Weekly Update

C0 | EXTERNAL PUBLICATION

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All data taken from Bloomberg (20/12/2018).

Not so Mellow Yellow

After the "bonnets rouges" in 2013, France has experienced another of its periodic bouts of violent, if colourful, protests with the recent "gilets jaunes" movement. Although the initial trigger was again linked to vehicle transport – the "écotaxe" arches five years ago and the increases in fuel taxes in 2018 – this year's movement quickly evolved into a broad protest against declining living standards and ever-higher taxes (left-hand chart).

Faced with pitched battles between police and protesters in major cities and roadblocks around commercial centers and refineries, the French government switched tack. First, the hikes in fuel duties were postponed for six months. Then, Emmanuel Macron announced on December 10 a series of measures designed to address the protesters' demands and reduce tensions.

These included a 6% increase in the minimum wage, fully financed by the State; the cancellation of the planned increase in social security contributions for the poorest pensioners; and tax exemptions for overtime hours and 2018 year-end bonuses. These boosts to household purchasing power will be financed in part by the postponement of planned cuts to corporate taxes. However, President Macron decided to hold the course on other reforms – the partial repeal of the wealth tax and the reduction in capital gains taxes, for example.

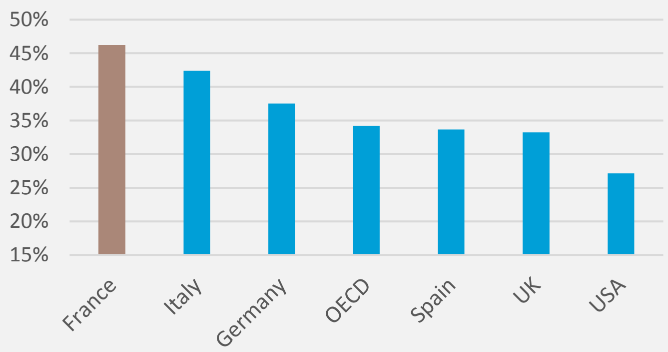
Our economists calculate that these measures will cost around €10 billion, adding around 0.5 percentage point (pp) to France's deficit to GDP ratio. This is likely to take the deficit over the 3% threshold enshrined in the Maastricht Treaty, an uncomfortably high level given recent tensions with the European Commission over Italy's (lower) planned budget deficit. However, the spike in the deficit should only be temporary – 2019 will see a tax credit replaced by permanent cuts to social security contributions, a one-off factor adding 0.8pp to next year's deficit.

Provided that the protests die down, the impact on growth should be limited. On the one hand, INSEE (French official statistics institution) has cut its Q4 GDP growth forecast from 0.4% to 0.2% QoQ. On the other, our economists suggest that the concessions, combined with the recent decline in oil prices, could boost household purchasing power by 0.9pp next year, the fastest pace in ten years. And as the measures target lower-income families – which spend a higher proportion of income than others – household spending is expected to benefit. In all, the fiscal slippage should bolster next year's growth by around 0.2pp.

Putting it all together. For now, Macron's reforms remain on track despite the hit to credibility. The gap in yields between French and German government bonds has widened by 10 basis points since end September. However, the relationship between French debt and its neighbours (75% Germany, 25% Italy and Spain) continues to hold, as shown on the right-hand chart.

France has the highest tax burden in the OECD

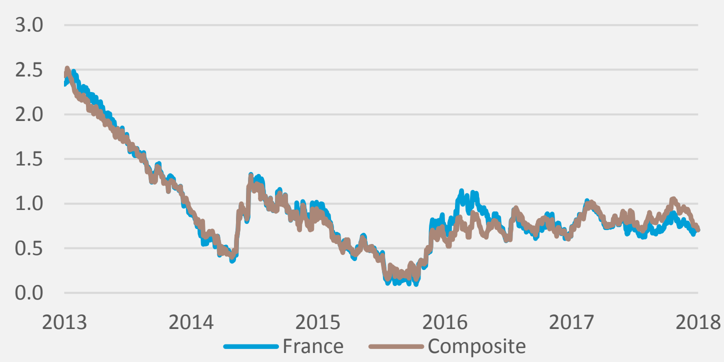
Tax revenue in % of GDP (2017)



Sources: SGPB, OECD, data as of 19/12/2018

France: 75% core + 25% periphery?

French OAT yield vs composite (%)



Sources: SGPB, Datastream, data as of 19/12/2018

This week and next

EUROZONE

- Eurozone inflation was revised down from 2.0% to 1.9% YoY in November after October's 2.2%, the highest since 2012. Core inflation dropped to 1% from 1.1% in October, in line with flash estimates.
- ECB confirmed the end of the asset purchase programme this month, highlighting "continuing confidence but increasing caution" as macro risks are tilted to the downside.
- Germany's Ifo Business Climate Index dropped to 101 in December from 102 in November, the lowest level in over two years.

