

3rd Quarter 2014 Alvine Capital Newsletter

The Battle for France

Key issue - a prolonged economic crisis is rapidly spilling over into the febrile world of French politics. With a history of sometimes revolutionary change the prospects for some sort of dramatic rupture cannot be discounted.

Key recommendation - with almost three years until the next Presidential election it is difficult to make political forecasts. However the key external players, the ECB and the Germans, are sufficiently fearful of the rise of the National Front to prioritise a substantial upscaling of monetary stimulus and thereby attempt a rescue of the economy. Expect negative interest rates, mass buying of ABS and further appreciation of asset prices.



How can you govern a nation that has 246 different cheeses?

General Charles De Gaulle (source: Brainy quote.com)

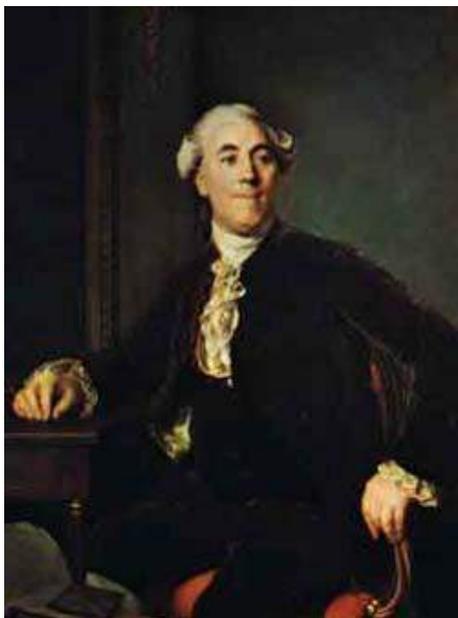
1789/1830/1870/1940/1958 - are all dates in history that brought the downfall of French government regimes. From the storming of the Bastille on July 14th 1789 to the collapse of the 4th Republic and the ascent of the wartime hero De Gaulle, complete changes of institutions and constitutions, with fresh players and policies have taken place five times in a little over two hundred years.

With Francois Hollande’s government at record levels of unpopularity, and the center right factional and divided there is every prospect that Marie LePen can make a genuine challenge for the Presidency in 2017. A National Front government would be to say the least a complete break from the past, abandonment of the euro and effective ending of the EU’s principles of the freedom of trade and people.

A little bit of *histoire*

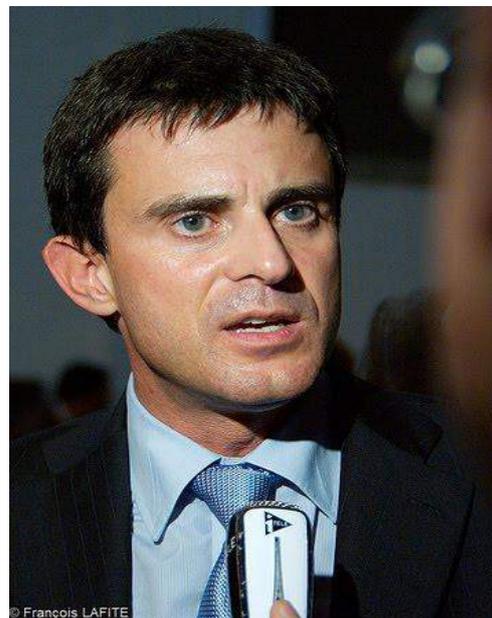
In the later part of the eighteenth century France struggled to hold onto her position as the leading European power as Britain’s rapid industrialisation blunted competitiveness. As the ancien regime was slow to adjust, a succession of poor harvests and cumulated war debts led to a fiscal crisis. **An uneven path between transformation and tradition left the country unable to cope with modernity.**

Fast forward to the present day ‘France finds itself in a pre-revolutionary situation where everything is becoming possible’ Le Point (source FT.com 15/8.)



