EUROPE'S LIFTOFF

THE RECOVERY IN EUROPE IS PICKING UP SPEED

May 21, 2021

After a difficult start to the year, Europe's recovery is picking up speed. Expectations for growth and inflation, while still relatively low, have been ratcheted up of late. A release of pent-up demand, a reopening to vaccinated travelers, new fiscal stimulus and a focus on structural reform all point towards an upside surprise. This bodes well for European equities, but less so for European fixed income.

Northern Trust
Global Asset Allocation

Wouter Sturkenboom, CFA
Chief Investment Strategist EMEA & APAC
ws65@ntrs.com

Colin Cheesman, CFA
Investment Analyst
cc327@ntrs.com

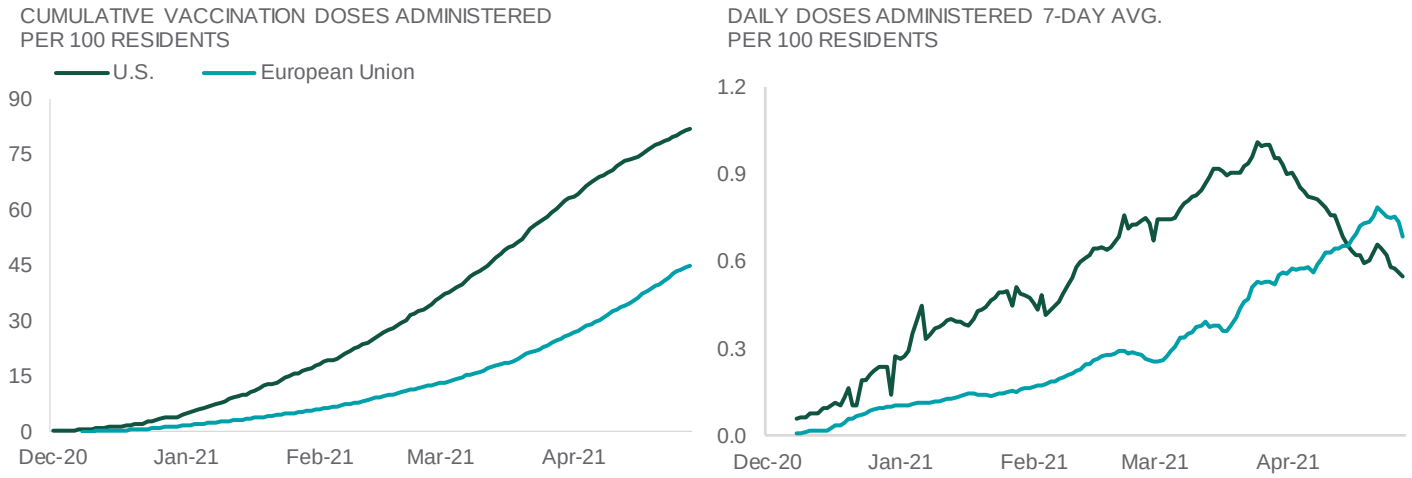
Jim McDonald
Chief Investment Strategist
jxm8@ntrs.com

The European economy is achieving liftoff. As Europe struggled in the first quarter with rising COVID-19 cases and vaccine supply shortfalls, we argued its pending recovery was delayed but not disrupted. The economic data over the past month has confirmed this was correct. Real activity has accelerated across all economic sectors and forward-looking confidence indices have moved sharply higher. The data has also revealed that the second wave of regional lockdowns and restrictions was much less of an economic headwind than the first wave. Pandemic adaptation has been real and the double-dip recession was not as deep as feared.

Vaccine momentum. Europe's accelerated vaccine program has driven the economic recovery. As supply shortages were overcome, Europe was able to rapidly increase the pace of vaccinations. Whereas it took roughly three months to administer a first dose to 20% of the population, it took only one additional month to get to 40%. We expect Europe will catch up with the U.K. and U.S. in the next couple of months (see Exhibit 1). This improvement has already allowed governments to end lockdowns, ease restrictions and once again allow (vaccinated) tourists. We expect full reopening in the next few months.

EXHIBIT 1: CUMULATIVE AND DAILY VACCINATION DOSES ADMINISTERED

Europe is expected to catch up to the U.S. in the next few months.



Source: Northern Trust Asset Management, Ourworldindata.org. Data from 12/20/2020 to 5/17/2021.

NextGenerationEU. The implementation of the European Union's joint economic recovery fund is taking shape — and is another reason for optimism in Europe. Now that almost all member states have submitted their plans to spend their share of the €800 billion fund (roughly €400 billion in grants and €400 billion in loans), it is possible to estimate its impact on the recovery. These estimates are not overly precise because the fiscal multiplier of the fund's investments is hard to assess. Estimates for the multiplier range from 0.4 to 1, meaning some economists expect that, for every €1 invested, gross domestic product will rise between €0.4 and €1. This is fairly typical for government spending; U.S. stimulus efforts likely carried similar multipliers. As such, the positive impact on the recovery over the next five years will be significant, especially if the take-up of the loans exceeds expectations. So far, five countries have requested a combined €150 billion, which is a very good start. An additional positive aspect of the recovery fund is that member states need to focus their investments on green and digital projects and implement structural reforms aimed at improving public sector efficiency. So far, member states appear to be aiming high with robust proposals and clear targets. This bodes well for the fiscal multiplier although the quality of implementation will still be key.

Everything is relative. We expect European growth to surprise to the upside and for inflation to outpace still-low expectations. On the latter, it is important to emphasize that the higher-than-expected inflation will be seen as a positive development — as it is more indicative of improving growth than an overheating economy. In fact, because European equities have meaningful exposure to cyclical sectors (and greater than U.S./global equities), it will be welcomed by investors. And it's important to repeat that, while the European Central Bank wants to keep real yields low and financing conditions easy, it applauds a move higher in nominal yields if it is caused by higher inflation expectations.

Market implications: Constructive on European equities. The robust recovery continues to bode well for Europe's equity market. As such, we remain tactically overweight the region (often achieved through developed ex-U.S. equities). Government bonds will face a modest headwind and we have increased our 10-year government bond yield forecast for both Germany and the U.K.

What do you think of this commentary? **Click one:** ***Like it*** **—** ***Just okay*** **—** ***Don't like it***