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

## Difficult winter ahead, ongoing recovery expected in 2022

### Summary

- **European ex-UK equities reduced to neutral, UK equities overweighting slightly reduced.** The coming months will see rising costs of living, company labour and material shortages, and exposure to the slowing Chinese economy. However, on a 12-18 month horizon the markets should be supported by ongoing earnings growth, above-average dividend yields, and undemanding valuation multiples. The region has high exposure to quality companies with strong balance sheets, value in sectors like financials, defensive exposure in sectors like healthcare, and rising alternative energy investment opportunities.

- **Underweight fixed income**. Sovereign bonds remain expensive, even after the recent backup in yields. The coming months will see further price pressures, driven by rising inflation and rising tapering expectations. We see selective opportunities in EU green bonds and in corporate high yield bonds.

- **Sterling and the euro are unlikely to sustain rallies.** Positioning in both currencies is not over-extended and next year could benefit from the resumption of inflows into the region. However, in the short-term the current support levels are vulnerable.

- **The UK budget today** aimed to re-establish sound public finances even while supporting the growth upturn and jobs recovery.

- **The German coalition-building process** is expected to lead to a coalition led by the SDP, with a smooth transition and policies that are not likely to be radical changes.

INVESTMENT PRODUCTS: NOT FDIC INSURED · NOT CDIC INSURED · NOT GOVERNMENT INSURED
NO BANK GUARANTEE · MAY LOSE VALUE

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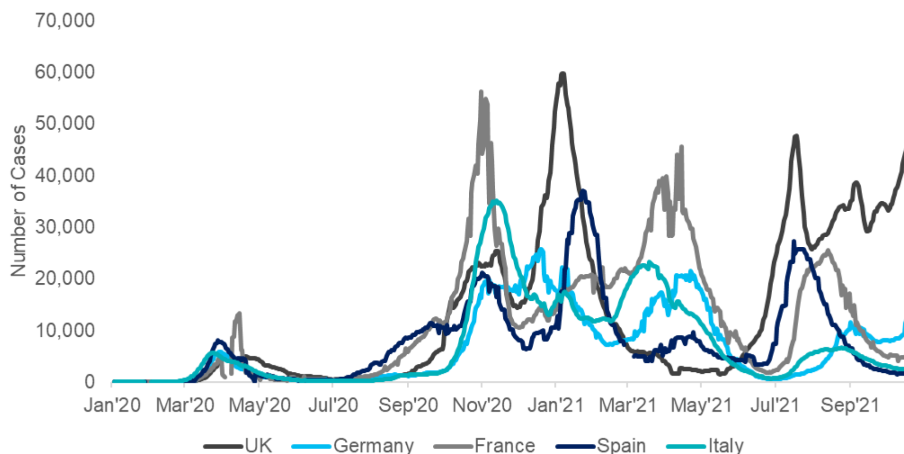
## COVID update

In recent weeks the COVID situation in Europe and the UK has been differing. Europe has been vastly improving its vaccination rate, whereas the UK has taken a negative turn, as positive case numbers and hospitalization rates have been increasing. New COVID infections in the UK are reaching levels seen in July 2021 (**Figure 1**). Current October indications are that UK cases are 7x Western Europe's, hospitalizations 6x, and deaths 3x.

Prime Minister Boris Johnson has acknowledged the rise in infections is quite high, however believes the levels are within the government's expected parameters. Nevertheless, as winter approaches, there are rising potential risks stemming from COVID and especially from potential new variants. Regarding the latter, there is focus on the new Delta sub-variant AY.42, which at this stage is seeing rising levels of infection but doesn't appear to lead to a more severe disease or seem to render existing vaccines less effective.

**Figure 1: New Covid Infections – rising cases in UK and Germany**




Source: Haver Analytics,

## Higher energy prices

UK and European natural gas spot prices have surged to record levels. European natural gas prices are up around 650% year-on-year, oil prices are 100% higher and carbon prices on the EU's emissions trading system have risen 170%. The causes include supply issues in Russia and Norway, untimely demand for LNG by China and an absence of traditional energy alternatives as coal-fired power plants now are paying-up for coal. Over the past 6 months LNG imports into Europe were 15% below 2020's volume and natural gas inventories are well below their long-term average (**Figure 2**). Ironically, looking backwards, Europe is emerging from a period of unusually low gas prices. In real terms, gas prices now are unchanged since the 2008-09 recession.