Jacques Necker

Genevois outsider brought in by Louis XVI



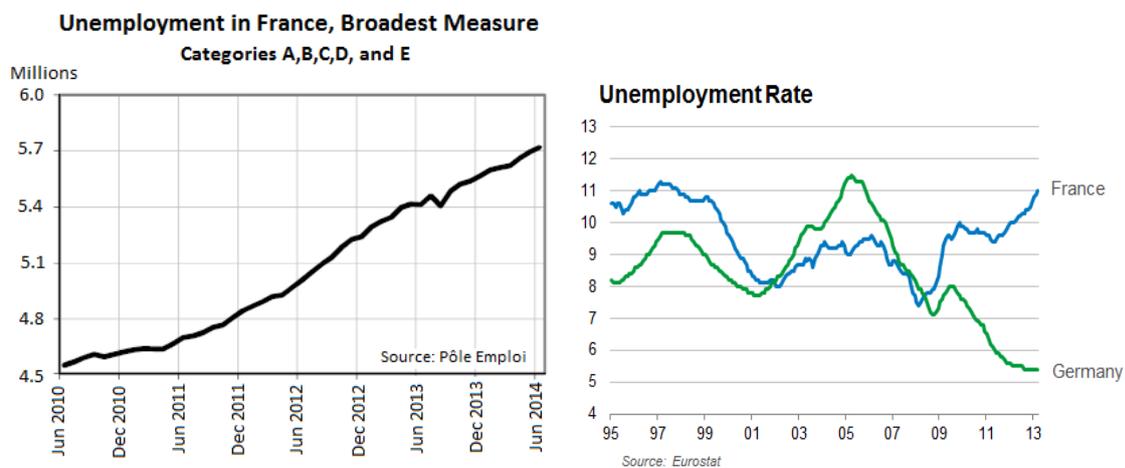
Manuel Valls

Hollande’s man from Catalan

The symbolism of outsiders used to signal a serious desire for reform, but the political roadblocks remained insurmountable.

It looks bad

Ever since the late 1980's and the advent of the 'Franc fort' policy to force down French inflation to German levels the economy has struggled to perform. While France is blessed with **great natural beauty, a vibrant tourist industry and many valuable luxury goods businesses** the **core agricultural and industrial complex has languished**. Intense competition from within open European borders has been in recent years been augmented by new Asian competitors.

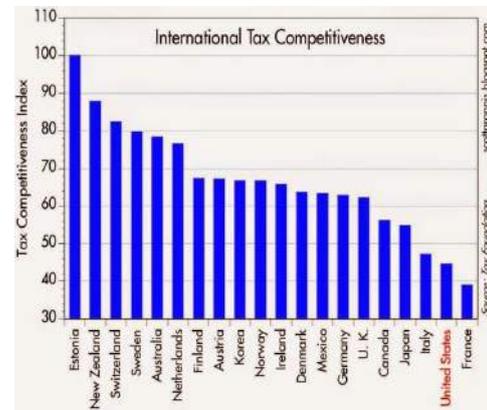
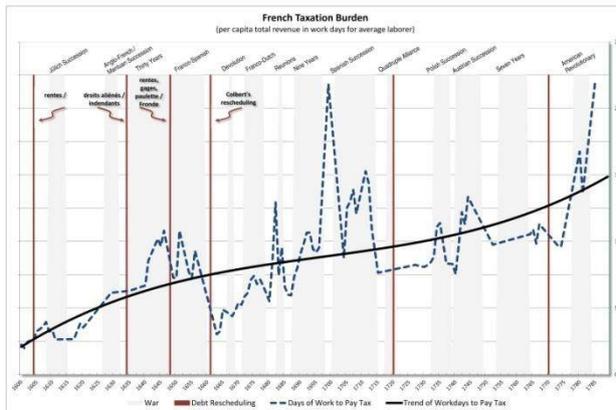


A tit-for-tat round of Russian sanctions is hardly helping with France's already struggling farming industry.

High taxes - *and social security proliferate*

Tax rates are some of the highest in the developed world with the recent imposition of a **75% top rate of income tax** the latest insult. For 2014 the overall tax take will rise for a fifth consecutive year and reach 46.5% of GDP a full six points above what Germany extracts, and eight more than the UK (source: The Economist.)

