Citi Global Wealth Investments

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Winter is coming…no place to hide in Europe?

- **Europe's continued gas issues:** Russia halts gas supply to Europe, as EU respond with price cap on oil. EU officials are mulling over an adjustment of electricity and gas prices. The risk is that if implemented Russia might not resume any deliveries of hydrocarbons to the EU.
- **Broad-based economic slowdown**: Europe and UK economic outlook remains particularly uncertain and clearly skewed to the downside, with growing concerns being expressed by both households and businesses. As the global outlook for trade also weakens and financing conditions tighten, both Europe and UK will likely see a recession in 2023, to the tune of 0.5% and 1.0%, respectively.
- **Central banks go bigger:** post the ECB and BoE announced outsized rate hikes at their last policy meetings and will probably continue to do so in the near-term.
- **UK equity outlook:** Higher rates and commodities paired with weaker sterling are supportive of UK large cap relative to small and mid-cap equities. The Global Investment Committee continues to remain neutral on UK equities, favouring large cap over small and mid-cap equities.
- **UK sovereigns outlook:** newly elected Prime Minister Truss' fiscal package adds to a worsening deficit outlook and will pressurise the gilt market. Yields across the curve to remain volatile and likely rise towards year end. We continue to remain underweight UK government bonds.

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Europe's energy crisis: price caps and market reforms to minimise damage?

The last few weeks have seen an escalation in the energy crisis facing Europe. At the start of September, Russia's Gazprom indicated that it would not be able to meet a deadline for the resumption of natural gas flows through the NordStream 1 pipeline citing an oil leak in a turbine. This news coincided with the Group of Seven finance ministers announcing a price cap on Russian oil. With natural gas prices rising again back to their highest levels since April 2022, EU countries are working diligently to reduce consumption to avoid shortages of natural gas in the winter, while energy ministers are mulling the introduction of price caps, the suspension of power derivatives and power-demand cuts.

Momentum is growing for a proposal to decouple electricity and gas prices (**Figure 1**), going beyond an EU Commission plan for a levy on excess profits. The latest discussions point to a possible suspension of the current pricing mechanism for a likely period of at least six months with the possibility of an extension. Not only are some of the largest countries such as France, Italy and Spain already supporting a price decoupling initiative, but some of the more liberally minded countries such as Sweden are beginning to see merits to the idea at a time of record energy price inflation.

Yet, the strategy is risky for those entirely reliant on Gazprom natural gas since the Russian operator could refuse to sell any supplies at the EU's price cap. The breadth and depth of the EU's policy response will likely be a necessary but perhaps not sufficient condition to bring about some improvement in the EU business cycle in the second half of next year after a likely recession during the winter and the early spring.

In early September, Europe's gas storage capacity stood at around 82.7%, up almost 13 percentage points (pp) year-on-year (**Figure 2**). While the number looks high compared to 2021, current stock levels represent only 22.2% of annual gas consumption. Even if the EU managed to exceed the targeted 90% threshold by October (by maximising gas imports while elevated prices are reducing consumption), it would only have 24% of annual consumption in stock. A total interruption of the Russian gas supply would likely lead to a real risk of supply disruption by the end of January, based on normal consumption volumes.

The most likely consequence of this scenario could be some form of energy rationing and factory closures, especially if the temperatures were to be lower than average this winter. As Europe diversifies its supplies away from Russian gas and more storage facilities are being prepared, we think that the situation will likely improve for the winter of 2023-24. In the meantime, fiscal policy is likely to be the only solution to minimise the damage to economic activity created by record high prices. The prospect of a return to a stringent application of EU fiscal rules remains a distant prospect, in our view.

