On the Minds of Investors

July 2021

Four reasons why investors should not underestimate the European Union's pandemic recovery fund

In the last economic cycle Europe was a laggard. A major reason for the region's economic and market underperformance was the years of fiscal austerity that followed the global financial crisis and the eurozone sovereign debt crisis. The sovereign debt crisis also revealed that European monetary union would be unsustainable without fiscal union.

The pandemic has proved to be the catalyst needed to fix these flaws, with the agreement of the European Commission's EUR 2 trillion recovery fund. Not only does the recovery fund give the European Commission authority to raise debt and distribute money around the region, enhancing the European Union's (EU's) institutional architecture, it should also have a positive impact on European growth.

There are four reasons why investors should not underestimate the impact the fund will have on regional economic activity:

1) The fund will provide a multi-year boost to growth that may be at least on a par with President Biden's infrastructure plans in the US;

2) The countries most in need of a fiscal boost – in the south of Europe – will be among the largest beneficiaries of the fund;

3) The fact that the recovery fund was agreed makes structural reforms more likely;

4) The fund should help to keep Europe at the forefront of efforts to tackle climate change and it should also help the region to catch up with its international peers in technology adoption.

There are risks to how such ambitious plans are implemented, mainly related to possible delays to spending or the partial use of allocated funds. However, if well implemented, the EU recovery fund could ultimately prove to be a catalyst for a resurgence in investor appetite for European assets.

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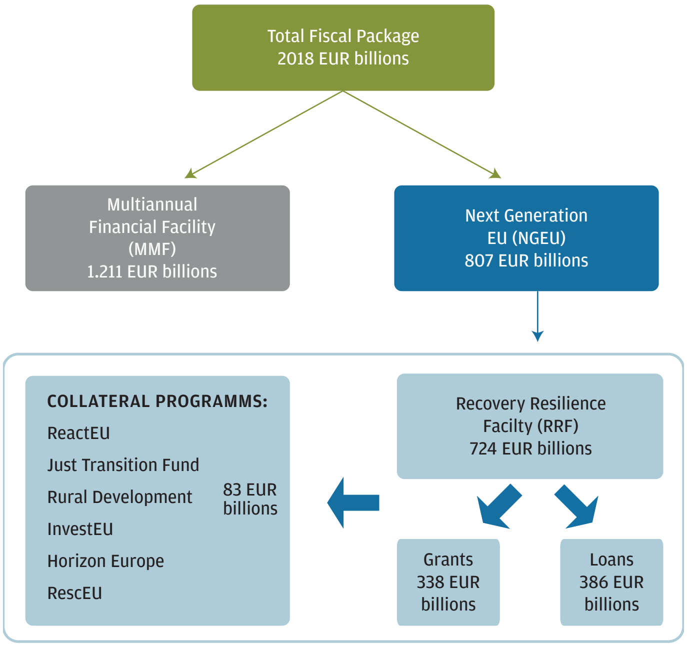
EU FUNDS COULD BE COMPARABLE TO US FISCAL SUPPORT

EU authorities love acronyms. Let's start by clarifying the alphabet soup that makes up the recovery fund's EUR 2 trillion fiscal package. More than half the fund, EUR 1.2 trillion, is made up of the 2021-2027 Multiannual Financial Framework (MFF), while the remaining EUR 800 billion comes from the Next Generation EU (NGEU) fund.

The NGEU fund is dedicated to promoting a green, digital and sustainable post-pandemic recovery, with the majority of funding coming from the Recovery and Resilience Facility (RRF), which is then roughly split between direct grants (that recipient governments do not need to repay) and loans (**EXHIBIT 1**).

EXHIBIT 1: SCHEME OF THE EU RECOVERY FUND AND ITS MAIN COMPONENTS



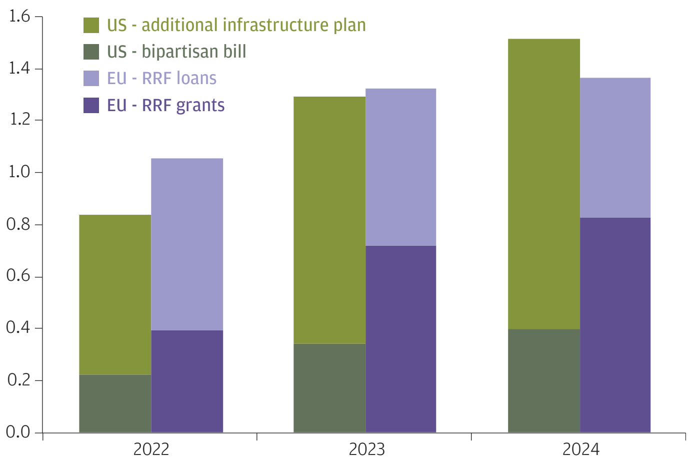
Source: The EU's 2021-2027 long term budget and Next Generation EU. Facts and Figures. Data as of 30 April 2021. Numbers are at current prices.