**Figure 2: Europe Gas Storage % Full**

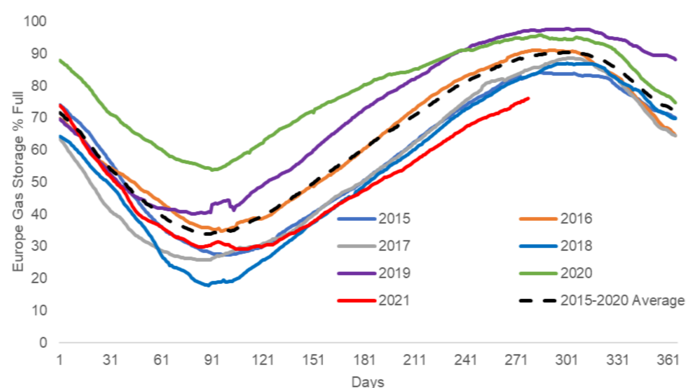
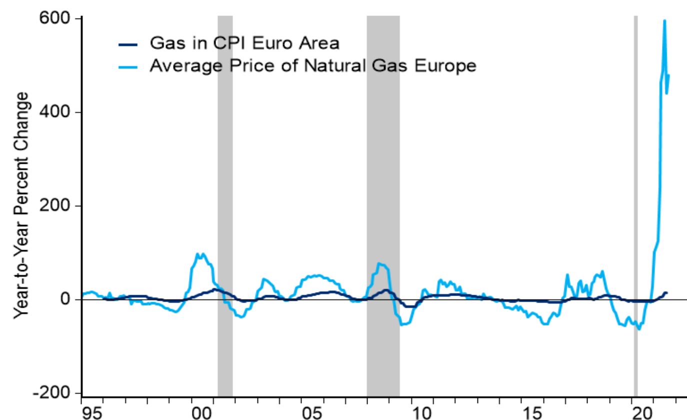



**Figure 3: Europe natural gas prices and consumer prices of natural gas**




Source: Bloomberg as of October 18, 2021. Note: Shaded areas denote recessions.

The history of natural gas pricing is binary. Production rises and falls moderately; demand is very lumpy. When supply is short, bidding for the scarce asset causes price spikes. However, the "rationing price" is not the "equilibrium price." This is why you see the highest prices fail to persist. Emergency switching of energy supplies is difficult but can be a better choice than paying the "spike price." See our October 3, 2021 CIO Bulletin for further discussion.

Governments are starting to step in to support households and to a lesser extent businesses also. The support varies by country. France is taking steps to shield voters ahead of next year's general election by blocking any new increases in regulated gas tariffs and cutting taxes on electricity. Greece promised to subsidize power bills and suggested creating a carbon-market fund to hedge against rising prices. Italy recently unveiled a €3 billion package to mitigate the rising energy prices, aimed at helping poorer households and small businesses. Spain wants to impose a windfall tax on utilities and proposed a central platform for natural gas purchases. Poland wants debate on the crisis at this week's ministerial meeting, as the price rise threatens a backlash over the EU's clean energy reforms. So we expect that the EU collectively and countries individually will act to mitigate the impacts of energy shortages and higher marginal prices. See our previous EMEA Bulletin on the topic – A Greener Europe Offers Compelling Investment Opportunities**.**

Looking towards the spring, we see these energy price pressures abating. The impact on consumers is mitigated by the structure of energy markets and delivery systems across Europe. Services are delivered by regulated utilities and the consumer's costs are lower and very different than industrial users. In addition, we believe that the gas shortage in Europe is temporary and will have a smaller impact on economic performance and inflation than expect.

## Growth rebound transitioning to a slower-paced long-term recovery

The strong global GDP growth this year is losing momentum, however we expect the recovery to continue into 2022. As discussed in the Quadrant – Growing Pains, global GDP growth will likely be 5.6% in 2021 and fall to 3.8% in 2022 (see **Figure 4**). The Europe and the UK growth outlooks reflect this also.

**Figure 4: Citi Global Wealth GDP Assumptions for 2021-2023**

| | 2020 | 2021 | 2022 | 2023 |
|---|---|---|---|---|
| **China** | 2.4 | 8.0 | 4.5 | 5.0 |
| **US** | -3.4 | 5.5 | 3.5 | 2.6 |
| **EU** | -5.9 | 4.8 | 3.9 | 2.4 |
| **UK** | -9.7 | 6.0 | 4.2 | 2.5 |
| **Global** | **-3.2** | **5.6** | **3.8** | **3.5** |

Source: Citi Global Wealth Office of the Chief Investment Strategist and National Sources, Haver Analytics and FactSet as of October 19, 2021.

The key regional growth drivers over the first half of this year were inventory rebuilding in the surging goods sector, rebounding personal consumption supported by pent-up demand as well as savings built up during the pandemic, and the trade sector as Asian import demand strengthened. More recently and looking towards year-end, growth momentum has been lost due to a combination of higher energy costs and production disruptions due to supply shortages of both goods and labour. The loss of momentum in 3Q has been sudden, with the Bank of England's (BoE) 3Q21 new growth forecast half of what it was earlier this year. Despite the second half loss of momentum, **Figure 5** shows continued expansion across both services and manufacturing, and **Figure 6** shows ongoing economic activity across the regions which are also matched by high frequency datapoints**.**

Looking to 2022, in line with our global growth view, we expect the region's energy costs to decline, production bottlenecks to ease, and services to pickup significantly. Regarding the latter, the flash IHS Markit data for UK Purchasing Managers' Index showed a rise to 56.8 in October (from 54.9 in September) led by services which reached a three-month high of 58.0.

