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# CIO Strategy Bulletin

## Europe in the Eye of the Storm

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### SUMMARY

- For the moment, Europe is not in recession. However, we expect present conditions to come under significant pressure as we enter fall and winter. Despite an economic slowdown, we believe the ECB will likely deliver a total of 150bp in rate hikes to fight rising inflation.
- Inflation is unlikely to peak before autumn. The latest June reading showed an 8.8% year/year rise across the continent, overshooting consensus expectations and showing no signs of near-term moderation. Our 18-month outlook for inflation is more constructive. We believe that the rate of HICP inflation is more likely to be 4% or less by the end of 2023.
- Europe's dependence on Russian energy remains significant and is a major economic vulnerability. Europe's strategy of rationing energy supplies creates some clear and present risks to Europe's business cycle, while the persistence of high fossil fuel prices will keep headline inflation elevated. There are no immediate solutions to this crisis.
- Political uncertainty is building across Europe. France's Emmanuel Macron was re-elected for a final 5-year term, but lost his absolute majority in the lower house of parliament, making governance more difficult. German Chancellor Olaf Scholz continues to lose critical local elections. The UK Conservative Party will now spend the summer choosing its next PM. And the Italian government is in disarray, with the possibility of snap elections in September or October.
- As long as Europe's economic stresses remain regional and financial shocks are not transmitted elsewhere, a 2022 second half contraction in real GDP fits our base-case RESILIENT scenario for the world economy. Our views are below Street consensus, with global GDP growth estimated at just 2.6% this year. Our forecasts for 2023 are likely to be under downward pressure.
- We believe European markets have priced in an economic slowdown, but not a recession. If there was a further significant reduction to gas flow to Europe, we could expect another 10% contraction in European EPS over the next 12 months and further downside to European markets.
- For long-term investors regional pharmaceuticals, food, and even world-leading luxury brands deserve to remain in portfolios. Unfortunately, for overall stock and bond allocations, we do not believe investors are presently being adequately compensated for the Euro region's risks.

## Europe in the Eye of the Storm

Europe is at the epicenter of the geopolitical events impacting world markets. The war in Ukraine has catapulted inflation higher in Europe and the West, destabilizing the supply of food commodities and natural gas. Despite the exogenous nature of the shock, the events have caused central banks to change longstanding interest rate policies. The European Central Bank (ECB) has just mimicked the Fed's initial rate move, raising policy rates unexpectedly by 50 basis points.

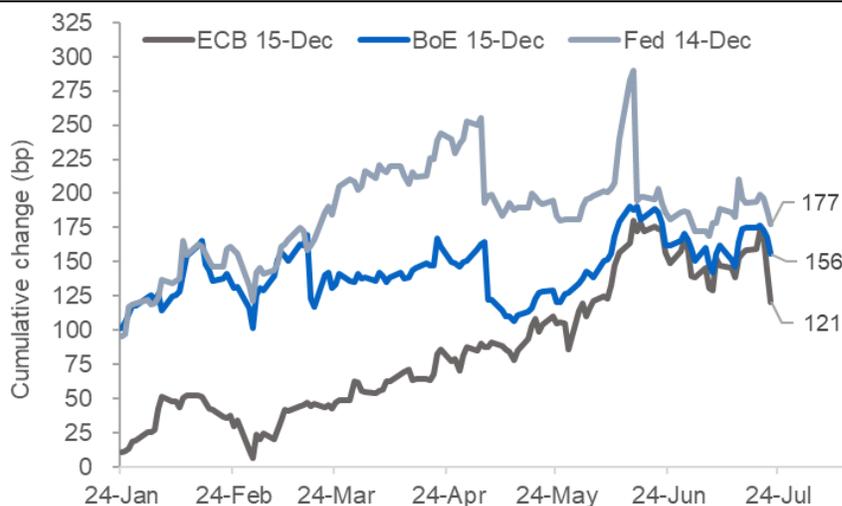
The move ended the ECB's negative interest rate policy initiated in June 2014. While this would ordinarily be welcome news, tightening into a weak economy adds to the shock of the war. Like the US, there was little inflation in Europe before the pandemic and Russian invasion of Ukraine. Weighed down by weak demographics and low industrial productivity, latent growth in Europe is slow (see our July 21 Europe Strategy Bulletin, "[ECB Goes Big](#)").

