EU agreement: a powerful answer that can lift further EU assets and ESG investing

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- *The agreement reached among EU leaders at the end of the longest European Council in history regarding a comprehensive package worth €1,824bn – including the Multiannual Financial Framework (MFF) and the Next Generation EU (NGEU) instrument –* ***is a significant achievement and a net positive in the short term for EU assets.***
- *The* ***Recovery Fund will increase the resilience of the EU****, but it will not stabilise activity in the next 12 months. Indeed, this Recovery Fund will not be operational before the first quarter of 2021. The economic impact will not be felt until 2022. Cyclical stabilisation policies therefore remain the responsibility of the Member States.*
- *However, the agreement on the budget is a significant step forward and a game-changer for the EU. For the first time, the EU will mobilise the budget in a counter-cyclical manner. Fiscal policy thus becomes a stabilisation instrument in the event of a crisis.*
- *We see this Recovery Fund as a* ***permanent tool to promote real convergence among EU countries.*** *The loans will enable the fragile countries (those hardest hit) to take on long-term debt at rates they would not obtain on their own, thanks to the European Commission's triple-A rating. For the first time, the European Commission will issue debt on behalf of the EU with the objective of convergence and redistribution between countries. It's not a zero-sum game. The borrowed sums will have to be repaid, but not before 2028 (and by 2058). This means that all EU countries (including net contributors) will benefit from this massive borrowing in the coming years.*
- *The new debt issued by the* ***Commission on behalf of member states should consolidate the international reserve status of the euro*** *at a time when the role of the US dollar could be called into question due to the drift in public finances. Moreover, this will also be relevant for fixed income investors, as in a world "short of safe assets", it will provide a large and liquid highly rated asset to meet investor demand.* ***We believe that the issuance of a large volume of common debt should encourage foreign investors to consider the EU as a whole and not as the puzzle of single issuers.***
- *Regarding equity, the approval of the Recovery Fund was one of the five pillars calling for a re-pricing of EU equities in absolute and relative terms. We still see upside potential from current levels, especially if – as we believe – the cyclical recovery will continue. While European equities overall are likely to benefit, we believe this is particularly positive for financials as well as peripheral countries.*
- *Regarding EU fixed income, credit markets probably have more room to compress further – as they have not reached the historical low yet. But, the overall environment could become more difficult going forward, with more idiosyncratic events occurring down the road. Sovereign peripherals look likely to benefit from the Recovery Fund, though they now are quite expensive. Today's market reaction suggests that markets were expecting a positive outcome. To dig down further, sovereign spreads will need more fuel and, clearly, this will depend on the pace of the recovery and the capability of the peripheral countries to fully benefit from it – in particular, Italy.*
- *The significant allocation of resources for climate change/environmental projects should help boost ESG-related investments in both fixed income, with the green bond market growing in assets and diversification, and equities.*

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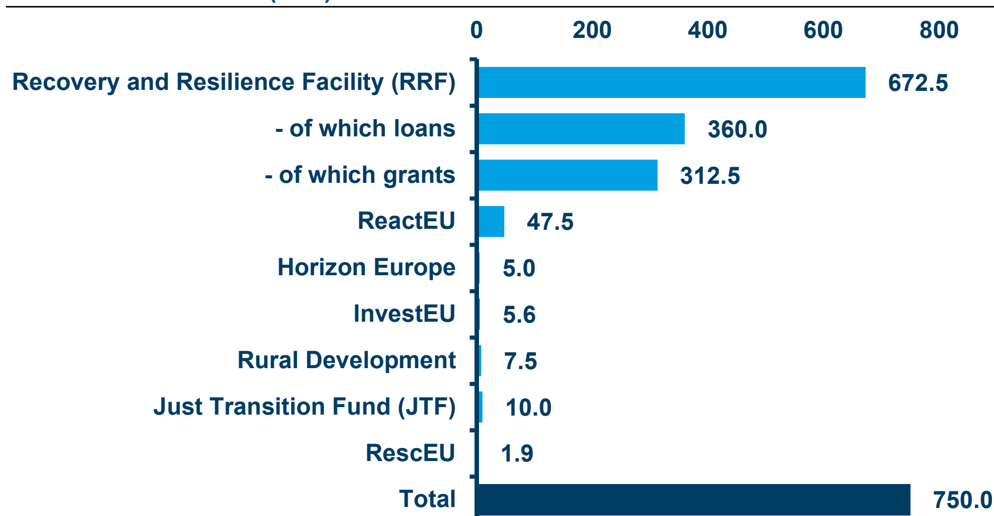
THE MACRO VIEW

Key Takeaways from the EU agreement

At the end of the longest European Council in history, EU leaders have agreed to a comprehensive package worth **€1,824bn** which combines the **Multiannual Financial Framework (MFF)** and an extraordinary recovery effort under the **Next Generation EU (NGEU)** instrument.

