Outlook on **Europe**

Summary

- Equity markets calmed after a volatile first quarter as governments and central banks put forward an aggressive and globally coordinated monetary and fiscal response to mitigate the effects of the COVID-19 pandemic.
- Europe now faces the challenge of reopening its economies to stave off further economic damage without triggering additional outbreaks.
- We continue to assess stocks based on their risk/return profile, alongside valuations, with some out-of-favour areas of the market now so deeply discounted that they are hard to overlook.
- In fixed income, unprecedented monetary easing will continue to support corporate and periphery bonds. However, valuations are lofty and negative surprises during the recovery remain a risk.

European Equities

Equity markets calmed after a volatile first quarter as governments and central banks put forward an aggressive and globally coordinated monetary and fiscal response to mitigate the effects of the COVID-19 pandemic. The challenges now facing many countries include: tackling the economic fallout from lockdown measures, mitigating the risk of additional COVID-19 outbreaks, and assessing the long-term impact of ballooning debt balances for sovereigns, companies, and individuals. The shape of the recovery remains in question, as there is little historical precedent for a global economic shutdown and reopening on this scale.

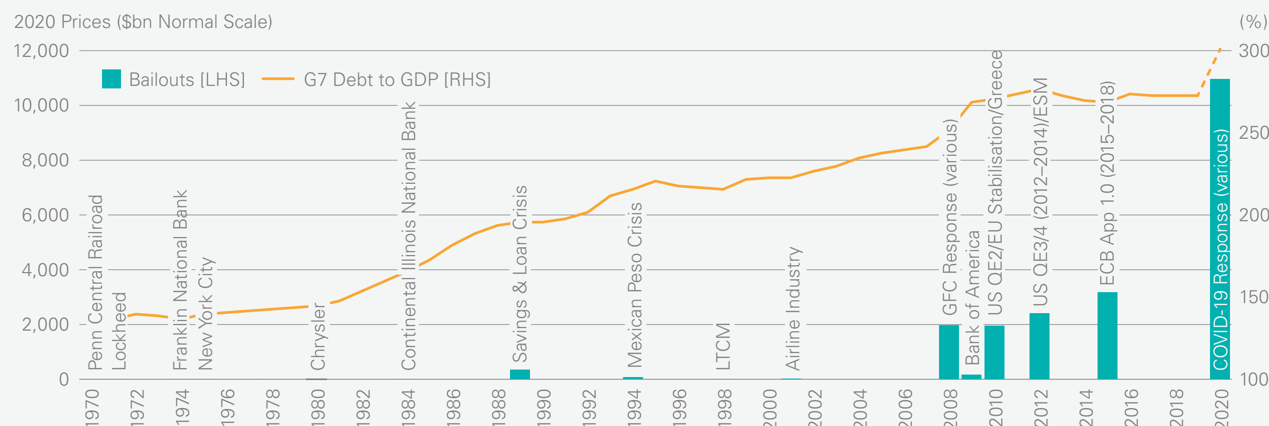
The crisis created an opportunity to reinforce positions in companies that should be able to grow under any circumstances and have the ability to compound returns, but it has also resulted in historic discounts in some areas of the market that we believe are worth considering as we move through the next phase of the economic cycle.

Aggressive, yet Surprising Fiscal and Monetary Stimulus

The scale and global coordination of government and central bank responses to the COVID-19 crisis is unprecedented (Exhibit 1), and the speed and size undoubtedly surprised markets in the second quarter. G20 governments have now pledged over $5 trillion in economic support, while the US Federal Reserve cut rates to zero and committed to unlimited expansion of bond-purchasing programmes. The European Central Bank (ECB) also announced more than €1 trillion in quantitative easing measures.

The combination of all these measures both helped struggling economies absorb the shock of COVID-19 and drove markets higher from their late March lows. In recent weeks, the market has also become broadly more positive due to improving economic data (albeit from record lows) that appears to show that the economic fallout from the pandemic may be less than initially forecasted.

Exhibit 1
The Global Response to COVID-19 Dwarfs Other Historical "Bailouts"



As of 30 April 2020
"Bailouts" refers to large bailouts/interventions, covering both government and central bank moves, seen each year since 1970 in US inflation–adjusted terms.
Source: Deutsch Bank, Haver Analytics, IMF

LAZARD
ASSET MANAGEMENT

One of the consequences of the aggressive stimulus is that markets have moved ahead of economic indicators and, strangely, leading indicators. The market has become Pavlovian in the way it responds to monetary and fiscal measures: The more stimulus governments and central banks provide, the more investors appear to anticipate a full-blown recovery and asset price inflation. It seems likely that investors' dependence on government action for their enthusiasm for financial assets will push governments and central banks into continuing to provide support, although there is a downside risk that the economic recovery will not match the current optimism of the market. In the long run, there will also be implications for governments and central banks, as debt balances have risen substantially during the crisis.

