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Europe Strategy

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Where is Europe headed?

- **The global economy's upward momentum is fading** – Given Europe's sensitivity to external demand dynamics, the loss of momentum in global economic activity could make investors more cautious about adding exposure to European assets in the short-term unless there were to be some surprisingly positive geo-political developments.
- **Record gap between manufacturing and services sector activity** – Historically, when the gap widens beyond -5 points, the services activity measure troughs within zero and four months. Excluding the pandemic, the average trough was 46.7 for services sector activity and 44.8 for the composite PMI output, suggesting that in the short-term the direction of travel is likely to be towards weaker PMI readings as the contraction in manufacturing begins to affect services.
- **Europe will improve, but this is likely to be a 2024 story** – We think that economic activity is likely to remain constrained in the aftermath of one of the largest monetary policy tightening episodes in history, unless inflation pressures were to decline very rapidly, or China's reopening story were to regain momentum. But in the medium term, the balance of risks between headwinds and tailwinds suggest that Europe will be in stronger position to outperform.
- **Opportunities are presenting themselves in medium- and small-cap equity markets** – The latter, especially compared to US 10-year real rates, look fairly-valued, and have significantly strengthened their balance sheets.
- **Relative valuations** – Compared to expensive large-caps, European small-caps look cheap both on an absolute and a relative price to earnings (P/E) basis. The price to sales (P/S) ratio shows that European small caps screen cheap relative to European large caps.
- **Conclusion** – Following a year of clear underperformance in 2022, as we search for opportunities in this volatile market environment, we would argue that European small-cap equities are becoming more attractive on many metrics. Fundamentals look strong and valuations are cheap. Despite the likelihood of a global economic slowdown in coming quarters, and despite the banking system adopting a more cautious attitude towards these smaller firms, we think that a point will come at which removing this underweight will be justified.

Where is Europe headed?

In the five months to May, European equities are continuing to outperform most developed markets when measured in both local currency and dollar. This situation is at odds with signs of softening economic activity in recent weeks.

Yet, the global economy's upward momentum is flagging, as illustrated by Citi's Economic Surprise Index (ESI) for the global economy which fell from +41 on 28 March to +2 on 5 June (**Figure 1**). Given Europe's sensitivity to external demand dynamics, we think that upside surprises are probably unlikely in the short-term, even if the -82 reading for the euro area ESI (lowest since Jul-22) suggests that expectations have been pared back already.

This is also the conclusion of the latest ZEW survey of financial analysts who in the middle of May indicated that expectations of economic activity had declined in all countries, with the biggest drops seen in China (-19.3 points) and the euro area (-15.8 points). As shown on **Figure 2**, survey respondents believe that China is the only country in the recovery quadrant, while the US slowdown is clearly at risk of morphing into a recession. For Germany and the euro area, the assessment is one of broad economic stagnation, with the former more at risk of recession.

Figure 1: Global ESI moving to neutral territory

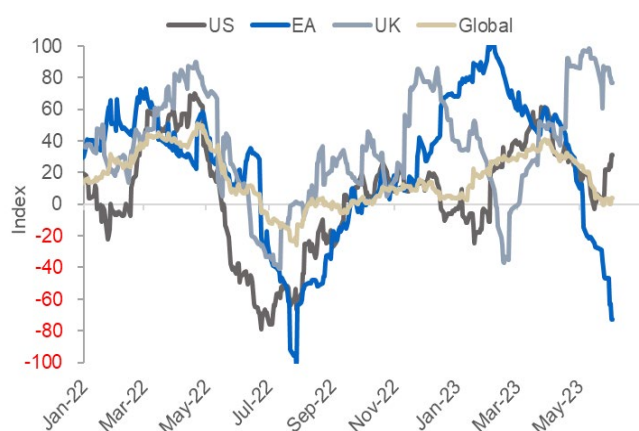
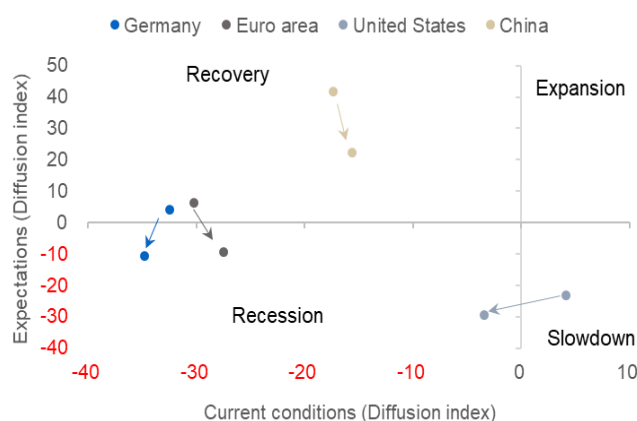