The ability to provide grants – a key innovation of the NGEU plan – will help highly indebted countries to promote a strong and sustainable recovery without adding to the pressure on their public finances. Countries that gain European Commission approval for their National Relaunch and Recovery Plans, which have already been submitted, will be eligible to receive, probably by July, a first tranche of payments worth 13% of their total allocation. This will allow governments to starting making investments immediately.

EXHIBIT 2 compares the RRF with the infrastructure programme that President Biden intends to implement in the US, in terms of weight of GDP. We can see that Biden's infrastructure plans are comparable to the EU's programme, although we know that the Biden administration has broader ambitions and there is uncertainty around the final size of the spending programme.

EXHIBIT 2: US INFRASTRUCTURE PROPOSALS VS. EU RECOVERY FUND

% of 2019 GDP



Source: Bruegel, The White House, J.P. Morgan Asset Management. RRF is Recovery and Resilience Facility. Data as of 30 June 2021.

It is also not yet clear if all European Union countries will request the entire amount of loans that they are entitled to. Nevertheless, over the next three years, the entire RRF funding – which is essentially the EU's infrastructure programme – is comparable to, if not greater than, what is on the table in the US.

SOUTHERN EUROPE IS THE BIGGEST BENEFICIARY

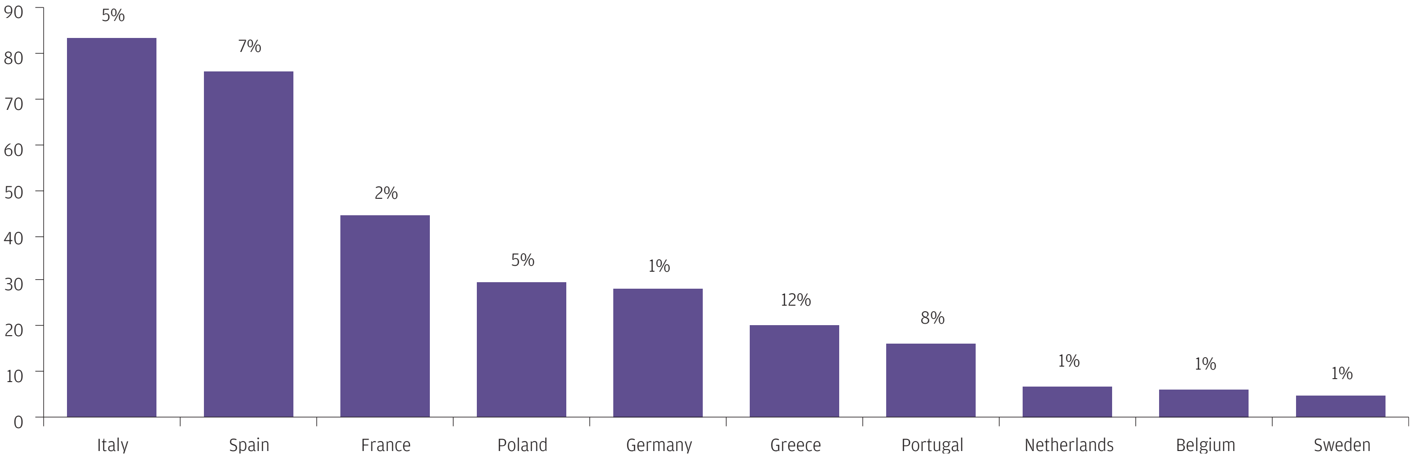
The distribution of NGEU funds to southern Europe will be particularly sizable. Italy and Spain together will receive roughly half of the total available funds. **EXHIBIT 3** shows that for countries in the south of the region – Italy, Spain, Greece and Portugal – grants are large when compared to the size of their economies. The intention is to favour those countries that suffered the most in the pandemic, and that have limited internal resources to support their economies due to already high levels of debt.

The two largest EU economies – Germany and France – have access to relatively modest funding, but our expectation is that these economies will be the key beneficiaries of the post-pandemic global upturn.

There are always valid questions as to whether these resources will actually be used to boost economic growth and whether governments will allocate the funds effectively. The NGEU fund is designed to minimise this risk, since payments can be suspended if key milestones and targets are not met through the course of the programme.

