Europe Strategy Monthly | 19th April 2021

Jeffrey Sacks, Head – EMEA Investment Strategy | +44 207 508 7325 | Jeffrey.ian.sacks@citi.com
Shan Gnanendran, CFA – Vice President, EMEA Investment Strategy | +44 207 508 0458 | shan.gnanendran@citi.com

UK and European equities continue to look attractive

Summary

- **Overweight UK equities.** UK equities are cheap in absolute and relative terms and offer attractive dividend yields. The rapid vaccine rollout along with ongoing fiscal and monetary policy support should lead to a strong GDP growth rebound this year. In turn, average EPS growth may approach 40%. Early logistical and administrative challenges from leaving the EU are no worse than expected. We believe that early challenges in implementing the Northern Ireland protocol will be overcome.
- **Overweight European equities.** The patchy vaccine rollout is starting to improve in the present quarter. European Central Bank (ECB) policy remains very supportive, while the EU Recovery Fund implementation is likely to gather momentum over the summer. The Biden presidency should be a net positive factor for Europe. 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 and more broadly for all the periphery countries and for European solidarity.
- **Both UK and European equities offer particularly good exposure to the areas we favour globally**: COVID cyclicals (*), value, mid-caps, high dividend yielders (**) and dividend growers (***).

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

There are five reasons to keep accumulating UK equities:

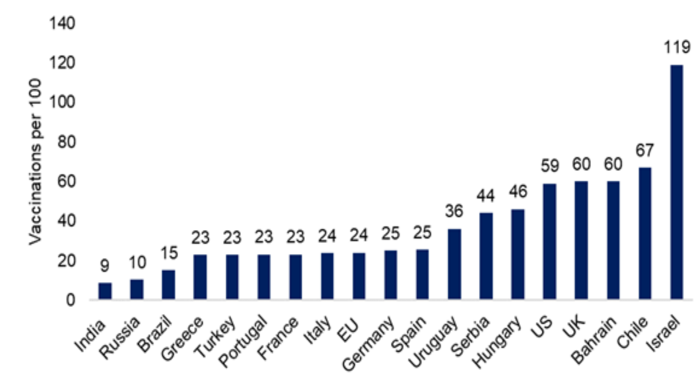
1. **Brexit has caused less upheaval than had been expected.** Initial logistics and administration issues are gradually being resolved. This is starting to be reflected in UK-EU trade. In February, UK exports to the EU rose by 46.6% month on month after a fall of 42% in January. Imports from the EU rose by 7.3% month on month, after a fall of 29.7% in January.

   The key challenge is in Northern Ireland where violence has been escalating. The problems are partly the result of 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. Some Northern Irish Unionists believe this weakens their province's place within the UK. A further catalyst for Unionist anger was a decision not to prosecute members of Sinn Fein for alleged breaches of lockdown rules at the funeral of a former IRA leader.

The UK and the EU are now making progress in intensive talks on how to apply post-Brexit trade rules in Northern Ireland. The talks follow a draft implementation plan for the Northern Ireland protocol that was submitted by the UK to Brussels at the end of March. There is rising optimism from both sides, particularly over making checks smoother and faster by way of more efficient IT systems.

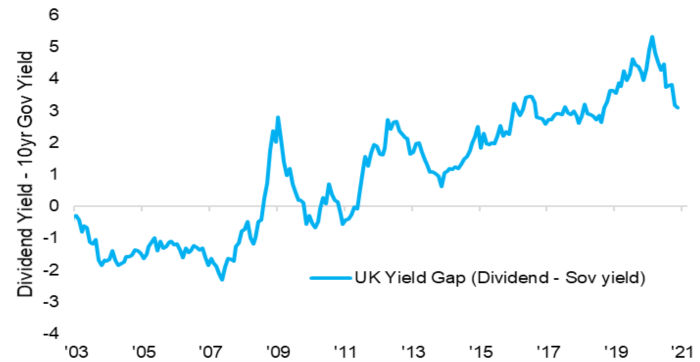
2. **UK vaccine progress remains on track for the lifting of all restrictions on 21st June 2021.** Around 60% of the population have been vaccinated at least once, 10% have had two vaccinations, and all adults are expected to have their first vaccines by the end of July. With infections, hospitalizations and deaths all falling, the country has probably passed through the worst phase of the pandemic. See **figure 1.**

Figure 1: Vaccine roll-out



Source: Haver as of April 16 2021

Figure 2: UK yield gap (%)



Source: Bloomberg as of April 16 2021. UK represented by FTSE 100. 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.

3. **Policy support is ongoing from both the government and the Bank of England (BoE), driving a GDP growth uplift.** Even as the UK budget deficit continues to rise to peacetime highs, the Chancellor (UK finance minister) has extended some of the 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. Corporate tax rises will be delayed until 2023.

