EUROPEAN UNION - UPDATE

THE EURO BOND MARKET NEW HEGEMON?

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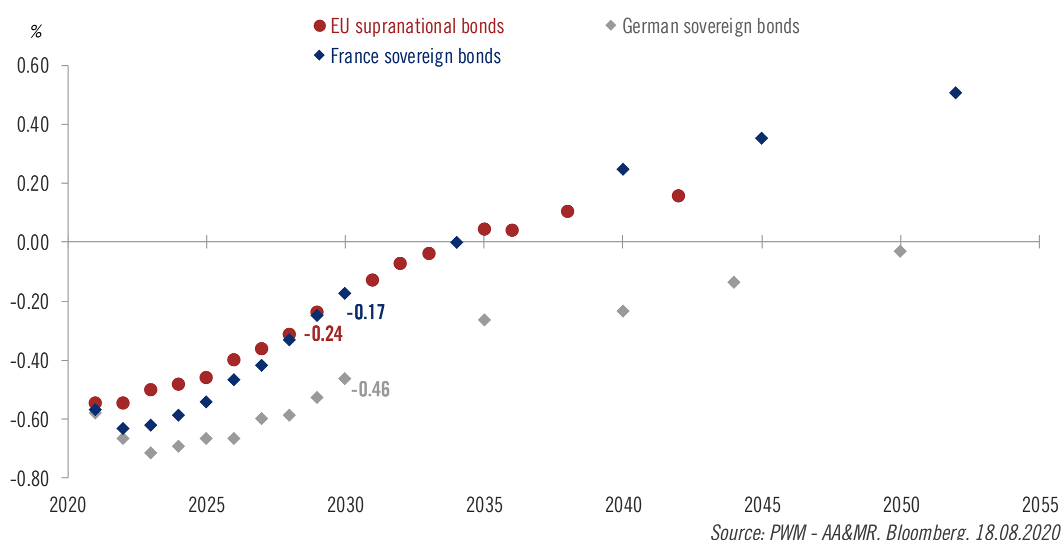
SUMMARY

- Combining the SURE unemployment insurance scheme and the Recovery Plan, the pool of bonds issued by the European Union (EU) could amount up to EUR900.6bn by 2024. EU bonds could share many of German government bonds' 'safe-haven' asset characteristics: A high rating, liquidity, significant modified duration, and a negative correlation with risky assets.
- First, the EU has been assigned the highest rating, AAA (by Moody's, Fitch Ratings and DBRS), although the implied rating from EU bonds yields, as calculated by Moody's, shows an average rating closer to Aa3, partly due to their lack of liquidity.
- Second, as the amount outstanding increases, making its bonds much more liquid, we could see EU yields trading closer to their AAA-rated euro government peers, thanks to a compression of the 'liquidity' premium.
- Third, the EU issues bonds with maturities ranging between 3 and 30 years. Although the European Commission (EC) has not yet published any details regarding upcoming auction maturities and amounts, the bulk of issuances will likely be concentrated in the long end. The EC has mentioned that it wants to give Member States enough time for their economies to recover fully before having to contribute more to the EU budget in order to reimburse the debt. As such, we expect the average modified duration of EU bonds to lie around seven years.
- Last, the 9-year EU bond yield has a spread of 22 bps (on August 17) versus the German 10-year Bund yield. We expect this spread to diminish as outstanding amounts increase, so long-dated EU bond yields are likely also to be negatively correlated to risky assets, although German sovereign yields should remain the euro risk-free rate of reference. All in all, investors could deem EU bonds 'safe-haven' assets, meaning that they could grow the pool in euro.

