Eriswell Market Insights

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EU Recovery: Forecast or Utopian Dream?

BY MARK PAGE, MANAGING PARTNER

The current combination of degraded conventional economic yardsticks and the enhanced importance of storytelling in a low-r* world opens the possibility that people confuse dreams with unbiased forecasts.

Hopes are high for the EU's new Recovery and Resilience Facility, a breakthrough agreement to borrow €750 billion to fund €390 bn in outright grants and €360 bn in loans to member states. This is the first time the EU had collectively borrowed to finance expenditures, and the first time outright transfers will made to member states primarily at the discretion of the EU not its member states.
The 'Recovery and Resilience Facility' is designed to:

- *"Address the main challenges they are facing identified in the European Semester, in areas such as competitiveness, productivity, education and skills, health, employment, and economic, social and territorial cohesion."*
- *"Ensure adequate focus of these investments and reforms on the challenges related to the green and digital transitions, to help create jobs and sustainable growth and make the Union more resilient."*

Utopian dreams aside, it would be money very well spent if the EU could even restart stalled productivity. In practice, however, €390 bn represents 3% of EU GDP, enough money to meaningfully support southern countries: Portugal (5% of GDP), Spain (4%), Greece (9%), alongside continued development aid to the Eastern EU.

While it is politicians' job to dream, the balance between storytelling and numerical forecasts has also been altered in stock and bond valuations. This is because a greater and greater proportion of a security's value is represented by faraway events and cashflows as interest rates fall, i.e. well beyond the horizon of traditional forecasting techniques.

This insight and the models that flow from it underpins our Barbell Stock Strategy, currently up 31% vs benchmark since April 1, 2020.

We all instinctively relate to tales which address the journey from the 'imperfect present' to the 'perfect future'. Deep emotions are evoked by these stories; in fact, the expression, "Let there be light" is translated from the Torah, the first part of the Hebrew Bible.

However, whether one is a left-brain number-cruncher or right-brain dreamer, hard data helps to convince all of us that the underlying stories are correct. In which vein it is worth noting that, today, there is no reliable numerical support for either the upbeat ECB or EU economic narratives. Conventional econometric yardsticks and models have been seriously degraded by the collapse in EUR r* to zero and below, and little consensus exists as to whether these models should be replaced and if so by what.

Free from the constraints of numerical scrutiny, the EU and to a lesser extent the ECB are free to dream. Perhaps the new Recovery and Resilience Facility will finally open the door to similar future EU initiatives and perhaps ultimately fiscal union.

Aware of the reputational damage, if this goes wrong, the European Commission is taking its time to agree on the priorities and conditions it will attach to the new grants and loans. As a consequence, under 10% of the funds are expected to be disbursed in fiscal year 2021, 12-16% in 2022, with the rest later. The EU views this delay as a strength not a weakness.

The thinking is that rather than providing a traditional Keynesian stimulus, which national governments are already implementing to the tune of 6-11% of national GDP, the Recovery and Resilience Facility is instead designed to underpin the structural reforms necessary to boost productivity, increase territorial cohesion, and all the rest of it. Protecting its central role, the EU will ask national governments to devise initial plans that support its objectives but which, importantly, the EU will be under no obligation to accept.

Well, that is the dream; the EU has fought and lost numerous battles to make financial support conditional on politically explosive societal reforms, rule of law constraints, milestones, and targets; Italy, Poland, and Hungary being the obvious examples.

There's little point diving into a forensic dissection of this Recovery and Resilience dream; dreams were never made for that. Investors must nevertheless recognise that what they are looking at here is a dream, a hope, and worthy as it may be, it is not a forecast and has little numerical basis.

The current combination of degraded conventional economic yardsticks and the enhanced importance of storytelling in a low-r* environment, however, opens the door to people confusing political dreams with reliable forecasts.

In which circumstances, every effort must be made to develop new models for the purpose of accurately pricing assets in today's new world.

Mark Page

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