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UK and European equities offer much more than short-term recovery rallies

Summary

- **Overweight UK equities.** UK equities have rallied 27% off their November 2020 lows, but have much further to go. GDP and EPS are growing strongly this year, supported by accommodative monetary and fiscal policy, along with great vaccine progress. The market is cheap in absolute and relative to other markets, and the high average dividend yield of 4% compares favourably with average fixed income yields. Early logistical and administrative challenges from leaving the European Union are no worse than expected. We believe that early challenges in implementing the Northern Ireland protocol will be overcome.
- **Overweight European equities.** The vaccine rollout is accelerating, with Europe around 6-8 weeks behind the UK. European Central Bank (ECB) policy remains very supportive, while the EU Recovery Fund implementation is likely to gather momentum over the summer. Alternative energy is a powerful long-term growth driver, supported by increasingly ambitious government initiatives. Italy's new PM Draghi – the former ECB chairman – is positive for Italy, for peripheral Eurozone countries more broadly, and for European solidarity.
- **Both UK and European equities offer particularly good exposure to the areas we favour globally**: COVID cyclicals (*), value, mid-caps, dividend growers, and "green" stocks.
- **Underweight fixed income**. Despite the recent back-up in sovereign bond yields alongside rising inflation concerns, sovereign bonds remain expensive. In the current environment of financial repression, there are potential selective opportunities in the corporate bond market, particularly amongst high yield bonds.
- **Both the euro and sterling are well supported**. A key driver for both currencies in the coming months could be improving relative growth momentum.

UK equities are starting to discount the post-Brexit and post-COVID environment

At the start of the pandemic, the UK had been through four years of testing negotiations with the EU that had drained investor confidence. The process was acrimonious and that had also been reflected in domestic political turbulence. Even as the "transition" year began in early 2020, it was not clear-cut that the UK would leave with a trade deal. The pandemic then hit the UK very hard because services account for 80% of UK economic output, while cyclical stocks are over 55% of local equity market capitalization. To worsen matters, companies slashed their dividends, removing an area of UK relative advantage. Finally, the UK market didn't participate fully in the initial COVID recovery, which was led by technology, a sector where the UK market has only limited exposure.

The Global Investment Committee (GIC) raised UK equities to overweight in November 2020. That was before the confirmation of an EU trade deal and before the first vaccine announcement, as valuations reached compelling attractive levels. It came at a time when the GIC was looking at diversifying global equity exposures. The GIC then trebled the size of the UK overweighting in March 2021, with the UK seen as a great market for getting significant exposure to the areas favoured most at a global level – cyclicals, value, and dividend yield. The UK market now offers more than a trading rally. In our view, it is in the early stages of a prolonged bull market.

There are five reasons to keep accumulating UK equities:

1. **Growth. The 1.5% GDP growth in the first quarter included a March rise of 2.1%. For the full year, the economy could grow more than 7%, with several drivers:**

   Firstly, there is ongoing policy support from both the government and the Bank of England (BoE).

   Even as the UK budget deficit continues to rise to peacetime highs, the Chancellor of the Exchequer (UK finance minister) has extended some emergency measures. Most notably, these include the furlough scheme, cheap company loans, property stamp duty holiday, and company rate holidays at least until mid-2021. Total emergency fiscal measures total around £400 billion. There is little risk of an early retrenchment, with corporate tax rises to be delayed until 2023.

   At its recent meeting, the BoE slightly reduced its pace of bond buying. However, it emphasized that this was “smoothing” rather than tapering. To raise interest rates, the BoE is seeking “significant progress” particularly in “eliminating spare capacity.” It continues to think that the UK economic outlook is uncertain due to the pandemic. No substantial monetary policy changes are likely until there is visible strength after the end of the fiscal emergency support measures in the summer. The November BoE meeting will likely be critical. If the growth rebound disappoints, a further £50 billion quantitative easing extension may occur. But if the rebound is strengthening into a firm 2022 recovery, the BoE may signal monetary tightening to come.

   Secondly, in the current lockdown, the economic downturn has been much less severe than in the second quarter of 2020. That is because UK factories, shops, and consumers were better prepared and more adapted this time. This is reflected in the manufacturing rebound, and our expectation is that inventory rebuilding still has further to go. Asian import demand is supporting the UK’s manufacturing rebound, with approximately 14% of UK exports going to the region. The final stage of the unlocking process is expected on 21 June 2021, assuming the Indian mutation of the virus does not gain a firmer foothold in the UK.

