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## Europe makes a positive step towards a Pan-Europe fiscal recovery fund

### Summary

- The EU have announced a €750 billion fiscal-stimulus package. It will be jointly financed for the first time in history. Italy is set to be the largest beneficiary of the grants.
- Along with the recovery plans, the European Commission have proposed a revamped budget of €1.1bn between 2021-2027.
- While this proposal is significant in scale and size, it requires unanimous approval by all 27 EU member states. The EU's 'frugal four' of Austria, Netherlands, Denmark and Sweden are likely to offer some resistance.
- EU leaders are set to discuss the proposals at the next EU summit on June 19th. We expect a compromised version of this emergency fund proposal will likely be agreed, with disbursements to begin in 2021.
- Periphery bonds rally on the announcement, Euro stays broadly flat, while equities rally, driven by the banks.

### Details on the Recovery Fund revealed

**The EU have announced a jointly financed fiscal-stimulus package for the first time in history.** The package, called Next Generation EU, will predominantly be funded via issuance of up to 750 billion euros in debt. Within this, there will be the following elements:

- €560 billion of the new recovery and resistance facility will see 310bn of grants raised by central bond issuance, funded by each member state according to its share in the capital key framework.
- €55 billion to top-up cohesion funding to poorer countries.
- €31 billion to take equity stakes in healthy companies (unlocking €330 billion of private investment).
- €15 billion to another fund to make the EU more self-reliant and strategic (unlocking €150 billion of private investment).
- €32 billion to the Just Transition Fund, helping countries eliminate carbon emissions.
- €15billion for rural development.

The distribution of the grants will see Italy as the largest beneficiary. Italy will receive €82bn, Spain €77bn, France €39bn, Poland €38bn, Germany €29bn, Greece €23bn and Portugal €16 bn. The European Commission will issue debt across the yield curve with repayments extended to 2058 to alleviate any medium-term funding pressures.

While this proposal is significant in scale and size, it requires unanimous approval by all EU member states by June 19 2020. The EU's 'frugal four' of Austria, Netherlands, Denmark and Sweden, had reportedly already rejected the Merkel/Macron initiative ahead of today's announcement.

**We expect a compromised version of this emergency fund proposal will eventually be agreed, as economic and German Constitutional Court pressures are very high and necessitate bold EU action to support the ECB stimulatory efforts (figure 1).**

Should this proposal or a version close to it be approved at the June 18-19 council summit, it would signify (1) a meaningful step towards greater Euro-area unity, (2) German commitment towards the Euro project, and (3) support the periphery nations who require the greatest support. Indirectly, the credit ratings and sovereign costs of borrowing of the periphery countries would improve as the fiscal transfers would support their debt sustainability.

### **Market reaction to today's announcement**

The periphery has rallied on the back of today's headlines, with Italian and Spanish 10-year yields rallying 5-7bps today to 1.49% and 0.63% respectively. Combined with rising expectations of further ECB measures on 4<sup>th</sup> June (see below), both respective sovereign yields have declined 40-50 bps in the last three weeks. The Italian to German 10-year spread has also declined 60 bps to 190 bps (**figure 2**). We maintain our preference for quality BBs or better in Euro Investment Grade, and see selective opportunities in high yield space despite a rising level of defaults

The Euro is currently trading flat today at \$1.0980. We advocate selling Euro rallies ahead of the June 19 summit and absent further subsequent reform measures (**figure 3**).

European equities are up 1.8% today, with the banks driving the rally (up 5.5%). The banks have been supported by potentially reduced periphery risk, with Italian and Spanish banks representing 46% of the Euro Stoxx Banks Index.

While we are underweight European equities, we still see selective opportunities. These include healthcare, information technology and consumer staples, as well as certain select cyclical sectors as industries begin to re-open. Aggressive measures by the ECB on June 4<sup>th</sup> and EU endorsement of the rescue fund could turn us more constructive.

