No Vin, just Pain, for the French Welfare State

President Trump has brokered a ceasefire between Israel and Hamas as phase one of a broader Trump peace plan. The agreement includes a partial Israeli troop pullback, a limited prisoner-hostage exchange, and an increase in humanitarian aid into Gaza.

Sanae Takaichi was unexpectedly elected the leader of the ruling Liberal Democratic Party over the weekend and is to become Japan’s first female prime minister, with immediate impact - Urging the Bank of Japan to align monetary policy with government growth objectives and cautioning against premature rate hikes reasoning that inflation is more cost-driven than demand driven.

This is a reversal of the interest-rate normalisation policy of previous leadership which was expected to drive the Yen higher. The next step will be a raft of immediate measures to ease the cost of living, but the biggest factor affecting the cost of living was the weakness in the Yen, so it is a fickle conundrum.

It looks like a return to old politics in a world which is demanding political change, but one hurdle has since emerged with the LDP’s coalition seemingly breaking down, so Takaichi will need to broker 37 more seats on its 196 to reinstate a majority.

France is seeking its sixth prime minister since the 2024 election following the resignation of Sébastien Lecornu with the “bench” now looking relatively thin and with the remaining candidates representing a slight shift to the left, it’s hard to see any progress being made without something else changing.

In short, the French parliament needs to bite the bullet and engage in austerity measures to right the fiscal budget, which is in dire straits:

The country's debt now exceeds the UK's at 110% of GDP. When including off balance sheet liabilities such as pensions, French debt exceeds 400% of GDP. The country has not run a budget surplus since 1980 with deficits hovering around 6%, double the level permitted under European rules.

The French state forms the largest part of the economy with the highest percentage of total spending in the world at 57%. The UK's is 44%. Average French tax rates are 46%. By comparison it is 35% in the UK.

France spends 14% of GDP on pensions vs 8% in the UK, and as the population ages, this cost is crowding out all other areas of public spending. There is clear scope for policy adjustment here:

France's retirement age is 64 and the French enjoy the longest retirements in the world, averaging in excess of 25 years. France is the only place in the world where the average pensioner earns more than the average worker. The annual cost exceeds 350 bn Euros. France's population is ageing faster than the European average. In 1981 there were 5 million pensioners, today there are 17 million.

Yet this is to be paid by a working population with a GDP per capita of only $44,000, far less than the US at $82,000 and shy of the UK at $49,000. In 2023, average French real wages fell 3.6% while state funded pensions rose 5.3%. Absent a decade of explosive economic growth, the trajectory is not sustainable.

It is maybe no surprise after that veritable pot-pourri that French bond yields are now higher than in Spain, Greece and Italy. That's government borrowing costs to you and I.

Absent some political will to make necessary changes, a financial crisis or an ECB bailout could be on the cards. The promise to do "whatever it takes" to protect and preserve the Euro was an expensive undertaking when Greece faced similar issues. France, as the second largest economy in the EU, could be totally a different proposition.