**Figure 5: Euro-Area Manufacturing and Services Purchasing Managers' Indices**

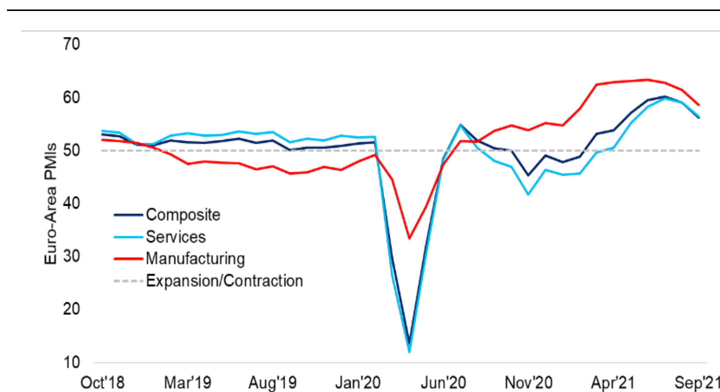
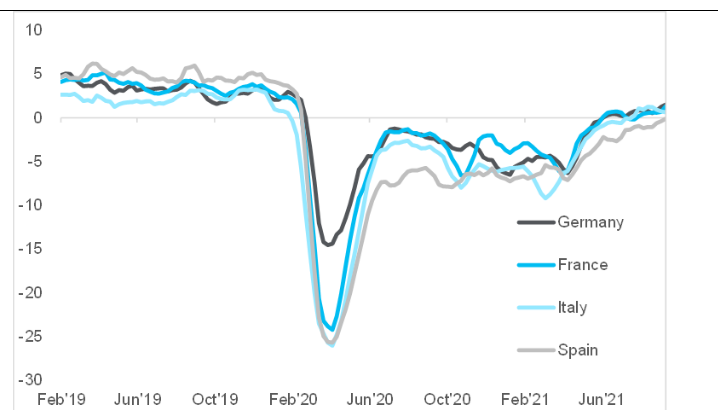



**Figure 6: OECD Economic Activity Tracker 2Y-% change**



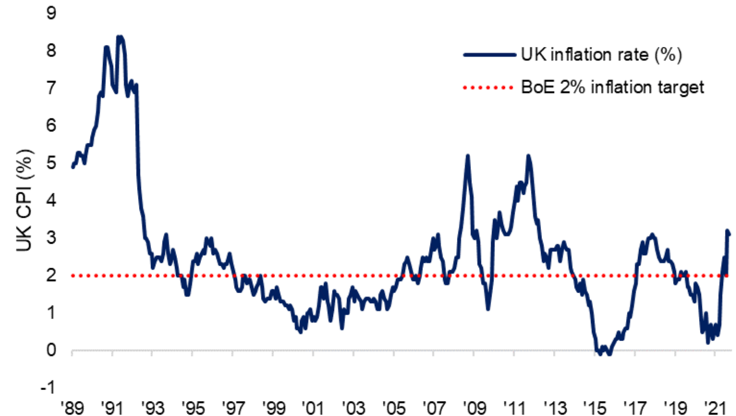

Source: Bloomberg / Citi / OECD / Haver Analytics as of October 18, 2021. OECD is the Organisation for Economic Co-Operation and Development. Note: The OECD Weekly Tracker of Economic Activity provides a real-time high-frequency indicator of economic activity using machine learning and Google Trends data.

## Inflation surge not likely to be sustained

Across the region, prices are expected to keep rising for the rest of this year, taking headline inflation briefly to above 4% in both Europe and the UK (see **Figures 7 and 8**). However even with this second half surge, Citi Research expect full-year inflation this year to still be at a modest 2.4% (Europe ex-UK) and 2.5% (UK) this year. Price pressures are expected to ease in the first half of next year, taking Citi Research full-year forecasts to 3.0% (Europe ex-UK) and 4.2% (UK).

**Figure 7: Eurozone Inflation (%) vs ECB Target**

**Figure 8: UK Inflation (%) vs BoE Target**




Source: Bloomberg as of October 18, 2021.

The uneven nature of the economic recovery is one of the key reasons behind our view that the inflation surge is temporary. Output is still around 4% below pre-Covid levels and even more below where output would have trended too, in the absence of the pandemic. Demand is hitting supply constraints this year, however next year we expect a better supply response, as the economic reconfiguration continues. In addition, we are not seeing signs of rising inflation expectations feeding through into rising wages.

## Differing central bank approaches

Despite similarities across Europe and the UK in terms of the trends for growth and inflation, the respective central banks are taking different approaches. We expect the BoE to raise its base rate by 15bps to 25bps in December 2021 with a further increase to 50bps by May 2021. The market is already discounting further increases in the second half of next year, taking the base rate to 100bps. However, this seems overly aggressive discounting given our inflation forecast. It is possible but not certain that they will reduce the size of their asset purchase programme slightly towards year-end.