Figure 2: ZEW survey suggests muted growth ahead



Source: Bloomberg, ZEW and Citi Global Wealth Investments, as of June 2, 2023

Given the importance of China as a destination for European exports, a slower-than-expected rebound in Chinese domestic demand will likely be seen a drag for European equity valuations. We think that this could make investors more cautious about adding exposure to European assets in the short-term unless there were to be some surprisingly positive geo-political developments.

Any policy measures lifting consumer confidence in China would likely lift tourist visits into Europe this summer. As such, it was interesting to read on Friday a Bloomberg story reporting that the Chinese government is working on a basket of support measures to support the property market after existing policies failed to sustain a rebound in the ailing sector.

Against this softening global economy backdrop, we investigate how the clear dichotomy between a contraction in European manufacturing activity and an expansion in the services sector is likely to be resolved by looking at the historical pattern of PMI surveys, going back to the late 1990s.

Record gap between manufacturing and services sector activity

Manufacturing sector activity is very cyclical and is sensitive to shifts in global demand and foreign trade.

Manufacturing output has been contracting in ten of the last twelve months, except in February and March 2023 when output barely increased, averaging 50.2, barely distinguishable from the 50 neutral level.

A decline in manufacturing activity is the logical consequence of a decline in new orders over the last 12 months. As global supply chains are beginning to function more normally, delivery times have improved at a record pace. Declines in input prices are materialising as supply constraints fade and demand disappoints. This should lead to further falls in the quantity of purchases and in stocks of purchases, both of which have been falling for the last ten and four months, respectively. Therefore, short of a rapid improvement in global demand for manufactured goods, we suspect that manufacturing activity could continue to contract in coming months, albeit at a slower pace.

By contrast, activity in the largely domestic services sector is expanding at a sustained pace, supported by a release in pent-up demand from both businesses and households who still hold large amount of accumulated savings from the pandemic period. Historically the extent of the disconnect in the relative performance between these sectors has no historical precedent, apart from the Great Financial Crisis of 2009.

Figure 3 shows that in May 2023, the gap between the PMI survey manufacturing output (46.4) and the PMI survey of services activity (55.1) was worth -8.7 points (pt), a level only exceeded in the three months between November 2008 and January 2009, with December 2008 posting the -10.8pt record low. By March 2009, both the PMI manufacturing output series and the PMI services activity had troughed, at 30.8 and 39.2 respectively.

The historical pattern shows that the lower the manufacturing output PMI, the quicker the series tends to rebound. And the faster the gap between manufacturing and services activity closes.

Figure 3: Second largest ever gap...

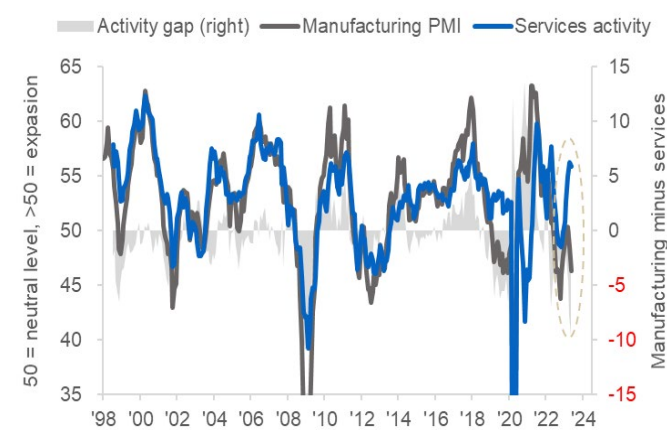
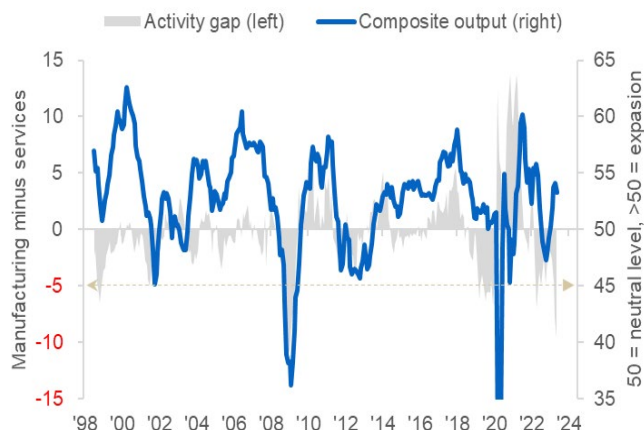


