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Citi Global Wealth Investments

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Jeffrey Sacks, Head – EMEA Investment Strategy | +44 207 508 7325 | Jeffrey.ian.sacks@citi.com
Maya Issa, Senior Vice President, Global Investment Strategy | maya.issa@citi.com

Economic rebounds transitioning to long-term recoveries,

Market rallies transitioning to long-term bull markets

Summary

- **Overweight UK equities.** UK equities have rallied 27.5% off their November 2020 lows, however have much further to go. GDP growth in 2021 could exceed 7% and average EPS growth could exceed 50%, supported by accommodative monetary and fiscal policy, along with great vaccine progress. The market is cheap in absolute terms and relative to other markets, and the high average dividend yield of over 3.5% compares favourably with average fixed income yields. The post-Brexit and post-COVID roadmaps could encourage further investor interest.
- **Overweight European equities.** The vaccine rollout has progressed, with much more momentum in the last few weeks. European Central Bank (ECB) policy remains very supportive, while the EU Recovery Fund implementation is likely to gather momentum over the summer. Alternative energy is a powerful long-term growth driver, supported by increasingly ambitious government initiatives.
- **Both UK and European equities offer particularly good exposure to the areas we favour globally**: COVID cyclicals (*), value, mid-caps, dividend growers, and "green" stocks.
- **Underweight fixed income**. Sovereign bonds remain expensive. In the current environment of negative real yields, there are selective potential opportunities in the corporate bond market, particularly amongst high yield bonds.
- **Favour sterling over the euro.** Sterling continues to benefit from inflows driven by pent-up demand for all asset classes and is inexpensive in valuation terms. The euro faces further consolidation as the European Central Bank (ECB) is expected to remain more accommodative for longer than other central banks.

UK and European equities in early stages of bull markets

Our Global Investment Committee (GIC) raised European and UK equities to overweight in November 2020. That was before the confirmation of the UK-EU trade deal and before the first vaccine approval. It came at a time when the GIC was seeking to broaden its global equity exposures. The GIC then trebled the size of the UK overweight in March 2021. Both markets now offer more potential than just trading rallies, with both in the early stages of prolonged bull markets. While European markets are undergoing a perception change in the eyes of global investors, and the UK is benefiting from pent-up demand, both have four similar underlying drivers.

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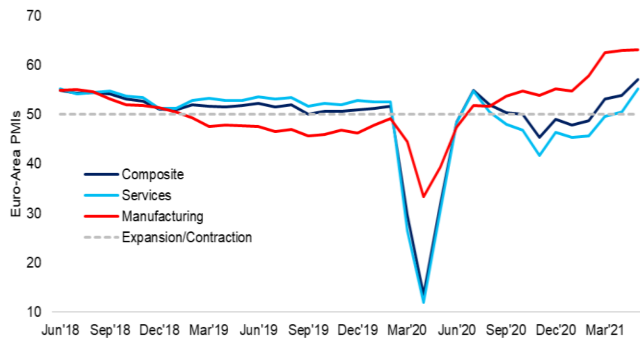
There are four reasons to keep accumulating UK and European equities:

1. **Growth**

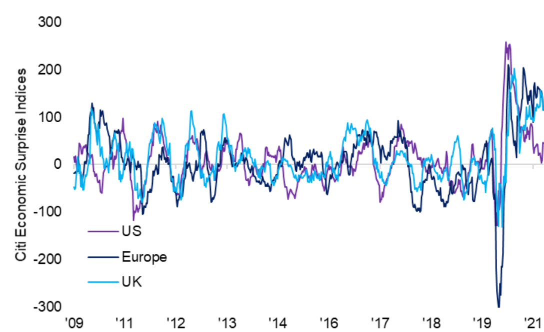
The UK's 1.5% GDP growth in the first quarter included a March rise of 2.1%. Consensus for UK GDP growth in the current quarter is 5% year-on-year. For the full year, the UK economy could grow by more than 7%. European growth this year is expected to at least match the global average of 5%. PMI indicators are not only in positive territory but are also still rising and led increasingly by services – **Figure 1.** The Citi Economic Surprise index is strong – **Figure 2.** Sentiment is rising strongly amongst consumers and businesses – **Figure 3.**

