June 2021

THE EUROZONE AWAKENS

Key macro themes

Catching up – The Eurozone has significantly ramped up its vaccination campaign over the past 8 weeks, lifting mobility by a staggering 30% and significantly improving regional growth prospects. Rapidly improving confidence (F1) and limited job losses could even **allow the Euro area to outperform other DMs in 2022** – a first in post-recessionary periods.

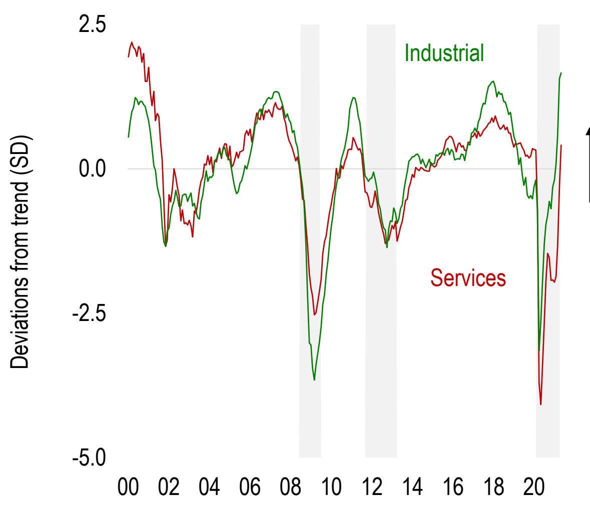
Euro outlook – A narrowing vaccination gap allowed the Euro to appreciate consistently between early April and until last week's FOMC meeting (F2). Although widening interest rate spreads could favour the USD in the very near term, **a reflationary envi- ronment significantly increases the likelihood of EUR appreciation** over the next 12M.

Investment strategy

Europe stocks – European equities are up nearly 20% since the start of the pandemic, breaking a long-term trend of negative returns in the two years following global economic downturns. **We expect the equity rally to continue** over the coming year, with regional indices benefiting from bullish growth prospects, a stronger Euro and a high share of 'reopening' stocks.

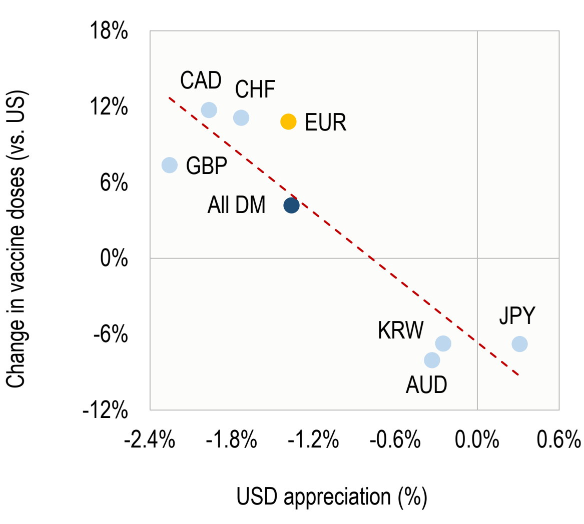
Charts of the month

F1: The Eurozone reactivated
EZ business confidence index



Note: Chart plots the industrial and service sector sub-component of the European Commission's business climate indicator (BCI). Source: European Commission.

F2: Closing vaccine gap favours Euro
DM FX vs. relative vaccination rates - 05/21



Note: Vertical axis measures change in cumulative vaccine doses between selected DMs and the US in May 2021. Source: Oxford University, Federal Reserve; Numera calculations.

Economic activity:

- **DM growth** – *Reflation*. A high vaccine coverage is lifting mobility and sentiment, while reducing policy uncertainty. DM AfH traffic is up 10-points since early May, pointing to higher spending on services. We have upgraded our baseline growth scenario for 2021 by 30 bps to 5.6%+. DM GDP should revert to its pre-COVID path by mid-2022.

- **EM growth** – *Uncertain recovery*. EM economic activity strengthened in May, benefiting from falling COVID cases and improved mobility in Asia and EMEA. In addition, improved vaccine availability has cut back the estimated time towards 70%+ immunity by half to less than six months – boosting consumer and business sentiment.

