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EURO STIMULUS HAS BROAD IMPLICATIONS FOR INVESTORS

Pragna D. Shere, CFA
SENIOR VICE PRESIDENT
PORTFOLIO MANAGER

Gregory M. Jones, CFA
SENIOR VICE PRESIDENT
PORTFOLIO MANAGER

The unprecedented levels of stimulus launched worldwide to combat the recession triggered by economic shutdowns and stay-at-home orders to contain the COVID-19 pandemic have garnered much attention from investors and the media. The impact from the more than $11 trillion in fiscal stimulus and massive amounts of central bank liquidity will aid many suffering economies and people. Among all the programs launched, one of the most interesting is the European Union's (EU) 750-billion euro Recovery Fund, part of a broader "Next Generation EU" recovery effort. This Next Generation stimulus package marks an inflection point for the region and is likely to have far ranging consequences, including:

- Greater unity among EU countries
- Narrowing the valuation discount between European equities and other developed market equities
- Advancing initiatives outlined in the Green Deal
- Accelerating digitization across the EU

Stimulus Proposal Passes Important Hurdles

After intense negotiations, the 27 EU member states in late July agreed to a stimulus plan of 750 billion euros or $875 billion, which is equivalent to approximately 4% of 2019 EU gross domestic product (GDP). A key difference from previous stimulus initiatives is that funding will be provided to countries as a mix of grants (390 billion euros) and loans (360 billion euros) rather than just loans. The recovery fund will be financed through bonds issued by the European Commission with maturities of up to 30 years and backed by future contributions of EU members. The majority of the grants will be distributed from 2021 to 2023 to the member states depending on their specific national recovery plans. Of the 360 billion euros in loans, countries are expected to begin repayment in 2027 based on the amount received, with the entire debt settled by 2058. The stimulus plan calls for the 390 billion euros of grants to be repaid initially by the EU from funds received through a new tax on plastic waste, with a future focus on green and digital taxes.

Cash will be directed to countries based on need rather than contributions made to the EU budget, thereby supporting countries that were the hardest hit economically by the pandemic and also having high debt levels and limited financial flexibility. Under the current plan, countries including Italy, Spain, Portugal and Greece will be among the largest beneficiaries and will be able to access funds financed by the European Commission's triple A rating instead of their own lower ratings.

More interestingly, the EU is leveraging the recovery fund to align with broader initiatives by contributing to green and digital reforms. In order to access the grants, member states must prepare national recovery plans that are required to boost growth and jobs while reinforcing the economic and social resilience of the EU countries.

The program is an important milestone for Europe and a significant inflection for Germany, which has traditionally opposed mutualized debt. Germany's leader, Angela Merkel, recognized Germany's responsibility to safeguard the union and the euro. More broadly, it establishes the principle that common challenges require common debt, and sets a precedent, allowing a common fiscal tool to be used in future crises.

A Sign of Increased EU Unity

In the aftermath of the Global Financial Crisis, rising populism and divergences related to austerity programs as part of reform requirements in exchange for bailing out countries threatened the EU. The issue became highly prominent and contributed to the United Kingdom's decision to leave the organization after tensions escalated over budget discussions. Throughout its history, the EU has struggled with countries maintaining autonomy while fostering intra-country commerce by developing shared regulations and encouraging the adoption of the euro as a single currency for the region. The Recovery Fund, however, represents a first step toward fiscal solidarity and suggests deeper fiscal integration for the EU bloc is possible while helping to alleviate lingering fears over the possibility of additional countries leaving the union.

The coronavirus crisis widened the economic divide between Northern and Southern Europe. The northern countries had lighter lockdowns and more fiscal power, having entered the pandemic in better economic shape than their heavily indebted southern counterparts where the health crisis has been more severe. The southern countries also faced increased potential for economic collapses from widespread government ordered shutdowns. However, the EU's response, using Recovery Fund grants, prevents this economic gap from widening further and prepares the region for a more synchronized recovery with stronger growth over a sustained period, while making the EU more stable.

