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Citi Global Wealth Investments

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Challenges are coming thick and fast as winter approaches

- **Energy worries remain centre stage, all eyes on Germany:** Despite the news of damages to Russian natural gas pipelines, natural gas storage levels are now sufficiently high to suggest that unless temperatures fall markedly below seasonal averages, Europe is unlikely to have to resort to meaningful gas restrictions in early 2023. EU criticism of Germany's €200bn energy support package is growing.
- **Confidence in free-fall while inflation still climbs**: The macroeconomic outlook is deteriorating. German business and consumer confidence are in freefall, with the Ifo expectations measure approaching its pandemic-era all-time low of 72. The euro area composite PMIs for September point to an imminent GDP contraction. With euro area inflation jumping to a new record high of 10% YY, ECB speakers are erring on the hawkish side.
- **Watching politics and sovereign risks:** The Italian hard-right wins the legislative elections, but falls short of a 2/3 majority that would have allowed for the possibility of destabilising changes in the Italian constitution. Bond investors' reaction was muted, with the 10-year Italian BTPs German bunds spread remaining contained at 240bp, for now.
- **Global Investment Committee implications:** we remain underweight European equities. We also remain strongly underweight on European sovereign debt at a time when the economy is struggling and recession risks are mounting, even if current yield levels have already risen meaningfully.
- **UK:** Polls show Labour building a strong lead over the Conservatives. New PM Liz Truss' mini-budget has not managed to instil much needed confidence in the targeted reboot of the economy through tax cuts and supply-side reforms. Meanwhile, the BoE is juggling the need to hike rate while delaying the start of QT.
- **Fixed Income Outlook:** In September 10-year Bunds and UK gilts declined by 5.2% and 9.7%, respectively. Year-to-date the performance of the European fixed income market is negative across the board. Relative to the BoE's Bank Rate on a 15-year basis, the short-end of the UK gilt market looks very cheap relative to the longer-end.
- **What if?:** Because of the jump in gilt yields, we think that demand will be much higher and that foreign investors might be attracted by the additional potential return that could be offered by currency appreciation in coming years.

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Energy worries remain centre stage, all eyes on Germany

Europe: Energy worries still very much in focus – Reports of explosions and gas leakage from three Russia-to-Germany pipelines in the Baltic Sea in the final few days of September raised the level of concern among European governments about the need to protect critical infrastructure from sabotage. Many countries are worrying about the possibility of further incidents, only a few weeks ahead of the start of the heating period as temperatures begin to decline.

Despite the recent falls in the price of natural gas and electricity, energy future prices will likely stay elevated in coming months. There could be renewed upside in case of prolonged adverse weather conditions. But as is shown on **Figure 1**, the worst is probably behind us in terms of the inflationary consequences of the energy price spike, as central banks are doing all they can to raise interest rates quickly and anchor long-term inflation expectations. Gas storage levels have reached 89.6% as of 3 October, a level largely in line with the 91.5% average between 2018-20 (**Figure 2**), suggesting that unless temperatures fall markedly below seasonal averages, Europe is unlikely to have to resort to meaningful gas restrictions.

Figure 1: Prices are beginning to fall materially

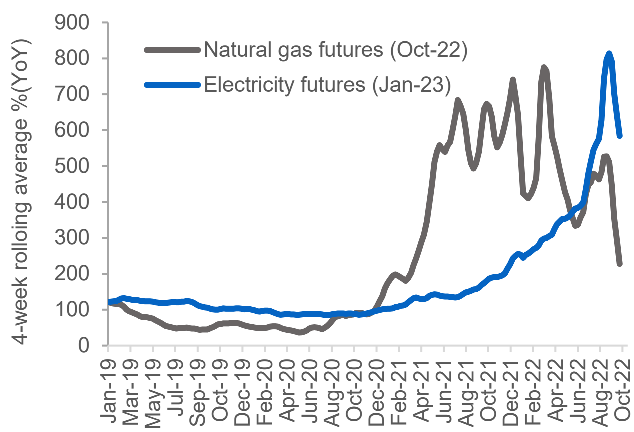
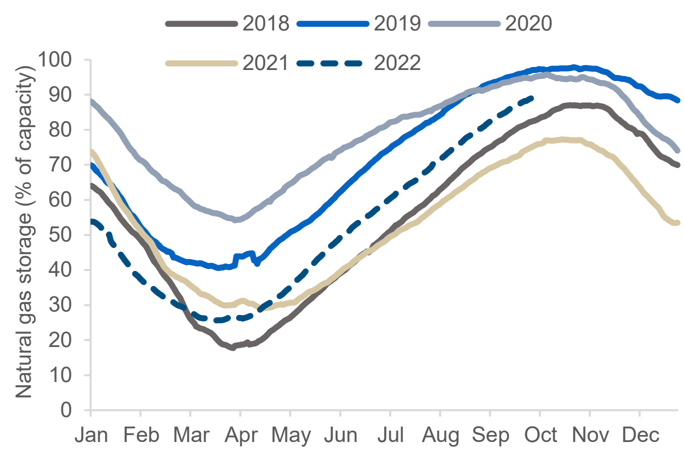


