THIS MONTH'S TOPIC


# Special Europe: investing in the recovery

by Global Research Team

<u>In a nutshell</u>

**As the European economy is recovering from the largest economic shock of modern history, we are revising our growth and inflation assumptions to the upside. Although the path to recovery is uneven among member states, we believe the EU will see two years of strong growth while inflation should revert below 2%. The ECB should implement a smooth transition from its emergency policies to a "classic" QE and keep policy rates on hold. We see the EUR/USD moving gradually towards 1.15 over 12 months.**

**In this context, we like periphery bonds and in particular Italian bonds in absolute and relative term. Within the European credit markets, we prefer high beta segments such as subordinated debt and BBBs within IG and high and mid-rated corporates within HY. We reiterate our positive stance on European equities, which brings a cyclical and value tilt to the portfolio. We also highlight the positive impact of NGEU for Central and Eastern European countries.**

## 1. The European economy in the context of a global recovery

**Annalisa USARDI,** *CFA, Senior Macro Strategist Cross Asset Research*

*We downgraded our US and China growth expectation for this year and next*

### 1.1 The global economy on the path to recovery

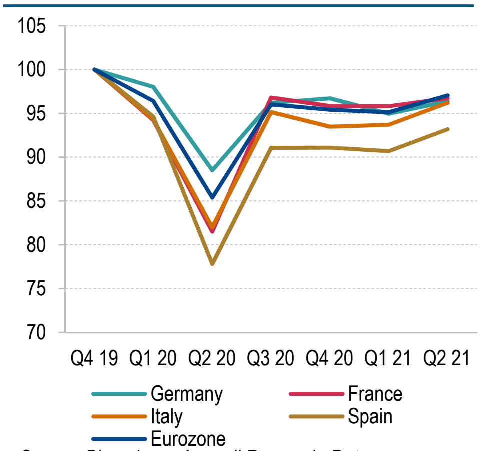
At the global level, **the recovery momentum remains solid,** yet characterised by uneven and multi-speed paths across regions. At the same time, growth momentum slowed somewhat, as suggested by high frequency and PMI data, as activity expansion continued but decelerated in several key economies at the start of Q3.

While the global economic consensus stabilised at high level, global economic surprises gradually declined and are now only slightly positive. **Pandemic developments continue to be a source of uncertainty** and may lead to an increasingly uneven growth path across countries, with a tug of war between vaccination campaigns and virus resurgence. Currently it seems that in the countries with higher vaccination rates, the new wave is somewhat contained, although not uniformly; new cases and hospitalisation rates remain a key factor to watch for risks of new lockdown measures.

**Growth forecasts revised down.** We expect World GDP to grow by between 5.8% and 6.4% this year and by 3.8% and 4.5% in 2022. China's growth profile has been downgraded as production, consumption and investment all disappointed recently. We now expect Chinese GDP to grow by between 8.4% and 9% this year and between 5.1% and 5.7% next year. US growth has been revised down too within a range of 5.8% and 6.2% this year and 3.3% and 3.9% in 2022. (Amundi's forecasts are available on in the section Macroeconomic picture.)

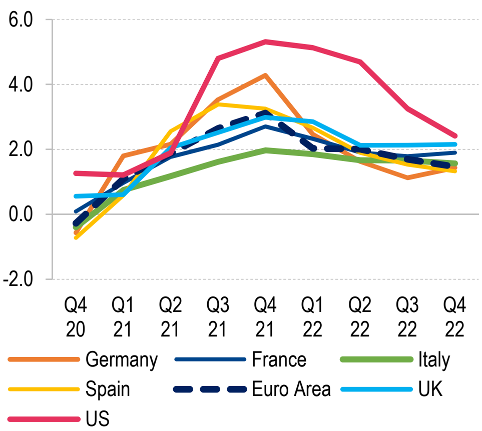
**Inflation risk remains.** Continued supply constraints and increasing headwinds from supply bottlenecks are weighing on activity and trade in goods. These factors are creating pressure on global inflation, as shown by the recent data. However, recent PMI input and

1/ **GDP Level Q4 2019=100**




Source: Bloomberg, Amundi Research, Data as of end August 2021

2/ **CPI-H Growth, YoY quarterly**




Source: Bloomberg, Amundi Research, Data as of end August 2021

THIS MONTH'S TOPIC
Special Europe

*Italy is closing the gap with France and Germany*

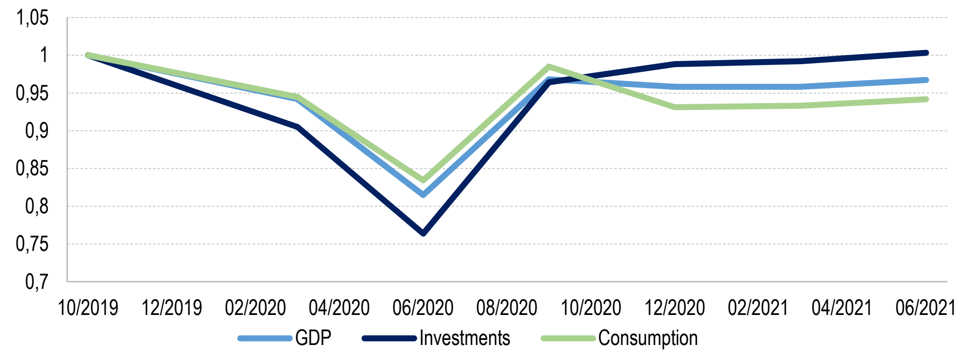
*We don't expect the wage factor to play a major role in the euro area*

output prices hinted at some moderation, while remaining very high. We expect inflation to remain above the Fed target over the forecast horizon for the US but the FOMC should stay on hold. Several EM central banks have started to increase policy rates as inflation numbers have been above target.

### 1.2. The euro area uneven recovery

The euro area economy expanded by 2% in 2Q21, leaving the region's GDP just 3 points below its pre-pandemic level. However, the rebound was not uniform across countries. There were differences in the timing and extension of restrictions in the first part of the quarter, with a delayed reopening in Germany and France. Different impacts from supply and capacity constraints in the manufacturing sector impacted the speed of rebound and are likely continue playing a role in Q3. The pace of growth of Italy and Spain in Q2 was much stronger than the euro-area average. This allowed Italy to close the GDP gap with Germany and France, while Spain narrowed the gap still lags behind (see chart 1).

