



October 4, 2023

# Europe Strategy

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## Challenging post-tightening landscape

- **Economic softening continues, perhaps exerting downward pressure on equities** – Hard data is softening while soft data is improving, pointing to better times ahead. Yet, the valuation gap between demand expectations and equities suggests that downward pressures in the latter could build in the short-term in the absence of positive economic surprises.
- **Firms have been the most affected economic sector from ECB tightening** – A combination of tightening financing conditions, higher level of uncertainty, labour hoarding and faster growth in wages are beginning to exert downward pressure on margins.
- **Households could contribute significantly to the rebound in 2024/25 GDP** – Savings rate remains well above its historical average and much higher interest rates will be adding to household incomes, creating the conditions for a significant rebound in spending from 2H-24.
- **Risks remain skewed to the downside for 2024, but energy concerns are fading** – On balance, there are more risks of a GDP growth disappointment in coming quarters even if demand should recover, while governments have managed the energy crisis well.
- **Inflation and central banks** – Inflation normalization is underway in Europe and the UK, meaning that central bank policy rates have probably peaked. Interest rates could stay high until the late spring or early summer of 2024, but the direction of travel is likely to be down from here.
- **UK gilt strategy** – We believe that the UK short- and medium-term gilt yield market has potentially peaked. We continue to believe current gilts yields are still very attractive over the next 12-18 months, offering a great opportunity for both local and European investors, in terms of income generation and total returns.
- **European Real Estate strategy** – Given the cheap valuations, strong dividend income, a positive earnings story for 2024 and the likelihood of peak ECB policy rates, we believe that our underweight position in European RE is becoming less justified and look to increase it to a neutral position over the medium-term (12-18 months). However, we do acknowledge the risks stemming from structural changes occurring in the sub-sectors which could create a slight downside risk to the sector.

# Europe: challenging landscape post-monetary tightening

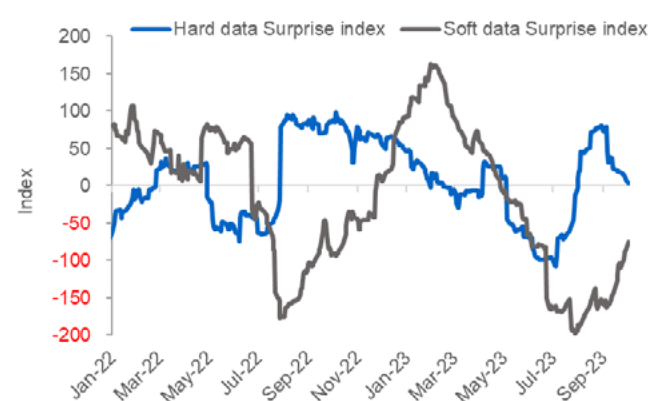
In this section, we look at the continuing softening in economic sentiment, what it might imply for equity market valuations and how businesses are performing compared to households. We think that risks remain skewed to the downside, in the short-term, but for 2024 energy concerns are fading, which should be good news for inflation and central banks' reaction functions.

**Mixed messages from CESI** – Citi's Economic Surprise Index (CESI) for the euro area shows that hard data surprises have come in above expectations, while the opposite applies to soft data. In recent weeks, the two series have tended to converge (**Figure 1**). This suggests that while economic activity is likely to soften in the second half of 2023, a turnaround is becoming more likely in the first half of 2024.

The September edition of the European Commission's (EC) business and consumer survey showed that the euro area economic sentiment indicator (ESI) had fallen for the fifth successive month to 93.3, its lowest level since November 2020. The strong historical relationship between the ESI and the 4-quarter change in euro area GDP suggests that economic activity likely continued to soften in 3Q-23.

**Downside risks for European equities?** Could we see a repeat of the autumn of 2022 when the improvement in soft data surprises coincided with a rally in equities? We would argue that things are different this time, since the European Central Bank (ECB) interest rates have risen rapidly and to their highest level ever, while economic activity has been soft in many countries and in most sectors. As shown on **Figure 2**, unless demand was to improve materially soon, the underperformance in the 12-month change in demand forecasts compared to household confidence and the performance in the STOXX50 suggests that there are some potential downside risks in equity performance in coming months.