Assessing the Shape of the Recovery

The difficulty in assessing the economic fallout from the pandemic and predicting the recovery path is that there is no historical event to which we can compare the current moment. We have never seen a near-total shutdown of the global economy from a single threat before, and therefore, we have little idea what form a recovery could or should take. We do know economists and others would prefer a V-shape, however.

In our experience, market recoveries always look V-shaped at the start. Whether the V is sustainable this time around depends in our view on how long the initial boost from pent-up demand lasts before longer-term impacts, such as rising unemployment and bankruptcies, start to kick in. In other words, we don't know how tall the slope is on the way out—it might look like a V, but it may look like something quite different. The rate of recovery will likely slow at some point, hampered by further outbreaks, bankruptcies, and high unemployment, which would result in a recovery shaped like a sine wave, rather than a V. However, if treatments or vaccines that essentially eradicate the health effects of the virus become available sooner than anticipated, the slope of the recovery could steepen.

One thing we think is clear is that recoveries will vary from country to country. There is a huge disparity between the effects the virus and lockdown measures had on Germany compared to the UK, Spain, and Italy. Germany has generally managed the crisis well, and therefore, economic activity levels have not fallen as dramatically there as in the rest of Europe. Vehicle traffic levels in Germany never fell to the lows Italy experienced at the height of its lockdown. Spain, Italy, and the UK have all suffered from higher death rates, more extended lockdown periods, and more dramatic declines in business activity than has Germany. One positive note: the health care systems in most countries coped admirably during the crisis. Most held up quite well during peak outbreak periods and will now be more prepared to deal with subsequent waves of infections.

At the macro level, European investors will look toward the €500bn recovery fund proposed by Germany and France and subsequently boosted by the European Commission, which put forward plans for a €750bn fund. Europe has a much more bureaucratic way of spending funds, which may result in slow progress and a plan that lacks clarity. Resistance so far has largely come from the so-called "frugal four"—Sweden, the Netherlands, Denmark, and Austria. All of these countries ran budget surpluses going into the pandemic and question what a recovery fund can do. Whether the fund will work as grants or loans, or whether it is given out by historic numbers or need, remains key points of debate within the bloc. The risk is that the fund doesn't materialise in the end, which could dampen recovery efforts. Longer term, the market will likely extrapolate the outcome of this fund to how close the European Union (EU) will be managed in the years to come, both politically and economically.

Mitigating the Effects of Subsequent Outbreaks

Markets remain highly focused on whether or not there is going to be a second wave of COVID-19 infections. However, we believe a second wave would be quite different than the first. Testing is now much more widespread, which likely means that more people will test positive. That won't necessarily indicate that there is a higher incident of hospitalisation or a worsening situation. Public awareness is obviously much higher than it was during the initial outbreak, which should help mitigate some of the risks of another "peak" wave occurring.

Still, we have never seen this kind of environment before, and the virus does seem capable of spreading quickly and easily. Where pockets have been identified, they have been particularly virulent, as evidenced by large spikes in cases attributed to abattoirs in Germany, China, and the UK in recent weeks. The key is how governments respond to any potential second wave. If lockdown measures become more targeted and regionally focused than the first wave, then the economic impacts will be less than we have witnessed so far. That should generally result in a better outcome than the first wave. Technology has the potential to improve the process of contact-tracing and tracking, which could also help limit outbreaks. How successful governments are at encouraging their populations to sign up for electronic tracking services will vary across countries and will lead to different outcomes across the continent.

Markets will continue to be highly attuned to medical discoveries, particularly any progress toward a viable vaccine. The sheer volume of capital going into vaccine and treatment research in such a short space of time will hopefully help support quicker discoveries in these areas.

Geopolitical Risks Are Rising

Globally, we are seeing increased signs of political instability. There are border disputes taking place in many regions of the world, including between India and China, and North and South Korea. Political uncertainty is also rising in a number of countries, partly due to government responses to COVID-19 and the associated economic impact.

For example, UK Prime Minister Boris Johnson performed well after the Conservative Party won a large majority in the UK election back in December 2019, aided by clear policies that would support the British economy after Brexit. That post-election popularity has now changed dramatically. The uncertainty around Brexit will likely persist as British and European negotiators try to find enough common ground to progress. It seems relatively unlikely that they will agree on a full trade agreement by the deadline, given the time constraints and the complexity of the issues. It seems more likely that the two sides could negotiate a high-level terms of trade. However, even that would require significant progress in a very short period, and both sides have set their plans in such a way that common ground is hard to perceive. The market will likely become more concerned about the risks of a hard Brexit the longer this stalemate persists.