CHART 1: EU SUPRANATIONAL, FRENCH AND GERMAN SOVEREIGN BOND YIELD CURVES



Source: PWM - AA&MR, Bloomberg, 18.08.2020

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An unprecedented policy response

Government policy responses have been impressive in Europe. On top of national responses, several packages have been agreed at the EU level. In April, the Eurogroup **put forward a EUR540bn emergency support package** consisting of:

- a EUR240bn credit line from the European Stability Mechanism (ESM);
- **a EUR100bn (loan-based) instrument to support short-time working arrangements** (labelled 'SURE' for Support to mitigate Unemployment Risks in an Emergency); and
- a pan-European guarantee fund of EUR25bn from the European Investment Bank (EIB), which could support EUR200bn of financing for companies, with a focus on small- and medium-sized enterprises (SMEs).

In July, European leaders struck a deal on a Recovery Plan (labelled 'Next Generation EU' or NGEU) and on the 2021-2027 EU budget. The NGEU represents an important milestone for Europe, an historic step toward further fiscal integration and financial solidarity. It breaks two important taboos. For the first time, the European Commission (EC) will be authorized to borrow funds on behalf of the EU on the capital markets at an unprecedented scale to fund EU expenditures (see *Chart 2*). Furthermore, part of the funds will be disbursed as grants and will therefore not add to the debt burden of the beneficiary country.

The total size of NGEU is **EUR750bn with EUR390bn of support coming as direct transfers and the rest (EUR360bn) as loans to Member States**. The NGEU will be channelled through seven different programmes. The bulk of the programme is the 'Resilience and Recovery Facility (RRF)' amounting EUR672.5bn (EUR312.5bn grants and EUR360bn loans).

A wave of issuance to come

To finance the SURE unemployment insurance scheme and the Recovery Plan, the EU via the European Commission will increase sharply its bond issuance (see *Chart 2*).

SURE

The SURE programme has been designed to protect jobs affected by the pandemic. The EC will raise money through bonds to lend to Member States – up to an aggregate total of EUR100bn. The SURE loans will be backed by a guarantee fund of EUR25bn committed by Member States to the EU budget.

The EU plans to start issuance for the SURE scheme in late September this year. The EUR100bn of loans for unemployment insurance under SURE are likely to be fully subscribed. At the time of writing, three countries have already sent a formal request for financial assistance to the EU Commission under the SURE. Governments in Italy, Spain and Portugal have asked for EUR28bn (2.2% of GDP), EUR20bn (1.6% of GDP) and EUR5.9bn (2.8% of GDP), respectively. **For 2020, we expect total disbursement of around EUR30-35bn, the remaining (EUR65-70bn) in 2021.**

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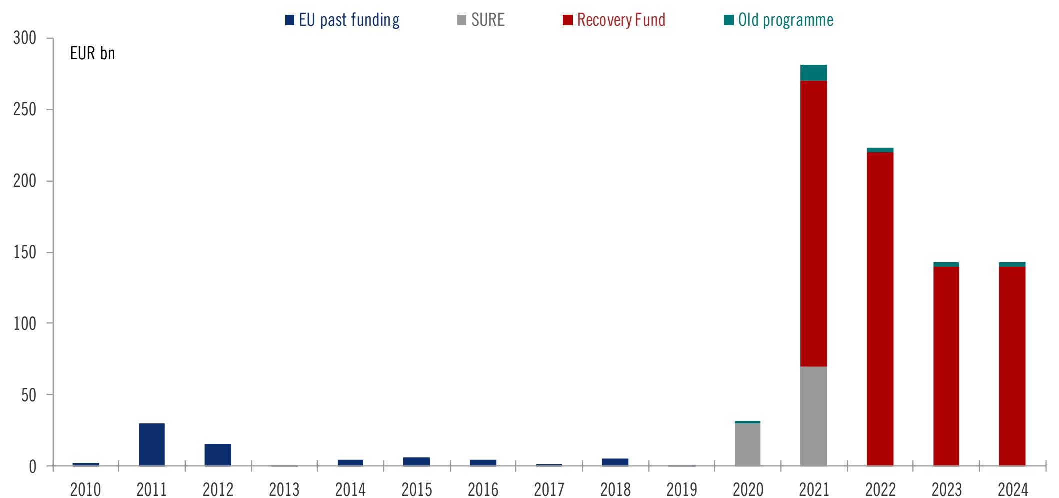
Recovery Plan