Figure 1: Euro-Area Manufacturing and Services PMIs positive and rising



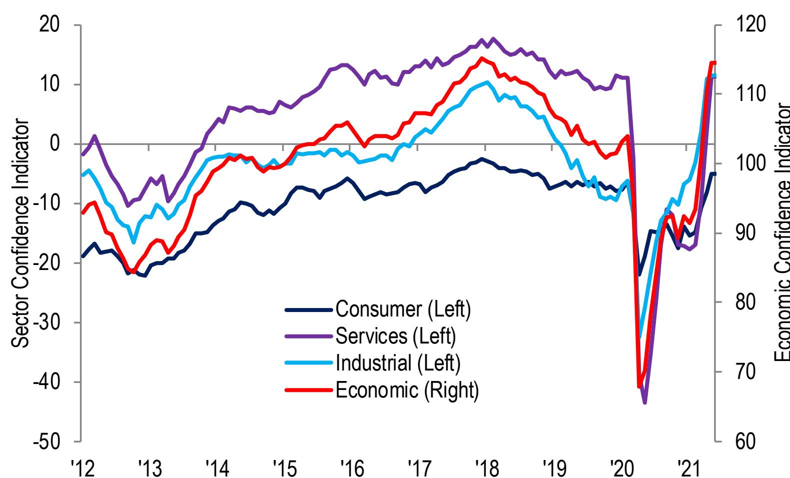
Source: Bloomberg as of June 22, 2021.

Figure 2: Citi Economic Surprise Indices – Europe and UK stronger than US



Source: Bloomberg as of June 22, 2021. The Citigroup Economic Surprise Index, or CESI, tracks how the economic data fare compared with expectations. The index rises when economic data exceeds economists' consensus estimates and falls when data is below forecasts.

Figure 3: Sentiment Indicators back at pre-COVID levels



Source: Bloomberg as of June 22, 2021. These measures are household survey-based confidence indicators by the European Commission across various sectors (consumer, services and industrial) and economy.

Growth is being driven by several factors:

Vaccine rollout progress has been great in the UK. Progress is now significantly picking up in Europe, with infection and hospitalization rates falling, while average vaccination levels have reached around 50%. If the Delta variant becomes more widespread – see page 8 – it should be manageable, assuming ongoing vaccine progress. This is boosting mobility, which is starting to support the depressed services sectors, which dominates 80% of UK output. Services picked up across Europe in May, led by particularly depressed close-contact service areas. June saw a pickup in high frequency services datapoints, which should show up in the hard data after more of a lag. In Europe, the travel sector contributes over 10% of GDP in many countries and is picking up from low levels.

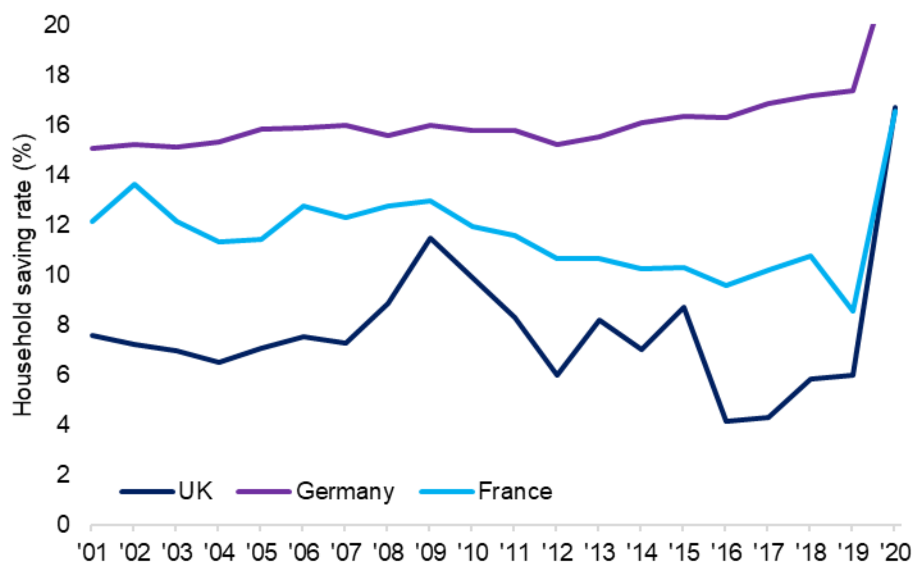
There is ongoing policy support from governments and the central banks. Even as fiscal measures start to have impact, we expect ongoing monetary accommodation for a prolonged period. In Europe, the distribution and spending of the €750 billion EU Recovery Fund will gather momentum throughout the rest of the year. This should be particular benefit to Spain and Italy, which each gain grants and loans equating to 12% of their respective GDP. In addition, there are ongoing significant national fiscal expansions.

