Daily Note

FRANCE: STILL BETTER THAN YOU THINK

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- **The impact of one-off drags on domestic demand is fading**
- **Surveys signal more consumption and investment to come**
- **While data remain mixed, the stock market points to resilience**

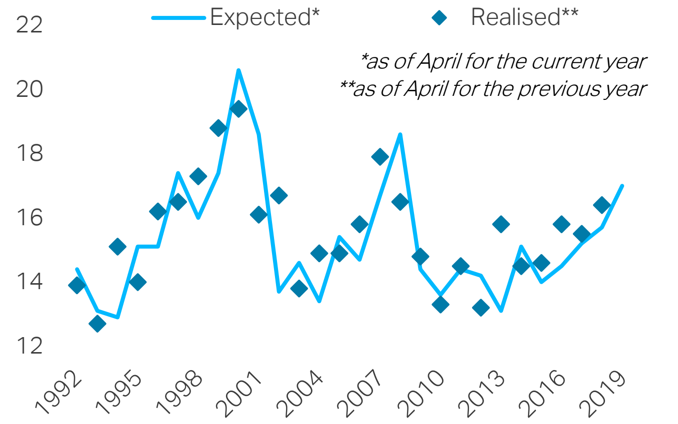
Plea for a nuanced approach to the euro area. Our long-held view that the aggregate euro area (EA) economy was headed for a sharper and more prolonged slowdown than many expected is now consensus. But the importance of a nuanced approach to the analysis of major EA countries remains largely underappreciated. France and Spain are cases in point. In this note we develop an argument we've been making (e.g. here and here) for being relatively bullish on France.

Fading idiosyncratic factors and a little fiscal stimulus release demand constraints. President Macron's grand plan to pursue a wide range of supply-side reforms (especially in the labour market) and corporate tax cuts while trimming public employment and expenditure triggered strikes nationwide in 2018H1. With higher inflation keeping a lid on household purchasing power and foreign demand weakness slowing job growth, the tensions erupted into the *gilets jaunes* protests, which paralysed the country several times in 2018Q4 and 2019Q1. Macron was forced to acquiesce to some fiscal expansion (mostly tax cuts for households), which, together with receding inflation and France's limited dependence on manufacturing exports, kept real growth unchanged in Q1 at 0.3% QoQ.

Pent-up demand in search of outlets. Meanwhile, capex has been robust. It grew 3% in 2018 (just behind Spain among the major EA economies) with steady contributions from intellectual property investment and construction. The business leaders' survey conducted by INSEE, which has historically proved to be a good guide to the direction of capex, shows that investment

Chart 1: More capex in the pipeline

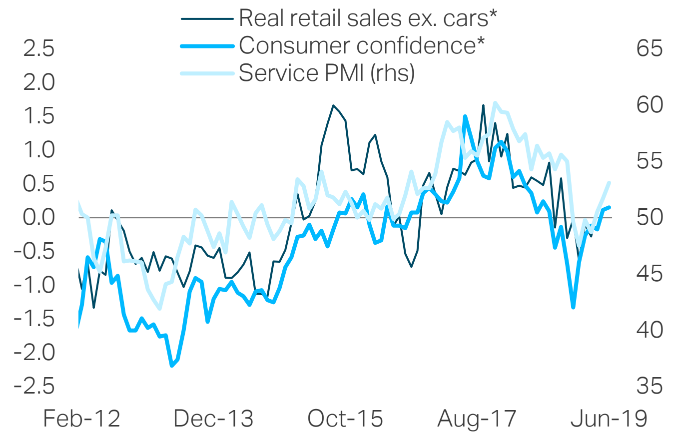
Business survey: investment in production capacity, %