3/ **France, Q4 2019=100**




Source: Bloomberg, Amundi Research, Data as of end August 2021

### 1.3. A brighter outlook for growth and inflation

**The near-term outlook for the European economy looks brighter than expected in spring.** We expect the recovery to continue in a multi-speed manner among member states, but it should benefit from positive spill-overs from strong momentum in internal demand and US growth. Overall, we expect GDP to peak in Q2/Q3 (reopening, vaccination campaign growth momentum and effects of national fiscal support among the key drivers) followed by above potential growth as the NGEU projects kick in (effects from 2022). We expect growth to average 4.7% in 2021, 4.1% in 2022, and 2.3% in 2023, reaching pre-pandemic levels in the first quarter next year. Germany, France and Italy should revert to pre-crisis levels at the beginning of 2022, with similar timing, while Spain should close the gap some time in H2 2022.

**Our forecast for inflation this year has also been revised upwards,** retaining a hump-shaped profile. The developments in Eurozone inflation partly follow the common trends at play in other DMs: energy is playing a major role in the year-over-year dynamics, together with other base effects on the anniversary of the first lockdown and subsequent rebound. On a monthly basis, the increase in prices due to demand supply friction (bottlenecks, supply disruption, reopening mix) is also at play. Yet, not all countries follow similar patterns, due to idiosyncratic factors, such as the temporary VAT cut in Germany, which is likely to contribute to a significant overshoot in inflation in Q4 this year, and changes in the timing of seasonal sales, which introduced volatility in France and Italy over the summer period.

Contrary to the US, we do not expect wage growth factors to play a major role going into next year. While we expect EA inflation to overshoot the ECB target this year, it should revert below target in 2022. Amundi's average Euro-area CPI headline annual rate assumptions are: 2021@ 2.2%, 2022@ 1.8%, 2023@ 1.6%.

We believe that the sharp rebound of the UK economy in 2021 (from 6.3 to 6.9%) will be followed by another year of strong growth (4.5 to 5.1% in 2022). Growth should then come back below 2.4% in 2023. British inflation should be in line with the euro-area this year and remain moderately above target into 2022. Reopening factors and Brexit related issues explain this higher level of inflation. However we assume that the BoE will stay on hold over the next 12 months.

### 1.4. Consumption and investment recovery

**Consumption and investment followed a different recovery pattern after the collapse in 2020.** While private consumption declined during the subsequent lockdowns, Q1 2021 for instance, reflecting a drop in the purchase of both durable goods and services, investment continued to expand, supported by a positive impulse from construction.

THIS MONTH'S TOPIC


Looking at available data for Q2, the recovery in investment seems to be almost completed while household consumption still lags behind, with the recovery in goods more advanced than that in services. As a broader range of spending opportunities becomes available again with the reopening and household purchasing power remaining broadly resilient, we expect the consumption of services to play a key role in the recovery.

Concerning investment, as of Q1, construction recouped almost completely the gap in relation to pre-Covid levels, but machinery and equipment investment still lags behind. Thanks to the boost provided by the new wave of investment driven by the national resilience plans and the NGEU, we expect both construction and fixed capital formation to accelerate and strongly contribute to growth.

## 2. Next Generation EU – opportunities and hurdles

**Tristan PERRIER,** *Global Views*

*NGEU will start to have a full impact in 2022*

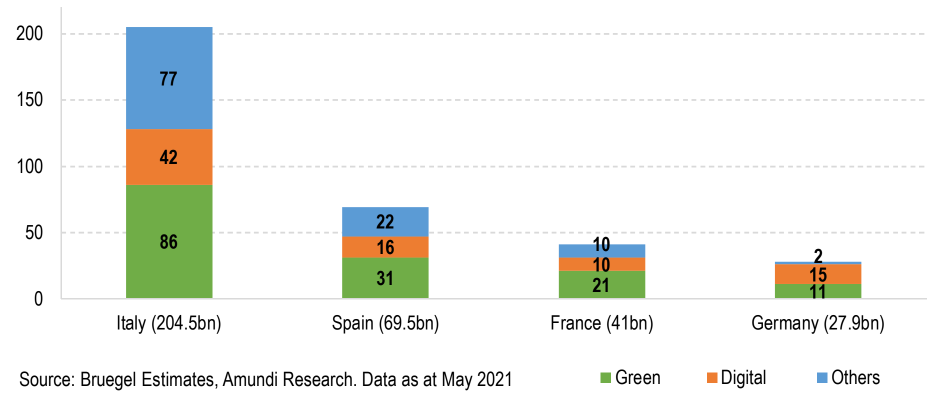
The €750bn (in 2018 prices) NGEU (Next Generation Europe) recovery fund, whose successful negotiation and announcement in 2020 **already played a critical role in defusing political tensions among EU members,** is now functional. This fund goes beyond many previous "red lines" in terms of fiscal solidarity within the EU: issuance of EU debt, transfers in the form of grants, support for cyclical and not just structural economic management.

After the resilience and recovery plans (to be funded by the NGEU) of most EU countries (including the four largest) obtained the necessary EU greenlights, the European Commission started issuing the required EU bonds in June and disbursing their proceeds in the form of loans and grants to member states in August. Regarding requests for loans, **there have been significant divergences across governments,** with some eligible countries requesting the entire envelope (such as Italy or Greece), some requesting only part of it (Portugal, Cyprus, Slovenia) and some choosing not to take this opportunity or delaying their decision (Spain).

Depending on the country, the NGEU may account for nearly all (Spain), most (Italy), a significant (France) or a small (Germany) part of the total fiscal effort for recovery planned for H2 2021 and beyond, with the rest represented by country-level resources. **All eyes are on Italy, where NGEU disbursement are nearly 1.5% of GDP for H2 2021 alone,** potentially providing a significant boost to growth, together with a powerful incentive to pursue the much-expected structural reform agenda of the Draghi government. In our projections, we assume that national resilience and recovery plans will start to be implemented in Q4 21, with a significant economic impact starting from H1 2022, and average fiscal multipliers applied to grant disbursements.

**The NGEU represents a powerful opportunity for the EU to recover from the Covid-19 crisis** and potentially boost GDP growth through a cocktail of public investment and reform. However, several programmes may also be slowed by bureaucracy and limited fund absorption capacity at country level. The NGEU's ultimate success or failure will set a precedent that will encourage either the proponents or the detractors of further fiscal mutualisation within the EU.

