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Brewin Dolphin

Markets in a Minute

Guy Foster, Chief Strategist, discusses the potential impact of trade tariffs on investment markets and the U.S. economy, and political turmoil in France. Plus, Janet Mui, Head of Market Analysis, analyses fresh U.S. inflation data.

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Last week was Thanksgiving weekend in the U.S. This important holiday tends to bring a gentle slowdown in activity. American markets were closed on Thursday and had a shorter trading day on Friday, allowing many investors to take a long weekend.

The week was relatively quiet for markets due to the reduced liquidity, but one pocket of excitement came from France.

France's challenging budget deficit

French Prime Minister Michel Barnier was on the sharp end of some fairly ominous comments from Marine Le Pen, leader of the National Rally party.

France is one of the major economies with a challenging budget deficit. Arguably, it's not much worse than the UK's deficit, and it's tangibly better than America's, but the combination of political and economic factors means the challenges are particularly pressing for France right now. Let's unpick the theory behind its challenging situation.

The U.S. is assumed to benefit from the exorbitant privilege of hosting the world's reserve currency. Generally speaking, this means other countries feel they must hold U.S. dollars for trade (and hold their reserves of U.S. dollars in U.S. assets, of which treasuries are the highest quality and most liquid). This required ownership of U.S. government bonds helps prevent yields from rising as much as they otherwise would.

Both the U.S. and the UK issue debt in their own exclusive currencies. This largely mitigates the risk of default. In extreme situations, these governments can print the money needed to pay bondholders if necessary. So, the risk for most developed countries isn't that they can't meet payments, but rather the consequences of doing so would be inflationary. This is why the period before the establishment of the euro saw a number of currency crises.

The Eurozone is now comprised of a group of countries that share a currency and must abide by rules to ensure the stability and efficacy of that currency. Theoretically, it means countries don't have the option of the printing press to fall back on and would need to tighten their belts, borrow, and default on their bonds if tax revenues fall significantly short of expenditure.

In practise, that's what has happened. Greece was forced into a painful austerity programme and bondholders suffered losses when the country found itself unable to balance its budget.

This hasn't always been the case. Subsequent financially stressful periods have seen the European Central Bank support Eurozone bond markets in a way that, arguably, supports the weaker members at the collective expense of all.

This comes at a time when the traditional powerhouses of French politics, the centre-left and centre-right, have been losing ground politically.

President Emmanuel Macron held a surprise legislative election in June and July, which saw his party lose a lot of seats. Indeed, it was only dark electoral arts (standing down the more centrist candidates to avoid splitting the vote) that prevented the more extreme parties from achieving a majority. In the absence of a clear winner, Macron's Ensemble coalition formed a minority government with Barnier as prime minister.

Making moves to reduce borrowing

It's from this perilous position Barnier attempts to deal with the issues of the day: a 5%+ budget deficit. France now breaks the European Union (EU)'s 'excessive deficit' monitoring threshold and must take steps to reduce its borrowing.

Prime Minister Barnier had promised to bring the deficit back to 5% of gross domestic product by the end of 2025, and within the 3% threshold by 2029, in accordance with 'excessive deficit' procedure. However, many are sceptical that he'll be able to achieve this.

A major hindrance will be the political circumstances – while the UK government has a large majority to force through unpopular decisions, France's minority government needs the support of its political adversaries to stay in power, a situation that seems doomed to fail.

Despite the diminished state of this government, Barnier can force through legislation without a vote. However, doing so effectively challenges his fellow lawmakers to pass a vote of no confidence in the government, effectively triggering a new election.

In negotiations so far, Barnier has conceded ground by cancelling planned increases in energy tariffs, but the National Rally party wants further concessions. This will make it harder to get back within the acceptable ranges of the demanding 'excessive deficit' procedure – as will the prospect of further tariffs on exports to the U.S.

Who will win in a trade spat?

Tariffs introduced by the U.S. would certainly be met by retaliatory measures from trading partners such as the EU, but a good shorthand for the eventual victor in a trade spat is to look at trade balances and determine who has most to lose.

If a country runs a trade deficit (like the U.S. is currently), it spends more on imports than it earns from exports – so if both imports and exports were subject to tariffs, the deficit country would be better off.

The U.S. generally has a trade deficit with most trading partners, which partly explains why President-elect Donald Trump is so disposed towards tariffs. However, that's a gross over-simplification and in practice, the beneficiary of trade isn't necessarily the party that makes the most sales.

While the revenue from tariffs, and the benefits of reduced trade, will also accrue to the biggest importers, the burden of them may still be more complicated. For example, if the goods are mobile and generic, a tariff will likely make it harder for an exporter to compete with international peers, and they will lose sales.

In contrast, if a product can't be widely produced, is really important, and can only be obtained from a specific source, then a tariff on that source raises prices for customers with less impact on the seller.

Some goods can be considered strategically important because they are used in defence or high technology systems. A recent study found that Europe sold 32 strategically important goods to the U.S. that it would be difficult to transition away from, while the U.S. sold just eight such goods back.

It still seems safe to assume that Europe has a relatively large amount to lose from a reduction in trade, but this does show how there can be costs to all parties. This is why free trade was considered, perhaps over-simplistically, to be a positive sum game that benefits all economies (if not everyone within those economies).

Will a sharp bond sell-off affect voters?

As the week ended, the standoff amongst French politicians intensified.

French assets sold off sharply as the political crisis deepened but were relatively stable towards the end of the week. Sharp selloffs in bonds (like the UK saw after the 2022 mini budget) will likely form a material test of populists' ability to remain popular.

Whether the financial market's reaction to this current tension in France is significant enough to become a consideration for voters remains to be seen. If Marine Le Pen is as good as her word, the beginning of this week may prove an important moment.

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