Figure 1: Natural gas and electricity futures contracts

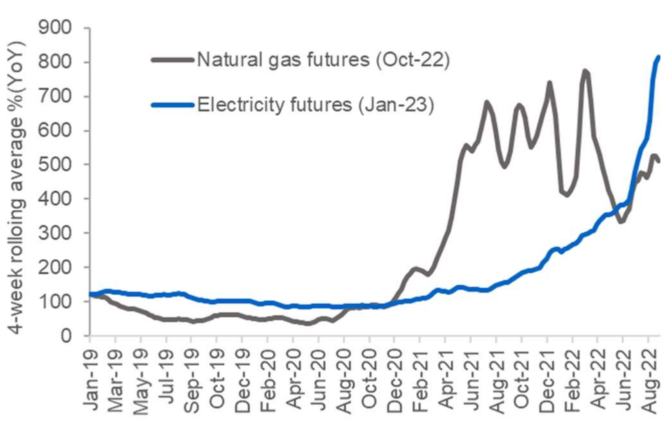
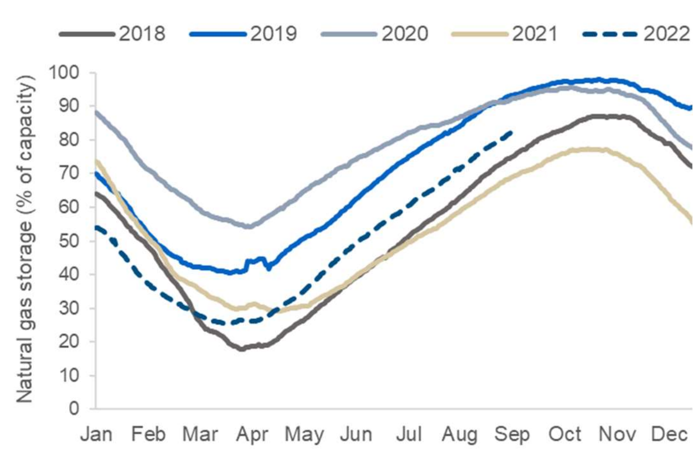


Figure 2: Natural Gas Storage



Sources: Bloomberg, Gas Infrastructure Europe as of September 9, 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.

Broad-based slowdown amid weakening domestic demand

While Europe and the UK have not yet experienced recession (**Figure 3**) and labour markets remain tight, uncertainty about the state of the economy in 2023 is rising, dampening business investment, bank lending and hiring intentions at a time when households sentiment surveys are close to their all-time lows.

Risks to the outlook are mainly skewed to the downside and it is difficult to construct scenarios in which more positive sentiment can materialise in the short-term given the probable lack of a resolution of the war in Ukraine and the obvious concerns related to the possibility of more serious disruption to European energy supplies. By contrast, it does not require much effort to envisage a stressed scenario in which the combination of weaker global trade, elevated uncertainty, higher commodity prices and a more significant tightening in financing conditions proves to be self-reinforcing while central banks remain focused on delivering urgent monetary policy tightening.

In the August *(Quadrant | Forecast Update: No Avoiding Slowing)*, we lowered our GDP forecasts for Europe materially to reflect the softening in the business cycle, ongoing concerns about the availability of natural gas supplies and a very challenging inflation picture which is prompting global central banks to hike interest rates aggressively.

Not only is the domestic situation more challenging because of the squeeze on real disposable incomes due to record high spot inflation and the damage to firms' competitiveness from exorbitant local energy costs, Europe and the UK also have significant exposure to the more difficult export environment we anticipate next year, though somewhat less than Asia and Latin America given the relative softening of the euro and sterling.

For Europe, we cut the real 2023 GDP estimate expecting a contraction of 0.5% after a gain of 3.0% in 2022. We expect real GDP to decline for three consecutive quarters from 4Q-22 to 2Q-23 (totalling around 1.2pp) before a recovery in the second half of 2023 and into 2024 when we look for a 1.0% GDP rebound (**Figure 4**).

In the UK, higher levels of inflation and the deeper cost-of-living crisis exacerbated by the complications of Brexit means that the recession could last for up to four quarters, during which we estimate a real GDP cumulative decline of 1.5pp. After an increase of 3.4% in 2022 GDP, we look for a contraction of 1.0% in 2023 followed by a gain of 1.0% in 2024.

