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INVESTING IN THE PAN-EUROPEAN ECONOMY (PEE). The new geo-political context after the pandemic shock.

The impact of COVID-19 on the European capital markets

AFME is delighted to again participate in the FEBAF/MIB Trieste School of Management Trieste Eastern Europe Investment Forum. During this first session, I would like to provide a brief overview of specifically how CV19 has impacted various pan-European capital markets, some brief thoughts on CV19-related "Quick Fix" primary and secondary markets legislation under discussion, as well as how CV19 has made the recently-issued CMU High Level Forum report even more relevant than ever.

Although it seems like ages ago, the negative impact of CV19 on European markets was very swift. In the space of ten days starting on 6 March, liquidity was seizing up rapidly to the point it was difficult for issuers to get any new transactions completed in any asset class. The interventions by the Bank of England on 11 March, by the ECB on 12 March and concurrent action by the Federal Reserve had an enormous positive impact on market liquidity and secondary market spreads on those asset classes eligible for purchase by the central banks. For those interested in the gory but very relevant details of bad it was getting on a day by day basis, I can highly recommend a speech given last week by Andrew Hauser, Head of Markets at the Bank of England, available here. The securities purchased by central banks included bonds issued by sovereigns, supranationals and large corporates, but notably not securitisations, nor more credit-intensive instruments such as high yield and leveraged finance. It is notable that the European equities markets have benefited from a halo effect of these central bank initiatives, even though equities are not an eligible asset class in almost all major jurisdictions. The provision of liquidity however by bank secondary market desks was significantly higher than during the global financial crisis ten years ago. European banks have improved the quality of their capital and are well positioned from a solvency and liquidity perspective to support households and businesses. In April, AFME published a comprehensive review of the initial impact of CV19 on markets, which we intend to update in the next few weeks. Some of our initial observations were:

a) The central bank liquidity resulted in the largest ever weekly investment grade bond issuance in Europe, of over EUR 50 bn, including from non-financial corporates.
b) In fixed income markets, spreads vs benchmarks increased significantly across all credit asset classes. Although most spreads subsequently declined, they have not declined to pre-CV19 levels. In addition, bid/offer spreads widened, in some cases considerably depending on the asset class.
c) In equities, although primary offerings declined significantly, quite a few corporates were able to place secondary offerings.

Iin terms of **trading volumes**, activity in the first quarter increased in comparison to Q4 2019.

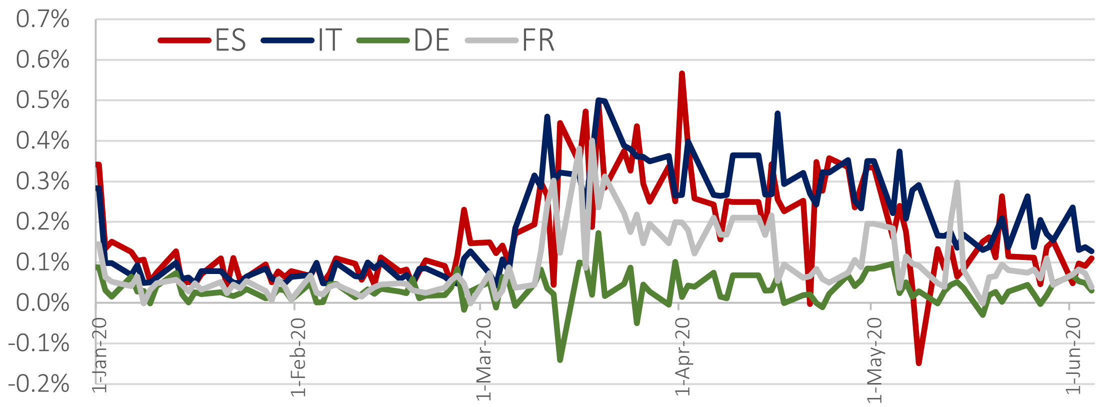
Trading	1Q 2020	4Q 2019	%Chg (latest)
Equity (ADV in EUR bn)	60.9	42.5	**14.7%**
Corporate (ADV in EUR bn)	73.9	54.8	**34.9%**
Sovereign debt (ADV in EUR bn)	79.1	62.9	**25.8%**
FX (thousand weekly contracts)	67.6	47.4	**42.6%**
Fixed income swaps (cleared trades)	32.6	23.3	**39.9%**

Repo (cleared trades)	32.7	31.1	**5.1%**

Not surprisingly, **fixed income secondary markets spreads** increased significantly:

