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French presidential election

Options market signals the need for Europe to change

Prices suggest populist movement has grown to a point where Brussels cannot ignore it

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In late February it emerged that officials from major financial institutions had been seeking and attending meetings with representatives of Marine Le Pen's National Front in an attempt to understand the French presidential candidate's economic proposals and possible plans to take the country out of the euro.

Institutions that might suffer losses on a re-denomination of euro assets into the French franc are evaluating and proactively preparing themselves for the "unexpected" should Le Pen earn a place on Sunday in the runoff and even win that vote on May 7.

The options market, which carries important information about the distribution of risk and its changes over the near- to medium-term, is not overly concerned about France, or another country such as Italy, electing to eventually leave the EU. Option prices indicate that French and Italian equities are offering higher expected upside gain relative to downside loss than German equities.

These option prices tell us that the populist movement has grown to a point where Brussels cannot ignore it and must be more open to policy changes that help revive growth by giving countries more flexibility to compete. Win or lose, the rightwing populist movement is likely to have left its pro-growth footprint in Europe. A one-size-fits-all approach to policymaking — which Germany arguably has been the biggest benefactor of — in a culturally highly diversified continent, has led to obvious national frustrations that Brussels must heed in future decision making.

Options that trade on France's CAC 40, Italy's FTSE MIB and Germany's Dax indices are indicating that the equities of Italy represent a better buying opportunity than those of France, which are more attractive than the traditionally "safer" German stocks.

However, since the recent rise of Jean-Luc Mélenchon's populist left movement, the options market has signalled a weakening outlook for France, amid concern that Mr Mélenchon's manifesto of strong government and wealth redistribution would put growth, entrepreneurship and competitiveness at risk.

In markets across Europe, it seems that the safe has become the new risky, and vice versa.

Using options market prices to garner information about the distribution of future outcomes is similar to using crowdsourcing to estimate possible results. Since option contracts are like insurance, their prices amalgamate the information of myriad market participants as to the risk of asset returns. Higher prices to insure the downside than the upside indicate the potential for a correction.

And it may well be that options favour Italy and France over Germany, not just because the populist movement has woken Brussels up, but because should they eventually opt to follow the UK and withdraw from the union with a populist right victory, it would restore vibrancy to their economies, just as painful austerity and devaluations have done for other countries.

Should France or Italy leave the EU, the support of the international community would become crucial to contain any systemic crisis. It would make little sense for Brussels to treat exiting countries severely as it would put the remainder more at risk. This is what is happening with the UK — nations are co-operating to reach a "friendly," rather than vengeful, self-defeating resolution. The upside-to-downside option market signals for the UK's FTSE 100 index are bullish.

This also happened with Iceland and Ireland, where growth has rivalled that of China and India after they took steps to fix their ailing, indebted economies. They received support from the International Monetary Fund but, more importantly, also received capital from their neighbours, who feared that instability would be contagious: as the saying goes, when your neighbour's house is on fire, your house is on fire.

So regardless of whether Ms Le Pen wins, the rightwing populists have accomplished their mission, by making it impossible for governments to ignore them. That would risk further revolt, which could speed the increasing likelihood of the demise of the European project.

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