



Citi Global Wealth Investments

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When the going gets tough and could get even tougher

- **From accelerating softening to growing risk of recession** – There are considerable economic distortions to contend with in coming months. We suspect that most euro area governments will have little choice but to resort to some targeted fiscal support towards certain sectors as well as towards lower-income households to mitigate the impact of the energy crisis and to limit the extent of the drop in GDP.
- **Inflation at record high, while work continues about anti-fragmentation tool** – Short-term inflation risks remain potentially skewed to the upside and could lead to second-round effects if wage settlements were to increase more meaningfully next year. Ahead of a likely first interest rate hike since 2011 in July and a new anti-fragmentation tool, the ECB is applying more flexibility to the reinvestment of its Pandemic Emergency Purchase Programme.
- **UK: perfect storm of plummeting confidence and challenging politics** – The outlook for households looks challenging and we see a likelihood that the downtrend in household confidence will continue into the second half of 2022, with inflation yet to peak, likely rising to close to 11% in the autumn. Together with a challenging political environment and fiscal tightening, we doubt that the Bank of England can continue tightening rates aggressively.
- **All central banks singing from the same hymn sheet** – Central bankers admit uncertainty about the future inflation regime that their respective economies are likely to experience. But most have acknowledged the need to react quickly to the spike in inflation which is threatening to damage their credibility. We continue to doubt however that many will lift policy rates above neutral given clear signs of softening in economic activity and more evidence of reasonably well-anchored inflation expectations in the absence of clear second-round effects.
- **Underweight European government and corporate bonds:** continued short-term pressure on European fixed income yields and spreads amid rising inflation concerns and added uncertainty from potential disruption of gas supply to Europe by Russia.
- **Underweight European ex-UK equities, neutral UK equities:** Current earnings mainly supported by the commodities sector. Excluding the commodities sector consensus earnings remain too optimistic. We expect more downward revisions and profit warnings to come in 2Q and 3Q for the Europe ex-UK companies.

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

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From accelerating softening to growing risk of recession

Germany currently faces a multitude of challenges: Chancellor Schulz has seen a series of local electoral defeats since his election in late 2021; his government is actively planning to ration natural gas this winter in case of further significant supply disruption; the still-weak momentum in the Chinese economy; and risk of more trade difficulties post-Brexit should the UK suspend the Northern Ireland protocol.

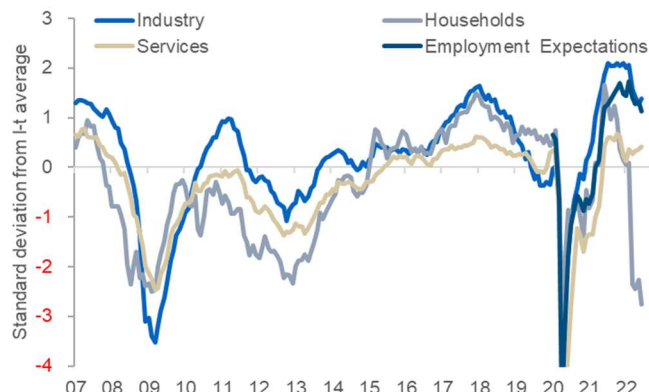
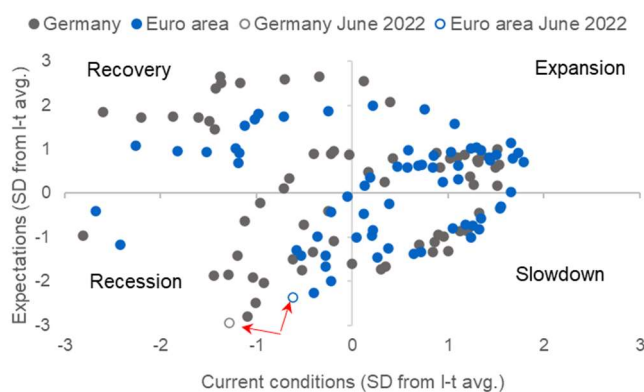
Confidence in Germany is softening across the board. Household confidence worsened markedly in June and the Sentix survey of investor sentiment recorded a 11.4-point drop in the overall index to -24.2 in July, its lowest since May 2020. Expectations also fell to an all-time low suggesting that the largest economy in the euro area is sliding towards an economic crisis and perhaps recession (**Figure 1**) given pressure exerted on households by the cost of living and some clear signs of demand destruction while inflation stands at an historical high. For the euro area, the overall Sentix index fell by 10.6 points to -26.4, its lowest since May 2020. Splits showed that the current situation measure fell to its lowest level since March 2021, while expectations slumped to their lowest since December 2008.