4/ **NGEU-Ressource allocation, €bn 4 main euro countries**




Source: Bruegel Estimates, Amundi Research. Data as at May 2021

## 3. Towards a new E.U. fiscal framework

**Didier BOROWSKI,** *Head of Global Views*

European fiscal rules were temporarily suspended in March 2020 to allow Eurozone states to implement stabilisation policies. With the end of the health crisis in sight, fiscal policy will needed to be "normalised". But according to what rules? The debate has only just begun.

True, fiscal rules of the Stability and Growth Pact (SGP) will be activated again in 2023. But many economists have called for a revision of these rules, even before the Covid crisis. A revision of the rules does not require a revision of the treaty. It does, however, require close

THIS MONTH'S TOPIC


*Different rules for each country would be more appropriate*

consultation within the Eurozone, and at least a convergence of views between France and Germany. From this point of view, the outcome of the German elections will be essential.

The criticism of the current rules is not new. Identical numerical thresholds for each country for debt (60% of GDP) and deficit (3% of GDP) have no real theoretical basis. Moreover, these rules have proven to be pro-cyclical and therefore counterproductive (especially after the sovereign debt crisis). Finally, they are based on estimates of structural (i.e. cyclically adjusted) deficits, which are by nature unobservable. Different methods are used to assess them, but none of them is unanimously accepted, which provokes endless debates. Methodological problems are exacerbated by large recessions.

The lines have shifted with the Covid crisis. When interest rates are low (close to their lower limit), the whole policy mix has to be recalibrated. It is striking that this argument was developed earlier this year by Isabel Schnabel (ECB board member). There are more degrees of freedom for a counter-cyclical use of fiscal policy when interest rates are much lower than GDP growth. In other words, **an unconventional monetary policy calls for an unconventional fiscal policy.** But it is unlikely that countries will be able to agree on a reform in the short term. **The current rules are highly symbolic,** especially for the least indebted countries, which believe that they have already made enough concessions when the NGEU recovery fund was set up. It is therefore unrealistic to think that these rules can be abandoned in the short term. Reflection on this issue will nevertheless be pushed by the French EU Presidency in H1 2022, although it will be difficult for France to be heard in the run-up to the general election (April/June).

However, after Covid-19, **concerns about debt-sustainability should encourage governments to amend the rules,** at least in practice. In order to strengthen fiscal credibility in the Eurozone, governments cannot only target a 3% deficit threshold. Other variables such as the primary balance, the debt burden, the level of debt and the ratio of public expenditure to GDP must play a role in the analysis of the efforts required. This would mean in practice that different rules for each country would be more appropriate than a rule based on the deficit alone...

## 4. The ECB new monetary policy framework

**Sergio BERTONCINI,** *Senior Fixed Income Research Strategist*

### 4.1. Implications of the ECB strategic review

*The ECB is committed to keep rates very low for a long time*

The results of the ECB strategic review came earlier than expected and before the July Governing Counsel. Although it did not materially deviate from the most expected outcome, **the strategic review produced an immediate impact on ECB communication,** with a significant shift in the forward guidance on rates at the July meeting. The central bank revised the forward guidance language to put it in line with the new strategy, but to some extent it went beyond that. Although counterbalanced by a lack of quantitative indications, aimed understandably at maintaining judgmental flexibility, a dovish twist was evident.

**The ECB introduced three criteria to start normalising rates** (corresponding to the numbers set out below). *"The Governing Council expects the key ECB interest rates to remain at their present or lower levels until it has seen (1) inflation reaching two per cent well ahead of the end of its projection horizon and (2) durably for the rest of the projection horizon, and it judges that (3) realised progress in underlying inflation is sufficiently advanced to be consistent with inflation stabilising at two per cent over the medium term".*

The first two conditions point to headline inflation remaining at or above 2% for the two years following its macroeconomic projections, while the third condition requires that, in addition, core inflation heads towards levels not far from 2% at the end of the projection horizon. As this set of conditions looks far from the numbers achievable in the foreseeable horizon, with this new forward guidance, **the ECB has radically reinforced the commitment to keep its rates very low for a long time.** More importantly, if rates need to remain low for a long period of time, this means longer QE, as the APP is still linked to the first rate hike *"it will end shortly before [the ECB] starts raising the key ECB interest rates."*

### 4.2. Slow reduction in QE and policy rates on hold

The ECB now needs to address the issue of non-conventional monetary policy tools i.e. APP, PEPP and TLTRO. The main take-away from the Strategy Review points to the **same degree of accommodation, but for longer:** not only a longer period without hiking rates, but also, a longer APP and reinvestment period than expected. This stance looks consistent with the need to fight financial fragmentation, maintain easy financing conditions and make NGEU efforts effective. While 2020 and 2021 saw record levels of public deficits and debt issuance, funding needs should decrease in 2022 for three reasons: (1) the economic recovery will improve the fiscal primary balance, (2) a reduction in debt servicing, and (3) the first NGEU funds become available. This means that **the size of QE will therefore**

THIS MONTH'S TOPIC
Special Europe

**be reduced through a lower increase in public debt.**

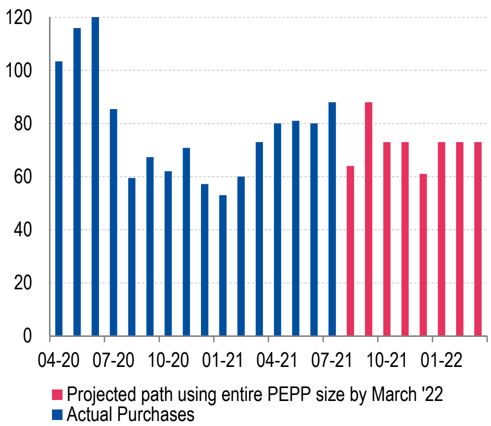
As far as **policy rates** are concerned, the ECB is likely to lag significantly behind both the Fed and the BoE on the road to policy normalisation. **The new forward guidance points to stable rates for the next three years** while we believe the Fed could start normalising rates in 2023. We therefore assume that euro-area policy rates will remain unchanged for our forecast horizon, with the deposit facility at -0.50%.This means there will be a significant time lag from a EUR rates perspective.