EXHIBIT 3: EU RECOVERY FUND GRANTS TO SELECTED EU COUNTRIES

EUR billions, labels are % of 1Q 2021 annualised nominal GDP



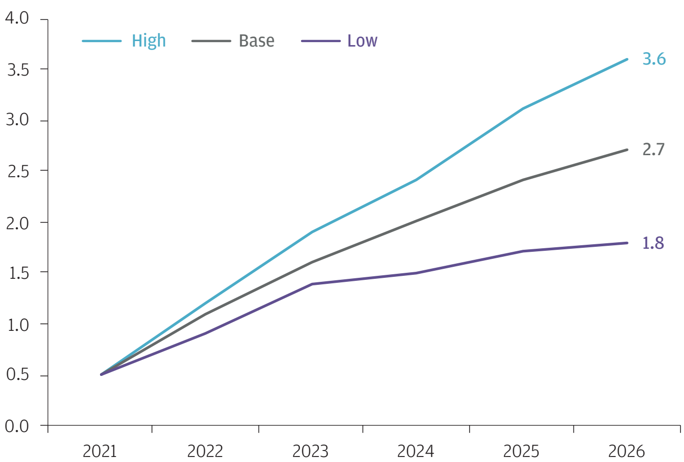
Source: European Commission, J.P. Morgan Asset Management. Expectations of the European Commission's proposal are based on the currently announced agreement. *Guide to the Markets - UK & Europe*. Data as of 30 June 2021.

As a base case, the Italian authorities forecast that in 2026, real GDP could be 2.7% higher than without the NGEU fund, and 3.6% higher in the most favorable scenario (**EXHIBIT 4**).

The Spanish government believes the funds will boost growth by 2% per annum in the coming four years. At the eurozone level we have raised our forecast for growth in the coming decade from 0.9% to 1.1%, meaning that at the end of 2026, the level of GDP in the eurozone could be 1.5% higher compared to a base case without NGEU investments.

EXHIBIT 4: ESTIMATED IMPACT OF ITALIAN RECOVERY AND RESILIENCE PLAN ON ITALIAN GDP

% of nominal GDP



Source: National Italian Recovery and Resiliency Plan, J.P.Morgan Asset Management. Data as at 30 April 2021.

STRUCTURAL REFORMS MAY REVITALISE LONG-TERM GROWTH

There is another important aspect of the NGEU fund that may serve to boost growth over the medium-term, especially in Italy and Spain. This is the structural reform that is required in exchange for the disbursement of funds. The failure to reform public administration, justice and tax systems, as well as labour markets and retirement laws, has long been blamed for the lack of competitiveness and dynamism in the region.

In Italy, the focus of reforms is on four key areas: 1) the simplification of the public procurement framework to reduce the time it takes for public works to be completed; 2) reform of the civil justice system to reduce the length of time needed to enforce contracts; 3) efforts to reduce tax evasion; and 4) efforts to effectively raise the pension age. The European Commission's scrutiny of Italy's reforms should be particularly strict. In this respect, it is encouraging to see that Italy's ruling coalition under prime minister Mario Draghi has reached preliminary agreement on crucial justice system reforms.

Spain, meanwhile, has announced a package of 20 reforms that will include plans to reduce temporary workers in the Spanish labour market, the implementation of social and inclusive policies in Spanish public services, and the strengthening of the pension system.

The need for structural reforms, and the political obstacles preventing them, were very clear in the years during and after the sovereign debt crisis. The difference now is that the funds on offer in exchange for reforms are so large. In effect, the carrot has finally become larger than the stick.

THE NGEU SHOULD INCREASE EUROPE'S LEAD IN PROVIDING CLIMATE CHANGE SOLUTIONS AND PROMOTE GREATER ADOPTION OF NEW TECHNOLOGIES

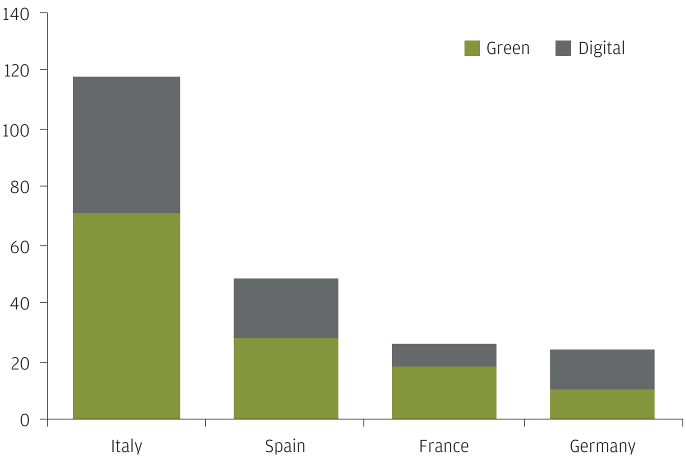
Two strategic upgrades will account for the majority of NGEU fund spending, with 37% of the money to be spent fighting climate change and 20% on digital transformation. Seven flagship programmes have been identified:

1. POWER UP. EU countries will need to increase renewable energy production by 500 GW, with 40% of this enhancement delivered by 2030.
2. RENOVATE. The NGEU plan aims to double public and private building energy efficiency by 2025, by improving thermal insulation, heating systems and self-production of electricity.
3. RECHARGE AND REFUEL. A network of 3 million recharging points for electric cars and 1,000 hydrogen refueling stations must be built, half of which must be ready by 2025.
4. CONNECT. Broadband and data cloud services will have to create extensive 5G network coverage by 2025.
5. MODERNISE. Digitalisation will be mainly focused on public services, justice and health systems.
6. SCALE-UP. The EU's internal production of semiconductors will be doubled.
7. RESKILL AND UPSKILL. Education plans will help to retrain and upskill workers.

Measures to boost female and youth employment will also be central to many of the recovery plans. If implemented, they have the potential to reduce the economic and social gap between the north and the south of Europe – a structural issue that has deteriorated further during the pandemic. **EXHIBIT 5** shows the breakdown of investments for the four largest European countries in terms of green and digital initiatives.

EXHIBIT 5: INVESTMENT IN GREEN AND DIGITAL PROJECTS OF THE MAJOR EUROZONE COUNTRIES

EUR billions



Source: European Commission, national recovery and resilience plans, J.P. Morgan Asset Management. Data as of 16 July 2021.

CONCLUSION AND INVESTMENT IMPLICATIONS

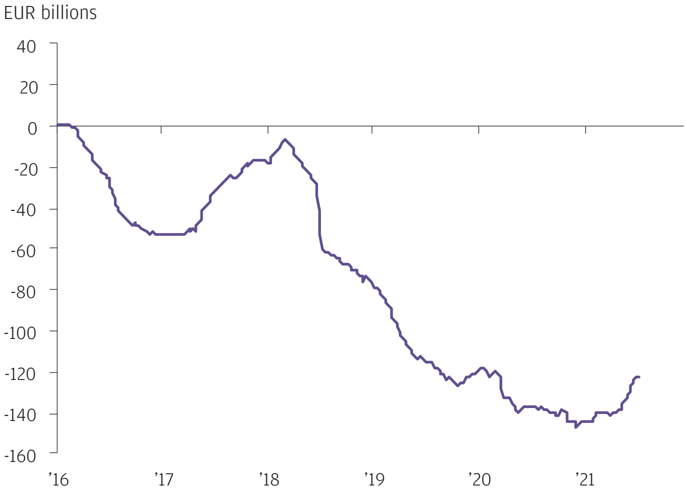
The NGEU represents a multi-year growth stimulus for the European Union that could be comparable to President Biden's infrastructure plans in the US. The impact on growth could be material and eurozone GDP at the end of 2026 could be 1.5% higher, or more if structural reforms also serve to boost productivity in the long run.

Italy is the key beneficiary, so how Italy fares will be crucial. The Italian prime minister Mario Draghi – a seasoned policymaker – has, in our view, the credibility to put the plan on a solid path, although we acknowledge risks beyond the next elections in 2023.

Funding for the recovery project is at least partly coming from the issuance of bonds by the European Commission, which over time is expected to reach a total amount of EUR 800 billion. Three tranches have already been issued, receiving stellar demand from investors. These EU securities and green instruments will extend the universe of AAA rated supranational fixed income instruments, while also offering a yield that is higher than the German benchmark.

By boosting the regional growth outlook, and by reducing the risk of another sovereign debt crisis, the recovery fund could encourage global investors to take another look at European stocks, which have been out of favour in recent years (**EXHIBIT 6**). The recovery fund may also serve up particular opportunities for companies that are key beneficiaries of the EU's spending objectives, such as renewable energy providers, electric vehicle producers, systems facilitators and firms at the forefront of digital transformation technologies.

EXHIBIT 6: CUMULATIVE EUROPEAN EQUITY MUTUAL FUND AND ETF FLOWS SINCE 2016



Source: J.P. Morgan Asset Management GFICC Group, J.P. Morgan Asset Management. Data as of 14 July 2021.

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