Under the agreement, the Commission will be able to borrow up to **€750bn** in the markets: **€390bn from the package will be distributed in the form of grants and €360bn in loans.** The Frugal 4 (the Netherlands, Austria, Sweden and Denmark) – belatedly supported by a fifth country (Finland) – were opposed to any form of debt mutualisation on the grounds that the transfers were intended for countries considered to be overspending.

Next Generation EU (€bn)



Source: European Council, data as of 21 July 2020

In order to reach an agreement, the other EU member states therefore had to make concessions:

- The share of grants fell below the symbolic threshold of €400bn, which was the minimum required by France and Germany and the Southern European countries.
- The Frugal countries have obtained a further increase in rebates (they are still net contributors, however).

To formally come into force, this compromise requires the approval of Parliaments in many countries. This will probably have to wait until the end of the year.

It should also be noted that (see details in the box in the next page):

- The allocation key is virtually unchanged from the European Commission's original proposal.
- States will have a right of control over the sums disbursed (**but no country will have a veto).**
- Emphasis is placed on energy transition (30% of expenditure will be devoted to this).
- The Europeans intend to set up an own resource by 2021, which can be increased over time.
- The Europeans have made no concessions with respect to the rule of law.

Ultimately, this is much more than a stimulus package. From a fundamental standpoint, **this is a very significant step**. **For the first time, the EU will mobilise the budget in a counter-cyclical manner.** Fiscal policy thus becomes a stabilisation instrument in the event of a crisis. **We see this Recovery Fund as a permanent tool to promote real convergence** (see *Covid-19 crisis, a catalyst for change and strengthening the EU,* Borowski& Blanchet July 2020).

- The loans will enable the fragile countries (hardest hit) to take on long-term debt at rates they would not obtain on their own, thanks to the European Commission's triple-A rating.

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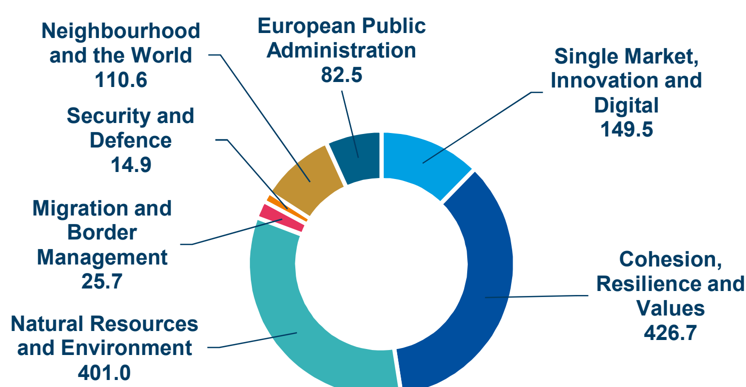
- For the first time, the EC will issue debt on behalf of the EU with the objective of convergence and redistribution between countries.
- It's not a zero-sum game. The borrowed sums will have to be repaid, but not before 2028 (and by 2058). This means that all EU countries (including net contributors) will benefit from this massive borrowing in the coming years.

"For the first time, the EU will mobilise the budget in a counter-cyclical manner. Fiscal policy thus becomes a stabilisation instrument in the event of a crisis".

EU 2021-2027 budget (€bn)



Source: European Council, data as of 21 July 2020. Multi Annual Financial Framework at current prices.

