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Citi Global Wealth Investments

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Delta variant slows the economic and market recovery

Summary

- **Overweight European and UK equities.** The resurgence in COVID infections is not expected to end the economic recovery nor the equity bull market. After a challenging summer of rising hospitalizations and slowly rebounding services sectors, we expect stronger growth to resume later this year and into 2022. The earnings recovery looks assured for this year, valuation multiples are inexpensive, average dividend yields are well above the global average, and ownership levels remain low. Both fiscal and monetary policies remain firmly accommodative. As we seek higher quality companies as the cycle matures, Europe offers a large number of companies with reputable management, strong cashflows, and the ability to grow dividend payouts. Over time, as the markets fully discount the end of the pandemic and reflect the better-than-expected Brexit outcome, along with regional leadership in green energy initiatives, we expect perception of the region to improve substantially.

- **Underweight fixed income**. Sovereign bonds remain expensive, especially after the recent rally driven by renewed COVID concerns. In the current environment of negative real yields, there are selective potential opportunities in the corporate bond market, particularly among high yield bonds.

- **Favour sterling over the euro.** Sterling continues to benefit from inflows driven by pent-up demand for all asset classes and is inexpensive in valuation terms. The euro faces further consolidation as the European Central Bank (ECB) is expected to remain more accommodative for longer than other central banks.

The UK removes restrictions before Delta variant peaks

The number of new infections in the UK has now fallen for seven consecutive days – **figure 1.** The number of new infections on 27th July was less than half of the 54,000 on 17th May and the seven-day average of cases in the UK has fallen 31% in the past week. The equivalent figure for testing has fallen only 14%. Under 3% of tests are positive compared with 4% a week ago. Internal government data shows that cases have fallen most among those in their late teens and early 20s. The overall R number is back below one. The number of fatalities has fallen to 0.1% of new cases, compared to a fatality rate of around 1% in the previous two waves – **figure 2.** Hospital cases are above 5,000 for the first time since 18th March, however the average length of stay is down to five days, as infected patients who have been vaccinated are generally suffering less. At this stage, the health system is coping.

INVESTMENT PRODUCTS: NOT FDIC INSURED · NOT CDIC INSURED · NOT GOVERNMENT INSURED
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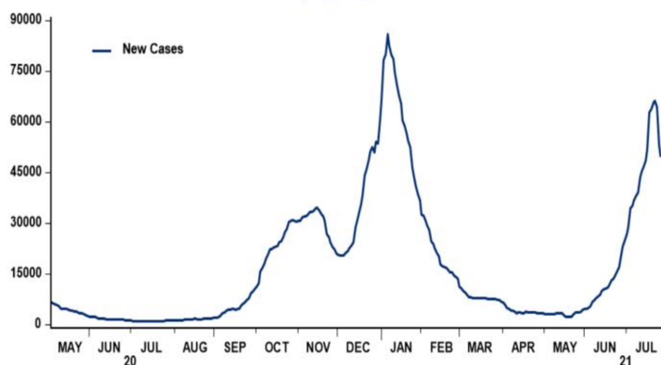
Several factors are driving the better data over the past couple of weeks. By the end of June, about 90% of the population had tested positive for antibodies, either through infection or vaccination. As 68.4% of the population have received their first vaccines, children have risen in relative importance, so it was helpful that the fourth and final reopening stage occurred after the school year ended. There has been a slight dip in testing in recent weeks due to some supply chain disruptions. The European football competition – with it large crowds – ended on 11th July. The heatwave has meant better home ventilation and more outdoor gathering. Behaviour since 19th July has generally not been completely unrestrained.