### 4.3. A smooth transition after the PEPP March 2022 deadline

The latest PEPP figures show that the ECB has enough firepower to keep a robust purchase path until at least March 2022. Roughly €580bn of PEPP remains at its disposal, meaning an average purchase of €72bn per month. Adding the APP, the ECB could buy up to €92bn a month (€740bn total), which is not far from the €100bn "higher path" taken in Q2 2021.

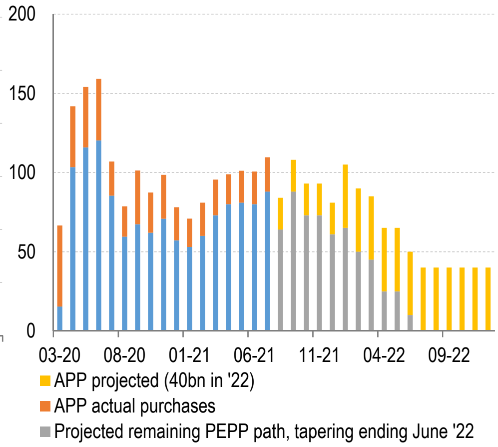
Even if the PEPP and the APP are supposedly two separate tools, they can be combined together in projecting the QE dynamic. Indeed they target the same instruments, although with different weights. After the March 2022 deadline, the ECB has therefore two main options at its disposal to prolong its stimulus: (1) increase the size of the PEPP and extended beyond March 2022, or (2) increase

5/ **PEPP monthly path: historical and projected scenario, in EUR bn**




Source: Bloomberg, Amundi Research - Data as of 6 August 2021

6/ **ECB QE: historical and 2022 scenario (PEPP tapering & increased APP) in EUR bn**




Source: Bloomberg, Amundi Research - Data as of 6 August 2021

temporarily or permanently the APP as the PEPP ends.

**The ECB's assessment of the recovery from the pandemic will drive its decision whether or not to extend the PEPP,** while the new forward guidance seems to favour a higher APP. Assuming the net issuance of sovereign debt will fall in 2022, and the EU's new issuance activity will remain close to this year, monthly QE flows could de facto slow down. For example, an average monthly €60bn, i.e. the remaining PEPP tapered through H122 and a doubling of the current size of the APP, could cover 60% of the net European government bond issuance in 2022 and a significant share of projected EU issuance. Therefore, **a simple increase in monthly APP purchases together with a slow tapering of PEPP** through H1 2022 could get a broad consensus among ECB members.

*We expect the EUR to be weaker over the short term*

## 5. FX: Interest rate differential will weigh on the Euro

**Federico CESARINI,** *Head of DM FX, Cross Asset Strategist*

The sequencing of slowing global growth and the Fed initiating a modest normalisation policy in the months to come is likely to continue to support the USD. We entered 2021 noticing the exceptionality of USD-denominated assets that were realigning in a similar manner to that which led to the USD bull-run in 2018. Whilst US growth and interest rate differentials slowed significantly in the second and third quarters, **we believe that, on balance, conditions remain positive for the dollar.**

**We see the EUR/USD moving gradually towards 1.15** (from our previous target of 1.16) in the next 12 months. We believe the currency undervaluation versus its fundamental value, which we estimate at around 1.20, is not enough to compensate both domestic and global factors at this stage.

**Slowing global growth prevents massive risk taking in the FX market and EUR interest rates are likely to stay low to sustain the recovery.** The EUR is the second weakest currency in G10, just ahead of Japan, as no

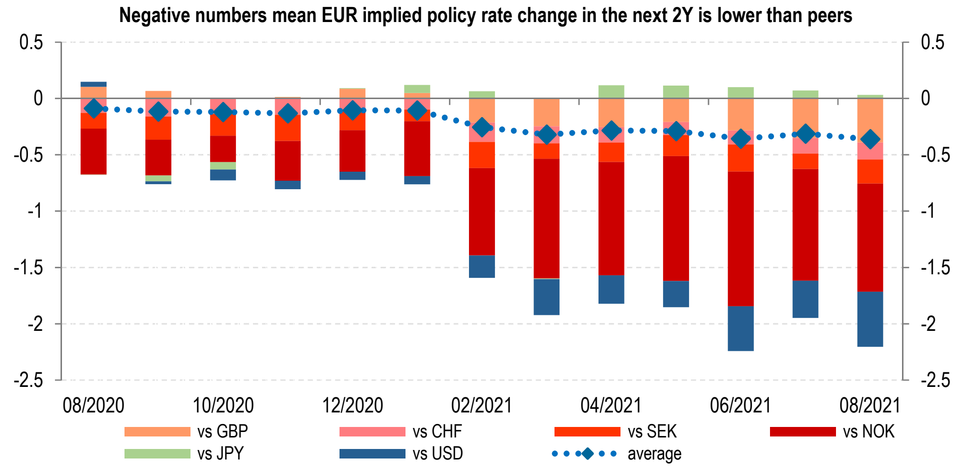
THIS MONTH'S TOPIC


hike in policy rates has been priced in for the next two years. Conversely, we still expect US interest rates to move higher, thus amplifying the interest rate differential.

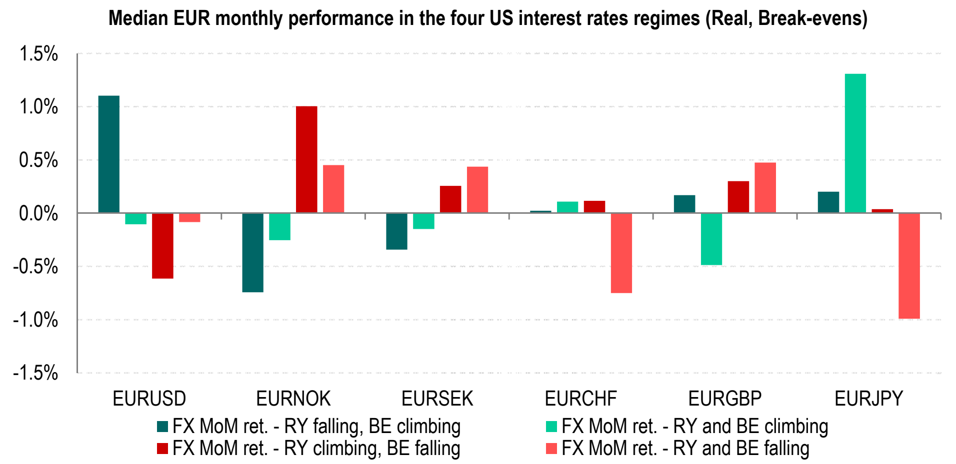
Back in Q1 2021, we argued that the combination of US real rates and US break-evens could capture most short-term fluctuations in G10 FX. As the rise in US rates should favour the real component, we believe that most of the cyclical bets have much less of a clear-cut potential.