AGREEMENT DETAILS

Allocation from the Recovery and Resilience Facility (RRF)

*"The plan ensures the money goes to the countries and sectors most affected by the crisis: **70% under the grants of the Recovery and Resilience Facility will be committed in 2021 and 2022 and 30% will be committed in 2023.** Allocations from the RRF in 2021-2022 will be established according to the Commission's allocation criteria taking into account member states' respective living standards, size and unemployment levels. For 2023 allocations, the unemployment criterion will be replaced by the drop in GDP in 2020 and 2021".*

Conditionality

"If, exceptionally, one or more member states consider that there are serious deviations from the satisfactory fulfilment of the relevant milestones and targets, they may request that the President of the European Council refer the matter to the next European Council".

Climate action

"30% of the total expenditure from the MFF and Next Generation EU will target climate-related projects. Expenses under the MFF and Next Generation EU will comply with the EU's objective of climate neutrality by 2050, the EU's 2030 climate targets and the Paris Agreement".

Own resources

"EU leaders agreed to provide the EU with new resources to pay back funds raised under Next Generation EU. They agreed on a new plastic levy that will be introduced in 2021. In the same year the Commission is expected to put forward a proposal for a carbon adjustment measure and a digital levy, both of which would be introduced by the end of 2022".

Rule of law

"The Union's financial interests will be protected in accordance with the general principles embedded in the Union Treaties, in particular the values referred to in Article 2 TEU. The European Council also underlines the importance of the respect of the rule of law. Based on this background, a regime of conditionality to protect the budget and Next Generation EU will be introduced".

The North/South divide is less pronounced than during the sovereign debt crisis. This European Council – the longest in the history of the EU – is in many ways reminiscent of the meetings to save Greece and monetary union. There are resonances with the sovereign debt crisis. As in 2010, the Union is divided between North and South. But, there is a big difference**: today, Germany has changed sides and the northern camp has fractured**. The Netherlands has been able to unite other small countries which, like that country, do not have confidence in the ability of the countries of the South in general, and Italy in particular, to reform themselves or in the Commission's ability to enforce budgetary discipline. Having said that, there is nothing in common between the Greek crisis and the consequences of a pandemic. Angela Merkel and Emmanuel Macron remained united throughout the negotiations.
The opposition of the frugal countries nevertheless shows that even without the UK, France and Germany cannot secure a deal alone.

"This European Council allows the EU to equip itself with a common debt instrument, which represents a real step forward for the Eurozone".

Recovery Fund: A real step forward for Europe

This Fund will increase the resilience of the EU, but it will not stabilise activity in the next 12 months. Indeed, this Recovery Fund will not be operational before the first quarter of 2021. The economic impact will not be felt until 2022. **Cyclical stabilisation policies therefore remain the responsibility of the member states.** Governments were waiting to see what would be done at the European level before putting in place new measures.
This European Council has enabled the EU to equip itself with a common debt instrument, which represents a real step forward for the Eurozone for at least three reasons:

(1) de facto, the only debt instrument to play this role in the EZ is the German bund (and its scarcity has contributed to pushing its yield into negative territory);
(2) the world is "short of safe assets" and therefore a large and liquid highly rated debt will meet investors demand; and
(3) the issuance of a large volume of common debt should encourage foreign investors to consider the EU as a whole, and not as the puzzle of single issuers.

When comparing Europe with the US, it is clear that the EU has fewer imbalances (less public debt, a large external surplus) while imbalances are growing fast in the US (notably, the public debt/GDP ratio). **In other words, this new debt issued by the Commission on behalf of member states should consolidate the international reserve status of the euro at a time when the role of the US dollar could be called into question due to the drift in public finances.**

"The ECB will have to continue its programmes, ensure that monetary conditions remain accommodative, and combat financial fragmentation".