Figure 3: Real GDP in Europe and by selected country

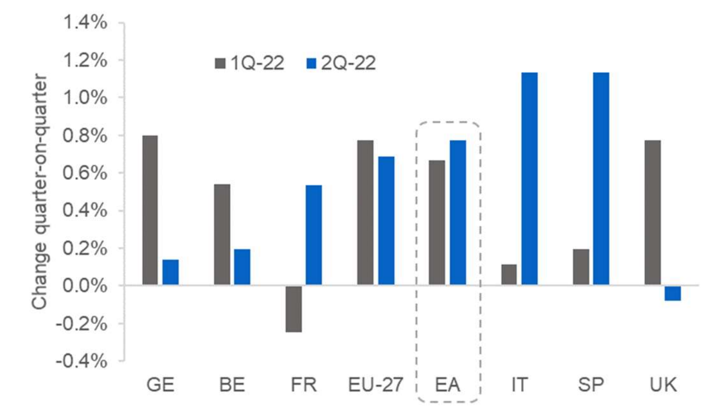
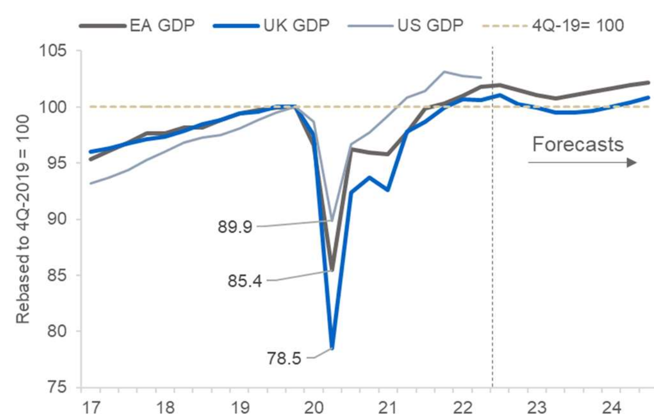


Figure 4: Real GDP versus pre-pandemic levels



Sources: Eurostat, Haver Analytics, Citi Global Wealth as of July 29, 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.

Central banks: going bigger but probably not for much longer

The pain from higher inflation is intensifying in both Europe and the UK. The euro area harmonised inflation rate rose to a new all-time high of 9.1% YY in August, beating the consensus forecast for another increase to 9.0% YY from 8.9% YY in July (**Figure 5**). Core goods inflation rose to a new record high of 5.0% YY in August and services inflation increased to 3.8% YY, its highest level since July 1992, well before the launch of the euro in January 1999. In terms of volatile items, energy inflation eased a little to 38.2% YY in August from 39.6% YY in July, while food, alcohol and tobacco inflation climbed into double-digit territory to 10.6% YY in August from 9.8% YY in July.

Inflation looks set to rise further in coming months, particularly given what is happening to the price of natural gas and other fuels ahead of what could be a challenging winter for households and corporates. We would not be surprised to see euro area headline inflation (and the UK figure, too) break briefly above the 10% YY level in the last quarter of 2022.

The European Central Bank (ECB) delivered an unprecedently large interest rate hike of 75 basis points (bp) on 8 September (*EMEA Strategy Bulletin | ECB puts down a hawkish marker with 75bp rate hike*). The monetary policy statement and the Q&A showed that the Governing Council (GC) is more concerned about high spot inflation and the risk that continued upside surprises could lead to second-round effects. The magnitude and persistence of the overshoot require that the ECB continues to front-load its monetary policy normalisation exercise.

We continue to believe that the ECB remain focused on a sharp but short tightening cycle but are adjusting the magnitude of interest rate changes that we anticipate by year-end. We now expect the GC to hike again by the same amount of 75bp at the 27 October meeting taking the deposit facility rate to 1.5%, which we think is close to the neutral rate. This would then allow the GC to shift down a gear with a 50bp rate hike in December to 2%. If necessary, we think that the ECB could easily extend its hiking cycle into next year with up to a couple of 25bp moves to a terminal rate of 2.5% by March 2023. Both the growth outlook and the possible need to ‘dampen’ demand will likely be the key determinant factors as to whether the ECB prefers to continue tightening through its policy rate rather than start adjusting the size of its balance sheet.