Brexit tensions will likely result in a higher equity risk premium for both the UK and the broader European market. A hard Brexit will undoubtedly be much more damaging to the UK than the euro zone, however. Pre-COVID, British economic growth was extremely low, yet relatively stable, and the impact of Brexit would have been very noticeable. In the more volatile, lower-growth post-COVID environment, it will be much harder to gauge the direct impact of Brexit. The crisis has undoubtedly added a new dimension to these negotiations.

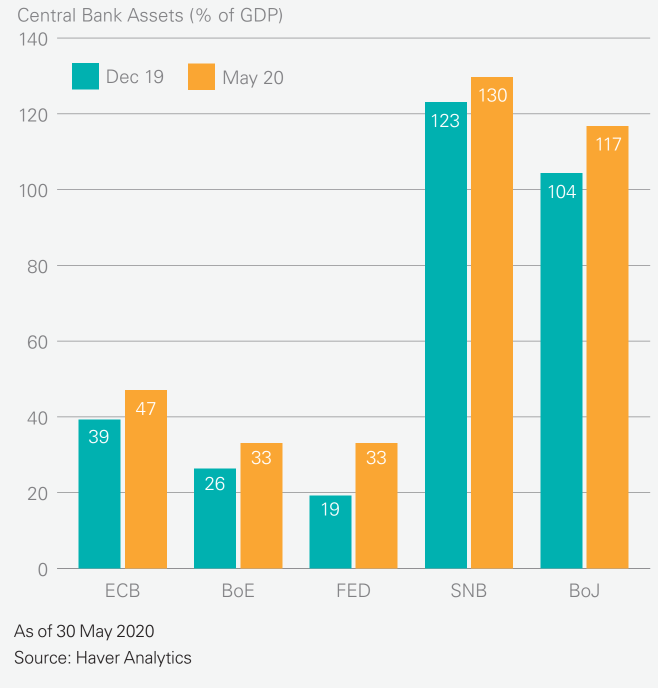
The looming US Presidential election in November this year will also be on investors' radar. If the effects of COVID-19 weigh on the US economy more significantly than currently being forecast, falls in unemployment slow, and social unrest continues to build, it may make US President Donald Trump's re-election difficult. Whatever the outcome, rising geopolitical pressures present an additional risk for equity investors.

Ballooning Debt Levels Will Have Future Implications

All governments, and many companies and individuals, have taken on more debt than they were expecting to because of this crisis. That, in turn, will have longer-term implications for future risks and returns. Noticeably, the UK government has now pushed its debt-to-GDP ratio over 100%, which is much higher than it would have liked or expected going into final Brexit and trade negotiations. Higher indebtedness is also a significant risk in countries such as Italy, which was already running a significant deficit before the crisis. Higher levels of debt make Germany stand out all the more for its fiscal prudence. The fiscal strength of some of the less indebted countries will mean they will likely see the effects of increased spending today be more impactful and less damaging in the future.

Bond yields are still very low, and investors will likely focus more on individual balance sheets of countries and central banks in the years to come. The balance sheets of most of the world's monetary bodies have now increased dramatically since the outbreak began (Exhibit 2).

Exhibit 2
Central Bank Assets Have Grown Significantly during the Crisis



As of 30 May 2020
Source: Haver Analytics

Clearly, central banks want to achieve enough inflation so that economies can grow faster than the underlying interest rate on their debt. Higher inflation would reduce long-term debt-to-GDP ratios, but there is a risk that central banks would need to raise interest rates in the future to bring inflation under control. Higher interest rates could have an opposing effect on economic growth and potentially spook investors. However, in the immediate future, rates are unlikely to rise, which could be seen as being supportive for asset valuations in general. Throughout the previous economic cycle, central banks largely failed in their efforts to maintain any significant rate of inflation. Near term, it is very obvious that governments are not willing to consider fiscal austerity—indeed, the reverse has taken place. Longer term, we must now all accept the fact that we are all living in a world with higher debt burdens across the board, which will have implications for investors across asset classes.

ESG Trends Could Benefit from Recovery Stimulus

Whatever form the recovery fund takes in Europe, it looks likely that environmental, social, and governance (ESG) trends will benefit from higher infrastructure spending on the continent. Before the crisis, there were already clear fiscal policies in France and Germany, such as car incentivisation and energy transition schemes, to help support the development of solutions to sustainability challenges. The European Commission will use the proposed €750bn coronavirus recovery fund and the European Green Deal unveiled last December to sharpen the region's focus on moving to a sustainable economy. The crisis has not for the most part tarnished Europe's status as the world leader in ESG trends, and we think it is unlikely that the push for more sustainable outcomes in Europe will slow down in the near term.