   Thirdly, the services sector is expected to pick up strongly as mobility increases and social distancing lessens. This is likely to be further strengthened with the £140 billion accumulated pandemic savings, of which around 10% is expected to be spent. Unemployment falling to 5.4% is supportive for wage growth, while there is substantial pent-up demand. Consumer confidence surveys are strengthening, and there are increasing signs of a firming in the property market, typically a key engine of UK growth –**figure 1**. Mortgage lending rose by £11.8 billion in March after a rise of £6.2 billion in February.

   Fourthly, Brexit has caused less upheaval than had been expected. Initial logistics and administration issues after leaving the EU are gradually being resolved. This is starting to show up in UK-EU trade data. In March, imports from the EU rose by 4.5% and exports to the EU rose by 8.4%. The key medium-term post-Brexit issue is in Northern Ireland, where there are challenges in implementing the Northern Ireland protocol. This part of the EU Withdrawal Agreement states that all goods entering Northern Ireland from Great Britain must follow EU customs rules, leading to a trade border in the Irish Sea. Pro-UK Northern Irish politicians believe this weakens their province’s place within the UK. The UK is calling for the EU to soften its checks at ports on the Irish Sea. If this is not done, the UK might suspend checks under Article 16 of the protocol.

2. **Value. The UK market is cheap in absolute terms, cheap relative to other developed market equity markets, and cheap relative to UK fixed income.** The FTSE 100 is 27% up from its November 2020 low, when the GIC first went overweight. And while it is up 9.2% so far this year, it remains 8% below its pre-COVID peak. The valuation multiple of 14X is cheaper than any developed market – **figure 2** – and is well-supported by expected 57% EPS growth this year. The average dividend yield of 4% enhances the quality of the potential total return and is particularly attractive versus fixed income. At a global level, we favour cyclicals and value, and these areas each make up nearly 60% of UK market capitalization.

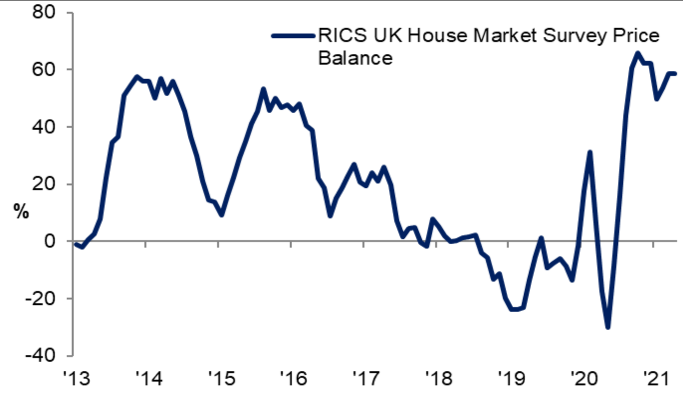
3. **Liquidity. There are early signs of global equity allocations to UK equities rising from low levels, with rising net inflows**. In addition, some of the huge emergency government and BoE funds are supporting market liquidity. The government’s £400 billion fiscal support measures have not only preserved many jobs and incomes, but also helped drive a £140 billion build-up in personal savings during the pandemic. Some of that is being spent on assets, notably in the very buoyant residential housing market. Meanwhile, retail volumes in the stock market are rising too. The BoE’s £795 billion asset purchase programme is containing bond yields and raising liquidity from bond sellers, some of which is flowing into equities driven by the very attractive dividend yield gap - **figure 3.**

4. **Currency. There is pent-up demand for all UK assets – equities, property, long duration bonds, driven by better Brexit and COVID clarity.** This is helping to support sterling, which is holding its gains from $1.13 in May 2020. We expect this to continue, helped also by the renewed dollar weakness that we are starting to see. Overseas investors considering buying UK equities thus do not need to hedge their currency exposure. **Figure 4** shows that positioning is only modest even after the rally so far. In the short-term, sterling could be held back by rising concerns about the new Indian COVID mutation.

