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Citi Global Wealth Investments

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Moving overweight Europe equities

- **Business cycle analysis:** coming off the highs. Business confidence is softening gradually across Europe as the pace of economic activity moderates following an exceptionally strong 2021. The good news is that employment expectations remain strong and demand forecasts elevated despite the latest round of restrictions designed to manage surge in cases from the Omicron COVID-19 variant.
- **Central banks adjusting their reaction function:** The Bank of England (BoE) looks set to hike rates again in February and May, given a likely further increase in headline inflation amid growing signs of tightness in the labour market. The ECB meanwhile is shifting more hawkish, even if net asset purchases are likely to continue until the end of the year, with a first hike perhaps by June 2023.
- **Politics:** the re-election of Sergio Mattarella as Italian President illustrates that central scenarios do not always come to fruition. In France, the Presidential (April) and legislative (June) elections are likely to cement a shift to the right in the political spectrum. While President Macron is the favourite to win a second and final5-year term, a win by Pécresse and her conservative party (LR) remains a distinct possibility.
- **European ex-UK equities slight overweight, UK equities remain overweight.** In our GIC asset allocation meeting, last week, the team decided to add a slight overweight position in European ex UK equities, providing a more diversified portfolio given the uncertainty stemming from the Fed at its impact on US equities. The region is currently seeing COVID restrictions easing, as the Omicron variant was not as worse as initially anticipated, however partial lockdowns placed across European regions potentially will affect some 4Q quarter data. Economic growth is slowing but remains on an uptrend, year-end growth estimation of 3.9% and 4.2% for Eurozone and UK respectively, according to Citi research. ECB policy remains supportive for European growth and the equity market. Europe and UK continue to provide strong corporate earnings and attractive high dividend yields which potentially should lead to price appreciation, as cheap valuations can only provide limited appreciation.
- **Underweight fixed income:** Even after the recent pickup in yields, yields remain unattractive the European regions. As the European Central Bank (ECB) and Bank of England (BOE) start tapering asset purchases, there is little valuation support for sovereign bonds particularly. Citi research estimates German bund and UK gilt 10-year yields to be at -0.05% and 1.25% respectively, at year-end 2022 which is also consistent with our teams' view.

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BUSINESS CYCLE ANALYSIS

SENTIMENT SURVEYS CONSISTENT WITH A SOLID PICTURE OF ECONOMIC ACTIVITY

The start to 2022 is proving to be a little more challenging in Europe. The euro area sentiment level declined for the third successive month, recording a fall of 1.1 point to a nine-month low of 112.7 in January, but remaining well above its historical average of 100. Sentiment softened in all sub-sectors, with a noticeable pull-back in services for the second successive month as more Covid restrictions were introduced. The only exception was the retail sector where January saw a large rebound in confidence, unwinding the December correction. As expected, manufacturing was resilient, while domestic-oriented industries such as construction suffered, and households' confidence remained essentially stable (Figure 1). There was some good news from the employment expectations series which only fell by 0.2 points to 113.3, also remaining well above its historical average of 100, suggesting that the outlook for the jobs market remains constructive.

Demand forecasts remain comfortably above their long-term average for the manufacturing sector while households also have a positive assessment of the economic outlook over the next 12 months. While the latest surge in Covid-19 cases have led to the imposition of new restrictions, temporarily impacting demand expectations in the service and retail sectors, the breakdown in the link between cases and hospitalisation is diminishing greatly thanks to a much higher share of the population been vaccinated. These are important steps towards Covid-19 becoming endemic, meaning that the impact of infections on mobility and ultimately on economic activity will continue to fade. We believe that the probable rebound in demand forecasts during spring and summer will prove to be a positive development for the equity valuations (Figure 2).

Figure 1: Euro area European Commission Sentiment survey

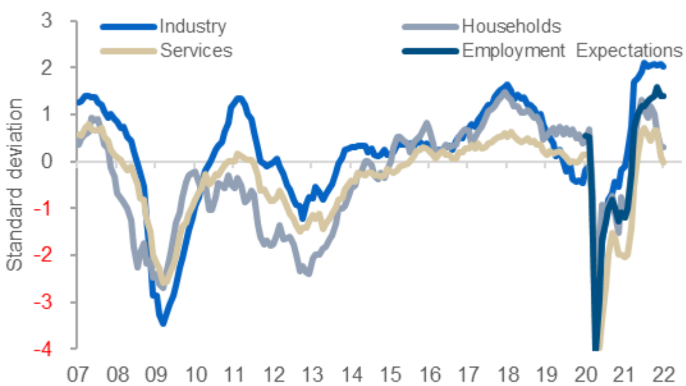
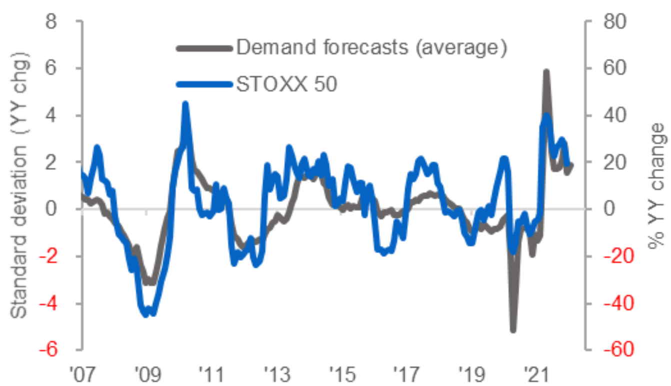


Figure 2: Euro area demand forecasts and equity market



Sources: Haver Analytics, Bloomberg, and Citi Global Wealth Investments - Office of the Chief Investment Strategist, 28 Jan 2022. Euro area European commission sentiment survey data as of Jan 2007 to Jan 2022. Demand forecast is the average of industry production expectations, retail expected business situation, services demand over the next three months and households' general economic expectations. SD stands for standard deviation, defined as the dispersion of a dataset relative to its mean and is calculated as the square root of the variance.