We believe the ECB will likely deliver a total of 150bp in rate hikes in this tightening cycle, bringing the deposit facility rate to 1% by December 2022. We expect another 50bp hike in September followed by two 25bp hikes in October and December, but changes in the macroeconomic outlook could alter the speed and magnitude of the ECB's moves. We also see very little chance of the ECB going into reverse unless inflation projections signal a clear undershooting of the central bank's 2% target. Therefore, we believe the ECB tightening cycle will likely be sharp but short (see figure 1).

For the moment, Europe is not in recession. Domestic demand is being supported by a tight labor market as well as above-average employment expectations. In fact, some businesses are reporting sustained recruitment difficulties.

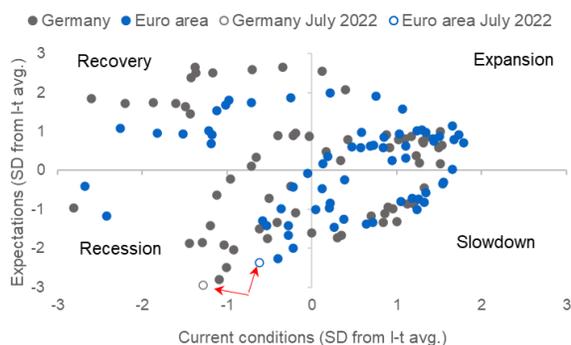
However, we expect that present conditions are likely to come under significant pressure as we enter fall and winter. Investor sentiment in Europe has already taken a turn for the worse. The Sentix survey of investor expectations gauging the position in the business cycle - and just as importantly household sentiment - signal recessionary conditions are likely in the six months ahead (see figures 2-3).

**Figure 1: Market expected policy tightening: Short-term interest rates will likely be much higher by year-end, even in the euro area**

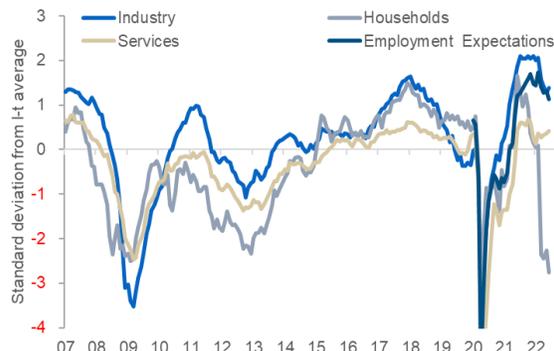


Source: Bloomberg, as of July 22, 2022. All forecasts are expressions of opinion and are subject to change without notice and are not intended to be a guarantee of future events. Past performance is not indicative of future returns. For illustrative purposes only.

**Figure 2: Sentix Survey (Jan. 17- July 22)**



**Figure 3 : Euro area sentiment indices**



Sources: European Commission, Haver Analytics and Bloomberg as of July 4, 2022. Past performance is no guarantee of future returns. Real results may vary. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Past performance is no guarantee of future results. Real results may vary.

## Europe's Energy Vulnerabilities

Europe's dependence on Russian energy remains significant and is a major economic vulnerability. Even after taking drastic measures to reduce their exposure to Russian gas supplies, Germany and France rely on Russia for 35% and 17% of current needs, respectively.

The Nord Stream 1 pipeline reopened this week, promising a reprieve from severe, immediate gas shortages, but at 40% of transfer capacity – with the probability that Russia will use its supplies as leverage this winter – Nord Stream's current operation does not decrease Europe's energy risks. In fact, this past Wednesday, the European Commission presented a plan to reduce gas use in Europe by 15% until next spring to address the risk of further supply cuts. This reflects the reality that Europe will not be able to "stock up" its gas supplies for winter, consistent with Russia's political objectives.

Rationing of energy supplies creates some clear and present risks to Europe's business cycle, while the persistence of high fossil fuel prices will keep headline inflation elevated, negatively impacting household real incomes and confidence. There are no immediate solutions to this crisis, given that LNG terminals and other long-term supply contracts cannot be "turned on." It will take two or more years to truly restructure the way Europe receives energy in a secure way.