The bulk of the issuance in the coming years will fund the Recovery Plan disbursements. The issuance will likely start at the earliest in January 2021 and net issuance will stop at the latest at the end of 2026, even though the majority will likely be completed by 2024. Maturity will vary from 3 to 30 years. The funds raised will be repaid after 2027 and by 2058 at the latest, from future EU budgets and via new own resources. **There is no precise timetable for disbursements and therefore the issuance is uncertain**. It will depend on the speed with which Member States can prepare their 'Recovery and Resilience' Plans and how much of grants and loans they will request. There might also be lags between commitment and disbursement which add some uncertainty. What we know is that 70% of all grants under the RRF will be disbursed in the first two years (2021-2022) according to the Commission's allocation key. The final 30% will be disbursed in 2023, based on the severity of the drop of GDP in 2020 and 2021. Individual countries can ask for loans worth up to 6.8% of their Gross National Income (GNI).

We have pencilled an issuance of EUR200bn in 2021, EUR220bn in 2022 and EUR140bn in 2023/2024. Beyond 2024, we would expect issuances to consist mainly of refinancing of maturing bonds. We assume some spare capacity in the loan component of the NGEU since for some core countries, EU loans would probably be more costly than national issuance. More information might become available by mid-October when countries will submit their draft budget plans to EU, which are likely to include their plans.

CHART 2: EU PAST FUNDING AND ISSUANCE VOLUME (ROUGH ESTIMATES)



Source: PWM - AA&MR, European Commission, 19.08.2020

Growing pool of euro 'safe-haven' assets

The EC will issue new debt on the capital market for a total amount of up to EUR850bn (EUR750bn for NGEU and EUR100bn for SURE), likely by 2024. The EC on behalf of the EU operates already three loan programmes: European Financial Stabilisation Mechanism (EFSM), the Balance of Payments (BoP) programme and the Macro Financial Assistance (MFA). **The current outstanding amount is EUR50.6bn**, which originates

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mainly from European Financial Stabilisation Mechanism (EFSM) loans to Ireland and Portugal.

With the SURE and the NGEU, the **pool of bonds issued by the EU could amount up to EUR900.6bn** (or USD1,060bn). This is less than the German government debt currently outstanding (USD1,613bn on August 12), but much more than the outstanding bonds of the other euro area AAA-rated countries (the Netherlands and Luxembourg). EU bonds could **share many of German sovereign bonds' 'safe-haven' asset characteristics**:

- high rating
- liquidity
- significant modified duration
- negative correlation with risky assets.

First, **the European Union is rated AAA** by Moody's, Fitch Ratings and DBRS with a 'stable' outlook, and AA by S&P Global Ratings with a 'positive' outlook (since July 31). Second, the **increased debt level will make EU bonds much more liquid.** In fact, we could see EU yields trading closer to their AAA-rated euro government peers, thanks to a compression of the 'liquidity' premium (see *Chart 1*). Third, **the EU issues bonds with maturities ranging between 3 and 30 years.** Although the EC has not yet published any details regarding upcoming auction maturities and amounts, the bulk of issuances will likely be concentrated in the long end. Currently the average weighted maturity of EU bonds is 7.7 years, and we would expect the EU to take advantage of the low yield environment: its bond yields are negative up to 2033. Moreover, the EC has mentioned that it wants to give Member States enough time for their economies to recover fully before having to contribute more to the EU budget in order to reimburse the debt.

As such, we expect the **average modified duration of EU bonds to lie around eight years.** Last, the 9-year EU bond yield has a spread of 22 bps (on August 17) versus the German 10-year Bund yield (see *Chart 3*). We expect this spread to diminish as outstanding amounts increase, so **long-dated EU bond yields are likely also to be negatively correlated to risky assets in times of financial market turmoil** (with yields typically falling along with equity indices), although German sovereign yields should remain the euro risk-free rate of reference, trading lower than any other euro government or supranational bond yields.