INFLATION HAS RISEN STRONGLY BUT PRICE EXPECTATIONS LOOK TOPPISH

Euro area inflation hits 5.0% YY in December. The headline measure was in line with consensus expectations, up from 4.9% YY in November. The 0.1pp increase in the overall Harmonised Index of Consumer Prices (HICP) 12-month change was primarily driven by the continued surge in food prices (3.2% YY from 2.2% YY) and non-energy industrial goods (2.9% YY from 2.4% YY). Governments' intervention to help limit the impact on consumers from their surging household bills was reflected in a drop in the rate of increase of energy prices (25.9% YY from 27.5% YY). We continue to expect that supply side pressures will abate towards the end of the first quarter, leading to some stabilisation of energy prices from their current high levels and to further declines in the YY rate (Figure 3). Note that there are some upside risks due to the uncertainty surrounding the Russia-Ukraine situation.

Core inflation was unchanged in December at 2.6% YY and continues to be partially distorted by the German value-added tax (VAT) change in January 2021. Services price inflation softened slightly in December to 2.4% YY from 2.7% YY in November, despite some further gains in hotels and restaurants (3.5% YY from 3.3% YY). Further upside in this sector is expected in the spring as European governments start to loosen COVID-19 restrictions, while the surge in non-energy industrial goods should soon fade due to falling demand and improving global supply chains. Nevertheless, we continue to think that the surge in inflation will likely prove transitory. Selling price expectations have probably peaked, easing from a historical record of 4.3 standard deviation (SD) above their historical average in November to 4.1SD in December and January, according to the European Commission survey published on 28 January. Historically, the correlation with producer prices has proved very strong, suggesting that the pressure to pass increases in intermediate goods onto final customers should ease gradually (Figure 4).

Figure 3: Euro area: contributions to HICP annual rate

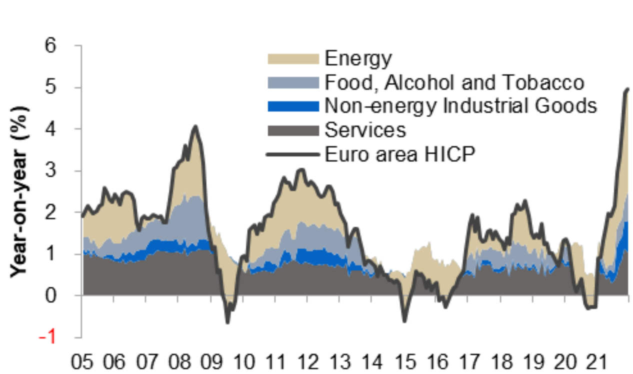
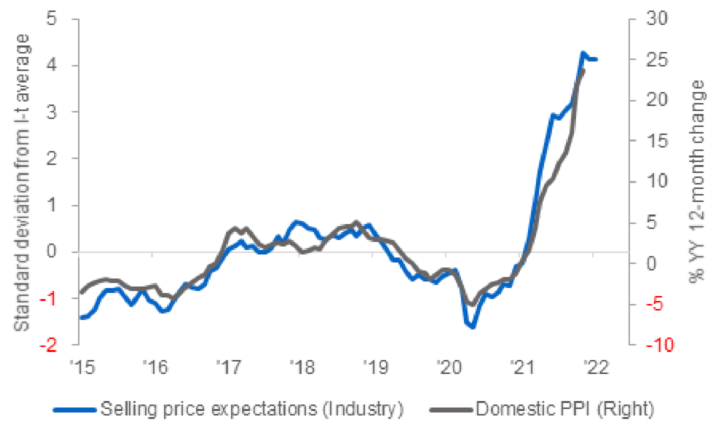


Figure 4: Euro area: Selling price expectations and Domestic Producer Price Index (PPI)



Sources: Haver Analytics and Citi Global Wealth Investments - Office of the Chief Investment Strategist, 20 Jan 2022. Data as 28 Jan 2022.

BUT SOFTER GROWTH LIKELY AHEAD AS ECONOMIES RETURN TO PRE-PANDEMIC LEVELS OF ECONOMIC ACTIVITY

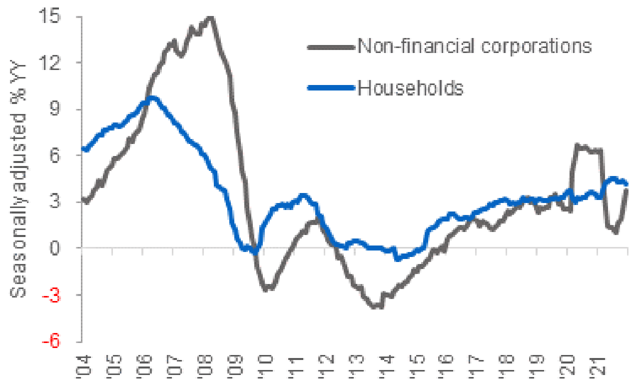
Flash estimates of real GDP growth from France, Germany, Spain and Belgium suggest that euro area real GDP growth likely expanded by 0.4% QQ in 4Q-21, likely exceeding the 0.2% QQ baseline contained in the December 2021 ECB staff macroeconomic projections. In all likelihood euro area real GDP will have likely surpassed its pre-pandemic level by 0.1%. In 2021, euro area real GDP likely rose by 5.2% after a fall of 6.5% in 2020. In this context, we find it remarkable that employment and unemployment are essentially back to pre-pandemic levels and labour markets anecdotally tight, suggesting that labour hoarding has taken place. As a result, the prospect of a meaningful and sustained acceleration in wage growth in the euro area remains limited in our view, validating our expectation that inflation will likely moderate markedly during the course of 2022 from the current level of 5.0% YY in Dec-21.

