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EU 27 Recovery Fund agreement reinforces more bullish European investment outlook

The investment outlook for Europe is improving, driven by four factors:

Firstly, domestic policymaking is now tackling the pandemic in a more aggressive and targeted manner, particularly in the European locomotives Germany and France. The cost of the increasing domestic fiscal accommodation is being supported by the ECB with continued low rates and its expanded asset purchase program, keeping bond yields low.

Secondly, the potential European breakup risks driven by the periphery are receding, driven by two factors:
1. The EU27 Recovery Fund has been agreed. In addition to the substantial size of Euro 750 billion, it demonstrates EU solidarity with Euro 390 billion grants being committed to the periphery.
2. The German Constitutional Court's threat to the primacy of the European Court of Justice has receded. The result is ongoing ECB bond-buying, including exceeding their capital-keys in the periphery countries.

Thirdly, Covid-19 is under better control. There are many tough months ahead before a vaccine, with regional surges likely, nevertheless we are not expecting another period of prolonged blanket lockdowns.

Finally, the economic data is improving from the second quarter lows. While the pace of the pickup is likely to ease, and while we do not expect output levels to reach end-2019 levels for at least two years, the trend of gradual improvement seems well underpinned. Our GDP forecast for 2021 has doubled to +3%.

All asset classes have the potential for gains in the second half:

Equities: The perception change towards European equities is slowly starting to improve, and that should drive inflows. While the earnings outlook remains challenging with much dispersion, the next few months should start to see more guidance before an average EPS rise of over 40% next year. Based on that EPS forecast, the Eurostoxx multiple of 21x is inexpensive in absolute terms and relatively attractive versus the US. European indices have more "Covid cyclical" than "Covid defensive" exposure (*), as well as undervalued areas that should perform well as interest moves away from growth. We prefer companies with balance sheet strength and cashflows that can support ongoing dividend payouts.

Bonds: Sovereigns remain expensive, with the potential to get more expensive due to the indiscriminate and ongoing ECB buying. The periphery sovereign bonds have further to go as the EU Recovery Fund agreement reduces perceived risks, as reflected in the Italian-German spread in **Figure 1.** Our preference is the high yield bond area, because defaults are only rising slowly. Average yields have fallen from 10% to 5.7% and we expect will fall further. Investment grade (IG) bonds do not have much downside risk as the ECB buying is supporting the sector and rating downgrades are not a widespread risk at this stage. However the average IG yield of only 0.73% means a selective approach is necessary.

(*) "Covid Cyclicals: Financials, industrials, materials, real estate, consumer discretionary. "Covid Defensives": IT, healthcare, communication services, consumer staples, utilities.

Euro: We expect a move towards Euro 1.1650 versus the USD to be driven by the EU Recovery Fund approval as Eurozone breakup risks are reduced. In the short-term this should be a bigger driver and more than offset the ECB easing. Longer-term, assuming the growth recovery gathers strength, and as the EU might announce further structural reforms which could support the periphery further, the Euro could gradually move towards 1.20. See **Figure 2.**

Figure 1: Italian to German 10-year yields (%)

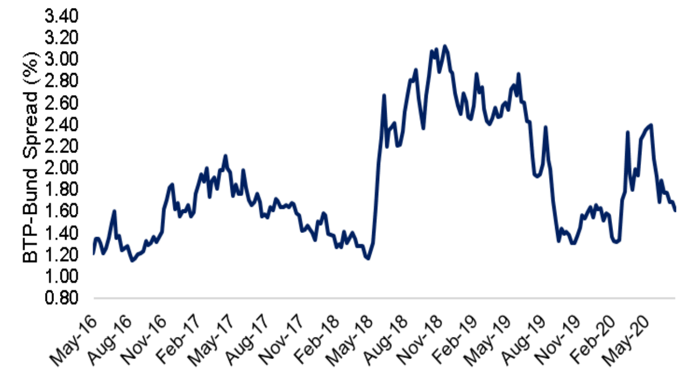


Figure 2: Euro versus the US Dollar

Source: Bloomberg as of May 27th 2020

Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only. Past performance is no guarantee of future returns. Real results may vary.

