Letter n°11

Europe, one more effort !

« *Everything comes in time to those who can wait* » Rabelais

What growth expectations? What recent or forthcoming solidarity? What position on the European Stock Exchange? These are the questions that we can consider in this letter and, in line with Rabelais' quote, the tone will be optimistic. Certainly, no federalism but more integration, no mutualisation of existing debt but more solidarity in the face of hardship. In 410, the Goths led by Alaric, in 455 the Vandals led by Genséric, in 472, the Ostrogoths and worse, in 1527, the Lansquenets of Emperor Charles V plundered Rome because it was the richest. Today, Italy, weakened but not without resources, is calling for the implementation of a support plan, and it is a question for Europe to deliver, helping Rome and showing solidarity. The ECB, under the leadership of Christine Lagarde, who took over from Mario Draghi, has been diligent and the European Commission has been responsive. Let us hope that the Council will endorse a bold recovery plan and that the Netherlands will stop being a divisive country. This third dimension is fundamental and the markets are worried. Despite the measures already announced, the interest rate differential between Italian and German debt continues to widen, and we will therefore focus on these issues, leaving the deepening of common policies and relations with China and the United States to be discussed at a later date.

What growth expectations ?

At the beginning of 2020, the European Commission had expected a GDP growth rate of 1.1%. In its latest estimates, it fears an average decline of 7.7% with a more pronounced fall in GDP in France (-8.2%), Italy (-9.5%), Spain (-9.4%) and more moderate contraction in Germany (-6.5%). Even Sweden, which is less strict in its containment measures than the southern countries, is expected to suffer a 7% decline in GDP, especially since 30% of its exports are destined for Europe. However, nothing is comparable with the 14% decline in GDP announced by the Bank of England for the UK. The Commission also expects a rebound of 6.3% in 2021 for the whole area. After an enviable budget surplus of 0.6% in 2019, Europe is expected to experience a budget deficit of 8.5% this year. These are flattering figures compared to the US, which is expected to run a deficit of 4.5% in 2019 and probably 15% of GDP in 2020. But there is no reason to be proud of the Eurozone just yet, as public debt will reach 103% of GDP and the average unemployment rate will reach 9% after 6.7% in 2019. Then again, there is a sharp contrast with the United States, where the unemployment rate rises from 3.6% to nearly 20%.

Deconfinement has begun and it is important for each European state to succeed since the border closures had hindered the free movement of goods.

What European effort ?

Before assessing the solidarity effort, let us recall a few figures: the GDP of the European Union is EUR 16 trillion compared to $22 trillion in the United States and $14 trillion in China. The annual budget is EUR 150 billion. On the eve of this crisis, the negotiations on the budget for the next seven years 2021-2027 were disappointing. The Commission had proposed to increase the budget to 1.11% of GDP, but discussions had stalled at 1.06% because the Netherlands, Austria, Sweden and Germany were against a budgetary effort. In light of the US federal budget at 18% of GDP, or the average public expenditure of EU countries at 47% of GDP, one could measure national selfishness and despair of progress. Europe's handicap compared to China or the United States is that it is not a nation. Paul Valéry had described Europe as the cape, the headland or spiritual promontory of civilisation. However, one could often add that in fact it has no direction.

In this context, when the crisis broke out, the rapid intervention of the ECB and the support of the Commission were encouraging elements, even if the score played by the Netherlands, the new "Mr No" of the Union, is very sad. Without co-signing the call of the nine southern countries for mutualisation, Germany has shown itself receptive to a community effort.