Equity strategy:

- **DM stocks** – *Overweight*. DM stocks rose 3% last month, fueled by stronger activity, falling uncertainty and low financial stress. A shift in tone by the Fed last week led to a modest sell-off, but the impact should prove transitory in a context of strong global growth and rock bottom real interest rates.

- **EM stocks** – *Select overweight*. EM stocks bounced back this past month, benefiting from rising commodity prices and rising mobility. A bullish growth outlook, a weakening US dollar, and rising global inflation improve the upside of EMEA and LatAm stocks, while falling public health risks reduce the extent of potential losses.

FICC strategy:

- **Fixed income** – *Underweight*. DM 10Y sovereign yields are up 50 bps in 2021, as vaccine optimism lifted growth and inflation expectations while lowering ‘flight-to-safety’ demand. Yields should rise further in H2 on the back of higher inflation. We suggest underweighting bonds in global portfolios, favouring gold and TIPS as macro hedges.

- **Commodities** – *Overweight*. Exceptionally strong demand (partly in expectation of stronger mobility) has caused a commodity ‘bull’ market. Raw material investments should deliver double-digit returns this year, led by further oil price gains. We are less optimistic about industrial metals, which continue to trade well above ‘fair’ value.

- **US dollar** – *Underweight*. The dollar appreciated this past week as the Fed’s more hawkish tone lifted US long-term rates. Because an actual hiking cycle remains unlikely, the USD should weaken over the next 12M weighed down by strong global growth, falling uncertainty, converging vaccination rates and elevated commodity inflation.

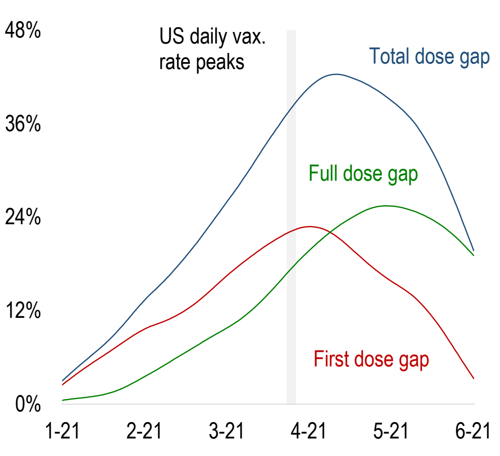
In this section:

- Could the Eurozone finally outperform? (p. 3–5)
- Fed policy and the Euro outlook (p. 5)

Closing the gap – After a slow initial rollout, the Euro area now boasts one of the highest COVID vaccination rates in the world. Eurozone countries are currently inoculating a staggering 1.3% of their population per day, 3.5X faster than the United States. Although the US retains a higher overall coverage, a much higher take-up rate in Europe will soon eliminate the vaccination 'gap' between both regions (F3). At the current pace of vaccination, in fact, **the Euro area should attain 70%+ immunity by mid-August**, six weeks ahead of the United States.

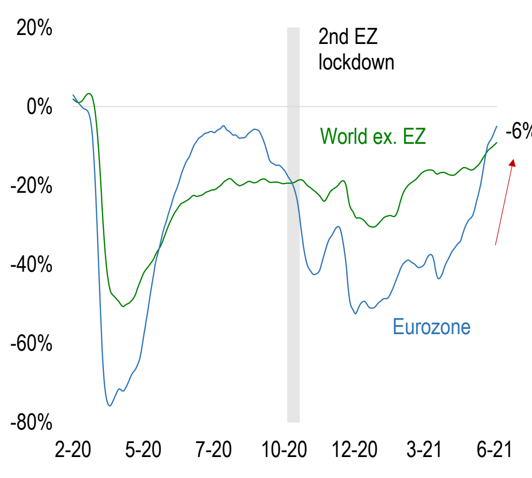
Accelerating vaccination rates have diminished public health risks, allowing authorities to remove targeted lockdown measures. As we can see from F4 below, away-from-home (AfH) traffic in the Eurozone is now 6% below pre-COVID levels, versus a 35% shortfall in early May. The rapid pace of vaccinations is **also lifting consumer and business sentiment** (see F1 in p.1) while reducing economic uncertainty.

