BBGI GROUP Global Investments

20 March 2020

ECB to inject 750 billion into new plan (PEPP)

Massive injections of liquidity. Trend reversal on long-term rates. Monetisation of new government debt. Opportunities in equities and real estate.

Key points

- ECB announces new 750 billion PEPP to support the EU's economy
- An essential action given the considerable risks of economic collapse
- ECB to reassure markets on quality of periphery countries' debt
- Trend reversal on long-term rates
- Long-term steepening of the yield curve?
- Monetisation of public deficits, inflation and real yields
- Euro is not a safe-haven currency
- European equities and securitised real estate offer investment prospects

ECB announce new 750 billion PEPP to support the EU's economy

The European Central Bank surprised observers by announcing the urgent implementation of a new support plan, the PEPP (Pandemic Emergency Purchase Programme). The size of this emergency programme is considerable for the European Union and the ECB's current balance sheet of 4,700 billion euros.

By international comparison, the plan that was announced by the new President of the ECB is also substantial and will come as a positive surprise to investors once the wave of panic of the last few weeks has subsided. The plan calls for 750 billion euros to be injected into the EU's economy in the next few months and will last until December 2020. On 12 March, the ECB had already announced a 120 billion euro budget and the status quo on interest rates, which had come as a disappointment to financial markets, while in the US the Federal Reserve acted more decisively and convincingly.

With the surprise announcement of this measure, the ECB is thus ready to inject an additional 870 billion euros, i.e. close to 20% of its current balance sheet. The ECB's injection represents approximately 9% of the overall GDP (9,691 billion euros) of the 19 member countries of the Eurozone, a considerable amount that will have a long-term impact on capital markets.

The ECB already owns a large part of Europe's sovereign debt and is already injecting 20 billion euros per month. We believe the currently available eligible stock of European sovereign debt stands at a little over 700 billion. Moreover, the ECB will most likely have to revise its allocation rules to help reinject these funds into Italy's sovereign debt in particular.

Since 2015, the ECB has considerably increased its holdings of European government bonds, which at this time represent more than 2,600 billion euros.

An essential action given the considerable risks of economic collapse

The emergence of the coronavirus in Italy and its spread throughout Europe in the last few weeks constitutes a major, completely new risk for Europe's population.

Europe's governments reacted to the health crisis very gradually and mainly under threat of seeing the health crisis affecting Italy increasingly dramatically spread to other countries in the European Union. Europe had ultimately not been affected in 2003 by the SARS epidemic and had thus not prepared for a new virus that could potentially affect the continent. Management of the health crisis in Europe has thus been particularly chaotic in comparison with the policies implemented in Asia.

The health strategies of countries like Singapore or South Korea are now held up as an example for their degree of preparation and anticipation of the emergence of such risks. This is certainly no time to point fingers, but the time for questions regarding the complete absence of preparedness of developed countries, unable to protect their populations, will come soon. The shortage of protective masks and alcohol-based sanitisers in Europe is in sharp contrast with the extreme preparedness of populations in Asia.

Having completely underestimated this risk before the outbreak of the crisis in China, then as the crisis grew in Asia and finally even when the Italian authorities warned of the severity of the situation in their country, European governments had no other choice but to react with haste and with means that will undoubtedly prove to be insufficient and not in keeping with a responsible management of the crisis.

In the last few weeks, we discovered how fragile our economies can be when our lack of preparedness for an epidemic shock ultimately leaves us with no other choice than confinement to put an end to the spread of Covid-19. Partial at first and probably total in many other cases, the confinement measures that have been implemented will have drastic effects on Europe's economic growth in the short term.

The market panic that ultimately followed this sudden awareness is certainly excessive despite the scope of the risks and the potential effects of the pandemic.

Obviously, the health crisis will be overcome in a few weeks or months in Europe too. The economic cost of this lack of preparedness will be altogether astronomical and the price paid in terms of human lives unbearable. The outcome will be different for the various countries, but this ongoing crisis will have an impact on people's minds and will change behaviours and health policies.

The ECB's action and that of various European governments to support Europe's economy are thus essential to protect the population from the economic impact of the health crisis.

We are pleased to see today that their capacity to react in that area is at least still assured.

ECB to reassure markets about quality of periphery countries' debt

The coronavirus crisis suddenly caused people to become aware of the emergence of new, completely different risks that could affect growth. Partial or total confinement is a completely unique situation, with temporary consequences on the global economy, but which could have longer-term repercussions on certain sectors of activity, for SMEs in particular and for some countries that have been more severely hit. The crisis will trigger a recession in Q2, a disorganisation of value chains, rising unemployment, a drop in consumption and other negative effects that will lead to lower taxes, an increase in government operating costs, growth in health expenditure, public deficits and finally, a rise in debt.