Spreads	3-Jun	31-Mar	1-Jan	bps Chg
Corporate				
European AAA	76	136	53	**+23**
European High Yield	536	866	308	**+228**
Sovereign				
5Y German CDS	10	14	5	**+5**
5Y Italian CDS	114	104	57	**+57**
5Y UK CDS	22	28	13	**+9**
Securitisation				
European CMBS Snr Euro FL	200	250	103	**+97**
European Autos A Euro FL 4-5 Yr	200	275	76	**+124**
UK Cards A GBP FL 7 Yr	260	350	150	**+110**
ECB eligible Spanish Snr RMBS	97	135	48	**+49**
Dutch RMBS Snr FL 5Yr	42	55	16	**+26**
UK Prime RMBS AA Euro FL 5 Yr	180	260	115	**+65**
UK Cards BBB GBP FL 7 Yr	360	500	190	**+170**
Italian RMBS BBB FL 10 Yr	420	500	252	**+168**

We also note the widening of **fixed income bid-offer spreads**, as illustrated in the below graph which tracks the difference between closing bid price and closing offer price on selected 5Y benchmark government bonds in key Eurozone markets.



Equities

- The secondary equity offerings market has been relatively active on European exchanges. Secondary offerings worth €25.6bn have been issued from the beginning of 2020 until 3 June above the €17.2bn issued in the same period in 2019

- Equity average daily volume traded on European MTFs and exchanges increased 94% YoY in March 2020 to €84.9bn per day when market turnover peaked (vs. €43.8bn in March 2019). Average daily volume in early June stood at €50.4bn per day.
- Declines of share prices of blue-chip index constituent companies varied across countries with YtD declines of between 11-26% as of mid-April, which most recently have partially recovered with year-to-date losses of 6-20% as of early June. Company valuations significantly declined over the year as result of the sudden change in the economic outlook and the uncertainty around the medium and long-term financial repercussions of the crisis for the corporate sector
- Market volatility of European equity shares rapidly increased to levels seen during the 2008-2009 financial crisis. European market-implied volatility of equity shares increased from 11bps in early January to a maximum of 86bps by mid-March, that later stabilised close to 30bps in early June'

Government bonds

- COVID-19 crisis has increased the price volatility and risk premia of European sovereign bond markets. For sovereign yield curves, the effect of COVID-19 on the market can be observed in the steepening of the Italian curve, and the downwards shift observed for the UK sovereign markets

Corporate Bonds

- Investment grade (IG) borrowers raised a record amount of corporate debt from markets during the crisis; from 1 March to early-June, the IG bond issuance totalled €214bn that is a 123% increase to the same period in 2019
- First week of April 2020 totalled €56bn, which is an all-time weekly record, and even more remarkable taken that large part of the financial sector workforce worked from home.
- The rapid increase in IG bond issuance contrasts with the subdued performance of the high yield and leveraged finance markets as investors price in potential credit losses of low-rated corporate debt.
- Between 1 March and early June, a total of €7.7bn in high yield debt has been issued in Europe, a 71% decline compared to the same period of 2019
- Leveraged loan issuance has also declined during the COVID-19 crisis as markets continue to reflect concerns about credit quality and highly leveraged companies

Securitisation

- There has been a notable decrease in the number of public deals for which there have been STS notifications, with only 19 public deals in Q1 2020, compared to 56 in Q4 2019

Economic Implications, and Official Sector Interventions

I highly recommend a recent European Commission document released on 27 May, available here, which provides both an aggregate as well as country-by-country impact of the crisis on EU member states. Specifically, the impact in the Balkan region is significant: In Croatia, 290 000 people applied for unemployment benefit during March and April. In Serbia: around 12 per cent of workers in Serbia had lost their jobs. In North Macedonia, unemployment is at 17% with 9000 new unemployment registrations during the crisis.

In terms of EU-wide measures, officials have:

- Postponed go-live dates of certain markets regulation
- Postponed of certain deadlines for regulatory responses
- Proposed a "Quick Fix" package of changes to primary and secondary regulations – Market Abuse Regulation, Prospectus Regulation, and MiFID
- ECB allowed banks to operate temporarily below the level of capital of Pillar 2 guidance, the capital conservation buffer and the LCR
- Banks dividend payments postponed as requested by the ECB and the BoE
- Basel III implementation postponed by one year
- Some national market regulators issued short selling bans during the COVID-19 crisis with the intention to stabilise financial markets.
- Some European countries have temporarily changed corporate insolvency filing obligations and/or enforcement of debts for companies hit by the crisis
- UK's Pre-Emption Group (PEG) relaxed the guidelines that UK listed companies may issue up to 20% of their issued share capital on a non-pre-emptive basis during the pandemic

Capital Markets Union

In the next few days, the CMU High Level Forum is expected to release its findings, which are welcome. I do believe that the recent CV19 experience in European capital markets demonstrates even more urgently the need to move forward with implementing key aspects of CMU. These include changes to European capital market structure and MiFID/MiFIR, securitisation frameworks, insolvency reform, post trade reform, and many other aspects.