France And Macron: A New Leader For Europe. Is The Economy Finally *En Marche*?

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What a difference a year makes. In early 2017, global investors were rightly concerned about the potential for a populist backlash by voters in France and how it might affect Europe and the rest of the international economy. After years of enduring onerous regulations, a bloated bureaucracy, a militant labor force, stubbornly high unemployment, and anemic economic growth, France had become the poster child for economic malaise, a veritable basket case in contrast to the vibrant German economy or even relative to neighboring Spain. However, fast forward to early 2018, and we believe France stands for the first time in a generation at the cusp of *leading* Europe — in its economic reform efforts, diplomatic initiatives, and integration plans. We believe France is finally on the march.

It's been four years since we last wrote about France and its economic prospects. At that time, a long line of French leaders had failed to live up to expectations for meaningful reforms. President Nicolas Sarkozy (2007 to 2012) talked a big game, but never delivered. And then President François Hollande (2012 to 2017), an economist by training, raised great hopes, but didn't live up to his potential. While he was taking up with mistresses and trying to impress the world with a muscular foreign policy, Hollande was far less successful in reforming France's economy, which was falling woefully behind Germany and the rest of Europe. After three recessions in five years and real GDP growth averaging only 1% for the past eight, the situation demanded change.

The May 2017 elections proved to be a decisive moment, but not in a way that anyone expected. At the time, right-wing, anti-immigration and anti-European Union (EU) Front National (FN) leader Marine Le Pen had higher polling numbers than any other mainstream candidate, and establishment parties appeared to be falling by the wayside. It was an ominous sign, and there was genuine fear that the 2017 election would get ugly. And then a very strange thing happened. While the established parties were swept aside in the 2017 presidential and National Assembly elections, as expected, it was not by Le Pen's FN or the far left. The surprise victory went instead to La République en Marche (LRM), a political movement established only one year earlier by former economy minister, and now current French president, Emmanuel Macron.

En Marche means "on the move," and that's exactly what Macron has in mind for France as he tries to improve on nearly two decades of paltry economic growth. President Macron, an avowed centrist and previous economy minister under Hollande who was disappointed by the lack of follow-through, campaigned on promises to build a vibrant French economy and restore the nation's standing in Europe. France took an unexpected gamble in choosing Macron, who just turned 40. He aims to encourage entrepreneurship and innovation, while protecting the vulnerable from globalization and technological change. It's a lofty ambition, and success won't come overnight. But based on his efforts so far, there's real hope that, unlike Hollande and other predecessors, Macron is already on the path that takes France forward.

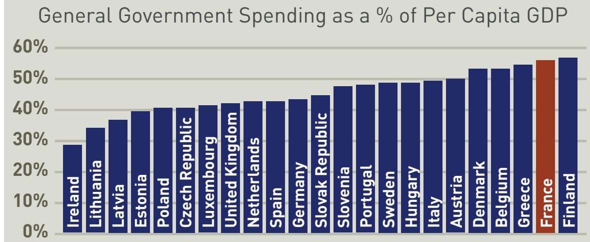
THE PROVERBIAL SICK MAN OF EUROPE: THEN AND NOW

In the 1970s, the United Kingdom (UK) was widely known as the "sick man" of Europe. The UK suffered from a poor long-term growth record, a bloated public sector, and a strike-addicted labor environment. In the 1980s, Margaret Thatcher and her Conservative Party introduced sweeping changes that successfully shrunk the state and boosted competitiveness in the private sector, leading the UK to its best economic growth in over a generation.

Similarly, in the late 1990s and into the early 2000s, Germany refused to deal with the costs of its reunification and consequently assumed the sick man status from the UK. Post-unification, Germany's economy was characterized by sub-par growth, high labor costs, and stubbornly high structural unemployment rates that rose from 9.2% in 1998 to 11.1% in 2005. In 2003, German Chancellor Gerhard Schröder and his Socialist Democratic Party unveiled their 2010 Agenda reforms that aimed to make Germany's labor market flexible, reduce labor costs, and regain competitiveness in international trade. Germany has since become been the engine of EU growth and in some ways has achieved hegemonic economic status on the continent.

Today, many consider France to be the reigning sick man of Europe. The country has thwarted its own growth by piling up high taxes and large amounts of public debt; imposing entrepreneur-crushing regulations, leading to an outflow of the best and brightest; and failing to grow jobs, as high labor costs have made France uncompetitive. Between 2000 and 2016, France's per capita GDP consistently grew more slowly than the Organization for Economic Cooperation and Development (OECD) average. France's public spending now accounts for 56% of GDP — the highest level among OECD nations — and the country taxes itself more than any other OECD country, except Denmark.