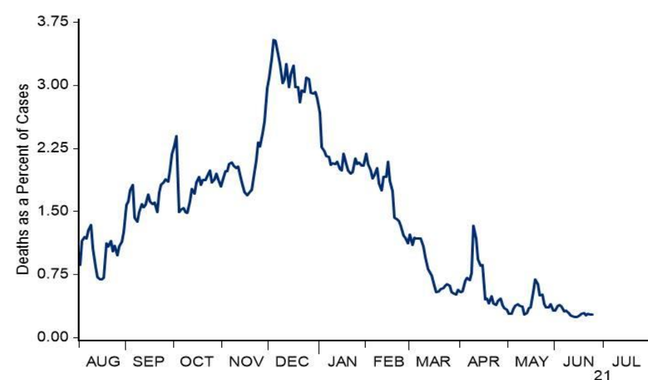
Thus there are grounds for optimism that the peak of the third wave driven by the Delta variant has passed. To be certain, though, we need more data from 19th July onwards. Should the UK follow the path that the Delta variant took in India, there should be conclusive signs of peaking infections by late summer. The government aims to have achieved herd immunity by then, augmented by booster vaccine doses to older people before the winter. At the same time, the authorities seem set on an irreversible path towards re-opening. The UK is set to allow travellers from the US and European Union to travel to England without needing to quarantine on arrival provided they are fully vaccinated.

Figure 1: UK new COVID infections



Source: World Health Organization, Haver Analytics as of July 27, 2021.
Note: UK: Cumulative Confirmed Coronavirus [COVID-19] Cases

Figure 2: UK fatalities per new COVID infection



Source: Haver Analytics as of July 15, 2021.

Europe is on a broadly similar Covid trajectory. While its average vaccination rate is lower, it has seen a slightly slower pickup in the Delta variant than the UK. Across the region, it seems reasonable to assume that by spring 2022, the worst of the pandemic will be over, albeit with some ongoing vulnerability to new variants from emerging countries, where vaccination levels are still not high enough to help alleviate global concerns.

Signs of sustained strong UK economic growth

Even with the Delta variant, the UK economy is showing strength and we continue to believe that GDP growth should rise around 7% this year, after around 5% year-on-year growth this quarter. This was reinforced with yesterday's International Monetary Fund (IMF) 2021 GDP growth forecast for the UK, which was raised from 5.3% in April to 7% now, above its 6% global average forecast. The IMF has raised its 2022 GDP growth forecast for the UK from 4.4% to 4.9%. The Bank of England (BoE) continues to expect 7.2% GDP growth this year, the fastest since 1941.There are several factors supporting this strength:

1. Monetary policy remains supportive

The BoE left its deposit rate unchanged at 0.1% and maintained the cumulative size of its asset purchase programme at £895 billion, to be spent by the end of this year. This was despite recognising that downside economic risks have declined and estimating that this month's economic output will only be 2.5% below the pre-COVID level. The BoE expects inflation to rise to 3%, 0.5% higher than its inflation forecast of only six weeks ago, partly driven by global supply chain pressures but also by rising demand for second-hand cars.

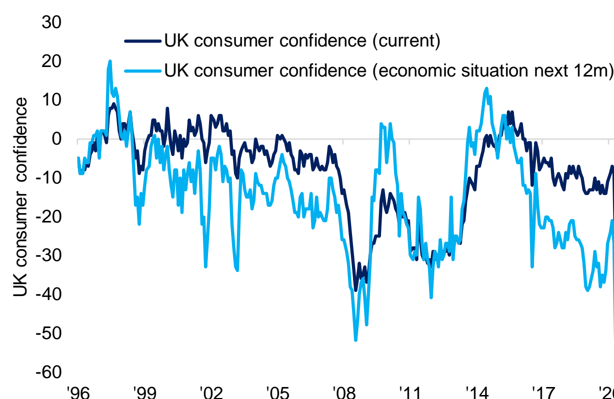
BoE Governor Bailey stated that "*it is important not to overreact to temporarily strong growth and inflation, to ensure that the recovery is not undermined by a premature tightening in monetary conditions*." He said that GDP would only return to pre-COVID levels by year-end, commodity price rises were already easing, and that supply would gradually adjust to huge pent-up demand after lockdown. However, there is no longer complete consensus within the Monetary

Policy Committee (MPC) with regard to the timing of the first rate rise. UK Deputy Governor Ramsden said that "*inflation could peak well above 3% and maybe nearer to 4%*" and that he could "*envisage conditions for considering tightening being met sooner than previously expected*." Our view is closer to the Governor's view, that the inflation pickup is transitory and there is unlikely to be a rate increase any time soon, reinforced by the recent heightened Delta variant uncertainty.

