Ostrum
ASSET MANAGEMENT

MyStratWeekly

Market views and strategy

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N° 072 // **May 30, 2022**

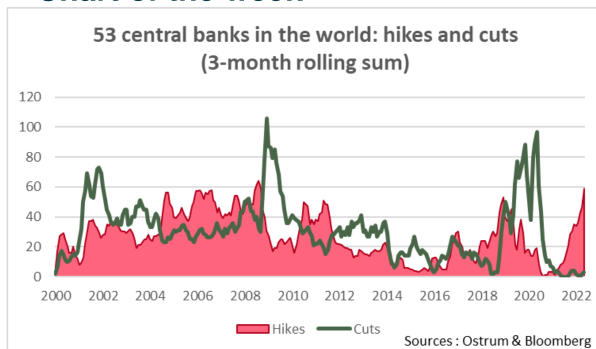
Topic of the week: REPowerEU: Urgency to quickly reduce EU's heavy dependence on Russian energy

- **The REPowerEU plan aims to make the EU independent of Russian energy well before 2030 while achieving carbon neutrality by 2050;**
- **It is based on 4 axes: increasing energy savings, diversifying sources of supply, accelerating the deployment of renewable energies and making massive investments;**
- **The Recovery and Resilience Facility will play an essential role alongside Member States and private investments;**
- **The success of this plan depends on the will and the capacity of the Member States to cooperate and carry out the investments and reforms essential to ensure the energy security of the EU.**

Market review: A little respite for equities

- **Bond rally and strong rebound in US equities;**
- **The dollar drops; euro through $ 1.07 threshold;**
- **Bond sales weigh on 30-year euro yields;**
- **Fragile equilibrium in euro credit space.**

Chart of the week



On our count there has been 59 rate hikes in the world over the past 3 months. This is very close to the all time high recorded in mid-2008 slightly above 60 hikes. This follows a near-record high number of cuts in 2020 during the Covid pandemic outbreak.

Many comments are concentrated on the major central banks, the Fed and the ECB notably that are putting in place their exist strategy. But this has to be viewed in a much general context of global monetary tightening.

Figure of the week

8%

Source : Ostrum AM

So far this is year, analysts' EPS expectations for the EuroStoxx have been revised up by 8%. This is yet another example of the resilience of profits, despite all the headwinds.

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Topic of the week

REPowerEU: urgency to quickly reduce the EU's heavy dependence on Russian energy

The European Commission has just presented the details of its REPowerEU plan intended to become independent of Russian fossil energy well before 2030. It is based on four axes: achieving more energy savings, diversifying reliable sources of supply, accelerate the deployment of renewable energies and make the massive investments required. There is an urgent need, both for security and climate reasons, to act now and in a coordinated manner to put an end to this dependence while achieving the objective of carbon neutrality by 2050.

Urgency to end the EU's heavy dependence on Russian energy

Beyond the human drama, the conflict in Ukraine has confirmed the strong vulnerability of the European Union vis-à-vis its strong dependence on Russian energy. Russia is in fact the leading energy supplier of the European Union in coal, oil and especially natural gas. In 2021, the EU consumed 400 billion cubic meters (bcm) of natural gas, 90% being imported. Nearly 45% of these imports came from Russia (i.e. 155 bcm).

This poses a threat to EU energy security, as demonstrated by Russia's recent decision to abruptly cut off natural gas supplies to Poland, Bulgaria and Finland following their refusal to make payments in rubles. Fears that a sudden stop in Russian supplies will affect other countries are increasing with the very near expiry of contracts to be paid for natural gas deliveries.

Moreover, by continuing to import, the EU contributes to increasing the revenues of the Russian State and thus indirectly financing the war in Ukraine, which is totally contradictory to the values of the EU and the sanctions it imposed against Russia.

In order to quickly reduce this dependence, the European Commission (EC) has already announced that it will stop Russian coal imports by August. Discussions are underway among member countries, as part of the 6th sanctions package, to stop imports of Russian crude oil gradually by the end of the year. A deadline would be granted to the most dependent countries such as Slovakia, the Czech Republic and Hungary. The latter opposes it for the moment, asking for additional time and resources to modernize its oil infrastructure since it currently has no means of substitution.