In contrast the European Central Bank (ECB) is not expected to raise their deposit rate from the current -0.5% anytime soon. We expect no policy change their meeting tomorrow, as they have already indicated that their December meeting is pivotal. In our view, the ECB will not reduce the envelope size of the €1.85 trillion Pandemic Emergency Purchase Programme (PEPP) ahead of its expiry in May 2022. What is less certain is their plan for the Asset Purchase Programme (APP) that was in place before the pandemic, with the likelihood being that they will announce in December that the APP will be continued with flexibility regarding its size, focus areas and timing of purchases.

## United Kingdom Budget

In the runup to today's UK budget, Chancellor Sunak had already announced tightening measures. In March he announced that corporate taxes would rise from 19% to 25% and while also announcing the freezing of income tax allowances (both with delays). In September he announced 1.25% rises in employee and employer national insurance contributions. These measures combined are expected to generate around £35-40 billion of incremental tax revenues. Also helping the Chancellor today is the fall in public borrowing this year, about £30 billion less than had been forecast, largely driven by the successful vaccine rollout programme.

The key aims today were to restore the Conservative's low tax credentials, while re-establishing sound public finances even as the Covid battle continues. Chancellor Rishi set forth "*Growth up, jobs up and debt down*" and promises for a new post-COVID economy. The below are the key points:

- ***Growth:*** Office for Budget Responsibility (OBR) predicts growth to reach pre-COVID levels at the turn of the year, 2022. OBR forecasts growth figure upwards to 6.5% from its initial estimate in March of 4% for 2021.
- ***Inflation:*** The rise in inflation, according to Sunak, can be defined by two global forces, one being the rise in demand for goods and the other the rise in energy prices. OBR estimated CPI to average 4% over the next year.
- ***Unemployment***: forecasted to peak at 5.2%, revised down from the initial estimate of 12% for this year.
- ***Borrowing:*** estimated to fall next year to 3.3% of GDP, from the current borrowing figure of 7.9% of GDP.
- ***Government spending:*** £150bn increase in spending across all government departments. In real terms spending should grow by 3.8% a year. £4.8bn in grant funding for local government over the next 3 years.
- **Employment:** the minimum wage will increase from £8.91/hr to £9.50/hr and the public sector workers pay freeze will come to an end. In addition, the government will increase its spending on skills and training workers by £3.8bn, which is an increase of 42%.
- ***Fuel duty:*** increase will be cancelled, saving consumers £8bn over the next five years.
- ***Healthcare:*** spending is to increase by £44bn to over £177bn, by the end of this Parliament.
- **Infrastructure and investment**: the government will invest £21bn for roads and £46bn to railways, to provide easier commute between cities. The plan is to invest around £20bn in Research & Development by 2024-25.
- ***Taxes:*** The banks surcharge will be cut from 8% to 3%, but the corporate tax rate for the sector will increase from 27% to 28%. Sunak also announced 50% business discount for companies in the hospitality, retail and leisure industries. It equates to around 1.7bn worth of cuts. Sunak announced the planned increase for business rates multiplier, next year, will be cancelled. This is estimated to be worth £4.6bn over the next five years.

While Sterling and equities were steady after the budget, gilts strengthened significantly. Coinciding with today's budget and the 30% lower government borrowing requirement, the UK Debt Management Office (DMO) announced a reduction in their gilt issuance programme for this fiscal year from £253 billion estimated in April to £220 billion now. This would be close to half the issuance during the previous fiscal year, as the government now seeks to normalize its pandemic emergency policies. This led to a surge in pension fund buying today, with yields falling sharply (with the 10-year yield falling by 11.7 bps to 0.99% and the 30-year yield falling by 17.3 bps to 1.14%), and in the medium-term could mitigate the impact of the December 2021 end to the £875 billion pandemic emergency bond buying programme.

## German coalition-building process nears its conclusion

The German election result gave the Social Democrats Party (SDP) 25.7% of the votes and a slight victory over the ruling conservative Christian Democratic Union/Christian Social Union (CDU/CSU) who got 24.1% of the votes. The SDP leader and current finance minister Mr Scholz are favoured to lead a coalition. Mr Scholz would become the next chancellor after 16 years leadership from Angela Merkel. He would be the first SPD chancellor since 2005.

The election result removes the potential tail-risk of a Left-wing coalition, with the Left party only gaining 4.9% of the vote. A 'grand coalition' between the SDP and the CDU/CSU is not likely, despite their combined votes being close to 50%. The kingmaking parties are likely to the liberal pro-business Free Democratic Party (FDP) (11.5% of the vote) and the Greens (14.8% of the vote).  The coalition-building process could take several months, however, if it stretches beyond the 17th December then Angela Merkel will become Germany's longest-ever sitting Chancellor.

The negotiations have begun in an unusual way, with the FDP and the Greens meeting first, to ascertain if their differences in key areas of policy can be compromised. Signs have been positive, and both are now negotiating with the SDP. We therefore think that a 'traffic light' coalition of SDP/Greens/FDP is more likely than a 'Jamaica coalition' of the CDU/CSU/Greens/FDP. With the probability of two opposition parties within the next government, this could be positive for

change in the areas that matter most to them like climate, and infrastructure investment. Overall with the Greens and FDP in government, there would likely be a smooth transition with only subtle not radical changes.

