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Citi Global Wealth Investments

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Global News and Markets Review: US, China and UK

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Summary

This week saw significant news across the US, China and the UK. The rise of Covid and regulatory actions are impacting markets, but we think some concerns are overstated while others are underappreciated. In this "News and Markets Review" we delineate the trends likely to impact markets and make recommendations consistent with our 2022 outlook.

US Growth in the Face of Rising COVID

The rising rates of the Delta variant are putting a damper on the US recovery, for now. We have seen a decline in commuting and travel activity in the US (**Figures 1 and 2**), while local retail traffic has continued to improve. We expect that the impact of the coronavirus will continue to grow across the US over the next 6-8 weeks impacting school opening schedules as well as "back to office" plans for companies. A sharp decline in consumer confidence has yet to materialize in concrete data, though this week's retail activity figures suggested some normalization in demand, while supply shortages persist. That said, our forecast for 3.5% GDP growth in 2022 remains intact.

Figure 1: Google Mobility: Retail & Recreation vs Workplace traffic

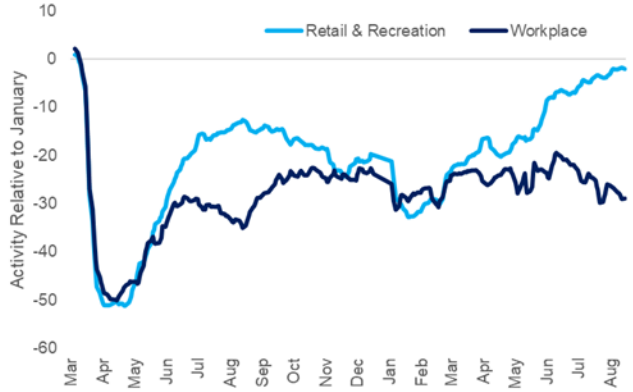


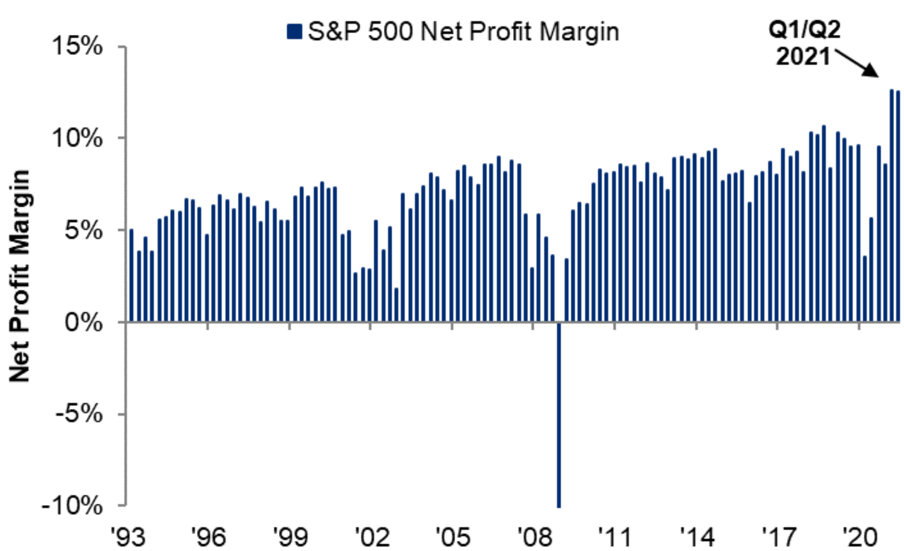
Figure 2: Airline Passenger Traffic

Source: Haver Analytics as of August 20, 2021.

Looking back at earnings season, we can see the resilience and adaptability of US companies. Earnings significantly outperformed expectations and we expect 2022 earnings growth to broadly exceed 10%, as it typically does in the second year of a new economic cycle. While corporate profit margins should moderate from elevated levels, US firms have capitalized on significant operating leverage and productivity despite concerns around rising input costs and a challenging labor market (**Figure 3**).