Figure 2: Storage of gas is rising steadily



Sources: Bloomberg, Gas Infrastructure Europe and Citi Global Wealth Investments s of October 5, 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.

EU: Criticism of Germany's support package is growing – Germany's €200bn plan (for 18 months, worth 5.5% of 2021 GDP) to subsidise the price of natural gas for households and businesses up to 2024 is ruffling a few feathers in the EU. The main issues are that 1) Germany is appearing to ignore the concerns of smaller member states as it pushes up gas prices to unaffordable levels and 2) acting selfishly instead of relying on the solidarity principles that worked well during the pandemic, in particular the joint procurement of vaccines, as well as the SURE programme of mutualised debt issuance. From an energy crisis management point of view, there will be widespread relief at the fact that natural gas prices are falling in Europe, partly due to the implementation of energy saving measures and demand destruction. The International Energy Agency estimates that natural gas demand will fall by around 10% in 2022 and a further 4% in 2023.

Yet, Germany's rejection of a proposal to table a natural gas price cap for all imports into the EU, despite having been supported by up to 15 member states including the five biggest ones, is going down like a lead balloon. Most EU countries are not happy with what many see as beggar-thy-neighbour tactics when they are paying the price of Germany's over-reliance on Russia. French Finance Minister Bruno Le Maire warned on Monday that there were risks of fragmentation of the euro area if the solidarity principle was to be set aside for matters as important as the provision of energy. EU Commissioners Thierry Breton and Paolo Gentiloni also published a joint op-ed in some newspapers proposing "*mutualised tools at the European level*". We would expect heads of state and governments to debate many of these issues at their informal EU Council meeting in Prague this weekend.

Confidence in free-fall while inflation still climbs

The macroeconomic outlook is deteriorating. This will most likely translate into the postponement and/or cancellation of some investment projects in many countries where sentiment is weakening fast. The closer to the East of Europe and the more dependent countries are on Russia hydrocarbon imports the tougher the adjustment is likely to be, even if governments attempt to limit the downside. We will be paying close attention to what EU energy ministers decide later this month in terms of price caps and whether pooling natural gas purchases to lower prices might interest more member states.

German business and consumer confidence in freefall – The composite measure of the German Ifo business climate fell by 4.3 points to a 28-month low of 84.3 in September. The Ifo expectations measure slumped by 5.3 points to 75.2, approaching its pandemic-era all-time low of 72.0. The Ifo current assessment declined by 3.0 points to 94.5. Splits by sector showed weaker confidence readings across the board. The German GfK consumption climate index fell sharply by 5.7 points (pt) to -42.5 in September, hitting a new record low for the fourth consecutive month. Many households are facing an acute cost-of-living crisis, as they are forced to spend more of their real income on energy bills.

Composite PMIs point to imminent GDP contraction– S&P Global final composite Purchasing Managers' Index (PMI) for the euro area declined to a 20-month low of 48.1 in September. The 0.8-point fall was the fifth successive monthly drop and means that the euro area is now on the cusp of recession since activity has been contracting (i.e. sub-50 level) for the third successive month (**Figure 3**). Services PMI activity fell by one point to a 19-month low of 48.8 in September, its second successive month below the 50 neutral level. The guts of the report also showed a likely deterioration in private sector activity in coming months. Worryingly, both input and output prices rose again, with the former jumping to 77.1 from 72.3.