**Let's consider the main areas of impact of having the likely Greens and FDP joining the SDP within the next coalition.**

- ***Tax:*** The Greens are allied with the SPD in wanting higher taxes, however the liberal FDP would be against raising taxes.
- ***European integration:*** We don't expect further new integration measures, with a stalemate between the Greens federalist views, at one extreme, and the FDP the opposite. Issues like the Eurozone budget and the Eurobond market development would not be dramatically accelerated with the Greens and FDP in the collation together. Germany will probably be passive in reforming the European growth and stability pact, leaving France to lead.
- ***Debt brake:*** The FDP would be against a loosening of the debt brake rule. So, the Greens would probably need to find another way to finance their Green agenda, possibly with efforts to finance investment off the main public balance sheet. Both would probably find compromise in fiscal stimulus that stopped short of changing the fiscal rules, perhaps leaving open the possibility of changing the fiscal rules at a later date.
- ***Fiscal transfers:*** The existing €750 billion EU Recovery Fund would probably not be expanded. However, there could be a compromise around agreeing to allow more 'one-off' fiscal transfers as needed.
- ***Finance Ministry:*** The FDP are keen to lead in this area, and might make it a condition for their participation in the coalition.
- ***Defense:*** The Greens were part of the 1998-2005 coalitions that endorsed the Gulf War. The party is not opposed to higher defense spending.
- ***International institutions:*** The Greens are in favour of a more active role for Germany in international institutions like NATO and the EU.
- ***Nord-stream pipeline:*** Don't expect a prompt agreement on the next implementation steps.

The recent resignation of the German finance minister Weidmann is significant in two respects. Firstly, given his generally hawkish stance, it is demonstrating that Germany has less influence within the ECB who maintain their loose monetary policy. Secondly, his successor is expected to be Mr Lindner the FDP leader, which would reinforce our view that Germany is unlikely to see a change in its debt rules and won't see higher taxes. However this view would change if the new finance minister is Mr Habeck the Green party co-leader who favours much higher government spending.

A relatively fast agreement on the coalition composition and its fiscal policies is increasingly important. The economic upturn is losing more momentum than several other European countries, largely due to the close correlation of German exporters with the Chinese economy, which is slowing, see **figures 9 and 10.**

**Figure 9: Germany Ifo Monthly Orders vs Li-Keqiang Index**

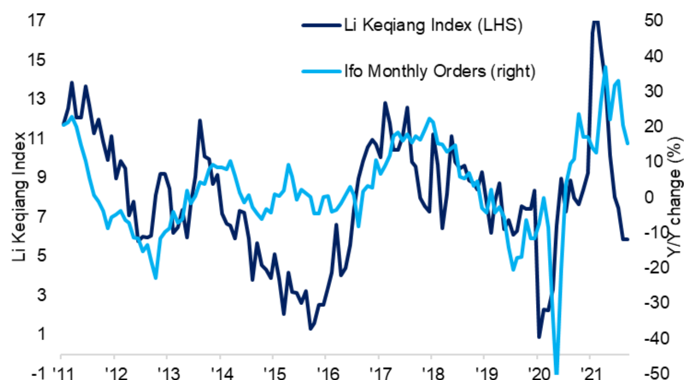
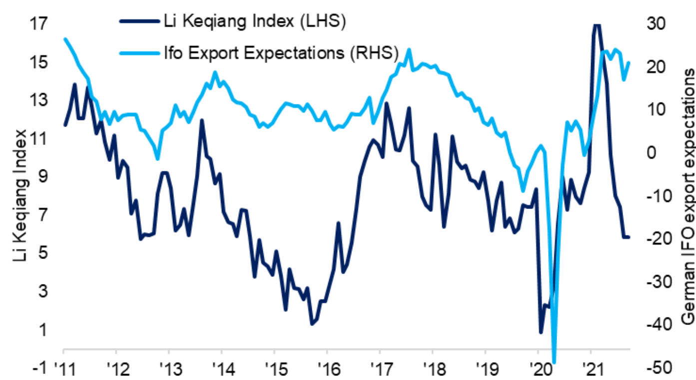



**Figure 10: Germany Ifo Export Expectations vs Li-Keqiang Index**




Source: Bloomberg as of October 18, 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. For illustrative purposes only. Past performance is no guarantee of future results. Real results may vary.

# Brexit update

## Focus on Northern Ireland Protocol

The UK has demanded a re-writing of the Northern Ireland protocol which is part of the EU Withdrawal Agreement that aims to avoid a hard border between Northern Ireland and the Republic of Ireland. The protocol placed Northern Ireland in the EU single market for goods, however, has faced significant implementation challenges. The high level of bureaucracy involved in the customs and regulatory checks on UK goods entering Northern Ireland has been cited as a factor in the April violence in Northern Ireland.

The European Commission response exceeded expectations and the two sides are now closer to a revised agreement. They have offered to cut up to 80% of checks on animal and plant products with less physical checks, and cut half the customs paperwork, for UK goods entering Northern Ireland. In return they have asked the UK to build full border control posts for goods inspections, and to provide more comprehensive product data and market surveillance information.