ECB remains committed to supporting the recovery

Even as the economic recovery strengthens, the ECB has made clear that the entire Euro 1.35 trillion committed to the Pandemic Emergency Purchase Program (PEPP) is likely to be used, and there could be an additional Euro 500 billion announced before the end of the year. There is likely to be ongoing divergence from the capital-keys, with overbuying of periphery debt. In doing so they are still also looking to demonstrate the 'proportionality' with respect to their targets in order to satisfy the German Constitutional Court request. In addition the deposit rate is expected to remain at -0.5% for a prolonged period. A key driver for the ECB will remain its 2% inflation target, along with a recognition that their ongoing support will be needed as national support programs unwind and impact on employment and spending. With regard to the Targeted Long Term Refinancing Operations (TLTRO) III operations, the take-up of cheap bank loans by companies is expected to remain high. See **Figure 3.**

Figure 3: Extensive emergency policy support measures:

EMEA				
	Monetary		Fiscal	
Euro area	No change (deposit rate at -0.5%)	€120bn APP + €1,350bn pandemic emergency purchase programme	**EU Wide**	Eurogroup delivered coordinated €540bn package. **€750bn recovery fund proposal to be agreed.**
			Germany	€130bn fiscal package for 2020 and 2021 announced in June. €156bn debt-financed package in March, as part of a 750 billion-euro broader package.
			France	€106bn fiscal package, includes €15bn for aerospace industry, €7bn loan package for France-KLM.
			Italy	€55bn fiscal package, including healthcare system, civil protection agency, tax deferral, wage supplements for those forced to stop work, govt guarantees on bank loans, increased healthcare spend (€3.5bn). Govt loan guarantees of €400bn. Alitalia nationalised for €3bn.
			Spain	€45.7bn fiscal package, €100bn Govt loan guarantees, no social security contributions if job preserved, €600m to help vulnerable, mortgage payment holiday
UK	Two cuts to base rate, going from 0.75% to 0.10%	£300bn asset purchase increase (Gilts + some corporates)	£30bn from summer statement in in addition to the £159bn worth of fiscal measures and £123bn in deferred tax and subsidised loans already announced. Govt guarantees also on £330bn loans.	

Source: Citi Private Bank, Office of the Chief Investment Strategist, July 20th 2020

Germany and France progressing with virus control and fiscal expansion

The European locomotives have moved aggressively in recent months to contain the virus, with early signs that they are not seeing widespread resurgences as they unlock their economies. Their respective leaders are also demonstrating real commitment to supporting local businesses and incomes, with Germany's latest fiscal package taking the country through it's deficit and debt targets, while France's fiscal expansion and shift in a socialist direction comes even in the face of President Macron's weak polling data. See **Figure 4.**

EU 27 recovery fund agreed

The EU 27 leaders agreed a deal for a Euro 750 billion Recovery Fund through the issuance of joint debt. It is combined with the normal multi-annual Financial Framework (MFF 2021-2027). The Fund will include Euro 390 billion in grants, Euro 390 billion in loans with low interest rates, bigger rebates of Euro 52.8 billion for the "frugal nations" (Austria, Netherlands, Sweden and Denmark). Instead of a veto, there is an 'emergency brake' mechanism that allows any country to raise concerns that another is not honoring promises of reforms. 70% of the disbursements will be committed in 2021 and 2022 according to GDP per capita and unemployment rates, with 30% to be disbursed in 2023 based on the Covid-19 impact on GDP. Disbursements will be contingent on upholding the rule of law, however only a qualified majority is needed for approval. Any compliance disagreements will be referred by Ecofin (EU 27 Finance Ministers) to the EU Council . Up to 10% of debt issuance will begin next year. Debt repayments can start during the MFF 2021-2027 period, and must be made by 2058. The 27 national governments as well as the European Parliament are expected to ratify the Fund and the MFF before the end of this year.

