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European recovery plan could also bolster the euro

ECB injects EUR 1,350 billion. Banks borrow EUR 1,300 billion at negative yields. Debt pooling and monetisation are moving forward. Recovery plan favourable to the euro.

Key points

- ECB is on every front
- ECB lends banks an additional 1,300 billion at negative yields
- ECB underwrites the fiscal expansion of European states
- An 1,800 billion recovery plan with a historical political profile
- Monetisation of public deficits, inflation and real yields
- Risks of a steepening ECB-controlled yield curve
- The euro may well benefit from the European recovery plan
- Equities relatively more attractive in Europe

ECB is on every front

The European Central Bank surprised observers by announcing in March the urgent implementation of a new EUR 750 billion support plan called PEPP for Pandemic Emergency Purchase Programme. The ECB has since, as we expected, increased the size of its asset purchase programme by 600 billion for a total of EUR 1,350 billion at this time. It will therefore see its balance sheet increase by almost 30%, exceeding EUR 6,000 billion by 2021. The size of the PEPP is considerable for the European Union. The ECB is thus clearly signalling its support for the European economy in the face of the Covid-19 crisis.

On the other hand, the ECB has not changed its key rates, although it has broadened its support for the economy by further easing its monetary policy. The time horizon for net asset purchases has been extended to the end of June 2021, but it is likely that the ECB Governing Council will have to extend and maintain its expansionary policy beyond 2021 and for as long as necessary.

The ECB's action therefore represents just under 15% of the aggregate GDP (EUR 9,691 billion) of the Eurozone's 19 member countries, a considerable amount that will have lasting effects on financial markets.

The ECB already holds a significant portion of European sovereign debt and is injecting EUR 20 billion per month. The Covid-19 crisis has considerably increased the financing needs of European states already this year, but European government debt issuance is expected to continue to grow significantly in 2021. The ECB's government debt purchases will therefore follow the evolution of these needs and will certainly increase beyond the amounts mentioned above, all the more so as the ECB will also have to broaden its support programme by revising its allocation rules and the universe of eligible debt.

For example, the ECB already bought 100% of the new bonds issued by the Italian government in April and May (approximately EUR 50 billion), which has helped stabilise the yields on Italian debt. The ECB has thus already taken some liberties given the urgency of the crisis by buying more Italian debt than allowed by its rules, to the detriment of Germany in particular. While the ECB has already purchased around EUR 300 billion worth of government bonds under the PEPP, it has also acquired nearly EUR 220 billion worth of bonds issued by

companies such as Airbus, Danone and Schneider since November 2019 and will continue to do so.

ECB lends banks an additional EUR 1,300 billion at negative yields

Banks literally rushed to the ECB to take advantage of the open offer of negative-yield financing. Demand reached EUR 1,300 billion, a record for this type of programme, due to the negative yields offered by the ECB on long-term loans. Nearly 750 banks participated in the TLTRO programme, which offered particularly favourable financing conditions to banks on condition that they maintain their pre-crisis level of lending to companies. The ECB's TLTRO programmes aim to provide banks with liquidity to lend to businesses and households. The EUR 1,300 billion in loans complements the EUR 1,350 billion of asset purchases mentioned above. The ECB is therefore very active on all fronts, trying to provide the bank liquidity that was lacking in 2008 when the financial crisis broke out. In terms of monetary injections, only about half of these loans constitute new liquidity injections, if we consider that the other half represents the renewal of amounts under the previous TLTRO.

ECB underwrites the fiscal expansion of European states

The ECB thus acted successfully to prevent yields from rising in Eurozone countries deemed riskier, such as Italy and Spain. While it is still difficult to fully assess the impact of the Covid-19 crisis on the 2020 and 2021 budgets of euro area countries, there is no doubt that budget deficits and financing needs will continue to increase significantly. The ECB will also be impacted by the European economic recovery plan currently being discussed, which could lead to a common spending plan at the end of July to finance the EU's economic recovery after the health crisis. The EU heads of state and governments are expected to reach a decision in mid-July on the proposal for a historic recovery plan, which has been negotiated for several weeks and which should be considerable in scope.

The increase in public spending, which is essential to protect businesses and individuals affected by this crisis, will thus weigh heavily on national budgets in the Eurozone and on deficits in 2020, but it could well become institutionalised for several years.

An already completely predictable consequence will be the increase in government indebtedness, which will undoubtedly lead to a rise in yields on the public debt of peripheral countries in the absence of the ECB's active support.