2. COVID income support schemes being reduced slowly

Consumer spending and confidence is buoyant – **figure 3** – supported by the government's emergency measure, which are being slowly tapered during the second half of this year. Employers now need to cover 10% of the outstanding furlough wage costs, increasing to 20% in August and September. Business rates relief for retail, hospitality and recreational firms will be cut from 100% to 66% of normal levels, with lower levels running through the end of the fiscal year. The reduced rate of VAT on services consumption will remain in place.

Figure 3: UK consumer confidence picking up



Source: Bloomberg as of July 15, 2021.

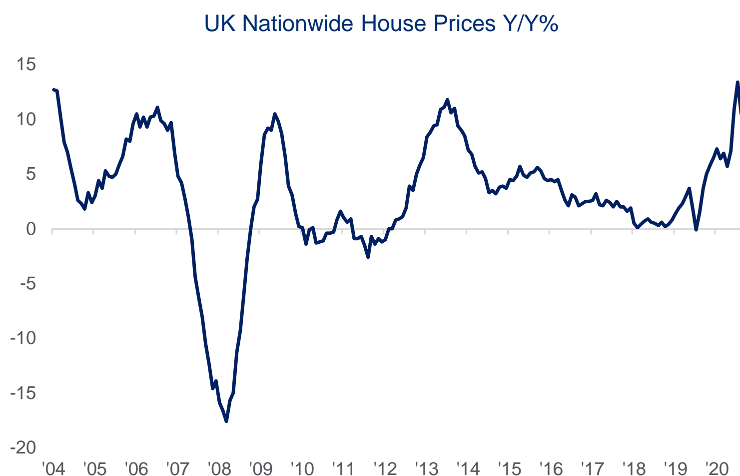
3. UK trade with European Union rises

Increasing support is coming from the external sector, particularly EU trade. In May, UK exports to the EU were £14.2 billion, up 8.8% from April. Exports to the rest of the world were £15.2 billion, up 5.5% from April. Brexit is less of a headwind than had been anticipated, notwithstanding ongoing issues with the Northern Ireland protocol – see page 10. On both sides of the English Channel, initial logistics and administration issues after the UK left the EU in January 2021 are gradually being resolved.

4. Strengthening property market

The UK residential property market has a significant impact on sentiment and spending, as the "wealth effect" is high due to a high level of home ownership. The market is currently very buoyant – **figure 4**, fuelled by low mortgage rates, better availability of high loan-to-value mortgages, the extended period for the stamp duty (purchase tax) reduction, and the impact of repeated lockdowns. UK house prices rose at their fastest annual rate for more than 17 years in June, up 13.4% year-on-year which was the biggest monthly gain since November 2004. Estate agency Savills raised their forecast for house prices to rise this year from 4% to 9%. They expect a further 3.5% rise next year and a 21.5% rise by the end of 2025. They have assumed that the BoE won't raise the deposit rate above 0.5% by 2025.

Figure 4: Rebounding UK house prices



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5. Rising investment in the UK

Rising UK business confidence and investment could be an important driver of the long-term post-Brexit economic recovery. Even as UK COVID infections rise again along with inflation pressures, the corporate sector is showing increasing confidence in several recent surveys. The Deloitte CFO survey showed 71% of chief financial officers plan to raise UK investment in the next 12 months. The recent Confederation of British Industry (CBI) survey showed strong investment intentions from both manufacturers and retailers. The Accenture-IHS Markit survey of the UK business outlook showed the highest level of capital expenditure this year compared with the last 6 years. The UK-US Trade Association found that more than half of 600 US companies with UK operations planned to raise their UK investment in the coming months, and one-third of them showed strongly rising confidence in the UK outlook.

There have been two notable investment announcements in the auto sector. Vauxhall are expanding at Ellesmere Port, while Nissan has announced plans to build a £1 billion battery plant in Sunderland with the intent to create 6,000 jobs and build a new electric vehicle in Sunderland. The Nissan deal includes £450 million investment from Envision AESC, the Chinese company that supplies Nissan's electric batteries. UK ministers did not disclose the size of government support and investment. Last autumn the government announced a £500 million battery fund, and yesterday announced new state aid rules which aim for a more "nimble, flexible" process for directing taxpayer funds towards investment. There are two pressures driving the government to secure this deal. Firstly, the government is looking to ensure the future of mass production of cars in the UK after the ban on new petrol cars from 2030. Secondly, the Brexit trade deal stipulates that UK manufacturers will face tariffs from 2024 if they do not have locally produced batteries.