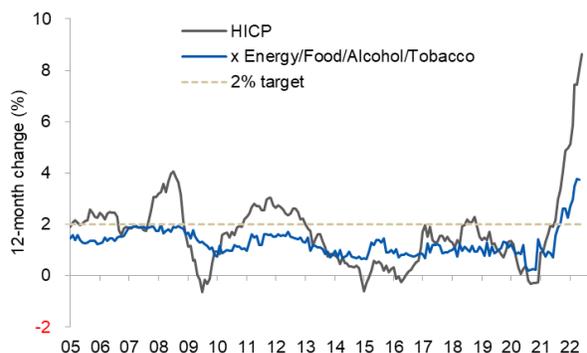
## Inflation Watch

Early estimates of European inflation (headline HICP) rose to a new record high of 8.6% year-over-year in June, exceeding expectations and rising from 8.1% in May (figure 4). Nine of the 19 euro-area countries reported inflation at 10% or higher year-over-year with France, at 6.5%, being the least impacted. In the short term, inflation risks remaining high as wages may increase to reflect the price shock. Gas rationing and the risk of further energy disruptions remain present dangers. Regional natural gas futures (figure 5) have been trading at 3.4x-3.9x 2021 levels, pushing the energy component of the harmonized CPI up 42.0% year-over-year in June.

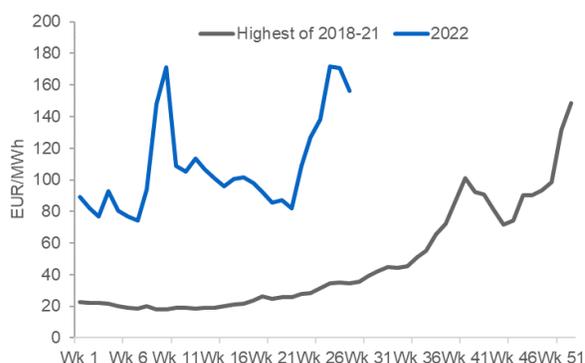
Our 18-month outlook for inflation is more constructive. We believe that the rate of HICP inflation is more likely to halve from around 8% in 2022 to 4% or less by the end of 2023. As demand slows and businesses resort to discounting to counteract an increase in inventories, we think goods price inflation is likely to be the first among key segments to ease. Services inflation might take more time to fall back, but we suspect a growing number of firms will be lowering their demand expectations as well as trimming hiring and investment plans soon amid growing evidence of a stagnation in demand.

Unless energy inflation were to spike beyond the autumn, we think a peak in European inflation is likely before the end of the year. As Europe teeters on the brink of recession, we still expect high inflation to self-correct amid much weaker real consumption (see our [Europe Strategy Bulletin](#) from July 6).

**Figure 4: Euro area inflation (headline, core and ECB target)**



**Figure 5: European Natural Gas Weekly Prices (one-month ahead futures contract)**



Sources: Eurostat, Bloomberg and Citi Global Wealth as of July 22, 2022. Past performance is no guarantee of future returns. Real results may vary. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Past performance is no guarantee of future results. Real results may vary.

## The Impact of Energy and Inflation on European Growth

Our base case for Europe in the coming quarters assumes that natural gas will continue to flow from Russia to Europe, albeit at much lower volumes than in the winter of 2021-22, due to the war and resultant geopolitical tensions. The clear risk in coming months is that volumes decline to such low amounts that aggressive rationing strategies need to be implemented. We doubt this is something Russia will aim for in the short term, as the high price of gas is generating a meaningful source of much need revenues.

In case of a complete shutdown of Russian natural gas exports to Europe, annual GDP growth rates for 2022 and 2023 could easily be 1.5% below our baseline, and inflation could be around 1 percentage point higher.

Because Europe's recovery timing lagged behind the US, its year/year real economic growth measures were strongest just before the economic shock of the war. This leaves the 2022 real economic growth rate deceptively high. The European baseline for growth and inflation are for real GDP growth to slow from 4.8% in 2021 to 2.3% in 2022 and to 1.8% in 2023. To maintain this path, the energy shock would need to moderate quickly.

Overall, European GDP is likely to contract in the second half of 2022. Economic activity continued to soften in July; this was evidenced by the flash composite PMI output measure slipping below the 50 neutral level for the first time since early 2021.