The likely passage of the two infrastructure bills (see CIO Bulletin August 15, 2021) will not have an immediate impact on the US economy, but beginning in 2022 will add to the profitability of firms directly tied to infrastructure spending, construction materials, and renewable energy production. US firms will likely have to grapple with a modestly higher corporate tax rate, especially those profitable firms who pay minimal effective tax rates at present. However, we do not expect any changes to the tax code to be significant enough to derail the earnings growth momentum into next year.

Figure 3: S&P 500 Profit Margins



Source: Haver as of August 20, 2021. 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. Index returns do not include any expenses, fees or sales charges, which would lower performance. Past performance is no guarantee of future results. Real results may vary.

The spreading Delta variant has also yet to impact the employment recovery. This week's initial jobless claims data continued to decline, falling to new post-pandemic lows. We will be watching closely for any potential impacts from a struggle to reopen schools or any large-scale shutdowns that may be implemented, but both the US economy and markets seem to be dealing with each new wave of COVID based on actual impact rather than fear. Eight million people will stop receiving special federal unemployment benefits at the beginning of September 2022. In our view, the net effect will be to increase the amount of available labor and improve the availability of staff for socially close businesses. At the same time, if schools do not reopen, a portion of this labor pool will not be able to seek employment and will suffer from lack of income until they do.

As we have written before, interest rates are low and are likely to remain low even through a fuller economic recovery in 2022 (see CIO Bulletin August 8, 2021). We do expect interest rates to rise gradually into year-end as the Delta variant subsides, with a likely trading range for 10-year Treasuries between 1.5% and 2%. Given the rise of COVID and its near-term economic impacts, we expect that Federal Reserve Chair Jerome Powell's speech at the annual Jackson Hole conference this upcoming Friday to favor a conservative path toward tapering to ensure the recovery maintains momentum.

The Market in China: Regulatory, Political and Covid Headwinds

China's economy is slowing due to its response to the Delta outbreak. China has handled the pandemic much differently than the West, imposing strict regional lockdowns following even the most limited of COVID flare-ups. With a much lower vaccination rate and available vaccines that are less effective against COVID-19, China's COVID prevention efforts are likely to have a more negative impact on its domestic economy than experienced in the West. The second half of the year should see a decline in China's growth rates. China had more momentum than the West going into this slowdown. Retail sales were up 8.5% in July over the prior year and industrial production grew by 6.4% over that period. More importantly, amid signs of a slowing economy, the Chinese government moved to reduce bank reserve requirements last month and we expect further easing actions to support the real economy ahead of the National People's Congress next year.

Recent, rapid government regulatory actions have negatively impacted share values in sectors associated with large parts of Chinese society (**Figure 4**). Given a significant share of Chinese equity market capitalization is concentrated in internet, e-commerce and gaming companies, Hong Kong's Hang Seng Index has lost more than 20% from its most recent peak from February 2021 to-date, while the MSCI China is 32% off its YTD highs. More than $560 billion in market value was eliminated on Hong Kong and mainland China exchanges over the past two weeks.

Market declines were a direct result of a broad regulatory reset targeting leading Chinese technology firms, steelmaking, e-commerce and education. This past week, tougher oversight of cosmetic firms, liquor makers and online pharmacies was proposed. For technology, a newly announced law creates higher standards for the management and use of customer data. Notably spared from these regulations are sectors like artificial intelligence, renewable energy and electric vehicles, that are closely tied to China's long-term innovation goals (**Figure 5**).