There are undoubtedly considerable economic distortions to contend with in coming months, at a time when the European Central Bank (ECB) is also gearing up to hike its key policy rates for the first time since 2011. We suspect most euro area governments will have little choice but to resort to some targeted fiscal support of certain sectors as well as lower-income households to mitigate the impact of the energy crisis and to limit the extent of the drop in GDP. Europe can probably navigate its way out of the eye of the storm, but it will likely require some time and expertise for the right policies to be deployed, suggesting equity valuations would likely remain under pressure for the time being.

Although sentiment surveys are continuing to soften, there are no strong signals yet about an imminent recession. The Economic Sentiment Indicator (ESI) of the European Commission softened in June, recording a 1.0-point fall to 104.0, the third decline in four months confirming the gradual softening in sentiment to 0.4 standard deviation (SD) above its historical average against a backdrop of significant headwinds. Apart from the depressed level of household sentiment due to record high inflation and the invasion of Ukraine (**Figure 2**), all sectors show that confidence remains above its historical average, including for employment (+1.1SD). Our recession proxy showed that ~75% of forward-looking indicators remain above their historical average, but our aggregate measure of demand forecasts softened by 0.2SD to a 19-month low of -1.1SD in June, suggesting that sectors are adjusting to the disruption caused by the invasion of Ukraine and Chinese lockdowns.

Figure 1 – ZEW survey (from Jan-17 to Jul-22)

Figure 2 – Euro area sentiment indices



Sources: European Commission, Haver Analytics and Bloomberg as of July 4, 2022. Past performance is no guarantee of future returns. Real results may vary. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Past performance is no guarantee of future results. Real results may vary.

Inflation at record high, while work continues about anti-fragmentation tool

The flash estimate of euro area headline HICP rose from 8.1% YY in May to a new record high of 8.6% YY in June, exceeding consensus expectations (**Figure 3**). As many as nine of the 19 countries of the euro area reported HICP inflation prints in double-digit territory, including readings above 20% in Lithuania (20.5% YY) and Estonia (22% YY). The lowest

print within the largest euro area member states came from France at 6.5% YY, with Germany at 8.2% YY and Italy at 8.5% YY. Looking ahead to the second half of 2022, our colleagues from Citi Research see core inflation rising towards 4.5% YY in the autumn and envisage a peak in the headline HICP rate close to 9.5% YY. This trajectory is higher than the one presented in the June 2022 Eurosystem staff projections, suggesting that in the short-term inflation risks remain skewed to the upside and could therefore lead to growing risks of second-round effects, if wage settlements were to increase more meaningfully next year, even we think the rate of HICP inflation is expected to roughly halve from around 8% in 2022 to around 3.5% in 2023.

Figure 3 – Euro area inflation (headline, core and ECB target)

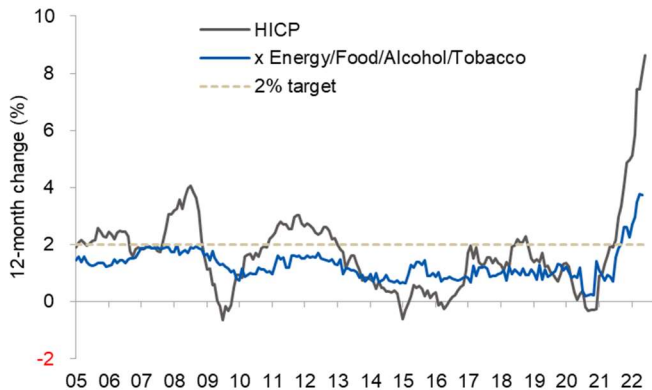


Figure 4 – Italy and German 10-year yields and spread



Sources: Eurostat, Bloomberg and Citi Global Wealth as of July 4, 2022. Past performance is no guarantee of future returns. Real results may vary. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Past performance is no guarantee of future results. Real results may vary.