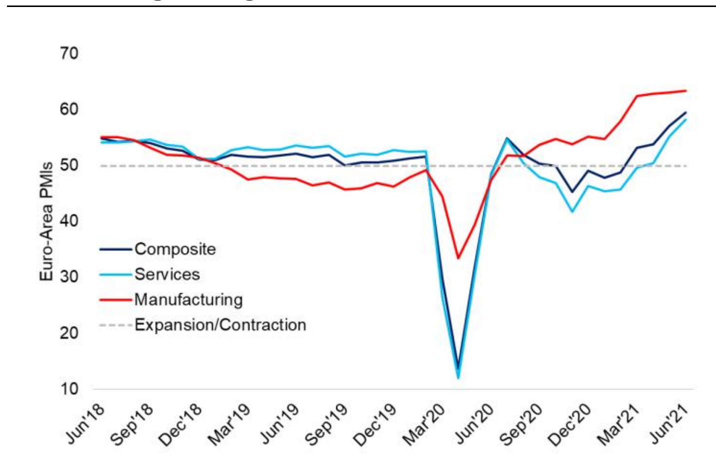
The Nissan deal follows the UK's announcement of a trade deal with Australia, and both offer templates for other future FDI (foreign direct investment) and trade deals. The British government is looking to drive the economy in new growth areas, using an approach that was also behind the successful vaccine programme – government support for the private sector in areas regarded as critical.

Pace of upturn of European growth easing as ECB remains accommodative

Strong first half growth rebound

The first quarter euro-area GDP fell by 0.3% quarter-on-quarter and by 1.3% year-on-year, however this was better than expected. The second quarter saw significant progress, primarily driven by the improving program for vaccine purchases, delivery and inoculation. Real GDP is now 5.1% below pre-pandemic levels. There have been powerful pickups in both business and consumer surveys, as well as in mobility data. Manufacturing remains robust despite some supply constraints. Investment remains resilient despite the ongoing COVID-related headwinds. Inflation pressures will probably keep rising over the summer period, driven mainly by energy prices, the German VAT reduction, and supply chain pressures in manufacturing. However, these factors are all likely to be temporary. Services are now picking up particularly strongly, **see figure 5.**

Figure 5: Euro Area Manufacturing and Services Purchasing Managers' Index



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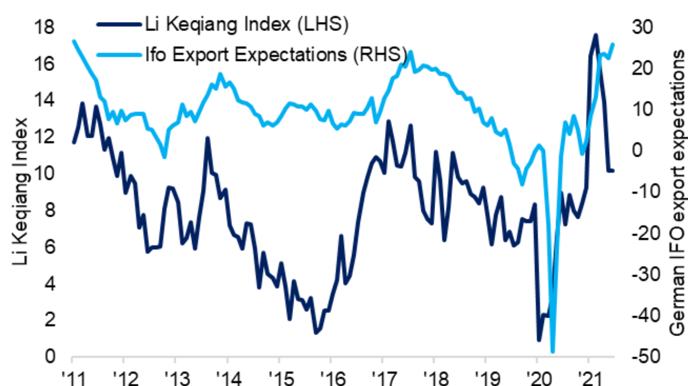
Recent data showing German upturn slowing

Germany is the largest economic driver of Europe. Its economic recovery is losing some momentum, despite remaining at high levels, according to the July reading of the Ifo Business Climate Index. The Index fell to 100.4 in July, below consensus expectations at 102.5, and down from 101.8 in June. The expectations component fell from 104.0 to 101.2. Companies appear to have grown more concerned about the impact of global supply chain disruption and rising cases in coronavirus infections. German manufacturers are struggling to keep up with rising global demand due to supply bottlenecks arising from shortages of materials including semiconductors and metals. The easing in China's growth upturn is not helpful – **figure 6.**