Figure 4: ... points to clear downside output risks



Source: Haver Analytics and Citi Global Wealth Investments, as of June 2, 2023. The dotted circle on Figure 3 shows the extent of the divergence in May 2023. The dotted line on Figure 4 shows the average activity gap in the five episodes when it exceeded 5 points and the corresponding level of the PMI composite output

Looking back at the five episodes when the gap between manufacturing and services activity widened beyond -5 points, the services activity measure troughed within zero and four months, with an average of 2.4 months. Excluding the pandemic trough which greatly skews the result to the downside, the average trough in the remaining four episodes was 46.7 for services sector activity and 44.8 for the composite PMI output (**Figure 4**).

We therefore think that in the short-term the direction of travel is likely to be towards weaker activity readings, as the contraction in manufacturing is likely to have some negative repercussions on services, albeit somewhat limited given the remaining distortions from the COVID-19 pandemic and the continued support to economic activity from a slightly supportive fiscal stance. The current period of clear services outperformance also looks overdone to us on the basis that monetary policy is likely to remain a headwind for the next 12-18 months, given the time it takes for interest rate increases to feed to the real economy.

Headwinds and tailwinds

Economic activity in Europe and the UK has proved stronger than expected only a few months ago, thanks to lower energy prices, the easing of supply bottlenecks and fiscal policy support for firms and households.

We judge the risks to economic activity to be broadly balanced. On the negative side of the equation, renewed financial market tensions and unexpected developments in Russia's war against Ukraine remain key concerns. On the positive side, there could be a faster unwinding of past adverse supply shocks and continued resilience of the labour market. With respect to inflation, in the short-term, the balance of risks continues to remain skewed to the upside, even if there are signs of core inflation peaking. We list on Figure 5 some of the key short-term risks that Europe is likely to face, while remaining more constructive looking ahead to 2024 and beyond.

Figure 5: Broadly balanced, but at the margin, probably slightly skewed to the downside in the short-term

• Weak global growth	• Improving terms of trade and declining commodity prices
• Monetary policy tightening weighing on investment and hiring plans, dragging down domestic demand	• Easing inflation to foster a recovery in real disposable income
• Fiscal impulse likely to turn negative	• High savings ratios
• Tighter bank lending standards	• Re-shoring of global supply chains
	• Improving relationship with the UK

Europe will improve, but this is likely to be a 2024 story

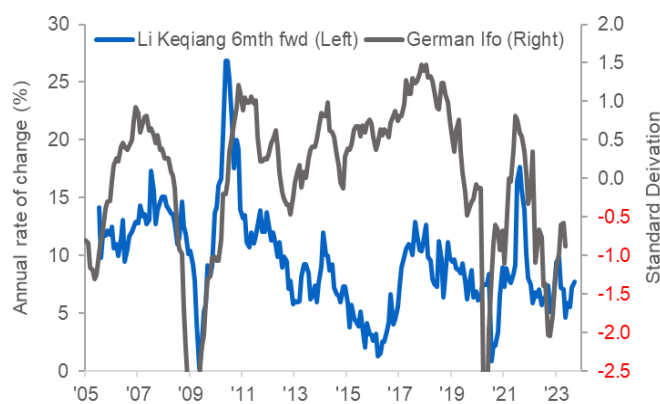
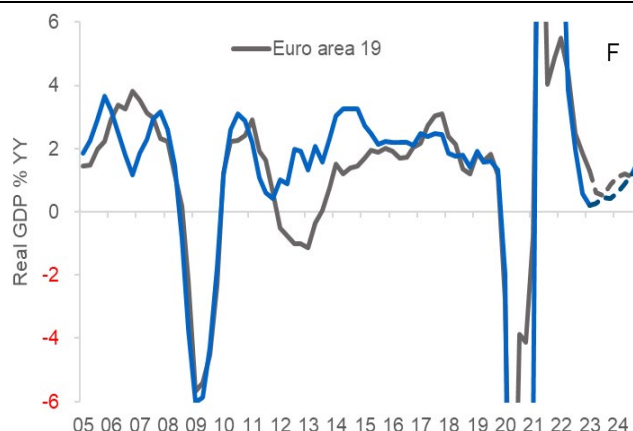
We believe that Europe is a beta play on the global economy and that as global demand improves, Europe is in a stronger position to outperform. This is explained in part by the growing importance of China as a key contributor of global GDP growth, and the rising share of European (and especially German) exports of goods to China.