European Central Bank (ECB) President Christine Lagarde reaffirmed in her opening address on ‘price stability and the transmission of the monetary policy stance’ to the Sintra central banking forum the Governing Council (GC)’s intention of raising rates by 25 basis point in July and leaving the door open to doing more in September if necessary. The priority seems to take key interest rates out of negative territory before the end of summer, perhaps being mindful of the likely softening in economic activity in the second half of 2022. Lagarde remarked that there is no trade-off between delivering medium term price stability and a new anti-fragmentation tool, stressing that “*preserving policy transmission throughout the euro area will allow rates to rise as far as necessary*”. Investors have reacted positively to the ECB’s new guidance, with the spread between 10-year Italian BTPs and German Bund yields narrowing from 242 basis points (bp) on 14 June to 190bp on 4 July (**Figure 4**).

Before more progress can be made on the anti-fragmentation tool, Reuters News reported that as of July 1 the reinvestment of proceeds from maturing government bonds purchases that formed part of the ECB’s Pandemic Emergency Purchase Programme (PEPP) would likely be re-directed primarily towards countries of the euro area periphery to prevent financial fragmentation at a time when the GC is set to announce a first hike in its key policy rates at its monetary policy meeting on 21 July. Sources suggest that the ECB would divide the 19-euro area member states in three groups (donor, recipients and neutrals) determined by the speed and size of the rise in bond spreads in recent weeks, measured against the benchmark of German bunds. The plan is to update the three groups each month. At present the ‘donor’ list is said to include up to half a dozen or so countries, including Germany, France and the Netherlands, while the ‘recipient’ list contains Italy, Spain, Portugal and Greece.

This temporary mechanism would likely operate alongside an anti-fragmentation tool that would allow the ECB to make new purchases if a country meets certain conditions, which could be either determined by the European Commission (using fiscal rule and/or economic criteria/recommendations) or by the ECB (focusing on a debt-sustainability assessment). While the ECB has yet to agree about the size of the tool as well as its essential characteristics, it is highly likely that purchases would be sterilised or ‘offset’ by draining cash from the banking system through auctions. This way banks can park cash at the central bank for a more favourable interest rate, perhaps as high as the refinancing operation rate, currently at 0%.

UK: perfect storm of plummeting confidence and challenging politics

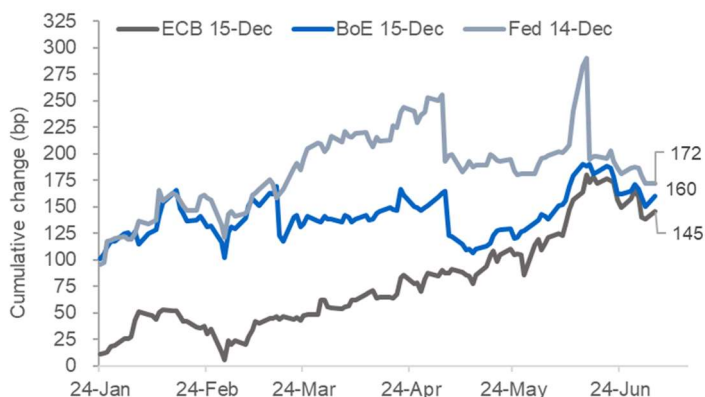
UK household disposable income fell by 0.2% QQ in 1Q-22 according to final figures from the Office of National Statistics, recording a fourth successive decline and the longest period of contraction since the 1950s. The outlook for households looks very challenging as the increase in national insurance contributions and the surge in energy bills will begin to be reflected during the second quarter. As a result, there is a strong likelihood that the downtrend in household confidence will continue into the second half of 2022, with inflation yet to peak, likely rising to close to 11% in the autumn.

Internationally, beyond some clear leadership being displayed in support of Ukraine, the diplomatic and trade relationship with the European Union remains fraught. In the middle of June, the UK government unveiled new legislation to overwrite significant parts of the Northern Ireland protocol unilaterally. Unsurprisingly, there has been some hardening of relations with the EU, with European Commissioner Maroš Šefčovič responding that the EU would not renegotiate the protocol. Beyond a possible update of the EU's compromise proposals made in October, next steps could be the re-launch of infringement procedures against the UK and the possibility of trade retaliation further down the line.

The UK conservative party suffered two substantial by-election defeats in late June, losing the recently acquired 'red-wall' West Yorkshire seat of Wakefield to Labour due to a 12.7 percentage point swing on a 39% turnout, and more embarrassingly the 'blue-wall' Devon seat of Tiverton & Honiton to the Liberal Democrats due to a 29.9 percentage point swing on a 52% turnout. Conservative party chairman Oliver Dowden, a long-standing supporter of UK Prime Minister Boris Johnson, resigned the following morning indicating in a letter to the PM that "someone must take responsibility" and that "we cannot carry on with business as usual". These events leave PM Johnson in a precarious position, which we expect to become even more untenable as the economic situation deteriorates and will likely lead to another challenge of his leadership in the autumn. Earlier in June, PM Johnson had survived a confidence vote among conservative members of parliament (MPs) by 211 votes to 148 to allow him to remain as leader of the Conservative Party. His narrower majority win of 59% was smaller than the 63% obtained in 2018 by his predecessor PM Theresa May who subsequently resigned.