The Dark Cloud over Valuations Could Dissipate

Over the past 20 years, European equities have consistently traded at a discount to U.S. equities based on forward price-to-earnings ratios (see Figure 1). While multiple factors may have influenced this disparity, investor fears over a breakup of the EU, the lack of a fiscal union and the euro's inability to rival the U.S. dollar are among the largest contributors to negative sentiment. The European Recovery Fund could be the catalyst that triggers a multi-year re-rating period for European investments. Reduced potential of a breakup suggests European assets could warrant a lower risk premium and therefore higher equity valuations.

The Green Deal Gets a Boost

With 18 of the past 20 years being the hottest on record globally plus wildfires in Australia, California and the Amazon forest and a 350% increase in weather-related

Figure 1: **Discount of MSCI Europe Equities Relative to S&P 500 Based on Price-to-Earnings Ratios**

Source: FactSet as of July 31, 2020.

natural disasters since the 1980's,[1] the urgent need for addressing climate change is a key priority for many policy makers. Europe is at the forefront of adopting climate change policies as the region continues to focus on the need for immediate action.

Last December, the EU states agreed on the European Green Deal as a long-term strategy and roadmap for transforming the Union into a modern, resource efficient and competitive climate neutral economy by 2050. The plan's focus is to eliminate fossil fuels as an energy source while building clean infrastructure, increasing the use of renewables and promoting clean transportation such as electric vehicles. To enable this transition, the EU Commission presented the Green Deal Investment Plan, which seeks to mobilize 1 trillion euros of public and private investments by 2030. While this was the original goal, the COVID-19 crisis provided a short-term catalyst to utilize the Green Deal as a key policy lever to restart the EU economy. About 25% of the seven-year EU budget (used to finance policies carried out at the European level) of 1.1 trillion euros will be targeted at securing financing for climate investments from 2021 through 2027.

The benefits of the Green Deal extend beyond social and moral responsibility, as it serves as Europe's next platform for growth. The International Renewable Energy Agency (IRENA) recently estimated:[2]

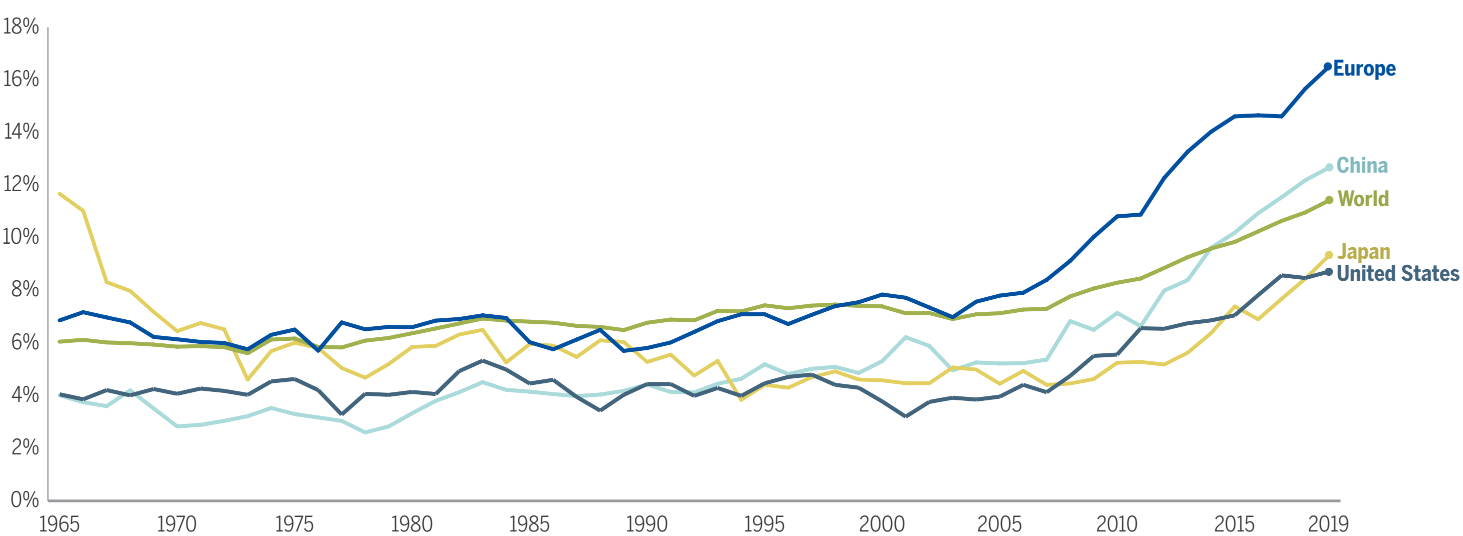
- Each dollar of climate investment could represent a 5x GDP multiplier effect.
- Each million-dollar investment in renewables or energy flexibility could create at least 25 jobs, while each million dollars invested in efficiency could create about 10 jobs.
- Compared to plans in place prior to the pandemic, an accelerated energy transition could add 5.5 million jobs by 2023. In the meantime, the increased funding for environmental initiatives could help Europe expand on its position as a global leader in green energy (see Figure 2).