In the short-term, we still see the case for a mixed positioning: long USD, NOK and GBP vs. the EUR (on the back of relative hawkish CBs, which we see strengthening vs. the usual safe havens (JPY and CHF). Moving towards 2022, however, we believe a more defensive positioning will be required.

### 7/ EUR 2Y implied policy rate change vs main currencies




Source: Amundi Research - Data as of 31 August 2021




Source: Amundi Research - Data as of 31 August 2021

## 6. Looking for relative return in Euro bond markets

**Sergio BERTONCINI,** *Senior Fixed Income Research Strategist*

### 6.1. Euro core bond yields should stay low for longer

*Bund yields should revert back over the next quarters*

In our view, the difference between the ECB's policy and those of the Fed and the BoE is evident and will play a role in impacting the relative trends of the fixed income markets. Indeed, **the ECB is likely to keep low rates for longer,** with QE stimulus persisting for longer (see above). The Fed will taper first, then will focus on raising rates, while the BoE will start raising rates first and then follow with the balance sheet. Despite these different policy normalisation methods, we expect higher US Treasury and UK Gilt yield-to-maturities and a steeper curve than for core EUR government bonds.

**We assume that Bund yields will move higher over the next few quarters,** supported by the improved fundamental picture, but to a limited extent because of the technical role played by ECB QE. Moreover, supply projections compared with ECB purchases support the EUR bond market at least until the end of the year. As of end-July the EMU-10 countries had already funded two thirds of expected yearly gross issuance and on average 80% of projected overall net funding for 2021. Net issuance after ECB QE is likely to be negative until December 2021 (see chart n°8).

In the UK, we expect long end Gilts yield will move smoothly higher over 12 months.


*Within EUR IG we prefer high beta segment*

### 6.2. A positive environment for peripheral bonds

The monetary policy outlook and improving economic fundamentals are supportive for peripheral country debt in 2022 for at least three reasons: (1) NGEU funds will support the recovery while reducing financing needs; (2) continued ECB QE with an increase in holdings as a percentage of marketable debt, will keep debt service costs low; (3) the economic recovery is stronger than expected and should last until 2023.

**Among the "big four" countries, Italy seems most advanced with its funding programme,** very close to the overall yearly target, thanks also to remarkable volumes of remaining redemptions. According to our projections (see chart 8), ECB demand should be greater than supply in the last five months of 2021. The cash balance of the Italian Treasury remains much higher than historical levels and reached a new peak in July, supporting a more flexible approach to primary market issuance. On the valuations side, Italian debt is among the few with yields above 1%, while half of IG corporate bonds are currently in negative yield territory. **Therefore, we are maintaining our positive stance on Italian government bonds.**

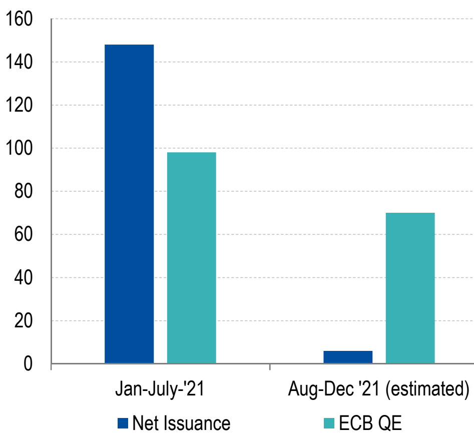
### 6.3. Improving fundamentals and QE support EUR Credit markets

Improving fundamentals supported by a rebound in earnings and deleveraging, and strong technicals (ECB CSPP) are keeping spreads tight and the asset class resilient to rates and other risky asset volatility. The ECB corporate bond portfolio should reach 35% of the QE eligible debt universe by the end of 2021, after having increased from 20% to 26% in 2020. **The EUR IG credit markets are therefore being supported by steady QE flows** while net supply has remained almost flat over the past quarters. As a reference, in the first seven months of this year, the ECB increased its corporate holdings by roughly €50bn, while the cumulated net issuance of non-financial corporate debt was just €24bn. July saw the lowest EUR corporate gross and net issuance since 2002.

Available bank funding, liquidity buffers and longer debt duration explain these low market funding needs. Looking at the remaining months of the year, net supply from non-financials from August to December should be lower than net CSPP purchases.

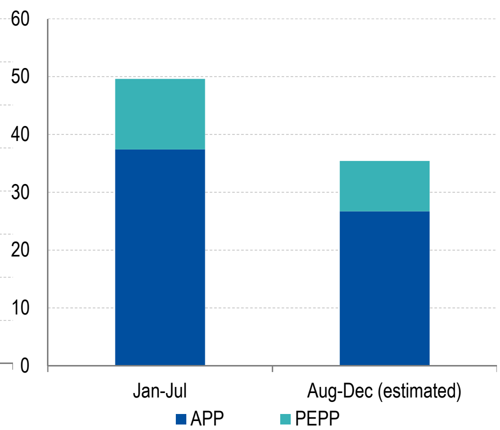
**The combination of (1) an improved macroeconomic outlook, (2) easier for longer monetary stimulus and funding, and (3) limited upside on EUR rates, represents a tailwind for the asset class.** Default rates are likely to decrease in Europe over the next few quarters, after having already reached a low and an earlier-than-expected peak. **Within the European credit markets, we prefer high beta segments such as subordinated debt and BBBs within IG and high and mid-rated corporates within HY.**

8/ **ECB QE vs Net issuance of Italian debt: Ytd vs remaining estimated volumes, in EUR bn**




Source: ECB, Bloomberg, Amundi Research - Data as of 13 August 2021

9/ **ECB net purchases of corporate bonds, in EUR bn**




Source: Bloomberg, Amundi Research Data as 6 August 2021

## 7. Reiterate our positive stance on European equities

**Éric MIJOT,** *Head of DM Strategy Research*
**Ibra WANE,** *Senior Equity Research Strategist*

**Asset class views:** The stock markets have rallied strongly since March 2020 (supportive policy mix, vaccination progress, impressive earnings rebound, etc.). Still, after an almost twofold increase in the MSCI World AC and ahead of the well-flagged Fed tapering, **the case for global equities is becoming more neutral.**