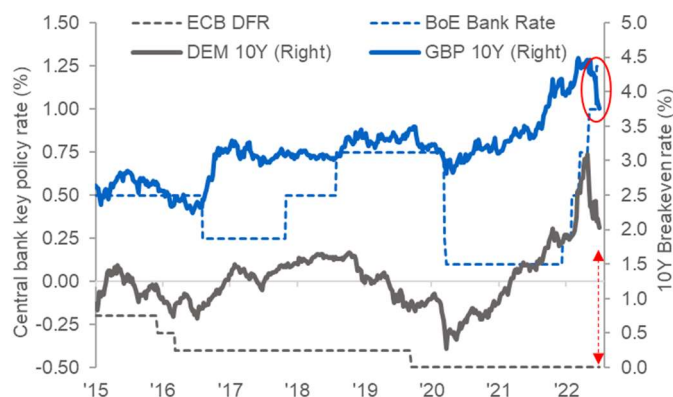
At its 16 June Monetary Policy Committee (MPC) meeting, the Bank of England (BoE) announced a 25-basis point rise in its policy rate to 1.25%. The MPC signalled it would 'act forcefully' if needed to curb more persistent inflation. In addition, the MPC changed its guidance on the likely path of interest rates in coming meetings, saying that the scale, pace, and timing of further increases would be dependent on the evolving economic outlook. The MPC sent its strongest signal yet that it is prepared to unleash larger moves if necessary to tame inflation. Yet, we see limited upside in sterling as the BoE gets caught between slow growth and high inflation. We expect the next move by the BoE to be another 25bp on 4 Aug but doubt that the MPC can deliver as much as the 160bp the market currently discounts by year-end (**Figure 5**).

Figure 5 – Central banks' implied policy rate path to year-end



Sources: Bloomberg and Citi Global Wealth as of July 4, 2022.

Figure 6 – Policy rates and inflation breakevens



Sources: Bloomberg and Citi Global Wealth as of July 4, 2022.

All central banks singing from the same hymn sheet

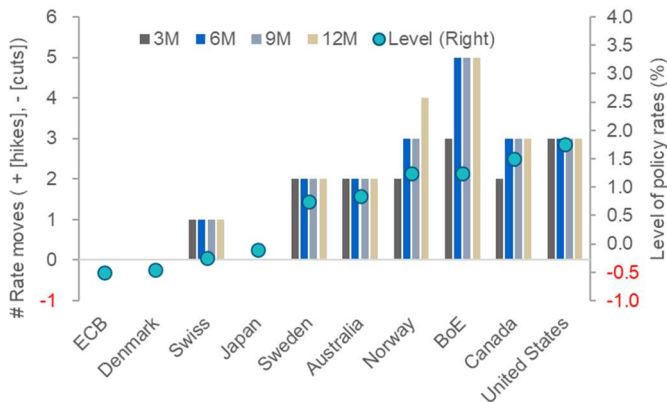
Central bankers admit uncertainty about the future inflation regime that their respective economies are likely to experience. That much was clear from the various speeches and panels during the Sintra central bank forum in Portugal at the end of June. More broadly, while the central bank appears to be more worried about the risk of second round effects as inflation expectations become more entrenched, we continue to think there is a limited amount of rate hikes that can be delivered before the slowdown in economic activity become more obvious and inflation expectations start to normalise as firms pare back their investment and hiring plans, contributing to some downward adjustment in the level of demand. This much is clear from the decline in the inflation breakeven market in both the UK and Europe in recent months (**Figure 6**).

In June, **Sweden's Riksbank** hiked interest rates by 50 basis points (bp) to 0.75%, the highest level since 2014, reacting to "the risk of the high inflation becoming entrenched in price setting and wage formation has increased", according to the monetary policy statement issued by the central bank. In terms of the projected path, the Central Bank's Executive Board forecasts that the policy rate would likely increase to around 2% by the start of 2023.