Figure 4: MSCI China Returns by Sector

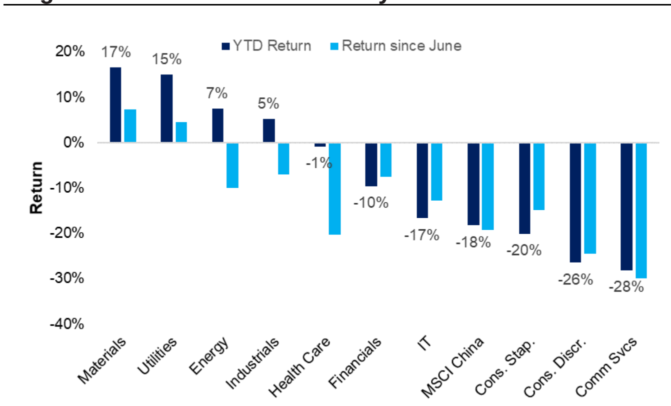
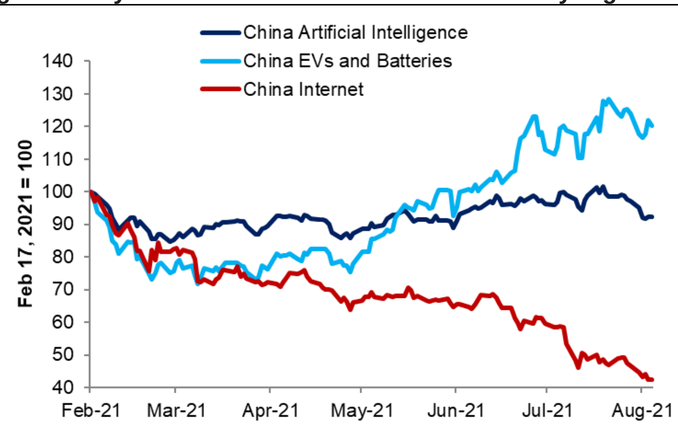


Figure 5: Key Chinese sector returns since February High



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The concern over Chinese equities is not just domestic. Worries are being compounded by likely future rule changes associated with US-listed Variable Interest Entity ADRs. Governments on both sides of the Pacific have expressed displeasure with the current system of Chinese companies listing on US exchanges, and we expect many Chinese unicorns will choose to list closer to home going forward. We suggest investor caution in adding exposure to US ADRs, particularly those firms which have yet to achieve profitability and therefore are ineligible to initiate a dual share listing in Hong Kong.

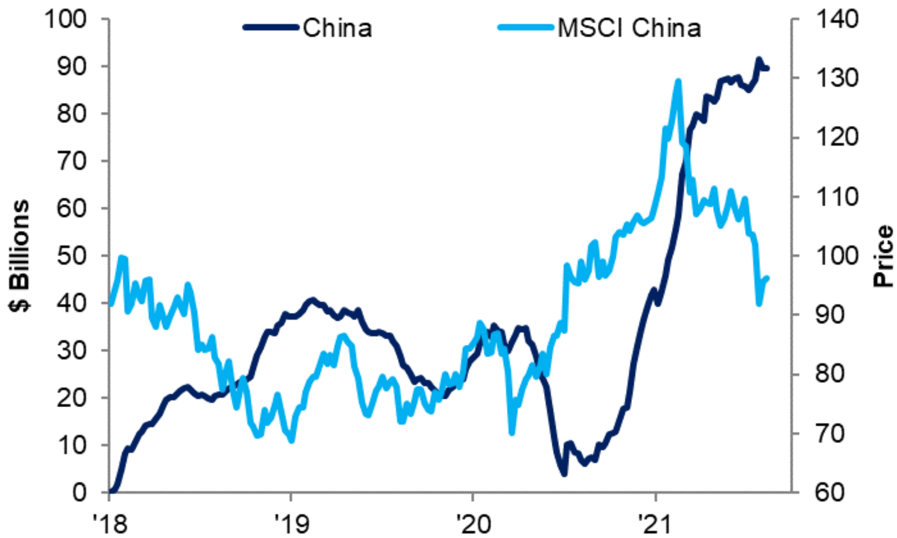
The recent series of Chinese regulatory crackdowns has caused investors to question the efficacy of investing in China. We think the most recent regulatory changes and the associated decline in markets need to be assessed in light of prior market action. Chinese shares have experienced two boom-bust periods in the last decade and both selloffs ultimately turned out to be buying opportunities. The government's currency adjustment in 2015, which followed a period of true euphoria in Chinese equities, preceded a 43% decline in Chinese equities which persisted through early 2016. Then President Trump's trade war brought down Chinese shares again in 2018 until a trade deal was reached in 2019. While we do not believe that Beijing has completed its regulatory roll-out, we see some investors as selling first and asking questions later which may present opportunities for adding to quality Chinese names at a discount to global peers (**Figure 6**).