In total during the pandemic, the UK's BOE has committed £875 billion and the government has committed £400 billion (17% of GDP). European emergency commitments are €1.85 trillion (17% of EU GDP) from the ECB as well as the €750 billion EU Recovery Fund (7% GDP). The key point regarding national fiscal expansions is that lessons have been learnt from the austerity imposed soon after the Global Financial Crisis. This time, the consolidations and normalization will occur much more slowly. There are two key points regarding the EU Recovery Fund. Firstly, a broad intention exists to spend the funds on areas which will have high multipliers through the EU economies. Secondly, the spending will be persistent through to 2026, starting with a fiscal impact this year of around 1.5%.

The manufacturing rebound is gathering strength. This is driven by inventory rebuilding and particularly Asian import demand, and is occurring despite supply chain bottlenecks in some areas. Some 14% of UK exports go to Asia. China and developing Asia combined account for 11% of European exports. Germany has particularly significant exposure to Asia with approximately 15% of exports. Industrial production levels have normalized, having not been impacted by the COVID third-wave restrictions. Forward-looking indicators such as new orders and business expectations suggest further upside ahead.

Falling unemployment and high levels of accumulated savings during the pandemic are resulting in high pent-up demand and supporting consumer confidence – **Figure 4.** In the UK, there has been around £150 billion incremental savings since the onset of the pandemic.

Figure 4: Household savings rates have risen significantly during the pandemic



Source: Bloomberg as of June 22, 2021. Annual data through 31/12/2020.

Brexit has caused less upheaval than had been expected. This is starting to show up in UK-EU trade data. On both sides of the channel, initial logistics and administration issues after the UK left the EU in January 2021 are gradually being resolved. The key medium-term post-Brexit issue is in Northern Ireland, where there are challenges in implementing the Northern Ireland protocol. This part of the EU Withdrawal Agreement states that all goods entering Northern Ireland from Great Britain must follow EU customs rules, leading to a trade border in the Irish Sea. Both sides are working towards a more flexible solution, supported by President Biden who has stressed the vital importance of preserving the Good Friday Agreement.

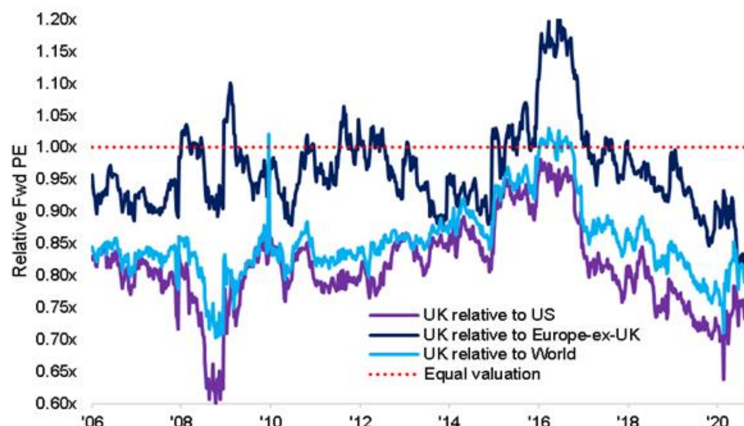
See further detail on the growth, trade and inflation outlook in pages 7-8.

2. Value

The UK market is cheap in absolute terms, cheap relative to other developed market equity markets, and cheap relative to UK fixed income. The FTSE 100 is 27.5% up from its November 2020 low, 10% so far this year, yet it remains 7% below its pre-COVID peak. The valuation multiple of 14X is cheaper than any developed market and is well-supported by average forecast

EPS growth this year of more than 50%. The average dividend yield of over 3.5% enhances the quality of the potential total return and is attractive versus fixed income. At a global level, we favour cyclicals and value, and each of these areas make up around 60% of UK market capitalization.