Figure 6: China leading German export expectations



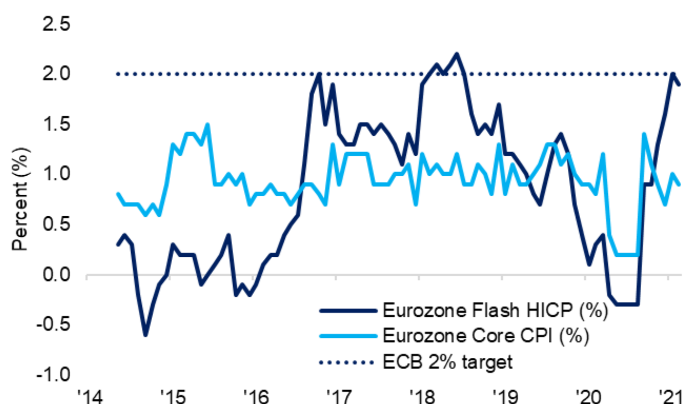
Source: Bloomberg as of July 15, 2021. Li Keqiang Index: Measures Chinese economic output using a composite of railway cargo volumes, electricity consumption and new loans. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not 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 Central Bank still accommodative

On 8th July, the ECB announced the outcome of its 18-month strategy review. The Governing Council confirmed a symmetric medium-term inflation goal of 2%, will include climate change considerations in monetary policy going forward, and recommended the inclusion of owner-occupied housing in inflation calculations. The review was the first to be conducted by the ECB since 2003, and the most comprehensive attempt to rethink its role in serving the Eurozone member states.

At the ECB's subsequent meeting, rates were unchanged, with the deposit rate at -0.5%, the marginal rate at 0.25%, and the refinancing rate at 0.0%. There was a reiteration of the ECB Governing Council view that policy needs to be "*forceful and persistent*." The new forward guidance was that the "*Governing Council expects they key ECB interest rates to remain at their present or lower levels until it sees inflation reaching two per cent well ahead of the end of its projection horizon and durably for the rest of the projection horizon*" if the growth upturn is still fragile and the inflation pressures are transitory. **Figure 7** shows that despite the inflation pickup, the level is still below the ECB's 2% target.

Figure 7: Eurozone inflation rising



Source: Bloomberg as of July 15, 2021.

The ECB will continue with its Pandemic Emergency Purchase Programme (PEPP), indicating no changes to the programme's €1.85 trillion size. The ECB reaffirmed that this quarter will continue seeing a higher pace of PEPP purchases compared with the first months of 2021. The ECB has no current plans to phase out the PEPP before at least March 2022 while maturing PEPP bonds will be reinvested at least through the end of 2023. Net purchases of the regular Asset Purchase Programme (APP) will remain at €20 billion per month, for as long as necessary and won't end before rates begin to rise.

Dovish actions and messaging are consistent with rising infections from the Delta variant across the continent despite vaccination progress. ECB President Christine Lagarde acknowledged that while the economic rebound was on track as COVID restrictions have been eased in most euro-area countries and households resume normal economic activity, the Delta variant was a growing source of uncertainty in the region and could dampen the recovery in services, tourism and hospitality.

There is ongoing fiscal policy support from the EU and from national governments

Even as fiscal measures start to have impact, we expect ongoing monetary accommodation to remain in place for a prolonged period. In Europe, the distribution and spending of the €750 billion EU Recovery Fund will gather momentum throughout the rest of the year. This should be particular benefit to Spain and Italy, which each gain grants and loans equating to 12% of their respective GDP.

In addition, there are ongoing significant national fiscal expansions, with a key point being that lessons have been learnt from the austerity imposed soon after the 2008/09 Global Financial Crisis. This time, the consolidations and normalization will occur much more slowly.

There are two key points regarding the EU Recovery Fund. Firstly, a broad intention exists to spend the funds on areas which will have high multipliers through the EU economies. Secondly, the spending will be persistent through to 2026, starting with a fiscal impact this year of around 1.5%.

