December 5, 2024

Watch The French Consumer To Gauge The Euro Area Economy

- Global investors have soured on the euro area and need a solid catalyst to return. The most likely positive spark would be an improvement in the French economy, specifically the consumer sector
- France is the second largest euro area economy, and we find it serves as a better proxy for the aggregate euro area economic landscape compared to the presumed bellwether - Germany.
- Manufacturing has been the weak spot of the French economy, but demand for services has held up. Investors should place a greater emphasis on the latter, since services is a much larger part of the aggregate economy and employment.
- France's economy is driven by consumer spending, which has been sluggish over the past year, albeit largely due to very weak auto demand. However, there are green shoots starting to appear, with real consumer spending on services now growing at an annual rate of 2.4%, compared to mildly negative for goods.
- Moreover, retail sales volumes excluding all motor vehicle sales are now expanding at a 4% year-over-year rate and point a recovery in final household consumption growth ahead.
- France has decent wage growth and households have large excess savings, which provide underlying support for overall consumer spending. An offset is that political uncertainty could weigh on business and consumer sentiment in the near run, something that needs to be monitored.
- Finally, France is more interest rate sensitive compared to other euro area members that have deleveraged over the past decade. While a risk, this also means that French consumers and the economy could respond more positively to ECB rate cuts.

Focus on the French consumer not German manufacturing

Euro area assets have been under pressure in the aftermath of the U.S. election as investors have been discounting a more negative economic outcome in the euro area compared to the U.S. as we head into 2025 (**chart 1**). Indeed, investors have piled further into the "U.S. exceptionalism[1]" trade, at the expense of other regional equity and FX markets, including the euro area. However, with relative price trends now stretched, it is crucial to dig deeper and understand what is driving this persistent weakness in the euro area.

[1] **MRB:** "*Positioning For The New Fat Tail U.S. Economy*", November 20, 2024

We recently published two research reports addressing both the ***cyclical*** (*Part 1*[2]) and ***structural*** (*Part 2*[3]) backdrops for the euro area. The main takeaways included:

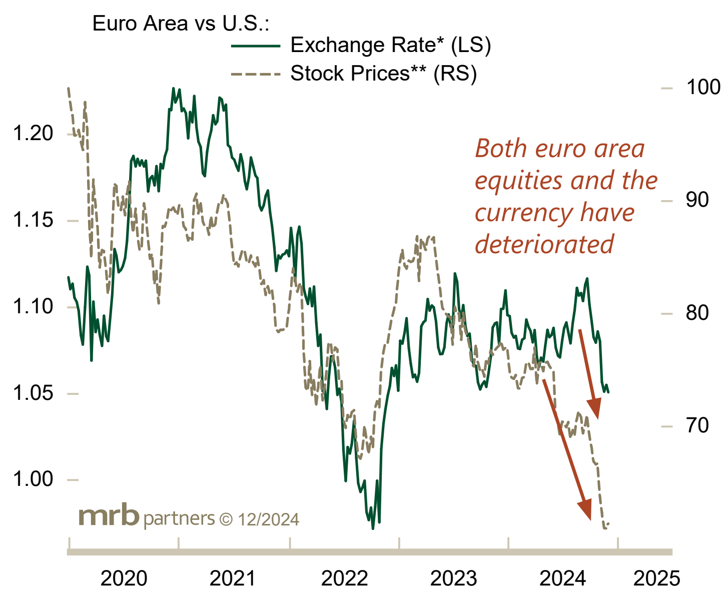
- Germany has the weakest ***cyclical*** backdrop in the region, with an economy that has largely stagnated over the past couple of years. The weakness stems from a large manufacturing sector, which has been a drag in most economies but especially in Germany where businesses are struggling to compete with Asian auto and industrial producers. Also, German households have been reluctant to spend and provide an offset, partially due to uncertainty over employment. The good news is that Germany has the strongest ***structural*** foundation in terms of household and government sector balance sheets, with a significant accumulation of household excess savings since the pandemic. This is key since it provides a substantial firewall to prevent cyclical weakness in Germany from morphing into a self-reinforcing downturn that becomes recessionary for the aggregate region.