F3: Europe is catching up to the US
US - EZ vaccination gap (% population)



Note: Chart compares cumulative COVID vaccine doses administred in US and EZ as a % of the population. Source: Oxford Universty; Numera calculations.

F4: EZ mobility has surged since May
Global away-from-home traffic (%)

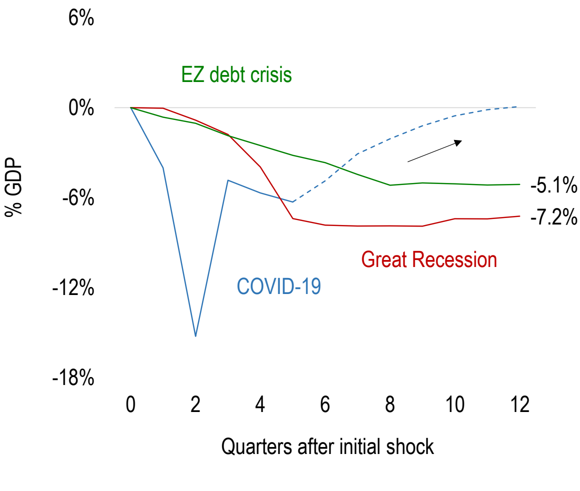


Note: Chart plots changes in retail and recreation (AfH) traffic versus January 2020. Regional aggregates are GDP-weighted. Source Google Mobility, Numera calculations.

All three factors improve the EZ growth outlook, **particularly given limited job losses and high savings rates**. As we consistently emphasized last year, the widespread adoption of wage subsidies in Europe led to a relatively small employment shortfall. Direct transfers further boosted personal income, which in combination with weak consumption have caused EZ household savings to rise $650B (4.5% of GDP) above their long-term average.

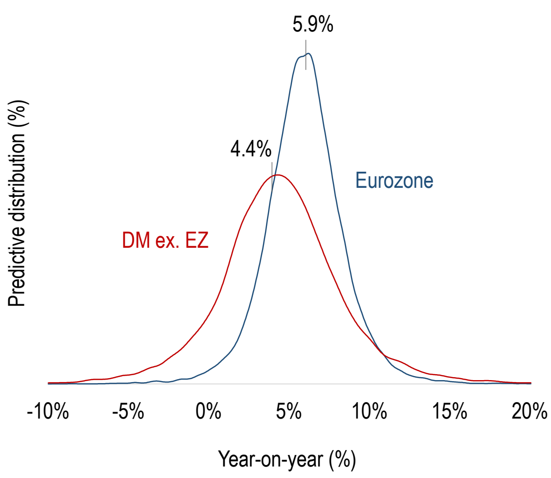
Higher confidence translates into a greater willingness to spend, while less stringent control measures increase the range of goods and services available for consumption. In this context, household spending should become the

F5: Less scarring than in past downturns
EZ output shortfall during deep recessions



Note: The output shortfall is the % difference between actual (and projected) EZ GDP against its pre-crisis path. Source: Numera Analytics.

F6: EZ should outperform next year
DM growth outlook - Q2/22 (%)



Note: Chart compares probability forecasts for YoY GDP growth in the Euro area (blue line) and other DMs (red line) in Q2/22. Source: Numera Analytics.

key driver of EZ growth after weighing heavily on demand so far in the pandemic. Even if disposable income stayed unchanged, these **'excess savings' alone could reduce the region's existing output shortfall by nearly 60%**.

We have upgraded our baseline EZ growth outlook for 2021 by 70 bps to 4.9%. More importantly, the combination of strong private spending and limited employment losses increase the likelihood of a sustained economic recovery. This is in stark contrast to the Great Recession and the EZ debt crisis (F5), when elevated uncertainty and deleveraging efforts by businesses and households caused permanent output losses.

