by using forecasts for the 10Y BTP and Bono yield spread over Bunds (Figure 3).

We use our FAST FX EUR/USD model framework for our simulations (we replace the peripheral yield spread variable that is part of the model's specification). We use average historic beta coefficients that are calculated over periods with elevated sovereign credit risks. As a result, we are using higher beta coefficients for our simulations than estimated at present. Our econometric analysis also suggests that a debt-weighted-average of OAT, BTP and Bono yield spread over Bunds has a better explanatory power than OAT-Bund yield spread alone (see also Figure 4).

Fig 4. EUR/USD vs t-stats of 10Y OAT & BTP & Bono yield spreads to Bunds and 10Y OAT-Bund yield spread



Source: Crédit Agricole CIB, Bloomberg

We also incorporate our central bank rate expectations for the quarters ahead. Our economists expect the ECB and the FOMC to deliver one and two rate hikes respectively in the next 3-6M before cutting rates at the end of 2027. This compares with market expectations of 71bp and 81bp of ECB and Fed rate hikes respectively in the next 12M, at the time of writing. Our forecasts are thus more dovish than the market on the ECB and the Fed but more so on the former than the latter. These differences become important especially when simulating the FX impact of the more adverse outcomes that could both fuel contagion in the EGB markets and force the markets to turn more dovish on the ECB.

Prior to the EUR impact simulations, we further condense the eight scenarios shown in Figure 3 into five broader scenarios mainly because the results for the FX impact were quite similar for some of the scenarios.

1. **Positive scenario – Centrist president and either a centrist majority in the National assembly or a technocrat government**
2. **Baseline scenario – RN president and centrist majority or a centrist president and RN majority in the National Assembly**
3. **Adverse scenario 1 – Absolute majority for either RN or Left**

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4. Adverse scenario 2 – Hung parliament and policy paralysis

5. Adverse scenario 3 – Hung parliament with runaway deficit

Our results are shown in Figure 5 and are further depicted in Figure 6. They suggest that the EUR could recover under several scenarios including our baseline – eg, either an RN or centrist president coupled with either a centrist or RN majority in the legislature – and some more positive outcomes – like a centrist president with either a technocrat, centrist or RN government. We see the OAT, BTP and Bono yield spreads to Bunds tighten notably to push EUR/USD back towards 1.17 or higher. This would be with our current EUR/USD forecasts for 2027.

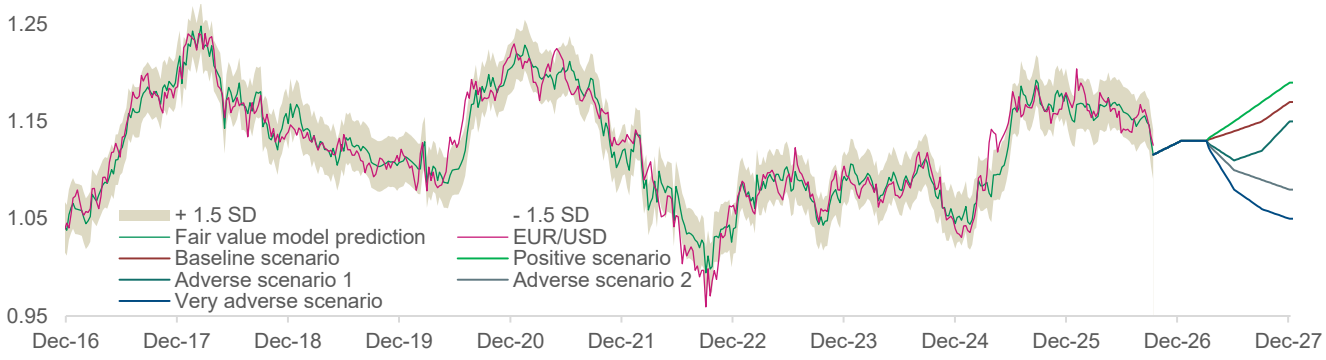
Fig 5. EUR/USD scenarios ahead of the French 2027 elections