**Figure 1:** Hard data >0, soft data up from lows



**Figure 2:** Confidence rebound losing momentum

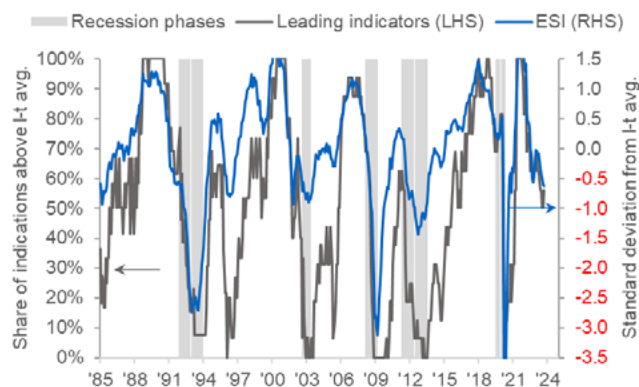


Sources: Bloomberg, European Commission and Citi Global Wealth Investments, 29 September 2023.

**We continue to believe that a contraction in GDP is unlikely in coming quarters** – There are, in our view, three key reasons that make this baseline the most plausible scenario. First, demand expectations rose in September; Second, the share of forward-looking indicators that are above their historical average rebounded in September to a three-month high of 56% (**Figure 3**); Third, employment expectations rose by 0.5-points (pt) to 102.7, remaining above its historical average level of 100.

For a recession scenario to become our baseline, we would likely need to see the ESI weaken further to around -1.0 standard deviation (SD) below its longer-term average (vs -0.6SD now) and the share of forward-looking indicators above their historical average to fall to around 30% (vs. 56%).

**Turning to the manufacturing sector, July might have been the bottom in the cycle** – Manufacturing output has been falling in 14 of the last 16 months. **Figure 4** shows that quantities of purchases have averaged 37.6 in the three months to September, declining at their fastest pace since the COVID-19 pandemic. Stocks of purchases are contracting at the fastest pace in the three months to September than at any time since the Great Financial Crisis (GFC) of 2008-09. Finally, stocks of finished goods have been declining for the fifth successive month and doing so at the fastest rate since September 2021. Troughs in manufacturing activity usually materialise before those in services, with the latter expected to see activity soften during the remainder of 2023.

**Figure 3: Conditions for outright recession not met**

Sources: European Commission, Haver Analytics and Citi Global Wealth Investments, 28 September 2023.

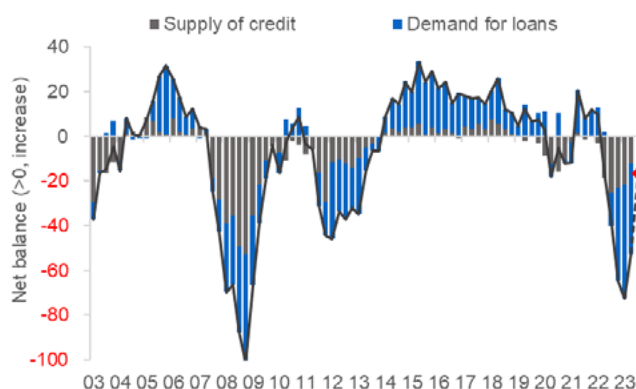
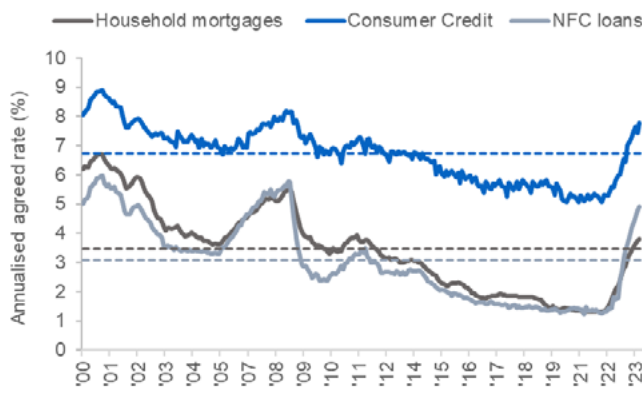
**Figure 4: Manufacturing turning point in sight?**

