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Market views and strategy

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Topic of the week: Mario Draghi alerts the EU to the urgent need to act to increase productivity

by Aline Goupil-Raguénès

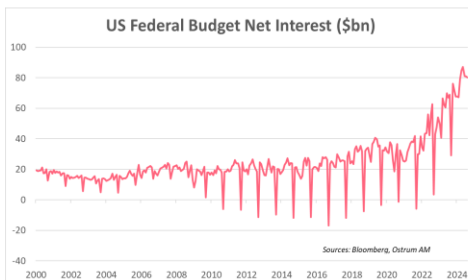
- Mario Draghi's report provides an accurate overview of Europe's decline compared to the United States in terms of productivity and China's rapid catch-up, in a world that has become less collaborative;
- It identifies three areas of action. The most important: reduce the innovation gap with the United States and China, particularly in advanced technologies, develop a common decarbonization and a productivity plan to strengthen defense and reduce dependencies;
- Massive investments are necessary: 750 to 800 billion euros per year in additional investments according to the EC and the ECB. Part of it will have to be financed by the public sector, notably through an increase in common debt;
- Mario Draghi warns of the urgency of acting collectively to avoid “a slow agony” of the EU. The question now concerns the political will of governments to take up this “existential challenge”.

Market review: The Fed in "Risk Management" Mode

by Axel Botte

- The Fed acts preemptively by cutting rates by 50 bp;
- The BoE and the BoJ maintain status quo on rates;
- Curve steepening resumes;
- Equities and high yield react positively to monetary easing.

Chart of the week



The Fed's decision to opt for a 50 bp rate cut, and not 25 bp, was justified by J. Powell as an insurance to protect against a more marked deterioration in the job market.

The reason may also be found in this graph. Government spending on net interest has increased sharply in recent years, reaching $80.2 billion in August compared to $68 billion a year ago. This reflects higher public debt and rising interest rates.

By lowering its key rates more quickly, the Fed makes it easier to finance the government's debt service.

Figure of the week

1

Only one Fed member opposed the 50 basis point rate cut: Michelle Bowman. She wanted a reduction of 25 bp. This disagreement is rare for a member of the Board of Governors.
Source: Fed

Topic of the week

Mario Draghi alerts the EU to the urgent need to act to increase productivity

Mario Draghi's report on the competitiveness of the EU, commissioned a year ago by the European Commission, was eagerly awaited. It provides a fair overview showing the EU's decline in relation to the United States and China's rapid catch-up in a world that has become less cooperative. Mario Draghi presents recommendations to increase the competitiveness of the EU and sounds the alarm. It is urgent to act collectively and invest massively to avoid a "slow agony" of the EU. Europe faces "an existential challenge".

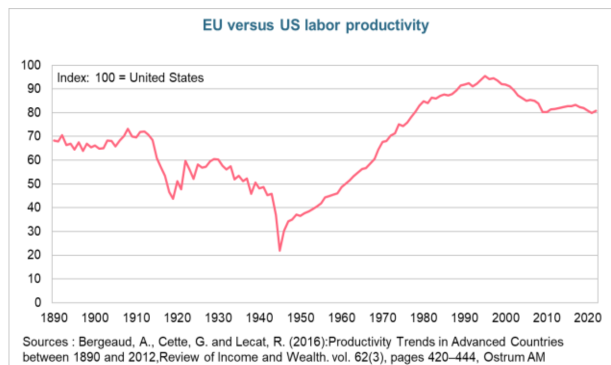
The observation: durable slow growth due to low productivity

EU growth is slower than that of the United States while China is catching up strongly

For decades, growth in the EU has been slowing. For almost 25 years, the EU's growth has been slower than that of the United States, while at the same time China has quickly caught up. As a result, the growth gap between the EU and the United States has steadily increased from a little over 15% in 2002 to 30% in 2023. In terms of GDP per capita expressed in power parity purchasing (PPP), the gap with the United States is also significant: 34% (31% in 2002).

This is linked to the sharper slowdown in EU productivity

The more pronounced slowdown in EU productivity growth explains 70% of the gap in GDP per capita with the US (expressed in PPP). European households have suffered the consequences through lower income growth and weaker internal demand. Real disposable income per capita has in fact increased almost twice as much in the United States as in Europe since 2000.



Sources : Bergeaud, A., Cette, G. and Lecat, R. (2016):Productivity Trends in Advanced Countries between 1890 and 2012,Review of Income and Wealth. vol. 62(3), pages 420–444, Ostrum AM

Three external supporting factors are also fading

In addition to this persistent weakness in productivity, the EU must also face the

dissipation of 3 factors that supported its growth.