5. **Management.** In addition to the five years of challenging EU exit negotiations, the UK had constant domestic political turbulence including three prime ministers over the same period. The current government did not do well in containing COVID-19 in its early stages. Now, though, the backdrop is very different. The ruling Conservatives have a large majority, there is a

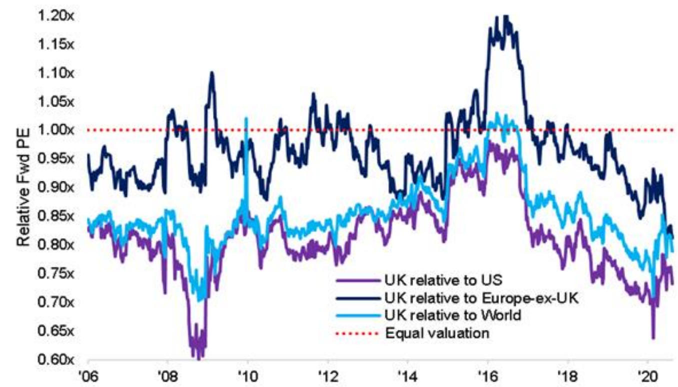
cohesive cabinet, and PM Johnson's personal standing has improved following the EU trade deal, and great vaccine progress. This was reflected in the recent domestic mayoral contests and a by-election, particularly in the north of England. The importance of this is twofold: firstly, the government is now in a position to articulate and then implement a post-Brexit post-COVID economic game plan. Part of this game plan will be non-EU trade deals, and an Australian trade deal is likely to lead the way in the coming weeks. Secondly, foreign direct investment is more likely to increase.

Figure 1: Rebounding UK house prices



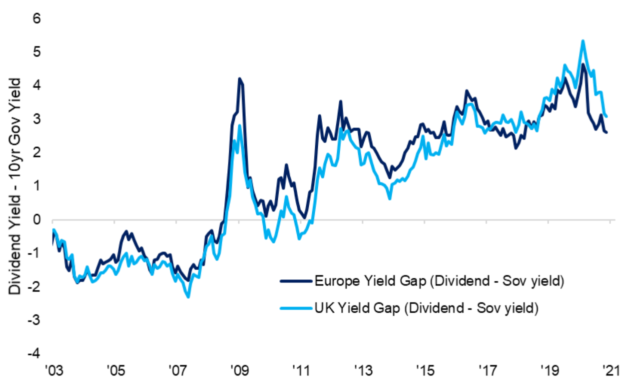
Source: Bloomberg as of May 17th 2021.

Figure 2: UK equities – relative forward 12m P/E



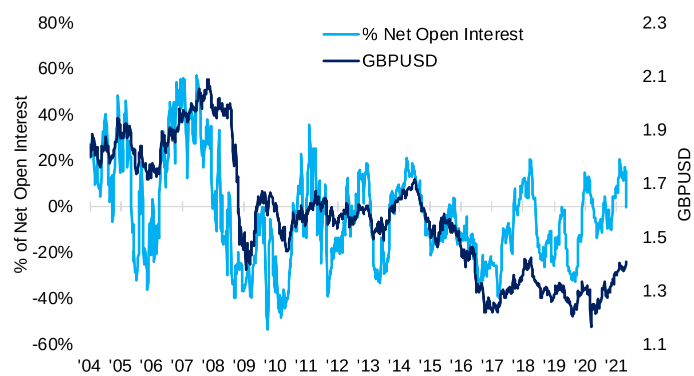
Source: Bloomberg as of May 17th 2021. All forecasts are expressions of opinion and are subject to change without notice and are not intended to be a guarantee of future events. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only. Past performance is no guarantee of future returns. Real results may vary.

Figure 3: Dividend yield gaps supportive for equities



Source: Bloomberg as of May 17th 2021.
Past performance is no guarantee of future returns. Real results may vary.

Figure 4: British pound positioning



Source: Bloomberg as of May 17th 2021.

European equities which are seeing improving investor perception

European growth has consistently disappointed over the past decade. And it suffered more than many countries last year because of the high reliance on travel and tourism, being around 13% of GDP in the periphery countries. However, growth this year may at least match the global average of around 4%, with the rising potential of a decent recovery next year as well.

This is growth is underpinned by several drivers:

1. **Vaccine.** After a slow start, there are now firmer signs of a more aggressive vaccine procurement programme from the European Commission. The second quarter is seeing a sharp pickup of 300 million vaccines. Momentum is rising across most countries, led by the core nations. Germany is now vaccinating over 700,000 people a day.