The China ESI measuring data surprises relative to market expectations stands at +8. This is the lowest reading since the middle of January, illustrating the scale of investor disappointment about the speed of the post-COVID-19 reopening. Similarly, the China Li Keqiang Index has failed to gather any meaningful momentum lately, suggesting that the rebound in Germany's Ifo survey of confidence in the manufacturing sector could be overdone (**Figure 6**).

The global growth picture looks challenged, with real GDP growth around 2.5%, well-below the historical average. By being close to its stall speed, the global economy would be less able to weather an unexpected shock.

On balance, this analysis of the euro area business cycle suggest that economic activity is likely to remain constrained in coming quarters and that downside surprises to GDP growth are more likely to upside surprises unless inflation pressures were to drop rapidly, allowing central banks to become much more confident about their ability to re-anchor inflation expectations at levels consistent with price stability.

We stand by our expectation that the euro area and the UK will likely avoid recession in coming quarters (**Figure 7**) but see some downside risks to our forecast that real GDP will likely average 0.2% QQ in the second half of 2023 for both the euro area and the UK. Macroeconomic and financial conditions should gradually improve in 2024, when we expect real GDP growth in both regions to rise to around 1%.

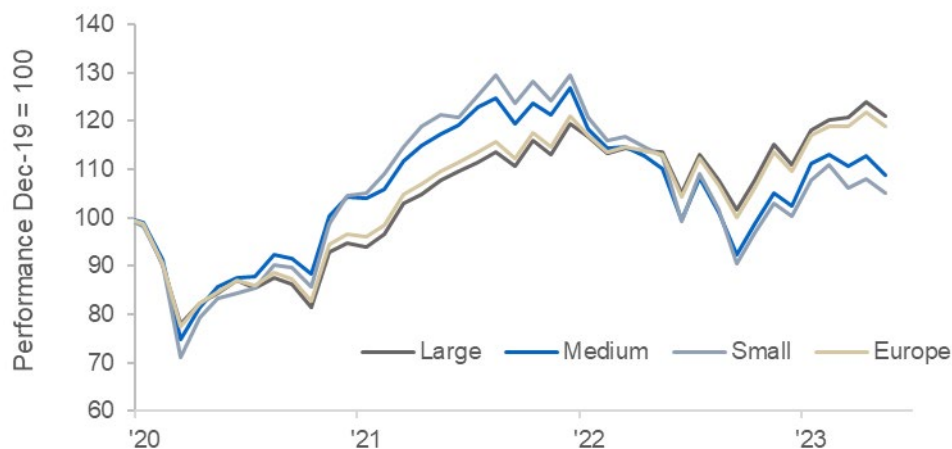
Figure 6: Has the Ifo survey rebounded too far?**Figure 7: Economic outlook should improve in 2024**

Source: Bloomberg, Haver Analytics, and Citi Global Wealth Investments, as of May 4, 2023; F stands for forecast

Fundamentals

In 2022, European equities sold off across all segments, but small- and medium-cap equities underperformed compared to large-cap equities (**Figure 8**). This correction in risk assets was mainly the consequence of central banks' actions as policy rates were raised by very large amounts and quickly, while some embarked on quantitative tightening programmes to shrink their balance sheets.

However, as fears of a global recession spread during the fourth quarter of 2022, investors moved to find safety in large-cap quality equities, which typically have robust balance sheet, high levels of free cash flow and a strong management track record.

