Confidence must be earned

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Why investors should care about French “yellow vests” protest

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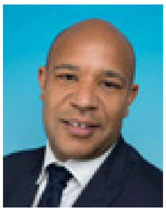

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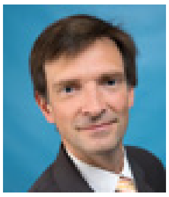

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- *The Gilets Jaunes (Yellow Vests) are a largely spontaneous protest movement that emerged in France, in October. With no declared political affiliation, they called for lower taxes and a higher level of social transfers and public services.*
- *The protests, in our view, will have a modest negative economic impact on growth, as a consequence of two opposite effects: a fiscal stimulus (with an impact on public deficit) and damage to business and investor confidence. We have just reduced our forecast on French real GDP growth from 1.5% to 1.4% for next year, while the deficit, depending on the measures, could be higher than 3%, before declining in 2020.*
- *We believe the protests will de-escalate but their consequence is that the French government may refrain from pushing further forward reforms in France, and may be in a weaker position to drive reforms at the European level.*
- *On the French Equity market, the possible boost in purchasing power could support the consumer sector, which was the hardest hit during the recent protests.*
- *Within a broader perspective, France just added to the political noise which is weighing on investor confidence in European assets, equity in particular. Political-driven volatility will be a feature of the next year, at least until the next Parliamentary elections occur in May. However, we believe the recent market correction incorporates a too-pessimistic scenario and pockets of value are opening-up for profitable, not over-indebted companies, currently trading at discounted prices, due to political risk.*

1. What is the *Gilets Jaunes* movement about?

TP: The *Gilets Jaunes* are a mostly spontaneous movement that appeared in October, largely among the inhabitants of medium and small towns, initially to protest against the planned rise in gasoline taxes. The Macron presidency was largely caught off-guards and, as this movement was orchestrated neither by opposition political parties, nor by trade unions, the government has had a hard time identifying partners to negotiate with. Protesters’ demands have progressively extended well beyond the gasoline tax issue (the planned hike was cancelled by the government anyway) turning to address a greater number of grievances, related to purchasing power and social issues. Beyond often confused and sometimes contradictory demands, the *Gilets Jaunes* share the feeling that inhabitants of medium and small towns (who are more car-dependant than urban dwellers) are negatively affected by globalisation and a declining level of public services. They also share a distaste for Macron’s decisions and style, as he is seen as a “President of the rich” (an expression often heard), embracing this very globalisation that is seen as benefitting mostly the relatively well-off inhabitants of large cities. A paradox of this movement is that most protesters seem to want both lower taxes and a higher level of social transfers and public services. Opposition political parties initially voiced some sympathy, but became a lot more prudent when protests were accompanied by increasing violence. Non-mainstream (far-left and far-right) parties and some trade unions continue to show sympathy, although they cannot be described as part of the movement and the *Gilets Jaunes* show a lot of distrust for all politicians in any case.

“The pro-business reform agenda of the Macron presidency may have to be considerably toned-down”.

2. What are the implications on French growth?

TP: The protests will weigh on Q4 activities (notably as the Saturday protests are very damaging to the retail sector, among other). For 2019 there will be the opposing effects of a de-facto fiscal stimulus due to a number of tax cuts announced on December 10 (in addition to the cancellation of the rise in gasoline tax) vs. the damage done on confidence (both domestic and that of international investors) due to the rising political uncertainty and the strong probability that the pro-business reform agenda of the Macron presidency may have to be

"While the French government could have less strength to push for further reforms in the Eurozone, we foresee that the crisis will de-escalate".

considerably toned down. All in all, we believe it will be at least slightly negative for 2019 growth: we have just reduced our forecast from 1.5% to 1.4%.

3. What are the implications of President Macron's concessions on French finance?

TP: The government did not give in to one of the key demands of some *Gilets Jaunes,* which was the reinstatement of the wealth tax on financial assets (it was removed by President Macron last year, instead limiting its application to real estate wealth), which could have had implications on the financial industry. However, in his December 10 intervention, the President stressed the necessity for international corporations active in France and for leaders of French corporations to pay taxes in France, with precise measures yet to be detailed. More generally, the necessity for the Macron government to devote more attention to small towns, may take away some energy that was initially directed at improving the status of Paris as a global financial city. Due to the rising uncertainty and doubts over the reform momentum, there could also be less appetite for international finance leaders to locate or relocate activities in France, notably against the backdrop of Brexit. Depending on the measures, yet to be announced, to offset some of the concessions made to the *Gilets Jaunes*, the French public deficit could also be well above 3% of GDP next year (it was initially planned at 2.8%, slightly higher due to the temporary combined effects of schemes intended to reduce corporations' social contributions). However, if the concessions stop here and the recovery continues, the deficit should still be on a declining path into 2020.

4. Do you foresee any effects on Europe?

TP: Although a national phenomenon, the *Gilets Jaunes* are part of the global trend of political and social movements, voicing their distrust of mainstream political institutions, across developed economies. Events in France, which are closely watched abroad, may increase the momentum of non-mainstream parties, in France as well as in other countries, as we get closer to the May 2019 European parliamentary election. Although the European Parliament has little power, this election will be an important gauge of the weakening of traditional parties. Since 2017, France had been relatively spared of political agitation, compared to the tense situation in Italy and the UK and, to a lesser extent, the uncertainty in Germany and Spain. Now, the situation is much less comfortable and the French government will have less impetus and less legitimacy to push forward its agenda of strengthening Eurozone institutions. Moreover, French budget credibility, always an important factor for Germany, will also suffer some damage. Yet, against a still positive economic backdrop and with a President Macron government that controls a very comfortable majority in the Assembly, while opposition parties remain very weak or divided, our central scenario is that the crisis can be de-escalated and we do not see France (nor neighbouring countries) generating a systemic Eurozone crisis in 2019.