Figure 5: UK market in terms of its relative PER



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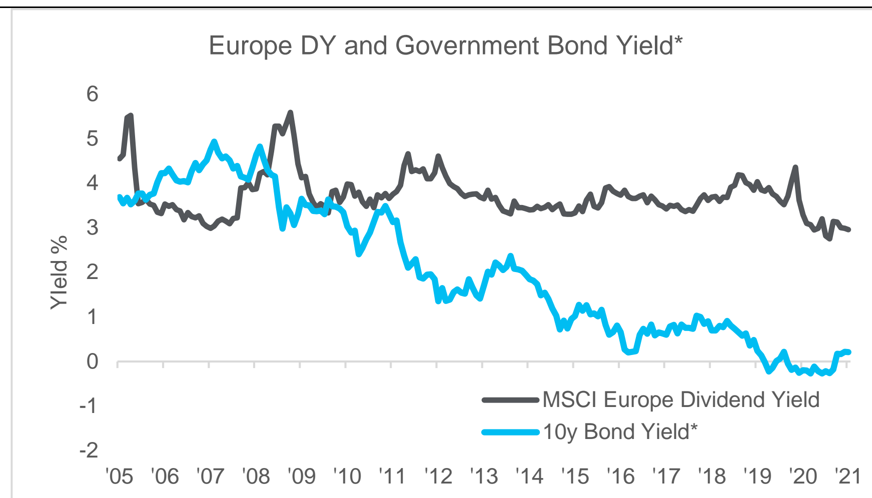
European equities are one of the strongest global performers so far this year, up 15%, yet global investors' change in perception of Europe is only in its early stages. The perception change is being prompted by upside growth surprises being reflected in a strong year for EPS growth this year of around 42% and another good year for earnings in 2022 starting to be discounted. European markets offer over 55% of market capitalization in the areas we favour at a global level: cyclicals and value. The average dividend yield of around 2.9% is attractive versus deposit rates, versus other markets, and versus European fixed income – **Figure 6.** The Swiss yield gap of around 300 basis points is the highest in the world. The valuation multiple is at a 6% discount to the global average, and in absolute terms the high teens multiple is in line with Europe's historic average at a time when the discount rate is historically low.

Figure 6: European Yield Gap – strongly supportive for inflows into equity from fixed income



Source: Bloomberg, Citi Research as of June 18, 2021. *60% Bunds & *40% Gilt yields. 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.

3. Liquidity

There are early signs of global equity allocations to UK and European equities rising from low levels, with rising net inflows. The region's equity markets have seen net inflows in 11 of the last 12 weeks. Global ETF flows are now seeing the

greatest pickup in demand in Europe and the UK. In the first half of this year, ETF inflows into the region are up 40% compared with the first half last year. The UK ETF demand is broadening from large-cap to mid-cap. In addition, some of the huge emergency government and central funds are supporting stock market liquidity indirectly. Finally, inflows from fixed income are ongoing, driven by particularly wide yield gaps in favour of equities.

4. **Technicals**

   The technical backdrop is strong. With typical ownership levels still low, consolidations are on light volumes. Indices are trending higher with higher highs and higher lows, with increasing breadth of buying support. Upward trendlines are firmly intact.

Equity investment opportunities

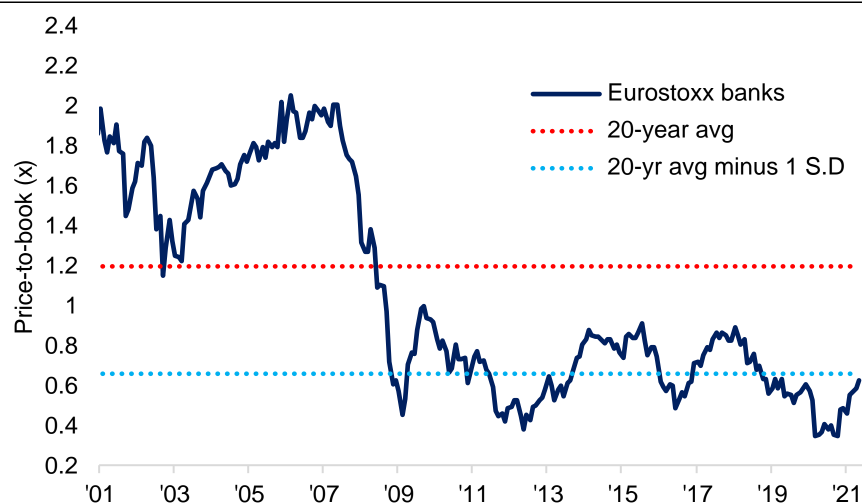
1. **Following the underperformance in 2020, COVID cyclical equities (*) have rebounded strongly in 2021. We believe there is further to go.** In terms of index weighting, COVID cyclicals make up over 55% of European and over 60% of UK market capitalisation. COVID cyclical sectors include industrials, energy, financials, materials, and consumer discretionary.