**Monetary policy tightening is being felt more by firms** – The deceleration in economic activity is being felt by non-financial firms which are beginning to struggle with the rising cost of labour, after a period of significant labour hoarding. Employment growth is continuing to outstrip that of output, resulting in a drop in productivity, which if left unchecked will prove highly detrimental to firms' ability to generate profits.

**Demand for loans has fallen materially in recent quarters** but it has been more pronounced in the corporate sector. For instance, the net flow of bank loans to firms has turned negative in the three months to August 2023, to -€17bn compared to +€151bn in the three months to August 2022. By contrast, net lending to households contracted by €4bn in the three months to August 2023 compared to a gain of €63bn in the three-months to August 2022.

**The reassuring aspect is that the supply picture is not as challenging as during the GFC of 2008/09**, suggesting there are no capitalisation issues for the banking system (**Figure 5**). Expectations for 4Q-23 (shown by the red dot on **Figure 5**) suggest that a smaller number of banks anticipate a need to tighten lending standards than in 3Q-23. However, the largest improvement is expected to be in terms of loan demand, with a much smaller retrenchment.

**Financing conditions have deteriorated the most for non-financial corporates**, even if interest rates are up for all sectors (**Figure 6**), firms taking on new loans have seen the cost of borrowing rise in the last 12 months by +320 basis points (bp) to 4.9% (+1.3SD). For household mortgages, the 12-month increase was +172bp to 3.8%, +0.2SD, and +199bp for consumer credit to 7.8% (+1.1SD).

**Figure 5: More a demand deficit than a supply issue****Figure 6: Firms most at risk from higher interest rates**

Sources: European Central Bank and Citi Global Wealth Investments, 29 September 2023.

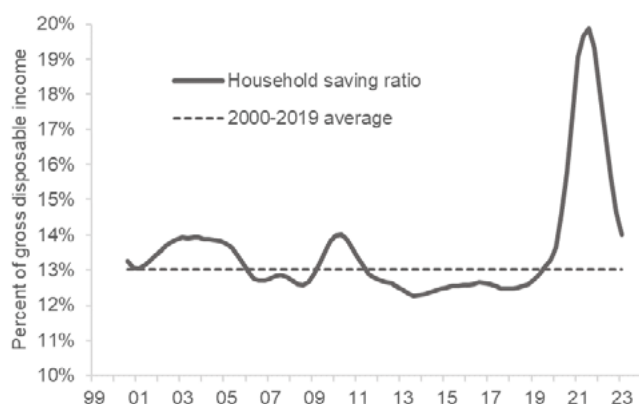
**Could households be the most significant contributors to GDP growth in 2024/25?** – Although the rebound in economic activity following the pandemic has seen real GDP increase by 3.1% since 4Q-19, households have continued to be parsimonious with their spending, accumulating savings instead. In the euro area, as of 2Q-23, we estimate that these amount to 49% of households' annual disposable income. In the UK, the magnitude is broadly similar at 53% (**Figure 7**).

Despite the normalization post-COVID, households have maintained a very cautious attitude, suggesting that there is a significant amount of pent-up demand that could play an important role as a source of resilience in the face of an expected slowdown in job creation. Households could easily decide to smooth their consumption if faced with negative surprises.

