BearBull Global Investments Group

Economic Research

WEEKLY ANALYSIS

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How far can risk premiums go down in Europe?

EU finally to release 750 bn in recovery spending. GDP likely to contract in Q4. ECB to increase its support programmes. Fall in risk premiums reaches its limits. Risks return to the markets.

Key points

- End of 1st element of suspense: EU will finally be able to distribute 750 billion in Covid relief
- End of 2nd element of suspense: Brexit will be effective with or without an agreement as of 31 December 2020
- GDP rebound will likely be followed by a contraction in Q4
- Expected GDP growth of +4.5% in 2021
- ECB remains expansionary and reassuring
- How far can risk premiums go down in the Eurozone?
- Strength of the euro puts it back in the 1.20-1.30 fluctuation band
- Return of short-term risks for European equities

End of 1st element of suspense: EU will finally be able to distribute 750 billion in Covid relief funds

In July 2020 the 27 members of the European Union adopted a massive EUR 750 bn recovery plan aimed at countering the effects of the health crisis on the economies of EU countries, but the vetoes of Poland and Hungary quickly blocked the implementation of this much-needed recovery plan. The Brussels summit on 10 December finally helped lift these two vetoes thanks to the efforts of the German Chancellor, who holds the EU presidency for just a few more days. Unfortunately, it took almost six months to unblock the situation and start supporting the countries and economies most affected by the health crisis.

The recovery plan called “Next Generation EU” was supposed to finally enable the European Commission to borrow EUR 750 billion in the financial markets on behalf of its member states. This plan was intended to finance the reconstruction of European economies affected by the Covid-19 crisis by preparing the European economy overall for the challenges of the 21st century.

The plan comprised a grant component (EUR 312 billion) and a traditional borrowing component (EUR 360 billion). A further 78 billion was earmarked for the European budget (2021-2027) and for the React-EU, Just Transition Fund and Horizon Europe programmes. The bulk of the funds was to be distributed in 2021 and 2022. Italy (65.5 billion) and Spain (59.2 billion) were to be the main beneficiaries of the plan, ahead of France (37.4 billion) and Poland (23.1 billion).

Both Poland and Hungary had initially refused the agreed-upon conditions for granting support funds, which concerned in particular compliance with the rule of law as well as guarantees in terms of corruption and judicial independence. The 27 therefore seem to have reached an agreement, but we will still have to wait for ratification by the European Parliament and the parliaments of each member state. It is thus not clear that uncertainty has completely abated.

Furthermore, in the best-case scenario, the funds will be released only from the middle of next year. In the meantime, Poland and Hungary may still decide to challenge the agreement before the European Court of Justice. Thus, the EU may well have to find another way to deal with the appeals that these two countries are likely to file in January, which could delay the implementation of the scheme until 2022 or even 2023.

There is therefore a good chance that, in 2021, the EU will decide to move ahead with 25 of its members without waiting any longer for a definitive agreement from the two recalcitrant countries in order to finally support their economies and put the recovery plan into action at last.

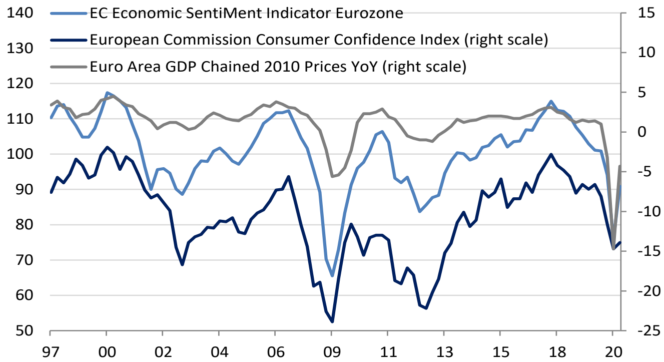
End of 2nd element of suspense: Brexit will be effective with or without an agreement as of 31 December 2020

A few days away from the final deadline, the outlook could improve somewhat for a last-minute agreement. The President of the European Commission suggested in mid-December that some progress had been made that could lead to a last-minute agreement. The issue of respect for fair competition between the UK and the EU is crucial and could finally be resolved by a commitment by the British to accept a "non-regressive" clause covering environmental, social and fiscal areas. The UK could agree to comply with the standards in force on 1 January 2021 without being tempted by deregulation and possible unfair "dumping" from the point of view of Europeans. An agreement also seems underway to allow future disputes between the two parties to be settled by compensatory measures that could be taken unilaterally by the EU in the event of non-compliance by the British. The fisheries issue, while not a determining factor in economic terms, may be the sticking point preventing the implementation of an agreement before the deadline. A "no deal" therefore still cannot be ruled out.

GDP rebound will likely be followed by a contraction in Q4

European GDP bounced up by +12.5% in Q3, erasing a good portion of the fall recorded at the end of June. Unsurprisingly, Italy, Spain and France benefited more from the reopening of their economies during the summer than Germany (+8.2%). However, this excellent recovery is already being challenged by the second wave of Covid-19, which has hit European economies hard, forcing them to implement new lockdown measures before Christmas and New Year's, which are bound to weaken economic performance in the last quarter. New government restrictions are likely to plunge the European economy into recession towards the end of the year. GDP contraction could reach -2.5% in Q4 and settle at -7.2% for the full year 2020. Hopes for a lasting recovery are therefore postponed to 2021 when the risks of new lockdowns will be mitigated by the arrival of vaccines and the launch of campaigns to protect populations.

