

March 3, 2017

Dear clients and colleagues,

The European political calendar will be quite busy in the following months with the Netherlands, France and Germany holding elections. The French election, which remains wide open, could be the main political event to follow this year. Investor fears have pushed the French bond yield up by more than 70 bps in the past five months. The French small cap equity index has also underperformed its German and Italian peers year to date.

It seems like foreign investors are either over-anxious about the possibility of a “Frexit” or polls are overestimating the risk of a populist party winning the upcoming election. 2016 showed us that polls are not perfect forecasting tools; nevertheless, they do provide a useful estimate of a result. However, based on our analysis of the current situation in France, we believe that these risks are overstated.

Understanding the Election

The upcoming French election is not a binary event like Brexit in the UK (yes/no) or the US presidential election (Democrat/Republican). As opposed to the US, French presidents are elected via a direct suffrage in a two-round voting system. This two-round system favours alliances in the second round and tends to be unfavourable to small parties or parties that have no allies, such as the Front National (Le Pen’s party). So although Le Pen’s populist party leads in the polls, a victory in the second round is highly improbable.

The three candidates currently leading in the polls are Le Pen (populist-right), Macron (centre-left) and Fillon (centre-right). When looking at the most recent voting intentions from different surveys, polls suggest that Le Pen would win the first round with 26% of the vote while Macron (centre-left) and Fillon (centre-right) would get 24% and 21% respectively. The latest trend shows that Macron is gaining momentum over Le Pen and Fillon.

We see two possible scenarios for the second round: Le Pen against Macron or Le Pen against Fillon. In the first scenario (Le Pen versus Macron), polls suggest that Macron would win by a wide margin of around 61%-63% of the vote. In the second scenario (Le Pen versus Fillon), result could be tighter, but once again Fillon should win with 58% of the vote. Mathematically speaking, the only way Le Pen could win the second round is if the voter participation rate drops significantly from the historical average of 80% to 50%.

Another fact that diminishes the chance of a Frexit is that in France parliament plays a predominant role in all domestic affairs including any constitution reform changes. The next parliamentary election will take place a month after the presidential election, so unless Le Pen’s party gains the majority in parliament, a Frexit referendum won’t happen. To secure an absolute majority in parliament, Le Pen’s party would have to obtain 40% of the votes in the first round, which seems extremely unlikely based on recent polls.

This report is provided solely for informational purposes and nothing in this document constitutes an offer or a solicitation of an offer to purchase any security. This report has no regard to the specific investment objectives, financial situation or particular needs of any specific recipient and does not constitute a representation that any investment strategy is suitable or appropriate to a recipient’s individual circumstances. Global Alpha Capital Management Ltd. (Global Alpha) in no case directly or implicitly guarantees the future value of securities mentioned in this document. The opinions expressed herein are based on Global Alpha’s analysis as at the date of this report, and any opinions, projections or estimates may be changed without notice. Global Alpha, its affiliates, directors, officers and employees may buy, sell or hold a position in securities of a company(ies) mentioned herein. The particulars contained herein were obtained from sources, which Global believes to be reliable but Global Alpha makes no representation or warranty as to the completeness or accuracy of the information contained herein and accepts no responsibility or liability for loss or damage arising from the receipt or use of this document or its contents.

Performance figures are stated in Canadian dollars and are net of trading costs and gross of operating expenses and management fees. Further information about the Global Small Cap Composite is available by contacting the firm. Global Alpha Capital Management Ltd. (Global Alpha) claims compliance with the Global Investment Performance Standards (GIPS[®]) and has prepared and presented this report in compliance with the GIPS. Global Alpha has not been independently verified.

Post-Election

Under a centre-left or a centre-right government, fund flows would likely come back into the euro area. More market friendly policies from Macron or Fillon would likely push equities higher and bring down the French bond yield.

The Macron and Fillon programs have similarities. They both want to reduce taxation, make labour markets more flexible and reduce inefficient government spending. Therefore, we believe that small and medium companies could benefit from any of these two programs. The main difference is that a centre-left government won't necessarily lead to large cuts in the government spending.

As the election approaches, markets should remain volatile. We would expect a trend reversal once the election is over. As the political risk weakens, we believe that more investors will seize the opportunities that the French equity market can offer.

Have a good weekend.

The Global Alpha Team

This report is provided solely for informational purposes and nothing in this document constitutes an offer or a solicitation of an offer to purchase any security. This report has no regard to the specific investment objectives, financial situation or particular needs of any specific recipient and does not constitute a representation that any investment strategy is suitable or appropriate to a recipient's individual circumstances. Global Alpha Capital Management Ltd. (Global Alpha) in no case directly or implicitly guarantees the future value of securities mentioned in this document. The opinions expressed herein are based on Global Alpha's analysis as at the date of this report, and any opinions, projections or estimates may be changed without notice. Global Alpha, its affiliates, directors, officers and employees may buy, sell or hold a position in securities of a company(ies) mentioned herein. The particulars contained herein were obtained from sources, which Global believes to be reliable but Global Alpha makes no representation or warranty as to the completeness or accuracy of the information contained herein and accepts no responsibility or liability for loss or damage arising from the receipt or use of this document or its contents.

Performance figures are stated in Canadian dollars and are net of trading costs and gross of operating expenses and management fees. Further information about the Global Small Cap Composite is available by contacting the firm. Global Alpha Capital Management Ltd. (Global Alpha) claims compliance with the Global Investment Performance Standards (GIPS[®]) and has prepared and presented this report in compliance with the GIPS. Global Alpha has not been independently verified.