DECEMBER 2024

French government changes: market factors to watch

What has happened?

The French parliament voted on 4 December to oust Prime Minister Michel Barnier over his proposed budget. Mr Barnier's resignation follows snap parliamentary elections in July, which resulted in a hung parliament with no party having an overall majority. New parliamentary elections cannot be held until June 2025.

For now, Mr Barnier will likely stay on as "caretaker" until a new government is chosen. The immediate objective for the next government will be to find a minimum political common agreement to construct a budget. If not passed by the end of December, the 2024 budget will be rolled over, ensuring there will be no shutdown.

However, rolling over the budget could increase the country's budget deficit – the gap between spending and tax income – even further. Initially forecast at 4.4% of gross domestic product (GDP) in 2024, and then successively revised to 5.1% and 5.6%, the deficit should finally exceed 6% this year. As the government is expecting 2025 growth to be above 1%, any risk of undershooting this target could drive the deficit higher, leading to further deterioration of the debt to GDP ratio above the initial 114.9% targeted (see Exhibit 1).

As Mr Barnier noted before the vote "the French debt will not disappear because of a vote".

Fixed income market impact: focus turns to France's financing plan

Today's average sovereign financing costs of 2.1% will likely trend upwards as yields have risen.

Assuming a trend nominal GDP growth of around 3-3.5%, France could afford a primary deficit of 1-1.5% of GDP. As of today, the estimates for the primary deficit are at 2.5%+. In our view, the French budget needs to be cut by around 1.5% of GDP – or EUR 40 billion – to return to a stable debt/GDP ratio.

Impact on risk premium

How will France's risk premium evolve in the days and weeks ahead? Reflecting growing unease in financial markets, French sovereign borrowing costs have risen sharply since June. The premium over German bonds – at 50 bps in June – reached the highest since the euro zone debt crisis in 2012, with the OAT-Bund spread hitting 90 bps before the government fell. It is down to 80 bps this morning, as the ousting of the French Prime minister was expected by investors. In addition, investors have been shorting French debt since June and may be tempted to reduce their exposure.

Volatility ahead

We expect further market volatility. A spread of 80-100 bps is consistent with a downgrade of France's credit rating to single A. Whether the spread could go higher is difficult to assess today. Markets will be looking for political stability to support a positive deficit trajectory.

The financing plan for France will be key next year as, faced with an increased deficit, borrowing needs will increase. The investor base shows non-resident holdings represent 54.6% of the total negotiable debt, and last summer we experienced a large sell-off of French debt. Therefore, it will be interesting to see whether the amount of debt held by foreigners will remain stable in a context where the European Central Bank (ECB) has ceased to be the main buyer post-quantitative easing but could continue to use the lighter PEPP (pandemic emergency purchase programme) reinvestments to support French debt, as observed in recent months. However, even though France may have little credibility in Europe when it promises to cut spending, we think comparisons with Greece are wide of the mark. We do not expect a genuine financial crisis, and the risk of a default is not part of our scenario planning. France never misled about its deficit, and investors trust the French authorities. Moreover, the household savings rate in France is high, and even increased to 18.16% in the third quarter of 2024 from 17.94% in the second quarter of 2024. So savings could be tapped, as has been proposed by left-wing parties.

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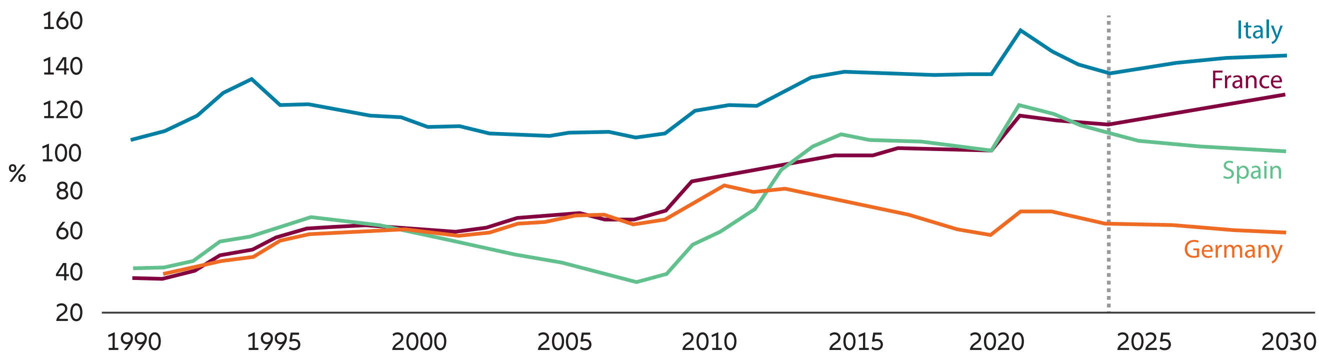
Finally, the ECB has started lowering interest rates. While France is now borrowing at higher rates than its neighbours, the cost is still lower than earlier this year, when the five-year interest rate exceeded 3%. Moreover, since the global financial crisis the ECB has put in place a framework for countries in debt trouble that could be used as a last resort.

For investors, good entry points might appear but it is important to be mindful of the inevitable volatility.

Exhibit 1: French government debt to GDP compared to its European neighbours



Source: LSEG Datastream, AllianzGI Economics and Strategy 12/3/2024. Note: includes IMF estimates.

Equity market impact: some French companies can weather the upheaval

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Since French President Emmanuel Macron dissolved the National Assembly and called snap elections in June, the CAC 40 has lost almost 10%. French stocks have rarely been at such a discount compared to stocks in other developed markets.

However, the large companies listed in Paris are not hugely dependent on the health of the French economy. In 2023, only a quarter of the sales of the stock market giants were generated in France, a proportion that has remained stable since 2015.

The closely watched spread between French and German government bond yields has risen to more than 10-year highs. But many listed companies, which are not highly leveraged, are not overly sensitive to the rise in the spread as they do not need to raise debt regularly on the markets.

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Equity market factors to consider

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In equity markets, we're watching the following factors closely:

1. French companies may see higher financing costs versus their non-French peers. We see the most affected sectors as potentially banks and other financial companies, as well as companies within infrastructure, utilities and telecoms.

2. Political uncertainty may lead to the gradual pricing in of a France-specific equity risk premium.

3. The structural requirement to bring down budget deficits will likely limit economic growth in the short-term. Over time, France's potential growth rate may rise if the government's share of GDP decreases from the current high levels.

4. Other European exporters and importers will also be affected if a government or sovereign debt crisis in France triggers a meaningful depreciation of the euro. Such a scenario will also carry implications for the euro zone's terms of trade and, ultimately, ECB decision-making due to imported inflation.

Allianz Global Investors 2024| December