**While today's announcement is a necessary step, and approval on 19<sup>th</sup> June would be positive, it would not in itself be sufficient as a long-term 'game-changer'. This is because Europe would still have major challenges in reviving growth (figure 4) and in achieving political unity. So the initial likely moves higher in most European assets may not be the start of more sustained uptrends.**

Two other factors have been concerning in recent weeks, however are also now moving in a positive direction:

### **German Constitutional Court ruling**

Earlier this month, the German Constitutional Court (GCC) ruled the European Court of Justice (ECJ) acted outside its mandate by approving ECB QE measures. The ECB now have a 3-month ultimatum to provide a "proportionality" assessment. While the ruling only covers the asset purchase programme (APP) and not the €750 billion Pandemic Emergency Purchase Programme (PEPP), any potential purchase programme not including Germany would be negative from an EU unity perspective and would likely place the Euro under pressure. This ruling has several potential implications:

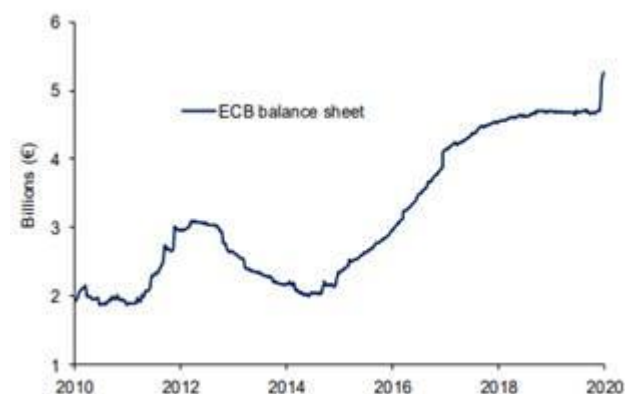
1. **ECB doesn't need to stop bond buying.** However should GCC receive what they consider an insufficient response from the ECB, then the Bundesbank will be ordered to stop purchases. The ECJ may need to intervene again with regards to judgement.
2. **Supremacy of EU laws.** Given the GCC has ignored the ECJ, it opens the doors for other nations to follow suit, which could undermine legal foundations of the EU. It also further fuels doubts around EU solidarity at a time where it is most needed.
3. **Greater fiscal expansion is needed.** With doubts raised about further monetary easing, Pan-European fiscal action becomes more important.

### **ECB measures thus far**

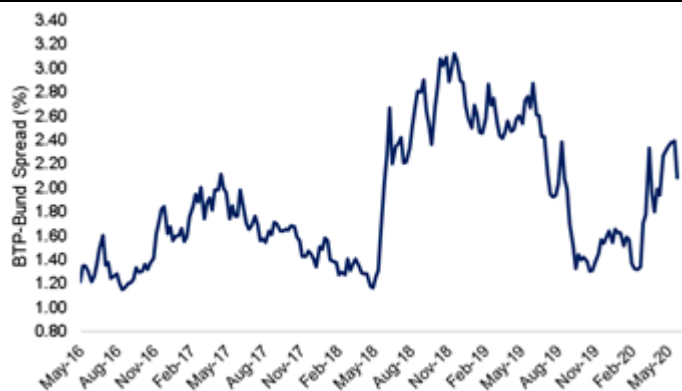
At the onset of Covid-19, in addition to increasing their asset purchase programme by €120bn through to the end of 2020, the ECB introduced a new PEPP of Euro 750 billion. They have since given an ongoing commitment to use it flexibly across asset classes and jurisdictions, with a likely increase in size at the 4<sup>th</sup> June meeting. The ECB balance sheet is expected to reach €6.5 trillion with these measures.

In addition to announcing more favourable terms for their third TLTRO (Targeted Longer-term Refinancing Operations) programme, the ECB also announced a new facility PELTRO (Pandemic Emergency Longer-term Refinancing Operations) to provide an effective liquidity backstop and the smooth functioning of money markets, with refinancing available at 25 basis points below the MRO (Main Refinancing Operations).

**Figure 1: ECB balance sheet over €5.5 trillion**



**Figure 2: Italian to German 10-year yields (%)**



Source: Bloomberg as of May 27<sup>th</sup> 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.

**Figure 3: Euro versus the US Dollar**



**Figure 4: Collapse in European economic surprises**



Source: Bloomberg as of May 27<sup>th</sup> 2020

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