**Valuation:** It is certainly true that robust 2021 results will absorb some of the increase in

THIS MONTH'S TOPIC
Special Europe

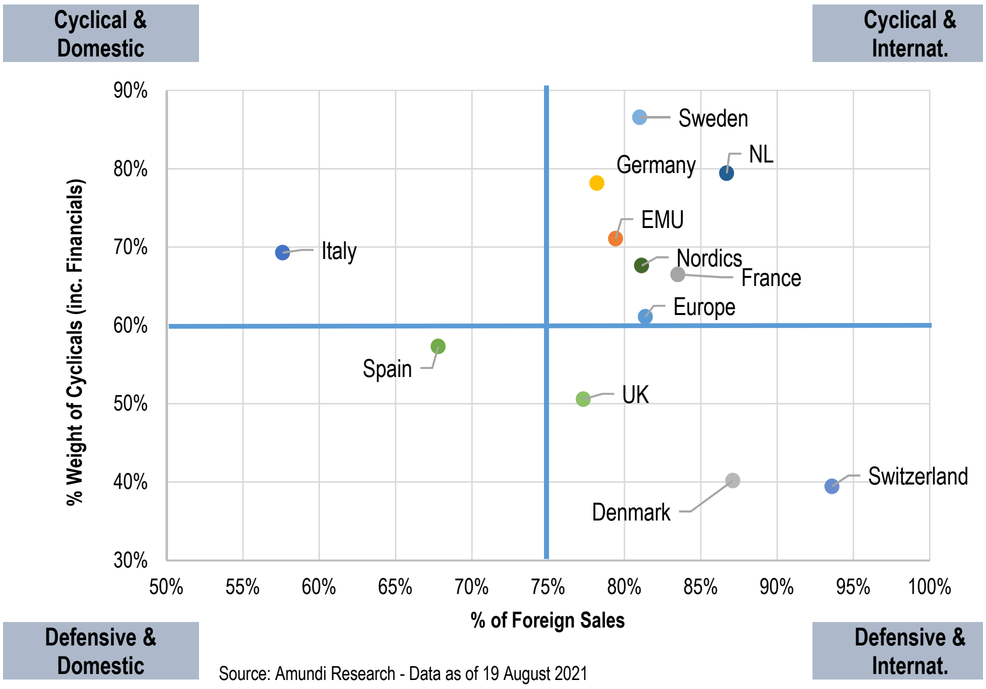
valuations that occurred in 2020. But as the pace of global EPS growth is seen to normalize from a record +45% in 2021 to a muted 8% in 2022, **the current forward P/E of 18.6x remains quite rich** compared with the pre-Covid era (13x to 16x range).

**Relative preferences:** While the US is a long-duration and quality play, it is also expensive, with an almost record-high cycle-adjusted P/E premium versus Europe. If we assume that GDP growth will decelerate but remain above potential until 2022**, it would make sense over a 12-month horizon to favor the more pro-cyclical and relative value play of the two, i.e. Europe.** Within Europe, the EMU - an affordable cyclical option and value case **- is a natural candidate compared to the UK** (relatively cheap but more defensive and low beta market).

**Main risks: Will inflation subside** once base effects and bottlenecks dissipate or prove stickier than anticipated? This will determine the timing and extent of the tapering and how bond yields react. **Covid is the other unknown.** Even if its impact on the AEs economy is much lower than it used to be, the timing of an almost full normalization has become hazier with the Delta variant. A combination of lower-than-expected growth and bond yields would jeopardize our rather constructive view.7. Reiterate our positive stance on European equities

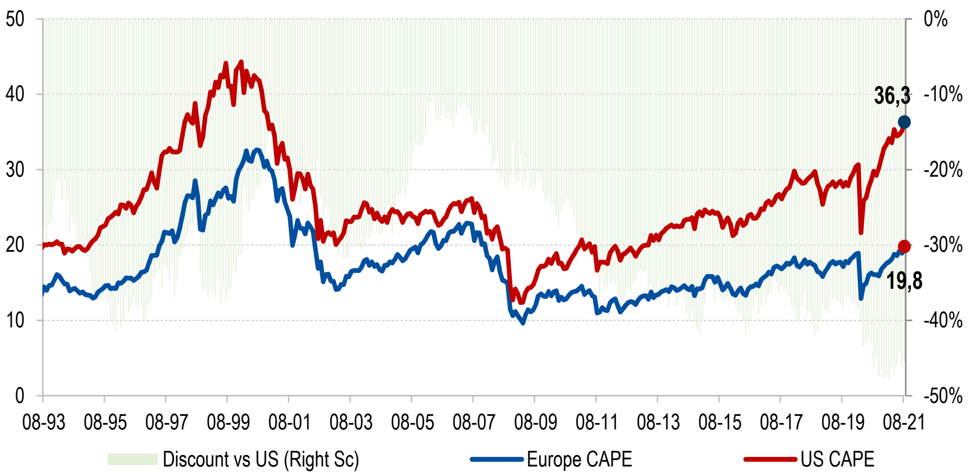
*A relative preference for EMU within Europe*

10/ **Exposure MSCI European indices**




Source: Amundi Research - Data as of 19 August 2021

11/ **MSCI Europe and USA Cycle Adjusted PE**
**Europe at an almost all-time high discount**




Source: Amundi Research - Data as of 19 August 2021

THIS MONTH'S TOPIC


*Europe will have to cooperate with Russia on the Afghan situation*

## 8. Europe geostrategic dilemmas

**Pierre BLANCHET,** *Head of Investment Intelligence*

The end of US military presence in Afghanistan leaves the Europeans with a first strategic dilemma of a cooperation with Russia. Although China seems to play an active role in the future of the region, it is unlikely to protect European interests whereas Russia could. But at the same time, **Russia's growing influence at the borders of Europe** is a source of concerns for the E.U. Indeed, the conflict in Ukraine/Crimea remains unsettled, and Belarus is moving towards more integration with the Russian Federation while Baltic countries always felt the pressure at their border. Afghanistan would be added to the list of situations such as Syria and Irak where the E.U. needs Russia.