Figure 8: European all cap equities performance

Source: Bloomberg, data as of 31 May 2023. Past performance is no guarantee of future results. Real results may vary.

Year-to-date European large-cap equities are up 9.0%, medium-cap equities up 6.3% and small-cap equities up 4.8% (as of 31 May 2023). Quality and defensive equities have been key drivers of the outperformance in European large-cap, alongside the China re-opening story. However, as the European Central Bank (ECB) moves closer to the end of its tightening cycle, we would expect some opportunities to arise, leading to some shifts in asset

allocation. Currently (as of May 2023), the GIC is underweight European medium-small-cap equities and overweight European large-cap equities.

After a decade of very low real yields (ranging from flat to negative), real rates turned positive in the second half of 2022 and look set to remain elevated in our view. As a result, there is now a growing disconnect between European large-cap equity performance and US 10-year real rates (**Figure 9**). We suspect that this outperformance of European large-cap equity will prove difficult to sustain. On a relative basis, European small-cap equities have significantly de-rated to reflect the higher real rates environment, appearing more reasonably priced (**Figure 10**).

Figure 9: European large-cap appears expensive relative to 10-year US real rates



Figure 10: European small-cap appears fairly-valued relative to 10-year US real rates



Source: Source text add here

European large-cap and small-cap companies display stronger fundamentals than in the past, as companies have deleveraged since 2009 (**Figure 11 and 12**). At 2.8x, European small-cap net debt/EBITDA is 1-standard deviation (SD) below its 15-year average, making European small-cap companies particularly more appealing, as in the past decade leverage ratios have displayed more cyclical relative to large-caps.

Figure 11: European large-cap companies have deleveraged since 2009

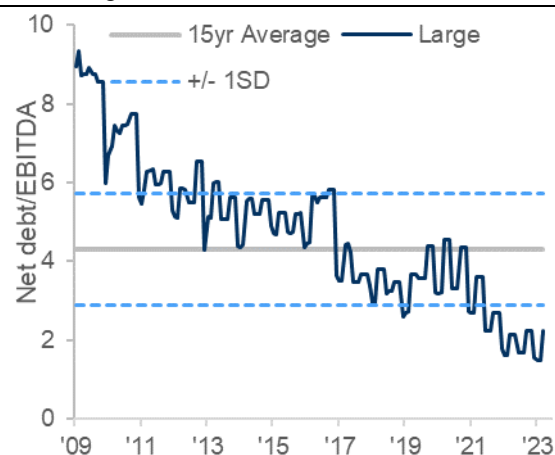


Figure 12: European small-cap companies have deleveraged since 2009



Source: Bloomberg, data as of 31 May 2023. Past performance is no guarantee of future results. Real results may vary.

Valuations

At 12.6x, absolute P/E valuations suggest European large-cap equities are closing in on their fair value of 14.2x, whereas European small-cap equities remain 1SD below their 15-year average at 13.3x (**Figure 13 and 14**). Nonetheless, European large-cap equities now trade expensive to the overall index (**Figure 15**), whereas European small-cap equities are comparatively cheap (**Figure 16**).

Figure 13: European large-cap P/E nearing fair value

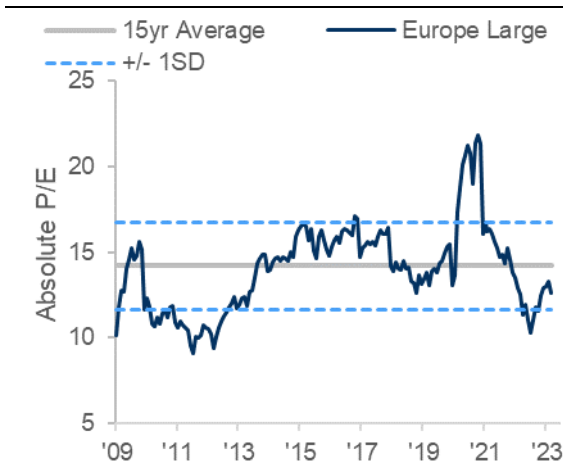
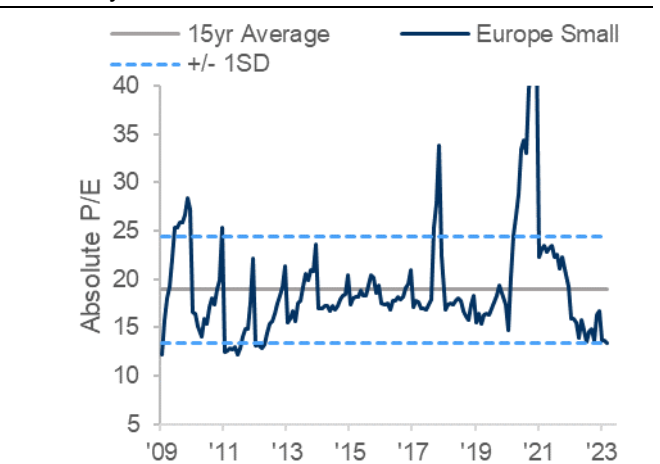