Euro area: Inflation jumps to new record high of 10% YY – The flash estimate of euro area HICP inflation jumped from 9.1% YY in August to a new all-time high of 10.0% YY in September (**Figure 4**). More worryingly, the core HICP measure excluding energy and food rose from 4.3% YY in August to 4.8% YY in September. Non-energy price inflation continued to rise, from 5.1% YY to 5.6% YY, while services price inflation rose from 3.8% YY to 4.3% YY, illustrating the breadth of the challenge. Although many countries are trying to mitigate the rise of energy prices on to households and businesses, there will still be risks of further price increases from elevated energy prices feeding into the final utility bills.

ECB speakers erring on the hawkish side – Governing Council members of the European Central Bank (ECB) who spoke recently erred on the hawkish side, arguing that there was a lot more that needed to be done with respect to increasing interest rates to ensure a return of inflation to its 2% medium term target. We think that these numbers will likely push the more dovish members towards accepting that the path to a neutral level of interest rates, widely acknowledged to be around ±2%, will likely be steep and that another 75 basis points (bp) rate hike to 1.5% on 27 October will be hard to resist.

Figure 3: PMIs slipping below 50 in most countries

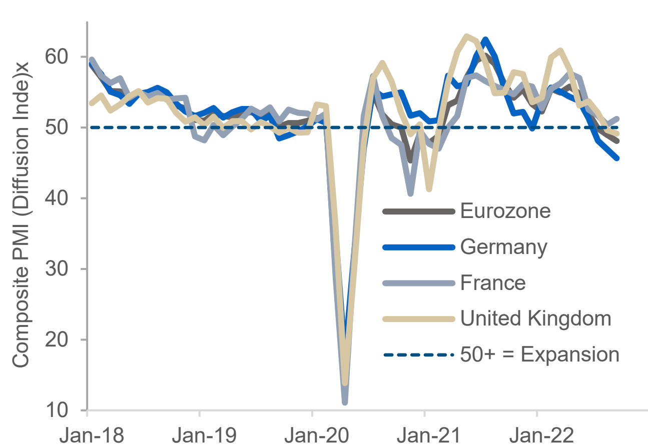
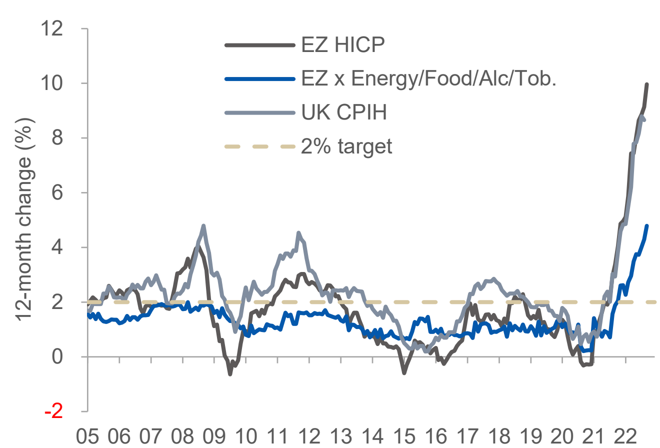


Figure 4: Inflation climbing to record highs



Sources: Eurostat, Haver Analytics, Citi Global Wealth Investments as of October 5, 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.

Watching politics and sovereign risks

Italy: hard-right wins the elections, but falls short of 2/3 majority – Giorgia Meloni, leader of the nationalist Brothers of Italy (FdI), looks set to become Italy's first woman Prime Minister (PM) in the next couple of weeks, replacing Mario Draghi. President Sergio Mattarella will consult with party leaders over the next few weeks before appointing the PM. In the meantime, investors will focus on the name of the likely finance minister who will be tasked to interact with his euro area (and EU) peers to guarantee the delivery of semi-annual financial assistance tranches. A Pro-Europe, fiscally cautious personality looks the most likely choice at this stage. The right-wing bloc of FdI, Lega (led by Matteo Salvini) and Forza Italia (led by Silvio Berlusconi) will have a solid majority in both houses of parliament, with 237 out of 400 seats in the lower house and 115 seats in the 200-seat Senate.

Meloni's first speech stressed the need for responsibility, governing for all and focusing policies on uniting the country. The electoral result means that the coalition of hard-right parties fell short of the 2/3 qualified majority that would have allowed for the possibility of destabilising changes in the Italian constitution. As a result, investors' reaction to the news was muted, with the spread between 10-year Italian BTPs and German bunds remaining contained at 240bp (**Figure 5**).