The laudable attempt to close off the government's deficit has largely been made with higher taxes, rather than a more balanced approach of matching tax rises with expenditure cuts favoured by Britain and others.



Regulations stifle enterprise

George W Bush in an apocryphal outburst once complained **‘the French don’t even have a word for entrepreneur’** forgetting that the word’s origin is of course French.

He had a point as intrusive and overarching bureaucracy encumbers all aspects of French life. Employment law is a particular concern with an almost impossibility to shed labour.

‘The most complicated procedure is for large redundancies, which requires the employer not only to inform and consult the employee representative bodies (works councils and the health and safety committee) and implement dismissal ordering criteria, but also to implement a social plan to limit the number of dismissals, assist employees made redundant to find new employment and mitigate the impact of their redundancy.’ Guillaume Bordier partner Capstan (source: The Lawyer May 2013).

The consequences are inevitable in the paucity of job creation.

At a time when the economy is in deep trouble and the President’s personal approval rating in free fall somehow time has been allocated to answer the important question as to how to address a woman! **The age old distinction between Madam and Mademoiselle is to be outlawed.** A tiresome set of expensive regulations on how to address ladies should hardly be a priority.

Owning or establishing a small business exposes you to a plethora of agencies responsible for a multitude of social security payments.

In an attempt to be helpful, the property web site www.french-property.com has a section titled 'Getting Advice on starting a business in France.' This is full of the rules and regulations of how you will need to register your rental property, and then make it safe. However they go on to admit, **'So whilst France may be a good resting place for those who**

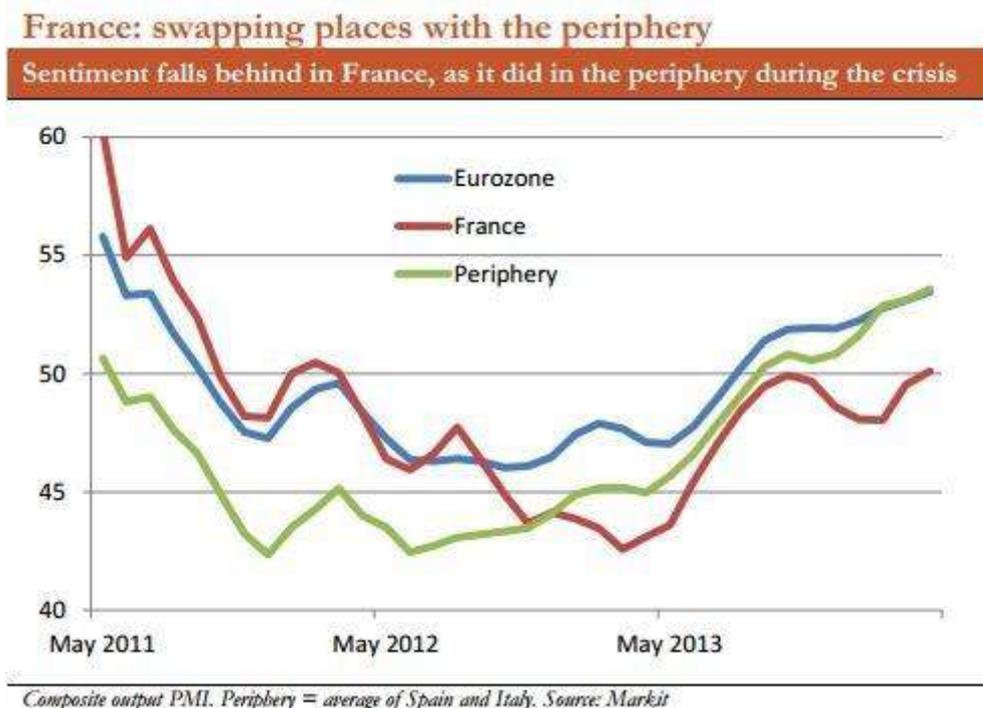
are retired, or who have an independent means of income, it is not necessarily an attractive country for younger people who need to work and who want to make money.'