2. **EU Recovery Fund.** The distribution and spending of the €750 billion EU Recovery Fund will gather momentum throughout the rest of the year. In addition, there are ongoing significant national fiscal expansions. Italy is the largest recipient of the Recovery

Fund, with a €200 billion allocation. In addition, PM Draghi is planning another €40 billion emergency package, equivalent to 2.5% of GDP. This would take Italy's fiscal deficit to 10% of GDP, with no signs of a reversal of the EU's COVID-driven relaxation of its rules.

3. **ECB** support is ongoing. To preserve financial stability, the ECB has increased its bond purchases from €15 billion per week to €19 billion per week. See detail in the fixed income section on page 6.

4. **Asian import demand** is helping European exporters. Looking forward, they might benefit further from spill-over from the huge US fiscal packages. As Asia has contained the virus relatively well, its economies have recovered over recent months. China and developing Asia combined account for 11% of European exports. Germany has particularly significant exposure to Asia with approximately 15% of exports.

These factors are driving strong pickups in European PMI data – **figure 5** – and a strong trend in the Citi Economic Surprise Index – **figure 6**.

In addition to the growth pickup, 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 helped European solidarity further.

Figure 5: Euro-Area Manufacturing and Services PMIs

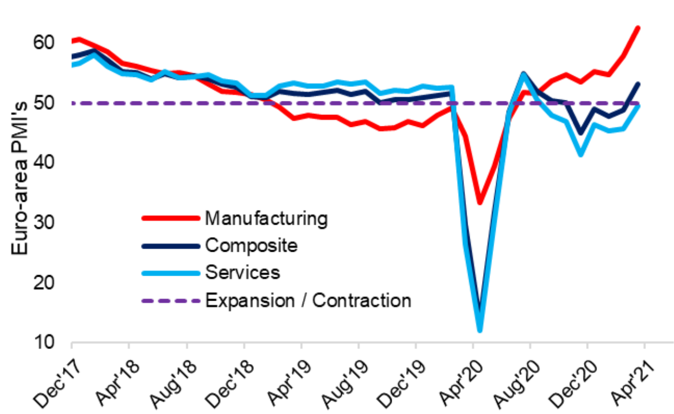
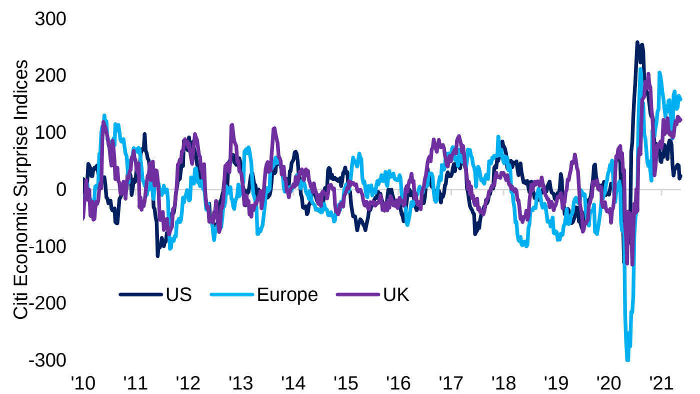


Figure 6: Citi Economic Surprise Indices



Source: Bloomberg as of May 16th 2021. The Citigroup Economic Surprise Index, or CESI, tracks how the economic data fare compared with expectations. The index rises when economic data exceeds economists' consensus estimates and falls when data is below forecasts. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only.

Equity investment opportunities

1. **Following the underperformance in 2020, COVID cyclical equities (*) have rebounded strongly in 2021. We believe there is further to go.** In terms of index weighting, COVID cyclicals make up over 55% of European and UK market capitalisation. COVID cyclical sectors include industrials, energy, financials, materials, and consumer discretionary.

   In Europe so far this year, COVID Cyclicals have rallied 12% while COVID Defensives* are only up 5%. This outperformance has been even greater at 12% since early November 2020 when the vaccine announcement led the cyclical rally. Rebounding economic growth should help this outperformance continue.