Multilateral world trade

The period of strong growth in global trade appears to have passed in a context of trade tensions

The weakness of internal demand was partly offset by the dynamism of world trade. European exporters gained market share in the goods they specialized in, in high-growth areas, such as Asia, and imported goods and services they needed (such as certain raw materials and technological goods). Between 2000 and 2019, the share of foreign trade in EU GDP increased from 30% to 43%, while it remained relatively stable in the United States (from 25% to 26%).

Since then, multilateral international trade has been in crisis with a sharp increase in trade tensions and a world that has become less cooperative. The period of strong growth in world trade thus seems to have passed, with the EU facing increased foreign competition and more restricted access to foreign markets.

Importing energy at a relatively attractive price

The EU had to do without cheap Russian energy very quickly

Until 2021, the EU massively imported energy from Russia at a relatively cheap price. In 2021, 45% of EU natural gas imports came from Russia via pipeline. The war started by Russia in Ukraine has completely changed the situation. The EU had to suddenly do without Russian energy by investing in infrastructure to import liquefied natural gas at a higher cost.

Geopolitical stability under the hegemony of the United States

Need to strengthen EU defense

Geopolitical stability has allowed the EU to separate its economic policy from security considerations. It has also been able to devote more public spending to its national objectives due to lower spending allocated to defense. This framework is changing following tensions between China and the United States, the war started by Russia in Ukraine and growing instability in Africa, a source of crucial goods for the global economy.

Added to this, as in many countries, is the rapid aging of the population which will weigh on long-term growth. By 2040, the EU working population is expected to fall by 2 million each year. The report indicates that if productivity growth were maintained at the average rate recorded since 2015, this would only keep GDP constant until 2050.

For Mario Draghi, the EU faces an existential challenge

Mario Draghi therefore calls on governments to act quickly. “If Europe fails to become more productive, we will be forced to choose: we will not be able to be at the same time a leader in new technologies, a beacon of climate responsibility and an independent actor on the world stage; we will also not be able to finance our social model; and we will have to scale back some of our ambitions — if not all. It’s an existential challenge.” Mario Draghi is thus urging Europe to make a radical change, failing would expose it to “slow agony”.

Three areas of action to revive growth

Most important: Reduce the innovation gap with the United States and China, particularly in advanced technologies

The productivity gap between the EU and the United States since 2000 comes mainly from

Only 4 of the 50 largest global technology companies are European

the technology sector. Only 4 of the 50 largest global technology companies are European. EU companies specialize in mature technologies where the potential for technological breakthrough is limited. According to the report, the EU's industrial structure is static: few new companies emerge and disrupt existing businesses or create new engines of growth. Spending on research and development is therefore lower than that of the United States (270 billion euros less in 2021).

Difficulty translating innovation into commercialization

The problem is not the lack of innovation in Europe but the fact that it is difficult to translate it into commercialization. In addition, innovative companies that want to develop face heavy regulation, sometimes inconsistent, leading some of them to find sources of financing abroad, in venture capital companies in the United States, and to develop across the Atlantic.

The EU must act to place itself at the forefront of new technologies, seize the opportunities linked to Artificial Intelligence and integrate it into industrial sectors. A central element will be improving skills to benefit from new technologies. Accelerating innovation and identifying new growth drivers will help increase productivity.

Common plan combining decarbonization and competitiveness

The ambitious targets set by the EU for decarbonization can be achieved through coordinated policies within a coherent framework.

EU energy prices are much higher than in the US

Despite the sharp drop in energy prices since the energy shock of 2022, they remain much higher than in the United States: 2 to 3 times higher for electricity prices and 4 to 5 times higher for natural gas. This is linked to the lack of natural resources but also to questions relating to the common energy market. Operating rules do not allow households and businesses to pass on the benefits of clean energy to their bills.

In order for the decarbonization of the economy to be a source of growth, a common plan is necessary for industries producing energy and those responsible for decarbonization, such as clean technologies and automobiles.

Strengthen security and reduce dependencies

Mario Draghi advocates a real “foreign economic policy”

Security is a prerequisite for sustainable growth. Rising geopolitical risks can increase uncertainty and weigh on investments. Major geopolitical shocks and the cessation of trade have harmful consequences. In a context of increasing geopolitical risks, Europe is particularly exposed given its greater dependence on foreign trade. It is also very dependent on a few suppliers for the supply of essential raw materials, in particular from China, which is the subject of strong demand for the energy transition. Europe is also very dependent on imports of digital technology. Mario Draghi recommends a real “external economic policy” of the Union to “coordinate preferential trade agreements and direct investments with resource-rich countries, build up stocks in certain critical areas and create industrial partnerships to secure the supply chain of key technologies”.

In terms of defense, Europe collectively has the 2nd largest military budget in the world but the defense industry is too fragmented, which prevents it from producing on a large scale and is limited by a lack of standardization of equipment.