Global Investment Committeee (GIC) implications – The deteriorating macroeconomic picture and rising cost of intermediate goods mean that many businesses will likely be forced to increase prices to avoid too sharp a compression in their profit margins, which will likely dampen sale volumes. We believe that the worsening cost-of-living crisis, continued worries about the war in Ukraine and aggressive monetary policy tightening by central banks will have significant negative consequences on businesses' ability to invest and hire, while households will most certainty cut back on discretionary spending.

From a Global Investment Committee perspective, we remain underweight European equities. We also remain strongly underweight on European sovereign debt at a time when the economy is struggling and recession risks are mounting, even if current yield levels have already risen meaningfully. One of the key risks going forward for the fixed income market will be the possibility of still-elevated inflation into year-end due to euro weakness. Another possibility is the start of a debate around the broader monetary policy normalisation process, with regards to ending reinvestments of fixed income instruments which were is added on the Eurosystem's balance sheet.

Figure 5: Italian yields suggest contained risk, for now

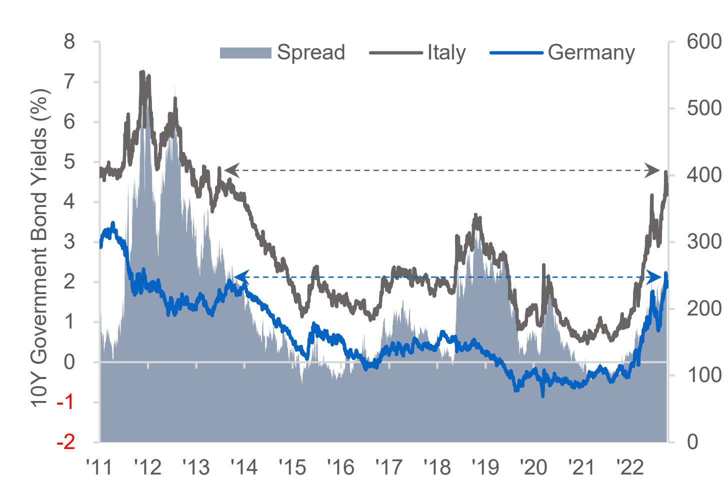
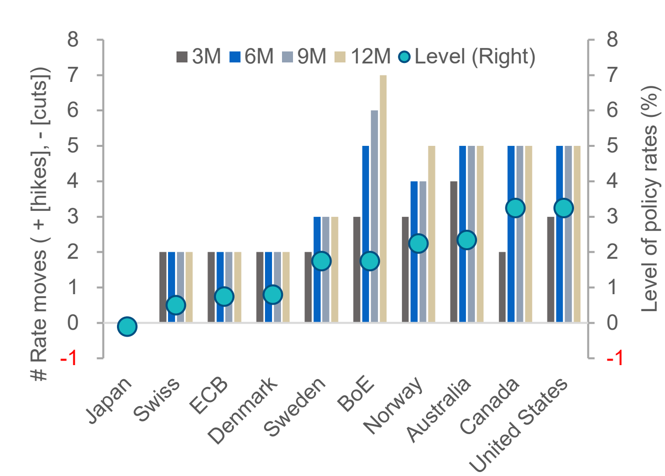


Figure 6: Central bank hiking cycle: mostly sharp and short



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UK: Polls show Tories losing support, and a corresponding gain for the opposition – The UK conservative party has been in turmoil during 2022. First, MPs managed to force the resignation of Prime Minister Boris Johnson, which led to a leadership contest that was resolved in early September by the choice of Liz Truss as Johnson's successor. Less than a month into her job, Mrs Truss' support is ebbing, particularly noticeably since the announcement of the mini budget. An Observer poll shows that her approval ratings are lower than of those of her predecessor Boris Johnson at the end of his premiership. Net approval ratings for Truss have fallen from -9 points to -37 in just one week (18% approve of her actions while 55% do not but remain above Johnson's worst ever level of -42 (since the party-gate scandal).