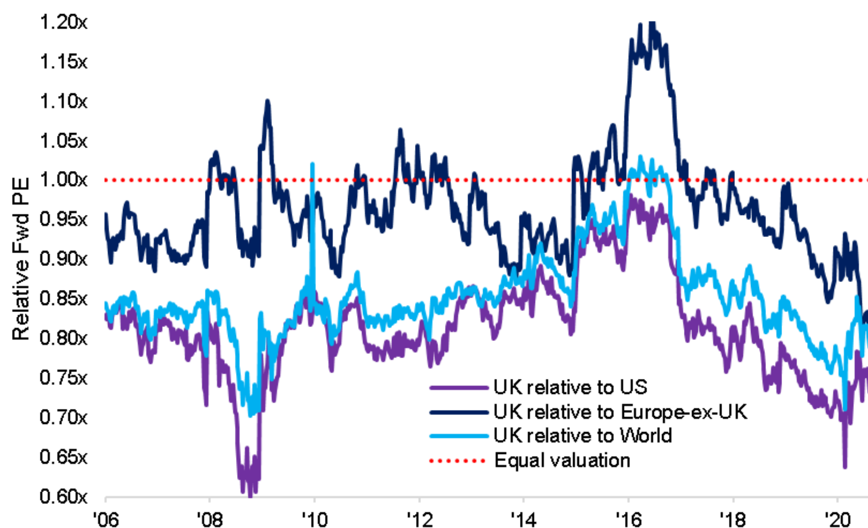
European and UK stock markets remain overweight

Our reasons for going overweight late last year are still largely intact despite the recent pickup in COVID cases driven by the Delta variant. There is still a gradual perception change towards Europe, driven by few signs of major disappointments with growth and politics. The UK continues to be well-supported by pent-up demand, and this is expected to be sustained as the policy post-Brexit and post-COVID becomes clearer.

Earnings valuation multiples for both Europe and the UK are undemanding at 18.5X and 12.6X respectively relative to the low discount rate and relative to global markets – **figure 8**, 2021 EPS growth is very strong at 40% and 70% respectively, and average dividend yields are higher than the global average at 2.6% and 4.2% respectively. The yield gaps are very wide in favour of equities, at 3% in Europe – **figure 9** and 3.6% in the UK. As we seek more quality companies at a global level, the region is well-endowed with companies with long histories of strong management building strong brands and sustainable cashflows.

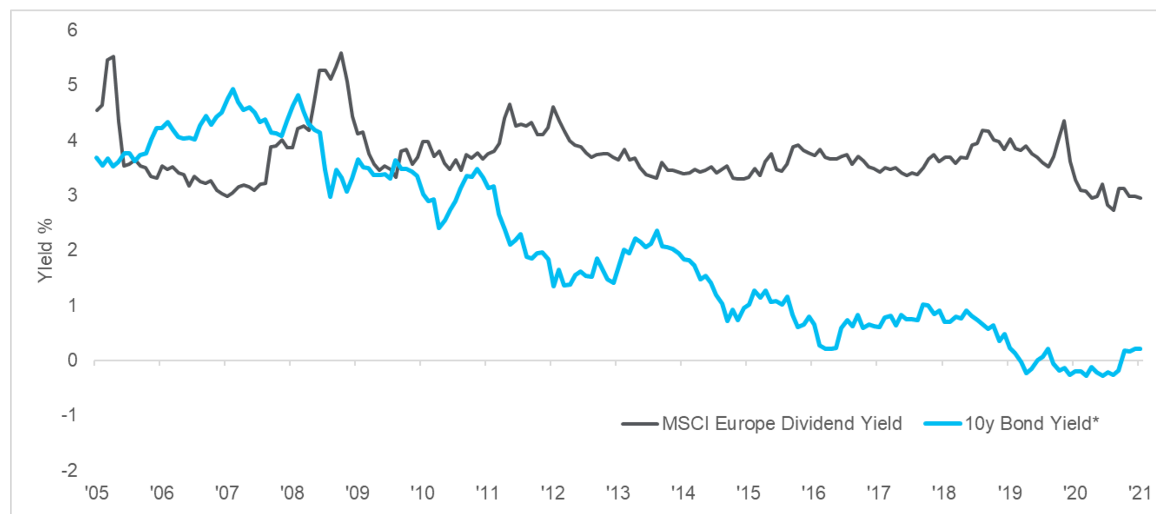
The second quarter European earnings season is poised to be strong. 2Q21 earnings are expected to increase 120.8% from 2Q20. 2Q21 revenue is expected to increase 21.5% from 2Q20. 104 companies in the STOXX 600 have reported earnings for 2Q21, and of these 64.4% reported results exceeding analyst estimates.

Figure 8: UK market is cheap in absolute and relative terms. Relative forward 12-month price to earnings



Source: Bloomberg as of July 16 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. Past performance is no guarantee of future results. Real results may vary. All forecasts are expressions of opinion and are subject to change without notice and are not intended to be a guarantee of future events.

