BearBull
Global Investments Group

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Economic downturn in the EU at the end of the year

The health crisis is making a comeback in Europe. The ECB is monetising public and private debt. Capital markets are under control. The agreement of 21 July strengthens the euro. Significant downside risks for equities.

Key points

- Economic downturn in the European Union
- Germany shores up European growth
- EU rules on public debt will have to be rethought
- Germany leads in terms of government aid
- ECB is monetising public debt and supporting businesses
- Sovereign debt spreads and yields decrease
- 21 July agreement strengthens the euro
- Significant consolidation risks for European equities

Economic downturn in the European Union

European GDP growth already seems to be flagging after the probable sharp recovery at the beginning of Q3. European industrial production slowed down significantly during the summer after an initial rebound in May, but could finally turn out to be only slightly positive in September.

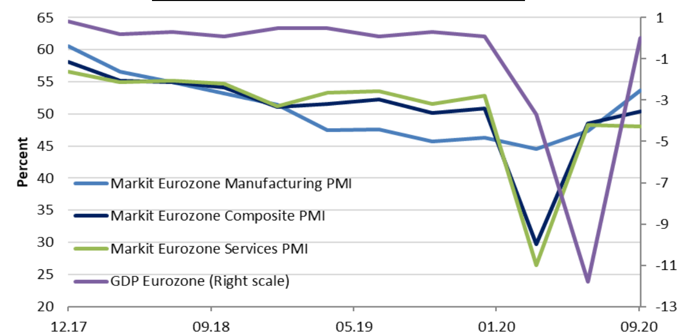
However, PMI leading indicators point to an even stronger recovery than in the US, with manufacturing PMI indicators rebounding sharply from 33.4 in March to 53.7, the highest since September 2018, and services PMI indicators rebounding from an all-time low of 12 in March to 48 in September, albeit in slight decline over three months.

The unemployment rate increased only slightly between March (7.2%) and September (8.1%), which continues to support household consumption.

The +9% rebound in growth expected for Q3 will logically not erase the -11.8% contraction observed in the previous quarter.

2020 is expected to end on much slower growth in Q4, particularly if the current resurgence of the pandemic once again has a lasting impact on the consumption climate in the main countries of the European Union.

Eurozone PMI indicators & GDP



Sources: BearBull Global Investments Group Limited

The very clear rebound in consumer sentiment observed in recent months is still less than that which prevailed before the health crisis, but it has nevertheless coincided with a recovery in consumption and retail sales during the summer, which could weaken significantly in Q4.

At the end of the year, health measures will probably affect certain service sectors more than others, such as transport and sectors linked to tourism, restaurants, hotels and events.

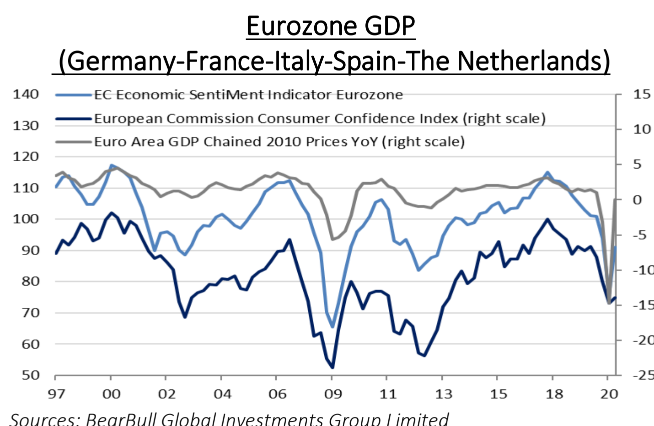
From this point of view, the recent evolution of the pandemic in Europe is worrying in terms of the outlook for the last quarter of 2020.

The strengthening of public health measures in a growing number of cities already implemented in France, for example, partial lockdowns in other European countries and the surge in cases recorded in recent days do not presage a strengthening of the economic situation at the end of the year. Overall, Europe's GDP is therefore unlikely to strengthen significantly over the coming months. Quite the opposite.

Germany shores up European growth

Despite a probable recovery of +9% in Q3 for EU countries, the expected slowdown in Q4 could lower the pace of economic recovery to below +2%.

Eurozone GDP
(Germany-France-Italy-Spain-The Netherlands)



Sources: BearBull Global Investments Group Limited

Over the year, Europe's GDP might therefore fall by almost -8% before a possible recovery of +5.5% in 2021. In 2020, growth in Spain will decrease the most (-12%), while France and Italy's GDP will fall by -10%. Germany, on the other hand, is expected to withstand the crisis better and only decline by -6%, shoring up the European economy as a whole.