   Rebounding economic growth should help this outperformance continue. The biggest EPS rebounds in 2021 as well as upward revisions for 2022 are concentrated in COVID cyclical sectors.

2. **Value in both Europe and the UK remain compelling.** Value sectors tend to benefit in an environment with steepening yield curves and rising yields. Since the beginning of the year, German 10-year yields have risen from -0.55% to -0.182% currently, while UK 10-year yields have risen from 0.2% to 0.78%. The best two performing sectors, financials and cars, which can both be defined as “value,” are both up 30% year-to-date.

   We continue to recommend the bank sector, which is up over 90% since our recommendation in November 2020, but is still on a cheap average price/book valuation of 0.7X. Returns on equity are benefiting from slightly steeper yield curves supporting net interest margins, fee income from M&A is likely to rise, and strong balance sheets (average CETI of 13%) make provision writebacks likely next year. See **Figure 7.**

Figure 7: Financials at historically cheap valuations even after strong rally



Source: Bloomberg as of June 22, 2021. Note: 20-year average minus 1.S.D refers to 1 standard deviation below the 20-year average. Standard deviation is a measure of the amount of variation or dispersion of a set of values. 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.

3. **The “green” story remains attractive.** This follows the EU Green Policy, which targets 32% of its energy needs from renewable sources by 2030. It also comes after the EU Green Deal, targeting a fall in carbon emissions to 55% of 1990 levels by 2030, with likely enforcement tariffs for countries that don’t comply. The EU Recovery Fund will raise 30% of the debt needed through green bonds, and the spending of the loans and grant money will have a significant focus on green initiatives. The next decade is projected to see approximately €1 trillion worth of green investment across Europe.

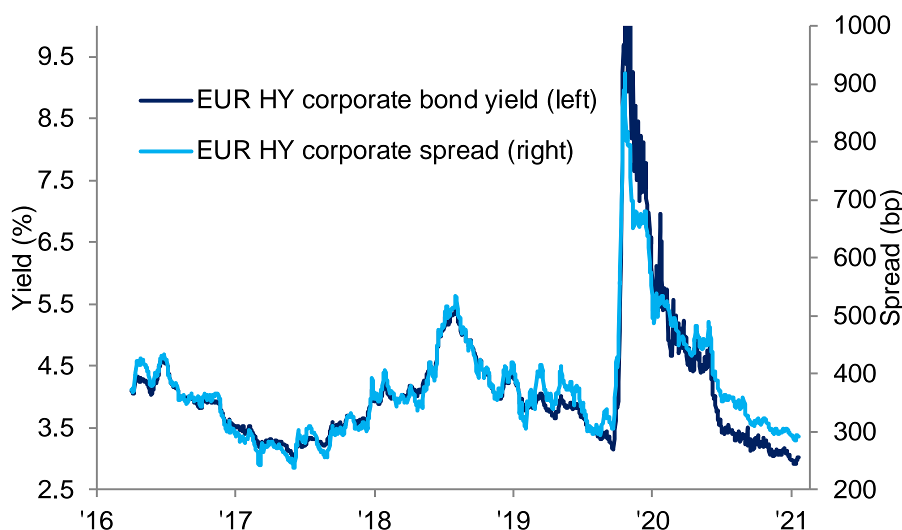
4. **Europe and UK are attractive markets for dividend yield**. The absolute average dividend yields of around 3.5% in the UK and 2.9% in Europe are high by global standards. Furthermore dividend-orientated strategies are heavily biased towards COVID cyclicals, with weightings in Europe and the UK of 74% and 65% respectively.

(*) COVID cyclicals: Financials, industrials, materials, real estate, consumer discretionary. COVID defensives: IT, healthcare, communication services, consumer staples, utilities.