From a country perspective, France is one of the countries which is leading the recovery charge, with real GDP growth of 0.7% QQ (5.4% YY) in 4Q-21 (+7% in 2021 vs. -8% in 2020), while real GDP in Spain and Belgium was reported to have risen by 0.5% QQ and 2.0% QQ respectively in 4Q-21. Germany by contrast saw a 0.7% QQ (+1.4% YY) decline in 4Q-21 (+2.8% in 2021 vs. -4.9% in 2020). Compared to pre-pandemic levels, real GDP in France is around 0.9% above its 4Q-19 level, while in Germany and Spain it remains 1.5% and 4.0% below, respectively (see Figure 5). In the US, a comparable calculation shows that real GDP moved above its pre-pandemic level in 2Q-21 and stood 3.1% above in 4Q-21.

Figure 5: Real GDP (change compared to 4Q-19)

	EA-19	Germany	France	Italy	Spain	UK	US
4Q-19	**0.0%**	**0.0%**	**0.0%**	**0.0%**	**0.0%**	**0.0%**	**0.0%**
1Q-20	-3.5%	-1.8%	-5.7%	-5.8%	-5.4%	-2.6%	-1.3%
2Q-20	-14.7%	-11.6%	-18.4%	-17.8%	-22.1%	-21.6%	-10.1%
3Q-20	-4.0%	-3.6%	-3.2%	-4.8%	-9.0%	-7.8%	-3.3%
4Q-20	-4.4%	-2.9%	-4.3%	-6.4%	-8.8%	-6.4%	-2.3%
1Q-21	-4.6%	-4.5%	-4.1%	-6.1%	-9.4%	-7.6%	-0.8%
2Q-21	-2.5%	-2.4%	-2.9%	-3.6%	-8.3%	-2.6%	0.9%
3Q-21	-0.3%	-0.8%	0.2%	-1.1%	-5.9%	-1.5%	1.4%
4Q-21	0.0%	-1.5%	0.9%	-0.5%	-4.0%		3.1%

Figure 6: Euro area bank lending



Sources: Haver Analytics, Citi Global Wealth Investments - Office of the Chief Investment Strategist, 27 Jan 2022. Euro area bank lending data as of Jan 2004 to 31 December 2021

Euro area credit growth accelerat2ed in December, while real M1 growth continued to soften. Financial and monetary conditions are an important element in the assessment of economic activity. Liquidity remains ample and interest rates very low. With the banking system having strengthened its balance sheet through higher capital rations and fewer non-performing loans, the annual growth rate of adjusted loans to the private sector accelerated to 4.1% YY in December from 3.7% YY in November. Splits by sectors showed that the annual growth rate of adjusted loans to households stood at 4.1% YY compared to 4.2% YY in November, while the annual growth rate of adjusted loans to non-financial corporates increased to 4.2% YY in December from 2.9% YY in November (Figure 6). These numbers illustrate that despite a slight tightening of lending standards, thanks to an improved capital position and solid growth in deposits, the banking system remains in a position to extend cheap credit to the private sector. This is a strong positive for our expectation of a significant increase in capital expenditure by firms and households in 2022-23 as the post-pandemic recovery broadens to all sectors.

However, there are some unmistakable signs of a likely softening in the pace of real GDP growth in coming quarter, given the strong leading indicator properties of narrow M1 money supply (comprising currency in circulation and overnight deposits). Its annual growth rate eased to 9.8% YY in December from 10.0% YY in November. Adjusted for headline HICP inflation, real M1 growth slowed to a 35-month low of 4.8% YY from 5.1% YY in November. This trend is consistent with a likely gradual deceleration in the growth rate of real GDP over the course of 2022, given the 9-month lead of this series to real economic activity.

CENTRAL BANKS

ECB SHIFTING MORE HAWKISH. Banque de France governor and ECB Governing Council member François Villeroy de Galhau argued in late January during an interview with Europe 1 radio that the "*ECB will do what is needed to get inflation around 2% over the medium term*", indicating that "*monetary policy needs to be normalized gradually, but it needs to be done at the right speed of reality -- it mustn't be done in too tight of a way*". He referenced an argument made by ECB President Christine Lagarde saying that "*monetary policy should be a shock-absorber for the crisis, which means it must not be a brake on growth or an accelerator of inflation*". Finland central bank governor and ECB Governing Council member Olli Rehn indicated that an increase in borrowing costs is "*logical*" in 2022 as there are not "*any new economic disruptions*" in an interview with the Handelsblatt newspaper.

In light of the disruption to economic activity from Omicron, we expect that the ECB Governing Council will remain focused on managing the deceleration in the pace of net asset purchases throughout 2022 and keep financial conditions accommodative. This is predicated on an expectation of GDP growth decelerating in 2023-24 and inflation falling back below 2% toward the end of 2022 and staying below the symmetric medium-term target in 2023-24. At the same time, since the balance of risks to inflation probably remains skewed to the upside, we suspect that the ECB could sound more hawkish in the second half of 2022, once Europe moves beyond the Covid-19 pandemic and the trajectory of economic activity is perhaps revised up after a challenging start to the year. But we struggle to see a first 25bp rate hike much before the middle of 2023, to be followed by a 25bp rate move in Dec-23, taking the deposit facility rate out of negative territory for the first time since Jun-14.

Market pricing seems aggressive to us (Figure 7). It implies almost seven rate hikes for the Fed by the end of 2023 to around 2%, almost four hikes for the ECB to around 0.4% over the next three years and an even more abrupt trajectory for the BoE with almost four further hikes beyond the first move already announced in December to around 1.4%. Yet, if one compares this trajectory with some of the moves already implemented in some central banks in the east of Europe, the direction of travel points to higher rates also (Figure 8).

