Sunny Days Ahead for the EU?

1 June 2020

The European Union is starting to look like they may have their act together. Not a hard task compared to the US, UK, or China but still a bit of a surprise.

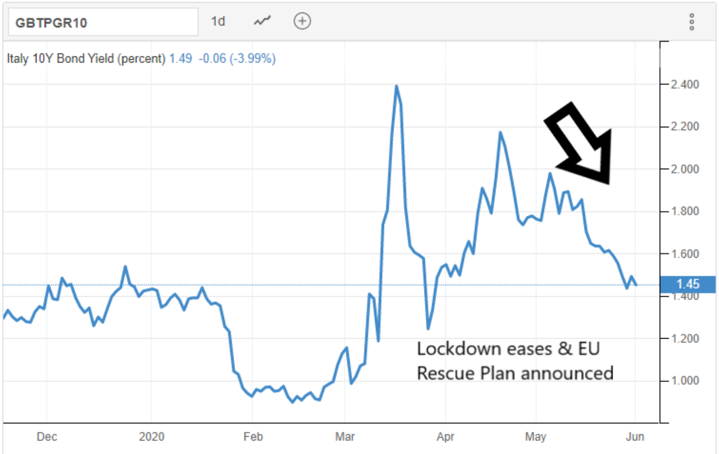
During the Sovereign Debt Crisis, the European Union responded slowly to what the region needed but eventually got there, trading the shaky ground of the EFSF for the robust ESM. Albeit the European Central Bank drew the line under the crisis.

Italian 10 YR Bond with a steadily decreasing yield from Draghi's 2012 declaration. Source: trading economics

With today's corona-induced health and economic crisis, the EU is again slow off the blocks. The recent rescue package and plans for the EU's 7-year budget look like European Commission President Ursula von der Leyen has been taking lessons from Zidane and is now surpassing expectations.

Let us not get ahead of ourselves though as there is a long path to implementation fraught with political cleavages. However, there is enough on the table that even with lots of horse-trading there is enough to please both Italy and the Netherlands. The political landscape looks like it could be supportive of a true economic revival. In terms of sovereign debt, there will be a lot more of it but it is unlikely to put any pressure on yields given the heavy hand of the ECB. With the firm backstop of both the ECB and the EU, there are opportunities with limited downside.

As reliable as the tides though, Italy will present opportunities and they should be seized. Buying Italy and Spain on dips is a good way to bet on Brussels. The EU is looking as safe as ever and secure in its role of backstop even though anti-Brussels sentiment has spiked.



Italian 10 YR yields begin to tick down again after Lockdown eases and the EU Rescue Plan is announced. Source: trading economics

The Italians won't easily forget how when they needed European solidarity most, the response was silence. Anti-EU sentiment is at an all-time high; A Techne poll in April 2020 shows just 44% of Italians wanted to remain in the EU against 65% in 2018, while 42% wanted out against 26% two years ago.

At the same time, the political landscape has changed. It doesn't look like Matteo Salvini can capitalize on the EU discontent to disrupt the government or gain space for himself or the La Lega either. In January, before the health emergency exploded, his approval rating was 42% but it has now slumped to 31%.

The proportion of Italians who say they would vote for the League has declined from 35% last summer to 25% in May, according to an Ipsos poll.

The EU dropped the ball significantly when it failed to aid Italy during its darkest days of the novel coronavirus pandemic. The PR opportunity that Brussel lost, China gained. The headlines almost everywhere were flashier than the blunt press statement from the EU Commission

on how China was now returning the favour after the EU had sent aid to China earlier in the year.

That is a lot less glossy and attention-getting than the headlines and photos.

Chinese Medical Teams arrive in Italy to help with its Covid-19 outbreak. Source: Asia Power Watch

But just like during the sovereign debt crisis, the EU comes through eventually. At least with announcements which is sometimes enough. Von der Leyen is tying the EU's 7-year budget with the proposed EUR 750 bln rescue fund and putting nice conditionality around it that lends to building the EU back with sustainability front of mind. The EU to borrow to fund the part of the rescue fund and thus create a new sovereign debt issuer of size and begin to counterbalance demand for Treasuries, Gilts, JGBs, and Bunds.

It will all need unanimous approval and probably some time but I think we'll get a watered-down version that will encompass increased EU issuance, tighter oversight on national use of EU funds, and demonstrate a further commitment to the EU concept by EU members.

The ECB moved a bit faster and already has the Pandemic Emergency Purchase Program (PEPP) in place. In addition to what it was buying under the Asset Purchase Program, non-financial commercial paper is now eligible for purchases both under the PEPP and the corporate sector purchase program. As of 2 May 2020, the ECP has spent EUR 211.8bln of the EUR 750 bln firepower in the program.

Brussels is making strides in creating a future for the EU beyond bickering though it will see a lot of bickering before it can get there. The ECB will continue to carry the weight but thankfully Brussels leadership is thinking critically and realistically about how to get the EU over the health and economic fallout from Covid-19 as well as plan for a strong economy of tomorrow. Very much makes the UK and the US look like bastions of yesterday. China occupies another space and one we'll leave to another blog.

Feel free to file under HOW OFTEN DO YOU GET TO BE POSITIVE ON THE EU?