Fixed Income

We continue to remain underweight sovereign bonds, while seeking selective opportunities in corporate bonds. We anticipate continued “trickle-down” demand into high yield (HY) to stay supportive, potentially driving average high yields down another 50 basis points (bp) to around 2.6%. Since the March 2020 price lows, European HY has rallied 30% compared to the 10% rally in investment grade (IG). However, the average HY yield of 3.1% and the average spread of 280 bp remain attractive as investors are increasingly challenged in finding compelling yield opportunities. We expect defaults to remain contained, given ongoing monetary and fiscal support, and many company debt maturity walls being pushed further out through new issuance. We prefer the risk-reward in the “fallen angels” area, which are HY bonds that were recently classified as IG. See **Figure 8.**

Figure 8: HY bonds have rallied significantly yet still have further potential



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The focus will soon turn to the EU’s launch of a €800 billion bond vehicle, to be raised by 2026. Some €20 billion of EU bonds have been successfully issued over the past fortnight and there is €60 billion further EU issuance to follow by year-end. In addition to financing the €750 billion EU Recovery Fund, which is making significant loans and grants to the periphery, the EU bonds will substantially enhance European bond market liquidity and provide a reliable curve for more rational pricing of existing and future sovereign and corporate bonds. Finally, if the EU bonds sell easily, even with slightly higher coupons than envisaged a few months ago, that would be powerful endorsement for the European investment outlook more broadly.

Currencies

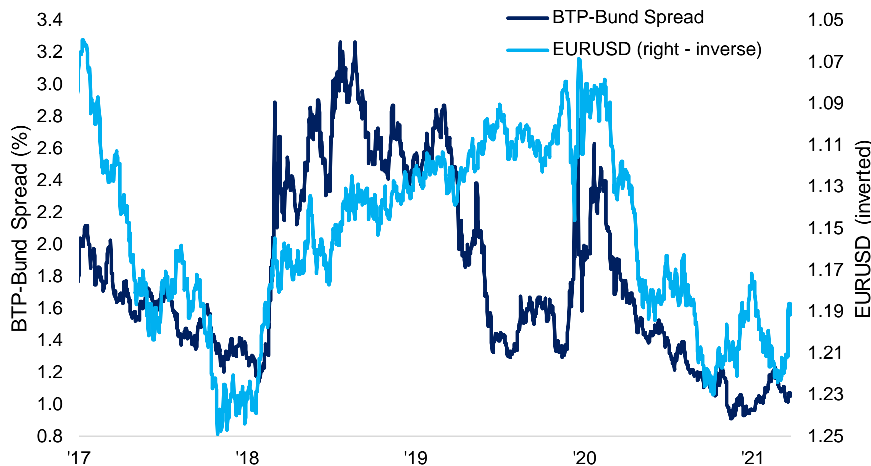
Sterling remains 10-15% cheap based on its CPI and PPI deflated real effective exchange rate. Inflows are well-supported by pent-up demand for all UK assets, and Sterling should continue to be accumulated below $1.40. The next resistance level is $1.4250. Once the long-term roadmap for the UK is clarified, post-Brexit and post-COVID, there is a strong likelihood of further sterling strength to $1.45.

The euro could face downward pressure in the coming months. While the strength earlier this quarter was driven by relative vaccine momentum, looking forward the euro could face pressure as the driver turns to relative growth and relative rate momentum. The next support level is $1.1850.

However, euro downside should be limited, mainly because Eurozone periphery risks are low. For several years prior to the pandemic, the periphery was perceived as an area of weakness. Now, despite the huge healthcare and economic impact of COVID-19,

the peripheral countries are benefiting from improved European solidarity and support. The appointment of Mr Draghi as the Italian PM has been a further positive factor as he has announced significant new plans to revive the Italian economy – a new electricity grid upgrade, hydrogen power projects, and structural reforms like reducing legal system bottlenecks. This is reflected in recent strong support for a €5 billion 50-year Italian sovereign bond issue which was 13 times oversubscribed, as well as in wider periphery sovereign bond issuance. For example, a Greece issue of €30 billion 10-year sovereign bonds was 12 times oversubscribed. See **Figure 9.**

Figure 9: BTP-Bund spreads remained at their lows



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Elections upcoming in Germany and France

Europe has had a benign political backdrop for many months, which has supported the COVID recovery as well as financial assets. In the coming months, Germany and France go to the polls, with the latter posing the greater risk.