However there remain negotiation hurdles. The EU have not responded to the UK's request for a "full dual regulatory regime" for Northern Ireland, that would allow goods compliant with EU and UK standards to circulate freely side by side. The EU have not agreed to a rewrite of Article 10 that requires any government subsidy decision that effects goods trade in Northern Ireland to comply with the EU's state aid rules.

Finally, the EU have not yet agreed to the UK's demand for an end to the European Court of Justice's (ECJ) oversight role. Regarding oversight, there is some speculation that the two sides might agree on a "Swiss-style" governance arrangement. This could include setting up an arbitration panel to deal with protocol disagreements, with the ECJ retaining a role to interpret questions of EU law.

If the hurdles are not resolved, either parties could invoke Article 16, which is a deal that allows parts of the protocol to be suspended, temporarily, if some aspects of the agreement are causing difficulties. The Irish Foreign Minister has indicated a deadline of late December for the talks to conclude.

## Immigrant workers

Boris Johnson's latest speech on immigration has promised higher wages and a departure from the old economic model, which claims uses "uncontrolled" immigration as a substitute for not investing in UK people, skills, and equipment. PM Johnson wants to promote the Tories as the party of higher wages. The new transition model is partly a result of the

shortages seen from HGV drivers and agricultural workers, and keeping with one of the Brexit promises, which is to move away from UK's dependence on EU labour.

However, the implementation of this new model is tough to implement. Lorry drivers from the EU are not in favour of the UK government's existing three-month visa scheme, where EU workers can come to the UK for three months to live and work but then will have to leave. Despite PM Johnson's new initiative to progress to a new skilled economy, lower immigrations does not mean higher wages, without a serious plan for investment in education and skills. The implication is that this policy needs to be planned out sensibly, without hurting the UK economy, both in the short and longer term.

## Turkey's central bank cuts rates again, currency falls to record lows

President Erdogan installed the current Governor Sahap Kavcioglu in March, replacing hawkish predecessor Naci Agbal after back-to-back rate hikes. Governor Kavcioglu kept policy rates unchanged for six months before cutting rates by 100bps in September to 18%, when consumer inflation surged to 19.6%.

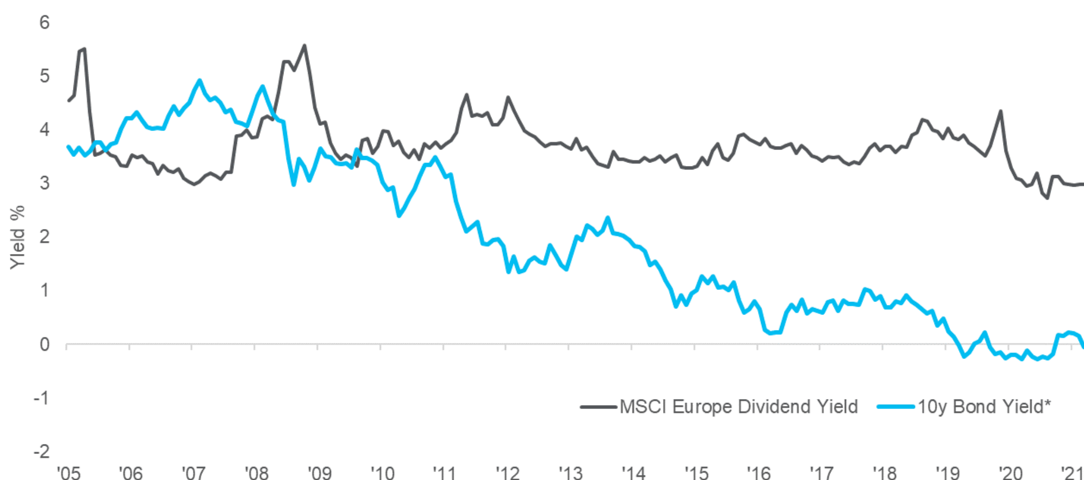
That was followed by the Central Bank of Turkey cutting rates more than expected at this month's meeting, saying it has limited room left for further reductions this year. The main interest rate – the one-week repo rate - was reduced by 200 bps to 16%. Markets had been looking for a 100bps cut.

Earlier this week, President Erdogan pulled back from plans to expel 10 western ambassadors in the country's latest diplomatic spat with the US and other foreign governments after the group had demanded the release of a prominent Turkish businessman. Erdogan's move de-escalates a diplomatic row that had pushed the Turkish currency to a record low of 9.85 per dollar intraday on Monday, before settling at around 9.42 per dollar. The currency has lost 22% year-to-date against the USD. The rally in the lira was further supported by a possible meeting with US President Joe Biden at the upcoming G20 summit in Rome, which could provide further relief.

## Investment recommendations

We prefer European equities over European bonds. Equities have strong earnings support along with reasonable valuations, compared with the fixed income universe continuing to trade at historically low yield levels. In addition, in the global financial repression environment, **Figure 11** below shows the significant yield differential in favour of equities that should continue to support inflows.