The cost-of-living crisis has been dampening household confidence (**Figure 7**), with new record lows being registered as inflation soars to multi-decade highs. PM Liz Truss' mini-budget (EMEA Strategy Bulletin | UK: Turmoil ahead for both economy and markets) has not managed to instil much needed confidence in the targeted reboot of the UK economy through (yet-to-be funded) tax cuts and supply-side reforms (details of which are lacking also). The Bank of England (BoE) was called into action to prop up the gilt market despite having announced a few weeks earlier its intention to start quantitative tightening (i.e. sales of gilts and corporate bonds on its balance sheet accumulated during the various QE programmes).

Support for the largest party of the opposition, the Labour party, has been gaining momentum. A survey of 2,000 voters conducted by Savanta ComRes taken during the opening days of the Conservative conference in Birmingham shows that Labour has a lead of 25 percentage points over the Conservatives, potentially pointing to a Labour party victory in the next general election. This is just one in a long string of polls showing a rapid erosion of support for the Tories, who have been in government for the last 12 years. Aggregated polling intentions suggest that Labour, the opposition party, is firmly on track to win the next legislative elections that must be held no later than January 2025 (**Figure 8**).

UK: GDP revisions show lower growth potential – UK 2Q-22 GDP was revised up from its initial reading of -0.1% QQ to 0.2% QQ, much higher than the BoE's forecast, meaning that the UK economy has not yet fallen into recession as predicted by the BoE. The level of real GDP remains 0.2% below that seen in 4Q-19, making the UK the only G7 nation to not have recovered to its pre-pandemic level. More importantly, significant downward revisions to the GDP back data sent an important warning for UK policymakers that the effective level of UK potential GDP growth is lower than we thought.

The Bank of England (BoE) raised Bank Rate by 50bp to 2.25% at the 21-22 September meeting – Monetary Policy committee (MPC) members voted unanimously to raise Bank Rate. This was the seventh consecutive hike, making this the fastest rate of policy tightening since 1997. All members agreed that further tightening of the monetary policy stance was warranted. Five MPC members argued that a combination of tight labour market conditions, elevated wage growth and above target levels of domestic inflation justified the decision to continue with a 'forceful response'. Three members preferred a 75bp increase due to growing data evidence that inflation pressures were becoming more persistent and that '*medium-term measures of inflation expectations had remained high'*. Looking ahead, we now expect the BoE to announce a 75bp rate hike in November to 3%, followed by a 50bp hike in December to 3.5%, to be followed by perhaps two final hikes of 25bp in February and March 2023, bringing Bank Rate to 4.0-4.5% in the spring of 2023. See EMEA Strategy Bulletin | Bank of England (BoE): 75bp likely to be on the table in November for more details.

Figure 7: UK: Record high inflation = record low confidence

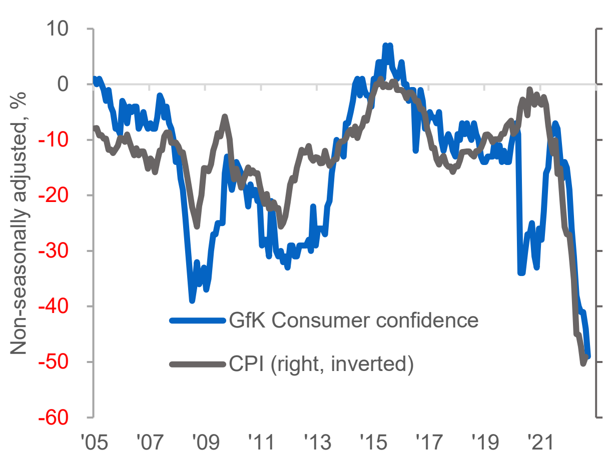
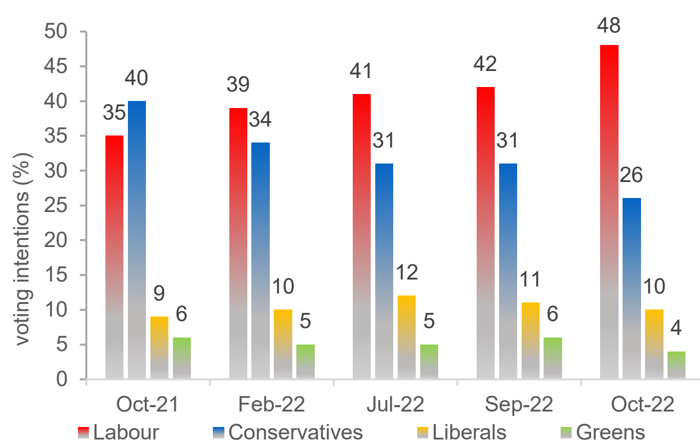


Figure 8: Labour party on track to win the next elections



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Fixed Income Outlook

In September 10-year Bunds and UK gilts declined by 5.2% and 9.7%, respectively. Year-to-date the performance of the European fixed income market is negative across the board (**Figure 9**), largely driven by the conflict in Ukraine, cost-of-living crisis, persistent supply side disruptions and the central banks continuing their rapid pace of tightening.