- At the other end of the spectrum is the major southern euro area economies, including Greece, Italy, Portugal and Spain (i.e. SEU-4), which have a much stronger cyclical backdrop (**chart 2**). These economies are more reliant on services (which have been a bright spot) and their consumers have been much less reluctant to spend. Together the SEU-4 economies have the same GDP as Germany and in aggregate are expanding at a brisk 4.9% annual pace. In turn, the weakest euro area member (Germany) and

[2] **MRB:** "*Euro Area: Member Divergences Provide Opportunities*", October 23 2024

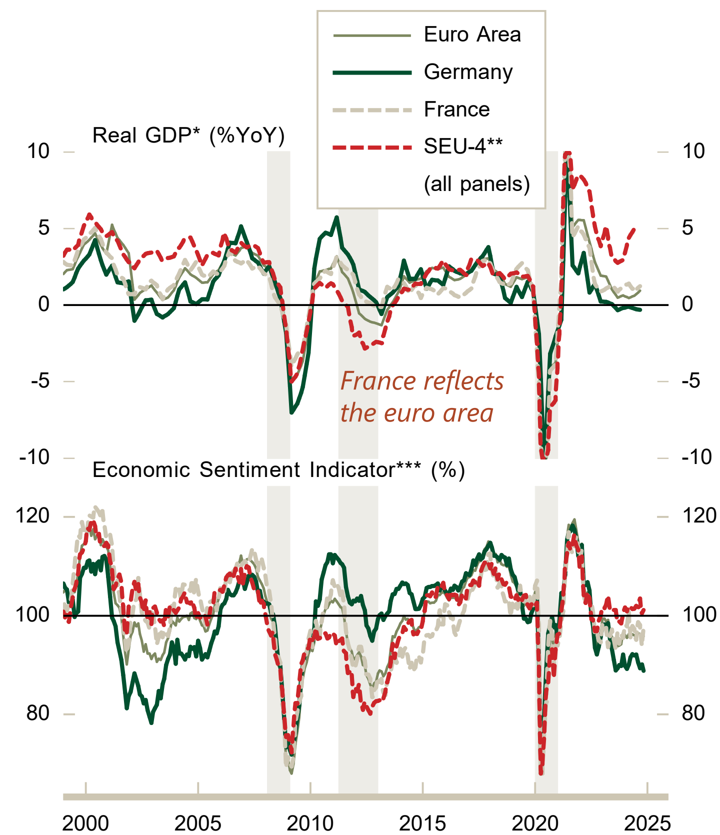
[3] **MRB:** "*Euro Area: Under Pressure, But More Resilient Than Perceived*", November 7, 2024

Chart 1 **Euro Area Assets Are Under Pressure**



* Euro / U.S. dollar exchange rate
** Rebased; source: MSCI

Chart 2 **France = Euro Area Growth**



* Truncated at 10 and -10; source: National Source
** GDP-weighted aggregate of Greece, Italy, Portugal and Spain
*** Truncated at 68; source: European Commission Survey
Note: Shaded for Center for Economic Policy Research-designated euro area recessions
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This is assuming the debt brake is relaxed the strong members (SEU-4) net out to slightly above trend growth.

- This leaves France as the remaining major economy within the euro area. Our research showed that France's economic expansion has been broadly in line with the aggregate euro area. The French economy has been sluggish, expanding at only a 1.2% annual rate, which is mildly below its longer-term potential growth rate. While manufacturing has been a headwind (like elsewhere), it is not structurally impaired like Germany. Instead, the larger drag has been the French consumer, which has been in a funk, although there are some tentative but encouraging signs. An improvement in consumer spending could dramatically lift the profile of the French and aggregate euro area economy.

