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OPINION

Markets Insight

The EU pandemic fund will transform the investment landscape

Greater stability — and a new breed of triple A bonds — should boost markets and the euro

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Investors will view Europe's €750bn pandemic recovery fund with a mixture of hope and apprehension.

Apprehension, because even though the scheme has won the approval of the EU 27, there can be no guarantees of a smooth journey from this point. Keeping sceptics such as Austria, Denmark, the Netherlands and Sweden on board will be fraught with difficulty.

The region's "frugal four" economies may have secured key concessions but will demand constant scrutiny of how the money is spent. Fund recipients can expect zero tolerance if they backpedal on reforms, which could mean further political disputes and spending delays.

Still, hope is in sufficient supply. Much of it comes in the form of Franco-German resolve. There is every possibility that Europe's two economic powerhouses — upon whose shared vision the plan is built — succeed in bridging the gaps.

Indeed, whenever the two have worked in tandem, they have proved a formidable pairing.

It was their alliance that kept Britain out of the European Economic Community for years in the 1960s, and it is to their collective effort that the euro owes its very existence. Given that the frugal four account for just one-tenth of the bloc's total population, it is a fair bet that Paris and Berlin — which speak for almost two-fifths — will prevail again.

If they do, they may end up transforming the investment landscape. Europe's bonds, currency and stocks could become much bigger features of international portfolios.

Bonds, in particular, could benefit. That is because the fiscal co-ordination at the core of the plan will create a sovereign fixed-income market for the eurozone worthy of the name.

Currently, less than a quarter of European sovereign and supranational bonds carry triple A ratings. The recovery programme could increase the amount of top-rated debt to some €1.4tn.

Europe's riskier sovereign bonds might also become sturdier investments — not least if the recovery fund were to succeed in sharing the costs of economic reconstruction and easing the pressure on the most indebted nations.

With the risk of the bloc's break-up contained in this way, southern European government bonds could become core holdings for a broader circle of investors.

A more stable Europe and a deeper bond market would also boost the euro's standing. Since its inception, the single currency has lived in the shadow of the US dollar.

Its failure to mount a challenge to the greenback's status as a reserve currency has in part reflected the lingering risk of the break-up of the bloc.

Greater political and economic stability — and a new breed of pan-European triple A bonds — change that calculus. They should enhance the euro's appeal among international investors and central banks. By our reckoning, the euro is trading 16 per cent lower against the US dollar than is warranted by fundamentals such as a healthy current account surplus.

What is more, the euro is also under-represented in global central bank reserves relative to the bloc's economic size, accounting for just 20 per cent of the total compared to the US dollar's 62 per cent share. With the anti-pandemic fund in place, the euro's status as both an investment and store of value is sure to grow.

Europe's equities could also enjoy a re-rating. Over the past 20 years, they have consistently traded at a steep discount to their US counterparts. Over that time, US stocks' price-to-book ratio has been some 50 per cent higher on average. The gap is not an anomaly, but rather testifies to three fundamental differences between US and European markets. First, the US is home to a far larger number of faster-growing, tech-oriented companies; there are no European versions of Facebook, Google or Apple. Second, due to more favourable tax and regulatory regimes, American companies enjoy superior profitability. Third, valuations for eurozone stocks have consistently embedded the risk of a break-up.

The recovery fund could reduce some of these disparities. By channelling as much as a third of its total funding to tech and green sectors, it could revitalise Europe's "new economy" stocks.

Spurred on by tighter environmental regulations, European companies are already making advances in renewables, smart city infrastructure and energy efficiency technology. With additional public and private investment, the region could become a global leader in these and other fast-growing environmental industries.

So investors would do well to embrace the EU's radical change of direction. Betting on the old continent might soon deliver a new kind of reward.

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