Amour propre

When the euro zone crisis hit across southern Europe most parties understood that some sort of reform process was indispensable. Many of the same trends affecting France were writ large across the entire continent.

While the necessary reform process--cutting expenditure, reducing taxes and regulations---is still an uneven and slow process it is fair to say that good starts have been made. Ireland and Spain in particular, are reaping rewards from painful restructuring.

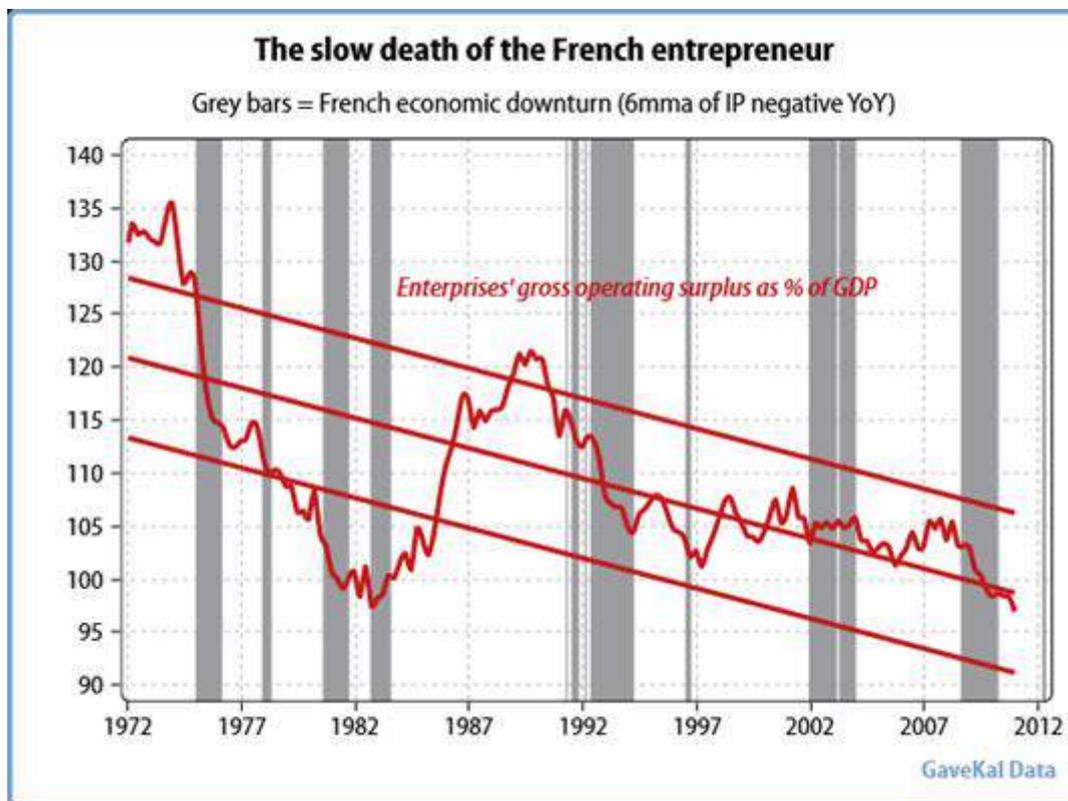
These peripheral nations had done well with the European project over a period of decades. The multitude of grants, subsidies for what had been poorer parts of the union greatly enhanced standards of living as did free trade and population mobility to the richer north. **When push came to shove - bale out of the euro-zone or knuckle down and take the medicine--the populace decided the history had been a good one and they stayed in.**



Mr Normal and the prospects for reform

As the first Socialist President since Mitterrand, Francois Holland was elected in a wave of revulsion against the ‘bling’ and reforms of his predecessor. In one of his first actions as leader increases in the pension age from 60 to 62 were reversed. Instead a complicated matrix of the length of pension contributions was proposed in 2013. As Pierre Gattaz head of the employers Federation complained;

‘This is a dangerous reform that is not acceptable to us. In truth it is a non-reform: no structural problem is resolved.’ (source: FT.com 27/8/13.)