**Figure 11: European Yield Gap Strongly Supportive for Inflows into Equity**




Source: Bloomberg, Citi Research as of October 19, 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.

## Equities:

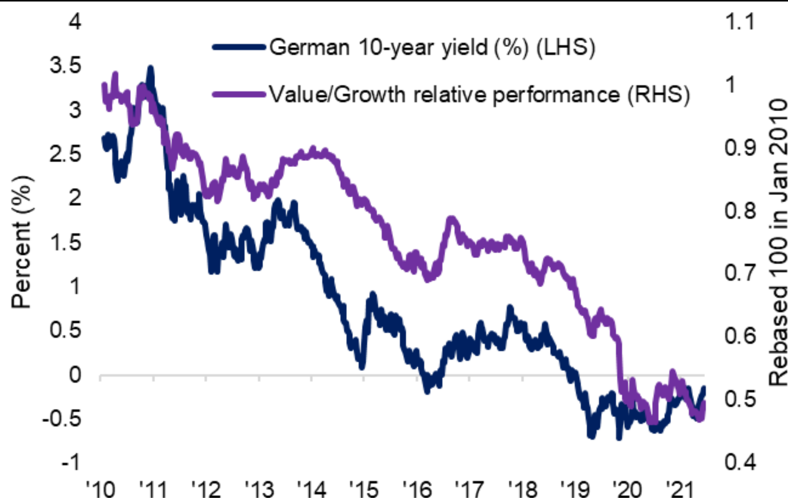
The next few weeks should provide good entry levels for clients who are still underweight. In the short-term, the region will discount the slowing growth upturn and slowing EPS growth, German policy uncertainty as the coalition negotiations continue, COVID numbers worsening, and the challenging Northern Ireland Protocol discussions, at a time when global pressures are elevated with central banks beginning to shift direction, while supply chain and energy pressures are impacting on prices.

However, most of these factors should ease early next year. On an 18-month horizon, the region stands out for its low relative valuations (Europe ex-UK 17X and UK 13X), high dividend yields of 2.8% and 3.8% respectively, and ongoing EPS growth albeit at a slower pace. The strong 2021 EPS growth is transitioning into another positive year in 2022. Citi Research has estimated Europe ex-UK and UK 2022 EPS growth to be 7.7% y/y and 2.7% y/y respectively. Within the regions there are some particularly strong sector earnings, in high double teens territory, coming mainly from the Financial, Consumer Discretionary, Industrial and Healthcare sectors. The continued recovery from COVID and supply side risks abating, should support corporate earnings within these sectors.

***These are the areas we favour:***

- **European financials** – **Figure 12** shows how value sectors including financials are starting to show better relative performance as long bond yields stop falling. While the financial sector has doubled in share price since we recommended it a year ago, the average valuation is still cheap at 0.75 price-to-book value. Average returns on equity are likely to move higher next year even if yield curves don't steepen much and net interest margins don't improve markedly. Two drivers are likely to be rising loan growth from depressed levels and a further increase in fee income from M&A activity. In addition, balance sheets are mostly strong, with average CET1 levels of over 13%, which is likely to lead to further dividend resumptions, share buybacks and provision writebacks.

**Figure 12: Low yields have led value underperformance**

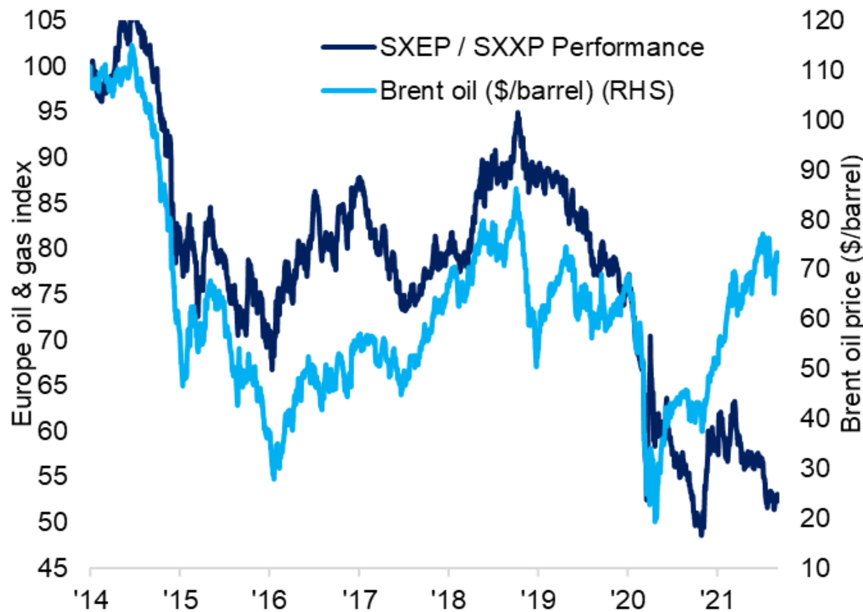



Source: Bloomberg as of October 19, 2021. Value represented by MSCI Europe Value Index, growth represented by MSCI Europe Growth Index. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Index returns do not include any expenses, fees or sales charges, which would lower performance. For illustrative purposes only. Past performance is no guarantee of future results. Real results may vary.