Next week's key events	Per.	Prev.	Cons.
28 Dec Germany: Inflation rate YoY	Dec	2.3%	1.9%

UNITED KINGDOM

- Consumer price inflation slowed to 2.3% in November from 2.4% in October, while core readings dropped to 1.8% from 1.9%. Headline prices hit a 20-month low on a sharp fall in oil prices.
- UK retail sales rose 3.6% YoY in November versus 2.0% expected, while core retail sales also rose 3.8% in November from October's 2.7%.
- The Bank of England (BoE) kept the benchmark rate unchanged at 0.75% as consumer demand and business investment were likely to have suffered amid Brexit uncertainty.

No key events next week	Per.	Prev.	Cons.

UNITED STATES

- The New York Fed's Empire State manufacturing index fell to 10.9 in December from 23.3 in the previous month. That is the lowest level since May 2017, and the biggest decline since May 2016.
- The US current account deficit climbed to a 10-year high in Q3 at $124.8bn, up from $101.2bn in Q2 as growth remains strong.
- The Federal Reserve hiked Fed Funds by 25 basis points (bp) to a range of 2.25% to 2.5% on Wednesday, much as expected. 10-year yields tumbled further to 2.76% from 2.82%.

Next week's key events		Per.	Prev.	Cons.
27 Dec	Consumer Confidence	Dec	135.7	133.6
27 Dec	New Home sales	Nov	544k	567k

ASIA & EMERGING COUNTRIES

- Japan's export growth slowed to 0.1% YoY in November from 8.2% in October, as shipments to the US and China weakened sharply amid trade war tensions.
- The Bank of Japan (BoJ) kept policy unchanged, maintaining that economic expansion remains steady despite the US/China trade war.
- Unemployment in Turkey continued to rise, hitting 11.4% in September in the aftermath of August's sell-off.

Next week's key events	Per.	Prev.	Cons.
28 Dec Japan Retail trade YoY	Nov	3.5%	2.1%
28 Dec Japan Jobless Rate	Nov	2.4%	2.4%

Sources: Datastream, Bloomberg, 21 December 2018, Note: YoY = year-on-year; QoQ = quarter-on-quarter; MoM = month-on-month, P = preliminary figure, A = advanced figure, F = final figure, seasonally adjusted, ECB = European Central Bank

Our 3-month targets for currencies and commodities

	Thursday close	3mth target
EUR/USD	1.14	1.12
GBP/USD	1.27	1.28
EUR/CHF	1.13	1.12
USD/JPY	111	112
Brent	$54.9	65
Gold	$1258/once	1220

No changes made to our 3-month targets this week.

Past performance should not be seen as a guarantee of future returns.

Question time

Past performance should not be seen as a guarantee of future returns.

SPAIN – THE CURRENT PICTURE

A look at macro-economics, public finances and Spanish equities

What is the current macro-economic picture in Spain?

The Spanish economy has been resilient this year despite slower growth in the eurozone. The country has addressed its imbalances and achieved (a) gains in competitiveness, (b) steady decline in unemployment over the past five years, (c) deleveraging of both the private and financial sectors, and (d) a lower rate of non-performing loans. Economic growth has expanded at a sustained pace over the past three years. Real GDP growth printed at 2.5% YoY in Q3 2018, while core inflation remains moderate (1% YoY in October). Growth drivers are far more diversified than in the past when the economy was mostly driven by real estate and construction – exports and services are now significant contributors to the economic expansion. Thanks to improved wage competitiveness, export growth has been solid and the current account has moved from deficit to surplus, at around 1.2% of GDP in 2018. However, Spain's ratio of trade to GDP remains lower than in France and Germany, making it is less vulnerable to trade tensions.

What about public finances?

Spain has gradually reduced its deficit over the past decade. According to European Commission forecasts, the public deficit should fall from 2.7% to 2.0% of GDP in 2019, and public debt is now close to the eurozone average at 97% of GDP.

Could you give us your views on Spanish equities?

Despite a supportive economic background, the Spanish equity market has trended lower this year, down -9.4% year-to-date* (YTD), roughly in line with the Euro Stoxx. The main culprit is the heavyweight Banking sector (29% of total market capitalisation) which has dropped 23.7% YTD*. Bank stocks have been weak across the Eurozone, but Spain faces some specific worries – Spanish banks have high exposure to Turkey, and have suffered as Italy's woes have revived worries about banking stability in the periphery.

Nevertheless, the IBEX 35 index has outperformed the German and Italian indices, as it is less exposed to the ongoing trade war than the others. For example, the Automobile and Metals & Mining sectors account for less than 2% of total market capitalisation, compared to 13.2% for the DAX, 11.8% for the FTSE MIB or 5% for the CAC 40.

In coming months, the banking sector could remain a significant hurdle for the Spanish equity market. However, heavyweight exposure to several defensive sectors (Utilities and Communications services) may provide some support despite the global economic slowdown.

**Source: Bloomberg, as of 19 December 2018*

Market performance

Past performance should not be seen as a guarantee of future returns.