The very weak Euro, a product of the shocks and the fast-tightening Fed, is helping regional exports. However, the energy shortage could reduce Europe's capacity to export, particularly from Germany.

## Global Growth at Risk

As long as Europe's economic stresses remain regional and financial shocks are not transmitted elsewhere, a 2022 second half contraction in real GDP fits our base-case RESILIENT scenario for the world economy (see "[Three Scenarios for the Economy and Markets](#)"). Our views are below street consensus, with Global GDP growth estimated at just 2.6% this year, slow enough to raise global unemployment. Our forecasts for 2023 are likely to be under downward pressure.

## Credit as a Warning Signal in Europe

As we wrote last week (see the July 16 CIO Bulletin, "[Now \(2022\) and Then \(2019\)](#)"), we are watching for signs of credit distress as a leading indicator for our [three economic scenarios](#). Against a backdrop of rising uncertainty amid rising interest rates, we would expect that a significant repricing of corporate debt costs could occur. Another factor we are watching over the coming quarters is the extent to which a decline in consumer and business confidence might lead to a more precautionary attitude from the banking system, resulting in a tightening of lending standards and a higher cost of borrowing.

## Implications for Europe-UK Equities

We believe European markets have priced in an economic slowdown, but not a recession. If there was a further significant reduction to gas flow to Europe, we could expect another 10% contraction in European EPS over the next 12 months and further downside to European markets, especially across energy-sensitive sectors. Given the growing complexities and uncertainties in the euro area, we continue to remain underweight European ex-UK equities, while taking advantage of some defensive properties in UK equities (neutral in our portfolios).

European ex-UK equities have fallen by around 14.7% YTD (local terms), while a 10% depreciation in the euro has meant even worse performance for global investors outside the region. Like we've seen across other major equity markets, earnings expectations remain elevated, supported by energy, metals and mining sectors, which have benefited from a global shortage of commodities this year. Even after excluding commodities, estimates for 6.2% earnings growth among the remaining European sectors seem too lofty in our view, considering macro headwinds described above.

UK equities have benefited from the rising interest rate environment and favorable index composition towards energy, materials, consumer staples and health care sectors, where some have benefited from elevated commodity prices. Year-to-date, UK equities are up 2.95% (in local terms).

As is often the case, when economic risks are "front page news" and investors are bearish, counter-trend rebounds can occur. This is particularly the case in illiquid summer markets, when short-covering can move asset prices quickly. This is insufficient reason, however, to price in a lasting European recovery.

## Implications for Europe-UK Bonds

Our Global Investment Committee remains underweight European sovereign bonds given the earlier stages of the European tightening cycle and lower real yields than the US (see the [July Quadrant](#) for more details). However, for local currency investors, we will consider adding back certain safer bond assets to portfolios. For sophisticated investors, the sharp repricing of yields and currencies can provide opportunistic bond trades.

We think the 10-year bund yield will probably remain within in the 1.0-1.5% range for the much of the second half of 2022.

The asset class has been very volatile in recent months, with the German 10-year risk-free rate rising from -0.1% at the end of December 2021 to a peak of around 1.7% in early June. The aggressive pull-back in yields toward 1.05% this week looks overdone, at least until one can be certain that inflation has peaked in the autumn and more clarity emerges about the scale and pace of the ECB tightening cycle. We look for the ECB deposit facility rate to increase a further 100 basis points to 1% by year-end.

## Final Observations

Europe's struggles are front page news. Its economies and markets face the most visible shock in the world from the regional security crisis. The key regional currency, the Euro, has briefly been pushed down to parity with the US dollar on bearish investor positioning. The local currency weakness has also pushed its already cheap equities to deep underperformance in US-dollar based portfolio.

In such circumstances, investors should be prepared to “expect the unexpected.” While we do not expect a de-escalation of Russia’s war in the Ukraine, the possibility could see a sharp change in very weak European sentiment. Unfortunately, however, the bulk of the probability distribution in Europe is pointed weaker.

We do not exclude all regional investments. For long-term investors regional pharmaceuticals, food, and even world-leading luxury brands deserve to remain in portfolios. Unfortunately, for overall stock and bond allocations, we do not believe investors are presently being adequately compensated for the Euro region’s risks.

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