The thorniest point comes from Russian natural gas, on which the EU is very dependent, and which does not currently benefit from sufficient infrastructure to transport gas from other countries to the most dependent countries, such as the Baltic countries, Eastern European countries, but also Germany.

The REPowerEU plan

The European Commission thus proposed, on March 8, the outline of a plan to reduce and end the heavy dependence on Russian energy well before 2030 by focusing very largely on natural gas. It has thus announced a target of reducing its imports of Russian natural gas by 2/3 by the end of the year (i.e. a reduction of 100 bcm) and becoming independent well before 2030. During the Versailles summit of 24 and 25 March, the Heads of State validated this objective and invited the EC to draw up a detailed plan. This one, called REPowerEU, was thus presented on May 18. It is an ambitious plan aimed at putting an orderly and coordinated end to Russian gas imports without jeopardizing the achievement of the objective of carbon neutrality by 2050 and the intermediate objective of reducing greenhouse gas emissions by 55% by 2030 (compared to 1990).

It is based on four axes: further increase energy savings, diversify the offer, accelerate the deployment of renewable energies and make massive investments to achieve this.

The implementation of the "Adjustment to target 55" package of measures aims to reduce annual fossil energy consumption by 30%, or 116 bcm by 2030. The REPowerEU plan would reduce it by more than an additional 155 bcm, which corresponds to the volume imported in 2021 from Russia.

Achieve energy savings

Reducing energy demand is the cheapest and fastest way to reduce dependence on Russian energy. The EU's legally binding energy efficiency target for 2030 has thus been raised to 13%, compared to 9% previously. The latter is part of the "Adjustment to target 55" package intended to achieve carbon neutrality in 2050 and achieve an intermediate target of reducing greenhouse gas emissions by 55% by 2030 (compared to 1990). While the long-term objective is binding, the EC proposals to reduce oil and gas demand are not. In particular, they aim for short-term energy savings of 5% through an immediate change in the behavior of households and businesses. A 1 degree lowering of the thermostat would save 10 bcm of Russian gas imports. The

EC encourages countries to launch communication campaigns with stakeholders and to adopt tax incentive measures such as reduced VAT rates on building insulation and the use of heat pumps.

Diversify supply sources

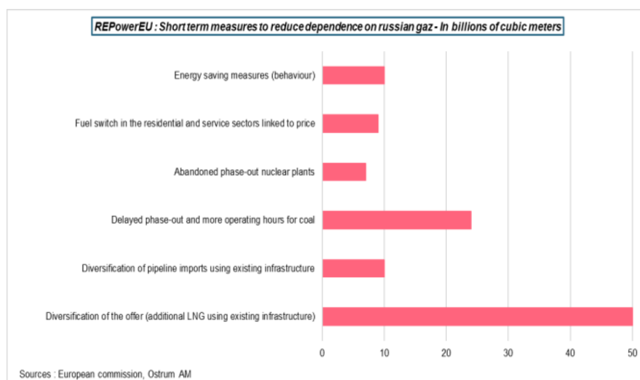
The 27 Member States have agreed on the establishment of an EU energy platform for the acquisition of gas and LNG and to coordinate the use of infrastructure. REPowerEU offers a joint purchasing mechanism to negotiate and conclude on behalf of the Member States, on a voluntary basis, the acquisition of gas and, in the future, of renewable hydrogen. This would thus make it possible to benefit from lower prices.

The EU has also adopted an external energy strategy making it possible to diversify sources of supply via long-term partnerships with reliable countries. LNG imports are expected to increase by 50 bcm per year and come from the United States, Qatar, Egypt and some West African countries. An additional 10 billion would come from imports via gas pipelines, notably from Azerbaijan, Algeria and Norway. Large “hydrogen corridors” will be set up in particular in the North Sea and the Mediterranean.

Accelerate the deployment of renewable energies

The rapid reduction in dependence on Russian energy will affect the EU's greenhouse gas emissions reduction trajectory. Russian gas demand will drop rapidly while the deployment of renewable energy requires vast investments and a certain time to be operational. In the short term, coal will thus have to be used a little longer than expected and the countries will have more recourse to nuclear power and domestic gas to compensate for the lower Russian imports.