Figure 14: European small-cap P/E is cheap relative to history

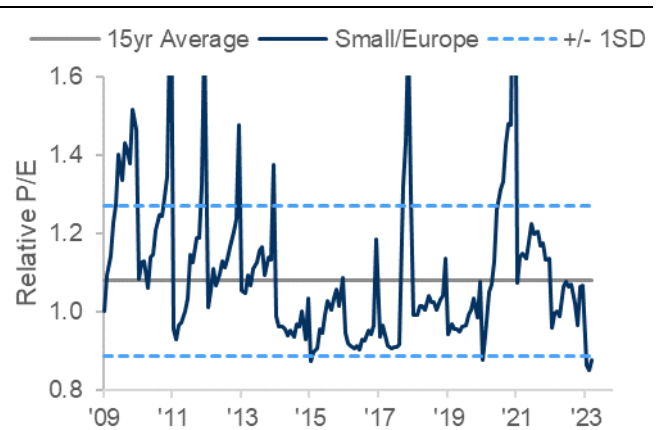


Source: Bloomberg, data as of 31 May 2023. Past performance is no guarantee of future results. Real results may vary.

Figure 15: European large-cap relative Europe look expensive



Figure 16: European small-cap relative Europe look cheap



Source: Bloomberg, data as of 31 May 2023. Past performance is no guarantee of future results. Real results may vary.

Another valuation measure of European small-cap equities looks at their price to sales (P/S) ratio. This metric aims to alleviate the issue of high operating costs impacting earnings in these start-ups, focusing on sales instead. Figure 17 and Figure 18 shows the stark difference in P/S valuation between European large-cap and small-cap equities. On a P/S basis, the former look expensive at 1SD above the 15-year average (1.4x), whereas the latter are cheap, at 1SD below the 15-year average (0.8x).

Figure 17: European large-cap are expensive on a P/S basis

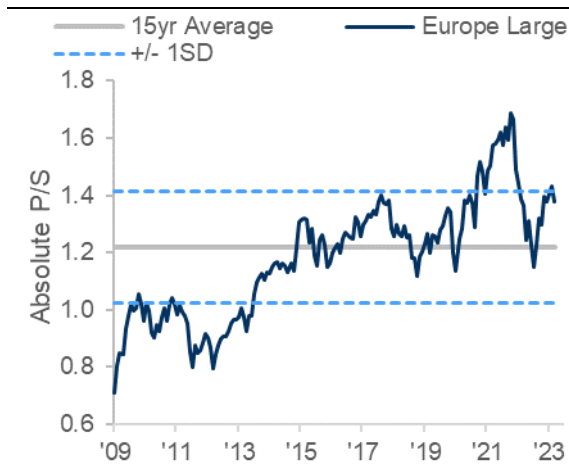
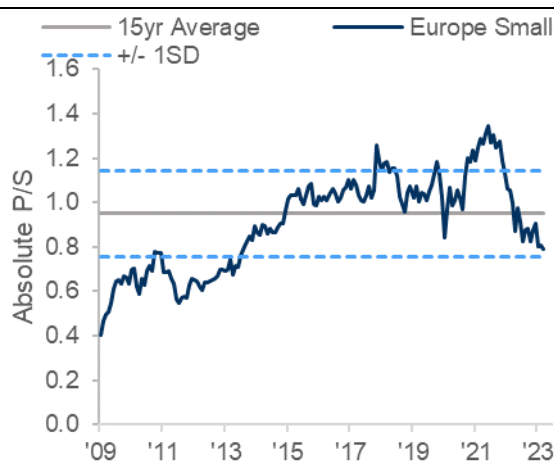


Figure 18: European small-cap are cheap on a P/S basis



Source: Bloomberg, data as of 31 May 2023. Past performance is no guarantee of future results. Real results may vary.