Figure 6: MSCI China during the past decade

Source: Bloomberg as of August 20, 2021. Past performance is no guarantee of future results. Real results may vary.

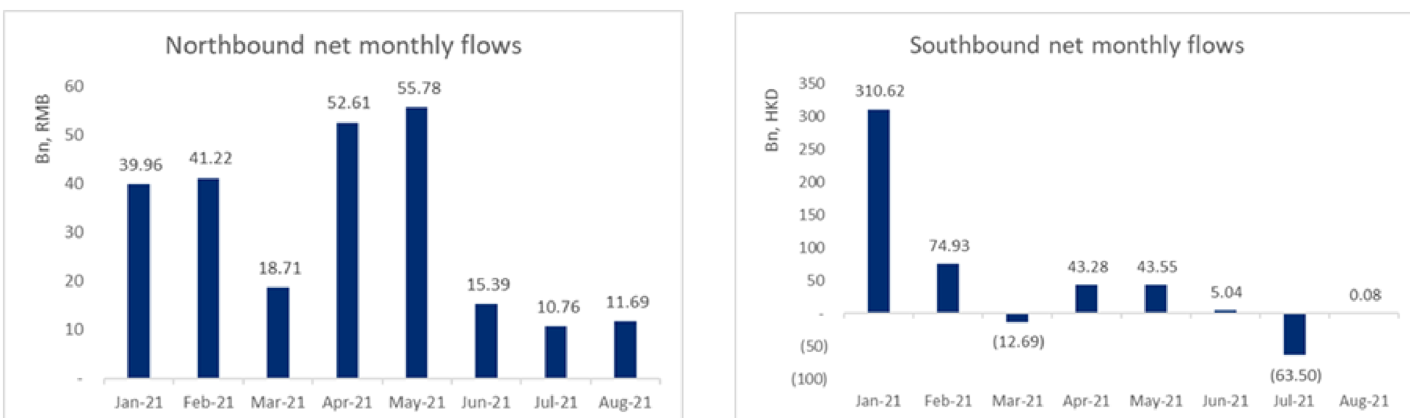
Despite negative price action, net flows into Chinese equities have remained steady. Data from the Hong Kong mainland Stock Connect indicate that much of the recent selling has in fact come from mainland investors, while "northbound" flows into A-shares from foreigners have moderated though remained positive in July and August. This presents a risk to markets if foreign buyers lose confidence due to the government's intervention in public and private businesses. And foreign buyers have not been reassured by recent government statements supporting China's capital markets.

Figure 7: Chinese equity fund flows vs MSCI China



Source: EPFR.com (Emerging Portfolio Fund Research) and Haver as of August 20, 2021. 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. Index returns do not include any expenses, fees or sales charges, which would lower performance. Past performance is no guarantee of future results. Real results may vary.