While European assets have generally been firmer ahead of the formal announcement, and some profit-taking on the news is possible, the longer-term implications are very significant and support further gains. Firstly, the 'achilles heel' of Europe, the periphery countries, will benefit directly from the grants. Secondly, the solidarity demonstrated by the fiscal transfers should allay European breakup risks. Thirdly, the fund proceeds are going to be partly used to develop the high-growth Green and Digital areas. See **Figure 5.** Finally, the Fund could be a precursor to further EU structural reforms.

Figure 4: Fiscal stimulus % GDP

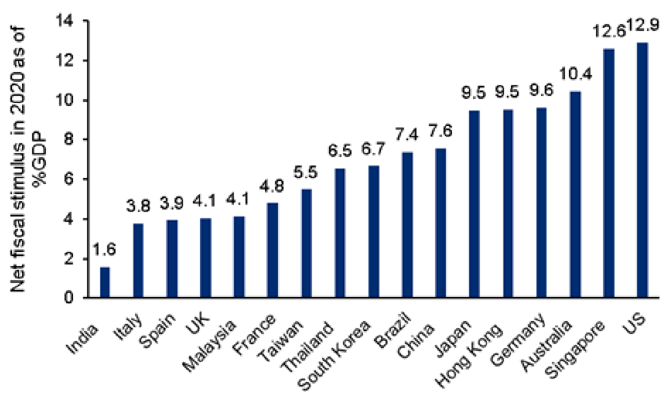
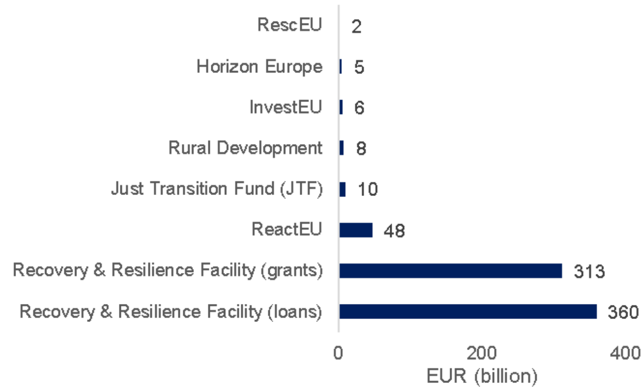


Figure 5: Breakdown of the €750bn Recovery Fund



Source: Bloomberg as of July 20th 2020

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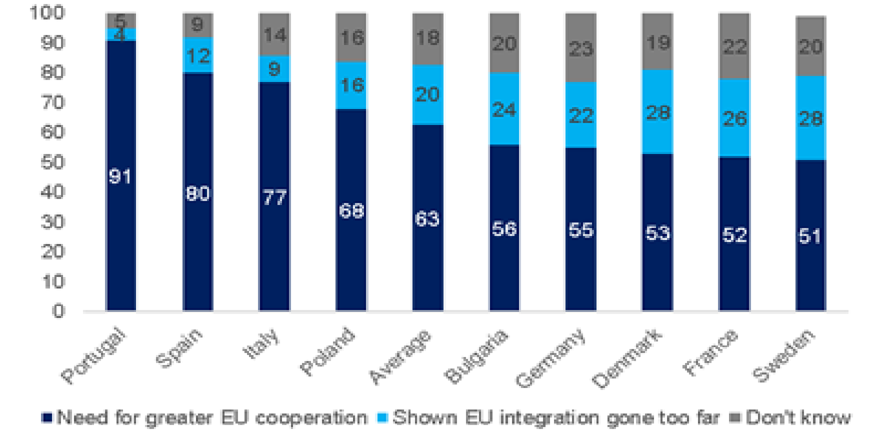
Europe showing better containment of Covid-19

There have been successful government responses with acceptance of tough measures. Europe had entered the crisis ahead of the US, and much of Europe has now emerged from lockdown. New cases have also broadly been contained. Europe on the whole also seems to be responding better to the Covid-19 challenges than the United States. Much of Europe seems well beyond the peak in cases per million, after the March peak. Similarly, looking at deaths per million, most of Europe seems to be considerably below the peak in deaths per million.

