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GLOBAL MACRO

# Bright Spots in an Otherwise Lackluster Recovery, Part 2: Capital Investment in France

**As we mentioned in Part 1 of our series on the bright spots in the Eurozone's emergence from recession, here in Part 2 we look at the second surprise: an improved outlook for capital investment in France.**

Falling capital spending in France since the beginning of the year has been a source of serious concern for the country's future. Not that France has underperformed its peers—Germany has experienced an even sharper contraction. It's just that this turn for the worse suggested further trouble for what stands out as the French economy's key weakness: a questionable ability to rebuild its industrial potential, boost productivity, and eventually return to net job creation.

Therefore the improved leading indicators for French industrial investment that emerge from current trends are not to be sneezed at. Although it's hard to predict with any accuracy at what point the macroeconomic numbers will reflect the changes under way, we can confidently assume that capital spending by French companies should swing back upward before the year is out. Such a rebound would offer no guarantee that large numbers of jobs will be created, but is still a prerequisite to any real improvement on the employment front.

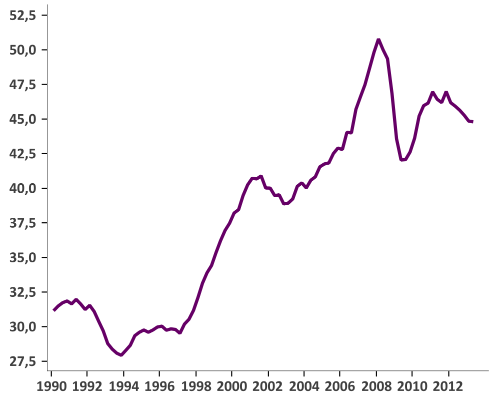
*Note: The INSEE survey published this morning on the 2013 outlook for industrial investment has not altered our view. Since the survey covers the current year, it reports on cutbacks to capital expenditure that have already been made. Moreover, the fact that French companies plan to keep capital expenditure steady in the second half supports the thrust of our analysis.*

## A Job Market Badly Bruised by Falling Capex Since 2008

In the second quarter of 2013, capital investment by non-financial companies shed another 0.1 percent. Although this decline is moderate in comparison with previous quarters, it was the sixth decrease in as many quarters—over a period that saw spending on capital goods shrink by a total of 4.5 percent. And since the French economy had not fully recouped the losses from the 2009 recession, this recent retrenchment actually reflects a nearly 12 percent falloff in Capex from the peak in early 2008. Over the same period, the rate of capital investment, which measures corporate spending on capital goods as a percent of GDP, contracted by more than one percentage point—its steepest decline since the 1993 slump.