As the following graph shows, to reduce Russian energy imports by 2/3 in the short term (i.e., a reduction of 100 bcm), the EU will import 50 bcm of LNG via other countries, 10 bcm via gas pipelines, but it will also have to temporarily increase the use of coal and nuclear power.



To offset this temporary increase in emissions and create more clean energy sources, the EC wants to significantly accelerate the deployment of renewable energies in order not to jeopardize its intermediate objective of reducing greenhouse gas emissions by 55% by 2030 (compared to 1990) and to achieve carbon neutrality by 2050. This will result in a massive uptick in renewables for power generation, industry, construction and transportation.

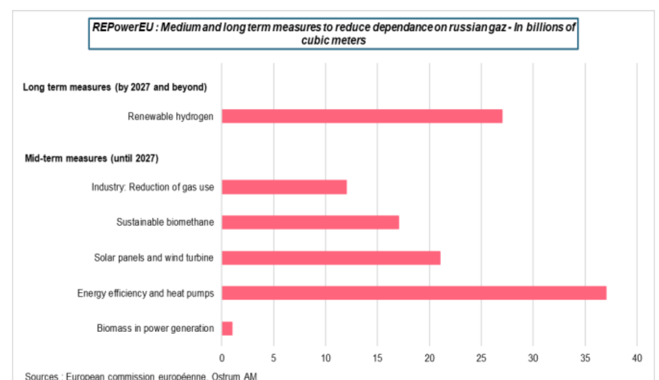
The EC thus proposes to increase from 40% to 45% the share of renewable energies in final energy consumption by 2030, as part of the “Adjustment to target 55” package.

To achieve this, the EC has launched a specific solar energy strategy. Solar energy will be the main source of energy in 2030, with solar roofs accounting for more than half. Photovoltaic solar energy being one of the fastest technologies to deploy and one of the most affordable, its capacity will thus be more than doubled by 2025 compared to 2020 (to 320 gigawatts) and will be increased to 600 GW by 2030. The EC proposes to make the installation of solar panels on the roofs of new public and commercial buildings (over 250 square meter) compulsory by 2026, by 2027 for existing public and commercial buildings (over 250 sqm) and by 2029 for all new residential constructions. The development of individual heat pumps will be multiplied by 2.

There is also great potential for wind energy, particularly offshore, and the production of biomethane. Wind turbines will represent 31% of capacity.

To achieve these ambitious objectives, the procedures for granting permits for major renewable energy projects will be accelerated, in particular by determining areas suitable for their deployment by the Member States, where the environmental risks are lower. In these areas, authorization procedures should not take more than a year compared to up to 4.5 years currently for ground-based photovoltaic projects and up to 9 years for wind projects. The same will apply to associated infrastructures such as networks.

The EC has also set an internal production target of 10 million tons of renewable hydrogen and 10 million tons imported by 2030. Biomethane production would be increased to 35 bcm by 2030, including under the common agricultural policy.

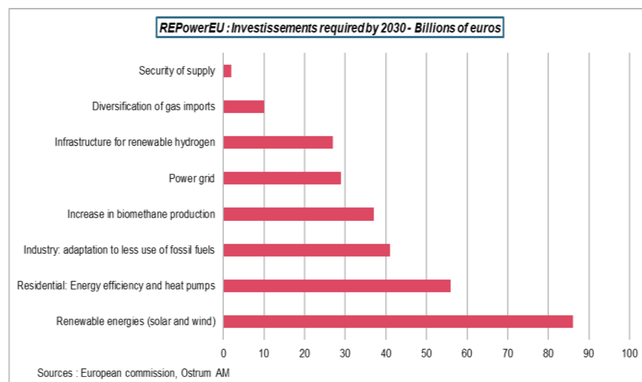


The EC further proposes to establish a European Solar Industry Alliance and a European Competence Partnership. In order to achieve the development of renewable energies, the EC will intensify work on the supply of critical materials and will prepare a legislative proposal on the subject. It is indeed a question of not replacing our dependence on

Russian energy by dependence on countries supplying specific and rare components for the production of renewable energy (such as cobalt, lithium, etc.), first of all China. The EU is thus seeking to diversify its sources of supply and strengthen circular economy models.