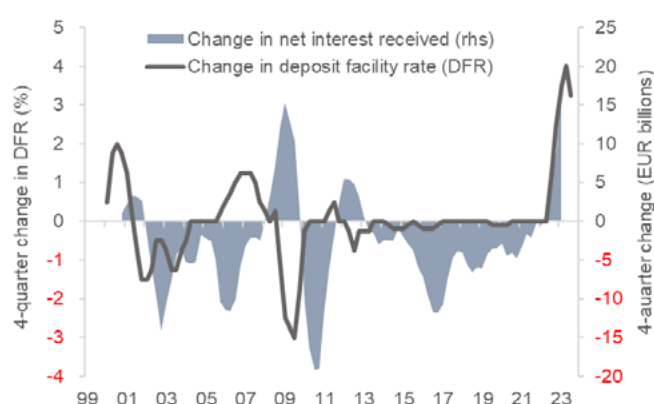
Looking ahead to the next few quarters, higher nominal interest rates will also add to households' net income and eventually to consumption. The inverse correlation between the level of inflation and consumer confidence suggests that the acceleration of a disinflationary trend in coming quarters should translate into a more positive attitude by households.

Rising real wages, supplemented by growing interest income revenues (**Figure 8**) from a combination of higher interest rates on deposit and a high stock of savings ought to be a positive driver for consumption. Given some expected softening in the labour market in the next few quarters, the likelihood of a noticeable rebound in consumer spending is higher for 2024 and beyond.

**Figure 7: A lot of pent-up savings to be spent**



**Figure 8: higher rates to add to net interest income**



Sources: Eurostat and Citi Global Wealth Investments, 29 September 2023.

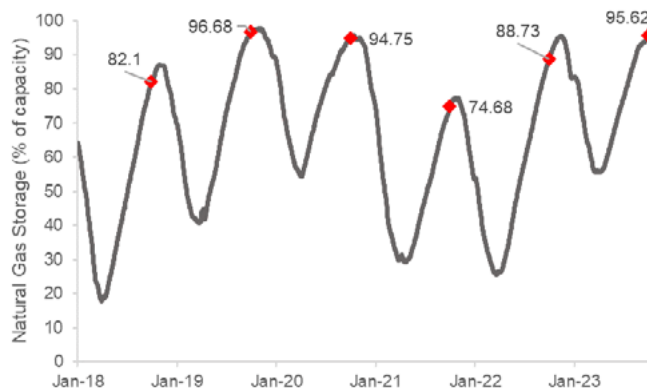
**The energy situation is unlikely to be a large downside risk** – While there are many downside risks that could lead to more cuts in GDP forecasts in Europe during 2024, including a potential further slowdown (and associated financial stresses) in China and its spillovers, as well as the possibility that the effects of monetary policy tightening could be more forceful than expected, we doubt that Europe will be facing the same adverse energy shock that was threatening the very existence of its manufacturing business model in the autumn of 2022.

The latest data on natural gas storage levels shows that as of 30 September, Europe is in a strong position compared to previous years. Based on the normal pattern of significant natural gas injections into the storage system during the late summer, we estimate that Europe storage levels could be very close to 100% capacity by the end of October (**Figure 9**). At full storage, Europe can hold around 97 days of annual consumption, suggesting that any restrictions in exports of natural gas to Europe would be very unlikely to affect businesses and households seriously during the 2024 heating season.

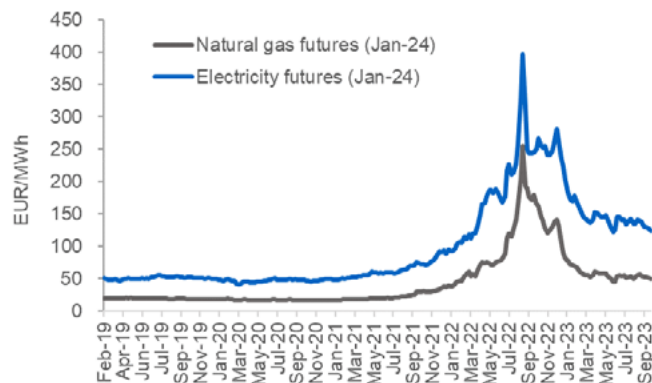
While natural gas prices are 72% YY lower in the four weeks to September 29 compared to the same period last year, the average price of natural gas remains almost 3 times the price that prevailed between February 2018 and March 2021, in the three years prior to Russia's invasion of Ukraine. For electricity prices, the decline is slightly smaller at -48% YY and the multiples are only slightly lower at 2.7 times (**Figure 10**).