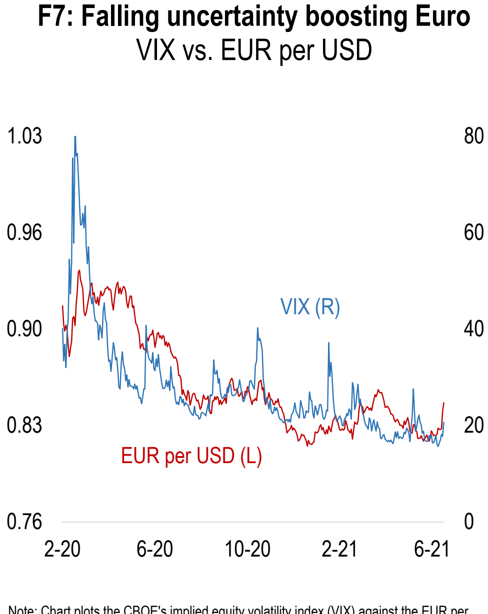
Since the EZ experienced a technical recession in Q1, there is a 75% chance that growth will be weaker than in other DMs in 2021. Nevertheless, a bullish consumption outlook and favourable external conditions means Europe could

T1: DM growth dashboard	Likelihood of stronger 2022 growth than:					
Region	All DM	US	CA	JP	EZ	UK
All DM		40%	66%	80%	34%	15%
United States	60%		66%	78%	47%	28%
Canada	34%	34%		70%	16%	11%
Japan	20%	22%	30%		21%	14%
Eurozone	66%	53%	84%	79%		22%
United Kingdom	85%	72%	89%	86%	78%	

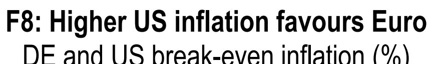
Note: Each row tracks the probability of GDP growth in a given region outpacing other developed markets (including the regional aggregate) in 2022. The columns are the object of comparison, so a green shade represents a higher probability of higher GDP growth than that region. Source: Numera Analytics.

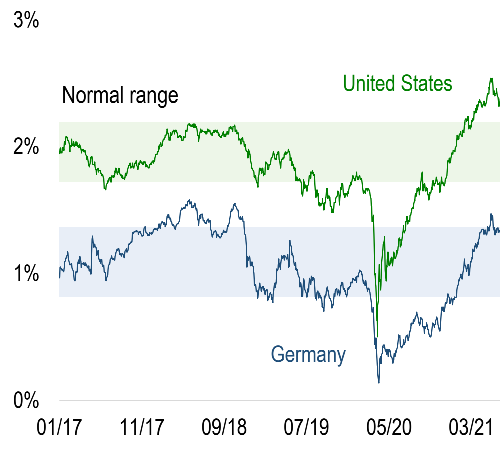
outperform over the medium term (F6). As we can see in T1 above, **we currently estimate a 66% probability that the EZ will outpace other DMs in 2022**, and even a higher than one-in-two chance of stronger growth than the US. This also differs markedly from past downturns, characterized by persistent periods of EZ underperformance.

All eyes on the Euro – The Euro began the year by falling 4% against the USD, as a much faster US vaccine rollout widened relative growth prospects between the US and Europe. While many strategists turned bearish on the Euro during this period, we warned the dollar spike was transitory in nature, expecting the Euro to pick up as vaccine rates converged. This is exactly what happened until last week's FOMC meeting, with **narrowing vaccine differentials causing the Euro to appreciate 3%** after hitting a 5-month low in late March (see F2 in p.1).



Note: Chart plots the CBOE's implied equity volatility index (VIX) against the EUR per USD. Source: CBOE, Macrobond.





Note: Break-even inflation computed as the difference between 10Y nominal yield and the equivalent yield on inflation linked bonds. Source: Macrobond.

Most of these gains reversed this past week, however, as Fed officials signaled a faster-than-expected normalization of US monetary policy. The shift in tone lifted US long-term Treasury yields, increasing the opportunity cost of holding other reserve currencies. But will wider interest rate spreads dominate beyond the very near term?