**Capital Spending by Non-Financials**

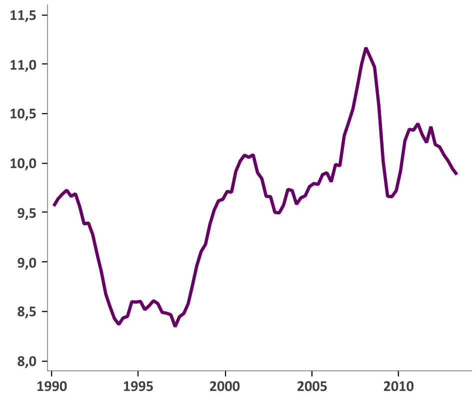
Constant prices, billion €




Sources: RichesFlores Research, Macrobond

**Rate of Capital Investment by Non-Financials**

% of GDP, constant prices

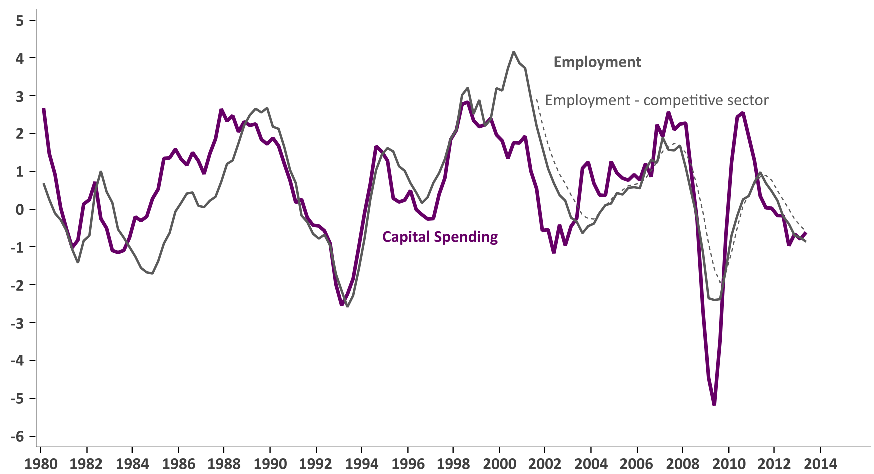



Sources: RichesFlores Research, Macrobond

Because employment growth necessarily correlates closely with growth in capital investment, not only has the downward trend cost a large number of jobs since 2008, but we can clearly expect no serious improvement in the job market until such investment has recovered.

**Change in Employment and Capital Spending by Non-Financials in France**

By volume, YoY in %




Sources: RichesFlores Research, Macrobond

## Investment Contraction on the Way Out

But however uninspiring the recovery may seem, we should take comfort in the latest indicators. To start with, the decline in capital investment has leveled off. More importantly, **the prerequisites for a return to capital spending finally look like they are materializing.** We have distinguished three indicators that, we believe, bear out this contention.

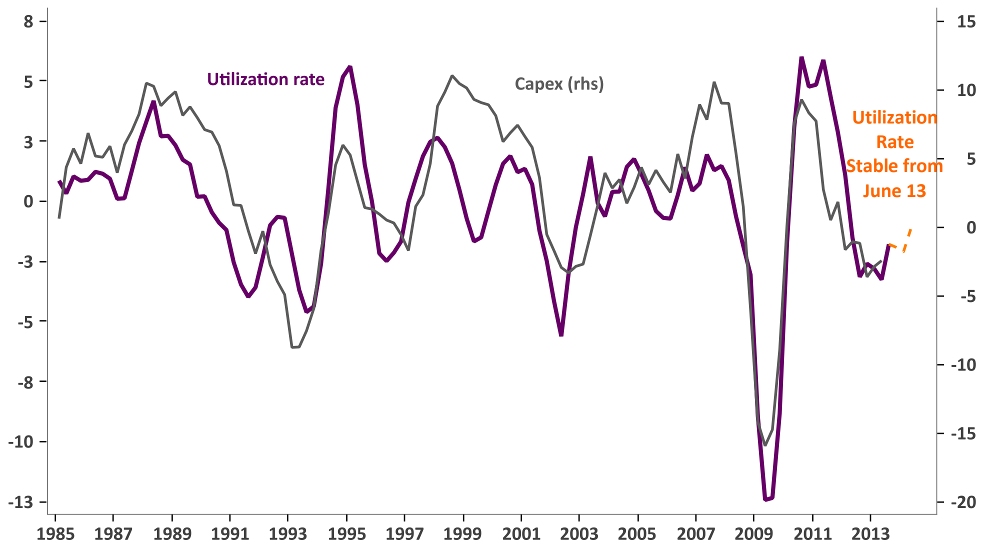
### - Greater Utilization of Installed Capacity

The first indicator measures the extent to which existing plant and equipment is being used—in other words, the capacity utilization or operating rate. Since this indicator is computed solely for goods-producing industries, it is often considered unrepresentative of the economy as a whole. Yet capacity utilization remains one of the most reliable metrics when it comes to forecasting capital expenditure by the non-financial sector. For one thing, manufacturing accounts for almost half of all corporate Capex in France. For another, cycles in the manufacturing sector still heavily influence those in the service sector.

Accordingly, we place less emphasis on capacity utilization rates as such than on the underlying trend in capital spending. As it turns out, that trend not only shows undeniable improvement over the past few months, but—in light of the economic data coming out now is likely to continue in the same direction as manufacturing recovers, however moderately.