**European governments are turning off the taps of fiscal policy support** designed to offset the high cost of energy to reinstate fiscal rules in 2024 following a long suspension during the COVID-19 pandemic. This could leave households and businesses more vulnerable in case of sudden spikes in natural gas prices due to idiosyncratic events such as strikes in LNG plants in Australia, for instance. From a supply perspective, the diversification of the supply of natural gas to Europe has increased markedly since 2021 and the reliance on natural gas exports from Russia has diminished greatly.

**Figure 9:** Close to 100% achievable by end Oct?\*



**Figure 10:** Prices unlikely to fall back to pre-war level



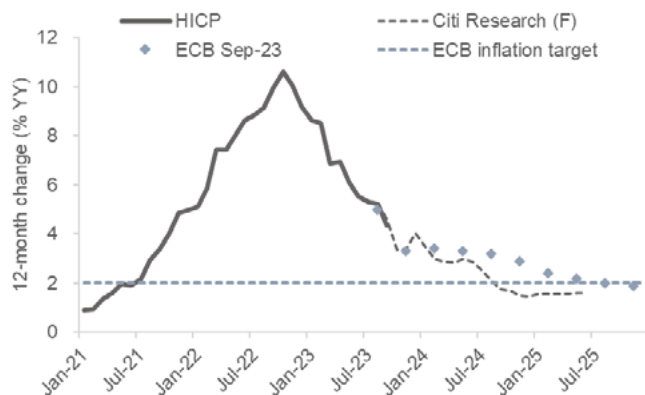
Sources: Gas Infrastructure Europe – AGSI+, Bloomberg and Citi Global Wealth Investments, 29 September 2023; \*Red dots indicate natural gas storage levels as of 5 September in every year presented.

**Inflation and central banks** – Inflation normalisation is underway in Europe and in the UK. Headline inflation in the euro area fell to a 23-month low of 4.3% YY in September, while core inflation also eased to 4.5% YY, its lowest level since August 2022. Euro area inflation averaged 5.0% YY in 3Q-23, as had been anticipated by the [ECB staff macroeconomic projections](#) in September. Core inflation came in at 5.2% YY, just 0.1-percentage-points (pp) above the September estimate. This accurate forecasting effort should help build investor confidence about the fact that disinflationary pressures are building while GDP growth is weakening (**Figure 11**).

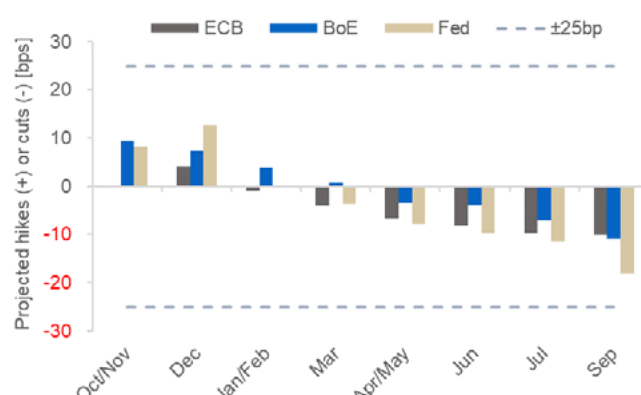
While deflationary pressures are increasing in the goods sector, services inflation is proving stickier but likely peaked in 2Q-23 as employment expectations began to moderate. We continue to see some upside risks for inflation in 2024 given the recent increase in energy prices that could add a few decimal points to the 4Q-23 and 1Q-24 estimates. The size and length of the inflation overshoot since the summer of 2021 means that the ECB will likely exercise patience in the assessment of its restrictive policy stance, especially as inflation markets are not convinced that a return to the 2% target is achievable any time soon.