Figure 5: Euro area and UK inflation

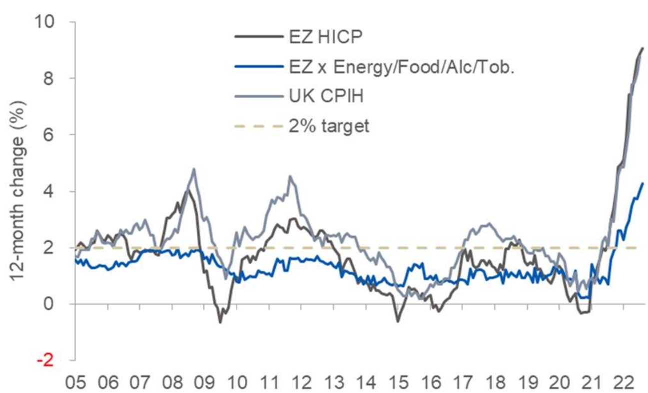
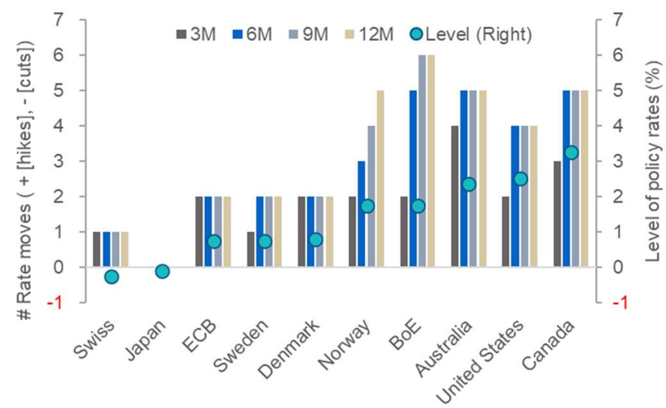


Figure 6: Central Bank rate hikes



Sources: European Commission, Eurostat and Citi Global Wealth, data as of 9 September 22. 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.

The Bank of England (BoE)’s Monetary Policy committee (MPC) members voted 8-1 to raise the key Bank Rate by 50bp to 1.75% (**Figure 6**) in early August. This was the sixth consecutive hike in interest rates (*EMEA Strategy Bulletin | BoE: Newest member of the 50bp rate hike club*), making this the fastest rate of policy tightening since 1997. The BoE joined the 50bp hike club of central banks forced to react to a material deterioration in the inflation outlook, even if a significant recession now becomes the baseline.

UK Prime Minister (PM) Liz Truss presented a new large fiscal stimulus package which could easily cost 5% of UK GDP or GBP130bn for households only to parliament in early September. Full details are unlikely to emerge before the end of the month when the Chancellor will present his autumn statement to the lower house of parliament. This policy change will likely mean that the BoE could have to deliver additional rate hikes beyond the 2.75% level that we had pencilled in earlier.

We now estimate that Bank Rate could more than double to 4.0% by the spring. With hikes of 75bp becoming the norm, we think that the BoE will likely choose this option in September, especially as the date of the monetary policy meeting has been pushed back to 22 September as the country begins a 10-day period of mourning following the passing of Queen Elisabeth II. Afterwards, we will expect to see at least two more rate hikes of 50bp in November and December to 3.5%, and perhaps two final moves of 25bp in February and March 2023 before the recession hits.

UK Equity Outlook

In August, UK equities (MSCI UK index) declined by 1.8%, largely driven by a continued softening in the macro environment. Data showed lower consumer and business sentiment, deteriorating PMI activity and the intensification of the cost-of -living crisis. Given the outlook, we expect the UK economy to contract in 2023, where real GDP growth is estimated to decline by 1.0%. Regardless, UK equities held up relatively well given its unique index composition which is skewed towards energy, financials, and defensive sectors.

Higher commodity prices remain attractive for the UK energy sector

Both higher rates and commodity prices have had a clear and positive impact on UK earnings and equity performance this year. However, not all UK equity markets have benefited as UK large cap equities have outperformed UK mid and small cap equities (**Figure 7**). The UK large cap index (MSCI UK index), which has a favourable index composition made up of financials, energy and materials (40% of the index weight), has benefited from strong earnings from financials but even more so from commodities, whereas mid and small cap UK equity markets (21.4% and 23.5% of the index) have underperformed. (**Figure 8**).