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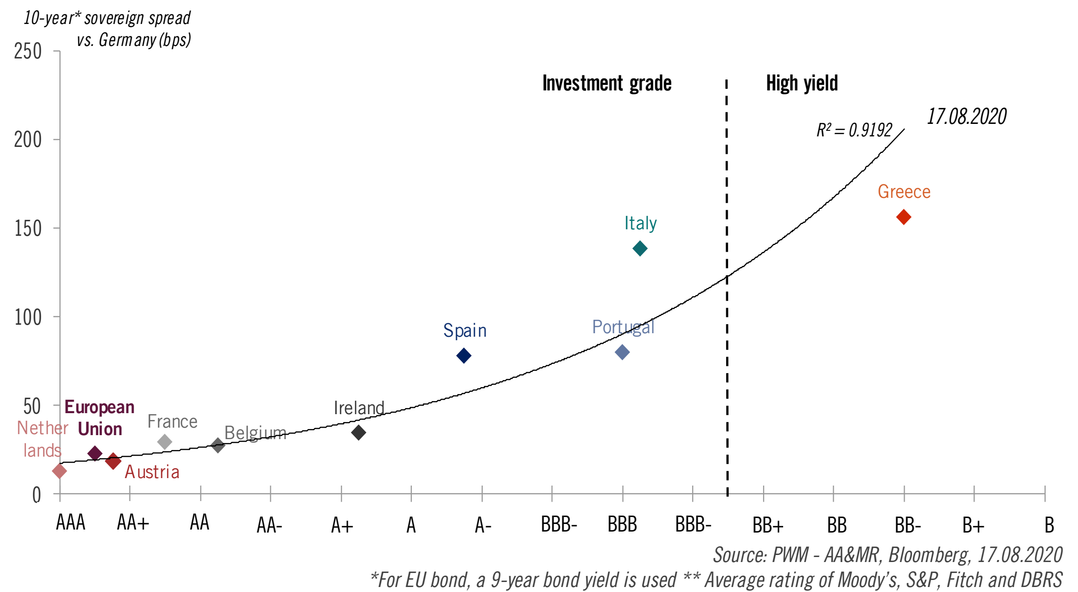
CHART 3: TEN-YEAR* EURO GOVERNMENT AND EU BOND SPREAD VS. THE BUND AND RATINGS**



Source: PWM - AA&MR, Bloomberg, 17.08.2020
**For EU bond, a 9-year bond yield is used ** Average rating of Moody's, S&P, Fitch and DBRS*

All in all, **investors could deem EU bonds 'safe-haven' assets**, meaning that they could grow the pool in euro. In fact, adding the projected EU bond amount to all the 'safe-haven' bonds that have been issued by euro area governments and supranational entities (with a minimum credit rating of AA), **the pool of euro 'safe-haven' assets will grow larger, second only to US Treasury bonds** (see *Chart 4*). Here we exclude Japanese government bonds (JGBs) considering them as a less attractive 'safe-haven' alternative. In fact, Japan credit rating is only A, and the Bank of Japan's growing holdings (more than 40% of total outstanding) and control over the yield curve make JGBs not only less liquid, but also less sensitive to global market sentiment.

Although **Europe supranational entities have been present in the euro bond market for years, amounts issued were small,** except for the European Investment Bank (EIB, with EUR438bn bonds outstanding) and for the European Financial Stability Facility (EFSF, with EUR194bn). The four other entities that are also eligible for ECB's bond purchase programmes have together a total of EUR146bn bonds outstanding (European Stability Mechanism (ESM), Council of Europe Development Bank (CEB), European Atomic Energy Community (EURATOM), and Nordic Investment Bank (NIB)). As such, thanks to its new issues, the **EU will by far become the largest supranational issuer in euro, making its bonds also eligible for ECB's purchases up to a maximum share of 50%.**

This growing pool of euro 'safe-haven' assets could increase the attraction of the euro as reserve currency, becoming a potential alternative to the mighty US dollar and its enormous pool of US Treasury bonds (amounting to almost USD20,000 bn). Moreover, the NGEU and SURE packages by helping European countries in difficult times with grants and cheap loans, not only introduce a powerful counter-cyclical mechanism at the EU level, but also consolidate the EU as an (efficient) institution. The **larger pool of euro 'safe-haven' bonds and the improved EU resilience and longevity perceived by investors could lead them to see euro financial assets as more 'investable'**. This could in turn contribute to an appreciation of the euro in the longer term.