Figure 7: Market pricing of central bank rate hikes (28 Jan 2022)

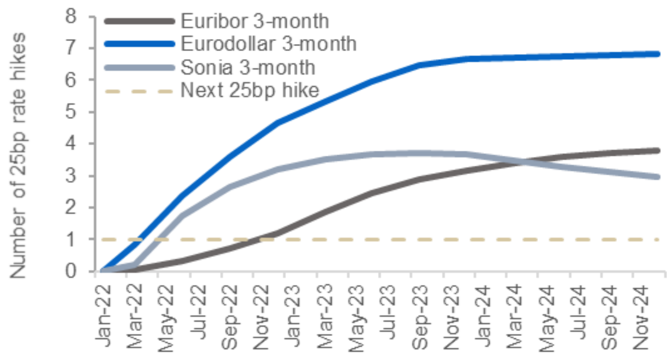
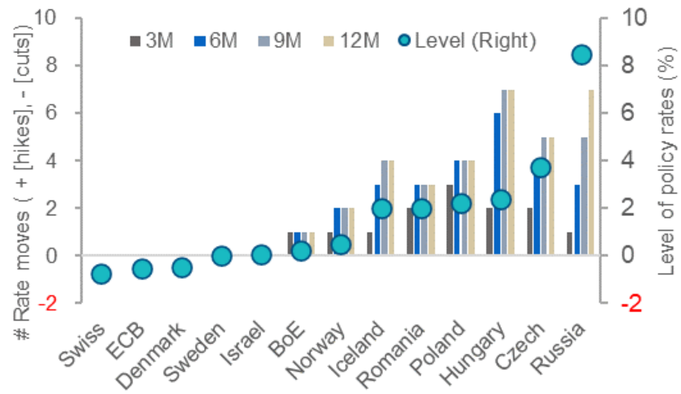


Figure 8: EMEA central bank policy rates (changes and levels)



Sources: Bloomberg as of 28 January 2022 All forecasts are expressions of opinion and are subject to change without notice and are not intended to be a guarantee of future events. Past performance is not indicative of future returns. For illustrative purposes only.

BOE LIKELY TO HIKE RATES AGAIN IN FEBRUARY AND MAY. UK Headline CPI inflation surpassed the Bank of England's (BoE) November forecast by 0.9 percentage point (pp) in December rising to 5.4% YY from 5.1% YY in November. This is the highest print in 30 years, adding to the pressure on the BoE to hike by 25bps to 0.5% in their 4 February meeting. Two of the main drivers of CPI inflation were food, alcohol and tobacco (rising from 3.2% YY in November to 4.1% YY in December) and services (from 3.3% YY in November to 3.4% YY in December). As the economy re-opens and discretionary spending is released, there is a clear risk in our view that headline inflation continues to accelerate and surpasses consensus expectations. Some scarcity of labour in the aftermath of Brexit and the further rise in energy prices will likely drive inflation upwards until the late spring.

Core CPI rose to 4.2% YY in December from 4.0% YY in November, comfortably exceeding consensus expectations of 3.8% YY. The key driver was the acceleration in traded goods inflation which rose 0.4pp to 6.9% YY in December, largely contributed by the rise seen in clothing and household goods. We continue to believe the worst may be yet to come with an inflation peak to be potentially seen in April, as we anticipate the spike in energy price to push the CPI inflation rate towards 6.7% YY according to Citi Research. Given the tight labour market data and the higher CPI prints, we think that the BoE will likely have to hike again lifting Bank Rate by 25bps to 0.5% on 3 February and will likely have to stay alert for a further 25bp move to 0.75% during the second quarter of 2022, possibly by 5 May, coinciding with the release of BoE Inflation Reports.

POLITICS: ELECTIONS IN FOCUS FOR ITALY AND FRANCE, UNCERTAIN FUTURE FOR UK PRIME MINISTER

On Saturday, members of the Italian parliament re-elected President Sergio Mattarella for a second term, after eight rounds of voting. President Mattarella received 759 votes out of the 1,009 that could be cast by grand electors. Over a televised statement from the presidential palace, Mattarella told the nation he would not let his personal plans come in the way of his “sense of responsibility” to help the nation out of the COVID-19 pandemic. The elections of a new Italian President proved to be a complicated process, giving the lack of an initial consensus behind Prime Minister Mario Draghi. As shown on Figure 9, scenario D was not the best outcome as it leaves a weakened government and higher medium-term uncertainty. But it also preserves the status quo and takes away the near-term election risk.

We see some risk that increasing political fragmentation could weaken the support behind the government coalition, with a growing risk of snap elections. Such a scenario would jeopardise the smooth implementation of the reform agenda that is necessary for the continued disbursement of NextGenEU grants (and later on loans) meant to transform Italy’s medium-term economic outlook by lifting its potential growth rate. Since the start of 2022, the Italian bond/Bund 10-year sovereign bond spread has been fluctuating in a ±15bp range around 135 basis points since the middle of December (Figure 10).