Armin Laschet is the frontrunner to become the next German chancellor in the September federal election. Laschet's CDU party and its Bavarian sister party the Christian Social Union are favourites to win, with around 100 days to go. If elected, he is expected to continue Angela Merkel's policies towards supporting the economy, with a proposed 25% cap on corporate taxes and income tax relief for people on low and middle incomes, while seeking "as soon as possible" to bring Germany into compliance with the Maastricht treaty by bringing the debt-to-GDP ratio below 60% and rejecting attempts to remove Germany's "debt brake" to limit the budget deficit. The CDU would be very committed to ongoing EU integration, which should be supportive for the euro. In addition, Laschet would seek to maintain strong economic ties with China. Another possible outcome is a CDU coalition with the Green Party, which is much keener to challenge China on its human rights record and its environmental commitments.

The French regional elections in the PACA region (Provence-Alpes-Cote d'Azur) are important as they are the last elections before the presidential election next year. Overall, the left and centre right parties did better than expected, while Le Pen's far-right Rassemblement National (RN) saw its share of the vote fall to 19% (down 8% from the first round in 2015) and President Macron's La Republique en Marche (LREM) won only 11% in fifth place. However, the big surprise was that turnout was very low. In the second round this coming weekend, with the announcement of the withdrawal of the Green candidate that finished third, voters will choose between the RN party of Le Pen (candidate Mariani) and the LR candidate Mudelier. Whatever the final result of the regional election, the second half of this year will see increasing focus on the 2022 national election. Given Macron's poor current polling, this is likely to impact on French market sentiment and could potentially start to have impact on the euro.

Other topics

1. **UK inflation rising faster than Eurozone inflation**

UK inflation rose by 2.1% in May, above the Bank of England's forecast of 1.8% and above its target of 2%. The rate of inflation has trebled over three months and is up seven-fold since November 2020.The main drivers were recreational goods and services, clothing, petrol, restaurants, and car prices. While producer output prices rose at the fastest pace since 2012, the bigger driver was producer input prices which saw a 10.7% increase due to surges in material costs. Other UK data points have also been very strong, indicating further inflation pressures are likely into the autumn: residential property prices rose 8.9% year-on-year in April; unemployment in May showed a sixth consecutive monthly improvement.

European core inflation only rose by 1% year-on-year in May, up from 0.7% in April. Even with greater mobility in most countries, there are few signs of broad normalization in COVID-depressed prices. This is supportive of the ECB's conclusion last week that it would be premature to begin the process of monetary policy normalization.

2. **Central banks remain accommodative despite pickups in growth and inflation**

At its meeting today, the BOE maintained its deposit rate at +0.1% and maintained the cumulative size of its asset purchase programme at £895 billion to be spent by the end of this year. This was despite recognizing that downside economic risks have declined and estimating that this month the economic output will only be 2.5% below the pre-Covid level. While they expect inflation to rise to 3%, 0.5% higher than their inflation forecast of only six weeks ago, partly driven by global supply chain pressures, they expect this to be a transitory spike. They expect labour market pressures to remain in the short-term before easing later this year, and furthermore there is still slack in the economy. This is a positive message for equities which have risen 0.3% after the announcement. The 10-year Gilt yield fell by 3 basis points to 57 basis points, despite market pricing for the deposit rate increasing to 21 basis points by August 2022 from 13 basis points before the meeting. Sterling gave back its pre-meeting hawkish surprise positioning, trading just below $1.40.

The ECB remains accommodative while raising its growth forecasts. Its real GDP growth projections were upgraded to 4.6% (2021) and 4.7% (2022), from 4.0% and 4.1% respectively. Its inflation projections were upgraded to 1.9% (2021) and 1.5% (2022). However, it was deemed "premature" and "unnecessary" to start tapering, and the ECB's focus remains on maintaining "favourable financial conditions."

The ECB left rates unchanged, with its deposit rate at -0.5%, its marginal rate at 0.25%, and its refinancing rate at 0.0%. The ECB will continue with its Pandemic Emergency Purchase Programme (PEPP). The programme's size is €1.85 trillion, and the ECB reaffirmed that this quarter will continue to see a higher pace of PEPP purchases compared with the first months of 2021. The ECB has no current plans to phase the programme out before at least March 2022. Maturing PEPP bonds will be reinvested until at least 2023. A flexible approach is being taken with the PEPP, with the total envelope being recalibrated if necessary and will not be fully utilized if conditions justify. Net purchases of the regular Asset Purchase Programme (APP) will remain at €20 billion per month, for as long as necessary and won't end before rates start to rise. Bank lending is still encouraged through the Targeted Long-Term Refinancing Operations (TLRTOs).