Interest rates

Interest rates	Last	1wk		3mth	YTD	12mth
EONIA (EUR)	-36 bp	0 bp	→	0 bp	-2 bp	-1 bp
3mth Euribor (EUR)	-31 bp	0 bp	→	1 bp	2 bp	2 bp
3mth Libor (USD)	282 bp	4 bp	↑	46 bp	113 bp	117 bp
3mth Libor (GBP)	91 bp	1 bp	→	10 bp	39 bp	39 bp
10-year US Treasury bond	279 bp	-12 bp	↓	-29 bp	38 bp	29 bp
10-year German bond	23 bp	-5 bp	↓	-25 bp	-19 bp	-17 bp
10-year French bond	68 bp	-5 bp	↓	-12 bp	-11 bp	-7 bp
10-year UK bond	127 bp	-3 bp	↓	-32 bp	8 bp	1 bp

Credit

Credit	1wk		3mth	YTD	12mth
BAML EURO Corp. IG	0.2%	↑	-0.6 %	-1.1 %	-1.3 %
BAML EURO Corp HY	-0.2%	↓	-3.8 %	-3.5 %	-3.4 %
BAML GBP Corp IG	0.3%	↑	0.1 %	-2.0 %	-1.4 %
BAML US IG	0.6%	↑	0.2 %	-2.3 %	-1.5 %
BAML US HY	-2.2%	↓	-4.4 %	-2.1 %	-1.9 %
JPM Global EM Sov. Plus	0.3%	↑	-0.4 %	-5.3 %	-5.0 %

Exchange rates

Exchange rates	Last	1wk		3mth	YTD	12mth
EUR/USD	1.14	0.7 %	↑	-2.8 %	-4.7 %	-3.6%
EUR/CHF	1.13	0.1 %	→	0.1 %	-3.4 %	-3.5%
GBP/USD	1.27	0.0 %	→	-4.6 %	-6.3 %	-5.4%
USD/JPY	111	-2.1 %	↓	-1.1 %	-1.2 %	-1.9%
USD/BRL	3.84	-1.3 %	↓	-5.8 %	16.0 %	16.5%
USD/CNY	6.89	0.1 %	→	0.6 %	5.8 %	4.7%
USD/RUB	68.3	3.2 %	↑	3.0 %	18.5 %	16.4%

Government bonds*

Government bonds*	1wk		3mth	YTD	12mth
United States (3-7yr)	0.5 %	↑	2.1 %	0.7 %	1.0 %
United Kingdom (3-7yr)	0.1 %	→	1.6 %	0.8 %	1.1 %
Germany (3-7yr)	0.1 %	↑	0.8 %	0.9 %	0.7 %
Japan (3-7yr)	0.1 %	→	0.4 %	0.2 %	0.2 %

Equities*

Equities*	Last	1wk		3mth	YTD	12mth
MSCI AC World	451	-5.3 %	↓	-13.9 %	-10.0 %	-9.4 %
Eurostoxx 50	3,000	-3.5 %	↓	-11.4 %	-11.3 %	-12.5 %
DAX	10,611	-2.9 %	↓	-13.9 %	-17.9 %	-18.8 %
CAC 40	4,692	-4.0 %	↓	-13.5 %	-8.7 %	-9.4 %
S&P 500	2,467	-6.9 %	↓	-15.4 %	-5.9 %	-6.1 %
FTSE 100	6,712	-2.4 %	↓	-8.2 %	-9.0 %	-7.0 %
SMI	8,414	-4.5 %	↓	-6.5 %	-7.2 %	-6.5 %
Topix	1,517	-6.2 %	↓	-14.4 %	-14.8 %	-14.9 %
IBOV Brazil	85,269	-2.9 %	↓	9.2 %	11.6 %	16.2 %
MICEX Russia *	2,353	-1.1 %	↓	-2.0 %	11.5 %	11.9 %
MSCI EM	960	-2.6 %	↓	-7.2 %	-14.9 %	-12.9 %
SENSEX 30 India	36,432	1.4 %	↑	-1.7 %	9.1 %	9.2 %
Hang Seng (H-K)	25,624	-3.4 %	↓	-6.5 %	-11.3 %	-9.2 %
Shanghaï Composite	2,536	-3.7 %	↓	-7.1 %	-23.3 %	-22.9 %

Commodities

Commodities	Last	1wk		3mth	YTD	12mth
Brent	$55	-9.4 %	↓	-30.2 %	-17.6 %	-14.8 %
Gold	$1,258	1.2 %	↑	4.5 %	-3.5 %	-0.5 %
Silver	$14.7	-0.3 %	↓	3.5 %	-13.4 %	-9.1 %

Source: DataStream, on 20/12/2018. 1wk = 1-week change, 3mth = 3-month change, 12mth = 12-month change, YTD = year-to-date change, YoY = year-on-year change, BAML = Bank of America Merrill Lynch, JPM = JP Morgan, IG = Investment Grade, EM = emerging markets. * Price return for MICEX equity index. Equities; total return in local currency. Government bonds = 3-7 year returns. Figures are rounded.

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