Additionally, a recent pan-European survey conducted by ECFR suggested that following the start of Covid-19, there has been a marked increase in public support for unified EU action to tackle the pandemic. On average, 63% of respondents believed that Covid-19 has shown the need for greater EU cooperation, with Italy, Spain and Portugal showing 77%, 80% and 91% respectively – **figure 7.**

Figure 7: How Covid-19 has changed attitudes towards the EU



Source: ECFE as of July 20th 2020

Looking ahead, only short-term regional lockdowns may be needed. As continental Europe countries began phasing out lockdown measures in late April, many regions have begun to see various national or local lockdown measures re-enforced. For instance, the Catalan region in Spain has asked millions to stay at home, the UK has seen a regional lockdown in Leicester, while areas of the Balkans has seen cases pick up. It seems increasingly likely that further lockdowns will be temporary and regional.

In addition, during April Border closures were also introduced to place a halt on freedom of movement around Europe. More recently most EU countries are relaxing Covid-induced border controls, so a return to a fully functioning Schengen zone will likely be soon.

Scandinavia has seen different approaches and subsequent responses to Covid-19. While fairly strict lockdowns in Denmark and Norway have been successful in reducing pressure on their domestic healthcare systems, Sweden followed a more lenient approach, and recently has seen a rapid escalation in cases, while Denmark and Norway have the number of new cases under control. While Swedish economic data at the peak of the crisis may show a better economic performance given restaurants and businesses were able to function, the controversial response has led to a death toll far higher than its Scandinavian counterparts (Swedish has seen 556 deaths per million, Denmark and Norway have seen 105 and 47 deaths per million respectively). See **Figures 7 and 8.**

Figure 7: New cases per million (rolling 7 day average)

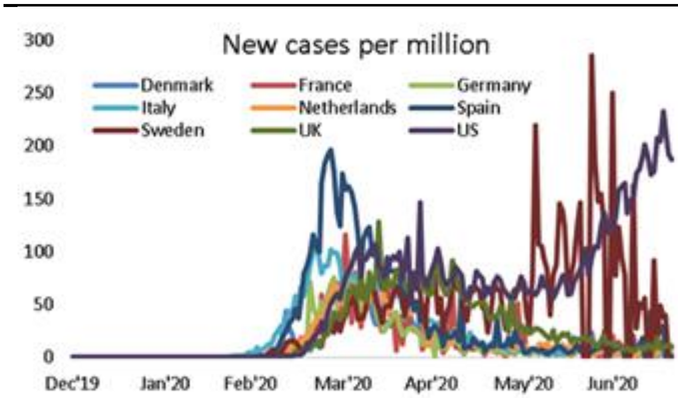
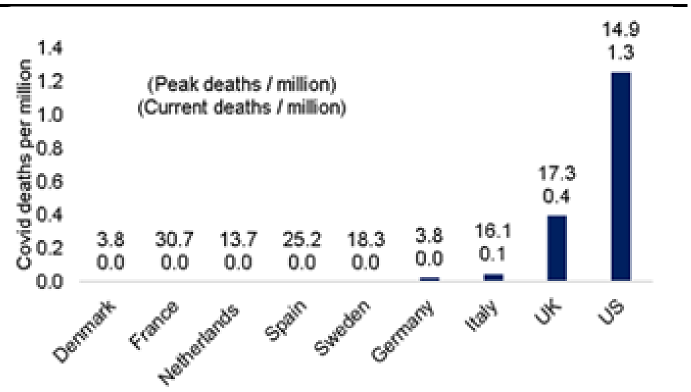


Figure 8: Deaths per million (current and crisis peak)