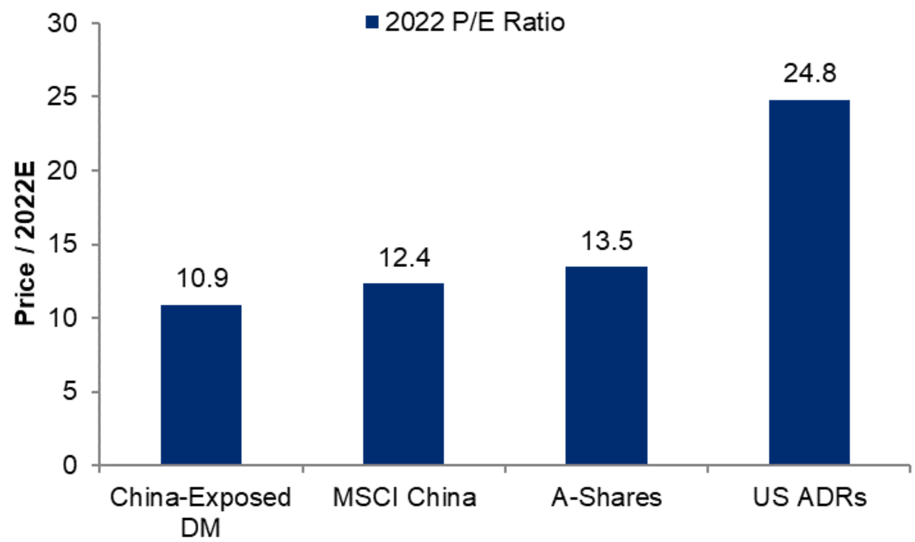
Figure 8: Northbound vs Southbound Equity Connect Flows



Source: Bloomberg as of August 20, 2021.

There has been a great deal of press speculating that the crackdown on wealthy Chinese executives and specific market segments is a power play by President Xi to retain his executive power beyond the 2022 National Party Congress. At the same time, the government's goal has been and continues to be the "rise of the middle class" and the regulatory policies initiated to date are largely consistent with that objective. For example, the Chinese regulatory changes regarding technology companies mirror concerns and proposed anti-monopoly legislation in the West. Thus, small- and medium-sized companies will be more able to compete with more dominant market leaders in China. This could potentially benefit Chinese consumers over time.

Figure 9: Chinese and Chinese-exposed Equity Valuations



Source: Bloomberg as of August 20, 2021

There is no doubt that the speed and depth of the regulatory actions taken by China and the political situation for 2022 as President Xi seeks an extension of his term in office are spooking investors and reversing the "market normalization" narrative that has powered Chinese shares higher over the past decade. That said, looking at the data we have thus far, the price levels reach by some Chinese shares presents opportunities for adding to quality Chinese names at a material discount to global peers (**Figure 9**).

UK Sees Rising Share Buybacks, Dividend Increases and M&A Activity

Summary:

We went overweight UK equities in November 2020 and added more to our overweight in February. The UK market has risen 11.2% so far this year and 17.2% over the past 12 months. However, it is still 7% below the pre-COVID high and 10% below the all-time high. In addition to a 60% increase in EPS this year, a key reason for our overweight position is the low relative market valuation of 13X. There are now clear catalysts for value to be unlocked, with the sharp rise in share buyback activity, companies resuming dividend payments and many raising their dividend payouts. Firms that are not cost-cutting and streamlining their business models to drive cashflow improvement are increasingly facing the threat of takeover. Many of these takeovers are from foreign companies, which are encouraged that the Brexit fallout is less than feared and the COVID vaccine progress has been rapid.

With companies either being more proactive in using their cash-piles or risking predatory action, there is likely to be rising institutional interest in the UK market. Our advice is to buy the broader market as the individual catalysts help to potentially drive overall price levels higher.

Where Valuations Are Now

The pressures on UK growth and dividends were reflected in its stock market over the past five years. UK equities fell in relative terms and the valuation multiple fell to as low as 12X prospective earnings – **Figure 10.** In absolute terms, the FTSE 100 now still trades at a low multiple of 13X versus 23X for the MSCI World Index.