A EUR 1,800 billion recovery plan with a historical political profile

In the next few days, the EU 27 will have to agree on a recovery plan of EUR 1,800 billion for 2021-2027. Initially, this plan will include EUR 750 billion to support the most affected countries, regions and sectors and EUR 1,100 billion in EU spending on various common policies.

The European Commission proposes to finance this plan through a loan obtained by the Commission on behalf of the EU. One third of the funds obtained would be made available to the countries hardest hit by the health crisis in the form of loans and the other two thirds would be distributed in the form of subsidies. Repayment of the loan is likely to be made thanks to European Union financial resources, e.g. through the introduction of new, specific taxes.

France and Germany already announced their support for the recovery plan on 18 May, but the plan still has to be accepted by net contributor countries such as Austria, the Netherlands, Denmark and Sweden, which will likely be reluctant to increase their net contributions. Germany's approval is, however, the clearest step towards building a more fiscally unified Europe, a major step for the European Union and for the euro.

German Chancellor Angela Merkel seems to have convinced the German Constitutional Court to reverse its decision to counter the ambitious project she is pursuing with Emmanuel Macron to pool European debt.

The outline of the future recovery plan is certainly still far from established, and negotiators will undoubtedly need a few more weeks of intense work to reach a consensus agreeable to all 27 member states. Nevertheless, it could well be a very important step for the credibility of the EU and for the euro.

Monetisation of public deficits, inflation and real yields

The ECB is therefore in the process of monetising public spending and is about to reinforce its action in this direction by buying an increasing amount of new public debt. The debt ratio of EU states will rise from 100% to 120% fairly quickly.

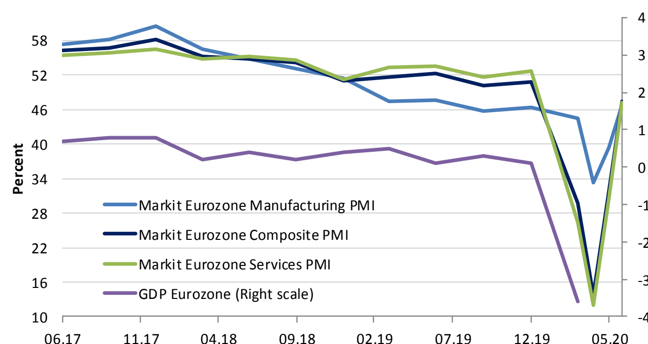
The risk of an increase in the money supply is thus significant and is likely ultimately to have inflationary consequences.

Let us note that, in the Eurozone, the monetary base had already increased by 200% during the financial crisis. From EUR 1,000 billion in 2008, it has now reached more than EUR 3,100 billion. By deciding to monetise close to 1,300 billion in new government spending, the ECB is agreeing to once again increase its monetary base very significantly. However, the ECB is not the only one to be acting this way, since US policy is already following this strategy.

Q2 will mark the low point of European growth

GDP growth in Q1 suffered a shock as expected, contracting by -3.6%. GDP estimates for Q2 are obviously more dismal, putting the fall in Eurozone GDP at -12.3%. A solid recovery of +8.3% is then expected for Q3, followed by +2.8% in Q4. Nevertheless, for the year as a whole, GDP is expected to remain down by a steep -8.1%. In this context, leading indicators have already rebounded sharply from their low points in April and point to a logical recovery of economic activity in the wake of the ongoing deconfinement. Indeed, the composite PMI index for the Eurozone rebounded from its April low (13.6) to 47.5 in June, just under the growth threshold of 50. Confidence has strengthened across the board, improving the outlook for both services (47.3) and manufacturing (46.9).

Eurozone PMI indicators & GDP

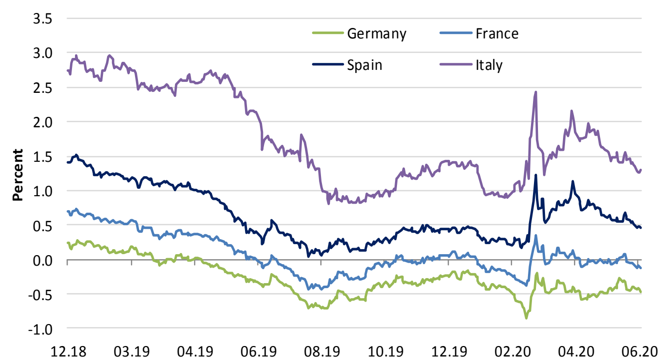


Sources: Bloomberg, BBGI Group SA

Risks of a steepening ECB-controlled yield curve

Euro yields had initially plunged at the height of the stock market panic in March before rebounding sharply, including on German debt, when the economic support to businesses and households announced by governments raised fears of an increase in the indebtedness of European states.