The Swiss National Bank (SNB) left its policy rate at -0.75%, driven mainly by its forecast of only very moderate inflation in the medium-term. It expects surplus capacity in many areas "for some time yet." It revised its inflation forecast up slightly by 0.2% to 0.4% for this year and by 0.2% to 0.6% for 2022. The growth forecast for this year was increased from 2.5% to 3%. A rate hike is unlikely anytime soon, and not before the ECB raises its deposit rate. The SNB continues to believe that the Swiss franc is "highly valued", and we expect them to defend the 1.10 level versus the euro.

3. **Improving European and UK trade outlooks**

The US and the EU have agreed to end their 17-year aviation subsidy dispute. The previous referral to the World Trade Organization for arbitration led to tariffs being imposed on both sides due to their respective subsidies for Boeing and Airbus. This agreement paves an amicable path towards a likely reversing of the steel and aluminium tariffs imposed by both sides during the Trump administration. In addition, a new EU-US Trade and Technology Council has been created, which will work on new rules for a wide range of areas including semiconductors, and make it easier to deepen digital trade and data transfers between the two economies. There will also be more collaboration on standard-setting in areas like the internet.

Since leaving the EU, the UK has rolled over free trade deals with seven EU member countries. Last week the UK reached a trade agreement in principal with Australia. Bilateral tariffs will be eliminated with a 15-year transition period which will include quotas. The economic significance is small, likely to boost the UK economy by £500 million, which is equivalent to only 0.02% of GDP. However, the agreement is important in three other respects. Firstly, it paves the way for the UK to join the 11-nation Comprehensive and Progressive Trans-Pacific Partnership, the world's third largest free trade zone. Secondly, it is an early demonstration that the post-Brexit approach will be outward looking. Thirdly, concessions granted with Australia will be key baselines for other negotiations with other countries.

4. Delta variant could slow COVID re-openings

The Delta coronavirus strain emerged in India and is the dominant strain in the UK. Its spread prompted a one-month delay to the government's lifting of most remaining COVID restrictions. The strain increases the risk of hospitalization by 2.2 times. Now it is dominant in Portugal and is appearing in clusters across Germany, France, Italy and Spain. The fear amongst scientists is that the Delta variant may already have spread further but has gone undetected because less of the genomic sequencing needed to identify variants has been completed in Europe. Research from the UK shows that the Delta variant causes first vaccine doses to be less effective than other variants, putting increasing pressure on governments across the UK and Europe to give more second vaccine doses to more people more quickly.

5. Mergers and acquisitions (M&A) picking up strongly

M&A typically rises around six months after markets bottom, driven by rising company confidence and cheap financing costs, and this up-cycle is no different. Confidence numbers have been rebounding for 3 to 4 months. Debt finance is very attractive, with companies able to borrow at around 1.4% in the bond market which can typically be used to buy earnings yielding over 4% in the equity markets. In the UK, private equity deals announced for UK-listed companies have risen in the last six months at the fastest pace in over two decades. £21 billion has been bid for 345 UK companies, 13 of which are in the FTSE 100 index.

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Bond rating equivalence

Alpha and/or numeric symbols used to give indications of relative credit quality. In the municipal market, these designations are published by the rating services. Internal ratings are also used by other market participants to indicate credit quality.

Bond credit quality ratings	Rating agencies		
Credit risk	**Moody's[1]**	**Standard and Poor's[2]**	**Fitch Ratings[2]**
Investment Grade			
Highest quality	Aaa	AAA	AAA
High quality (very strong)	Aa	AA	AA
Upper medium grade (Strong)	A	A	A
Medium grade	Baa	BBB	BBB
Not Investment Grade			
Lower medium grade (somewhat speculative)	Ba	BB	BB
Low grade (speculative)	B	B	B
Poor quality (may default)	Caa	CCC	CCC
Most speculative	Ca	CC	CC
No interest being paid or bankruptcy petition filed	C	D	C
In default	C	D	D

1 The ratings from Aa to Ca by Moody's may be modified by the addition of a 1, 2, or 3 to show relative standing within the category.
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