From a monetary point of view, the position of the European Central Bank was delicate, but it did not wait four years to act, as in 2008. It was prompt and diligent in committing to EUR 1 trillion of sovereign bond purchases by the end of the year, to abandon the principle of homothetical purchases by country, to exceed the historical maximum purchases of 33% of government bond issues and to give preference to the most indebted countries for bond purchases. It now accepts BB-rated bonds as collateral, i.e. two ratings below the rule in force until now, and it buys Greek debt that is classified as speculative. The ECB has also increased the Long Term Refinancing Operations (LTRO), announced an increase in corporate bond purchases of EUR 120 billion this year and decided to accept "junk" bonds as collateral for loans. From these measures and guaranteed loans, one may fear that "zombie" companies will continue to operate, but the audacity will be recognized. To sum up, the balance sheet of the ECB, EUR 2 trillion in 2015 and EUR 5.2 trillion today (40% of the GDP of the Eurozone), will increase significantly.

Some would like to go further with the issue of perpetual debt but the ECB is not yet allowed to buy bonds with a maturity of more than 30 years and these perpetual bonds would have a cost. In the short term, the ECB has to overcome the critical judgment of the German Constitutional Court in Karlsruhe on the 2015 support plan (EUR 2.6 trillion purchase between 2015 and 2018), a new attack on the ECB's independence, a refusal to accept a breach of the principle of proportionality in the repurchase, an idea already rejected by the European Court of Justice in 2018 and again two days ago, that German law would be superior to European law. The ECB has two months to show that these purchases were the right policy to achieve the 2% inflation target and it has little to fear because, notwithstanding the criticism, the judgment notes that the ECB has not monetized the debt, does not invalidate the current EUR 1 trillion plan and notes that "the German central bank can continue to participate in the joint purchase programme". From a political point of view, however, a clarification by Angela Merkel would be welcome, as giving primacy to the law of individual countries over European law would play into the hands of Hungary and Poland and emphasize the notion of "every man for himself".

After the ECB's monetary angle, let us look at the budgetary angle: the application of the Stability Pact and the limitation of the deficit to 3% of GDP were put on hold from the very first days of this crisis and, at the Brussels Commission, some people are dreaming of a new definition of the deficit, excluding expenditure on infrastructure and innovation, which are factors of competitiveness for businesses, and health expenditure, which is a factor of efficiency for employees. Let us welcome the Commission, which quickly decided on a EUR 540 billion programme that is based on a three-part mutualisation approach: EUR 240 billion to activate the European Stability Mechanism (ESM), to provide unconditional aid to applicant countries up to 2% of their GDP. Secondly, EUR 200 billion in guarantees provided to companies by the European Investment Bank (EIB). Finally, a fund of EUR 100 billion to finance partial unemployment.

In a few weeks, under the influence of necessity, undeniable progress has therefore been made by the ECB and the Commission. Europe has shown more solidarity than the US federal government in its $2 trillion aid package. To date, Europe has made EUR 540 billion of aid available and is preparing a recovery plan, while the US Senate has refused to grant more than $150 billion to the states, which are all demanding more, and some, notably New York, Illinois and New Jersey, are threatening to go bankrupt.

The third set of measures under discussion is the adoption of a recovery plan by the European Council, the expression of unconditional solidarity to cover the cost of this health-related crisis. Setting up "corona bonds" would have taken too long because it would have required a change in the treaties, the approval of each national parliament and the refusal of Netherlands to finance loans not accompanied by reform commitments. In order to get around this stumbling block, the French idea, which is between the expectations of the South and the reluctance of the North, would be to raise pooled debt of EUR 150-300 billion per year until 2023, repayable over 40 years with a grace period of three years. The objective would be, in conjunction with the European budget, to finance the recovery with a European focus on innovation, the European Green Pact and European industrial sovereignty. According to estimates, the plan could reach between EUR 500 billion to EUR 2 trillion, probably in the form of common guarantees. The idea is that of a coordinated plan to avoid an "every man for himself" policy that would distort competition and benefit the less affected and richer Germans. It is not only the southern countries that will benefit from the plan, but also Germany and the Netherlands, which are among the most open economies, as they are suffering from a slowdown in exports, particularly to southern Europe.