Figure 10: UK GDP year-on-year % change

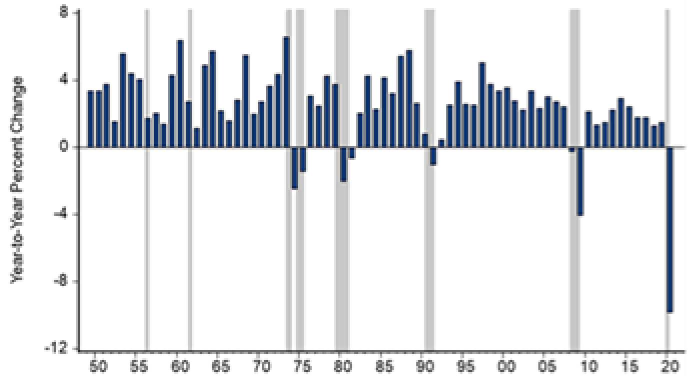


Figure 11: UK market is cheap in absolute and relative terms. Relative forward 12-month price to earnings

Source: Haver and Bloomberg as of July 28, 2021. 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. Index returns do not include any expenses, fees or sales charges, which would lower performance. Past performance is no guarantee of future results. Real results may vary.

Rising UK corporate cashflows support dividends and buybacks

There are two trends gathering momentum and both are the result of rising cashflows. First, there are more companies resuming dividend payments, and in many cases, raising their dividend payout rates. Second, many companies are now looking to raise their returns on equity through share buybacks. They are taking both of these actions to bolster their share prices, by offering more dividends, more growth, or sometimes both. The two most undervalued sectors – banks and energy – are leading the way.

Banks: In the early stages of the COVID recession in March 2020 last year, the UK Prudential Regulation Authority (PRA), the financial services regulator, barred banks from paying dividends. However, it is now relaxing that regulation.

Energy: Rising and generally firmer oil prices have been supportive of improving cashflows and higher shareholder payouts. For example, one energy company recently raised its dividend by 38% from the previous quarter. Another company posted $2.4 billion surplus cashflow in the first half of this year, reduced its debt below its $35bn target, and announced a $1.4 billion buyback. The dividend was raised by 4%, and management stated that if the oil price remains at or above $60/barrel, it would look to make share buybacks of $1 billion a quarter and raise its dividend by 4% annually until 2025.

The trend towards higher payouts is broadening in the UK. There are also more “special dividends” being announced. The dividend monitoring company Link Group calculate that £1.4 billion of special dividends were paid during the first half of this year by UK listed companies, much greater than during the whole of 2020.

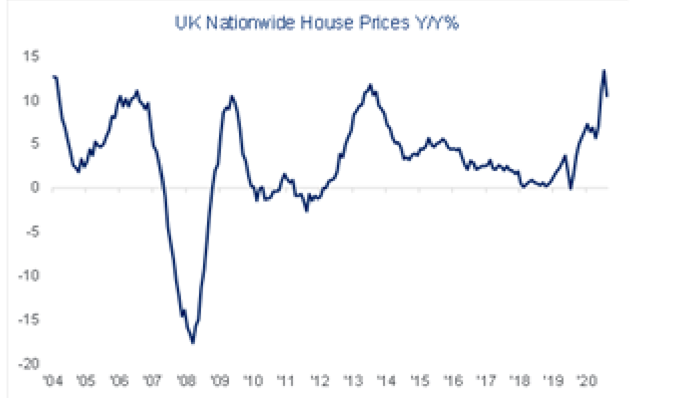
Rising UK corporate investment intentions

In aggregate AJ Bell has estimated that FTSE 100 dividends will grow by 25% this year to £67.9 billion, providing an average yield of 3.7%. While dividends are the tangible return from equity ownership, excessive cash return to investors can lead to cuts in investment, which ultimately lowers long-term profitability. So, it is encouraging that even as dividend payments resume and many payouts rise, along with a spate of share buybacks, the corporate sector is showing increasing confidence to invest in several recent surveys.