Figure 9: Europe dividend yield vs government bond yield*



Source: Bloomberg, Citi Research as of July 16, 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.

Equity investment opportunities

Value and cyclicals in both Europe and the UK remain well represented. Value sectors tend to benefit in an environment with steepening yield curves and rising yields. We expect that upward rate pressures will resume later this year as the Delta variant concerns ease. Cyclicals have held up reasonably well the recent correction, and company results are largely meeting expectations.

We continue to recommend the banks sector, which is up over 75% since our recommendation in November 2020 but is still on a cheap average price/book multiple of 0.6. Returns on equity are benefiting from slightly steeper yield curves supporting net interest margins, fee income from M&A is likely to rise, and strong balance sheets (average CETI of 13%) make provision writebacks likely next year.

The ECB lending survey shows loan demand in Europe is rebounding as confidence returns. Net demand for home loans is up 36% in 2Q21. Corporate loan demand has also turned positive as more deals are done and companies take advantage of low rates to finance growth or refinance debt. Europe's banks have set aside billions of euros in July last year in preparation for a wave of loan defaults, and now UK, Swiss, euro-zone lenders are expected to cautiously begin paring back some of the worst-case debt provisions as government support measures have prevented a torrent of bankruptcies and job losses. In 1Q21 the top 30 regional banks wrote back about 5% of the €35bn, and this is expected to rise to 25% in 2Q21. Banks' capital buffers have held up well, instead of buckling as they did in the financial crisis. Regulators are lifting sector-wide bans they placed last year on dividends and stock buybacks. (UK and Swiss regulators ended their bans this month, while the ECB has said it would follow suit).

Currencies

GBP: Strong momentum backed by strong fundamentals

Sterling remains 10-15% undervalued based on its CPI and PPI deflated real effective exchange rate. Sterling should continue to be accumulated below $1.40. The next resistance level is $1.4250. While rates are not likely to be raised soon, and while the Delta variant remains a challenge, the bigger driver is the pent-up demand from overseas investors for all UK assets – property, gilts and equities. Once the long-term roadmap for the UK is clarified, post-Brexit and post-COVID, there is a strong likelihood of further sterling strength to $1.45.

EUR: widening yield gap could cap Euro's upside

The euro could face downward pressure in the coming months. While the strength earlier this quarter was driven by relative vaccine momentum, looking forward the euro could face pressure as the driver turns to relative growth and relative rate momentum. The next support level is $1.1650. However, euro downside should be limited, mainly because Eurozone periphery risks are low. For several years prior to the pandemic, the periphery was perceived as an area of weakness. Now, despite the huge healthcare and economic impact of COVID-19, the peripheral countries are benefiting from improved European solidarity and support. The appointment of Mr Draghi as the Italian PM has been a further positive factor as he has announced significant new plans to revive the Italian economy – a new electricity grid upgrade, hydrogen power projects, and structural reforms like reducing legal system bottlenecks.

Fixed Income

We continue to remain underweight sovereign bonds, while seeking selective opportunities in corporate bonds. We anticipate continued "trickle-down" demand into high yield (HY) to stay supportive, potentially driving average high yields down further to around 2.6%. Since the March 2020 price lows, European HY has rallied 30% compared to the 10% rally in investment grade (IG). However, the average HY yield of 2.9% and the average spread of 260 basis points (bp) remain attractive as investors are increasingly challenged in finding compelling yield opportunities. We expect defaults to stay contained, given ongoing monetary and fiscal support, and many company debt maturity walls being pushed further out through new issuance. We prefer the risk-reward in the "fallen angels" area, which are HY bonds that were recently classified as IG.

The EU has launched a €800 billion bond vehicle, to be raised by 2026. €80 billion of this is expected to be issued by year-end. In addition to financing the €750 billion EU Recovery Fund, which is making significant loans and grants to the periphery, the EU bonds will substantially enhance European bond market liquidity and provide a reliable curve for more

rational pricing of existing and future sovereign and corporate bonds. Finally, if the EU bonds sell easily, even with slightly higher coupons than envisaged a few months ago, that would be powerful endorsement for the European investment outlook more broadly.