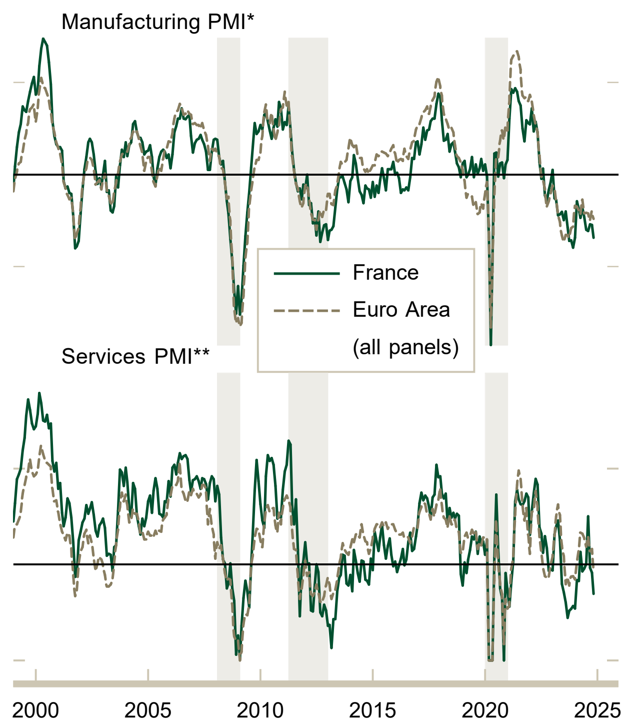
In short, France provides a much better bellwether for the aggregate euro area than Germany, which investors have traditionally fixated on. Indeed, the French consumer sector (rather than German manufacturing) is likely the key in tilting the entire regional economic growth profile.

Today's report focuses on the French economy and its consumer sector more specifically to gauge when the euro currency and regional equity market might outperform.

Focus On Services Not Manufacturing

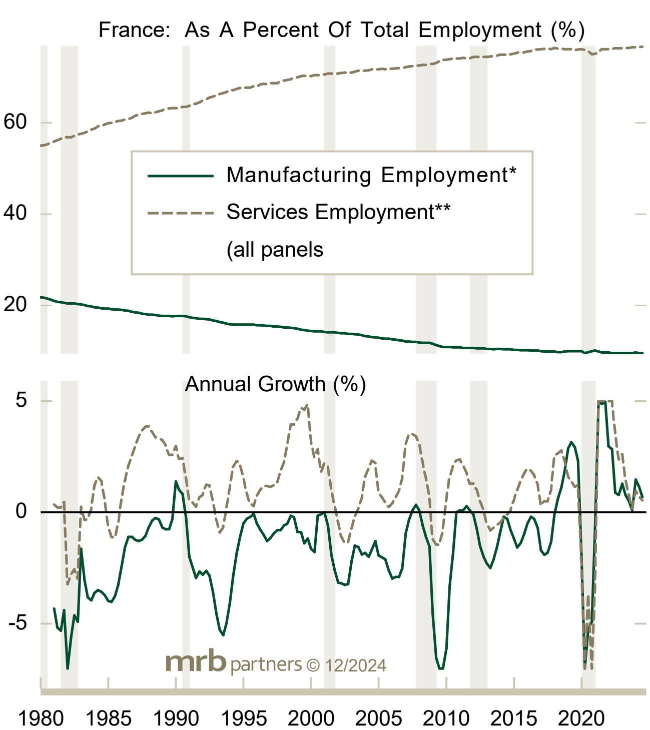
- Many investors perceive that the French economy is driven by its manufacturing (or industrial) sector. In turn, the regional PMI Manufacturing Index has been an important business cycle indicator, and the current weak readings have caused concerns (**chart 3**). However, manufacturing only accounts