Current pricing suggests that the ECB is done hiking and that the 4% deposit facility rate reached in September will likely be the peak of this interest rate cycle. A first 25bp rate cut is being priced in by the 18 July 2024 meeting (**Figure 12**). For the Bank of England, investors assign a 67% chance of a final 25bp rate hike to 5.5% in Bank Rate by the December meeting, to be followed by a long pause until a first 25bp cut at the 19 September 2024 meeting. On average, investors believe that central banks are likely to stay on hold for about nine months. This is the translation of the “higher for longer” that appears to have pre-occupied markets in the last few weeks.

**Figure 11:** Below 2% target unlikely before 2H-24\*



**Figure 12:** Limited conviction about the rate cut cycle



Sources: European Central Bank, Citi Research, Bloomberg and Citi Global Wealth Investments, 29 September 2023;



# Strategy

## Equity performance

Across the board, developed market equities have produced positive returns year-to-date (YTD), both in local and USD terms. In dollar terms, European and US equities have performed particularly well YTD, with the DAX up +10.5%, CAC 40 up +10.2% and S&P 500 up +13.1% YTD, all outperforming the MSCI World index which is up +10.1%. UK equities have paled in comparison, with the FTSE 100 producing returns of just 2.1% YTD (dollar terms) (**Figure 11**).

Where European sectors are concerned, strong performance was seen across Financials (Banks), Information Technology, and Energy, returning 20.4%, 12.2% and 11.7% YTD, respectively (**Figure 12**).

## FX performance

YTD, the Euro has weakened against the USD, CHF and GBP, reflecting muted GDP growth, as well as the more dovish tone adopted by the ECB after the final September rate hike to 4%. Sterling is gaining around 1% YTD versus the dollar (**Figure 11**).

**Figure 11:** Equity and FX performance

|                       | 1M   | 3M   | YTD  | 1M   | 3M   | YTD  |
|-----------------------|------|------|------|------|------|------|
| <b>Equity indices</b> |      |      |      |      |      |      |
| Stoxx 50              | -2.8 | -5.1 | 10.0 | -5.2 | -8.1 | 8.7  |
| FTSE 100              | 2.3  | 1.0  | 2.1  | -1.4 | -3.0 | 3.0  |
| DAX                   | -3.5 | -4.7 | 10.5 | -5.8 | -7.7 | 9.1  |
| CAC 40                | -2.5 | -3.6 | 10.2 | -4.8 | -6.6 | 8.8  |
| Swiss                 | -1.5 | -2.8 | 2.2  | -4.9 | -4.9 | 3.0  |
| S&P 500               | -4.8 | -3.3 | 13.1 | -4.8 | -3.3 | 13.1 |
| MSCI World            | -4.1 | -3.4 | 10.1 | -4.1 | -3.4 | 10.1 |
| <b>FX</b>             |      |      |      |      |      |      |
| EURUSD                | -2.5 | -3.1 | -1.2 |      |      |      |
| EURCHF                | 1.0  | -1.0 | -2.2 |      |      |      |
| EURGBP                | 1.3  | 0.9  | -2.1 |      |      |      |
| GBPUSD                | -3.7 | -4.0 | 1.0  |      |      |      |
| CHFUSD                | -3.5 | -2.1 | 1.0  |      |      |      |

Sources: MSCI, Bloomberg and Citi Global Wealth Investments, as of October 3, 2023