Other topics

UK makes bold new proposals for the Northern Ireland protocol

The existing protocol has created a trade border in the Irish Sea, to avoid a hard border on the island of Ireland while also requiring all goods moving from Great Britain to Northern Ireland to follow EU rules. There have been challenges in implementing the protocol, even with the exemptions which are expiring soon. While the EU recognizes the current problems in implementing the protocol, the UK is now trying to see how far the EU is prepared to compromise.

The UK now proposes that any UK trader moving goods to Northern Ireland declare the final destination, and only the goods intended for Ireland be subject to checks. The UK also wants the EU to allow goods that meet UK rules to be sold in Northern Ireland, even if they don't meet EU standards. The UK would like a rewrite of the protocol's Article 10, which requires any UK government subsidy decision that might have an impact on good trade in Northern Ireland to comply with EU state aid rules. In addition, the UK wants to remove the European Court of Justice role in enforcement in favour of international arbitration.

UK companies attracting high M&A activity and particularly high interest from private equity

UK M&A activity is up strongly over the past year, with $300 billion deals announced. Year-to-date around 2.5% of market capitalization has been involved in M&A activity. Many deals are leveraged, with acquirors borrowing at around 2% in the bond market and buying earnings yields of around 4.5% in the stock market. These leveraged deals are particularly prevalent in the mid-cap space.

The number of UK buyouts is up almost 60% in 2021 compared with 2019. There have been approaches for 13 listed UK companies. These are some of the reasons cited: the UK's "pro-business environment"; confidence driven by the UK's effective vaccine development an rollout; the UK's liberal attitude towards takeovers, making it an easy place to buy and restructure companies; and the relative cheapness of UK equities compared to other markets.

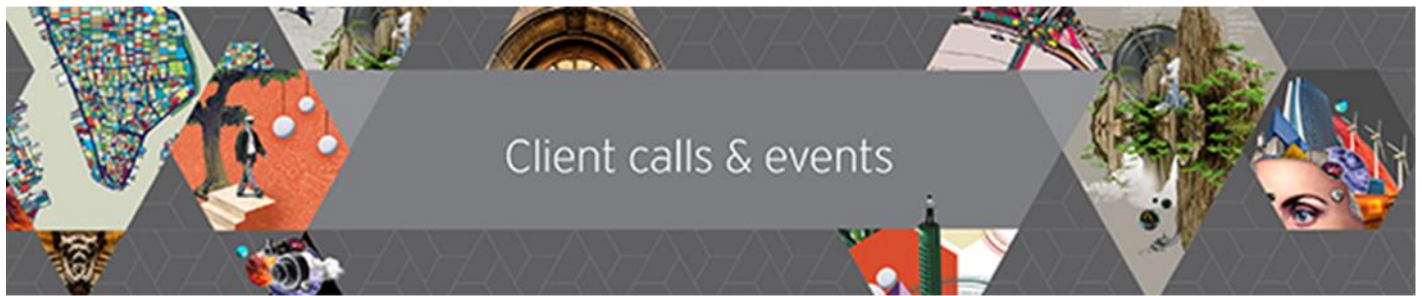
Ambitious new EU climate proposal – 'Fit for 55'

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

Earlier this month the European Commission went further, announcing an ambitious package of legislative proposals aimed at reducing the bloc's net greenhouse gas emissions by at least 55% from 1990 levels by 2030. This will include banning new combustion-engine cars by 2035, imposing new costs on dirty home heating, and forcing the aviation industry to emit less while paying more. In addition, there will be import levies on steel and aluminium for nations that apply less stringent environmental rules. A €72 billion compensation fund is being established, with funding from the carbon emissions market which will be expanded to include heating and road transport fuels. Agreement of the proposal will not be easy, will approval needed from the European Parliament and from member states in the EU Council to become binding.

OPEC+ reaches production deal

An OPEC+ deal to boost production was reached after Saudi Arabia and the United Arab Emirates reached a compromise on quota baseline levels. The UAE's new quota will be 3.5 million barrels per day versus 3.17 million barrels. The end to the stalemate marked a win for the oil cartel's longer-term unity. Our colleagues at Citi Research believe that the OPEC+ deal is not large enough to prevent significant inventory draws in 2H21 – and therefore continue to see upside, maybe reaching $80 this year, before seeing lower prices in 2022, partly on the back of carbon neutrality policies reducing demand.



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