French government spending as a percent of per capita GDP is one of the highest in the European Union.



Note: Annual data as of 2016 or latest available as of January 31, 2018. OECD data only available for 23 of 28 EU member nations.
Source: Organization for Economic Cooperation and Development

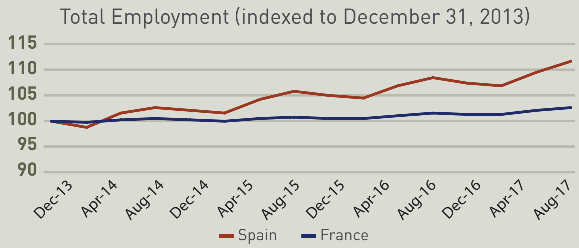
In addition, France has run a trade deficit every month since May 2004, and French companies have seen their international market share ebb as a result of declining competitiveness across the board. At 9.7% (as of October 2017), the country's unemployment rate is a staggering six percentage points higher than Germany's, and employment growth has been sluggish. Many young workers are hired on temporary contracts (80% of new labor contracts) to avoid a rigid code that offers an employer little flexibility in managing terminations and avoiding substantial severance costs. Adding to its employment woes, French workers have been notoriously opposed to change, with a strike rate more than twice that of Denmark, its closest European competitor. Immigration integration pressures and the threat of terrorism have only added to the level of malaise and tension in France.

ENTER MACRON: AN IMPRESSIVE START AND A CHANCE FOR LASTING REFORM

Macron, who took office in May 2017, is acting swiftly to take on the main impediments to growth: an overly large public sector, a lackluster private sector, a rigid labor market with high unit labor costs, and skittish investors. His recently passed budget is intended to bolster French influence in the EU and we believe his plans to slash spending on housing and jobs programs will decidedly shift the burden away from business and workers.

Labor reform worked wonders in Germany in 2004 and later in Spain in 2012 after the great financial crisis by improving management bargaining power and keeping labor costs in check. Why not in France? It all began in September 2017, when Macron signed several decrees to begin overhauling France's arcane labor rules. Through his actions, companies gained more freedom to collectively bargain at the enterprise level rather than at the national level, and new rules place a ceiling on payouts for dismissals that are deemed unfair.

Could French employment improve like that of neighboring Spain?



Note: Data is latest available as of January 31, 2018.
Not seasonally adjusted.
Source: FactSet

There are also plans to amend unemployment benefits and consolidate France's 35 pension systems. What was most remarkable to us, and to most French people we spoke with, was that these changes were only met with lukewarm resistance from the unions, which until now have had a reputation as being the most active and confrontational in the world. Surprisingly, there was little pushback and there were no major strikes or protests in the streets. The tepid response underscores the decline of labor's influence (only 8% of the workforce is unionized), French weariness with anemic growth, and Macron's innate ability to deftly maneuver within the new political environment and divide and conquer his opponents.

Macron was candid about his plans both before and after the election. He was careful to maintain a dialogue with interested parties, especially the Confédération Française Démocratique du Travail (CFDT). The CFDT is a more moderate union, as opposed to the more militant Confédération Générale du Travail (CGT). Macron's reforms have thus faced far less public opposition, as Reuters reported.[1 (*)]:

> Barely 26,000 attended one Paris rally on Tuesday to protest against the reforms, a fraction of the hundreds of thousands who went on strike in the heyday of French industrial action, freezing activity in swathes of the economy. French strikes are not what they used to be, reflecting a cooling in national attitude to union militancy plus a change in approach by Macron who flagged his reforms well in advance to union leaders who have in turn seen their powers decline.

And the young president isn't finished. Similar to recent U.S. congressional moves, he has further pushed to reduce the corporate tax rate from 33.3% to 25% by 2022, and he plans to lower payroll taxes by transferring some social charges to a more broad-based tax. In October, the National Assembly adopted measures for 2018 that included scrapping the wealth levy on everything except property. By 2022, Macron plans to have reduced public spending to 52% of GDP (down from 56% and the highest in the OECD) and to have sold off a portion of state holdings. He wants the government budget deficit to decline to 2.9% in 2018, which would be the first time in a decade that it has been below 3%. A recent Harris Interactive poll cites that close to 60% of French people are optimistic for 2018. Now, those are big changes.

There is some anecdotal evidence that things are actually changing on the ground as well, and that things have been literally turned on their head. The UK has long been considered internationally focused, innovative, traveler-friendly, and open for business, while France has been derided for being anything but that. Now with Brexit looming for Britain, Paris has made great strides forward. On our recent trip to the international finance capital of London for example, we were stuck in the passport-check line for over an hour at the airport as one, sole immigration agent slowly worked through the processing of dozens of passengers, even as other officials looked on. And most telling, London has refused to renew Uber's license to operate — in the city that spawned Uber's rise in Europe. By contrast and quite surprisingly, we found the Paris airport and immigration operations highly efficient, Paris Metro agents were omnipresent and smilingly reaching out to assist travelers, and the city was open for Uber business, with more than 20,000 Uber drivers available. Things really have changed.