**Change in Manufacturing Capacity Utilization and Capital Spending by Non-Financials**

Constant prices, YoY in percentage points for capacity utilization rate and in % for capex



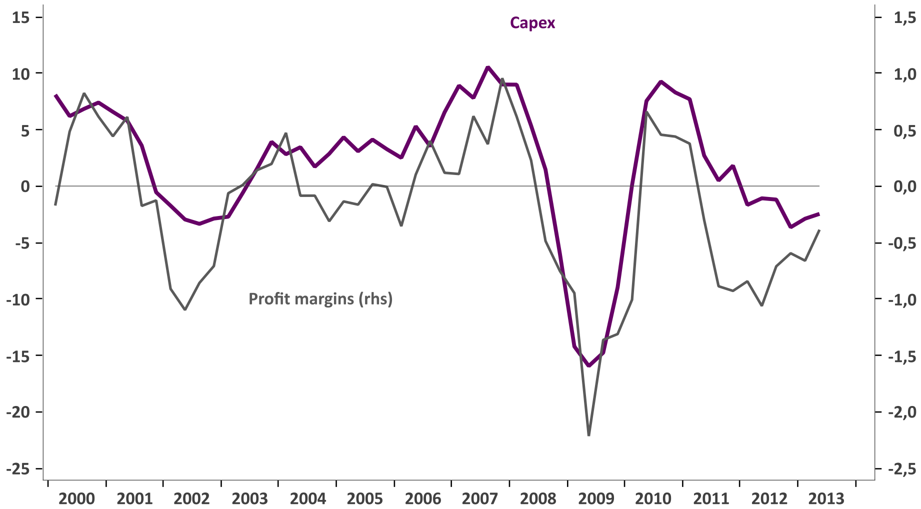

Sources: RichesFlores Research, Macrobond

## - Gradual Improvement in Profit Margins

Our second significant indicator, profit margins at non-financial companies, is reflected in the national accounts as the ratio of gross operating profits to value added. After declining steeply for several quarters, this leading indicator of capital investment has been leveling off since the start of the year, thus creating an environment that is much more conducive to future outlays.

**Change in Profit Margins for Non-Financial Private Sector Companies and Capex**

Constant prices, YoY in percentage points for Profit margins and in % for capex

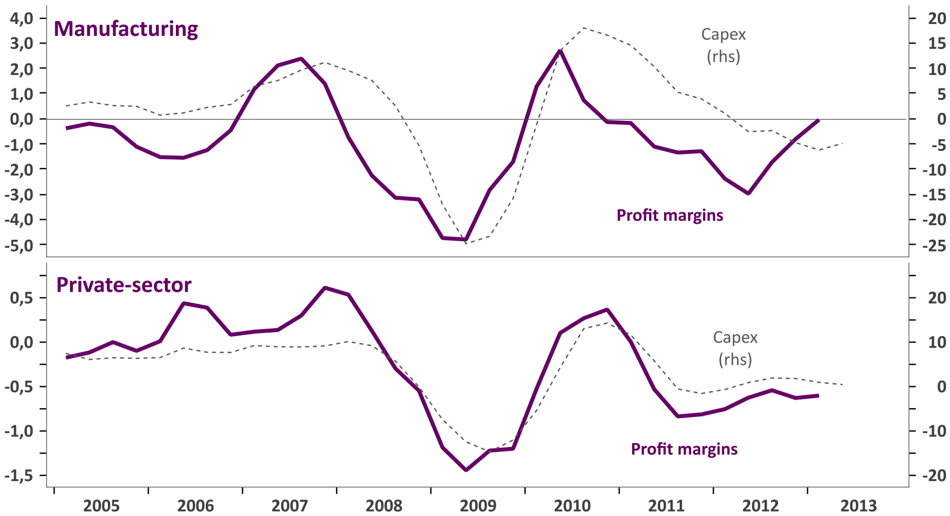



Sources: RichesFlores Research, Macrobond

We cannot track the latest trends by sector with any reliability, since the first quarter is the most recent period for which data are available. However, it is worth noting that manufacturing—which accounted for the entire falloff in corporate capital spending since early 2012—is also the main driver behind the current improvement in profit margins.