Chart 3 Weak PMIs Across The Board



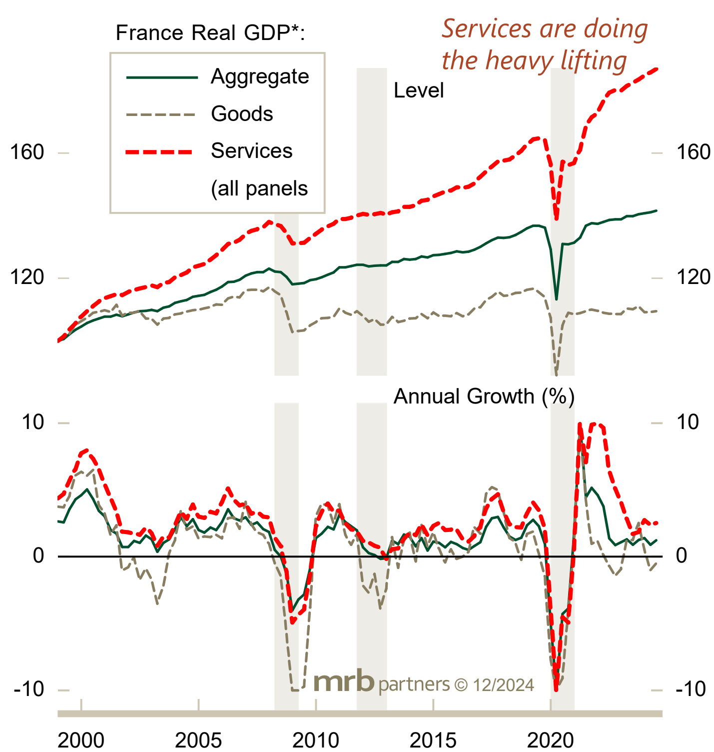
* Source: Markit Economics; excludes Portugal
** Truncated at 40; source: Markit Economics
Note: Shaded for Center of Economic Policy Research-designated euro area recessions

Chart 4 France Is Dominated By Services



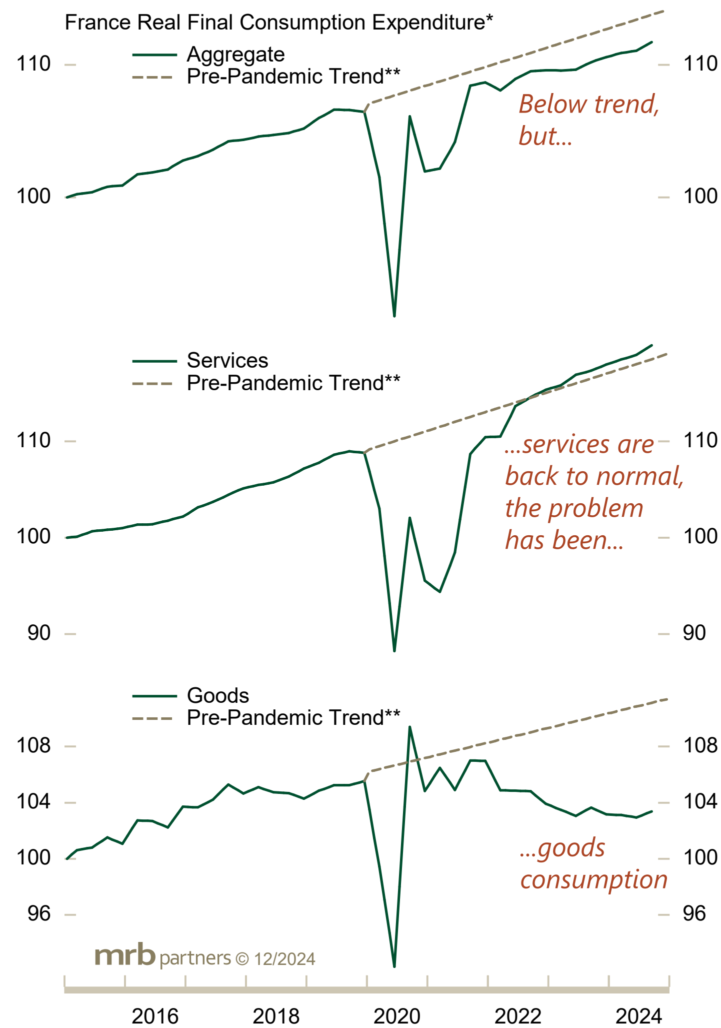
* Source: Eurostat
** Includes arts, entertainment, financial services, technology, professional services and retail
Note: Shaded for Center for Economic Policy Research-designated euro area recessions

Chart 5 France: The Tale Of Two Economies



* Source: Eurostat
Note: Shaded for Center for Economic Policy Research-designated euro area recessions

Chart 6 Services Back To Pre-Pandemic Trend While Goods Have Stayed Weak



* Rebased to 2015; source: Eurostat
** MRB calculation

for 10% of total French GDP, compared with over 64% for the service sector. Likewise, manufacturing jobs only account for 12% of total employment compared to 70% in the service sector (**chart 4**, previous page).