'France is not a normal country' Francois Holland on the campaign trail May 2012.

This telling boast made by the then aspiring candidate signalled much about the country he now leads. *France would not feel bound by the normal rules of finance, in particular those imposed without from the EU.* In fact the French narrative was that a set of European institutions had in fact been assembled for the benefit of the country.

The European project was firstly to cage German nationalism after the horrors of two world wars, and later for the benefit of France's agriculture and living standards.

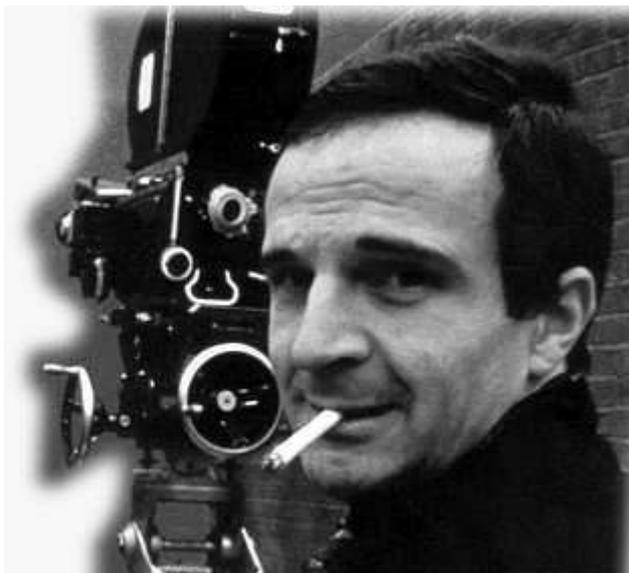


Jean Monnet the *French father* of the European community

The EU could never be seen in France as anything other than a servant to the nation, and reformist calls that appeared to threaten the national fabric and its way of life would always be resisted.

Constrained by the Socialist party and the notorious strike bound workforce, Hollande was not elected to enact reform but to stave it off.

***Nostalgie* for the 60's and better times**



Francois Truffaut---movie maker, and one of the symbols of the post –war dream

Nostalgie is of course a French word. A wave of ennui and wistful looking back to the glory days of the post war boom has swept the country. Memories of icons like Brigitte Bardot, the 2 CV and the confident comedies of the 60's seemed in sharp contrast to today's deep national depression. France sees itself as culturally and economically losing to globalisation.

All these factors make **the next round of elections seem so difficult to call and have played into the hands of those strident politicians who promise real change.**

The recent cabinet re-shuffle and parliamentary vote have at least calmed some nerves in Paris and made an immediate collapse of the government unlikely. It seems that political change will only come at the ballot box in May 2017, when both Presidential and National Assembly elections are due.

But at that stage the stakes will be high when a genuine alternative to the establishment exists.



Marie Le Pen still an outside shot for the Presidency - but not an impossibility

German roadblock crumbling

In theory there are 18 members of the ECB's governing council whereby all interest rate decisions are taken. In practice **not all members are equal**, with the representative from the mighty Bundesbank looming over all others. Partly due to Germany's economic size, but more due to the historical iconic status amongst central banks as the ultimate guardian of sound money, the Bundesbank's reach vastly outweighs its single vote. During the Euro zone crisis markets, and governments had to hang on every word from both Frankfurt and Berlin.

But change is afoot at this once intransigent organisation. The situation in France, and to a lesser extent in Italy and other euro zone strugglers, has forced the Germans to countenance once unthinkable policies. Previous understandable fears of **moral hazard, and asset bubbles** have had to be sacrificed to save France. **It is understood that the much needed genuine fiscal reform will simply not happen. Only aggressive and substantial monetary policy can fill the gap.**



"I'd love to, Barbara, but I'll have to check with the Bundesbank."

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COLLECTION

As summer torpor spread across Europe the Bundesbank argued for **higher wages** in forthcoming German negotiations. In effect the call was that if higher wages prevailed in Europe's largest market this might in some way alleviate the gathering deflationary forces.