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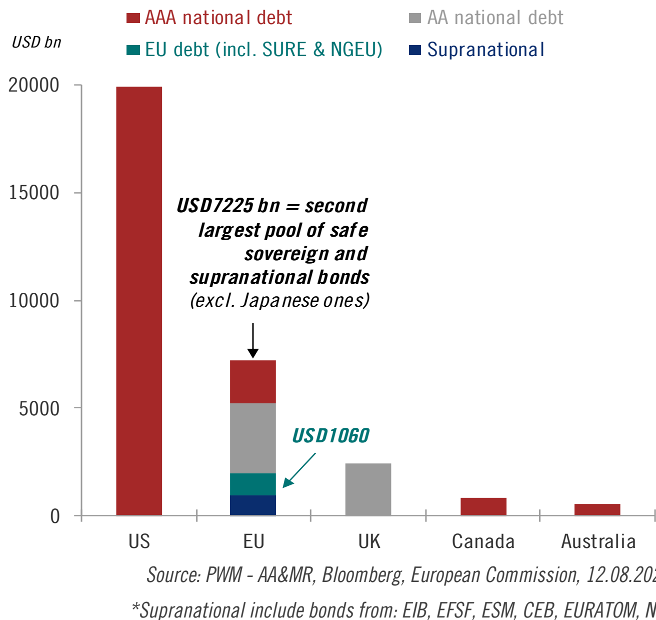
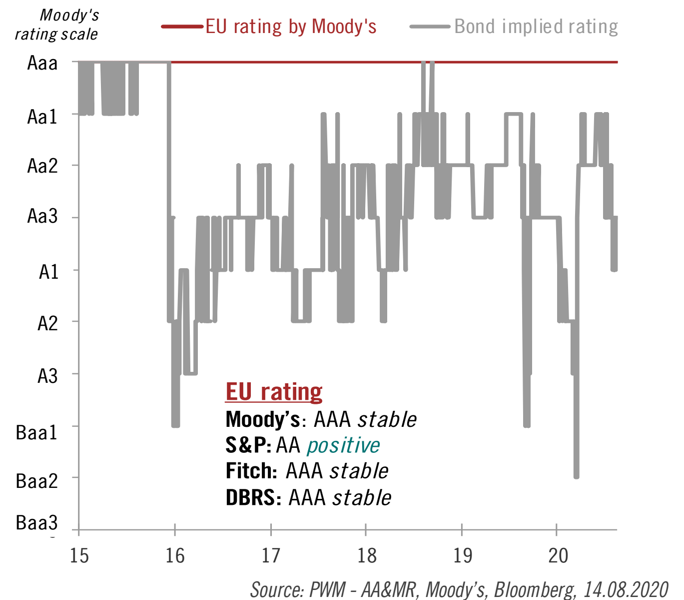
CHART 4: SAFE SOVEREIGN AND SUPRANATIONAL* BONDS OUTSTANDING



Source: PWM - AA&MR, Bloomberg, European Commission, 12.08.2020

*Supranational include bonds from: EIB, EFSF, ESM, CEB, EURATOM, NIB

CHART 5: EUROPEAN UNION RATING BY MOODY'S



Source: PWM - AA&MR, Moody's, Bloomberg, 14.08.2020

What lies behind the EU's AAA rating?