Figure 9: Italy Presidential election plausible outcomes (Citi Research)

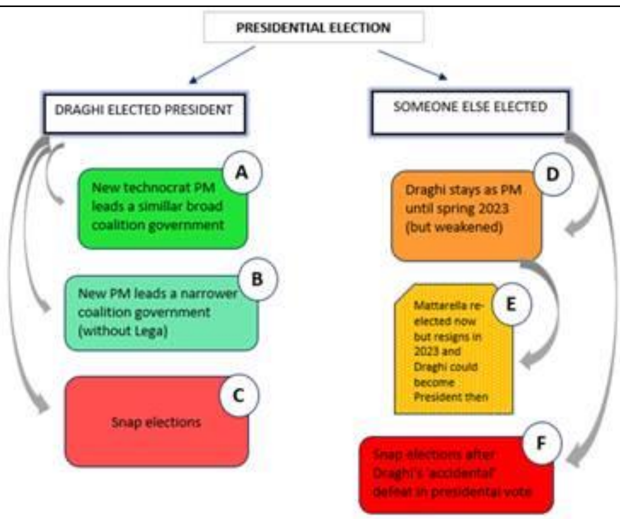
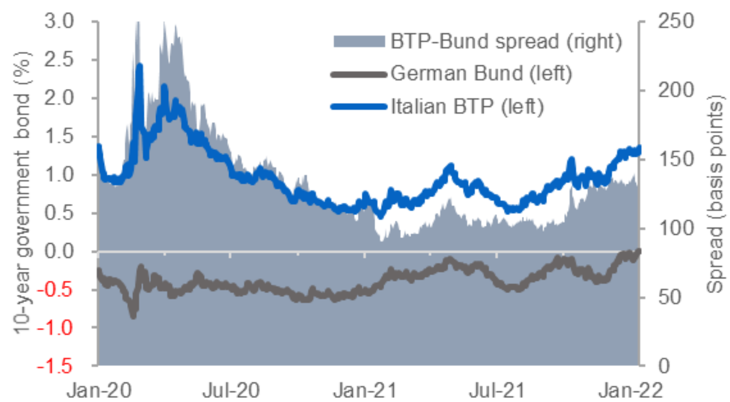


Figure 10: 10-year sovereign bond yields and spreads



Sources: Citi Research, Bloomberg and Citi Global Wealth Investments - Office of the Chief Investment Strategist, 27 Jan 2022. All forecasts are expressions of opinion and are subject to change without notice and are not intended to be a guarantee of future events. Past performance is not indicative of future returns. For illustrative purposes only.

With less than three months to go before the first round of the Presidential elections on 10 April, voting intentions are stabilising (Figure 11). Incumbent Emmanuel Macron, who has yet to formally indicate whether he will run, is broadly stable at around 25%, comfortably ahead of his three closest challengers, all of whom hail from the right of the political spectrum. Their combined share of the first-round vote of around 46% suggests that the subsequent legislative elections to be held on 12 & 19 June could see a re-composition of the political landscape in the lower house with a higher number of members of parliament from the mainstream right, challenging the hegemony of Macron’s party.

Marine Le Pen (RN party) who represents the far right is credited with around 17%, just ahead of the 16% obtained by Valérie Pécresse (LR party) for the mainstream conservative party members. The third and final challenger is Eric Zemmour (REC party) a former novelist, journalist and polemicist who stands on the extreme right on around 12.5%. The candidate on the right of the political spectrum most likely to approach 10% is Jean-Luc Mélenchon (LFI) party of the hard left. While there have been suggestions of a possible alliance of the moderate left to reach the theoretical 16-17% threshold which could open the door to the second round as the best-placed second, it would also require the involvement of the Greens (EELV party). Yet, there have been too many internecine rivalries between these parties on the left to attach a meaningful probability to this scenario.

Polls of second round voting scenarios (Figure 12) suggest that President Macron would likely comfortably defeat Mr. Zemmour (63%-37%) and Mrs. Le Pen (54.5%-45.5%) on 24 April if either of them managed to come second in the first round. Note that another Macron vs. Le Pen confrontation would be the sequel of the 2017 election. The most challenging scenario for Macron would be to face Pécresse who, according to a poll immediately following her nomination as the candidate of the mainstream right in early December, was credited with as much as 52% of the vote. Since then she has also slipped back to around 47.5% of voting intentions, making her the most credible challenger given the polls' ±2.5% margin of error around the 50% level. With voters' top priority focusing on the issue of purchasing power rather than the pandemic or security/immigration, President Macron's likely focus on his positive record of the management of the economy and some reform delivery makes him the slight favourite for a second term.

Figure 11: First-round voting intentions

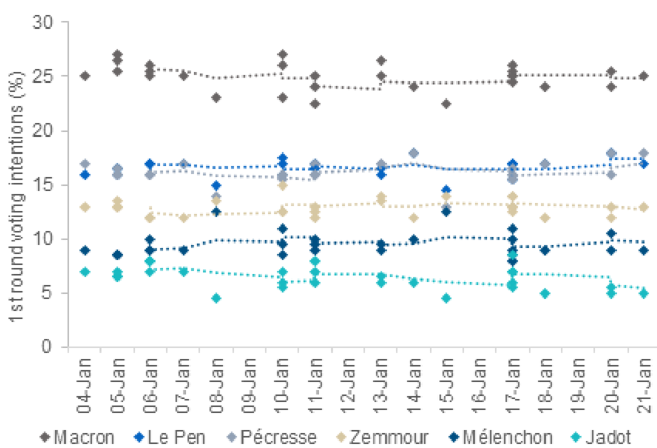
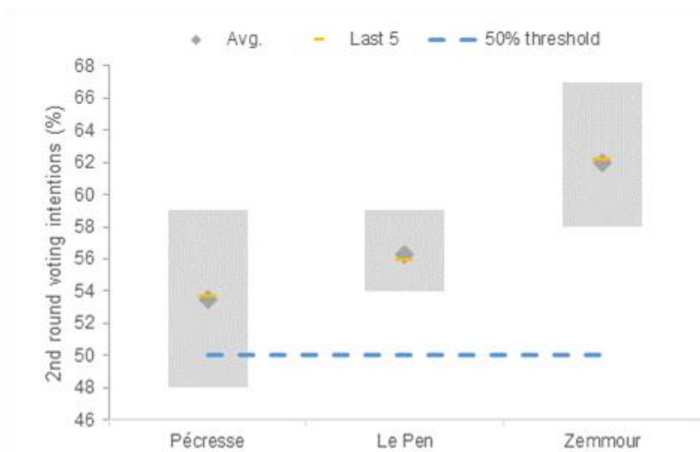


