Mehill Marku

Senior Investment Strategist

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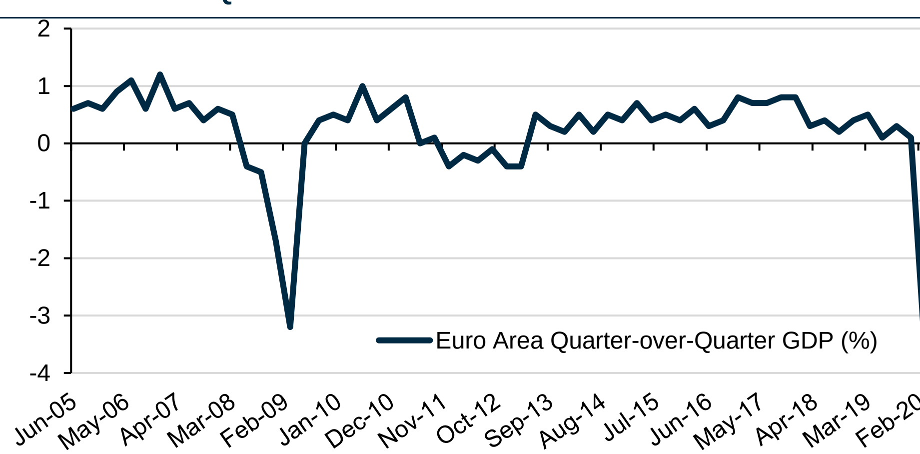
Current EU Crisis to Boost Solidarity, Not Fragmentation

The perceived lack of a forceful and unified response by European Union member states to the staggering economic cost of the COVID-19 outbreak has once again rekindled fears of EU fragmentation. However, we believe a commitment to "do whatever it takes" remains at the core of EU's response to its most recent crisis. European governments and institutions will likely take whatever steps are necessary to backstop the European economy, support peripheral yields, and prevent an asymmetric recovery when the pandemic ends. We believe that the ECB would increase the size and extend its asset purchase program if needed and that European governments will continue supporting growth-boosting measures to head off further risks to economic growth.

While political frictions will remain on the European stage for years to come, political discord is not enough to fragment the Union. Instead, the COVID-19 crisis will likely join the list of past crises that only served to strengthen EU institutions. In a world where existing and rising global and regional powers increasingly determine the course of events, European countries realize that, in order to stay relevant, they must strengthen the Union, not abandon it.

Over the last decade, Europe has gone through multiple crises that have raised fears of EU fragmentation—the sovereign crisis triggered by the Greek deficit debacle, the 2015 immigration crisis, Brexit, and now the COVID-19 crisis. Each episode has exposed various weaknesses and prompted responses from EU member states and institutions.

Figure 1. The Record Q1 Contraction Points to the Strains from the EU's Latest Crisis



Source: Bloomberg as of April 2020.

The sovereign crisis ushered in a period of rising populism, exemplified by the rise to power of the anti-establishment, left-wing Syriza party in Greece. It also highlighted the need to reform the banking sector as well as the EU budget and debt frameworks. The immigration crisis triggered serious political frictions within Europe, especially between the East and West political divide. It also led to the rise of right-wing, anti-immigrant political parties that not only threatened core European values, but that also dealt serious blows to the European political establishment, best illustrated by the collapse of the political center in Italy and Germany.

The Brexit referendum presented an existential risk to Europe as it threatened to set off a process that, if not controlled, would end up splintering the Union. At present, the COVID-19 pandemic has tested Europe's solidarity and its capacity to act in unison to address the growing economic crisis.

Given the formidable list of crises, it is understandable why the EU-fragmentation narrative still holds sway among some market participants. However, EU governments and institutions have acted determinedly to stave off the negative consequences of each crisis. In the process, they have ultimately restored market confidence in Europe's ability to repeatedly rally around a common goal of strengthening the Union's institutions and their ability to respond to future crises.