EU rules on public debt will have to be rethought

After having logically suspended in March enforcement of the rules of the Stability and Growth Pact (SGP) until 2021 in the face of the pandemic and the economic support measures taken by the European States, the European Union will have to look into a new definition of the applicable rules with regards to capping public deficits and national debt.

Indeed, a new mechanism will have to be found to replace the rules that required limiting the annual public deficit to 3% of GDP, the structural deficit to less than 0.5% of GDP and public debt to 60% of GDP. For the time being, the Franco-German "couple" disagrees on this subject, with Germany wishing to reinstate them after the Covid-19 crisis, while France wishes to replace them with a new formula.

The first steps taken in recent weeks towards coordinated funding at the European level could offer an avenue to explore. As long as the ECB finances the debt of European States by monetising their debt, one could imagine that budgetary solvency would be assured, but in the long term, the ECB's policy will eventually become more conventional. New budgetary rules will necessarily have to be invented to replace the previous ones, which will certainly not survive the Covid-19 crisis when Italy's public debt already exceeds 130% of its GDP.

Germany leads in terms of government aid

The European Commission has announced that it will extend until Q3 2021 the easing of restrictions on government aid granted to struggling businesses (temporary support), which would otherwise have expired on 31 December 2020. Once again, not all countries will be able to support their respective economies in the same way. The wealthiest countries in the European Union, especially Germany, will certainly be able to defend and support struggling businesses better than other countries with shakier public finances.

Indeed, Germany is very much ahead of the other States thanks to its superior capacity for action. Since March, German state aid has accounted for more than 50% of the total aid authorised by the European Union. Italy and France each accounted for only 15% of the EUR 3 trillion in reported state aid, which is furthermore three times more than Spanish aid (5%).

ECB is monetising public debt and supporting businesses

In accordance with its Pandemic Emergency Procurement Programme (PEPP) announced in March, the ECB is now intervening on a potential volume of EUR 1,350 billion. Corporate securities purchases have been substantial in recent months, as the ECB has decided to intervene in various sectors such as energy,

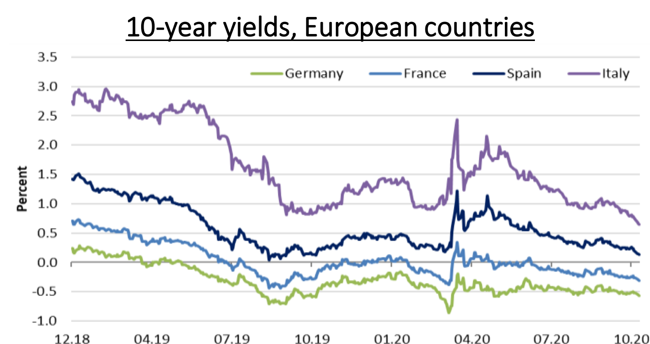
services to public authorities, transport, aeronautics, the automobile industry and air transport. The ECB's action has certainly led to a reduction in credit spreads, which had risen sharply in March, and has thus stabilised certain segments of the credit market in Europe.

The ECB has therefore acquired investment grade corporate bonds and sovereign debt. It has already purchased nearly USD 700 billion in sovereign debt in the first nine months of the year, while new government issuance did not reach USD 400 billion during the same period. The ECB's PEPP therefore finds some paradoxical limitations in the ultimately relatively low level of current, insufficient government issuance. While the ECB has succeeded in its first wager to restore a certain serenity in the capital markets, it may well be tempted to perpetuate this greater and more flexible capacity for action, which was initially intended to be exceptional and temporary.

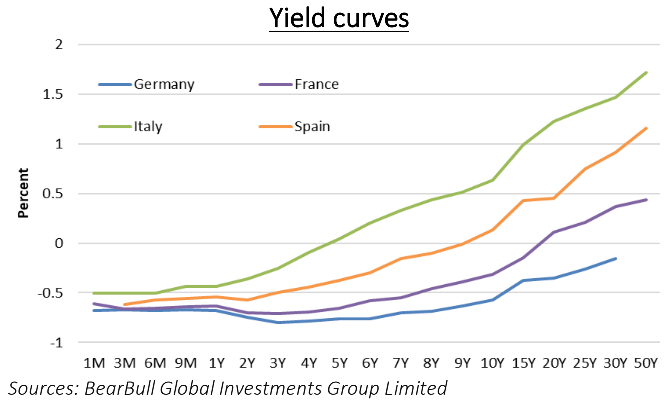
Sovereign debt spreads and yields decrease

The PEPP has been in operation for several months and has effectively been controlling the evolution of sovereign bond yields in Europe. After the first tensions regarding government bond yields observed globally in March and the explosion of spreads, particularly on peripheral sovereign bonds, the trend was towards lower yields and spreads. Over the last three months, German bond yields fell marginally, ending the quarter at -0.55%, while Italian bond yields fell from 1.25% to 0.65%.