Source: Ourworldindata as of July 20th 2020

High frequency data showing a rise in activity

Recent high frequency data has pointed towards a pick-up in broader mobility and economic activity**.** For instance, carbon emissions, a reflection of manufacturing and business activity, has jumped in the last couple months as industrial activity ramped up after the lockdown period. See **Figure 9.**

Greater need for social distancing and avoiding public transport has also seen a marked shift in travel patterns. Passenger driving activity has increased to above levels seen in January 2020, with this seen in most EU countries. The greater inclination towards driving versus taking public transport has seen driving trends rise (with some seasonality also supporting this trend). While EU car registrations had suffered in April and May (May 2020 was down 50% versus May 2019), in June 2020 new car registrations were only down 22.3% versus June 2019). France saw a positive increase in in car registrations in June. Meanwhile, public transport continues to suffer. As an example, footfall on the London underground tube network is still down 80% year-on-year. See **Figure 10.**

Areas of leisure are also beginning to see better performance as lockdown measures are easing. German restaurant reservations have jumped to over pre-crisis levels. While UK is still down 40%, this can be explained by lockdown measures easing over a month later. See **Figure 11.**

Areas such as these which have suffered from widespread lockdowns could be expected to recover strongly as they partially reopen. The high mobility data should be reflected in the official economic data with a lag. Over the coming months we expect the upturn to continue, at a lesser pace. This is because of the ongoing need for some social distancing in some services areas, and also only a gradual pickup in confidence. It is likely to take at least two years before December 2019 output levels are reached.

Figure 9: Carbon emissions show higher economic activity

Source: Bloomberg as of July 20th 2020. One lot of 1,000 Carbon Emission Allowances (EUA). Each EUA being an entitlement to emit one tonne of carbon dioxide equivalent gas, as further defined in the ICE Futures Europe Regulations.

Figure 10: Apple Mobility Data shows driving trends returned to above normality

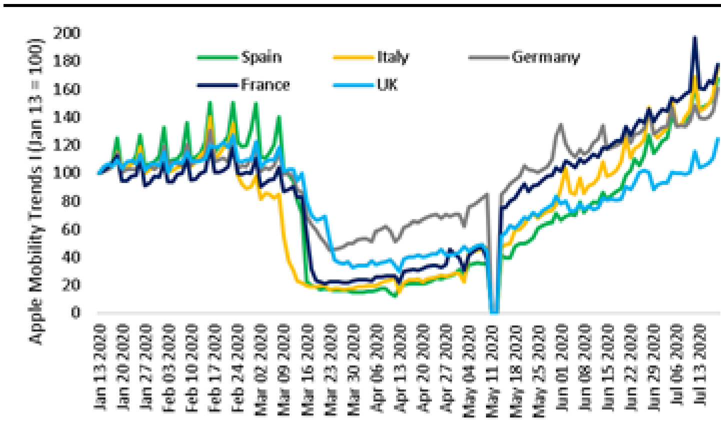
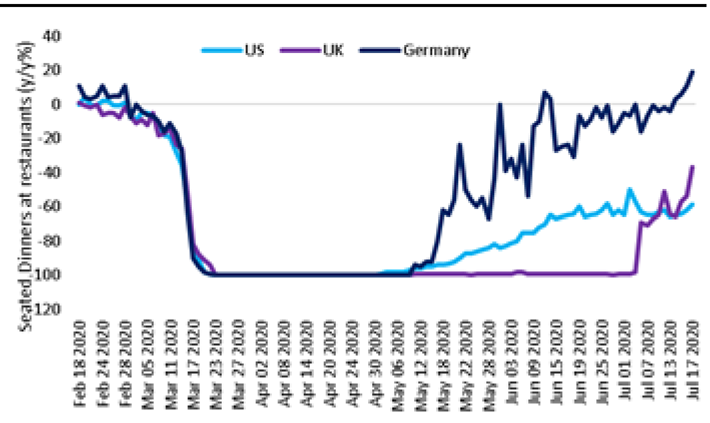


Figure 11: Restaurant reservations rising



Source: Haver, Apple, OpenTable as of July 20th 2020

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