Investments and financing

The European Union estimates investment needs at nearly 300 billion euros by 2030, including 210 billion additional investments by 2027. This is in addition to the investments necessary to achieve carbon neutrality objectives. The cost of these additional investments would be partly offset, according to the EC, by nearly 100 billion euros per year in savings made by stopping Russian fossil fuel imports. These investments will be made by the public and private sectors, at national, cross-border and EU level.



The European recovery plan NextGeneration EU, through the Recovery and Resilience Facility (RRF), will be at the heart of the financing of REPowerEU. 225 billion loans are still available under the RRF and can be requested until August 31, 2023.

The EC proposes to make targeted and rapid changes to the RRF regulations to integrate additional chapters of REPowerEU for countries to devote investments and reforms to accelerate the energy transition. Countries will be thus able to modify and supplement their national plans under the RRF. The EC also proposes that if countries do not request all the loans due to them under the RRF within 30 days of the entry into force of the new regulation, these loans will be transferred to other Member States. This aims to ensure the success of the plan.

NextGeneration EU is the European recovery plan for an amount of 800 billion euros intended to deal with the Covid-19 crisis and to support more particularly the countries most affected by it. It is financed by the common issuance of debt by the EC on behalf of all EU countries. To benefit from RRF grants and low-interest loans, countries must make investments and reforms to accelerate the energy and digital transition mainly.

The size of the RRF will be increased by 20 billion euros through subsidies from the auctioning of allowances from the EU emissions trading system. These are currently held in the market stability reserve.

Member States will also be able to transfer part of certain European funds to the RRF. 26.9 billion euros from cohesion policy funds can be voluntarily transferred by member countries to the RRF to achieve the objectives of RepowerEU. 7.5 billion euros from the European Agricultural Fund for Rural Development can also be transferred on a voluntary basis.

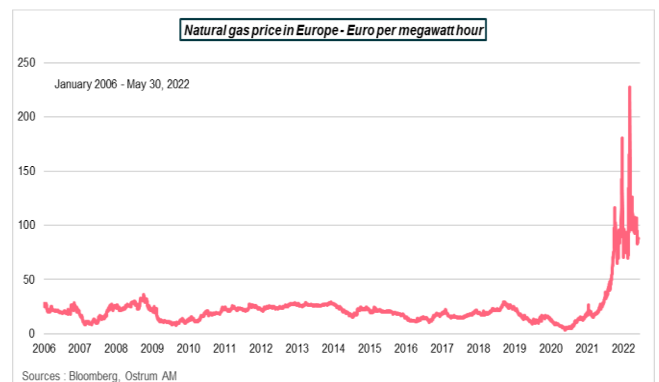
Funds for innovation will be doubled in 2022 to reach 3 billion euros.

10 billion euros of investment are needed to strengthen the interconnection of trans-European energy networks. To this end, the EC is launching a new call for contributions with a budget of 800 million euros.

Member States can also take tax incentive measures to achieve energy savings and reduce fossil fuel consumption.

Consequences for gas prices

The outbreak of the conflict in Ukraine and fears of major disruptions in the supply of Russian natural gas, on which Europe is very dependent, generated a sharp rise in the price of gas, up to 227 euros per megawatt hour on March 7. Since then, tensions have subsided and the price of gas is hovering around 100 euros per MW (87.9 euros on May 30), which remains a very high level compared to an average of 20 euros between 2006 and 2019.



The reduction in price pressures is partly linked to the sharp rise in natural gas inventories made possible by the large increase in imports of liquefied natural gas from other countries.

Notably, the EU and the United States have signed an agreement. The United States has committed to increasing its exports to the EU by 15 bcm in 2022 and to gradually increase them to 50 bcm per year by 2030. This will require additional investment.

Germany, for its part, has signed an agreement with Qatar on imports of liquefied natural gas. Having so far only had a gas pipeline for its supply, Germany has decided to speed up the construction of two gas terminals in order to be able

to diversify its supplies via liquefied natural gas (LNG). It will take at least 2 years, meanwhile Germany uses other terminals in neighboring countries.