Overall, credit spreads with Germany fell by about 50-60 basis points for Italy (120 bps), Spain (70 bps), Portugal (70 bps) and even France (26 bps). The yield spreads between European state debtors are thus once again close to those prevailing before the outbreak of the Covid-19 crisis.



Sources: BearBull Global Investments Group Limited



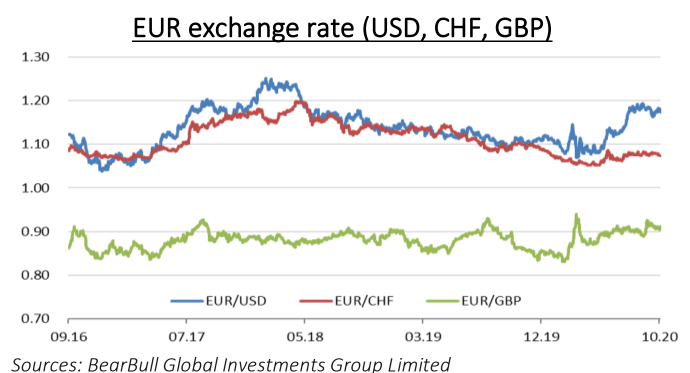
Sources: BearBull Global Investments Group Limited

21 July agreement strengthens the euro

Credit spreads had clearly already narrowed between German yields and 10-year US Treasury yields in March when yields had rapidly fallen by almost 150 basis points in the US. The interest rate differential then stabilised in favour of the dollar to remain close to 125 basis points at the end of the quarter. The 5% increase in the euro against the dollar between May and June could be explained at first glance by the narrowing of the spread observed in March.

But it already seemed to us in June that the European currency would benefit in particular from the change in outlook that the agreement of 21 July, allowing the Commission to borrow in the markets to finance Community expenditure, a first form of mutualisation of government debt in Europe, could bring about for the European currency by strengthening its long-term credibility.

We were expecting a phase of progression of the euro against the dollar, which partly occurred during the summer with a second wave of appreciation against the dollar that pushed the exchange rate from 1.12 to 1.20. Today, after this progression of around +7%, we believe that a temporary consolidation would be justified. The euro could thus weaken temporarily towards 1.15 before resuming an upward trend.



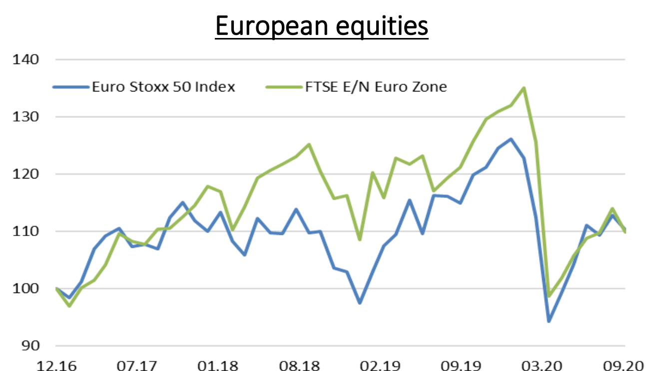
Sources: BearBull Global Investments Group Limited

Significant consolidation risks for European shares

At the end of March, we noted that although the health crisis would have undeniable economic repercussions in 2020 and 2021, the valuation levels reached after the fall in prices of around -40% already presented medium-term investment opportunities for European stocks.

The subsequent revaluation of European equities allowed the Stoxx50 index to rise by +50% between the extreme points of March and July. The concomitant rise in the PE from 10.4x 2020 earnings to around 21.5x compelled us during the summer to adopt a more cautious attitude in anticipation of a likely new phase of consolidation, which has since partly materialised. European equities have not risen since the end of June and ended Q3 on a slight decline of -1.25%.

European equities



Sources: BearBull Global Investments Group Limited

We still recommend underweighting European equities in the current, more uncertain context, firstly because of the worsening health situation in Europe and a less favourable economic outlook for Q4, but also because the overall uncertainty surrounding the US elections on 3 November may rapidly shift investor sentiment to the risk-off zone and cause new profit-taking on risky assets.

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