- Our advice has been to focus more on the much larger service sector, which has also shown relatively sluggish readings. However, demand for services is not as weak as perceived and is showing signs of improvement, in contrast with still depressed goods demand (**chart 5**).

Demand for services is not as weak as perceived and is showing signs of improvement

Consumer Spending: Green Shoots Appearing

- Like most developed economies, France's real GDP is heavily dominated by household spending, which accounts for 55% of total GDP. So far, aggregate consumption has not returned to pre-pandemic levels and is only growing at a 1.4% annual growth rate (**chart 6**). However, it is significant to point out that the drag on consumption has been demand for goods ***not*** services, as the latter is now above the pre-pandemic trend.

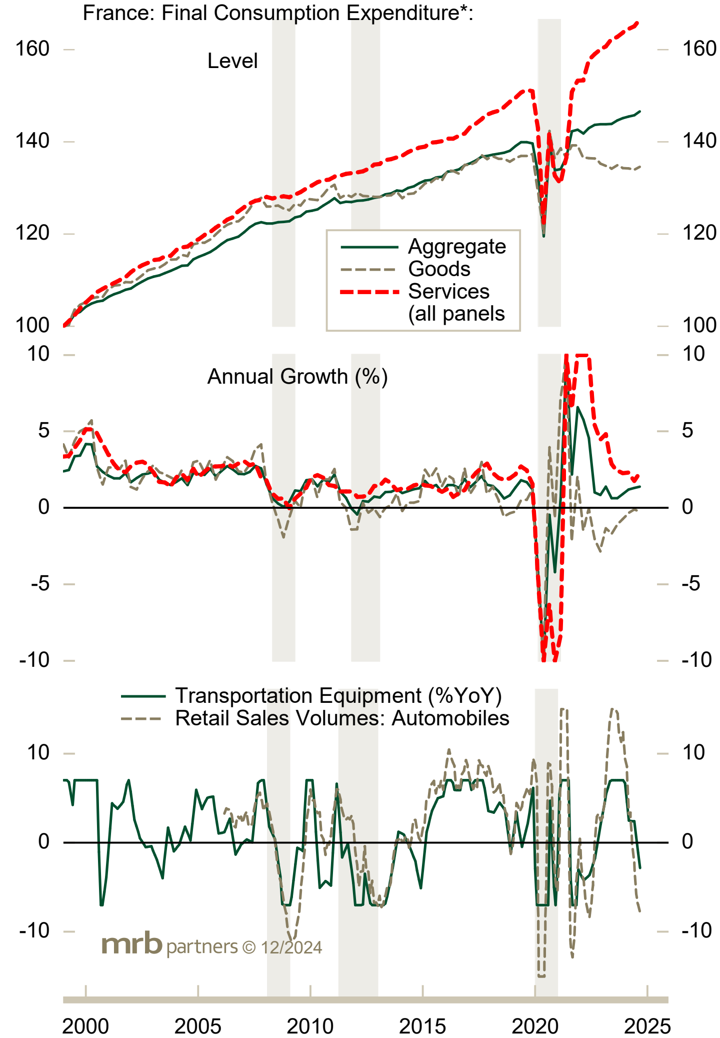
- Indeed, real final consumption expenditures for the service sector has been the bright spot of the French economy, expanding at a solid 2.3% annual growth rate compared to that of goods which is still mildly negative at -0.3% (**chart 7**, panel 2).

- It is important to point out that the biggest drag on goods consumption is demand in the transport equipment sector with sales for automobiles contracting by almost 10%, according to the last data point in retail sales volumes (**chart 7**, panel 3).

- Indeed, we find that dissecting retail sales provides a decent snapshot of recent consumer trends in France (**table 1**). The biggest drags on retail sales are demand for new automobiles. Other weak components include furniture, do-it-yourself (DIY), and jewelry. In contrast, demand for household appliances, textiles, and clothing as well as footwear has picked up materially.

- When constructing diffusion index out of all the variables incorporated in the retail sales basket one can see that there are now more items growing than those contracting (**chart 8**, panel 1). Historically, such positive readings herald better overall consumption trends.