Next steps and the role of the ECB

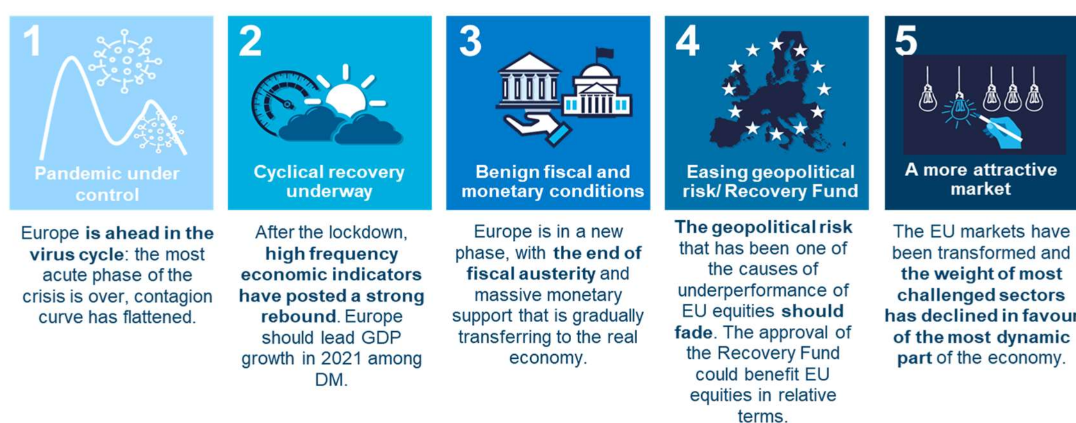
This Fund gives the countries of the South (and Italy in particular) the opportunity to re-convert towards the rest of the EZ. Time had to be bought**. The combined support of the ECB and the EU offers a unique opportunity to address the growing economic fragmentation of the area**. But, it would be a mistake to believe that the essential has been done
The monetary union must be completed, the CMU deepened, banking union achieved, and ambitious reforms implemented in the countries of the South (and in Italy in particular) – these steps represent the only means to increase potential growth in the medium term.
The road ahead will be long and difficult, but crisis after crisis, Europe has shown that it is capable of meeting the challenges.
Against this backdrop, the ECB will have to continue its programmes, ensure that monetary conditions remain accommodative, and combat financial fragmentation. Having said that, it will undoubtedly be helped by this European plan, as it should improve European investors' confidence in the stability of the countries hardest hit by the crisis.

"The agreement is a major positive for EU equities and significantly reduces the political risk that weighed in the recent past on the asset class".

INVESTMENT IMPLICATIONS

We think that the agreement will be a catalyst for European equity markets. Market reaction has been very positive. Month to date, the Eurostoxx is up almost 6%. As we recently highlighted in the piece, *Time to play a cyclical recovery in European Equities,* the approval of a Recovery Fund to support the EU economy was one of the five themes supporting the positive case for EU equities. It offers the market significantly more upside than bonds and, in relative terms, than the US market. European equities could enjoy good absolute and relative performances near term as this cyclical recovery continues. The agreement sends a strong political message and is an important step towards a coordinated policy response. The context is that European equities at times had been considered a broken market – challenged by redenomination risk and the risk of EU breakup. Risks still remain, but this coordinated action is important with regard to reducing these risks. It will likely increase the appetite for European equities, which have seen very low interest and flows for a long time. **While European equities overall are likely to benefit, we believe this is particularly positive for financials as well as peripheral countries.**

Recovery Fund: one of the five themes supporting EU equities



Source: Amundi, as at 21 July 2020.

"Significant resources to fight climate change may provide a boost for ESG investing in Europe".

ESG IN FOCUS

Moreover, there is another important aspect to consider regarding the new budget. With a third of the proposed Fund and next budget dedicated to projects that address climate change, we believe that the Recovery Fund will give a significant boost to climate change-related equity investments. There is a growing awareness of this among all stakeholders. ESG investing, which seeks to proactively address these challenges, will continue to grow in importance, in our view. In this, we believe that European companies are particularly well positioned given their technology and know-how in working with solutions on ESG and climate challenges. In addition, **we see tangible and investible opportunities around the EU green deal.**

In fixed income, this would provide a significant boost to the green bond market. With already more than €60bn of new green bonds issued this year, this market has kept up its momentum in line with last year, despite the Covid-19 crisis. The growth of the green bond market is tightly linked to the amount of real investment in climate projects. **The commitment of 30% of EU spending towards climate action is a very positive outcome for the green bond market:**

- A boost in the next three years, thanks to the European Recovery Fund worth €750bn;
- A long lasting trend with the EU 2021-2027 budget of 1 074bn€
- Issuers will use this financial instrument to show their commitments to financing green projects and this may help increase diversification in terms of issuers, sectors, types (IG vs HY), and structures of issuance (loans, bonds, seniority).

This should provide an interesting opportunity for investors.

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Definitions

- **ESG:** (Environmental, Social and Governance).

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