Europe Strategy Bulletin | 15th February 2021

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Europe is benefitting from Asia's recovery

Summary

- Historical data has shown Europe has a high dependency on both Chinese and broader Asian trade activity. Rebounding Asian import demand will be supportive for European growth in 2021, with exports making the largest contribution to overall GDP in the Euro area.
- **European companies with high revenue exposure to both China and broader Asia have outperformed. Over a 5-year period, exposed companies are up 154% versus China up 116% and Asia up 89%.** While performance has been strong, this has been distorted by semiconductors, materials and consumer durables which represent 45% of the basket (average performance within these sectors are 390%, 293% and 162% respectively). Removing these three industry groups would have resulted in a more modest 5-year performance of 59%. (*)
- While many companies have seen strong performance, we believe plenty of opportunities still exist at the single-stock level. This is supported by our positive outlook on the "Rise of Asia" and strong earnings - these companies show average consensus forward-looking earning growth rates of 12.1% versus Europe at 6.5%. As well as playing our positive European equity view, it can also provide a way of gaining Asian exposure through developed markets.

(*) Basket refers to Eurostoxx 600 companies which have at least 15% China revenue exposure, or at least 30% Asian revenue exposure. Sector performance refers to basket constituents only.

Rebounding Asia supportive for Europe

Within our last European monthly we highlighted five reasons why we're positive on the European economic recovery in 2021. These include (1) on-going monetary and fiscal policy, (2) less economically impactful lockdowns, (3) positive momentum behind the European green story, (4) positives from a Joe Biden's Presidency and (5) manufacturing support from the pickup in Asian import demand. We believe point (5) will be a key driver of the European recovery in 2021.

Exports make the largest contribution to overall GDP in the Euro area. As of September 2020, exports of goods and services accounted for 47% of Euro area GDP, with same figure below 30% only two decades ago. Germany and Netherlands currently have the largest dependence on exports (48% and 78% of GDP respectively), with Spain, Italy and France between 28% and 31%.

China has led globally in terms of the rebound in global trade activity. China's import growth has recovered sharply in late 2020, with imports booming from a 16% decline in early 2020 to a 6.5% growth in December. Chinese GDP growth is now expected to bounce from 2.1% in 2020 to 8.2% in 2021, supported by rising trade activity, technological growth and dominance in global supply chains. South east Asian markets are still recovering. The rebounding services sector can also further support a consumption recovery and import demand (see Asia Strategist | Broader Allocation for Broader Recovery).

This bodes well for European trade, given Europe has a high dependency on both Chinese and Asian trade activity. Outside of countries within the EU and the UK (which account for over 60%), developing Asia, China and the US are the EU's top three trading partners, with China and developing Asia combined accounting for 18% of imports and 11% of exports **– figure 1.** As a result, our expectation for South East Asian markets to see firm economic and market rebounds in the coming months will be a positive driver in the European story for 2021.

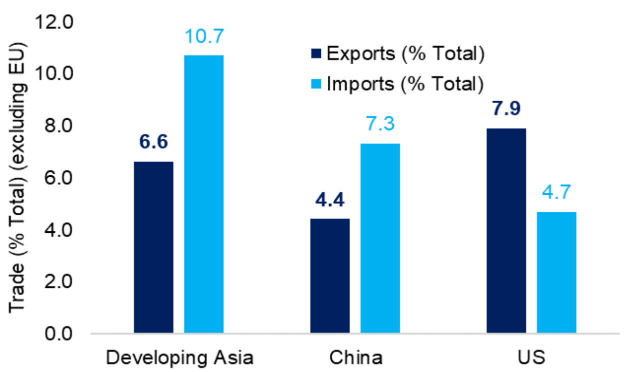
Below we highlight three reasons why Europe can benefit in this environment:

1. **EU exports to both China and developing Asia have rebounded firmly since Covid** – **figure 2.** This bodes well for German and European manufacturing activity, with their manufacturing PMI readings now firmly in expansion.

