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Market focus shifts to policy uncertainty

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By Richard Milne, Capital Markets Editor

Markets took fright at the results of the French and Greek elections in early trading on Monday. But by the afternoon the fear had largely dissipated, as investors became more comfortable with an outcome that was broadly in line with forecasts.

Many analysts said a similar level of volatility was likely to persist in the coming weeks as markets tried to judge which policies François Hollande would adopt as French president, and if – and how – a Greek government would be formed. "The uncertainty has shifted from poor outcome uncertainty to policy uncertainty," said Marc Chandler, currency strategist at Brown Brothers Harriman in New York.

Some even cheered Mr Hollande's victory as potentially giving a more balanced view to economic discussions in the eurozone through his desire to promote growth rather than just austerity.

Didier Duret, chief investment officer of ABN Amro private bank in Geneva, said: "This new shared European agenda will be arduous to bring to life; it will bring short-term uncertainty. But the other side of the coin is that it will bring more weight on growth. Although it is very difficult to achieve, at least it brings some hope in the medium term."

Market movements on Monday highlighted that struggle. European bourses fell in early trading while French, Italian and Spanish borrowing costs rose as investors fretted about the messy Greek result in particular.

But by lunchtime the mood changed, with European shares recovering and French borrowing costs falling as some investors decided the selling was overdone.

Greece remains a significant concern, almost three years after it sparked the eurozone crisis. Some in the markets fear that the difficulty in forming a government in favour of the second international bail-out agreed earlier this year could eventually jeopardise Greek membership of the euro.

European economists at Citi raised the likelihood of what they call a "Grexit" to 50-75 per cent from 50 per cent previously. But others dispute whether the odds are that high.

"The risks have clearly increased that [Greece] can't form a pro-programme government. But it's one thing not to agree a government at the moment and something else for your country to head for a uncontrolled default and possible exit from a currency zone," said Michael Krautzberger, head of European fixed income at BlackRock, the world's biggest fund manager.

In France, the big worry was that Mr Hollande's emphasis on growth, and calls to renegotiate the fiscal compact pushed by Germany, could lead Paris into conflict with Berlin. But investors such as Nick Gartside at JPMorgan Asset Management argued such concerns were overblown. "One thing we look at is: are we getting dialogue between leaders? Certainly, if a growth compact is tacked on to the fiscal compact it should be something markets should welcome," he said.

Still, investor interest in the relationship between Mr Hollande and Angela Merkel, the German chancellor, will be intense, as is the focus on next month's French parliamentary elections.

"Markets will be monitoring very carefully post-election developments in France and especially in Greece," said Mohamed El-Erian, chief executive of Pimco, which runs the world's biggest bond fund. "In France, there will be particular interest in positioning for the parliamentary elections and the manner in which the president-elect reaches out to German Chancellor Merkel".

Mr Gartside sounded a warning to anyone hoping that political risk might go away now these elections are over. "2013 sees Italian and German elections. This saga of elections will just go on and on," he says.