- **European healthcare** – the sector is favoured at a global level for its consistent top-line and profit growth through the cycle, and underperformance during the pandemic. In Europe the sector is well represented in indices with an average weighting of 14% and has a reasonable valuation multiple of 15X.

- **European green energy** – as the region's leaders increasingly prioritize this area, there is an increasingly breadth of green investment opportunities, both mature energy companies with growth in alternative energy, as well as midcaps focussed on alternative energy. In addition, traditional fossil fuel companies that make up the bulk of the European oil and gas sector, have significantly underperformed the oil price rise – **see Figure 13** – presenting short-term trading opportunities.

**Figure 13: Energy stocks lagging the oil rebound**




Source: Bloomberg as of September 2, 2021. SXEP: Stoxx Europe 600 Oil & Gas Index, SXPP: Stoxx Europe 600. 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. For illustrative purposes only. Past performance is no guarantee of future results. Real results may vary.

- **European quality companies** – as the bull market matures, we increasingly favour quality companies at a global level. Europe has a large number of quality companies – with strong balance sheets, well-tested management, and strong brands. This should drive further cost-cutting, focus on growth areas, pricing power to offset cost increases, and rising dividend payouts.

## Fixed income:

EU green bonds are a new asset class that could offer opportunities. The EU has issued its inaugural green bond by selling Euro 12 billion of 15-year bonds with a yield of 0.45% (in comparison, 15-year Bunds pay 0%). The response was very strong, with orders for Euro 135 billion. The issue will be followed by another Euro 240 billion EU green bonds in the coming months. The EU's green bonds will be based on the EU's sustainable finance rules. The capital raised will be used to help finance the EU's Euro 800 billion Recovery Fund. The national spending plans of the Recovery Fund loans and grants will be screened to ensure that the cash is used to fund genuine environmental projects.

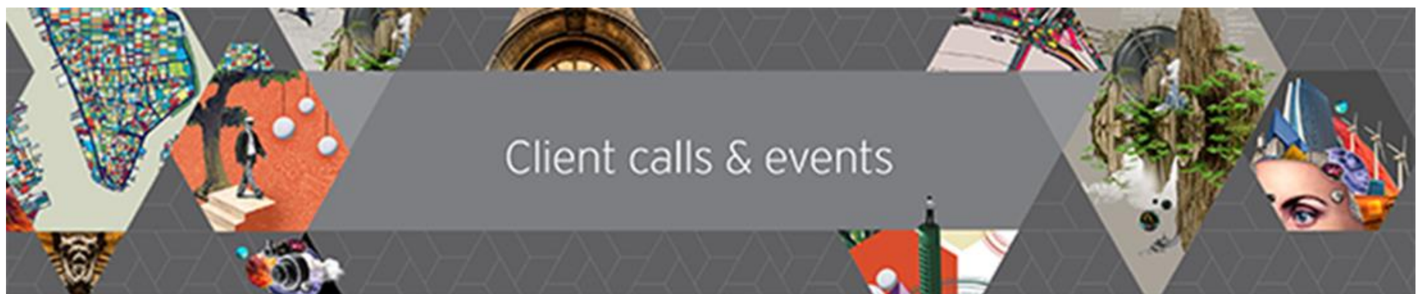
In the ongoing financial repression environment, the demand for the EU green bonds is likely to be consistently high. EU green bonds will be an important catalyst for member states to issue their own green bonds. In addition, they will provide greater breadth and liquidity to the European bond market, which should encourage more overseas buyers and that in turn could help support the Euro. Finally, the EU green bonds will have different maturities and could be followed by other EU bonds (not necessarily green), which over time should provide a reliable EU yield curve which could become a reliable benchmark for pricing European sovereign and corporate bonds.

**In addition to EU green bonds, we continue to find opportunities in corporate high yield (HY) bonds.** While average yields and spreads have fallen substantially, to around 3.6% and 317bps respectively, they are likely to fall further. As an indicator, the new issuance market, which has been very active for several months, continues to see regular sizeable oversubscriptions. Issuance over the last several years has pushed out maturity walls, which along with sustained low rates is presenting HY investors with a benign default outlook.

## Currency:

Both the Euro and Sterling are not likely to sustain rallies over the rest of this year.

- **Euro:** the key driver is likely to be ECB policy, with no immediate prospect of monetary tightening. In the medium-term, while there is no Eurozone breakup risk with the periphery on a firmer economic footing, next year's French election polling will be closely watched in the coming months and could hold back the Euro.
- **Sterling:** Even as the BoE is likely to lead the Fed and the ECB in raising rates, in the short-term the headlines describing the winter challenges will weigh on the currency. Early next year when those challenges are expected to ease, and assuming the government articulates its long-term post-Brexit post-Covid game-plan for repositioning the country, inflows are likely to resume. This should be supported by the cheap valuations for the currency as well as for equities.





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