2. **German data has historically held a close correlation with Chinese data, with an approximate 6-month lag**. **Figure 3** explores the Chinese Li Keqiang Index, which measures Chinese economic output using a composite of railway cargo volumes, electricity consumption and new loans. This index has historically correlated well with forward looking German export expectations with a six-month lag, suggesting German manufacturing strength is likely to remain strong. This also bodes well European equities and industrials. The historical correlation between industrial production and equities in both Europe and Germany have been between 0.4 and 0.5.

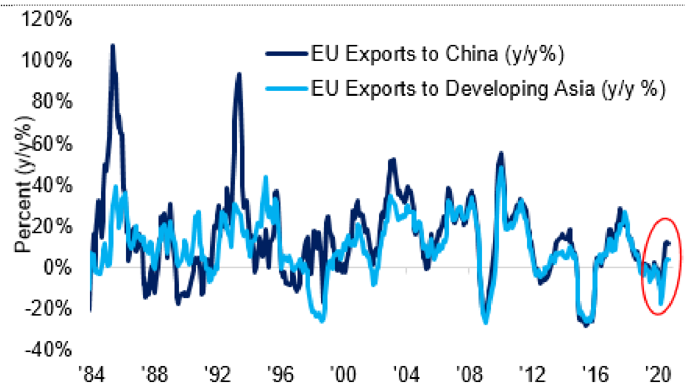
3. **The rebound in Chinese industrial production is also supportive – figure 4.** The relationship between Chinese industrial production and German equities has also historically been strong.

Figure 1: EU largest trade partners outside EU (% Total)



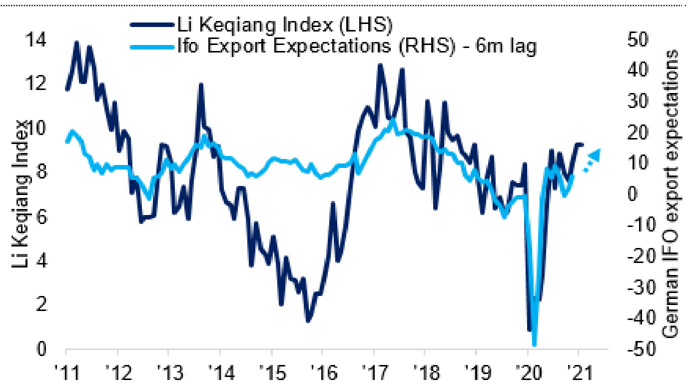
Source: Bloomberg as of February 10th 2021

Figure 2: EU exports to China / Developing Asia (y/y%)



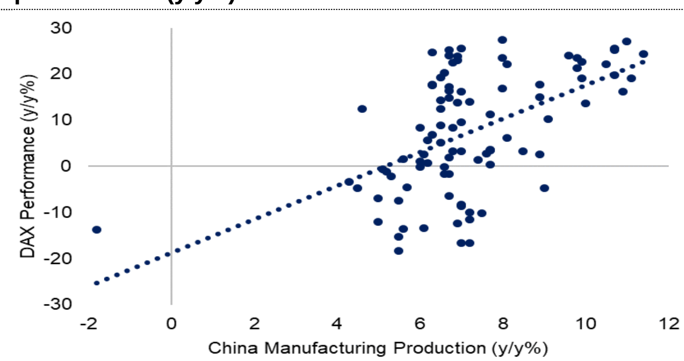
Source: Bloomberg as of February 10th 2021

Figure 3: China leading German export expectations



Source: Bloomberg as of January 20 2021. Li Keqiang Index: Measures Chinese economic output using a composite of railway cargo volumes, electricity consumption and new loans

Figure 4: Chinese manufacturing production and DAX performance (y/y%)



Source: Bloomberg as of January 20 2021. DAX consists of the 30 major German companies trading on the Frankfurt Stock Exchange. 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 not indicative of future returns. Real results may vary.