Figure 9: Fixed Income performance

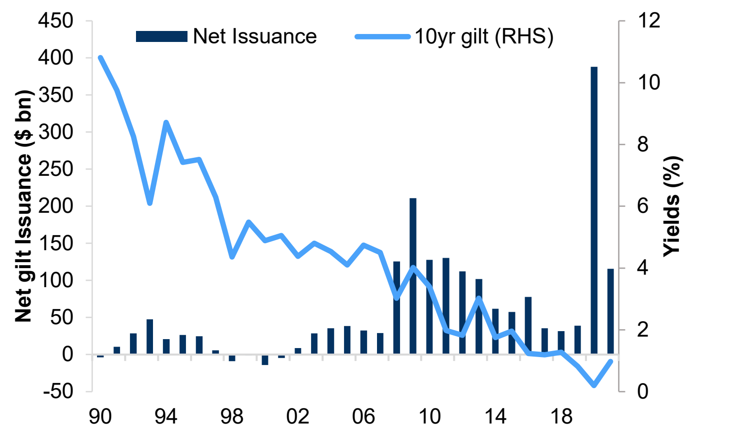
German 10Yr	-5.2%	-10.4%	-11.0%	-19.8%
BTP-Bund spread (bp)	5.9	20.6	92.0	106.2
UK 10Yr	-9.7%	-16.9%	-16.7%	-23.2%
EU IG	-3.3%	-7.4%	-10.1%	-14.6%
EU HY	-3.9%	-5.1%	-10.9%	-14.6%

Source: Haver Analytics and Bloomberg data as of 30 Sep 22. 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.

UK Gilt market in disarray – The gilt market saw indiscriminate selling due to an unprecedented amount of fiscal stimulus announced by Chancellor Kwasi Kwarteng on 23 September. By capping energy prices, the package will lower short-term inflation but could add to inflation risk in the medium-term. As referenced earlier, a combination of widespread tax cuts and financial support to the housing market was taken badly by investors in the gilt market where sovereign bond yields jumped to levels not seen since the Great Financial Crisis (**Figure 10**).

Figure 10: UK gilts spike to levels seen in the GFC crisis

Figure 11: Large net issuance to follow as QT gets underway



Source: UK DMO and Bloomberg data as of 30 Sep 22. 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.

BoE brought into the fray to stabilise the gilt market – Given the extreme moves in the gilt market and the need to preserve financial stability, the BoE announced that it would temporarily purchase long-dated UK gilts (20yr+), mainly for the benefit of UK pension funds, which are active buyers of longer dated gilt maturities (worth 27.5% of total issuance as of 1Q-22). The temporary support measure now sees the BoE purchasing a maximum of £5bn per day of 20yr+ gilts until 14 October. As a result of the intervention, the BoE has pushed back the start of quantitative tightening (QT) to 31 October, when they effectively will be adding to net supply by actively selling around £10bn of gilts per a quarter. Citi Research estimate that if this tentative calendar is followed, a net supply of around £148bn[1] will enter the UK gilt market for FY 22/23. This will be the second highest supply in history since the 2008/2009 (**Figure 11**).

We believe the UK is relatively well positioned amongst its developed market peers to fund its medium-term growth outlook. Indeed, the UK has the second lowest debt-to GDP percentage amongst its G7 peers (**see Figure 12**), with a current debt to GDP ratio of 87.8% for 2022, versus 123.7% for the US for example.