The community plan would be in addition to the budgetary measures implemented at the level of each country - to date, 1.1% of GDP in Spain, 2.4% in France, 6.9% in Germany (EUR 123 billion), 0.9% in Italy - and the state guarantees, equivalent to 38% of GDP in Germany, 14% in France, 29% in Italy, 9% in Spain (source: Institute Brueghel).

What position on the European Stock Exchange ?

No other region in the world will have added as much aid to boost the economy because, in addition to the three chapters of European action, there is also massive state spending. This is the reason for our overweight on Europe in terms of geographical allocation.

To date, market price recovery in both Europe and the United States is the opposite of that of 2009. Investors have favoured technology, healthcare and defensive stocks, neglected cyclical stocks and massively sold off banking and oil stocks, and the question is whether we can expect a new upward phase driven by these neglected themes. Notwithstanding the scale of the financial subsidies presented above, as long as the risks of a resurgence of coronavirus and a second wave of containment have not been averted, caution must still prevail over these stocks.

If the European stock market shows less recovery than the American market, it is partly due to the absence of technology giants such as the famous FAAMG top 5 (Facebook, Apple, Amazon, Microsoft, Google), now valued at $5.2 trillion, equivalent to 20% of the S&P500 capitalization, up by more than 10% this year while the other 495 stocks are still down by 13%. But the European market, including Switzerland, is rich in good quality defensive stocks. As an illustration, we will not yet buy, other than as a speculative touch, Airbus at -62% from its peak, Air France at -56%, Renault at -52%, ING at -57%, Société Générale at -55%. Essilor at -30%, Air Liquide at -28%, Dassault Système at -27%, Hermès at -26%, Sanofi at -20%, Roche at -17% or Danone at -17%.

Conclusion : “All power is weak unless united” La Fontaine in “The old man and his sons”

The Euro advantage :

The crisis has shown that the best armed countries are also the least indebted and this lesson is not new. Belonging to the Eurozone benefits everyone. For example, France, thanks to the Euro, benefits from low interest rates, its interest burden on a debt at 115% of GDP should only be EUR 36 billion in 2020, less than EUR 46 billion in 2011, when its debt was a little over 92% of GDP. The Euro, a still young currency, is used for more than 20% of international transactions and, after only 2% variation against the dollar since the beginning of the year, should continue to show stability. In the immediate term, Europe's objective must be clear: to prevent the markets from attacking the debt of a state, in this case Italy, to prevent a default by showing solidarity in crisis management, by pooling efforts in favour of the recovery plan.

The necessary deepening of Europe :

Europe must be aware of its assets. It is the world's leading trading power and its domestic market is rich. In the longer term, Europe must remove countries that do not share democratic values and drastically reduce regional aid to countries who take advantage of Brussels' windfalls but turn their backs on the common ideal. Europe must move towards industrial integration with new programmes such as the Europe Battery Alliance, move towards military independence with a community defence budget, invest in the path to self-sufficiency in strategic sectors such as the medical sector. Solidarity exists since Germany's annual net contribution amounts to EUR 10 billion and Poland's net profit is close to EUR 8 billion, but more needs to be done.

Solidarity must be consolidated because the exit from the crisis, the demand recovery and the reduction in unemployment might be slower than expected for all countries. Precautionary savings should last and many companies in fragile sectors such as aeronautics and tourism risk facing financial difficulties, excessive debt and a drop in competitiveness due to rising health costs if not compensated by an increase in working hours or a reduction in wage costs. Therefore, there is no guarantee, as the current doxa claims, that states will be able to reduce their budget deficits from the beginning of 2021.

Europe's necessary international affirmation :

Division is inherent in Europe, a fruit of its history, a legacy of many centuries of conflict. As **Milan Kundera** noted: "***Europe, maximum diversity in minimum space***". Today, threats are often external to Europe. Trump's United States would dream of seeing Europe dissolve, Xi's China exploits divisions, Putin's Russia is on the lookout with the same objective, where Gorbachev's "Common European Home" project would have been a better map. So many reasons to strengthen cohesion.

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