The **Swiss National Bank (SNB)** also surprised markets by unexpectedly raising interest rates for the first time since 2007, shifting focus from trying to tame a strong currency to controlling inflation. The policy rate was raised by 50 basis points to -0.25%. The SNB's statement justified the rate rise on 'increased inflationary pressure' and noted that further rate hikes make become necessary 'in the foreseeable future to stabilise inflation in the range consistent with price stability over the medium term. To ensure appropriate monetary conditions, the SNB is also willing to be active in the foreign exchange market as necessary.

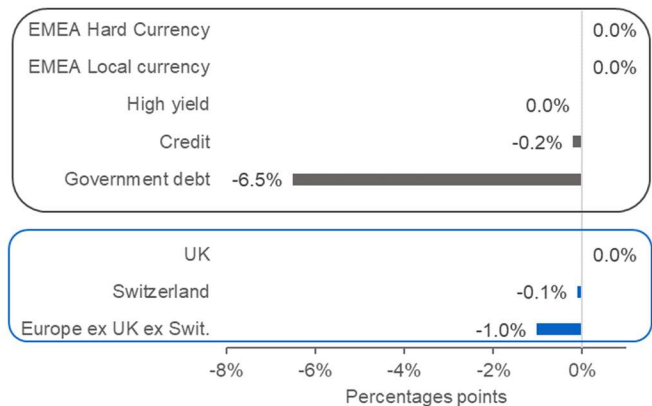
The **ECB looks behind the curve**. Higher-than-expected inflation and indications that economic activity continues to expand modestly suggest that the ECB is behind the curve. We think that market pricing of the near-term ECB rate path is reasonable, with around 25bp of rate hikes priced in for July, 48bp for September, 36bp in October and 29bp in December (**Figure 5**). This would be consistent with a 'sharp but short' approach, delivering almost 140bp of hikes before the end of the year, bringing the deposit facility rate to around 1% from its current level of -0.5%. We continue to think that there is a maximum amount of rate hikes of around 150bp that the ECB will need to deliver to re-anchor inflation expectations to its symmetric 2% target in the medium-term. So, the larger the hikes the shorter the tightening cycle is likely to be.

Figure 7 – Recent moves in key G-10 policy rates



Sources: Bloomberg, as of May 4

Figure 8 – Europe: GIC underweights and over-weights



Sources: Haver Analytics, as of May 4

Fixed Income Outlook

European Sovereigns

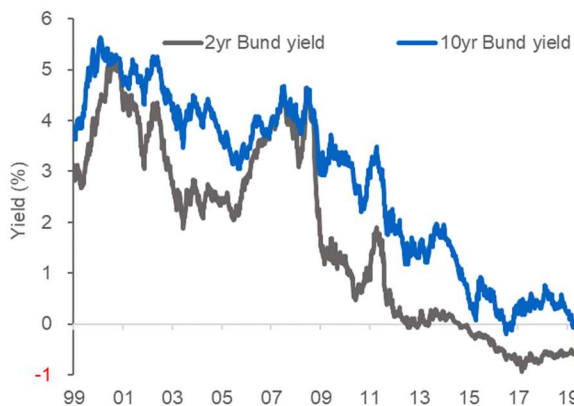
Figure 9 – European fixed income performance

| Fixed Income | 1M | 3M | YTD |
|----------------------|-------|--------|--------|
| German 10Yr | 0.0% | -7.3% | -13.8% |
| BTP-Bund spread (bp) | -18.1 | 34.9 | 56.4 |
| UK 10Yr | 1.2% | -4.1% | -9.3% |
| EU IG spread | -2.4% | -7.2% | -11.7% |
| EU HY spread | -6.7% | -10.7% | -14.3% |

Sources: Bloomberg and Haver Analytics data as of 4 July 2022. 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.

European fixed income markets have suffered along with equity markets this year. YTD both the German 10-year bund and UK gilt have lost 13.8% and 9.3% (**Figure 9**), respectively. For fixed income investors, the all-important question is whether the sell-off in the euro area risk free rate looks overdone. On the basis that inflation could still surprise to the upside in response to further restrictions of Russian natural gas supplies to Europe and some uncertainty about the cumulative size of ECB interest rate hikes, we think that the 10-year bund yield will probably remain within in 1.25%-1.5% range for the remainder of 2022 compared to the 1.5%-1.75% range of the last three weeks (**Figure 10**). Another, important market consideration will be the level of the 10-year Italian BTP-Bund spread which, if it were to widen markedly beyond the current 200bp level, would challenge the ECB's credibility as well as its ability to embark on a significant monetary policy tightening cycle (see section above on “*Inflation at record high, while work continues about anti-fragmentation tool*”). For the time being, we remain underweight European sovereign bonds but think that the peak in yields might be already behind us.