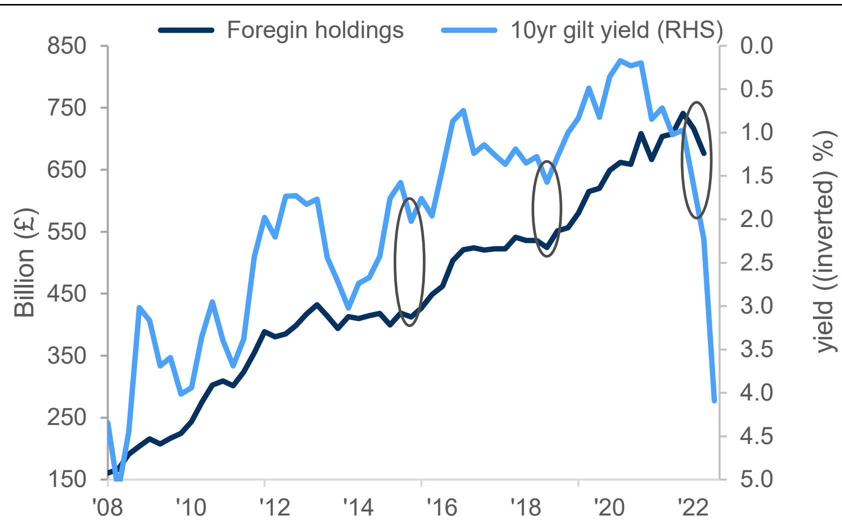
Figure 12: UK has the second lowest debt-to-GDP ratio relative to its G7 peers

Advanced economies	103.6	103.2	105.6	103.2	102.7	103.8	123.2	119.8	115.5
Canada	85.6	91.2	91.8	88.9	88.9	87.2	117.8	112.1	101.8
Euro Area									
France	94.9	95.6	98	98.1	97.8	97.4	115.2	112.3	112.6
Germany	75.3	72	69	64.7	61.3	58.9	68.7	70.2	70.9
Italy	135.4	135.3	134.8	134.2	134.4	134.1	155.3	150.9	150.6
Portugal	132.9	131.2	131.5	126.1	121.5	116.6	135.2	127.5	121.6
Spain	100.7	99.3	99.2	98.6	97.5	95.5	120	118.7	116.4
Japan	233.5	228.4	232.5	231.4	232.5	236.1	259	263.1	262.5
United Kingdom	85.5	86	85.8	85.1	84.5	83.9	102.6	95.3	87.8
United States	104.6	105.1	107.2	106.2	107.5	108.8	134.2	132.6	125.6

Source: IMF data as of 30 Sep 22. 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.

Foreigners to the rescue? Investors are wondering who will absorb the extra supply of gilts. Overseas investors, who have been a key source of funding, could certainly step in. Foreigners have been significant net buyers of gilts during the pandemic. However, foreign holdings declined by £40bn in 2Q-22, the biggest quarterly drop since 1Q-21 (**Figure 13**) and the second largest in history. Because of the jump in yields, we think that demand will be much higher and that foreign investors might be attracted by the additional potential return that could be offered by currency appreciation in coming years.

Figure 13: Foreigners enter the market at usually reasonable higher yields



Sources: Haver Analytics and Bloomberg, data as of September 30, 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

[1] . Citi Research, European Rates Weekly, “Making sense of the turmoil in the gilt market”, 30 September 2022

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What if?

In our view, higher gilt yields are quite attractive for both domestic and foreign investors. In addition, markets are now pricing up to 325bp of rate hikes by March 2023 compared to the 2.25% level of Bank Rate. We believe a hike of 75bp in November (with a real possibility of a 100bp) will be required and that another large hike on 15 December is inevitable, with further hikes in February and March of around 25-50bps, bringing the terminal rate to around 4.50%. With yields at historically attractive levels and a potential recession around the corner for the UK economy (we forecast that real GDP growth will fall by 1% in 2023) investors could start to position for a lower yield environment. Looking at **Figures 14-17** relative to the BoE's Bank Rate, we would say that compared to the 15-year average the short-end of the UK gilt market looks very cheap relative to the longer-end.

Figure 14: 2yr gilt yield minus Bank Rate = discount

Figure 15: 5yr gilt yield minus Bank Rate = discount

Source: UK DMO and Bloomberg data as of 5 October 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.

Figure 16: 10yr gilt yield minus Bank Rate = fair

Figure 17: 30yr gilt yield minus Bank Rate = fair

Source: UK DMO and Bloomberg data as of 5 October 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.

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