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French government collapses, what's next?

"Incertitude" is the name of the game

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FOCUS NOTE

SUMMARY

- Fall of Barnier government raises risks of political instability, fiscal slippage, rating downgrades, financial turbulence and economic underperformance.
- We see room for the 10-year French government bond (OAT) spread against the Bund to widen to 100bp.
- Persistent uncertainty supports our underweight stance on European stocks and bearish view on the EUR over the medium-term.

LOOKING FOR A PRIME MINISTER, AGAIN.

The Barnier government was brought down by the lower house of the French parliament last night, when the far-right Rassemblement National (RN) and the Nouveau Front Populaire (NFP, a coalition of left-wing parties) joined forces to pass a vote of no confidence**. The fall of the Barnier government comes at the worst possible time, in the middle of the budgetary process, when the French economy is facing increasing headwinds, and just weeks before the inauguration of Donald Trump, which could quickly be accompanied by a first wave of trade tariffs.** It raises many questions about the fiscal outlook and significantly increases uncertainty, as for the first time since 1979, France is likely to start a new year without a budget properly debated and approved by Parliament.

The first factor of uncertainty relates to the appointment of the next prime minister and government, which took over two months in the first place. Several options are on the table, none of them obvious.

The first would be a kind of status quo, with Emmanuel Macron appointing a prime minister supported by the current minority coalition, but more acceptable to the RN than the outgoing prime minister. The second would be a widening of the current coalition to the centre left. The NFP is on the verge of imploding and the Socialists may be willing to join a "non-censorship" agreement with the centrists and

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the centre-right if the prime minister moves to the left. Finally, Emmanuel Macron could appoint an Italian-style technocratic government, where political parties take a step back and give technocrats a mandate to govern on a very specific agenda.

Whatever the form of the next government, it will remain fragile, unstable, and likely short-lived. The chances of a new dissolution of the lower chamber in July and new elections were already high before the vote of no-confidence, and they have increased again. So far, Emmanuel Macron has repeatedly ruled out resigning, but he is likely to be under increasing pressure from all parties this deadlock continues.

BRIDGING THE FISCAL GAP PENDING A 2025 BUDGET

The second factor of uncertainty relates to the fiscal outlook. The next government will thus be charged with drafting a new budget plan for 2025, to be discussed in the coming weeks. If a government is formed quickly, and depending on its composition, Barnier's budget plan could be amended and sent back to parliament, for the sake of rapidity. If it takes time to form a new government, a new draft budget plan would likely be considered, and discussions take place in 2025.

In the short run, the new government will draft before December 21 a so-called "special" bill to guarantee fiscal continuity beyond the end of the year, pending the vote on a 2025 budget. The bill will ask parliament to authorise the government to collect existing taxes and borrow from the markets in 2025. Most parties including the RN have already said they would support such a bill. Once passed, it should ensure continuity on the revenue side, pending a real budget. On the expenditure side, the constitution allows the government to allocate the discretionary funds corresponding to the 2024 budget by decree from January.

RISK OF FISCAL SLIPPAGE AND RATING DOWNGRADES TO PUSH SPREADS HIGHER

The initial goal was to implement a structural fiscal consolidation of 1.4 pp. of GDP, the largest since the great financial crisis, to bring back the fiscal deficit from 6.1% to 5.0%. **Pending the adoption of a 2025 budget, next year's fiscal stance is set to be less restrictive, and the risk of renewed fiscal slippage is real.**

On the one hand, the freeze in nominal discretionary spending and in the income tax scale will automatically generate savings relative to nominal GDP. On the other hand, the bulk of social security spending, which accounts for half of total spending, such as allowances and pensions, is indexed to inflation and will automatically rise by around 2% in January. What is more, all the austerity measures planned by Barnier (temporary increase in corporation tax, increase in electricity tax, etc.) have been rejected. Recently, the ministry of finance stated that without corrective measures, the fiscal deficit could spontaneously slip to almost 7% next year. **Under the current circumstances, and pending a 2025 budget, our best guess would be a broadly stable deficit compared to 2024, close to 6%.**

Against this backdrop, there is a risk of continued rating downgrades by agencies. France was already downgraded by Standard & Poor's (AA-, stable) in May, and Moody's (Aa2) and Fitch (AA-) revised their outlook to negative in October. The review calendar for 2025 is still unknown, but ratings action as of Spring would be on