Value Areas of the Market at Historical Discounts

In recent times, any discussion of growth and value that has not focused entirely on the positives of growth and the negatives of value has largely been a waste of time. In Europe, growth stocks have had one of the strongest runs in history—in fact, many European investors have never experienced a market in which value outperformed growth. However, history tells us that there have been long periods of time when value did just that. The discounts available in some pockets of value stocks have reached all-time lows, relatively to both their own history and the market as a whole. It is starting to seem appropriate to think about these deeply valued areas of the market alongside the best compounding stocks as we move through the next phases of this economic cycle.

The crisis has given us the opportunity to reinforce positions in stocks that should be able to grow under any circumstances and have the ability to compound returns over the longer term, which we find attractive. We also believe that some areas of the market trading at deep discounts are pricing in an environment that is much more negative than the current one. It is fair to say that both growth and value stocks should be included in conversations in a way that has not been fruitful in many years.

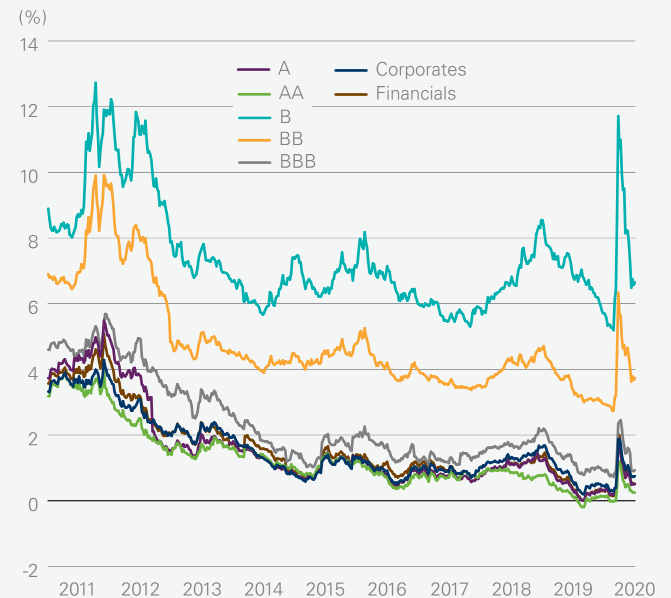
European Fixed Income

From mid-February to mid-March 2020, the European fixed income markets were completely dysfunctional. Risky assets, including corporate and peripheral bonds, experienced one of their worst monthly performances in history. Against this backdrop, the strength of the rebound that began in mid-March and lasted throughout the entire second quarter was completely astonishing for many market participants. The second quarter of 2020 was one of the best quarters in the last decade for risky assets, including periphery, corporate, high yield, and emerging markets bonds (Exhibit 3). Spreads on safe assets tightened dramatically.

There appears to be no doubt that the COVID-19 pandemic and the worldwide lockdowns, particularly in Europe, will generate the deepest recession since the 1930s. We expect the euro zone economy to shrink by around 10% in 2020, with a larger decline expected in Italy, Spain, France, and the UK. The markets have quickly discounted this recession as a short-term thing of the past and focused on the expected V-shaped economic recovery.

The reason for this abrupt change of market sentiment was the unprecedented monetary and fiscal easing that began in the early stages of the recession. In contrast to the last financial market crisis there were no discussions within monetary and governmental institutions about identifying and punishing culprits for the crisis, which paved the way for faster decision making and larger-scale programs.

Exhibit 3
Yields of European Corporate Bonds Fell Dramatically in Q2 2020



As of 23 June 2020
Source: Refinitiv Datastream

Observers viewed the agreement between Germany and France to cooperate with the European Commission in creating the so-called EU recovery fund to support weaker European countries as a positive signal for European cohesion. The exact size of the fund, the details of how it will be financed, and the share of loans and transfers for the weaker countries are all still unclear. However, the pure fact that core EU countries agreed to share the fiscal risks of the periphery strengthened the euro and caused sovereign bond spreads in Spain, Italy, and other periphery countries to tighten dramatically against German Bunds.

Although many asset prices are not cheap anymore, we expect the unbelievable size of monetary and fiscal easing to top recession problems and pandemic angst for quite some time. Market sentiment continues to espouse the TINA (there-is-no-alternative) philosophy, and we believe that view will remain relevant for some time, as nearly all safe assets are trading at yields near zero or below. As long as the ECB controls big parts of the bond markets—including through its new and massive Pandemic Emergency Purchase Programme, which supplements "normal" quantitative easing measures—we see corporate bonds and periphery bonds as a relatively sure investment.

However, we do not think markets will remain a one-way bet, as they have been in the last three months, given that there are many open questions surrounding the recovery from COVID-19 and valuations are lofty. A second lockdown is still possible as countries gradually open. The ideological difference between the United States and China remains a threat, as does the market disappointment if the recovery stalls. We remain overweight investments in risky assets but will permanently keep one foot near the brake to act on negative surprises.

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