Figure 10 – German government bond yields



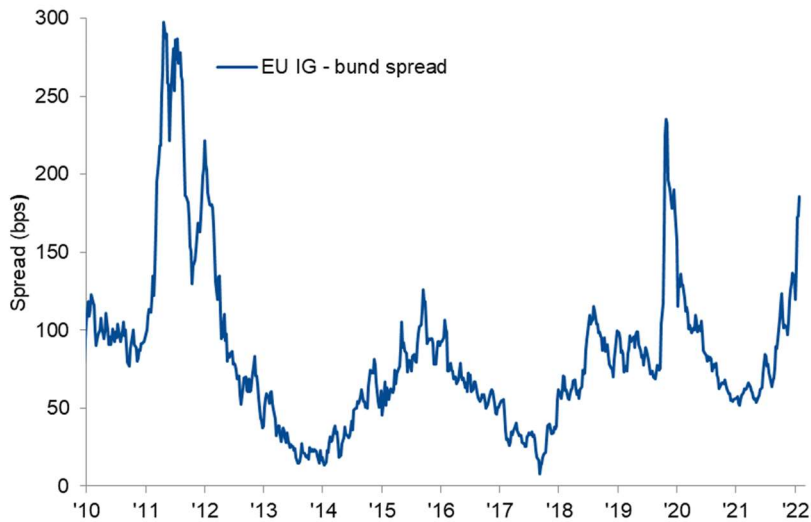
Sources: Bloomberg, as of July 4, 2022. Past performance is no guarantee of future returns. Real results may vary. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Past performance is no guarantee of future results. Real results may vary.

European Investment Grade and High Yield

European investment grade bonds (IG) and high yield bonds (HY) have significantly underperformed in the first half of 2022 (see **Figure 9**). The scale and speed of the recent sell-off point to potential opportunities to enter the market in the second half of the year. As indicated above, our expectation that bund yields will remain range-bound with the potential to get tighter towards the end of this year should benefit high grade, other things being equal.

Since the start of 2022, investment grade bonds have sold-off significantly, reflecting the drag on economic activity from the invasion of Ukraine and the jump in inflation which has prompted some destruction of demand. Both factors contributed to some weakening in the profitability of the corporate sector. The result was a sharp jump in the spread between investment grade yields and Bund yields, which now looks to be in oversold territory (**Figure 11**), at 186 basis points on 1 July compared to an average 77bp during the period of ECB net asset purchases. With a lot of bad news priced in and no support from the central bank, we see some potential for the spread to narrow again. However, there are still some risks of a disappointing period for corporate earnings as pricing power could weaken due to lower demand, in case of an escalating energy crisis. As a result, the OCIS team remains slightly underweight European IG and neutral on EU HY (**Figure 8**), with short-term risk and increased volatility outweigh the potential for a medium term spread tightening opportunity.

Figure 11 – EU IG – bund spread



Sources: Bloomberg, as of July 1, 2022. Past performance is no guarantee of future returns. Real results may vary. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Past performance is no guarantee of future results. Real results may vary.

Equity outlook

In local terms, Europe ex-UK (Stoxx 50) and UK (FTSE 100) equities have returned -19.7% and -2.1% YTD (4 July 22) (**Figure 12**). In our asset allocation, we remain underweight European ex-UK equities and neutral on UK equities. We continue to see many challenges for European equities given the softening growth outlook, cost-of-living crisis, and further potential disruption if Russia halts gas flows to Europe.

Figure 12 – European equity performance

| Indices | 1M | 3M | YTD | 1M | 3M | YTD |
|-----------------|-----------|-------|-------|---------|-------|-------|
| | Local (%) | | | USD (%) | | |
| Stoxx 50 | -10.1 | -12.6 | -19.7 | -12.4 | -17.0 | -26.5 |
| FTSE 100 | -4.9 | -4.3 | -2.1 | -8.2 | -11.6 | -12.4 |
| DAX | -12.8 | -12.0 | -19.6 | -15.1 | -16.4 | -25.9 |
| CAC 40 | -9.1 | -11.5 | -16.8 | -11.4 | -16.0 | -23.8 |
| Swiss | -5.7 | -11.8 | -15.5 | -4.5 | -15.0 | -19.6 |

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Over the past few months European companies have been delivering strong top-line growth, passing through price increases to consumers with ease. However, inflationary price pressures continue to persist, and supply-side issues have been aggravated with the conflict in Ukraine, thus reducing forward-looking profit margins.