Companies exposed to China and Asia

We've looked at companies within the EuroStoxx 600 with either (1) at least 15% revenue exposure to China, or (2) at least 30% revenue exposure to Asia. The outcome was a basket of 56 names which accounted for 26% of the Euro Stoxx market capitalization. **These names on an equally weighted basis have outperformed over both a 1-year and a 5-year period, outperforming MSCI China, MSCI Asia ex Japan and broader European equities – figure 5.**

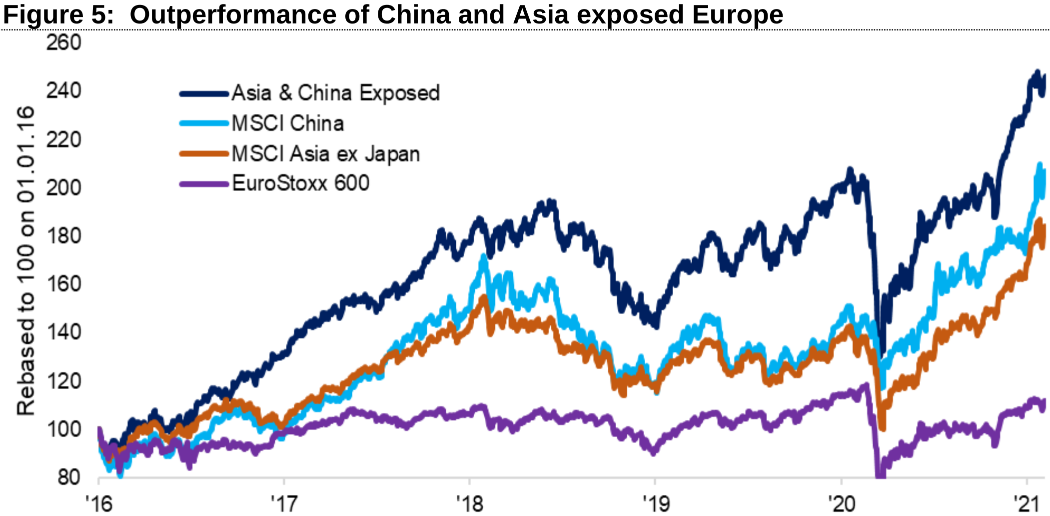
While performance has been strong, this has been distorted by semiconductors, materials and consumer durables, which represent 45% of the basket (average performance of basket constituents within these sectors are 390%, 293% and 162% respectively). Removing these three industry groups would have resulted in a more modest 5-year performance of 59%.

While the basket also trades at above average valuations (median forward PE multiple of 31x), this can also be justified for two reasons:

1. **Earnings potential:** The basket has an earnings compounded annual growth rate (CAGR) over the next 3-5 years of 12.1% based on consensus estimates, well above broader Europe's 6.5% average. 2022 EPS consensus estimates also point towards a more reasonable forward PE multiple of 23x.
2. **Industry composition:** Companies within luxury products and broader technology feature heavily and both trade at average forward PE multiples of over 33x. Many technology companies provide input for products that are assembled in Asia and get shipped to other end markets, while luxury consumer companies benefit from the rising Asian consumer demand story.

Given the strong momentum and our conviction in the Asian rebound story, we believe the outperformance of exposed European companies can continue. This is also supported by strong earnings (and likely potential upgrades) of European exposed companies. While many have already performance well, we believe plenty of opportunities still exist at the single-stock level. While European companies have greater corporate governance visibility than Asian listed peers, they also offer a more diversified and easily accessible way of gaining exposure.

Figure 5: Outperformance of China and Asia exposed Europe



Source: Bloomberg as of February 10th 2021. "Asia & China Exposed" refers to companies within the Eurostoxx 600 which generate (1) at least 15% revenue exposure to China, or (2) at least 30% revenue exposure to Asia. 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.