Chart 7 Consumption Sluggishness Coming From Demand For Motor Vehicles



* Source: Eurostat
Note: Shaded for Center for Economic Policy Research-designated euro area recessions

- It is notable that retail sales volumes ***excluding*** motor vehicle sales are now growing a 4% year-over-year rate, which points to a stronger print in final household consumption growth for Q4 (**chart 8,** panel 2).

France has decent wage growth and households have large excess savings to spend

Consumer Fundamentals Are Decent

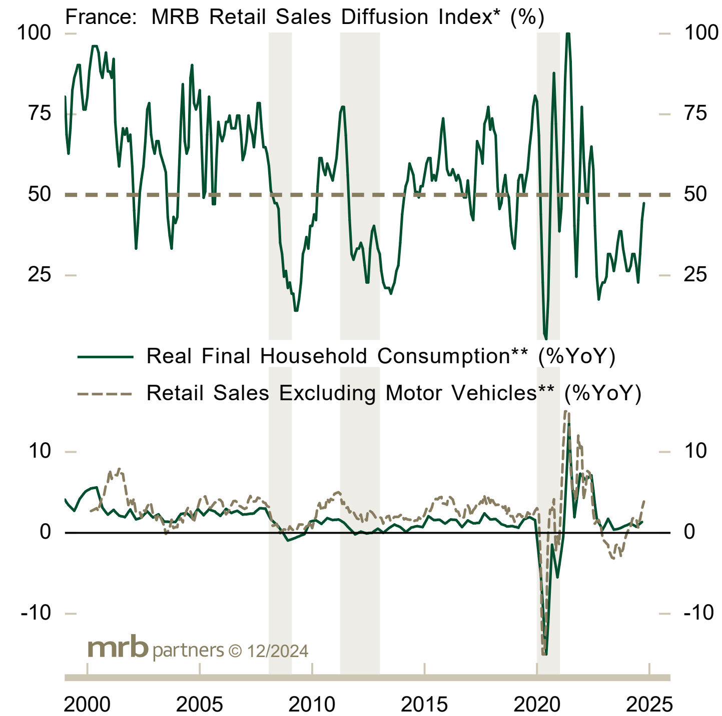
- France does not face the same competitiveness challenges as the German economy, but it is worth highlighting that it has among the highest household debt as a percent of disposable income (**chart 9**). This makes France one of the more interest rate sensitive countries in the euro area, ***although*** this also means it could respond more positively to ECB rate cuts than other countries.

Table 1 Retail Sales Breakdown

France: Retail Sales Volumes*	Weight	%YoY
Food Products	43%	-0.9
Industrial Goods Including Automobiles	57%	0.4
Textiles and Clothing	10%	5.8
Do-It-Yourself	7%	-4.0
New Automobiles	6%	-9.1
Consumer Electronics	5%	-0.7
Perfumes and Hygiene Products	4%	-0.7
Furniture	4%	-3.9
Pharmaceuticals	3%	7.6
Household Appliances	3%	6.1
Automobile Equipment	3%	2.2
Footwear	2%	6.9
Optical Equipment	2%	-1.2
Press - Stationery	2%	-3.5
Watches - Clocks - Jewellery	2%	-8.5
Sports Equipment	1%	1.5
Books	1%	-1.5
Games and Toys	1%	4.3
Bicycles - Motorcycles	1%	0.9