European equities indices have fallen by around -19.7% YTD (local terms) and are pricing in higher rates in Europe this year. Despite the derating in equities, consensus earnings forecast for '22 EPS YY growth remains high and have seen few downgrades. The high consensus EPS has been mostly supported by the commodities sector (**Figure 13**), as MSCI Europe ex-UK equities sees 12% YY EPS growth for 2022 whereas MSCI Europe ex-UK ex-commodities sees 6.3% YY growth. The same applies for the UK equity market, which shows a bigger drop in consensus EPS % YY growth ex-commodities of around 8.8% YY versus with commodities EPS growth of 27.9% YY for 2022.

Figure 13 – Europe YY EPS growth versus European ex-commodities YY EPS growth

| Regions | 31 Dec 21 EPS YoY % | | | 30 Jun 22 EPS YoY % | | | 30 Jun 22 EPS YoY % (ex-commodities) | | |
|---------------------|---------------------|------|------|---------------------|-------------|-------------|---|------------|-------------|
| | 21E | 22E | 23E | 21E | 22E | 23E | 21E | 22E | 23E |
| Global | 53.1 | 7.3 | 8.9 | 58.4 | 10.9 | 7.4 | 45.5 | 4.6 | 11.6 |
| Developed World | 51.1 | 7.7 | 8.7 | 56.0 | 11.5 | 7.4 | 44.3 | 4.3 | 11.6 |
| Emerging World | 64.1 | 5.2 | 9.8 | 73.2 | 7.3 | 7.8 | 53.4 | 6.6 | 11.9 |
| USA | 49.6 | 7.7 | 10.3 | 53.8 | 8.7 | 9.6 | 44.7 | 2.4 | 12.6 |
| Europe | 63.6 | 6.2 | 6.2 | 70.4 | 16.3 | 3.9 | 52.5 | 6.8 | 10.4 |
| UK | 82.4 | 2.4 | 3.7 | 86.8 | 27.9 | -0.5 | 44.0 | 8.8 | 11.6 |
| Europe ex UK | 57.0 | 7.8 | 7.2 | 65.3 | 12.0 | 5.8 | 55.0 | 6.3 | 10.0 |
| France | 109.0 | 9.2 | 5.6 | 112.8 | 23.5 | 2.4 | 81.9 | 11.8 | 12.1 |
| Switzerland | 16.7 | 9.3 | 8.9 | 24.8 | 0.0 | 11.1 | 24.9 | -0.9 | 11.0 |
| Germany | 66.4 | 5.6 | 8.4 | 72.1 | 3.6 | 7.6 | 69.9 | 5.3 | 8.6 |
| Italy | 77.6 | 11.7 | 7.2 | 56.3 | 40.7 | 5.4 | 30.1 | 28.9 | 11.9 |
| Spain | 52.4 | 7.7 | 9.5 | 66.7 | 9.4 | 6.1 | 58.0 | 0.3 | 10.7 |
| Portugal | 32.3 | 21.8 | 7.2 | 38.2 | 31.0 | 11.5 | 3.5 | 2.6 | 20.9 |

Sources: Factset, MSCI, Worldscope The above data are compiled based on companies in MSCI AC World Index. The market capitalization for regions, markets and sectors are free float adjusted. P/E, EPS Growth, P/B, Dividend Yield and ROE are aggregated from Factset consensus estimates (calendarized to December year-end) with current prices. CAPE is calculated by current price divided by 10-year average EPS based on MSCI index-level data. NM = Not Meaningful; NA = Not Available. 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.

As mentioned in our previous note [EMEA Strategy Monthly | Challenging economic and inflation backdrop calls for continued caution](#), we continue to believe the current consensus 22' EPS expectation (excluding commodities) is too high for both Europe ex-UK and UK equities and anticipate downgrades to come in the second half of the year and over the next 12 months, as companies struggle to pass on higher prices to consumers and as demand deteriorates due to lower household real disposable income.

Currency outlook

Since the start of the year, European currencies have continued to weaken against the dollar, as markets price in several US rate hikes for this year. YTD the EUR, GBP and CHF have deteriorated against the dollar 8.3%, 10.4% and 5.1%, respectively (**Figure 14**).