In our view, the Euro should quickly move past this near-term rout, **appreciating 5¢ or more against the USD** over the next 12M. Besides differences in vaccination rates, the Euro should benefit from strong global growth and falling market volatility. Lower volatility limits flight-to-safety demand, exerting downward pressure on the dollar (F7).

Another key factor favouring a strong Euro are widening relative price differentials. Higher US inflation (F8) weakens the international competitiveness of US-made goods versus EZ alternatives. Substitution towards EZ products would cause the EUR to strengthen on a trend basis. **We currently estimate a 61% chance that the EUR will appreciate against the USD 12M out**, 9 points higher than two months back.

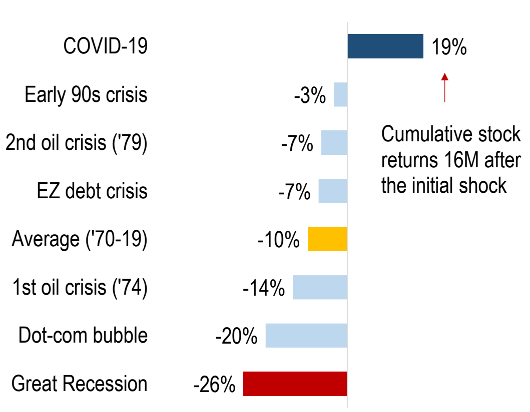
In this section:

- How sustainable is Europe's equity rally? (p. 6–7)

Europe's time to shine – The long-lasting impact of recessionary shocks in Europe makes EU equity investments especially vulnerable to economic contractions. We can see this in F9 below, which compares real cumulative returns on European equity investments during past recessions. Prior to the pandemic, EU stocks have *always* taken longer than a year and a half to recover, falling short of pre-crisis levels by 10% on average 16M after the initial shock.

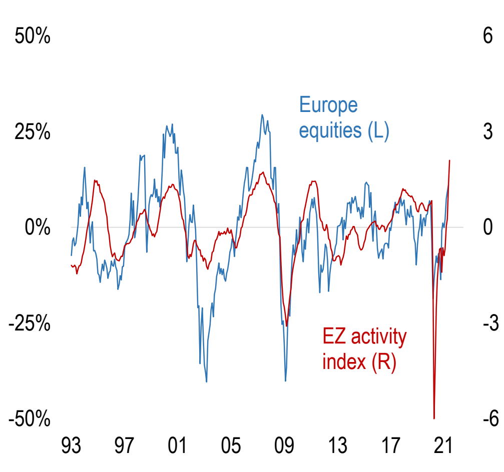
COVID-19 represents a clear break from this pattern, with investors shrugging off Europe's 'double dip' recession and focusing instead on government support and global vaccinations. As a result, **EU stocks have risen continuously since the initial COVID shock**, and are now 19% higher than before the pandemic (F9).

F9: Markets shrugged off 'double dip'
Europe stock returns following downturns



Note: Cumulative USD returns on European equity investments in the 16 months following a global or EZ-specific recession. Source: MSCI; Numera calculations.

F10: Rally supported by fundamentals
EU stocks vs. Numera EZ activity index

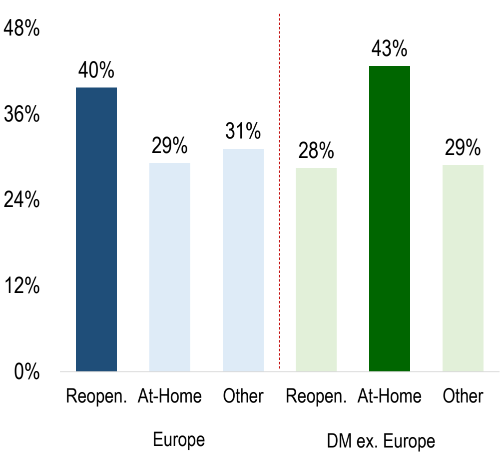


Note: Chart compares trend deviations in European equities (in EUR) versus Numera's EZ real activity index (in standard deviations). Source: MSCI, Numera Analytics.