   The BoE remains committed to its to £795 billion asset purchase program, with no acceleration of purchases to supress rising bond yields. There is also little chance of the deposit rate moving from its current +0.1% any time soon. This is despite the economy looking poised for a strong rebound. BoE Chief Economist Haldane has recently said the economy is "like a coiled spring," with particular reference to the possibility of the release of £160 billion of savings built up during the pandemic. Consumer confidence has risen to its highest since August 2018 (Source: YouGov poll), job market optimism is at a three-month high (Source: BDO, a professional services firm), and company capital expenditure reductions are falling (Source: Deloitte poll). Consumer prices rose 0.4% in February and we expect a steady increase in the coming months towards the BoE's 2% target. However, we do not expect a powerful long-term inflation uplift, because: services supply comes back onstream later this year so capacity constraints will be minimal, on the demand side some of the services pickup will replace goods demand, and there is likely to be only limited wage growth.

4. **The UK market is cheap, extremely well-supported by earnings growth and dividends, and offers great exposure to the areas we favour at a global level.** The FTSE 100 is 25% up from its November 2020 low when the GIC first went overweight. And while it is up 8.7% so far this year, it remains 8% below its pre-COVID peak. The valuation multiple of 14x is cheaper than any developed market and is well-supported by expected 40% EPS growth this year. The average dividend yield of 3.9% enhances the quality of the potential total return and is particularly attractive versus fixed income. (The yield gap over UK corporate bonds is 2.1% and the yield gap over sovereign 10-year gilts is 3.1%.). See **figure 2**. This is starting to encourage inflows – **figure 3**. At a global level, we favour cyclicals and value, and these areas each make up over 50% of UK market capitalization.

Figure 3: UK equities – price performance

Source: Bloomberg as of April 16 2021. Past performance is no guarantee of future results. 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.

5. **The UK market is underheld with pent-up demand.** The five-year Brexit negotiations held back investors due to concerns over the economic impact and political acrimony. The initial COVID-19 impact further deterred investors. The UK economy was disproportionately impacted given that 80% of its output comes from services. This was exacerbated by poor early virus containment. The situation has very much changed. As PM Johnson gains in popularity owing to the vaccine rollout success, and the UK prepares to host the G7 and global climate conference, the country is likely to become an increasing focus for investors.

European equities are in the early stages of improving investor perception

There are six reasons to accumulate European equities:

1. **After a slow start, there are now firmer signs of a more aggressive vaccine procurement programme from the European Commission.** With around 25% of Europeans vaccinated so far, the second quarter will see a sharp pickup of 300 million vaccines. Of this second-quarter increase, 250 million will receive the BioNTech/Pfizer vaccine. In addition, 1.8 billion additional BioTech/Pfizer vaccines have been purchased for 2022-23. Momentum is rising across most countries, led by the core. Germany is now vaccinating over 700,000 people a day.

2. **The distribution and spending of the €750 billion EU Recovery Fund will gather momentum throughout 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 – the former ECB head – is planning another €40 billion emergency package (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. **The 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. The ECB's €1.85 trillion Pandemic Emergency Purchase Programme (PEPP) might be further increased at the ECB meeting later this week. The programme's duration is currently to at least March 2022, with maturing PEPP bonds reinvested until at least 2023. The targeted Long-Term Refinancing Operations (TLTROs) are in place until at least June 2022.

4. **Exporters are starting to benefit from Asian import demand. 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. This bodes well for European trade, given that Europe has a high dependency on both Chinese and Asian trade activity. China and developing Asia combined account for 11% of European exports. Germany has particularly significant exposure to Asia with approximately 15% of exports.

5. **Europe and the UK have a new long-term growth driver in 'green' energy**

The EU Recovery Fund will raise 30% of its required debt via green bonds. And deployment of the loan and grant money will have a significant focus on green initiatives. This follows the earlier EU Green Policy, with its target of 32% of energy needs to come from renewable sources by 2030. It also comes in the wake of the EU Green Deal, which targets a cut in carbon emissions to 55% of 1990 levels by 2030, with likely enforcement tariffs for countries that don't comply. Europe is at the leading edge of the development of hydrogen energy.

The combination of the above factors led to great economic resilience during the latest lockdowns, better than might have been expected. The EU's composite PMI was 53.2 in March, with services surprisingly strong at 49.6. Businesses and consumers have adapted far better than during the first lockdowns a year ago. Forecast of 4% for this year compares with the IMF forecast of 4.5%.

6. **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. And it is reflected in the narrow spreads of the periphery sovereign bond yields over German Bunds. For example, the Italian-German 10-year spread is currently 100bps. The euro is also stable given the diminution of Eurozone breakup risk.

The Stoxx 600 index has risen by 7.5% over the past six weeks, outperforming global equities by 2.5%. However, this has been on low volume. We expect more buying interest as the Covid-19 and economic data improve over the coming weeks.