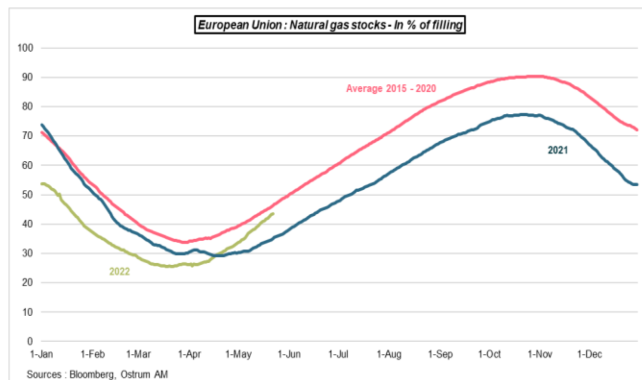
The EU is also diverting shipments that were destined for Asia by paying a higher price.

Ursula Von Der Leyen said that this increase in imports from other countries had reduced the share of Russian gas imports from the EU to 26% in April from 40% in 2021.

Sharp rise in inventory

The low level of gas stocks compared to the average over the 2015-2020 period had contributed to the rise in gas prices from the summer of 2021. There has been a real change in trend since April. Natural gas stocks increased significantly with the increase in LNG imports to approach their average for 2015-2020.

In order to secure supply before winter, the EU has just signed an agreement to increase natural gas storage capacity to 80% by November 1, 2022 and to 90% in the following years.



While the measures taken so far to reduce dependence on Russian energy have made it possible to limit tensions on gas prices, remaining nevertheless at a high level, the implementation of the plan risks creating volatility and price pressures as winter approaches. These are also likely to increase tensions between Russia and the EU with the end imports of coal from Russia in August and that of oil probably by the end of the year.

Furthermore, the EU is not immune to a sudden stop in Russian supplies, as shown recently by Russia's decision to stop its gas exports to Poland, Bulgaria and more recently Finland, following their refusal to pay in rubles. This poses a threat to EU energy security. Fears that a sudden stop in supplies will affect other countries are increasing with the very close expiry of contracts to be paid by different countries. The EU has been clear: a payment in rubles as requested by Russia goes against the sanctions imposed by the EU.

Consequences of a sudden stoppage of Russian natural gas supplies

In the event of serious disruptions in supply, the EC is in the process of defining emergency measures to be adopted, in particular establishing an order of priorities in the rationing of demand for certain companies.

In the event of a sudden stop in Russian gas imports, the consequences would be far reaching for European growth given its large dependence and its inability to quickly find other sources of supply. If households and certain essential sectors, such as public services and hospitals will be preserved, companies could be rationed in the short term, thus affecting activity. This would also result in a sharp rise in energy prices and a further acceleration in inflation, thus weighing more on household purchasing power and therefore on growth.

The ECB has carried out simulations concerning a gas rationing of 10% on the corporate sector. This would reduce the added value of the Eurozone by about 0.7%. The most affected industries are obviously those in the energy sector followed by base metals, non-metallic minerals (such as glass, cement, ceramics), paper and chemical producers. The most affected countries would be those whose industry is most dependent on gas and energy in a direct and indirect way. ECB simulations show that the impact would be greater for Slovakia, Austria, Portugal, Estonia, Latvia, Greece and Italy.

The Bundesbank recently did a simulation. In the event of a sudden embargo of Russian energy, German GDP would be, in the 1st year, 5% lower than the March forecasts of the ECB, i.e. a drop of 2% compared to 2021. This results in particular from rationing of energy consumption but also losses of purchasing power linked to the acceleration of inflation. This would effectively result in a sharp rise in energy prices (oil at $170) and an even greater increase in the price of natural gas and therefore a further acceleration in inflation. It would be 1.5 percentage point higher in 2022 and 2 pp in 2023, compared to the ECB's March forecast.

The EC has also carried out this exercise. In the event of major disruptions in Russian natural gas, EU growth would be only 0.2% in 2022, compared to a forecast of 2.7% in the central scenario, which corresponds to a severe recession given base effects contributing to add 1.9% at the end of 2021.