**Change in Profit Margins and Capex in Manufacturing and Private-Sector Services**

Constant prices, YoY in percentage points for profit margins and in % for Capex



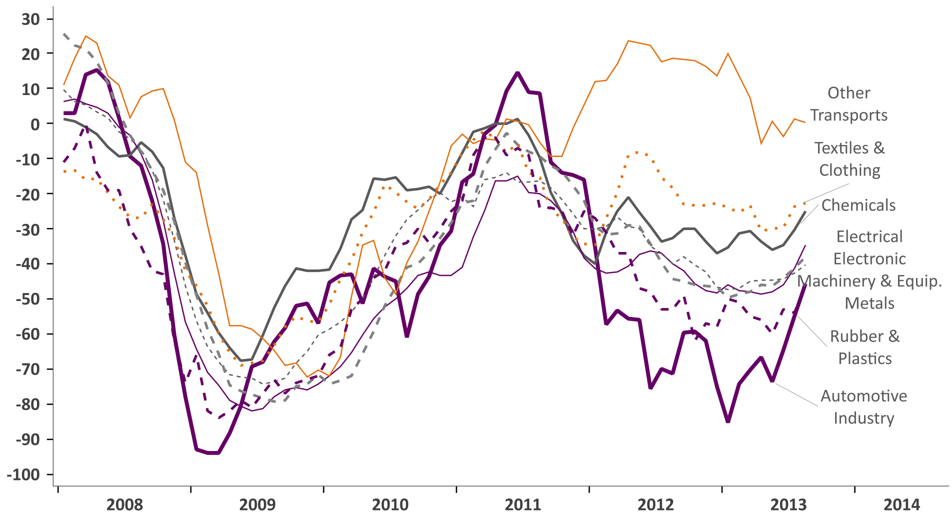

Sources: RichesFlores Research, Macrobond

## - Trends Supported by an Improving Business Climate

Needless to say, these signals would be fairly meaningless unless business sentiment also improved. Fortunately, the latest surveys point to just such improvement across a wide variety of industries. Particularly noteworthy are a widespread shift in manufacturing CEOs' perceptions of their order books, although most of the orders are domestic, and the first hints of a change in sentiment on investment and jobs, which strongly corroborate our preceding observations.

**Manufacturing CEOs' Order Book Expectations**

Balance of Opinions, %, 3MMA

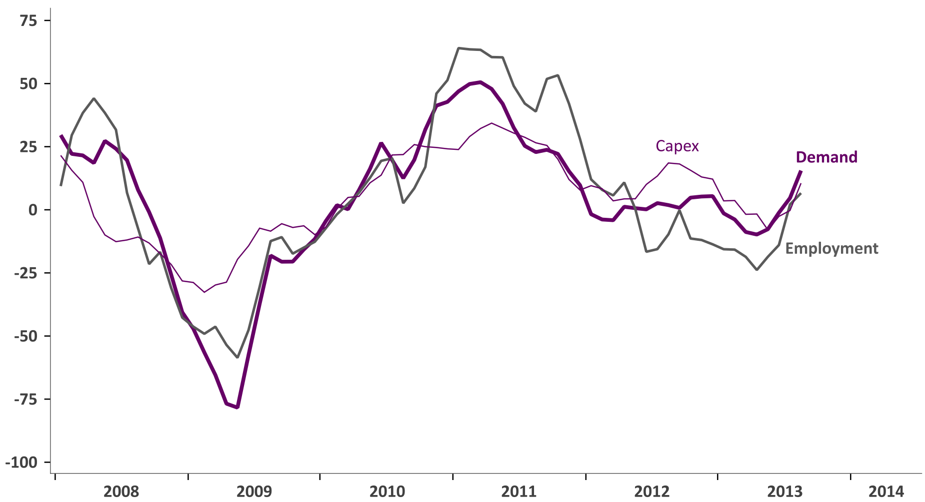



Sources: RichesFlores Research, Macrobond

Service company managers tell a somewhat less clear-cut story. While most consumer services still show signs of decline, business services are starting to pick up, as can be gauged from the increase in temporary positions—traditionally a reliable leading indicator for the economy at large.

**Expectations of French Temporary Agency Managers**

Balance of Opinions, %, 3MMA




Sources: RichesFlores Research, Macrobond

In any case, the overall picture is much more encouraging than it was before the summer. This more sanguine outlook partially substantiates forecasts of a return to growth in France, coming on the heels of a second quarter that got a hefty boost from a number of noteworthy developments.

The main sticking point is corporate financing. Although we may be willing to place our bets on the spillover effect of a brighter business climate, this is an issue on which the jury is decidedly still out. Banque de France's July survey suggests higher demand for corporate loans in the near future, which is in line with our analysis. What the survey doesn't tell us is whether the banks are willing to lend. This makes the government's decision to beef up its support for small-business financing a particularly welcome move.

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