Figure 14 – FX performance

| FX | 1M | 3M | YTD |
|--------|-------|-------|--------|
| EURUSD | -2.6% | -5.0% | -8.3% |
| EURCHF | -3.5% | -1.4% | -3.4% |
| EURGBP | 0.9% | 2.9% | 2.7% |
| GBPUSD | -3.3% | -7.6% | -10.4% |
| CHFUSD | 1.0% | -3.6% | -5.1% |

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EUR

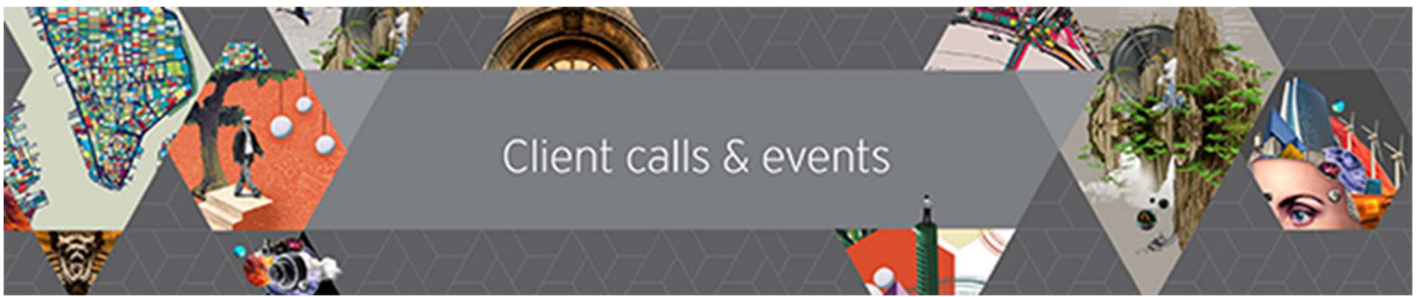
EURUSD slides to a 20-year low on 5 July, dropping to a 1.0235 low and breaching key support at 1.0341-50 (2017 & 2022 lows respectively). This leads analysts (including all CitiFX teams) to target parity as the next move, while suggesting multiple reasons for the overnight move, these being – weakness in the final estimates of euro area PMIs overnight, the recent decline in euro market rates pricing of the ECB, concerns about Russian gas supplies to Europe and concerns about euro area fragmentation risks once ECB starts to hike rates. The technical picture on EURUSD seems to have broken down which allows momentum traders to take advantage of the vulnerabilities, but the fundamental case does not appear to be strong enough to warrant a move to parity or lower. More likely, the pair could move back towards the 1.0350 (previous support) ahead of the ECB's July 21 board meeting.

GBP

Both Citi Research and OCIS think current market pricing of the Bank Rate rising to 3% by December 2022, looks aggressive and with the BoE itself unclear as to what happens next, sterling remains vulnerable even if the MPC decides to hike 3 more times (by 25bp each) as per the Citi Research call (to a cash rate of 2%). Overall, the BoE MPC remains closer to the end of its tightening cycle than almost all other G10 central banks with a terminal rate that is likely to be significantly lower than current market pricing (3.00%). Add UK's structural deficiencies (the doubling of its current account deficit and lowest level of real yield support within G10 FX) as well as a rising political temperature within UK, and sterling vulnerabilities only rise.

CHF

EURCHF now trades at parity, perhaps with SNB's blessing given very little change to SNB sight deposits from last week. The SNB's lack of intervention to weaken CHF follows the change in language on FX intervention at the June meeting and suggests the SNB is now willing to let CHF strengthen further (below parity) to counter inflation risks. Until June, the SNB had been clearly against CHF weakness, but this now seems to have changed which also suggests that the SNB may yet still hike by 50bps again in September to bring the cash rate to positive (to +0.25%) following its 50bp hike at the June meeting despite the prospects of sub parity in EURCHF. There are other drivers of EURCHF weakness as well from the euro side, namely – (1) still concerns about how effective the ECB's anti-fragmentation tool is likely to be when it is unveiled at the July ECB meeting; and (2) the outlook for Russian gas to Europe – things are already starting to look ominous and a complete shutdown would likely invite sharper CHF strength. The SNB therefore needs to be vigilant about starting something (i.e., a much sharper move lower in EURCHF) that it will find difficult to control once growth risks become the much bigger concern. The euro area already seems to be approaching that point, Switzerland may not be far behind. For now, though it seems there is little that can get in the way of EURCHF trading lower to the 0.98 handle before the pair starts to stabilize.



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