Conclusion

REPowerEU is the EU's roadmap to rapidly reduce its heavy dependence on Russian energy. It aims to achieve greater energy savings, diversification of reliable sources of supply and a net deployment of renewable energies through targeted investments. The Recovery and Resilience Facility will play a major role alongside investments from Member States and the private sector. The EU has just extended for another year, until the end of 2023, the suspension of the rules of the stability pact to give more leeway to the Member States in order to respond to the shocks on growth, linked to the war in Ukraine, the sharp rise in energy prices and disruptions in supply chains, and financing the reduction of dependence from Russian energy. The success of this plan depends first of all on its adoption by the Member States and above all on their will and ability to implement the necessary reforms and investments and to cooperate. It is urgent and essential that EU countries coordinate on energy policy in order to ensure the security currently threatened by Russia.

Aline Goupil-Raguénès

Market review

A little respite for equities

Treasuries outperform, sharp bounce in equities amid a weaker dollar

Financial markets are still looking for direction. The decline in several US economic indicators was accompanied by an easing in bond yields and a drop in the greenback, which sparked a sharp rebound in equity indices in the United States (4% on the S&P 500) and dollar-denominated credit markets. The rise of the euro above $1.07 appears to cap the relative performance of the European equity markets. The Euro Stoxx 50 nevertheless gained more than 3% over the past week. The yield on the Bund is pointing up around 1%, with selling pressure being even more significant on maturities beyond 10 years. Credit spreads are stabilizing despite persistent tensions on swap spreads. In China, economic difficulties and the reduction in the PBoC's 5-year benchmark rate are finally pushing Chinese government bond yields lower after a long period of stability. The yuan however remains fragile (6.71). The energy and food crisis is causing renewed upward pressure on commodity prices (Brent at $114 a barrel). Industrial metals are an exception.

Once again, global growth seems to rest only with the US consumer. The reported contraction in US GDP (-1.5% in the first quarter) reflects the surge in imports from China in March, as retailers worried about the risks of supply chain disruptions which eventually did materialize. The contribution from foreign trade shaved more than 3pp off US growth and the lower accumulation of inventories subtracted an additional 1pp of GDP. On the other hand, US household consumption and business investment are in good shape. The fall in consumer confidence and the rise in prices are barely influencing consumption behavior (+3.1% in 1Q 2022). In turn spending data for April (+0.7%) confirms this. However, attention should be paid to the magnitude of the current decline in residential investment caused by monetary tightening. Declining US military spending remains a puzzle, given the massive support for Ukraine. The conflict that is bogged down in the Donbass is also causing an unprecedented global food crisis. The blockade of the Black Sea by the Russian army prevents the export by sea of Ukrainian cereals. In Europe, the surveys (IFO, PMI) are still surprisingly resilient despite the weak hard data reported in the first quarter. Germany recorded a meager 0.2% GDP growth with disappointing household consumption (-0.1%). The United Kingdom, also subject to the Brexit impasse in Ulster, announced £15 billion fiscal stimulus for households. The Chinese government is facing economic difficulties much worse than in 2020 according to Li Keqiang. Youth unemployment has stands at 18% and the financial difficulties of real estate developers seem hopeless. A list of 33 support measures has been announced, with a sense of urgency for government officials to spur activity ahead of the 20th CPC Congress in the fall.

Financial volatility is barely decreasing. The dominant narrative in financial markets seems to be that the US slowdown will allow for a market-friendly shift in US monetary policy. The market has thus priced out 25bp worth of Fed tightening by next December. The rally in the T-note to 2.75% reflects a decrease in the real 10-year rate. The fall in the US dollar also encourages risk taking. However, this scenario could have ‘wishful thinking’ written all over it given inflation at 8%, made worse, again this week, by the rise in the price of oil. In short, rightly or wrongly, the market does not expect the Fed to continue putting a greater emphasis on the inflation part of the dual mandate. Like Treasuries, the slope of the yield curve in the euro zone has steepened. The 10-30 year spread widened by 10bp in the past week. Issuance including 30-year DSL, 15-year Bund or green RAGB (2049) may explain the weaker market conditions at the long end of the curve. Ten-year sovereign spreads, however, performed well despite the debate on the size of expected rate hikes. Klaas Knot and others are not ruling out raising rates by 50bp in July. The end of negative rates is fast approaching anyway. Italian BTP spreads nevertheless tightened towards 190bp, which seems compatible with expectations of a support mechanism from the ECB to control the asymmetric risks that had plagued the monetary union in the past.