"Measures just announced could boost the purchasing power and this could reinforce our positive view on the French consumer".

5. With an investment perspective, do you see any impact of the recent protests on the French equity market? What are the perspectives for the market?

FR: The French retail sector is most affected by the protests. Many commercial and luxury brands had to close their stores for the 3rd Saturday, just ahead Christmas period. Footfall in malls in France was down 17% on Saturday December 8, after a 14.3% fall on November 24 and 12.7% fall on December 1. Concessions companies are getting hurt as well. The protests started around November 17 and should negatively affect traffic in Q4 as several toll-gates have been blocked by protesters, some equipment has been damaged (repair cost should be covered by insurance) and also traffic flows have been slowed in some sections. We assume -15% traffic from Nov 16 to Dec 31 due to the "yellow vest" protests.

Looking ahead, one of the key drivers to assess the French equity market in the coming months, is the evolution of consumer confidence. Announced measures could boost purchasing power and this could reinforce our positive view on French consumers. In our view, in 2019, purchasing power will record its strongest growth since the financial crisis, very likely above 2% y/y. France is cutting taxes and spending some money to get pro-growth supply-side reforms through and this could be positive for the market. On the other hand, the market will increasingly call into question Macron's ability to legislate additional pro-growth reforms, beyond the ones he has already delivered.

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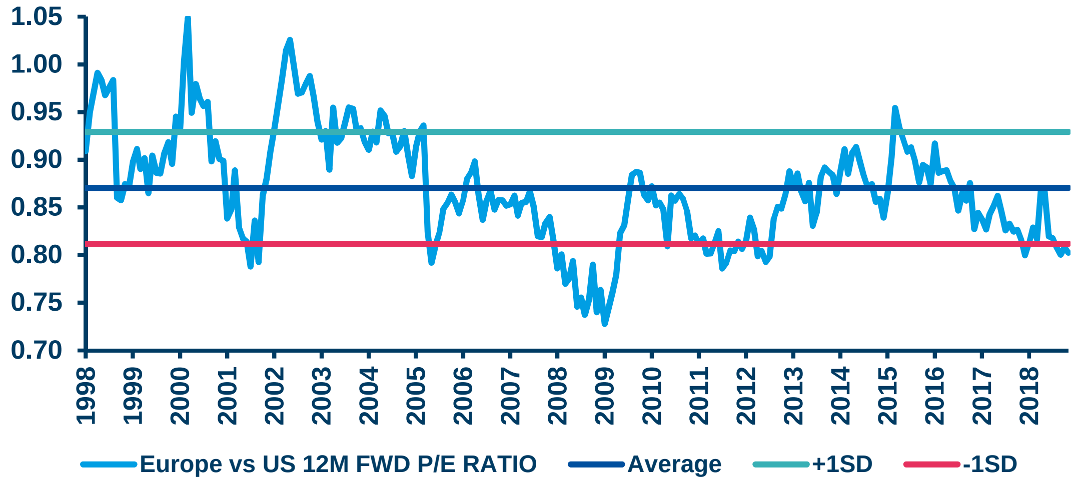
Hence, selection will be key to exploit these new market dynamics. We believe it is too early and risky to return to positions on food retail names, as consumer confidence needs to be restored first. On retail, investors should favour names with a multichannel business model that have been less impacted by recent protests. Other opportunities can be found in aeronautic stocks (strong visibility of earnings and structural tailwind), selectively in luxury brands that either benefit from Asian exposure (tourism and local sales dynamism) or that have implemented sustainable growth strategies, also through M&A.

6. How does France's situation influence the overall investment lanscape for European investors?

VM. Financial markets are increasingly influenced by the dominance of political themes, which has become even more pervasive this year. We believe that this feature will remain in place next year as well - especially until the European parliamentary election in May - continuing to fuel volatility, in a contest of global economic deceleration. Europe in particular is dealing with multiple political hot-spots. In the UK, the postponement of the Parliamentary vote on Brexit announced yesterday further increases the risk of a no-deal or a prolonged period of uncertainty (a scenario which has one third of probability to occur), with a rocky path ahead and various possible outcomes (including a different deal, a *Brexit* reversal or new risks of no-deal). In Italy, the negotiation between the Government and the EU Commission on Budget law is still ongoing and the concessions done by President Macron will restrain the current coalition to make significant revisions of the deficit figures. In Germany, the political landscape has changed dramatically after the results of recent regional elections, with new forces emerging. More recently France shows the untreated wounds of the great financial crisis in terms of raising inequalities and sense of precariousness. European risk assets and equity in particular are bearing the burden of this political risk, with higher risk premia. Equity valuations have become more attractive after the recent correction without an economic recession. The price dislocation we have seen this year, we believe, will open opportunities for investors next year, should the geopolitical risk stabilise, as the market already price a very negative scenario. Selection of companies, with attractive valuations and decent earnings per share growth, could provide good value to investors seeking sources of return, after a poor performance year.

"European equity is bearing the burden of higher political risk: pockets of value are opening up for an entry-point next year".

European equity valuations vs US market



Source: Amundi research, Datastream as of November 27, 2018. MSCI Europe vs MSCI US.

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