Massive investments to finance

Need for 750 to 800 billion euros per year in additional investments

In order to achieve the objectives set by the EU in terms of digital technology, decarbonization and defense, massive investments must be made. The report is based on estimates from the European Commission: they are of the order of a minimum of 750 to 800 billion euros of additional investments per year, which represents between 4.4% to 4.7%. of EU GDP in 2023. The ECB services also arrived at the same conclusions: 750 billion euros per year. This is unprecedented. This represents an increase in the share of investment in EU GDP of 5 percentage points, reaching the levels that prevailed in the 1960s and 1970s. For comparison, from 1948 to 1951, in the framework of the Marshall Plan, investment increased between 1 and 2% of GDP per year. The effort to be made is therefore more than double the Marshall Plan.

Need to move forward on the Capital Markets Union

Financing these massive investments requires progress in the capital markets union. The Draghi report agrees with that of Enrico Letta on the subject. The goal is to retain European savings, which are greater than American savings, to finance the EU's productive investments.

Most of the financing will be provided by the private sector, part by the public sector

The private sector will not be able to finance most of these investments without support from the public sector. Historically, EU investments are 80% financed by the private sector and 20% by the public sector. In order to facilitate financing, it is important that governments take the necessary measures to increase productivity growth and thus give them more budgetary room for maneuver. The report indicates that a 2% increase in the level of total factor productivity over 10 years would finance a third of the cost of these investments for governments.

Joint financing of certain key public goods such as advanced technologies

Finally, joint financing will be needed to finance joint investments in certain key European public goods such as advanced technologies, defense spending and cross-border networks. Mario Draghi recommends continuing to issue safe common assets but on a more regular basis, based on the NextGeneration EU model. It also suggests that Member States postpone Next Generation EU reimbursements in order to increase the Commission's available resources. To do this, tax rules must be strengthened so that the increase in common debt goes hand in hand with a more sustainable trajectory of government debt.

Strengthen governance

The EU decision-making process is too slow

The EU decision-making process has barely changed with the enlargement of the EU in a world that has become less cooperative at the same time. “Decisions are usually made on an issue-by-issue basis, with multiple vetoes along the way.". It takes on average 19 months to adopt a law. A strengthening of the EU requires a Treaty change. Targeted adjustments can be made while consensus is reached for that. Until consensus is reached for a Treaty change, the report calls for a renewed European partnership based on 3 objectives: refocusing the work of the EU, accelerating its action and integration and simplifying the rules.

Conclusion

Europe faces “an existential challenge” and must act collectively to revitalize its industrial policy and increase its productivity. Radical changes are needed to

achieve this. They require real political will. Europe has in the past taken decisive measures under the leadership of the Franco-German couple. This was particularly the case for the creation of Next Generation EU, paving the way for massive joint financing to enable all economies to deal with the consequences of the Covid-19 crisis. The EU was on the brink of the precipice and had to act quickly. There, the competitiveness problem is structural and can wrongly give the feeling that there is no real urgency. In addition, as soon as the report was released, German Finance Minister Christian Lindner rejected Mario Draghi's proposal to use more common debt to finance cutting-edge innovations and certain public goods. This even though Germany suffers greatly from a lack of competitiveness linked to its heavy past dependence on Russian energy. The French government is also weakened by a very divided Parliament. The risk is that Mario Draghi's cry of alarm will not be followed by decisive measures on the part of governments to collectively increase the competitiveness and productivity of the EU and that the Union will be faced with the risk of experiencing, according to the words of Mario Draghi, "a slow agony".

Aline Goupil-Raguénès

Market review

The Fed in "Risk Management" Mode

The Federal Reserve has reduced its rate by 50 bp, significantly altering the trajectory of interest rates for the coming year. This monetary easing has triggered a notable rebound in equities and a renewed steepening of the yield curves, with high-yield bonds outperforming. The yen remains volatile, reflecting the ambiguous communication from the Bank of Japan.

The suspense was palpable, and the Fed ultimately chose a 50 bp cut, bringing the benchmark rate down to 5%. This decisive move initiates a recalibration of U.S. monetary policy towards a neutral stance, estimated to be around 3%. The 50 bp reduction serves as an assurance aimed at preventing unemployment from exceeding the current equilibrium level (4.2% in August). Should the labor market deteriorate, the Fed would not hesitate to accelerate its actions. Quantitative tightening is expected to conclude soon. Inflation is approaching the target, with a projected deflator of 2.2% in August. Recent activity data—retail sales, Empire State Index, and Philadelphia Fed Index—reinforce our forecast of 2.5% (annualized rate) growth between July and September. In the shadow of the Fed, the Bank of England maintained its status quo at 5%, without altering the pace of its balance sheet contraction (£100 billion per year). The Bank of Japan kept its rate unchanged despite inflation at 3%, while reaffirming its intention to raise rates by year-end. The yen exhibited significant volatility this week, fluctuating between 140.50 following the Fed's decision and peaking at 144 against the dollar.