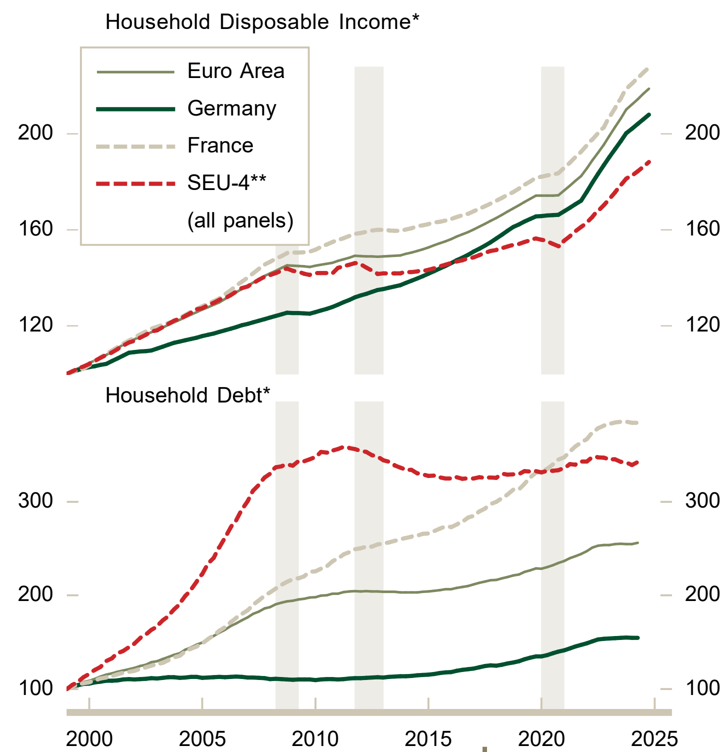
* Source: Eurostat

Chart 8 Watch For Retail Sales Ex-Autos



* Smoothed; net percent of retail sales volumes components in the Eurostat table with positive growth rates
** Truncated at 15 and -15; smoothed; source: Eurotstat Eurostat*
Note: Shaded for Center for Economic Policy Research-designated euro area recessions

Chart 9 France Is Interest Rate Sensitive



* Rebased; source: National Source
** GDP-weighted aggregate of Greece, Italy, Portugal and Spain
Note: Shaded for Center for Economic Policy Research-designated euro area recessions

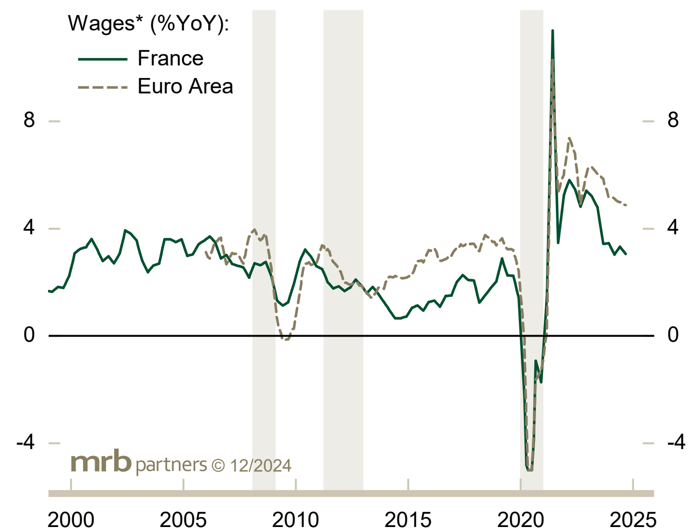
- While declining home prices have been a drag on consumer sentiment, wage growth remains reasonably healthy and consistent with the aggregate euro area (**chart 10**). Solid wages are indicative of strong corporate profits and wide margins throughout the region, despite lackluster overall GDP growth.

- French households have accumulated material excess savings amounting to roughly EUR 300 billion (**chart 11**). France has had an average savings rate over the past four years of 17%. In turn, solid wages, a sizable pile of excess savings, and ample room to lower the savings rate, provides underlying support for household consumption expenditures.

Final word: *The French economy and consumer sector have been held back by significant weakness in motor vehicle demand. However, households are still spending, particularly on services, and retail sales volumes* ***excluding*** *motor vehicles are improving and point to stronger trend in French consumption ahead. The key will be that political uncertainty within France does not blunt sentiment and the recent improvement (see next page).*