Figure 7: UK equity performance for various market cap

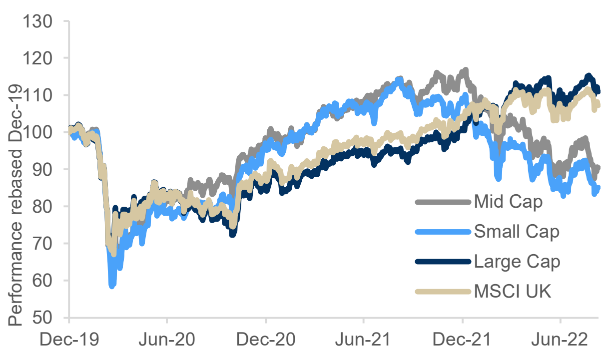


Figure 8: UK market cap equity sector composition table

Sectors	UK Large & Mid Cap	Large Cap	Mid Cap	Small Cap
Consumer Discretionary	5.2	2.2	21.2	13.0
Consumer Staples	20.9	24.0	4.1	4.0
Industrials	10.5	8.8	19.7	21.9
Financials	17.4	17.9	14.2	16.1
Information Technology	1.0	0.0	6.5	8.2
Communication Services	3.9	2.7	10.0	6.0
Materials	8.9	8.9	8.6	4.5
Energy	14.4	17.1	0.0	3.4
Health Care	12.9	14.6	3.9	6.8
Utilities	3.9	3.8	5.0	3.3
Real Estate	1.1	0.0	6.9	12.8

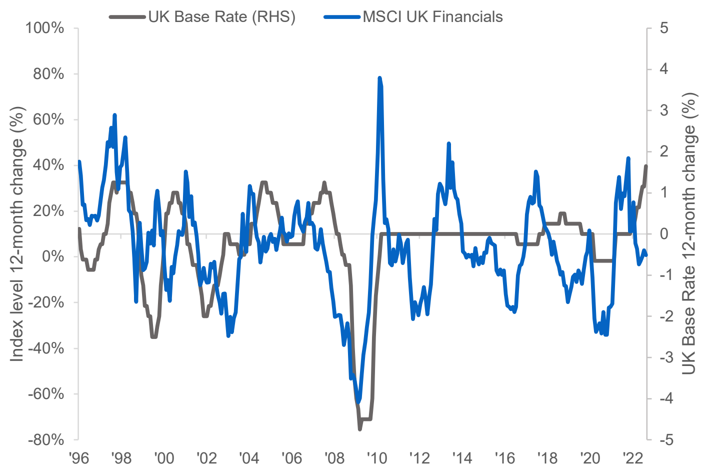
Source: MSCI and Bloomberg data as of 8 Sep 22. Past performance is no guarantee of future returns. Real results may vary. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Past performance is no guarantee of future results. Real results may vary.

If the conflict in Ukraine persists, we would expect commodities to remain elevated and oil supply potentially tight. The OPEC+ committee announced that they will be reducing production by 100k barrels/day. Despite this being somewhat insignificant the intention was to send a signal that OPEC is price watching with the likely objective of keeping the oil price above $85-$95. Such a scenario would likely be supportive of the UK energy market and UK large equities.

Financials are expected to benefit from continued monetary policy support

As we are forecasting that Bank Rate could reach around 3.5% by year end 2022 (see above and note that we see a risk of further increases to 4.0%) we would expect the financial sector firms to be strong beneficiaries and by extension the broader the UK market. **Figure 9** shows that the financial sector is undervalued relative to the significant increase in the UK Bank Rate, when looking at historical comparisons.

Figure 9: UK Financials remain undervalued



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Sterling weakness good for global revenue generation

Year-to-date sterling has weakened against the dollar by around 15%. Sterling weakness has supported most of the UK equity market especially the defensive sectors, given the negative correlation (**Figure 10 and 11**). Defensives, which have benefited from its global revenue exposure such as consumer staples and healthcare, account for a meaningful portion of the UK index, worth around 34%.