Following the agreement on the Recovery Fund on July 21, **ratings agencies have reiterated their rating of the EU**, with S&P Global Ratings even increasing the outlook from 'stable' to 'positive' on July 31. This could come at a surprise, as a planned EUR850 bn increase in debt level from an institution that has little own resources could have rather jeopardised stable outlooks to the downside. What stands out from agencies' reports however, **is the improved political cohesion that the approval of NGEU shows** – something that had been at risk following the Brexit referendum in 2016, leading S&P Global Ratings to downgrade it from AA+ to AA on June 30, 2016.

Now, even though the EU has been assigned the highest rating by three of the main four ratings agencies, the **implied rating from its bond yields, as calculated by Moody's, shows an average rating closer to Aa3** (see *Chart 5*). As explained above, the very small amount outstanding (EUR50.5bn in total, and only EUR2.25bn for the 9-year bond used here) **make EU bonds less liquid than typical safe government bonds**. Moreover, looking at EU bonds' investor base, fund managers and retail investors own only 31% of the total, the rest being in the hands of more 'stable' investors such as central banks, pension funds etc. (European Commission Investor Presentation, July 2020).

However, we expect **EU bond to fulfil all 'safe-haven' asset characteristics as outstanding amounts increase,** investors get more acquainted with this 'new' issuer, and the EU holds onto its AAA rating in the years to come. Underpinning this view is ratings agencies' methodology for assessing EU's rating. EU finances depend mostly on EU members' contribution to the budget, having for now little own resources (a tax on plastic has been approved in the new 2021-27 budget and others are to be discussed in the coming years), prompting rating agencies to monitor the following criteria to gauge the EU credit strength:

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- **Firm commitment to the EU and to their EU budget contribution from highly rated EU members** (Germany, Denmark, Sweden, Netherlands, Luxembourg). According to agencies' calculations, their budget contributions should be enough to cover coupon and principal payments of both NGEU and SURE debts.
- **EU Treaty requirement for a balanced EU budget**, making the EU rather conservative in the way it addresses financial matters.
- **EU's ability to require extraordinary support from Member States to service its debt obligation**, **and the existence of multi-layer debt servicing protection**. The EU has a high cash balance and the flexibility to redirect one-third of its budget expenditure towards debt servicing. Moreover, there exists a comfortable margin between the maximum budget contribution of its Member States and the actual contributions. As part of the EU Recovery Plan deal, the EC has proposed to increase the Own Resources ceiling (i.e. the maximum amount of resources in any given year that can be called from Member States to finance EU expenditure) on an exceptional and temporary basis by 0.6 percentage points. This increase will come on top of the permanent Own Resources ceiling of 1.4% of GNI (see *Commission Factsheet* here).

In terms of credit risk, ratings agencies mention:

- The low taxing power of the EU
- A future deterioration of Member States' credit ratings
- Political cohesion.

Thanks to the recent policy packages, these risks are now greatly diminished. The new MFF combined with NGEU can be seen as a real step towards fiscal union. Moreover, the decision to task the Commission to make proposals on new EU resources (i.e. new taxes) is a breakthrough compared with the previous positions of Member States regarding taxation. There is still a long way to go, but over the medium term, **the EU should gain more taxing power, enhancing its fiscal independence.**

The NGEU and SURE will also help to sustain the recovery in Europe and to close the gap between the North and the South. Although we expect Northern countries to fare better (the covid-19-related economic costs being smaller, partly due to less reliance on services activities, notably tourism), **ratings agencies have signalled that these packages limit the risk of Member States ratings downgrades** in the coming two years by improving the growth prospects of the weakest. The ECB is also playing a key role. Quantitative easing (QE) for longer (but not forever) still means that effectively the debt burden of euro area governments is artificially reduced, likely for years to come.

Finally, and as mentioned extensively, the agreement on the **Recovery Fund has shown reinforced political cohesion**, as not only all 27 EU members have signed it, but they have been able to give the EU new powers: those of issuing debt and the ability to transfer almost half of these proceeds in form of grants, thereby **moving a step closer towards fiscal union.** The road is likely to be long and arduous, but it seems that **having lost a member, the EU engine is moving forward again**.

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