For anyone with an ounce of historical perspective this was to say the least uncharted territory for this institution. As the FT commented, **'A desperate Bundesbank has abandoned principle'** Wolfgang Munchau (source: FT.com 3/8/14.)

In government circles the pressure is also rising as German politicians realise how vulnerable they would be in the advent of things going badly wrong across the border. **'I'm very worried about France. The crisis in other states is somehow bearable, but if France doesn't get back on its feet, that would be tragic. We can't manage without France!'** Rainer Bruedelle Handelsblatt (July 2013)

Conclusion - Germany will allow the ECB to try and save France

What the Fed and Bank of England were able to do in pursuing a mass long term purchase of government bonds is still controversial for Europe. Article 123 of the founding ECB charter expressly forbids the financing of deficits by central bank purchase, and it's not clear that the German Constitutional court would not intervene. It is hoped that the various LTRO type programmes in place are doing the work for the ECB by financing commercial bank holdings of government debt.



This is the only bazouka left

Mario Draghi has not shown himself short of dramatic involvement in the zone's crises. As the pressure from the Germans abates the way will be clear for the next salvo of easing. Here a substantial dive into **negative interest rates is likely to perhaps minus 1%**, the only

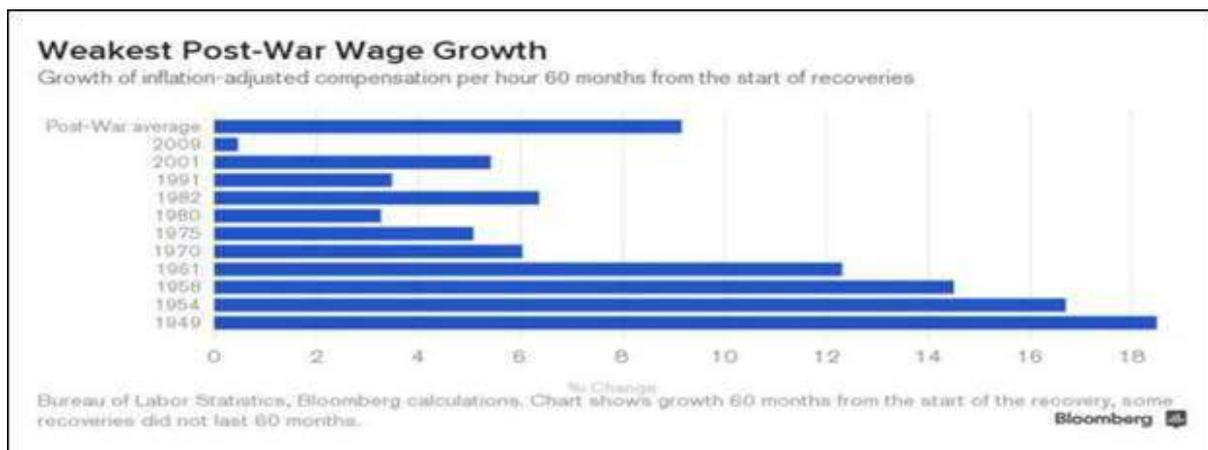
bold move that will get the markets racing and provide genuine blood supply for the economy.

The battle for France has begun!

Markets - needing more easy money

At the end of the 3rd Q two seemingly unconnected sectors fell sharply---UK supermarkets and global commodity players----have contributed to a sense that the broader index is heading into trouble.

Weak wage growth has been a problem since the end of the recession, even in the US where the headline employment figures have progressed so well.



Top line growth is restricted to a few remaining emerging markets--most of Africa and India--and parts of the tech industry, elsewhere stagnation is the day. It seems the E of PE ratios will prove elusive and is unlikely to provide positive stock market returns.

In a thought provoking article entitled '**Economic soufle at risk of implosion**' the FT spelt out the downside risks to global demand (source: FT.com 17/9/14.)

But this bull market has never been a classic one of earnings growth, rather a monetary policy led scramble to garner yields. For that reason as we pause in sight of 2015, the next salvo must be provided to force again bond prices higher and provide that impetus to risk assets.

We believe it will come courtesy of the ECB and for that reason we remain overweight risk assets.

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