**The second dilemma relates to Turkey,** which is the only NATO member with a muslin population (moreover sunny) and has a historical and ethnical relationship with Afghans. Turkey could play a key role as a mediator and eventually provide a lifeline for the new regime, while its relationship with Europe has deteriorated recently. **The third dilemma is about Afghanistan itself.** Would the Taliban be unable to monitor Al Qaeda and terrorist groups, or in case they would themselves be a support for international terrorism, Europe will certainly be a target and therefore will have to react. Lack of preventive actions in the previous decade has caused hundreds of casualties. Another wave of terrorism on European ground will not be acceptable. The fact that NATO allies were not involved in the US exit was already a blow for European leaders, and the future of Afghanistan might become an equation with too many unknown.

More generally, **the Afghan crisis shows how dependent Europe is on the United States,** especially when it comes to conducting large-scale military operations outside its borders. European defence is almost non-existent. This crisis acts as a wake-up call for European leaders who need to strengthen their military cooperation if they want to give substance to the concept of "strategic autonomy".

Moreover, **Europe could easily be trapped into the US-China "cold peace"** and needs to define a credible alternative to better protect its own economic and strategic interests.

| Asset classes | Investment views | Targets or favoured assets |
| --- | --- | --- |
| **Money Market** | ECB policy rates unchanged in the forecast horizon | ECB rate -0.5% |
| **FX EUR** | EUR slight depreciation | Q4 2021 EUR/USD 1.16 |
| | | Q2 2022 EUR/USD 1.15 |
| **Euro Sov Bonds** | Stay short duration on core | German 10y Bund yield target [-0.4; -0.2] |
| | Long periphery vs core | Long BTP vs Bund spread |
| **EUR Credit** | Positive on EUR Credit on improving fundamentals and ECB support | EUR IG: high beta segment, subordinated debt and BBBs |
| | | EUR HY: mid rated corporates |
| **European equities** | Positive on Europe vs US: pro-cyclical and relative value | Favour Eurozone equities |
| **EM CEE** | Sovereign bonds: limited space for yield tightening, despite inflation heading down | Short duration Hungary |
| | | Neutral Poland & Romania |
| | Equities: cautious stance on valuation and earnings growth expectations | Negative Czech Rep & Poland (versus Russia & Turkey) |


## A busy political agenda for Europe

by Tristan PERRIER, *Global Views*

### ■ Germany

**The German federal election, expected to be held on 26 September 2021, is unlikely to be a major short-term market mover.** It is true that the scenarios for the next government coalition (which may take some time to build) are quite open, even more so as some polls now unexpectedly show the SPD (center-left) ahead of the CDU/CSU (Merkel's center-right) and the Greens. However, the agendas of these three parties, two of which will certainly be the senior and main junior partner of the coalition, do not deviate radically from German policies so far (especially when it comes to European policies).

Moreover, the **need to build consensus within the government coalition** (that could also include the pro free-market FDP or, less likely, the left-wing Die Linke), together with the **powerful checks and balances of the German political system**, also limit the potential for substantial change.

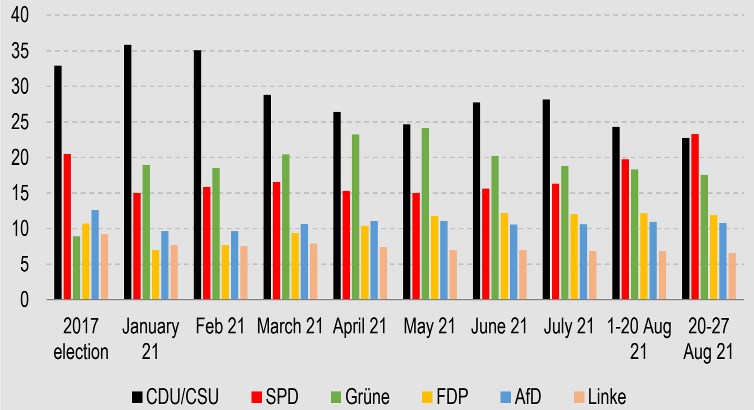
Nonetheless, these elections are likely to be closely followed as they will lead to **a new German Chancellor** (arguably Europe's top political position) taking office after 16 years of Merkel. This new Chancellor will no doubt have a pivotal role to play in shaping further institutional developments of the EU and euro area, and in keeping these blocs together should any new systemic continental crisis occur. This new German leader will probably be either SPD's Olaf Scholz (Germany's current finance minister, probably the most proven European profile of the 3) or CDU's Armin Laschet or the Green's Annalena Baerbock.

Moreover, beyond a lot of commonality of views and little potential for abrupt change, **there are nonetheless differences across** mainstream German parties that mean that the nature of the coalition may matter over time, both for Germany and for European affairs. Notably, **the larger the role of the Greens and/or the SPD in the coalition, the more likely it will be that Germany takes a more gradual and tolerant approach to fiscal normalization** (after the large Covid-related deficits) both at home and in the rest of the Euro area. **At the margin, the Greens and SPD are likely to be less opposed to potential new steps towards European fiscal union** (against the backdrop of the NGEU) than the CDU and FDP.

**A coalition that would include the leftist Die Linke party** (a scenario that looks less unlikely than a few weeks ago now that the SPD is ahead in the polls and does not rule out teaming with Die Linke) **may be seen as the major risk,** as it **could theoretically open the door to market-adverse policies** (such as a reversal of previous German supply-side reforms). However, even in that case, Die Linke's influence within the coalition would probably be limited and the checks and balances effective.

Including the far-right Eurosceptic and anti-immigrant AfD party in a government coalition is currently not an option considered by other parties.

German election: average of polls




Source: INSA, Vorschungsgruppe Wâhlen, Allensbach, YouGov, Kantar, Forsa, Infratest dimap, Trend Research, IPSOS, GMS, Redfield and Wilon Strategies, Wikipedia.org, Amundi Research - Data as of 30 August 2021.

### ■ 2022 French elections

After the German election at the end of September 2021, the next major scheduled political event in the Euro area will be the French electoral cycle: a two-turn presidential election on 10 an 24 April 2022, followed by a two-turn legislative election on 12 and 19 June.