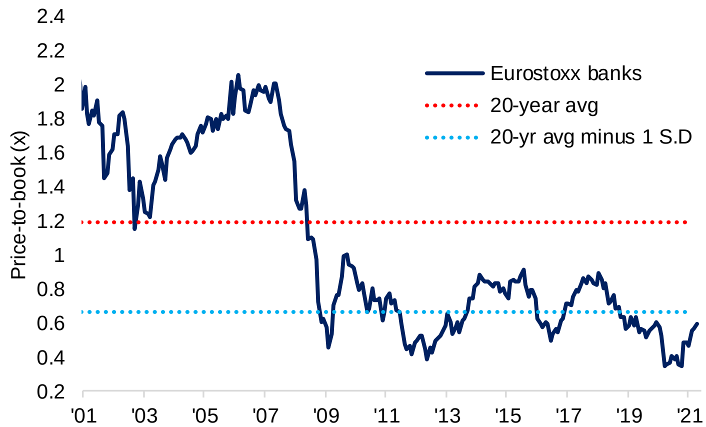
   UK COVID cyclicals have outperformed COVID defensives by 6% since the beginning of 2021 and by 18% since November 2020. The biggest EPS rebounds in 2021 are concentrated in COVID cyclical sectors, with energy, materials, consumer discretionary and financial sectors leading the rebound.

2. **Value in both Europe and the UK remain compelling.** Value sectors tend to benefit in an environment with rising yields. Since the beginning of the year, German 10-year yields have risen from -0.55% to -0.08% currently, while UK 10-year yields have risen from 0.2% to 0.9%. Since the beginning of the year, the best two performing sectors, financials, and energy, can both be defined as "value." Both are up 17% year-to-date.

   European banks are our favoured area of value. Despite rallying 75% over the last six months, the SX7E index is still down 10% relative to pre-COVID levels. While balance sheets have improved in recent years, lending growth is also expected to pick-up, while steepening yield curves and rising rates should also support net interest margins. An average price-to-book ratio of 0.4X is historically cheap, see **figure 7** with returns on equity expected to increase from depressed levels.

In 2021, dividend resumptions will also be a key catalyst for the European banking sector. Following suspensions in 2020, the ECB has now allowed dividends to resume in 2021, with European banks now allowed to pay dividends at the lower of 20bp of CET1 ratio or 15% of 2019 and 2020 combined net income. While bank dividend payments virtually stopped in 2020 – bank dividend futures were down 93% in 2020 – and a return to full shareholder pay-out levels will take time, the trend is positive. UK financials are also set to benefit in this environment. The UK Prudential Regulatory Authority has also allowed dividends to resume in 2021 at the higher of 20bp of CET1 ratio at end-2020 or 25% of 2019 and 2020 combined net income.

Figure 7: European financials at historic cheap valuations



Source: Bloomberg as of May 17, 2021. Past performance is no guarantee of future returns. Real results may vary. Note: 20-year average minus 1.S.D refers to 1 standard deviation below the 20-year average. Standard deviation is a measure of the amount of variation or dispersion of a set of values.

3. **The European "green" story remains attractive.** With ongoing impetus from the EU Green Deal and the EU Recovery Fund, we have been focused on this unstoppable for the long-term (A greener Europe offers compelling investment opportunities and A Cleaner Way to Play European Equities). Outperformance in this space is set to continue. 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. This follows the earlier EU Green Policy, which targets 32% of its energy needs from renewable sources by 2030. It also comes after the EU Green Deal, targeting a fall in carbon emissions to 55% of 1990 levels by 2030, with likely enforcement tariffs for countries that don't comply. The next decade is projected to see approximately €1 trillion worth of green investment. And with this number set to increase further, greater issuance will result in a widening and deepening of the European green equity universe.

4. **Europe and UK are attractive markets for dividend yield**. The absolute average dividend yields of 4% in the UK and over 2.5% in Europe are high by global standards. Furthermore dividend-orientated strategies are heavily biased towards COVID cyclicals, with weightings in Europe and the UK of 74% and 65% respectively. High quality dividend paying companies also tend fall within our definition of value, given their historically predictable and stable cash flows. Companies that can sustain dividend growth and continue to fund business expansions are likely to emerge from this crisis stronger. Since 2003, "dividend growers" in Europe have provided annualised total returns of 6.2%, versus broader Europe which has returned only 2.6%.