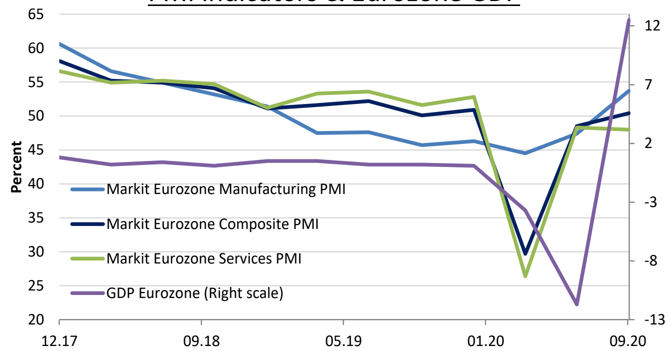
Eurozone GDP (Germany-France-Italy-Spain-The Netherlands)



Sources: Bloomberg, BearBull Global Investments Group Limited

Over one year, European GDP might therefore fall by almost -8% before a possible recovery of +4.5% in 2021. In 2020, Spanish GDP will record the strongest decline (-12%), while France and Italy's GDPs will fall by -10%. Germany, on the other hand, is expected to better withstand the crisis and record a decline of only -6%, supporting the European economy as a whole.

PMI indicators & Eurozone GDP



Sources: Bloomberg, BearBull Global Investments Group Limited

ECB remains expansionary and reassuring

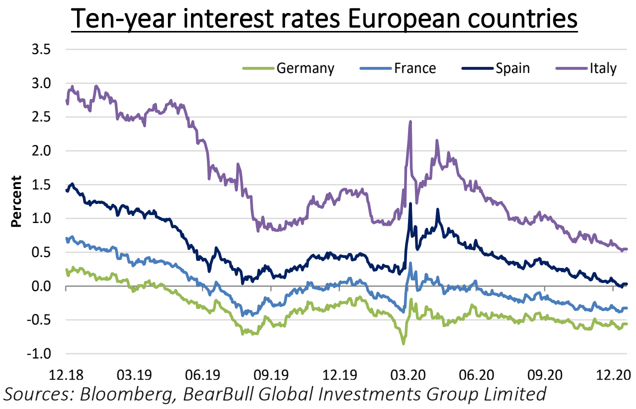
The ECB also wanted to reassure the financial markets by clearly announcing that a new stimulus would be implemented to counter the negative economic impact of the second wave of Covid-19, which is affecting the whole of Europe at the end of the year.

The bank stressed that the PEPP (pandemic emergency purchase programme) and TLTROs (targeted longer-term refinancing operations) had demonstrated their effectiveness and would therefore remain its preferred tools for steering monetary policy. It therefore logically increased the PEPP, announced in March, which covered a potential volume of EUR 1,350 billion, and its long-term refinancing operations (TLTRO-III). The PEPP will be increased to EUR 1.85 trillion and will be extended for 9 months. As for TLTRO-III, financing terms will be further eased by extending the period by 12 months. The ECB has adjusted its growth target for Q4 to -2.2%, to -7.3% for 2020, and to +3.9% for 2021.

It has also lowered its inflation expectations for 2021 from 1.3% to 1.1% and anticipates a return to normal conditions by the end of 2021. The message is clear: the ECB has the resources to effectively combat further economic slippages. The markets are likely to view these announcements as positive and as a form of insurance against the persistence of some Covid-19 risks in 2021, despite the scheduled start of vaccination campaigns. Moreover, there has been no further rate cut to potentially counter the strength of the euro.

How far can risk premiums go down in the Eurozone?

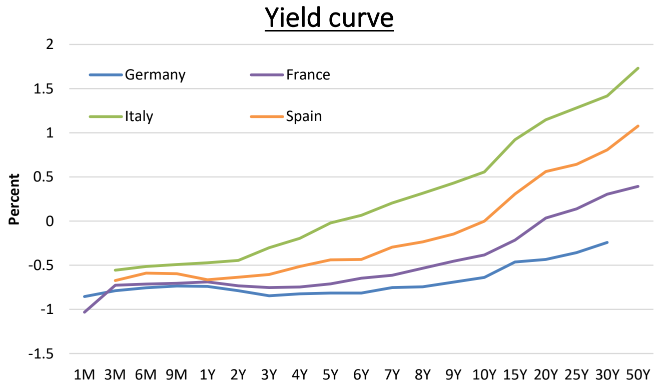
The PEPP has been operating for several months and is effectively driving the evolution of sovereign bond yields in Europe, which have been falling steadily since mid-March and are now sinking deeper and deeper into negative territory.



Sources: Bloomberg, BearBull Global Investments Group Limited

The 10-year Bund yield is again at its lowest level (-0.63%) since mid-March, similarly to French (-0.4%), Italian (+0.55%) and Spanish (0%) government yields, for example.