Since most of these gains took place during a technical recession (EZ GDP contracted in Q4/20 and Q1/21), however, the rally could have caused prices to detach from fundamentals. If stocks are trading at a premium, this weakens their upside while exposing new investments to deeper potential losses. We can gauge the degree of price misalignments by comparing fluctuations in European equities against Numera's EZ real activity index (F10).

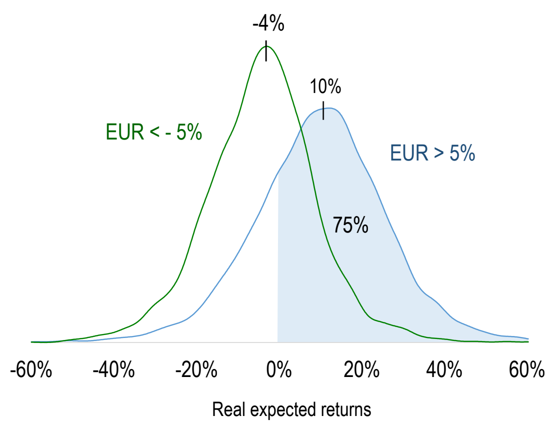
Our proprietary index measures actual and *expected* changes in regional economic activity, condensing information from 30+ EZ-wide and country-specific indicators at various frequencies. In contrast to the asset bubbles of the late 1990s and mid 2000s, **the latest rally matches improvements in domestic cyclical conditions**. Everything else constant, this improves the risk-reward balance of European equities versus a situation in which 'fear of missing out' pushes prices well above their fair value (e.g. as was the case in Europe prior to the Great Recession).

F11: Reopoening benefits EU stocks
Equity sector shares by region (%)



Note: Reopening defined as the sum of materials, energy, industrials and consumer discretionary; At-Home composed of IT, staples, communication services and utilities. Source: MSCI, Numera calculations

F12: EUR outlook has major implications
EU conditional equity outlook - 12M ahead



Note: The blue/green line shows the 12M probability forecast for European equity investments conditional on 5%+ EUR / USD appreciation rates. Shaded area denotes likelihood of positive returns conditional on a 5%+ EUR appreciation. Source: Numera Analytics.

Strong GDP growth should improve the profitability of EZ firms over the coming year, boosting local currency returns. In addition, **Europe should benefit from compositional changes in demand** as expenditure patterns normalize. Unlike the US stock market, 'at-home' stocks like IT make up a reasonably small portion of Europe's equity universe (F11). In contrast, 'reopening' sectors account for a very high share of overall market cap.

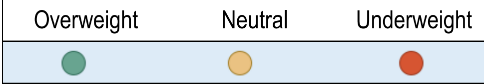
Besides growth and earnings prospects, the attractiveness of European equities depends heavily on the Euro outlook. Unlike past recessions, the US dollar has weakened against the Euro on a trend basis over the past year, explaining roughly 40% of the overall improvement in EU stocks during this period.

F12 and T2 compare the projected performance of European stocks conditional on two alternative FX scenarios. **If the EUR appreciates 5%+, EU stocks will likely strengthen 10%+**, with a 75% chance of positive real returns. In contrast, a 5%+ depreciation would probably result in equity losses of 4%+. Since the EUR will likely appreciate 12M out, this translates into a 61% probability of positive returns – enough to justify an absolute overweight stance.

T2: EU equity outlook 12M ahead	+5% EUR Depreciation	Unconditional	+5% EUR Appreciation
Real expected returns	-4.5%	4.0%	9.8%
Positive returns probability	36%	61%	75%
Left-tail risk (5% cVaR)	-35%	-30%	-27%

1. Investment recommendations

Position:



Global equity calls[1] Asset class	Absolute	Relative[2]	Downside risk	Comments[3]	Last change[3]
DM equities *World MSCI TR USD*	Overweight	-	High	Falling downside risk	Feb. 21
Australia	Neutral	Neutral	Moderate		-
Canada	Overweight	Overweight	Moderate	Falling downside	Mar. 20
Europe	Overweight	Neutral	Moderate	Falling downside	Jan. 21
France	Overweight	Neutral	Moderate		-
Germany	Neutral	Neutral	High		-
Italy	Overweight	Neutral	Low	Upgraded (abs / rel)	Jun .21
Netherlands	Overweight	Overweight	Moderate	Upgraded (abs / rel)	Jun. 21
Spain	Neutral	Underweight	High		-
Switzerland	Overweight	Overweight	Moderate	Upgraded (abs)	Jun. 21
United Kingdom	Neutral	Underweight	High		May. 21
Japan	Neutral	Underweight	High		Dec. 20
United States	Overweight	Overweight	Moderate		Feb. 21
EM equities *EM MSCI TR USD*	Neutral	Neutral	Moderate		Apr. 21
EM Asia	Neutral	Neutral	Moderate		-
China	Neutral	Neutral	Moderate		May. 21
India	Underweight	Underweight	Moderate		Apr. 21
South Korea	Overweight	Overweight	Low		-
Taiwan	Neutral	Neutral	Low		Apr. 21
EM EMEA	Overweight	Overweight	Low	Upgraded (rel)	-
Russia	Overweight	Overweight	Low		-
South Africa	Overweight	Neutral	Moderate		-
Latin America	Neutral	Neutral	Moderate	Upgraded (rel)	May. 21
Brazil	Neutral	Underweight	Moderate		May. 21
Mexico	Neutral	Neutral	Moderate		-

Global FICC calls[1] Asset class	Absolute	Relative[2]	Downside risk	Comments[3]	Last change[3]
DM sovereign bonds *World BAML TR USD*	🟡	🔴	Moderate	Downgraded (rel)	Sep. 20
Eurozone	🟡	🟡	Moderate		Oct. 20
Japan	🔴	🔴	High		May. 20
United States	🟡	🔴	High	Rising downside	Sep. 20
EM HC bonds	🟢	🟡	High		-
EM LC bonds	🟢	🟢	High		Aug. 20
Cash	-	🟢	Low		Feb. 20
Commodities *S&P GSCI TR*	🟢	🟢	High		Jul. 19
Crude oil	🟢	🟡	Moderate	Downgraded (rel)	Jul. 19
Gold	🟡	🔴	Moderate		Jul. 20
Base metals	🔴	🔴	High		-
Aluminum	🟡	🔴	Moderate	Potential downgrade	-
Copper	🟡	🔴	High		Apr. 21
USD vs. DM FX [4]					
CAD per USD	🔴	-	High		Feb. 20
EUR per USD	🔴	-	Moderate		May. 21
GBP per USD	🔴	-	Moderate		Jan. 21
JPY per USD	🔴	-	Low	Downgraded	Jun. 21
USD vs. EM FX					
BRL per USD	🔴	-	High	Downgraded	Jun. 21
CNY per USD	🟡	-	Moderate		Apr. 21
MXN per USD	🟡	-	Moderate		-
RUB per USD	🔴	-	High		-

1. Investment recommendations for a 12-month holding period (June 2020 - July 2021).
2. In every case, relative performance versus World MSCI TR. Please see charts on p. 10 for a full asset comparison.
3. Indicates change in position and warns of potential changes; last column tracks changes in absolute position.
4. All currency calls are from the perspective of the US dollar. An underweight position means 'underweight USD'.

Note: Click here for our in-depth commentary and underlying probability forecasts.

2. Asset comparison

Charts compare expected gains to potential losses for individual assets over a 12M holding period. Numbers in red rank assets by their risk-reward ratio. To rank investments, we divide excess returns (against a minimum acceptable rate) to the downside risk measure. The resulting metric is the 'Omega ratio', a measure of investment quality that explicitly considers risk preferences. The investment calls on p.9, in turn, depend on the evolution of the Omega ratios over time, which signal whether investors should increase, maintain or reduce their exposure to specific assets. The top panel is the ranking for balanced investors, who attach greater value to assets with a low likelihood of undergoing extreme losses. The bottom panel ranks assets for growth investors, with a higher risk tolerance.