The credit market is struggling to stabilize in the context of economic risks and the upcoming termination of the CSPP and rate hikes. The level of swap spreads remains unusually high, leading to a further widening of covered bond spreads. The average spread on IG credit in euros widened by 18bp in May. New issue premiums, although elevated since April, are proving insufficient to engineer performance in secondary markets. European high yield primary market is still dormant. However, selling pressure has slowed so that the average spread against Bunds has stabilized at around 500 bps. Conversely, thanks to the fall in the dollar, the US credit and high yield markets are taking full advantage of the rebound in risky assets.

The dollar thus no longer appears as the safe haven currency, as rate hike expectations adjust slightly lower. The yen strengthened back towards 127 and the euro crosses the threshold of $1.07. At the antipodes, the New Zealand dollar is benefiting from the monetary tightening reaffirmed by the RBNZ, which has raised its rate target for 2023 to almost 4%.

Axel Botte
Global strategist

Main market indicators

G4 Government Bonds	30-May-22	1wk (bp)	1m (bp)	2022 (bp)
EUR Bunds 2y	0.44%	+2	+18	+106
EUR Bunds 10y	1.05%	+3	+11	+122
EUR Bunds 2s10s	60.4bp	+1	-7	+17
USD Treasuries 2y	2.48%	-14	-24	+174
USD Treasuries 10y	2.74%	-11	-20	+123
USD Treasuries 2s10s	25.8bp	+3	+5	-52
GBP Gilt 10y	1.98%	+1	+7	+100
JPY JGB 10y	0.24%	0	-7	-1
€ Sovereign Spreads (10y)	**30-May-22**	**1wk (bp)**	**1m (bp)**	**2022 (bp)**
France	51.89bp	0	0	+14
Italy	196.63bp	-5	+13	+61
Spain	108.11bp	-4	+5	+34
Inflation Break-evens (10y)	**30-May-22**	**1wk (bp)**	**1m (bp)**	**2022 (bp)**
EUR 10y Inflation Swap	2.77%	-4	-31	+67
USD 10y Inflation Swap	2.97%	+12	-15	+19
GBP 10y Inflation Swap	4.6%	+13	-7	+43
EUR Credit Indices	**30-May-22**	**1wk (bp)**	**1m (bp)**	**2022 (bp)**
EUR Corporate Credit OAS	167bp	-1	+16	+72
EUR Agencies OAS	65bp	+0	+1	+16
EUR Securitized - Covered OAS	74bp	+1	-2	+28
EUR Pan-European High Yield OAS	499bp	-6	+49	+181
EUR/USD CDS Indices 5y	**30-May-22**	**1wk (bp)**	**1m (bp)**	**2022 (bp)**
iTraxx IG	85bp	-12	-5	+37
iTraxx Crossover	425bp	-51	-5	+182
CDX IG	79bp	-10	-5	+30
CDX High Yield	457bp	-50	-6	+164
Emerging Markets	**30-May-22**	**1wk (bp)**	**1m (bp)**	**2022 (bp)**
JPM EMBI Global Div. Spread	455bp	-34	+22	+86
Currencies	**30-May-22**	**1wk (%)**	**1m (%)**	**2022 (%)**
EUR/USD	$1.078	0.786	2.551	-5.2
GBP/USD	$1.265	0.461	1.233	-6.5
USD/JPY	JPY 127	0.424	2.199	-9.6
Commodity Futures	**30-May-22**	**-1wk ($)**	**-1m ($)**	**2022 (%)**
Crude Brent	$120.1	$6.7	$13.0	58.37
Gold	$1 855.6	$2.0	-$7.5	1.44
Equity Market Indices	**30-May-22**	**-1wk (%)**	**-1m (%)**	**2022 (%)**
S&P 500	4 158	6.58	0.64	-12.8
EuroStoxx 50	3 839	3.52	0.95	-10.7
CAC 40	6 558	3.14	0.37	-8.3
Nikkei 225	27 369	1.36	1.94	-4.9
Shanghai Composite	3 149	0.07	3.35	-13.5
VIX - Implied Volatility Index	26.42	-7.23	-20.90	53.4

Source: Bloomberg, Ostrum AM

Additional notes

Ostrum Asset Management

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Natixis Investment Managers

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