1 "With French down on strikes, Macron reforms get easier ride," Reuters, October 12, 2017

THE ELECTORAL LANDSCAPE: STILL SPLINTERED BUT THE MIDDLE HOLDS

Macron's 2017 surprise victory was in part due to France's unique electoral process. As the top vote-getters in the first round of the presidential election, Macron and Le Pen moved to the second round, which Macron won by a whopping two-to-one margin. LRM, the party that hadn't even existed before 2016, claimed 308 out of 577 total seats in France's National Assembly, putting Macron's new party in a dominant position. When added to ally MoDem's 42 seats, Macron has the support of 350 legislators.

The disillusion with elites and pervasive sense of gloom helped Macron, but he has no monopoly on disgruntled voters. Le Pen's support continues to be strong in the "France of the forgotten" where joblessness is high and the social fabric is weakening. At the opposite end of the political spectrum, hard-left candidate Jean-Luc Mélenchon has revived the spirits of the far left, and the 66-year-old firebrand's popularity remains high with those voters.

So far, Macron has proved to be canny in courting his opponents and in creating an electoral mandate for his ideas. As mentioned, he worked with the moderate CFDT in crafting changes to the labor code. In a nod to protectionists, Macron's government temporarily nationalized a French shipyard last summer to thwart a takeover bid by an Italian company. Macron is also demanding tighter controls on foreign workers who work in Western Europe. There are signs that his approach is working: After an initial slide in popularity, Macron's approval rating jumped to 52% by year-end 2017 according to French pollsters Ifop. Maybe French voters are not as averse to market-based reform as conventional wisdom would suggest.

MACRON AND EUROPEAN LEADERSHIP

Unlike his electoral opponents, the French president is staunchly pro-Europe and is now the driving force to further integrate the continent. And with Germany having been mired in post-election political wrangling, Macron has sensed an opening. He has a long and breathtaking wish list for further EU integration that includes a common European asylum agency and border police, a Eurozone finance minister responsible to the European Parliament, a much larger EU budget, and a European Monetary Fund to aid troubled member states. He has suggested a joint European defense budget, a continent-wide rapid-reaction force to work with national armies, the creation of a European intelligence academy to fight terrorism, and greater harmonization of national tax policies.

Macron sees France's national interest as meshing neatly with his vision for the continent. If France can demonstrate that it can be trusted to get its act together, it is in a better position to get Germany to support further integration of EU members. The developing relationship between Macron and German Chancellor Angela Merkel will be an interesting one to watch. While Merkel has previously established herself as the senior partner in the Franco-German alliance, she has recently struggled to put a governing coalition together in Germany following the 2017 election. From our perspective, Merkel was never a visionary, but more of a technocrat: Germany's success has largely been due to her predecessor's 2010 Agenda reforms and not the result of a grand strategy of her own. Potential successors to Merkel in her Christian Democratic Union are starting to jockey for position. Macron's stepping out from Merkel's shadow within Europe is but a metaphor for France's impending rise.

Aside from reforming the French economy, Macron clearly wants to re-assert French influence and act as the lead actor on the global stage. He is seen as a leader in the fight against global climate change, a role he relishes. His initiative in being a mediator in Lebanon's crisis and his desire to address the broader Saudi-Iran rivalry underscore Macron's goal of re-establishing France as a leading power.

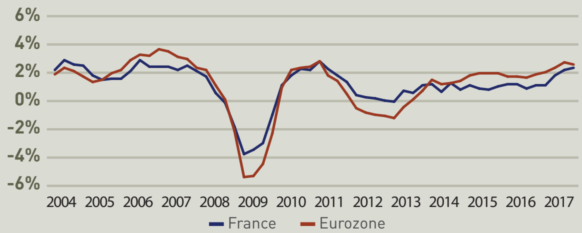
AN UPTURN IN EUROPE: FRANCE WILL NOW BE ROWING IN THE SAME DIRECTION

Led most recently by Germany, the European economy further improved and accelerated in 2017, propelled by resilient private consumption, stronger global expansion and increasing PMI's, and falling unemployment. Credit growth is beginning to pick up, and the economies of all member states are expanding. Labor markets are strengthening and inflation continues to be modest. The European Commission (EC) projects the EU economy is set to grow 2.3% in 2017, easily surpassing its prediction in the spring of 1.9%. The EC expects EU growth to continue at 2.1% in 2018.