The collapse of financial markets is in proportion with this new awareness and the return of risk aversion. Hence it is essential to reassure investors too that this crisis will not trigger the same concerns as those that arose between 2010 and 2013 during the Eurozone's crisis, when rising interest rates in periphery countries led to a recession and a risk of the Eurozone breaking up.

The ECB must prevent rates from rising in countries that are deemed riskier, such as Italy and Spain. It will probably commit a little further still to prevent doubt from returning.

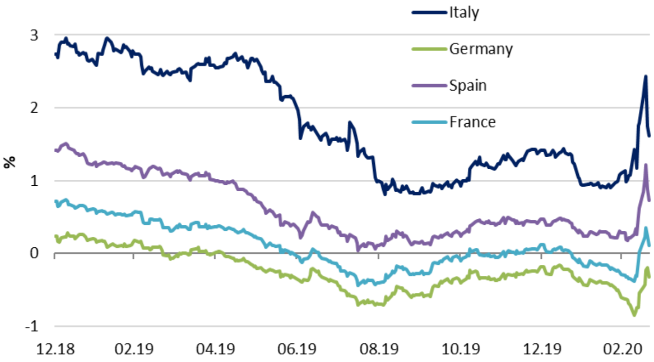
The rise in public expenditure, essential for the protection of businesses and individuals affected by the crisis, will weigh heavily on national budgets in the Eurozone and on deficits in 2020.

A rise in government debt is the most predictable consequence of this rise, which has already caused yields on the public debt of periphery countries to rise in the last ten days.

Reversal of trend on long-term rates

After 21 January 2020, the first signs of awareness of the possible gravity of the coronavirus epidemic in China affected financial and capital markets in euros. The initial reaction, which was then exacerbated through 9 March, was first to consider economic risks and the necessity of having to adjust interest rates given this new possible threat to the global economy and the Eurozone in particular. German long-term government rates thus dropped initially from -0.4% to -0.85%, while Italian government rates dropped from 1.4% to 0.84% in the same period between 21 January and 9 March, when the confinement measures were announced in Northern Italy.

Ten-year interest rates, European countries



Sources: Bloomberg, BBGI Group SA

This event marked a radical change in the assessment of the economic situation in Italy and, more generally, in all countries that might be affected by similar measures. After a few days of interest rates falling to historically low levels, most rate markets experienced a comparable upswing.

Investors thus became aware that the management of the health crisis might require the confinement of the population and a potentially complete interruption of economic activity in any country. The effects on government budgets and the risks of a strong increase in deficits and financing needs soon exceeded the expectations of falling long-term interest rates.

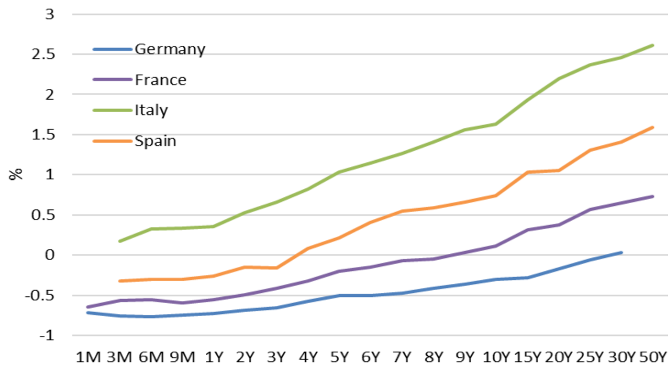
In a matter of just days, Italian rates tightened and tripled, going from 1% to 3% (18 March) before the ECB intervened to reassure the markets. The PEPP announcement seems to have worked, since, two days later, rates on Italian debt stabilised at 1.6%. In Germany, the increase in yields was spectacular, but those now stand at -0.2%, barely above their level on 21 January (-0.25%).

Long-term steepening of the yield curve?

The ECB's PEPP will likely help stabilise relative yields among the various countries in the Eurozone. Two days after its announcement, we have noticed that it has soothed investor concerns as suggested by the drop from 3% to 1.6% of Italian ten-year government rates.

Nevertheless, the reversal in risk perception that can be seen in other European countries points to an ongoing steepening of the yield curve. The French Treasury's ten-year yields have also bounced from -0.4% to +0.35% before themselves benefitting from the ECB's decision. The ECB's purchases are thus likely to curb this process, which nevertheless has rational foundations given the likely general increase in government debt.