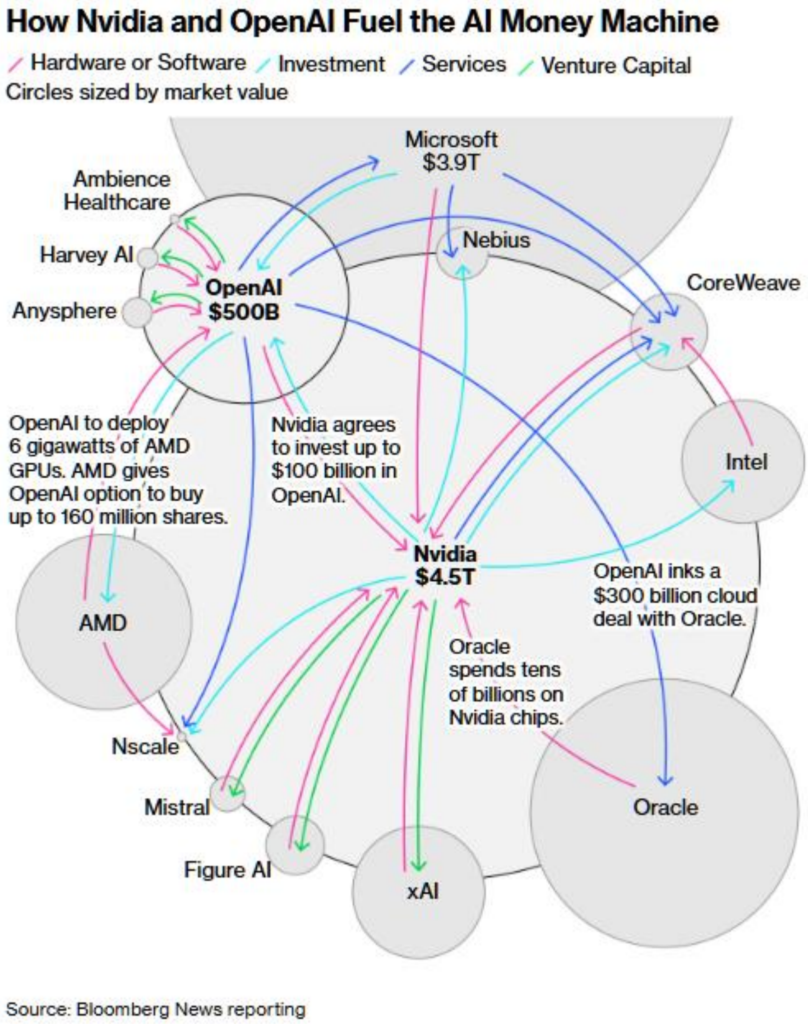
The price of an ECB rescue could include the loss of control over government spending, but after decades of high social spending and generous pensions which have now become politically untouchable, the inevitable reaction of the French population to its end could make more attractive the alternative option returning to a French currency.

With stock valuations returning to what may be best described as "confident" levels, there is reemerging concern that we are in an artificial intelligence bubble. The most recent concern is the emergence of several investments that look a bit like the "vendor financing" deals used to circulate money and inflate corporate results during the Dot-Com Bubble.

In this instance these deals make sense but still ultimately rely on the success or failure of AI as we remain in a pre-revenue investment period of significant scale. So, as long as there is transparency, we don't need to worry too much about the micro-movements in AI dealmaking and instead should focus on the bigger picture which frankly hasn't change - lots of investment, lots of waiting.

For now, much of the infrastructure build out is being funded by cashflow, but debt will be utilised in due course, and that's when the risk will intensify.

To illustrate the situation, these deals are within a group of companies engaged Stargate, a mega-infrastructure project initiated to support Open-AI's proprietary models:



Most of US GDP growth is being driven by AI capital expenditure. This isn't a concern, it should be considered a boon – While investors have grown concerned over US fiscal sustainability and the implications of unwinding excessive post-pandemic government spending, it is becoming clear that a large amount of debt which will continue to fuel the economy will be derived from the private sector in the form of AI infrastructure investment. This cycle is not yet at its peak.

The real key concern in the near term is that China has once again expanded its export control regime for rare earth elements and related technologies. This includes end-user controls and end-use restrictions for export licenses so if Beijing doesn't like what you are doing the supply chain could be cut. Rare earth elements themselves are not primary materials in semiconductor wafer production, but they are critical in the semiconductor supply chain, especially for manufacturing equipment and advanced components. They are also key materials for many Defence applications.

While some may be worried about frothy equity markets, if we are instead entering an extended technology-driven bull market, it is likely to experience volatility and overcome some drawdowns. Recent corrections have coincided with liquidity events: The Yen-carry trade unwind in August 2024, and the Basis trade unwind in April 2025 (albeit the latter coincided with Liberation Day).

It's possible the next liquidity event will be driven by increasing engagement in dispersion trades, which attempt to profit from the difference in volatility between individual stocks and the broader market. The growing popularity of these trades has led to a higher cost and while that could indicate a consensus belief that we are through the storm, a small shock could be the catalyst for an unwind in these positions stoking an even larger reaction from capital markets.

Where are markets up to?

The rolling 12 month % cumulative returns in local currency from various indices is shown in the following chart:

Where are the portfolios up to?

The portfolio performance, net of fees, to close of business on Thursday is as follows:

	1 week	1 month	3 months	12 months
Cautious	+0.76%	+3.01%	+5.83%	+7.58%
Balanced	+1.22%	+4.05%	+7.92%	+10.07%
Adventurous	+1.49%	+4.55%	+8.90%	+11.26%

As ever, if you would like to discuss any aspect of your portfolio, please do not hesitate to contact us on service@blythefinancial.com.

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