In response to the sovereign crisis, the EU adopted strict deficit and debt surveillance frameworks (including penalties) to encourage adherence to fiscal and debt rules. In co-operation with the ECB, the EU launched the European Stability Mechanism (ESM) and the Outright Monetary Transactions (OMT) tools to backstop EU sovereigns under financial and market stress. The EU also made significant progress in reforming the banking sector, including actively discussing the need for a common deposit insurance. Meanwhile, the ECB launched multiple lending and asset purchase (quantitative easing) programs to help weather growth concerns and support sovereign interest rates.

The 2015 immigration crisis highlighted different visions about European immigration policies, yet its impact was short lived. As the 2019 European elections showed, the anti-immigrant parties (with the exception of Italy's League party) fared worse than expected, and, contrary to expectations, their representation in the European parliament was lower than in previous elections. Although Europeans remain divided on immigration, it does not pose an existential threat to the EU's future as the immigration issue is no longer a dominant theme among European voters.

Similarly, Brexit—far from setting off the kind of reaction that many had feared—ended up strengthening the EU's resolve to safeguard Europe's single market. During the negotiations that led to last October's Brexit deal, the diplomatic climbdown always came from the UK, and, to its disappointment, the European unity was unassailable.

Despite the initial concerns about the lack of solidarity among European countries, the response to the COVID-19 pandemic has also been swift at the EU level. Early on, the European Commission invoked the "exceptional circumstances" clause of the EU Treaty, suspending fiscal rules, and effectively allowing EU countries to spend as much as needed to address the effect on their economies. The EC also released budget funds to support health-care systems in countries most affected by the virus. For its part, the ECB undertook an unprecedented €750 billion Pandemic Emergency Purchase Program (PEPP) that surpassed the monthly purchases at the peak of the sovereign debt crisis. Meanwhile, on April 23, the EU Council approved a €540 billion package that extends credit lines to countries needing money, provides certain guarantees to businesses, and allocates funds for an unemployment insurance program. Most importantly, the EU leaders agreed in principle to set up a Recovery Fund consisting of "trillions" of euros to help economies recover from the effect of the pandemic.

While the May 5th ruling by the German Constitution court (GCC) did not "concern any financial assistance measures taken by the EU or the ECB in the context of the current coronavirus crisis," it nonetheless threatens to block new purchases of German bonds under the existing QE program (PSPP) unless the ECB can justify "within three months" that the bond purchases fall within its mandate. This surely represents another challenge thrown in front of the ECB and EU governments. However, we believe the practical implications of the case are less concerning than the headlines suggest, especially regarding the implementation of the PEPP, which is time-limited in nature even if it is eventually extended into early 2021. Also, we would not rule out that the threat to the ECB's asset purchases might increase the willingness of EU governments to do more on the fiscal front.

Contrary to some expectations, the crisis has boosted pro-establishment parties, especially in Germany. Polls indicate that euro-sceptic or anti-immigration parties have not gained support during the crisis—a case in point being the decline in support for the AfD party in Germany. In Italy, however, support for EU membership has suffered due to the lack of initial support at the EU level to address the country's pandemic crisis. Yet, we believe the recent decline in support for the EU will likely reverse once the Recovery Fund is operational either by the end of this year or in early 2021 and the effect of the recently launched measures is hopefully felt across the country. In addition, Italian institutions are staunchly pro-European, and there's no constitutional pathway for a referendum on EU membership.

European Solidarity Should Prove Supportive of Most European Peripheral Debt

Ultimately, the performance of each European sovereign issuer will come down to its creditworthiness. While falling short vis-a-vis the original Maastricht criteria that were ostensibly required—but not generally met—at the outset of the European currency unit, member countries have nonetheless substantially reduced their budget deficits since the 2012 crisis. Some members have taken painful structural reforms that have boosted growth, and some—notably Greece, Cyprus, Portugal and Ireland—have even run budget surpluses. Will this be enough to stabilize or improve their credit ratings? Only time will tell. But as long as the member countries work in good faith to restore their credit quality, European sovereigns will have two things they can count on: the pressure of solidarity to comply with budgetary rules and solid support from the ECB in the credit markets. Combined, these factors likely make the European periphery a viable investment thesis in fixed income portfolios at least over the near to intermediate term.

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