Financial markets welcomed the 50 bp rate cut. U.S. equities rose between 3% and 5%, with similar positive trends observed in Europe and Asia. Volatility decreased (16% on the VIX), pulling synthetic credit indices along. The iTraxx Crossover (S41) consequently fell below 280 basis points. In this risk-friendly environment, gold's rise above $2,600 per ounce raises eyebrows, potentially reflecting a defensive response to the risk of a speculative bubble in equities.

The 10-year Treasury note stabilized around 3.70% following some profit-taking in long-term rates. The 30-year Treasury bond (4.06%) is trading at the same yield as a month ago, while the 2-year note has dropped by 38 basis points. The Bund remains less volatile than the Treasury note, hovering around 2.20%. The steepening of the curve is accompanied by a modest increase in inflation breakevens, with the 10-year Bund breakeven trading at 1.75%. Selling pressure on inflation-linked bonds remains predominant. Sovereign debt spreads are stable, except for France, due to deteriorating public finances. The primary market was relatively quiet ahead of the Fed's announcement. EU spreads reacted to the potential for issuance should Draghi's plan be adopted, before retracing towards the end of the week.

Investment-grade credit (-7 bp) benefits from the favorable financial environment and positive flows, despite the underperformance of cyclical sectors (autos), which is also observed in the European equity market. The spread on high-yield bonds is tightening rapidly (-27 bp in Europe).

Axel Botte

Main market indicators

G4 Government Bonds	23-Sep-24	1wk (bp)	1m (bp)	2024 (bp)
EUR Bunds 2y	2.17%	-1	-20	-23
EUR Bunds 10y	2.18%	+5	-5	+15
EUR Bunds 2s10s	0bp	+6	+15	+39
USD Treasuries 2y	3.6%	+5	-32	-65
USD Treasuries 10y	3.77%	+15	-3	-11
USD Treasuries 2s10s	16.5bp	+10	+28	+54
GBP Gilt 10y	3.93%	+17	+1	+39
JPY JGB 10y	0.85%	+0	-12	-52
€ Sovereign Spreads (10y)	23-Sep-24	1wk (bp)	1m (bp)	2024 (bp)
France	78bp	+7	+5	+24
Italy	135bp	-1	-6	-32
Spain	79bp	0	-4	-17
Inflation Break-evens (10y)	23-Sep-24	1wk (bp)	1m (bp)	2024 (bp)
EUR 10y Inflation Swap	1.93%	-2	-10	-21
USD 10y Inflation Swap	2.37%	+6	+0	-5
GBP 10y Inflation Swap	3.46%	+5	-4	-8
EUR Credit Indices	23-Sep-24	1wk (bp)	1m (bp)	2024 (bp)
EUR Corporate Credit OAS	115bp	-6	-2	-23
EUR Agencies OAS	65bp	+0	+1	-5
EUR Securitized - Covered OAS	60bp	0	-1	-19
EUR Pan-European High Yield OAS	363bp	-16	-9	-36
EUR/USD CDS Indices 5y	23-Sep-24	1wk (bp)	1m (bp)	2024 (bp)
iTraxx IG	59bp	+5	+7	+0
iTraxx Crossover	313bp	+23	+26	-1
CDX IG	52bp	+3	+2	-4
CDX High Yield	310bp	-15	-15	-47
Emerging Markets	23-Sep-24	1wk (bp)	1m (bp)	2024 (bp)
JPM EMBI Global Div. Spread	369bp	-16	-28	-15
Currencies	23-Sep-24	1wk (%)	1m (%)	2024 (%)
EUR/USD	$1.113	-0.054	-0.581	0.8
GBP/USD	$1.333	0.855	0.870	4.7
USD/JPY	JPY 144	-2.198	0.410	-1.9
Commodity Futures	23-Sep-24	-1wk ($)	-1m ($)	2024 (%)
Crude Brent	$74.5	$1.8	-$3.7	-1.0
Gold	$2 627.9	$45.5	$115.3	27.4
Equity Market Indices	23-Sep-24	-1wk (%)	-1m (%)	2024 (%)
S&P 500	5 703	1.36	1.21	19.6
EuroStoxx 50	4 889	1.28	-0.40	8.1
CAC 40	7 499	0.67	-1.03	-0.6
Nikkei 225	37 724	2.42	-1.67	12.7
Shanghai Composite	2 749	1.17	-3.69	-7.6
VIX - Implied Volatility Index	16.37	-4.49	3.22	31.5

Source: Bloomberg, Ostrum AM

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