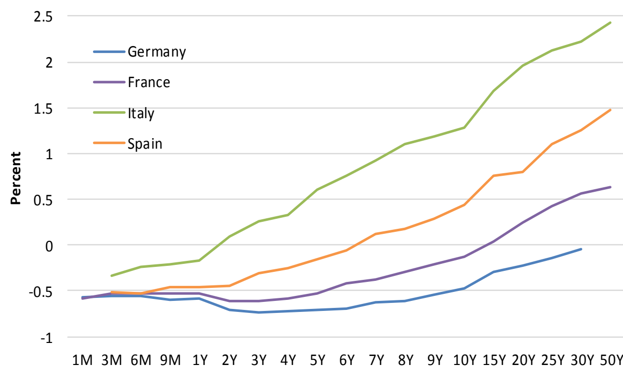
European countries 10-yr yields



Sources: Bloomberg, BBGI Group SA

Since the announcement of the ECB's PEPP, it has become clear that a rise in government debt ratios would not cause a significant increase in the yield required by investors. Indeed, the ECB's action has been clearly interpreted as an action to stabilise at low levels relative and absolute yields among the various Eurozone countries.

Yield curve

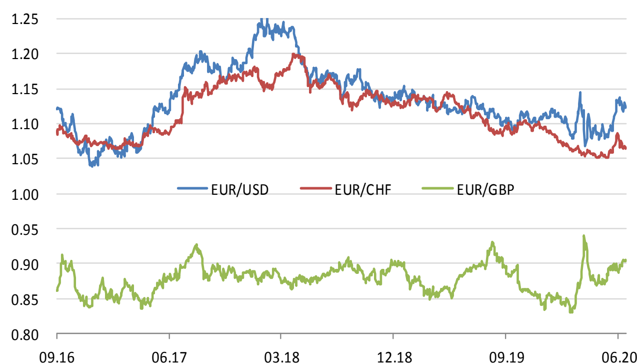


Sources: Bloomberg, BBGI Group SA

The euro may benefit from the European recovery plan

The euro appreciated by +7% against the yen, +5% against the dollar, +2.5% against the pound sterling and finally +3% against the Swiss franc (1.05 to 1.09) at the end of May, before sliding back to 1.0650.
The start of deconfinement in the Eurozone is somewhat favourable to the European currency, which could benefit from a faster return of consumption in Q3. Above all, the European currency could benefit from the pooling of debt in Europe, which would strengthen the long-term credibility of the EU and the euro.

Euro exchange rate (USD, CHF, GBP)

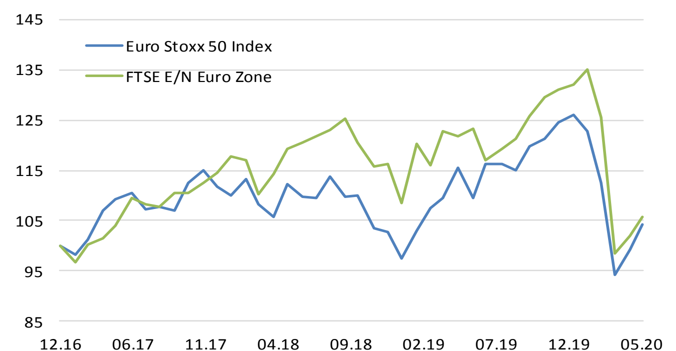


Sources: Bloomberg, BBGI Group SA

Relatively more attractive equities in Europe

Three months ago, at the height of the stock market panic, we noted that, although the health crisis would have undeniable economic repercussions in 2020 and 2021, the valuation levels reached after the fall in share prices of around -40% already presented medium-term investment opportunities with regard to European stocks. At the end of March, valuation levels for European companies stood at 10.4x 2020 earnings compared to 14.3x for S&P500 stocks. Now, after a share price increase of +46%, the SX5E (Stoxx50) index is trading at around 20x 12-month forward earnings. Relative valuation levels remain favourable, with a 20% premium over the S&P500's PE (25x). At the end of June, the European market remained 15% below its level at the start of the year and benefitted from an attractive yield (+2.8%). In the short term, however, European equities are likely to consolidate during the summer after an almost uninterrupted rise in share prices over the last three months.

Equities & real estate in Europe



Sources: Bloomberg, BBGI Group SA

We are now recommending a reduction in exposure to European equities, but beyond the risks of short-term profit-taking, the European recovery programme should then have a positive impact on European equity markets.

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