France has been a particular beneficiary of the ECB's unconventional monetary policy, resulting in consumer and corporate credit growth and an acceleration in housing, which is aiding the reinvigorated construction sector. Economic activity in France is forecast by the EC to accelerate to over 2%, possibly as high as 2.5%, driven by private investment growth and a strong recovery in the housing market. The unemployment rate is expected to fall to 9.3% in 2018 and 8.9% in 2019, and GDP growth is expected to reach 1.6% in 2017 and 1.7% in 2018. While these GDP figures may seem modest, it's a significant improvement over recent growth rates of 0.9% (2014), 1.1% (2015), and 1.2% (2016).

The French economy seems to be catching up to the rest of Europe.

Real GDP Growth (Year Over Year)

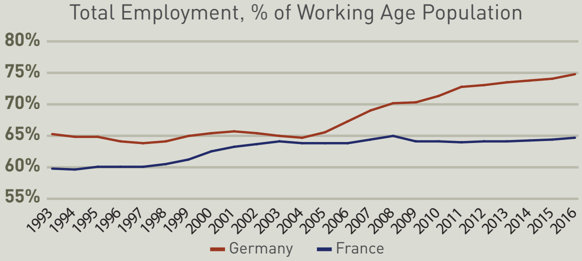


Note: Data is latest available as of January 31, 2018.
Source: FactSet

France has its challenges, but the near- and longer-term economic outlooks are encouraging and represent a sea change in how we view the market. France's uncompetitive unit labor costs have been a major economic headwind, accounting for its large trade deficit and relatively weak GDP growth. Now we see the employment wage gap with Germany as a big opportunity for investors to benefit from decreasing labor costs. We expect the new labor reforms to support corporate spending, and significant future tax cuts and other reforms will provide further upside, both cyclically and secularly. These reforms, coupled with a restraint on government spending, should allow France to become compliant with EU budget deficit rules once again.

France has the opportunity to play catch up with Germany in terms of employment.

Total Employment, % of Working Age Population



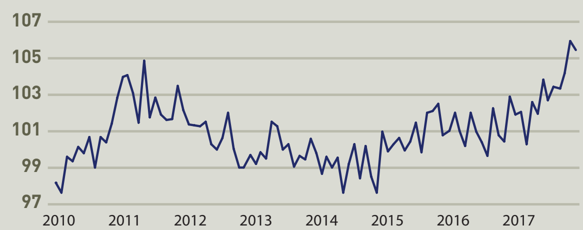
Note: Data is latest available as of January 31, 2018
Source: Eurostat

While we remain overweight Europe, we are looking to rebalance our holdings and slowly reduce our exposure to the region — but not to France. The improvements in France are not revolutionary, but evolutionary, which in our view is still big for France. With Germany treading water, we believe France presents better opportunities for investment. We have been overweight Germany since 2009, but are now reversing course. We also expect France to benefit from Brexit at the UK's expense. Emboldened by a coalition deal in Germany and a revived Franco-German alliance, both Paris and Berlin will play hardball with the UK and will push for a Eurozone reform deal and greater integration. Macron has the energy and initiative to lead Europe. With the UK struggling and Germany only slowly sorting out its leadership, this still looks to be France's moment.

We have been increasing our exposure to France for the first time since 2004, as we expect the country's current account balance, competiveness, and growth to improve markedly. Our main focus is on the leading French companies that we expect to benefit from domestic strength, in industries including consumption, transportation, and real estate/housing. As we expect the French economic revival to support regional growth and a strengthening euro, it also means we will pay increasing attention to European domestic-growth companies, perhaps at the expense of export-focused multinationals.

French industrial production increased meaningfully during 2017.

Markit Industrial Production Index, France



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Source: FactSet

We first began to flag Europe's improving economic outlook in 2015, when euro currency weakness, supportive monetary policy, banking reform, weak energy prices, and declining austerity measures were aiding a cyclical upturn in the region. Europe is finally — belatedly — reaping the benefits of its reform efforts, and markets are responding as corporate earnings recover. Even as some of these tailwinds become less supportive or even turn into headwinds, we expect any challenges to be offset by stronger business confidence, elevated employment growth, accelerating personal income, record consumer confidence (highest since 1985), and increasing capital expenditures in France. And even as Germany's economic growth hits six-year highs and consumption accelerates, we believe the baton will likely pass to France in the near-term future.

We have always viewed Europe's prospects as two steps forward, one step back. While Brexit, Italy's huge debt load and March elections, and Catalonia's independence push present near-term challenges for the continent, the good news is that France, the world's sixth-largest economy is finally getting its act together, taking its prescribed medicine, and is on the mend. And it's not just France, but the entire region that will be better for it.