The yield spreads between European sovereign debtors are thus once again close to those prevailing before the outbreak of the Covid-19 crisis. Risk premiums in euro bond markets have contracted and already reflect to a large extent the new European paradigm resulting from the mutualisation of debts. The low risk premiums for Italian (1.18%) and Spanish (0.63%) debt now leave little room for further price increases unless a target similar to the current premium in France (0.23%) is considered.



Sources: Bloomberg, BearBull Global Investments Group Limited

Strength of the euro puts it back in the 1.20-1.30 fluctuation band

The ECB also expressed its views on the strength of the euro against the dollar, noting in particular that exceeding the 1.20 threshold was a source of concern. The ECB is uncomfortable with the recent upward trend in the euro, which weighs in particular on imported inflation. Inflation has logically been declining since the beginning of the pandemic and could decline further during the second wave currently underway.

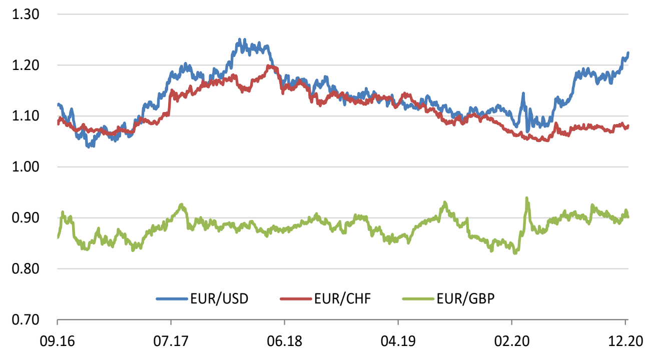
The measures to support the EU economy announced by the ECB on Thursday 10 December could have weighed on the European currency, which remains above 1.20. The ECB's warnings suggesting that it was not closing the door on a rate cut and that it was closely monitoring developments in foreign exchange markets had no effect. The euro/dollar exchange rate is therefore once again in a "natural" fluctuation or average value zone since 1999, when the euro was created. The weakness of the dollar, more than the strength of the euro, could however come to an end in January 2021, at least temporarily.

If, today, the outcome of the US presidential election casts doubt on the newly elected president's ability to implement his programme because of a divided Senate, it could be different if the last votes expected in January

2020 give the Democrats a majority. After a rise of nearly +5% at the end of the year, we believe that the Euro/USD exchange rate is more than likely to lose some momentum and return to a more horizontal trend in Q1 of 2021. While the monetary policies of the ECB and the Fed are relatively similar, with key rates close to zero and the steering of long-term rates through asset purchases, we believe that bond markets could move in different directions.

In this respect, while credit spreads on the short and long ends of the yield curve had already clearly narrowed between German rates and US Treasury yields in March, these spreads have now widened on the long end. The reconstitution of risk premiums in favour of US Treasury bonds seems to us to be an important element to consider that could support renewed interest in dollar investments and in the dollar itself from the end of the year. The ECB is therefore probably not wrong not to worry too much about recent developments favourable to the euro.

Euro exchange rates (USD, CHF, GBP)

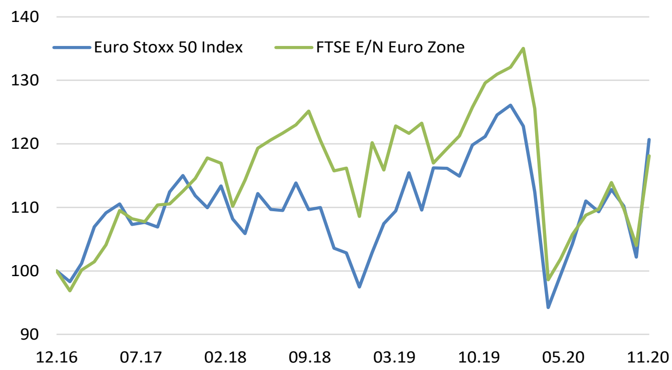


Sources: Bloomberg, BearBull Global Investments Group Limited

Return of short-term risks for European equities

After the SX5E index rebounded by nearly +50% between mid-March and mid-July, European equities suffered profit-taking in the wake of the agreement reached in July on a EUR 750 billion European recovery package. The expected decline of -15% that pushed European stocks down through the end of October was however followed by an extraordinary rally of the indices in November. This rebound enabled them to return to and surpass their July peaks in just a few days in the wake of renewed optimism linked to the outcome of the American elections. The economic upturn in Q3 also contributed significantly to this more positive stock market climate. However, as the year draws to a close, it is clear that the second wave of Covid-19 will once again have a negative impact on consumption and growth in Europe, as well as on corporate results. While 2021 is nevertheless looking brighter, valuation levels of nearly 23x earnings already seem generous and likely to generate temporary profit-taking.

European equities



Sources: Bloomberg, BearBull Global Investments Group Limited

We again recommend, temporarily, a somewhat more cautious exposure to European equities before we can expect a real recovery in activity and earnings growth in 2021.

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