**Figure 12:** European sector performance

| Europe Sectors                | 1M (%) | 3M (%) | YTD (%) |
|-------------------------------|--------|--------|---------|
| <b>Region</b>                 |        |        |         |
| Financials                    | -1.3   | -0.5   | 12.4    |
| <i>Banks</i>                  | 0.4    | 1.7    | 20.4    |
| <i>Diversified Financials</i> | -3.4   | -3.9   | 5.6     |
| <i>Insurance</i>              | -2.2   | -1.4   | 5.9     |
| Energy                        | 4.6    | 11.6   | 11.7    |
| Industrials                   | -4.5   | -7.0   | 11.3    |
| Consumer Discretionary        | -8.1   | -13.9  | 8.9     |
| Consumer Staples              | -6.0   | -7.3   | -0.1    |
| Health Care                   | -3.5   | -1.7   | 7.9     |
| Information Technology        | -8.3   | -13.1  | 12.2    |
| Communication Services        | -1.3   | -2.4   | 8.9     |
| Utilities Sector              | -6.5   | -10.6  | 2.0     |
| Materials                     | -3.2   | -2.6   | 1.2     |
| Real Estate                   | -7.3   | -2.8   | -2.9    |

## UK Fixed Income Strategy

In June 2023, the UK gilt market was pricing an aggressive rate path, anticipating that the terminal rate could reach 6.23% by March 2024 ([Europe Strategy | BoE update](#)). The situation has changed meaningfully throughout summer, thanks to meaningful declines in headline inflation and growing concerns over weakening UK growth. Investors are now anticipating a terminal Bank Rate of around 5.5% by the end of 2023.

Since June 2023, 2-year and 5-year gilt yields have declined by 34bp to 4.90% and 15bp to 4.51% (29 Sep), respectively while 10-year yields have risen by 5bp to 4.44% (**Figure 13**), resulting in curve steepening (**Figure 14**). We now believe that UK short and medium-term gilts have peaked. Further steepening is likely as the BoE pauses its rate hiking cycle and the market begins to discount a first 25bp rate cut in the summer of 2024.

**Figure 13: Short- and medium-term rates set to decline****Figure 14: Steepening in UK gilt curve**

Sources: Bloomberg and Citi Global Wealth Investments, as of September 29, 2023. 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.

The next BoE Monetary Policy Council meeting is on 2 November, some five weeks away during which we will obtain more macro data involving the labour market, GDP growth, and inflation. However, we believe that the coming weeks will see an extension of the current trend, whereby the labour market loosens slightly, growth softens, and inflation continues its downward trend.

**What does this mean for the yield curve?** The yield curve is likely to flatten in the short-term, with investors likely to be willing to extend duration perhaps beyond the 5- to 7-year segment as more evidence of a GDP growth slowdown mounts, prompting flight-to-quality purchases of gilts to reduce risk and diversify portfolios. However, over the medium-term the UK gilt curve is likely to steepen as markets price in monetary policy loosening towards the second half of 2024, causing short-term and medium-term rates to decline significantly.

We continue to believe current gilts yields are still very attractive over the next 12-18 months, offering a great opportunity for both local and European investors, in terms of income generation and total returns.

## European Real Estates

The GFC crisis has been followed by a decade of low central bank policy rates in Europe. This helped to fuel European real estate (RE) market outperformance until the COVID-19 pandemic (**Figure 15**). All parts of the real estate sector (residential, retail, office and healthcare) were able to obtain low-cost finance. The ability of corporates and households to borrow at a low rate has proven to be beneficial, especially through profits and sales of assets.

However, European RE performance peaked in August 2021 (**Figure 15**), largely due to idiosyncratic structural changes underway within individual sub-sectors. During the pandemic, companies with office space (10% of EU RE) realised employees wanted a flexible work life balance, questioning how much workspace is required. As retail stores (15% of EU RE) (**Figure 16**) shifted more of their sales online, one could wonder how much retail space in Europe is necessary over the longer-term. We acknowledge that these structural changes will be ongoing and impact the overall market.

**Figure 15: European Real Estate performance**

Sources: Bloomberg and FTSE Russell Factsheet. Data as of 29 September 2023. 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.

**Figure 16: European property breakdown by sector**

| Property sector breakdown | % exposure |
|---------------------------|------------|
| Diversified               | 31.8       |
| Residential               | 22.9       |
| Retail                    | 14.7       |
| Office                    | 9.8        |
| Industrial/Office/Mixed   | 9.1        |
| Industrial                | 7.3        |
| HealthCare                | 2.6        |
| Self Storage              | 0.9        |
| Lodging/Resorts           | 0.8        |

In addition, another reason for the decline is valuations as the sector became expensive in terms of price-to-earnings (P/E) and price-to-book (P/B) terms, +1SD above its 10-year average (**Figure 17 and 18**).