Yield curve (Germany-France-Italy-Spain)



Sources: Bloomberg, BBGI Group SA

Monetisation of public deficits, inflation and real yields

The ECB will thus have to quickly monetise the increase in public expenditure by buying the new public debt issuances to mitigate the impact of the health crisis. In other words, this monetisation of new debt will represent monetary creation that will be akin to a policy of "helicopter money".

The coronavirus's impact in the Eurozone will increase budgetary deficits and debt, whose proportion in percentage of GDP already grew from 65% to more than 90% between 2008 and 2014. While this ratio declined to 85% in 2019, it will likely pick up in 2020.

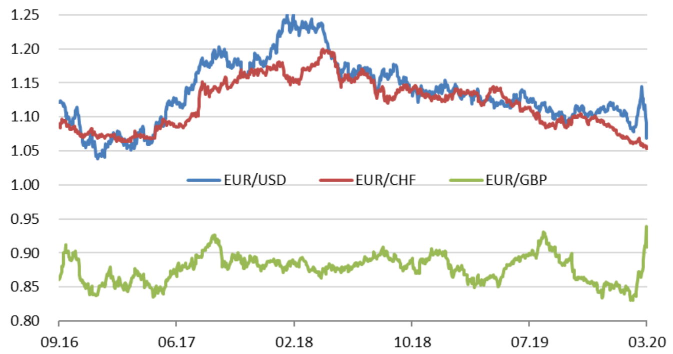
Another factor must now also be considered in this new monetary policy context, which is a rebound in the risk of an excessive increase in the money supply with potentially inflationary consequences.

In the Eurozone, the monetary base increased by 200% during the financial crisis. From 1,000 billion euros in 2008, it has now reached more than 3,100 billion euros. By deciding to monetise close to 900 billion in new government expenditure, the ECB has agreed to once again increase its monetary base very significantly. However, the ECB is not the only one doing so, since the US has already adopted such a policy. This type of strategy is likely to have a more targeted impact than the previous QEs and is likely to have superior inflationary effects supporting the central banks' stated objectives and reducing real yields further still.

Euro is not a safe-haven currency

The European currency has been suffering from several unfavourable factors for the last few weeks. The deterioration in the growth outlook for the euro area is clearly more significant than the decline in expectations for the US for one. Low interest rates have been a negative factor for a long time, but they quickly normalised after the rate cuts in the US. The fact remains that the euro ranks 4th amongst the safe-haven currencies included in the IMF's special drawing rights. The dollar, the yen and the Swiss franc are usually sought after during confidence crises, which is what happened in the last few weeks.

Euro exchange rate (USD, CHF, GBP)



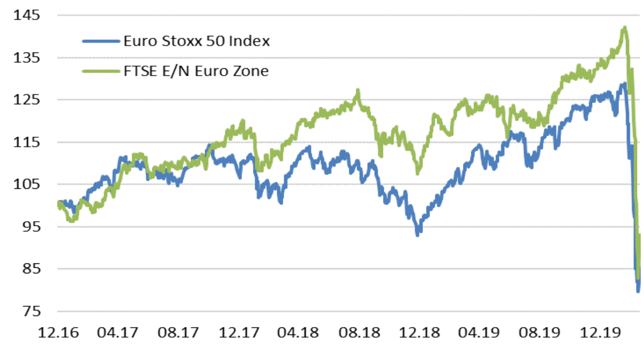
Sources: Bloomberg, BBGI Group SA

European equities and securitised real estate offer investment prospects

The coronavirus crisis has had a somewhat heavier impact on assets in euros than on other assets. Indeed, equities and securitised real estate have corrected substantially, often dropping by more than -40%. The performance of European equities (-40%) since 21 February is thus well below that of the US market, down 'only' -32% at this time.

The drop in the stock market in the last few days has preceded the 2020 earnings revision process, and it will certainly take several weeks or even months for the earnings outlook to fully adjust. The macro-economic context, which remains very uncertain for the next few months, will undoubtedly cause some volatility and risks of further decline in values. Nevertheless, current valuation levels of 10.4x 2020 profits (unrevised) for European companies can be compared with a 14.3x valuation for S&P 500 shares.

Equities and real estate in Europe



Sources: Bloomberg, BBGI Group SA

In this context, we believe that lower valuations have considerably reduced positioning risks for long-term investors, and we now recommend a more positive and constructive strategy for these two classes of assets on a 12-month horizon.

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