(*) COVID cyclicals: Financials, industrials, materials, real estate, consumer discretionary. COVID defensives: IT, healthcare, communication services, consumer staples, utilities.

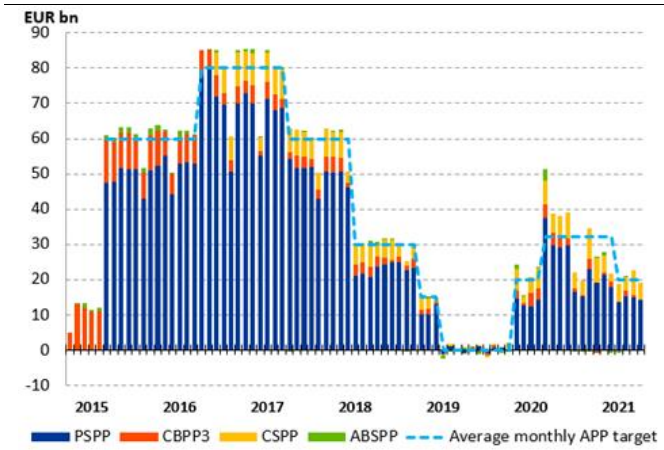
Fixed Income

The ECB reaffirmed its accommodative monetary policy stance at the April meeting. Having left broader rates unchanged, the ECB will continue with its Pandemic Emergency Purchase Programme (PEPP) at a size of €1.85 trillion. The PEPP will continue to run till at least March 2022, with maturing PEPP bonds reinvested until at least 2023. Under the current Pandemic Emergency Purchase Programme (PEPP), cumulative net purchases within the programme as of the end of April stands at €1.024 trillion, with €80 billion in monthly purchases added in April. The current Asset Purchase Programme (APP) will continue to run at €20 billion a month and is expected to run for "for as long as necessary to reinforce the accommodative impact of its policy rates, and to end shortly before it starts raising the key ECB interest rates" – **figure 8**. Over the course of its lifetime, we expect the ECB balance sheet to increase to at least €7 trillion – **figure 9**. The Targeted Long-Term Refinancing Operations (TLTROs) are in place until at least June 2022.

In the UK, the Bank of England has also left policy unchanged earlier this month, with the base rate at 0.1% and corporate bond purchase target at £20 billion a month. Despite reducing the pace of bond buying slightly, the BoE emphasised that this was smoothing not tapering. In order to raise interest rates, they are seeking "significant progress" particularly in "eliminating spare capacity." No substantial monetary policy changes are likely until there is visible strength following the end of the fiscal emergency support measures in the summer. The November BoE meeting should be more critical. If the growth rebound disappoints, a further £50 billion quantitative easing extension may ensue. If the rebound is strengthening into a firm 2022 recovery, however, there could be guidance towards monetary tightening. The latter seems less likely, after the BoE Governor statement this week that "we see a bounceback in the economy, but we don't see the momentum continuing forward at that pace".

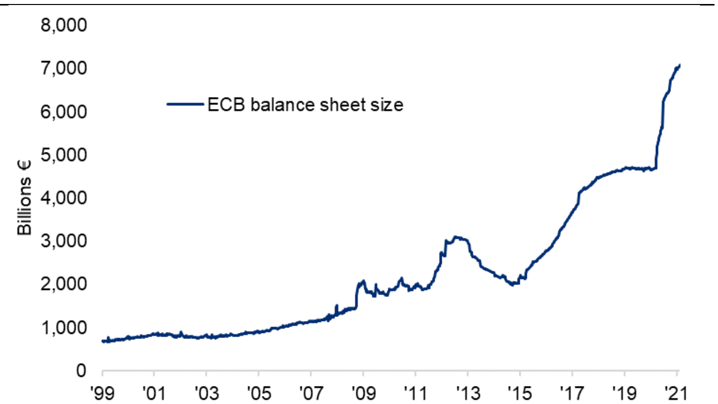
We continue to remain underweight sovereign bonds, while seeking selective opportunities in corporate bonds. We anticipate continued "trickle-down" demand into high yield (HY) to stay supportive, potentially driving average high yields down another 50 basis points (bp) to around 2.5%. Since the March 2020 price lows, European HY has rallied 30% compared to the 10% rally in investment grade (IG). However, the average HY yield of 3.0% and the average spread of 295 bp remains attractive as investors are increasingly challenged in finding compelling yield opportunities – **figure 10**. We expect defaults to remain 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.