Source: INSEE, Datastream, TS Lombard

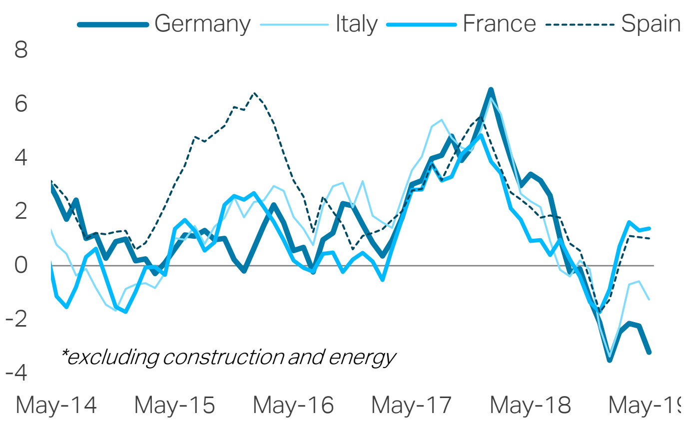
Chart 2: Consumption revives

*SA, standardised. Last obs. for retail sales: April



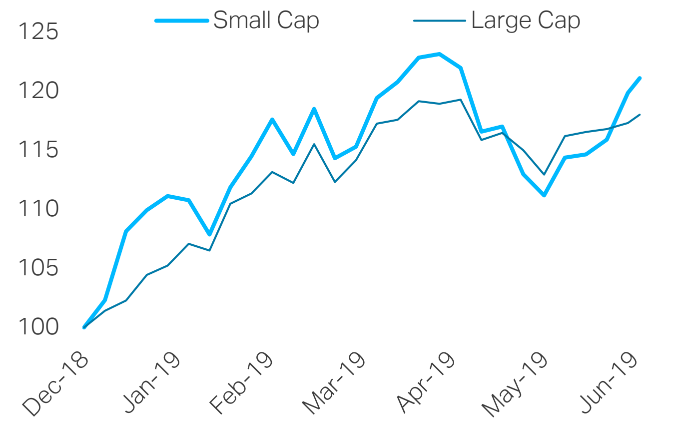
Source: INSEE, IHS Markit, Datastream, TS Lombard

Chart 3: Still buoyant industrial output
Industrial production*, volume indices, SA, YoY% 3M MA



Source: National sources, Datastream, TS Lombard

Chart 4: Trust the stock market on this one
France MSCI



Source: Bloomberg, TS Lombard

plans remain upbeat despite a marked weakening in business sentiment since the turn of the year. More importantly, Chart 1 shows that firms are allocating a growing share of total investment to increase production capacity and that over the past four years actual capex has exceeded expectations.

Accelerating real disposable incomes – both thanks to tax cuts, a still-expanding labour market and slower inflation – helped consumption to rebound meaningfully in Q1 with its contribution to real growth rising again to 0.2% QoQ after flatlining in 2018Q4. Real retail sales excluding cars in April (the last data point available) recorded the highest rise in six months (4% YoY), climbing back above the long-term average of the series. Moreover, household confidence rose again in June (4.6% YoY and 1.8% MoM), pointing to a further pick-up in retail sales. This augurs well for the service sector, which mostly caters for domestic demand, and corroborates the signal sent by the service PMI, which climbed above 53 in June – i.e. well into expansion territory.

Like elsewhere in the EA, risks to growth are mounting in France, but the outlook is still positive. French manufacturing output data out this morning show a brisk acceleration in May (2.1% MoM). But after the strong growth in Q1 largely also due to pre-Brexit stockpiling, we should expect some payback in Q2. In line with this expectation, the Bank of France's business sentiment index in June posted the sharpest MoM decline since 2011 (-3.3%). The press release explains that last month *"industrial production declined significantly, in particular in the automobile, rubber and plastic and IT and electronic equipment sectors"*. Although businesses already expect activity across the board to quicken again in July, this was a negative surprise that stands in stark contrast to the June PMI readings on manufacturing output and new orders (52.0 and 51.2, respectively). Overall, however, manufacturing remains on a decent footing (Chart 3). Nonetheless, other data paint a mixed picture. Hiring plans have weakened and the INSEE new foreign orders indicator in June dropped by 8pp, falling below its historical average. Finally, the Bank of France revised its real growth estimate for Q2 down from 0.3% to 0.2%. But, against the backdrop of a further slowdown in the rest of the EA (especially in Germany and Italy, which could even contract in real terms), France's outlook appears quite rosy.

Interestingly, the stock market provides a key to sifting through contradictory cues. Chart 4 shows that French large caps have underperformed small caps since January. French large caps, which benefit from significant revenue exposure to Europe and from operating in sectors that are less sensitive to the cycle (e.g. luxury goods), have fared well so far this year. But small caps, which rely much more heavily on domestic demand, have done even better. So, this time, if you are not sure which data series is the most reliable indicator of what is happening to the French economy, just trust the stock market.