The rising investment intentions are partly based upon Brexit being less problematic than anticipated, plus the great government vaccine development, procurement and rollout program. Companies are seeing this being reflected in a consumer demand pickup. The jobs market is strong, and low interest rates are encouraging much mortgage fixing which is helping drive the property sector. What is more, there are unplanned COVID-savings equating to around 10% of GDP, which will be partly spent on consumer goods – **Figures 12 and 13.**

Figure 12: UK consumer confidence picking up

Figure 13: Rebounding UK house prices



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Rising level of UK Corporate Activity

Companies not able to raise cashflow by way of organic growth are under increasing pressure to generate growth through more efficient use of capital. This involves shedding inefficient non-core businesses or through buying growth businesses. There are numerous companies with strong cashflows and rising payouts who still have pressing needs to shed assets to shift strategic direction.

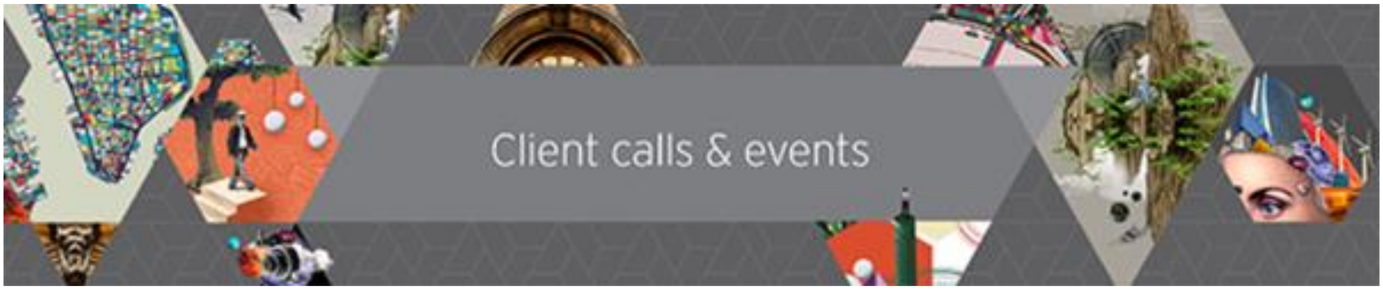
Companies with little cashflow and no proactivity are potential targets for acquisition, particularly those with strong brands, sizeable market shares and share prices that are low compared with their intrinsic asset value. Bid activity for UK listed companies has picked up markedly this year, with the combined value of takeover attempts involving UK targets reaching almost £156 billion. This is the highest total in 14 years and up from £45 billion in same period last year (Source: Refinitiv). Private equity (PE) buyout bids for UK-listed companies is the fastest in 20 years and the number of leveraged UK buyouts is up almost 60% in 2021 compared with 2019.

There are three notable factors driving this pickup in corporate activity:

1. First, there is rising business confidence, reflected in many of the statements accompanying recent results. This is leading to more transactions and it is notable that the average deal size is increasing;.
2. Second, the upturn is more than pent-up corporate demand after the pandemic period of inactivity. There is now a focus on strategic positioning. Some companies are seeking to secure future supply chains that have proved vulnerable during the pandemic. Others are seeking scale and diversification as defenses against potential unpredictable shocks; and
3. Third, there is cash on the sidelines, particularly from the PE sector. The shorter investment cycles in PE between entry and exit are feeding the transaction flow. In addition, strong historic PE investment performance has fueled investment into PE funds looking for hard to find reasonable target valuations. Cheap debt is also fueling leverage for many of these PE deals. There is reportedly around $413 billion of PE firepower earmarked for European investment alone.

Go UK

At a global level, we are increasingly focused on adding quality companies to portfolio as the pandemic progresses. The UK has many listed companies that meet our quality criteria, including strong brands built up over many years, strong balance sheets and improving cashflows. However, for a prolonged period, local institutional equity buyer demand has favored high dividend income relative to appreciation during the five-year acrimonious Brexit negotiations. As Brexit fades, foreign portfolio investor interest is rising. In our view, therefore, the stock valuations of many of these quality companies are cheap even after the 17% market rally over the past 12 months.



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