	10Y OAT-Bund (bps)	10Y OAT/ BTP/ Bono vs Bund yield spread (bps)	EUR/USD
Positive scenario	90-101 in Q327/ 87-101 in Q427	84-93 in Q327/ 77-88 in Q427	1.17 in Q327, 1.19 in Q427
Baseline scenario	106 in Q327/ 105 in Q427	97 in Q327/ 92 in Q427	1.14 in Q327, 1.17 in Q427
Adverse scenario 1	109-114 in Q327/ 105-110 in Q427	98-100 in Q327/ 95-97 in Q427	1.12 in Q327, 1.14 in Q427
Adverse scenario 2	122-125 in Q327/ 127-132 in Q429	104-106 in Q327/ 105-109 in Q427	1.08 in Q327, 1.09 in Q427
Very adverse scenario	140 in Q327/ 150 in Q429	115 in Q327/ 122 in Q427	1.06 in Q327, 1.05 in Q427

Source: Crédit Agricole CIB

In contrast, should anti-establishment parties to the right or left of the French political spectrum end up controlling both the presidency and the legislature and are able to exercise fiscal restraint, our econometric results point at EUR/USD trading between 1.12 and 1.14. The most EUR negative outcomes involve a hung parliament accompanied by either policy paralysis or runaway fiscal deficit. We see EUR/USD falling towards 1.05 under these outcomes (see Figure 5 and 6). Should any of these outcomes materialise, they would pose significant downside risks to our current EUR/USD forecasts.

Fig 6. EUR/USD vs fair value and fair value projections, based bond yield and rate forecasts



Source: Crédit Agricole CIB, Bloomberg

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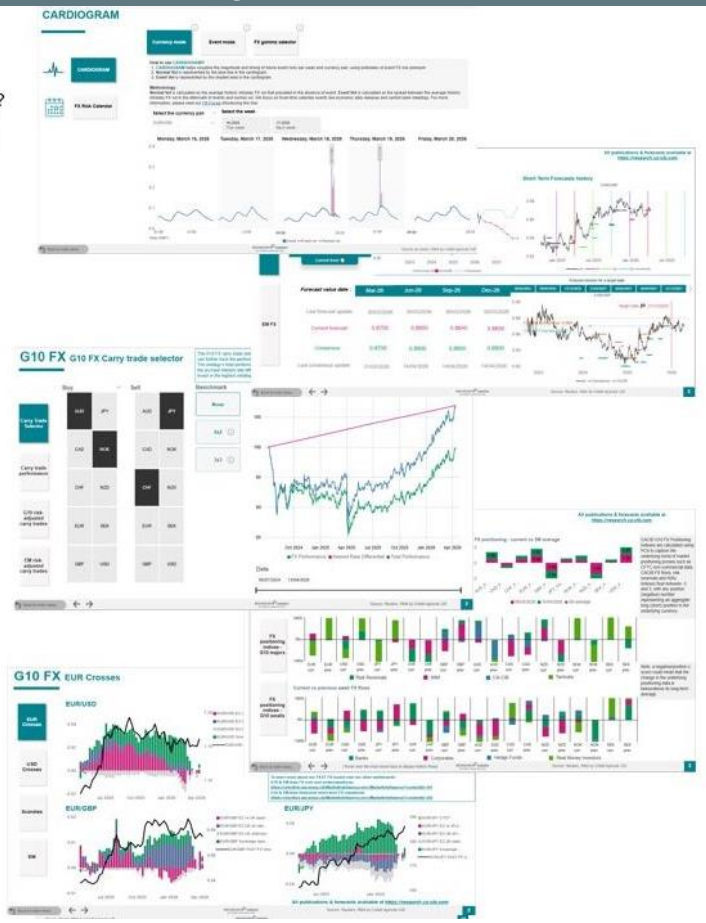
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