At this stage, President Macron and Marine Le Pen (far-right) are ahead in the polls for making it to the 2nd turn, with Macron projected to win it in the end (note that Macron can now claim a relative success at least for the vaccination campaign). However, it is still very early and other parties (notably the mainstream right-wing, that could still make a comeback) are yet to pick their candidates.

All in all, this French election could trigger a bit more market stress than the German one. This is due to the strong far-right and to the unpredictable nature of the two-turn system (if the vote is very fragmented, an unexpected candidate could in theory make it to the 2d turn). However this stress should be less than in 2017, as, unlike then, no major candidate has Frexit on his/her agenda. Mind also that, while this has never happened under the current constitution (since 1958), it is theoretically possible that the elected president fails to win a majority for his/her party at the legislative election, which would then trigger a search for a coalition.


## Central Europe challenges and opportunities

by Karine HERVÉ, *Senior EM Macro Strategist*

**Central and Eastern European (CEE) countries, together with Southern European countries, were the main beneficiaries of the 2021-2027 budget and the new NGEU** (Next Generation EU) recovery fund. CEE countries submitted their national programmes to the European Commission, expected to analyse and approve them over the summer before submitting them in turn to the Council for validation. As a result, funds should start rolling out in August to a number of countries whose plans have already been greenlighted by the Council (Croatia, Cyprus, Lithuania, Latvia, Slovenia, Slovakia). The process is under way for other countries, except for Poland and Hungary, which have seen their applications pushed back due to various rule of law violations, triggering a battle between these countries and the European Commission that could last several months (especially in Hungary's case).

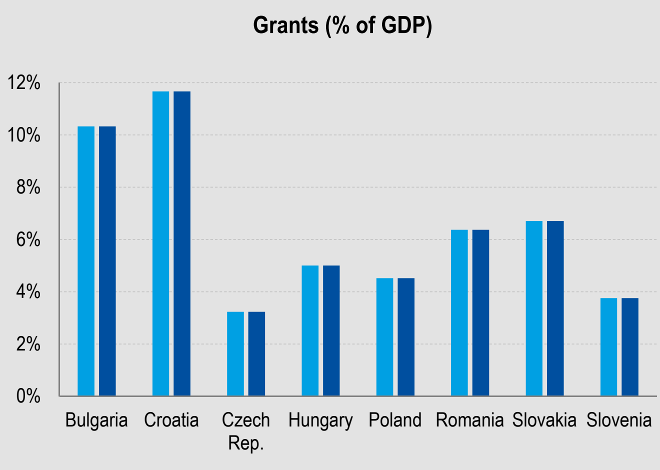
**The funds paid out by the NGEU make up roughly 10% of projected average GDP for CEE countries from 2021 to 2027.** Croatia and Bulgaria are the top beneficiaries in the region, in terms of % of GDP (18%). CEE countries have applied for all allocated grants but less than one-third of loans, with the exception of Romania which asked for the full package. At this stage, CEE applications represent an average of 4-8% of GDP estimated over the 2021-2027 period (see charts). For the time being, CEE countries have not asked for loans, but they have until August 2023 to do so and there is every reason to think they will once the grants have dried up. They can also wait to apply for loans in the hope that if the grants are not all allocated, they can get more, as the European Commission tends to be little inclined to give net contributors their money back.

In recent decades, CEE economic growth has been driven by traditional industry, export momentum, FDIs, low labour costs and European funding. This model is losing its effectiveness, however, and **CEE countries are on average under capitalised** compared to their other European counterparts with a capital stock estimated to be 60% smaller than Europe's five largest countries. Furthermore, labour costs have been continuously on the rise in recent years and the region's predominant industry (automotive) will be increasingly impacted by automation going forward. Against this backdrop, European funds focused on the energy transition, digitisation and research promotion sectors are arriving at just the right time. For one thing, 30% of funds are required to be allocated to climate change projects, which in light of the high carbon intensity of CEE countries is like manna from heaven.

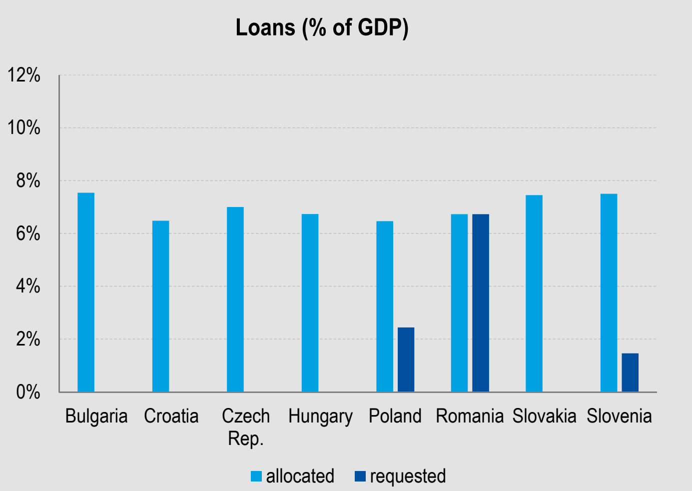
Multiple estimates have been calculated on the impact these funds can have on real GDP growth. According to a Commission study, NGEU funds are expected to boost European Union growth by 1.75 percentage points (pp) in 2021 and 2022, and by 2.25 pp in 2023 and 2024. Unfortunately, these estimates are undoubtedly on the generous side, as they are based on the assumption that 100% of grants and 50% of loans will be used, which is not currently the case as we mentioned above. Other independent analyses show that **the impact could end up being very high (between 0.6 and 1.6 pp per year) in Bulgaria, Croatia and Romania** – all of which asked for asked for larger sums than other countries in GDP percentage terms, and because they have substantial infrastructure requirements – as opposed to 0.2 to 0.6 pp in Czech Republic (low absorption rate) and Hungary (inefficient fund spending).

There are some risks surrounding these estimates, however. First, **the absorption rate of European funds in public sector investment is relatively low,** sitting at 30% for CEE countries (for the 2014-2020 budget). Second, taking past plans as a reference, even if the absorption rate is high, **there is a 3-year lag before all the funds are used.** Lastly, at least 30% of funds have to be allocated to the climate transition and 20% to the digital transition, the problem being that it may be difficult to find enough projects in these categories.

Regardless, there is no doubt that European funds are an exceptional boon for these countries and their continued economic development in the European Union.




Sources: European Commission,National Government, Amundi Research - Data as of 05/08/2021

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