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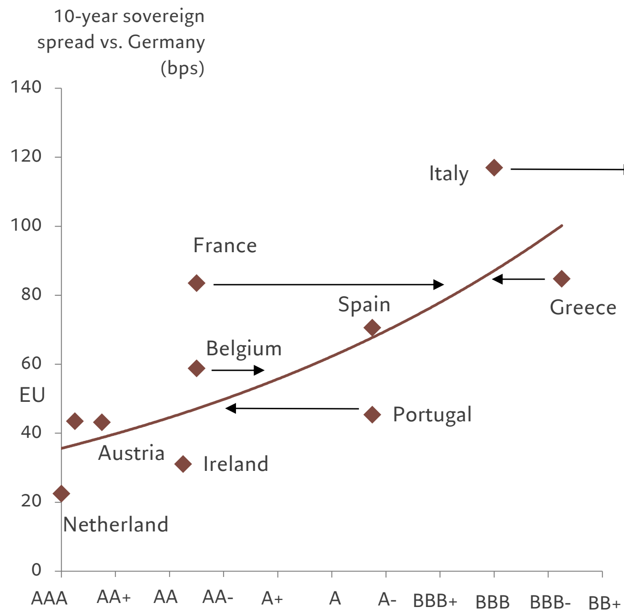
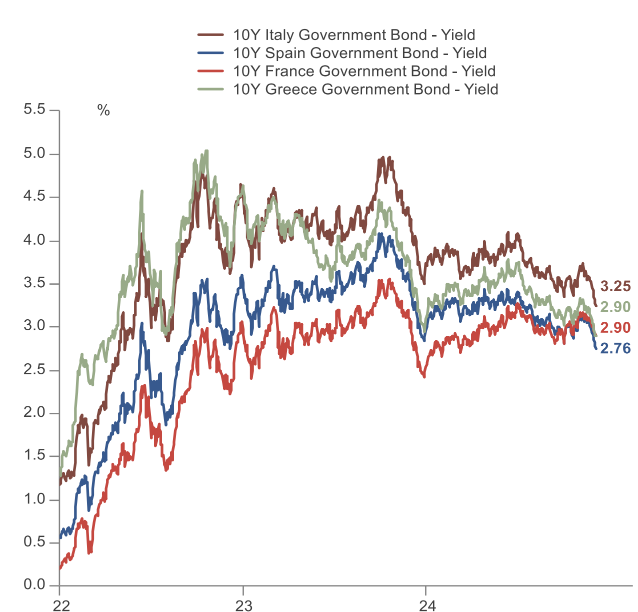
the cards for Moody's and Fitch, while Standard & Poor's would be keen on reviewing the outlook first, although standalone rating downgrades are possible.

Chart 1: OAT spread already discount several rating downgrades



Source: Pictet Wealth Management, Bloomberg Finance, L.P., 03.12.2024

Chart 2: 10-year euro government bond yields are falling



Source: Pictet Wealth Management, FactSet, 03.12.2024

We therefore see room for the 10-year French government bond (OAT) *spread* against the Bund to widen from 85bp to 100bp on a 6-month horizon. However, we expect the 10-year OAT *yield* to continue to hover around its current level of 2.9%, as we believe that the ECB's easing will lead to a decline in the 10-year Bund yield to 1.8% on a 6-month horizon, offsetting the widening of spreads.

POLITICAL UNCERTAINTY TO WEIGH ON GROWTH DESPITE LOOSER FISCAL STANCE

Under the current circumstances, an easier fiscal stance would not translate into stronger growth, in our view, as persistent political uncertainty and high rates will weigh on activity. We are sticking to our view that the French economy will expand below potential next year, by 0.6% only (after 1.1% in 2024).

With wider spreads, the transmission of lower policy rates to the real economy will be slower in France than elsewhere in the euro area. For households, precautionary savings may weigh on consumption. For corporations, higher uncertainty and higher spreads usually mean delaying investment and hiring. Overall, French political developments support our cautious view on the euro area macro outlook for 2025, although a potential reform of the so-called "debt brake" in Germany would leave room for a positive surprise.

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EQUITY STRATEGY: NO GOOD NEWS HERE; PERSISTENT UNCERTAINTY SUPPORTS UNDERWEIGHT STANCE ON EUROPEAN STOCKS

French and European equities have risen over the last few days despite the growing risk that a vote of no confidence would indeed happen in the French Parliament. We believe this outcome reflects a very tactical 'catch-up' trade post the prior large underperformance versus the US seen through November.

The continued uncertainty around French politics and related fiscal policy reinforces our existing view to be underweight European equities (in a global context). We think the potential for sustained political uncertainty will take precedent from any hopes around any near-term growth improvement associated with a smaller fiscal tightening in any new budget, which should weigh heaviest on those French stocks with a high proportion of domestically sourced revenues (and Financials). This suggests that mid and small cap French indices will be most adversely impacted given that around 80% of revenues from companies within the larger CAC40 index come from outside France.

Having said that, we still expect the CAC to come under pressure from more macro-oriented investors looking for a liquid way to position for weakness in French assets. Hence, within a pan-European context, we expect French equities in general to continue to underperform their regional peers over the coming months.

We do not expect French political uncertainty to lead to wider risk premia for other European assets at this time. The likely lack of cross-border contagion should limit the impact on the broader pan-European equity universe, however it does give investors another reason to avoid investing in European stocks.

EURO: LOSING ITS LUSTRE

The expected growth and inflation differentials between the US and the euro area are set to drive the euro and US dollar further apart over the coming year, with EURUSD headed towards parity as a result, in our opinion. Weak Chinese demand for European exports and the policies of the new US administration are set to further boost the dollar against the euro.

The political ructions in France are unlikely to derail this outlook, be it for the worse or the better. The economic impact is not significant, immediate, and quantifiable enough to affect the macro-financial outlook for the eurozone. In the medium term however, these issues could add to a building sense that European politics are becoming ever more polarized and dysfunctional. This could in turn dent the outlook for economic policymaking that yields market-friendly outcomes.

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