Figure 10: Sterling weakness supports UK healthcare sector

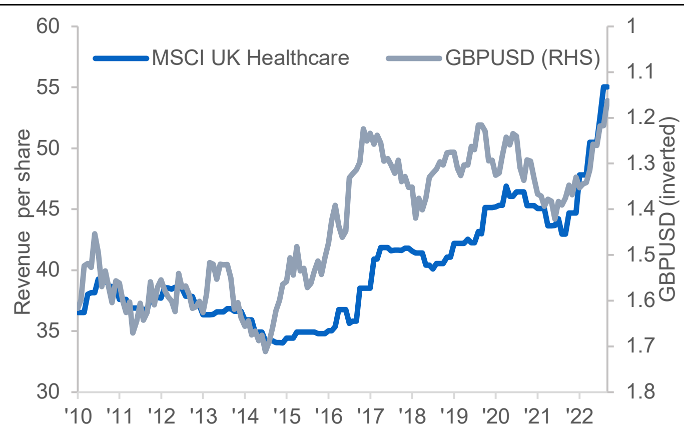
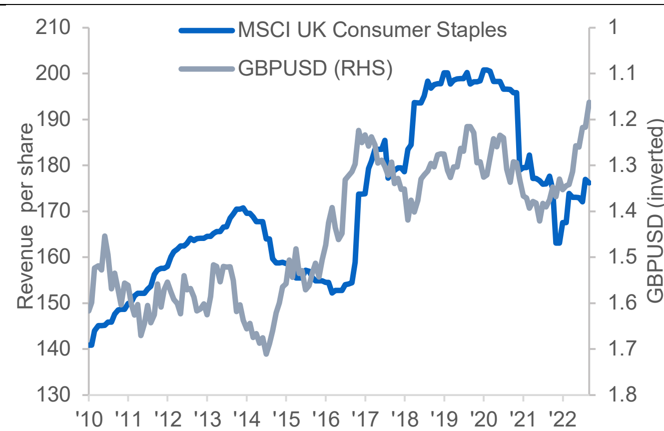


Figure 11: Sterling supports international revenue generation for UK companies



Sources: Bloomberg, data as of August 31, 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.

Going forward, continued political uncertainty related to the Northern Ireland Protocol and the expected economic deterioration will likely keep sterling under pressure. In addition, assuming that the fiscal stimulus announced by PM Truss will be funded by gilt issuance, the likely a deterioration in the balance of payments would be negative for sterling. These factors should be supportive for the UK large cap equity market, given that most of these firms generate a large part of their revenue overseas.

The OCIS Committee have placed emphasis on being invested in global quality large-cap equity markets and this is the same case for the UK equity market. Currently, the CGWI Global Investment Committee is currently neutral on UK equities, favouring large cap over mid and small cap equities.

UK Fixed Income Outlook

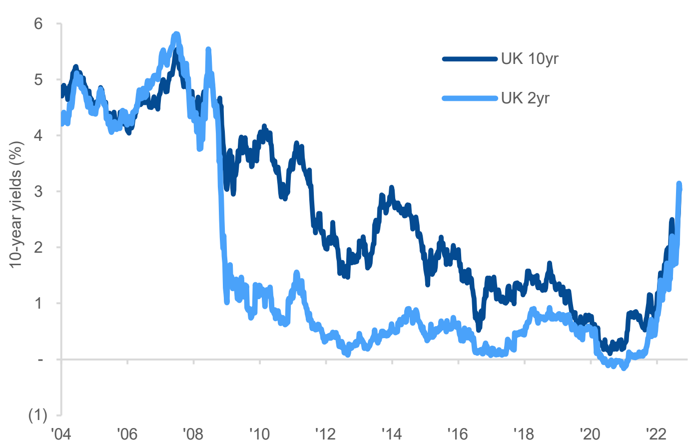
In August, UK gilts rose across the curve with 2- and 10-year yields rising by 131bp and 94bp, respectively, as UK inflation continued to rise above expectations while the labour market remained strong.

On 8 September, newly elected Prime Minister Liz Truss delivered her fiscal package in the House of Commons to tackle the UK cost-of-living crisis. The UK government is set to cap the average energy bill for a typical UK household at £2,500 for the next two years, until the government can find better solutions to manage the energy crisis. The package will save a typical household around £1,000, in addition with the proposed £400 credit that was already provided earlier his year. The plan is set to bring down inflation by 5.0 percentage points compared to what would have been the likely path without a cap.

However, not much has yet transpired about how the package will be funded, suggesting that gilt issuance will be the preferred avenue on the basis that windfall taxes on energy firms does not seem to be on the table (yet). This announcement will put pressure on the Bank of England (BoE) at a time when discussions about quantitative tightening are under way to envisage a reduction of the central bank's balance sheet.

Given the latest announcement of additional fiscal support, likely to be financed by a marked increase in the budget deficit, there is strong likelihood the BoE raising rates further into 2023. Net issuance of gilts will likely rise, causing the UK gilt curve to flatten (**Figure 12**). We feel comfortable with our current underweight position in UK sovereign debt.

Figure 12: 2- and 10-year yields rise above levels seen in 2014



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