Figure 12: Macron second-round voting intentions 2022



Sources: OpinionWay, Ifop, Elabe, Harris Interactive, Ipsos, Cluster17, Odoxa, BVA polling institutes, as of 21 January 2022

Pressure is rising on UK Prime Minister (PM) Boris Johnson after London's Metropolitan Police announced last week that it would investigate allegations of 'serious and flagrant' lockdown breaches at 10 Downing Street. Publication of the Cabinet Office investigation, which is expected soon, will likely be the deciding factor for many Conservative PMs to send additional letters to the 1922 Committee of the Conservative Party: once the 54 threshold is reached, a leadership contest will ensue. Going forward most political commentators expect the replacement of PM Johnson, even if the timing remains uncertain. This could have implications for the delivery of fiscal support in the near term and could make the Bank of England more cautious in the delivery of additional rate hikes beyond the expected second move next week, likely taking Bank Rate to 0.5%.

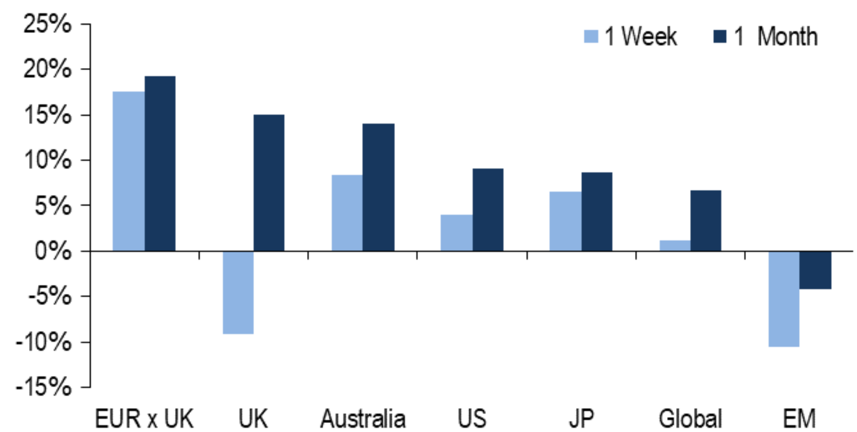
EQUITY OUTLOOK

Europe ex UK (MSCI Europe ex UK index) and UK (MSCI UK index) equities have returned -6.15% and 0.90% YTD (31 Jan 22) (in USD terms). Both equity markets have largely benefited from their index composition, heavily weighted towards the old economy sectors such as financials and industrials. YTD the broad MSCI Europe index continued to perform strongly, whereas regionally there were some diversions. Europe held on well with the US return too.

Recent volatility in the markets largely driven by the Fed adding more complexity surrounding tightening monetary policy, has caused a rapid de-risking amongst equities and general financials markets. However, this is quite beneficial for the non-US equity markets which may look more attractive, especially European ex UK equities and UK equities. Europe has always been an unloved region, for past five to six years, due to its lack of growth companies within the MSCI Europe index and its heavy weight towards the old economy sectors, such as commodities and financials. However, European equities may provide potential diversification in a portfolio where the share of long duration US stocks are more sensitive in a rising rate environment. As the ECB continues with the path of loose monetary policy and the Bank of England (BoE) begins to tighten at a slower pace, European equities may look potentially more attractive relative to US equities.

The earnings story in Europe continues to be positive and upward trending, as the economy recovers from the Omicron variant and restrictions being lifted, after being put in place in December to control the spread of the virus. Since the start of the year analysts continue to upgrade 2022 earnings-per-share (EPS) forecasts for both Europe ex UK and UK equities. Europe ex UK and UK equities continue to see the highest net upgrades relative to other developed and emerging regions from the prior month (Figure 13). For 2022 and 2023 EPS growth remains positive, where Europe ex UK will benefit from its exposure to global growth and diverging macro policies as consensus estimates for EPS growth remain strong at 6.6%YY and 7.0%YY, coming in line with global equity EPS growth rates and with an average dividend yield of 2.7%. UK equities also see positive EPS growth with 3.6% YY for 2022, then falling by 0.2% YY to 3.4% in 2023 with the highest dividend yield across all developed regions of 3.0%. As seen throughout 2021, we continue to believe 2022 may see more analysts EPS upgrades for Europe ex UK.

Figure 13: Regional Earnings Revisions: Net Analyst Upgrades (%)



Source: All charts and tables are sourced Factset, MSCI, data as of 23 Jan 2021.

Valuations in European markets have always been cheap relative to the US, Europe ex UK price-to-book is 2.2, UK price-to-book of 1.8 versus an expensive US price-to-book of 4.5. The valuations in the European markets continue to be low and are not always sufficient to accompany strong returns. However, the strong 2022 dividend yields, and estimated EPS growth continue to be robust, which may likely be the main drivers of return for these two markets this year. In addition, selectively investing in firms with a quality and sustainable dividend growth bias, firms who have established brand names, strong management, and rising returns on equity from depressed levels, could provide strong returns within this regional market.