Prompted 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 with a competitive advantage in these and other fast-growing environmental industries.

The Acceleration of Digitization

The COVID-19 crisis has demonstrated the central role of digital technologies in our economies and daily lives. According to Twilio, the lockdowns across Europe accelerated the transition to a digital workplace by an average of six years and increased traffic on Europe's telecommunications networks by as much as 60%.[3] While significant progress has been made, the pandemic also illustrated that the region trails North America and Asia in the race to digitize economies and business models. According to European Investment Bank estimates, only 66% of European manufacturers have adopted at least one digital technology, trailing the U.S. rate of 78%.[4] To combat this issue, the EU has set a goal of having 70% of Europeans acquire digital skills by 2020, which will require massive training programs. The Recovery Fund seeks to support training and other high-tech initiatives by requiring member states to provide proposals for digitizing their economies when they apply for financial assistance.

Figure 2: **Share of Primary Energy from Renewable Sources**



Source: Our World in Data based on BP Statistical Review of World Energy (2020).
Note: Primary energy is calculated using the 'substitution method' which takes account of the inefficiencies in energy production from fossil fuels.

Investment Implications of Stimulus

We believe the Recovery Fund will have a positive impact on the following:

- EU equity valuations
- European economy
- Clean tech industries such as electric vehicles, solar energy and wind energy
- High tech industries that support the transition to the digital age, such as better connectivity through rapid deployment of 5G networks, artificial intelligence, cybersecurity and e-commerce

Simply investing in broad indices that track European equities or industries such as clean tech or digital services, however, may yield disappointing results. In the fast-moving world of innovation and digitization, the divergence in the success of leading companies and lackluster businesses is growing as companies that are best suited to benefit from large-scale change quickly capture market share. To that end, we believe investors may be well served by conducting in-depth research to potentially find companies that are capturing market share by disrupting their respective industries with innovative and compelling products. These companies should have strong business models and defensible moats, such as patents, strong branding or economy-of-scale advantages.

1 Munich Re's NatCatSERVICE data on natural disasters since 1980.
2 International Renewable Energy Agency, "Global Renewables Outlook: Energy Transformation 2050" (April 2020).
3 JiaJen Low, "Pandemic has accelerated DX by 6 years, says Twilio" T_HQ (July 17, 2020).
4 EconoTimes, "Digitalization front and center in the European Union's Coronavirus Recovery Plans?" (August 4, 2020).

FactSet provides market research and data to financial professionals. The forward P/E ratio is the current market price of a company divided by its expected earnings during the next 12 months. The MSCI Europe Index captures large and mid cap representation across 15 developed markets countries in Europe. With 435 constituents, the index covers approximately 85% of the free float-adjusted market capitalization across the European developed markets equity universe. The S&P 500 Index is an index of large company stocks considered to be representative of the U.S. stock market. Index performance does not reflect deduction for fees, expenses, or taxes. Investors cannot invest directly in an index.

Twilio Inc. represented 0.40% of Alger assets under management as of 6/30/2020.