Conclusion

On a relative basis compared to the US, Europe looks better now than it has been for some time, both on a GDP growth and equity valuation basis. This is why we added a small equity overweight in Europe ex-UK and ex-Switzerland equities at our April GIC ([Global Strategy Quadrant | FX actions to Improve Long-Term Returns](#)). Within the European region we still favour large-cap versus mid-small-cap equities, even if the case in favour of the latter is beginning to strengthen. Note that we remain 5% underweight global SMIDs equities.

Overall, following a year of clear underperformance in 2022, as we search for opportunities in this volatile market environment, we would argue that European small-cap equities are becoming more attractive on many metrics (see **Figure 19**). Fundamentals look strong and valuations are cheap. Despite the likelihood of a global economic slowdown in coming quarters, and despite the banking system adopting a more cautious attitude towards these smaller firms, we think that a point will come at which removing this underweight will be justified.

Figure 19: European equities by size of market capitalisation

	Small	Mid	Large
Absolute P/E	Cheap	Cheap	Neutral
Relative P/E (vs. Europe)	Cheap	Cheap	Expensive
Absolute P/S	Cheap	Neutral	Expensive
Relative P/S (vs. Europe)	Cheap	Cheap	Expensive

Source: Bloomberg, data as of 31 May 2023. Past performance is no guarantee of future results. Real results may vary.

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Investment Grade			
Highest quality	Aaa	AAA	AAA
High quality (very strong)	Aa	AA	AA
Upper medium grade (Strong)	A	A	A
Medium grade	Baa	BBB	BBB
Not Investment Grade			
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

¹ The ratings from Aa to Ca by Moody's may be modified by the addition of a 1, 2, or 3 to show relative standing within the category.

² The ratings from AA to CC by Standard and Poor's and Fitch Ratings may be modified by the addition of a plus or a minus to show relative standing within the category.

(MLP's) - Energy Related MLPs May Exhibit High Volatility. While not historically very volatile, in certain market environments Energy Related MLPS may exhibit high volatility.

Changes in Regulatory or Tax Treatment of Energy Related MLPs. If the IRS changes the current tax treatment of the master limited partnerships included in the Basket of Energy Related MLPs thereby subjecting them to higher rates of taxation, or if other regulatory authorities enact regulations which negatively affect the ability of the master limited partnerships to generate income or distribute dividends to holders of common units, the return on the Notes, if any, could be dramatically reduced. Investment in a basket of Energy Related MLPs may expose the investor to concentration risk due to industry, geographical, political, and regulatory concentration.

Mortgage-backed securities ("MBS"), which include collateralized mortgage obligations ("CMOs"), also referred to as real estate mortgage investment conduits ("REMICs"), may not be suitable for all investors. There is the possibility of early return of principal due to mortgage prepayments, which can reduce expected yield and result in reinvestment risk. Conversely, return of principal may be slower than initial prepayment speed assumptions, extending the average life of the security up to its listed maturity date (also referred to as extension risk).

Additionally, the underlying collateral supporting non-Agency MBS may default on principal and interest payments. In certain cases, this could cause the income stream of the security to decline and result in loss of principal. Further, an insufficient level of credit support may

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MBS are also sensitive to interest rate changes which can negatively impact the market value of the security. During times of heightened volatility, MBS can experience greater levels of illiquidity and larger price movements. Price volatility may also occur from other factors including, but not limited to, prepayments, future prepayment expectations, credit concerns, underlying collateral performance and technical changes in the market.

Alternative investments referenced in this report are speculative and entail significant risks that can include losses due to leveraging or other speculative investment practices, lack of liquidity, volatility of returns, restrictions on transferring interests in the fund, potential lack of diversification, absence of information regarding valuations and pricing, complex tax structures and delays in tax reporting, less regulation and higher fees than mutual funds and advisor risk.

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