Investment Opportunities

1. **COVID cyclical equities (*) have rebounded well following their 2020 underperformance. And they have further to go.**

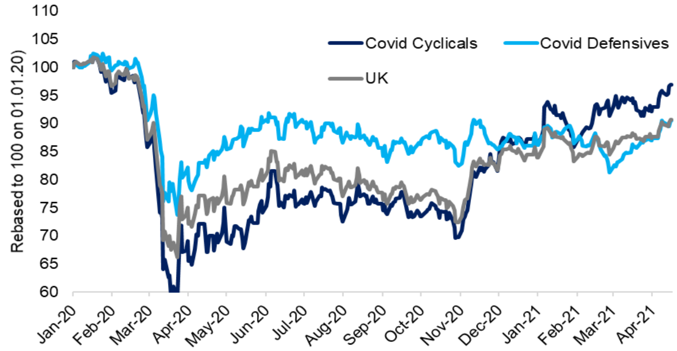
Since early November 2020, European COVID cyclical sectors have outperformed COVID defensive sectors by nearly 16%. These sectors include industrials, energy, financials, materials, and consumer discretionary. Since early November, rebounding economic growth should help this outperformance continue. In terms of index weighting, COVID cyclicals make up between 55% and 60% of European and UK market capitalization.
Since the beginning of November 2020, UK COVID cyclicals have outperformed COVID defensives by 22%, **figure 5**. Looking at **figure 4**, the biggest EPS rebounds in 2021 are concentrated in COVID cyclical sectors, with energy, materials, consumer discretionary and financial sectors leading the rebound.

Figure 4: Europe and UK sector valuations

	Europe-ex- UK				UK			
	2021 P/E	2022 P/E	2021 EPS %	2022 EPS %	2021 P/E	2022 P/E	2021 EPS %	2022 EPS %
Energy	13.1	11.0	241.7	19.4	10.8	8.6	2,502.4	26.2
Materials	19.5	18.4	42.2	6.2	8.6	10.5	62.6	-17.4
Industrials	25.4	21.0	51.7	21.2	23.8	20.0	330.1	19.1
Consumer Disc.	20.9	16.7	171.1	25.5	25.8	19.5	41.7	32.4
Consumer Staples	24.1	21.9	8.4	10.2	15.1	13.9	2.6	8.8
Health Care	18.5	16.7	4.5	10.2	16.7	13.9	4.4	19.8
Financials	12.0	10.5	19.7	15.1	12.4	10.5	29.8	17.5
IT	33.3	28.2	10.6	18.1	36.2	32.6	-2.0	10.9
Communication Services	17.0	15.3	-7.1	11.5	14.7	12.5	18.9	17.2
Utilities	17.6	16.3	8.1	7.6	16.6	15.5	5.5	6.8
Real Estate	16.0	15.3	-16.2	4.5	25.3	22.8	6.6	11.1

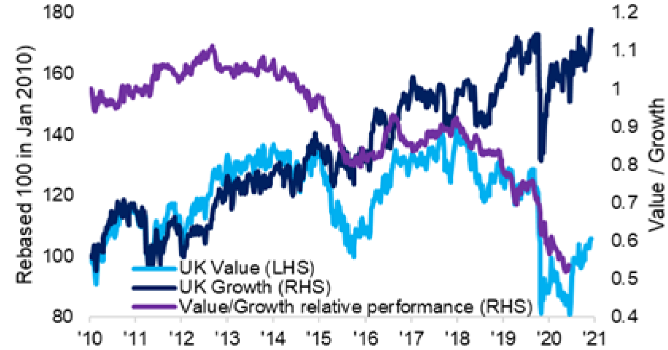
Source: Bloomberg as of April 16 2021. UK, Europe-ex-UK, US and World represented by FTSE 100, Stoxx Europe Index, S&P 500 and MSCI World. For illustrative purposes only. Past performance is no guarantee of future results. Real results may vary. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. All forecasts are expressions of opinion and are subject to change without notice and are not intended to be a guarantee of future events.

Figure 5: UK COVID cyclicals vs defensives (*)



Source: Bloomberg as of April 16 2021. Past performance is no guarantee of future results. 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.

Figure 6: UK value underperformance



Source: Bloomberg as of April 16 2021. For illustrative purposes only. Past performance is no guarantee of future results. 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.

2. **We continue to favour value in Europe and the UK.** Within the different areas of value, European banks are our favoured area of value. Despite rallying 70% over the last six months, the SX7E index is still down 15% relative to pre-COVID levels. While balance sheets have improved in recent years, lending growth is also expected to pick-up, while a steepening yield curve and rising rates should also support net interest margins. An average price-to-book ratio of 0.4 is historically cheap, 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 have 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 have 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. This sector is starting to drive value outperformance of growth, see **figure 6.**

3. **The European "green" story remains attractive.** With on-going impetus from the EU Green Deal and the EU Recovery Fund, we have been focused on this "Unstoppable Trend" for the long-term (A greener Europe offers compelling investment opportunities and A Cleaner Way to Play European Equities). We believe outperformance in this space is set to continue. 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 great markets for dividend yield**. The absolute average dividend yields of almost 4% in the UK and almost 3% in Europe are high by relative standards globally. Furthermore dividend-orientated strategies are heavily biased towards COVID cyclicals, with weightings in Europe and the UK of 74% and 65% respectively. Dividends stocks also have a value bias. High quality dividend paying companies 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.
(**) High dividend yielders are companies that pay high absolute dividend yields.
(***) Dividend growers are companies that are able to both sustainably pay and grow their dividends annually.