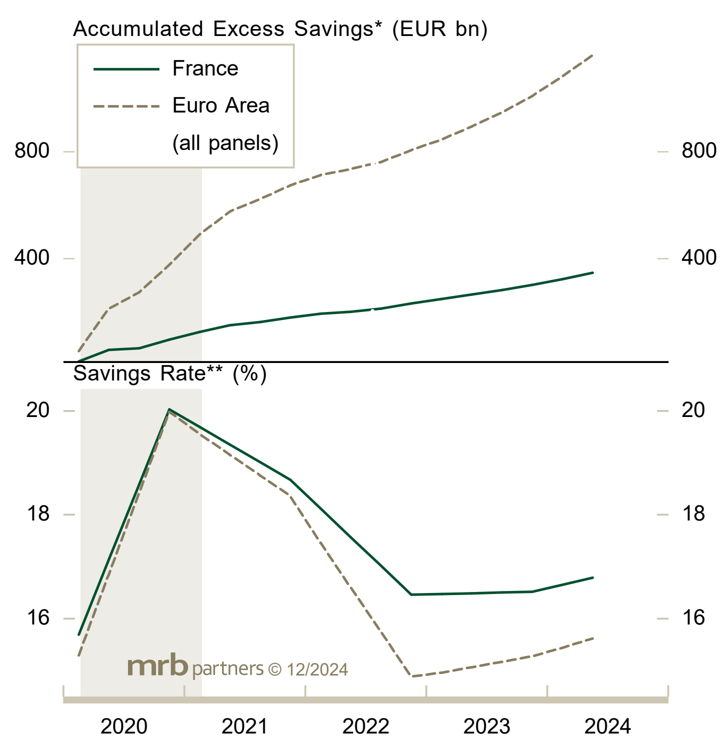
While global investors have considerably soured on the euro area, the French economy has several pockets of strength. Easier monetary conditions should set the stage from better aggregate growth for the region in 2025 and, thus, an improvement in depressed global investor sentiment. Contrarians, stay tuned.

Chart 10 **Wage Growth Remains Positive**



* Source: Eurostat
Note: Shaded for Center for Economic Policy Research-designated euro area recessions

Chart 11 **France Has Excess Savings To Spend**



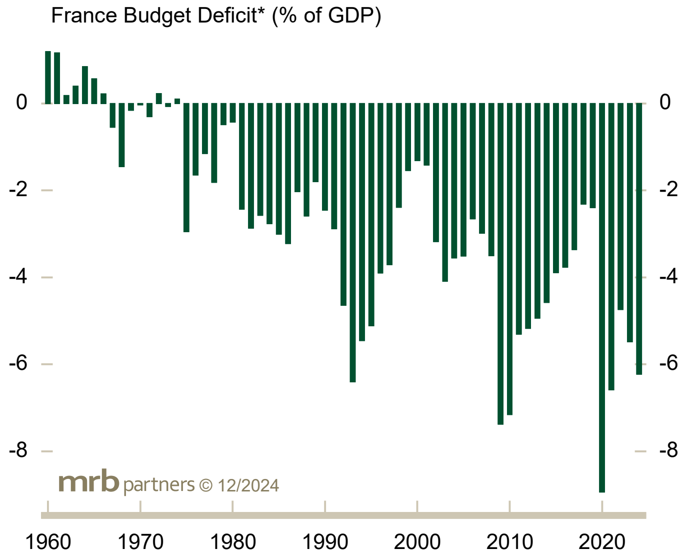
* Source: MRB Calculation
** Source: European Commission
Note: Shaded for Center for Economic Policy Research-designated euro area recessions

French Budget Deficit and Political Situation Update

France has been mired in political turmoil over the last several weeks. After enacting constitutional powers to bypass a parliamentary vote on his proposed budget, Prime Minister Barnier failed to survive vote of confidence. The situation is highly fluid, and the path forward is uncertain.

The most likely outcome is that President Macron will put in place a caretaker government that will rely on emergency powers to allow for basic operations including the collection of taxes and some expenditures. The implication is that France will likely not have a 2025 budget in place and will instead operate on a month-to-month basis.

Chart 12 The Government Deficit Will Remain A Drag On Economic Sentiment



* Source: European Commission

President Macron will have to appoint a new Premier though this could take time. As such, the government is likely to remain in disarray and partially paralyzed for some time. This will likely keep OAT-Bund spreads wide and make it more difficult (and costly) to reign in its budget deficit which is already nearly 6% of GDP (**chart 12**). The latter could also trigger the Excessive Deficit Procedure (EDF) by the European Parliament which could apply sanctions on France if it does not implement budget deficit control following a review protocol. This protocol is likely to drag out over several months.

Political turmoil could weigh on business and consumer sentiment, which needs to be monitored

Final Word: *Ongoing political uncertainty in France will weigh on investor, business, and consumer sentiment in the near run. It is premature to expect the recovery in French consumer spending to be sidetracked, but it is a risk that we will monitor. Stay tuned.*

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