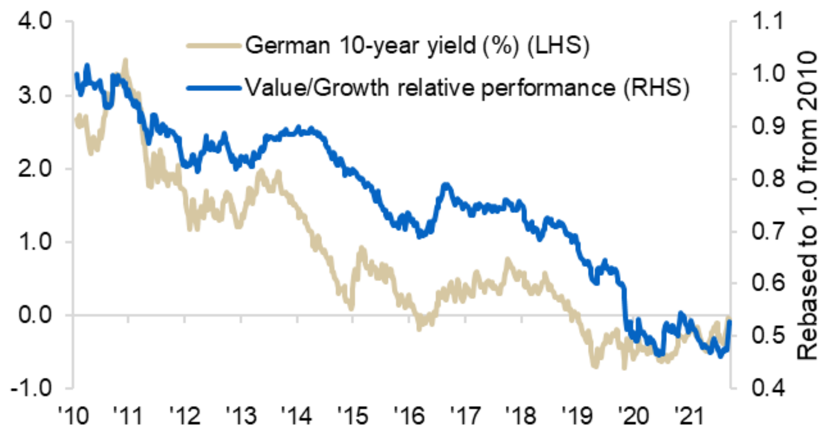
SECTOR OUTLOOK

With regards to European sectors, there are many potential selective opportunities, which are forecasting strong consensus EPS growth for 2022 and 2023. Sectors with double digit earnings growth YY are coming from Energy, Consumer Discretionary, Industrials and IT. Some of these sectors, industrials, and energy (value sectors), have been benefitting from the recent short-term supply side pressures (Figure 14) which we believe may peak towards the end of the first quarter of this year. However, for the medium to longer-term we favour the below European sectors.

Below are the sectors we favour in Europe:

- **European Financials** especially European Banks, which makes up most of the financial sector. Lower provisions, stronger fees and trading continue to be the top drivers for the major banks. Earnings momentum continues an upward trajectory and the rise in both the UK and Fed interest rates should support European Financial valuations. Financials remain cheap at 0.9 price-to-book on average. The continued momentum of declining provisions, increasing fee income from trading and M&A activity should provide solid footing for stronger returns for the next 12-18 months for the sector.

Figure 14: Short-term pick-up in value European values sectors



Source: Bloomberg as of January 21, 2022. MSCI European Value index/ MSCI European Growth index relative performance

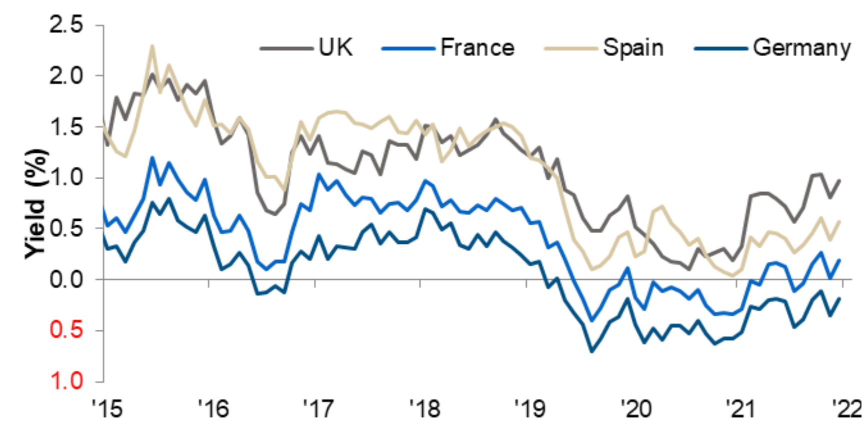
- **European green energy** – clean energy continues to be a major topic for global leaders but has been put on hold or has been very little given the recent shortages on energy supply. However, as "greening the world" discussions start to pick up again across government around the world, we see Europe as the leader for pushing towards a greener economy. As the discussion progresses, certain energy companies in Europe may likely benefit in the medium to longer-term. We see both mature energy companies with growth in alternative energy, as well as midcaps focused on alternative energy being potential drivers of returns in the next 12-18 months and even the longer-term.

- **European quality companies** – as we transition from a recovery to a mid-cycle market, we increasingly favour quality companies at a global level. Europe has many 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 pay-outs.

FIXED INCOME OUTLOOK

We continue to remain cautious and underweight in both European government bonds and investment grade (IG) corporate bonds, whilst recognizing that there are selective potential opportunities from an issuer level. Recently, we have seen an increase across 10-year European government yields (Figure 15), heavily influenced by the pick-up seen in the US 10-year treasury market, as the Fed pursues tightening monetary policy. YTD (31 Jan 2022) German 10-year bund yield has risen to 0.01% from -0.18% on December 31, 2021. Despite the recent pick-up in European government yields, valuations remain expensive as the ECB continues with its loose monetary policy keeping real yields negative. We expect 10-year bund yield to end the year near -0.05%.

Figure 15: European 10-year government bond yields, yield (%)

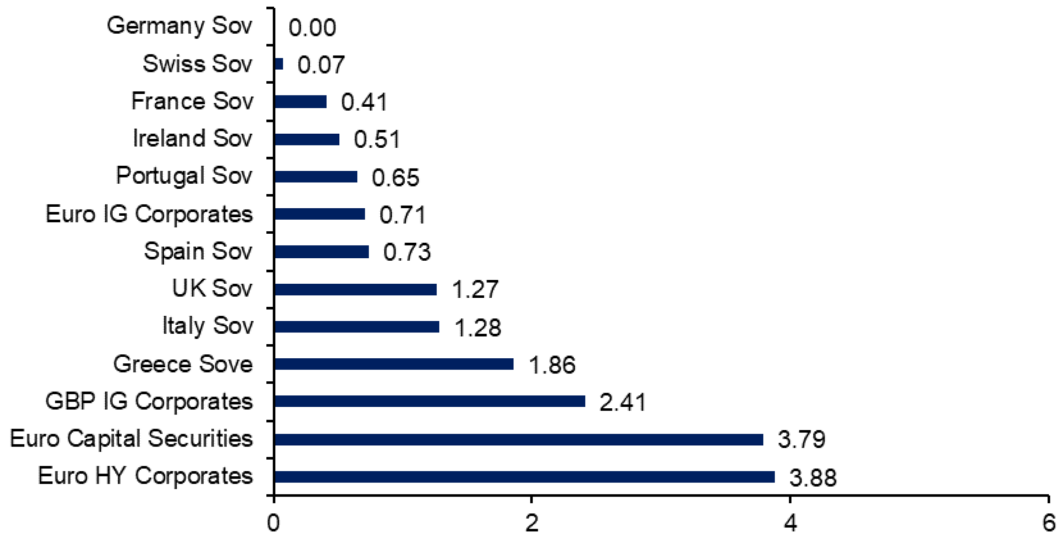


Source: Bloomberg as of December 31, 2021.