Figure 8: European Central Bank Asset Purchases, EUR billion



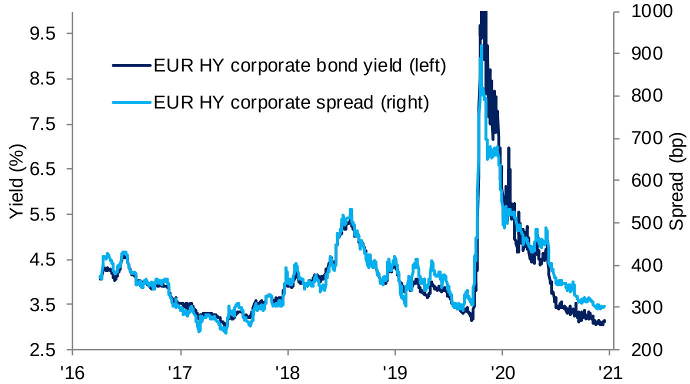
Source: European Central Bank as of March 17th, 2021

Figure 9: Rising European Central Bank Balance Sheet



Source: Bloomberg as of April 16th, 2021.

Figure 10: Euro High Yield corporate bond yields and spreads (%)



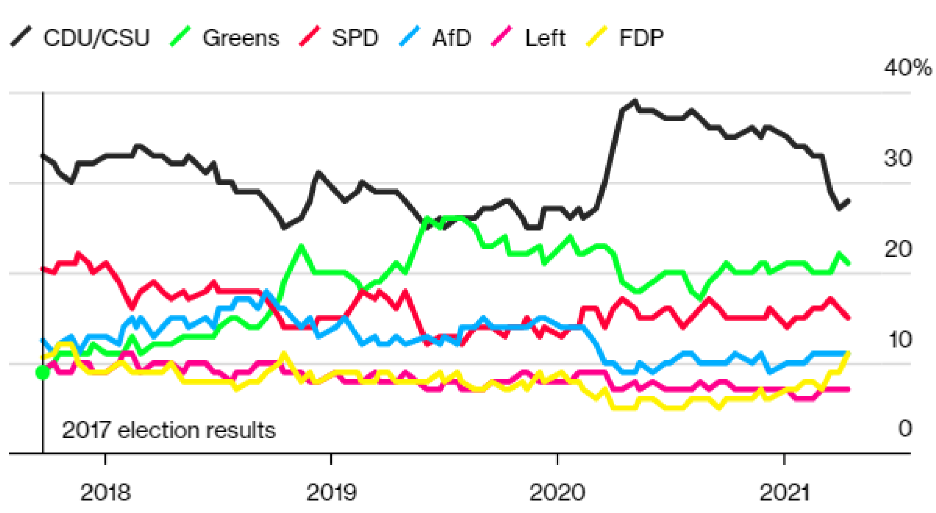
Source: Bloomberg as of May 17th 2021. Past performance is no guarantee of future returns. Real results may vary.

Currencies

The euro could appreciate further to around $1.25 over the coming months. The key driver is relative vaccine momentum. This is further supported by economic surveys and soft data surprising on the upside over the past six weeks. The currency is no longer being widely used as a funding currency, as it was earlier this year. In the medium-term, the key driver of direction versus the US dollar will be the respective monetary policies, in particular whether the Fed or the ECB begins to tighten policy first. The German election could also be a medium-term driver, with a Green-led coalition likely to be positive with a greater focus on EU integration – **figure 11.**

Sterling remains 10-15% cheap based on CPI and the PPI deflated real effective exchange rate. Inflows are well-supported by pent-up demand for all UK assets post-Brexit and post-COVID. The UK breakup threat from Scotland is elevated but in the short-term not a short-term factor that might hold back sterling. In the short-term, the factor more likely to potentially hold back sterling could be rising concerns about the new Indian COVID mutation.

Figure 11: Germany's Greens have narrowed the lead versus CDU/CSU – Election Results



Source: Infratest dimap as of April 16 2021. Note: CDU = Christian Democratic Union, CSU = Christian Social Union, SPD = Social Democratic Party, AfD = Alternative for Germany, FDP = Free Democratic Party,