Since the ECB started hiking rates in July 2022, European RE performance continued to meaningfully deteriorate (**Figure 15**), falling further by 22% to its lowest point in June 2023, impacted by the revaluation of assets due to a higher discount rate. Higher rates are resulting in deteriorating affordability for both corporates and households. European companies will have to re-finance maturing debt at a higher cost, thus reducing their profits growth. Households on variable rate mortgages and/or those with short-dated mortgages (residential property which accounts for 23% of EU RE) will have to refinance at higher rates, consequently reducing their spending power.

**Figure 17: European real estate P/E significantly cheap****Figure 18: European RE P/B 1SD below its 10yr average**

Sources: Bloomberg. Data as of 29 September 2023. 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.

However, we believe the ECB is now done with its hiking cycle, having reached a peak rate of 4% at its 14 September monetary policy meeting. As a result, it is likely that European RE has discounted most of the downside risk from higher rates. For example, since the announcement from President Lagarde of a likely pause, we have seen a short-term bounce in European RE. Over the medium term, we would expect the policy rate to fall back towards the 2% level rather than the negative rate experiment that lasted between June 2014 and July 2022. Therefore, we believe European RE performance is more likely to recover in the short- medium- term, but could become range bound over the longer-term, as the asset class tries to determine the level of the equilibrium policy rate (which will feed into the discount rate used to value assets).



Currently, the consensus estimates a deep contraction for 2023 earnings-per-share (EPS) of 28.9% YY, with a significant rebound forecasted for 2024 of 23.2% YY. Given the consensus expectation of a likely first cut in ECB policy rates in the late spring or early summer of 2024, we believe this earnings estimation is broadly justified, albeit on the somewhat optimistic side.

Regarding valuations, European RE is trading cheap with a P/E of 14x and P/B of 0.7x, both now 1SD below their 10-year average of 19x and 0.9x, respectively. In addition, the sector continues to provide a high dividend yield of 5% versus the MSCI Europe of 3.7%.

## Conclusion

Given the cheap valuations, strong dividend income, a positive earnings story for 2024 and the likelihood of peak ECB policy rates, we believe that our underweight position in European RE is becoming less justified and look to increase it to a neutral position over the medium-term (12-18 months). Within the sector, we look at quality real estate firms, who have a strong balance sheet to withstand higher rates, with quality asset exposure (in key regions such as cities), good tenants leasing structures, and which are not overly levered. However, we do acknowledge the risks stemming from structural changes occurring in the sub-sectors which could create a slight downside risk to the sector.

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| Bond credit quality ratings                         |                      | Rating agencies                  |                            |
|---|----------------------|----------------------------------|----------------------------|
| Credit risk   | Moody's <sup>1</sup> | Standard and Poor's <sup>2</sup> | Fitch Ratings <sup>2</sup> |
| <b>Investment Grade</b>                             |                      |                                  |                            |
| Highest quality                                     | Aaa                  | AAA                              | AAA                        |
| High quality (very strong)                          | Aa                   | AA                               | AA                         |
| Upper medium grade (Strong)                         | A                    | A                                | A                          |
| Medium grade  | Baa                  | BBB                              | BBB                        |
| <b>Not Investment Grade</b>                         |                      |                                  |                            |
| Lower medium grade (somewhat speculative)           | Ba                   | BB                               | BB                         |
| Low grade (speculative)                             | B                    | B                                | B                          |
| Poor quality (may default)                          | Caa                  | CCC                              | CCC                        |
| Most speculative                                    | Ca                   | CC                               | CC                         |
| No interest being paid or bankruptcy petition filed | C                    | D                                | C                          |
| In default  | C                    | D                                | D                          |

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