Regarding UK 10-year gilt yield, they too have risen from 0.97% on 31 December 2021 to 1.30% 31 January 2022, the biggest mover among the largest European countries. However, as the BoE adjusts short-term rates and purses a tightening policy relative to the ECB gilts' yield relative to other developed European sovereigns may increase somewhat further. We agree with Citi research estimate for UK 10 -year gilts yield at 1.25% towards year end 2022.

In high yield, both euro-denominated bank Tier 1 capital securities and non-bank issuers including loans offer yields around 3.90%. They are likely to see their credit metrics supported by the ECB's continuing provision of liquidity through its asset purchases.

Figure 16: EMEA Fixed Income Yields (%)



Source: Bloomberg Barclays, Bloomberg and The Yield Book, as of 31 Jan 2021. 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.

CURRENCY OUTLOOK

EUR STRATEGY COMMENTS (FURTHER EURUSD WEAKNESS NEAR TERM, NOT IN H2)

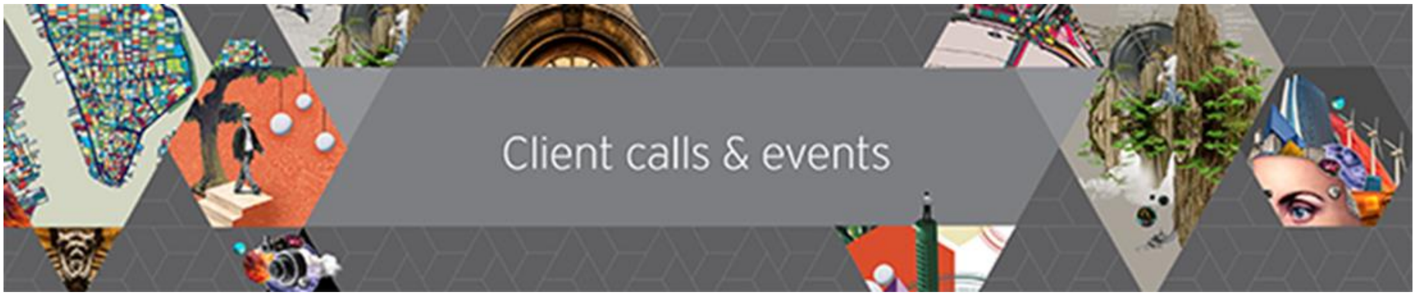
EURUSD has broken below major range support between 1.1180 -1.1210 with leveraged accounts seen selling before and after the Fed FOMC this week. This adds to the large real money buying of USD (vs EUR and JPY), potentially targeting the next area of support between 1.0880 and 1.1000 in EURUSD as DXY now looks to break through 97.75 resistance near term. The improved German consumer confidence and business climate reports are unlikely to change EUR's near term weakness bias but with the Fed hinting at optionality on the timing and extent to which it will quantitatively tighten, while ECB tapering and timing of rate lift-off now pretty much discounted (markets expect a first modest 15bp ECB tightening around Q1'2023 while Citi Economics expect net asset purchases to end in December 2022 and +25bp ECB hikes to begin in June and December each year between 2023-2025), the 1.08-1.10 area may offer more durable medium term support for EURUSD (assuming minimal risk from the French parliamentary elections in June).

In addition, CPB FX are long EURCHF spot as a medium-term play on CHF underperformance but are also long a EURCHF Put as a tactical hedge against political risk (EU-UK Brexit tensions, Russia – Ukraine tensions, Italian and French elections) all of which continue to currently put a bid into CHF and could take the cross to test support at 1.0296, the June 2015 low before turning around. Other trades to consider include a medium term bearish EURCAD structure as the BoC embarks on a faster path towards rate hikes and balance sheet run-off while EUR reverts to its funding status.

GBP STRATEGY COMMENTS - FED AND THE BOE HAVE VERY DIFFERENT BASELINES

The Fed's implicit warning that it may need to be aggressive in tightening has spooked the GBP front-end. A BoE hike in February is now almost 100% priced with nearly 5x 25bp hikes priced for the 8 meetings in 2022. If the BoE does hike this week – the house view is 2x 25bp in Feb/May before a long pause – it will be the second hike before the Fed has even begun. If the first stage is to take back emergency stimulus, then the pre-pandemic baseline is 2x 25bp (to 0.75%) away for the BoE vs 6x 25bp (to 1.75%) for the Fed. The BoE's guidance on the hiking path, therefore, could be key to the market reaction this week.

The BoE's current guidance that "…modest tightening over the forecast period is likely to be necessary…" does not align well with market pricing (that is far more hawkish). Sticking with that guidance could be sufficient to trigger a reversal in rates vs US rates. However, if the BoE opts not to push back on hike pricing for 2022, then the conversation around active QT (which the MPC will consider when Bank Rate is at least 1%) will just get louder and QT expectations could accelerate the tightening in financial conditions. This 2nd scenario could strengthen the bullish trajectory of sterling on non-USD crosses – versus (EUR, CHF, JPY) in particular and risk FX (AUD, NZD) to a lesser extent. Against USD though, the re-pricing post-Fed makes it harder for the BoE to out-hawk the Fed, skewing the risk-reward moderately bearish on cable (with solid support seen around the 1.3200 area) especially if the BoE sticks with guidance for "modest tightening" as market pricing is stretching beyond that.



Important information, including information relating to risk considerations can be found in the link above.

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