Europe Strategy Bulletin | 24th February 2021

Equities and Sterling supported by vaccine progress and ongoing policy support

Summary

- **UK equities overweight.** UK equities offer good valuations and good dividend yields. The UK's equities and currency have started the year well following the EU trade deal and vaccine progress, and are likely to have further to go.
- **Sterling well supported.** Even with significant post-Brexit challenges, and no services deal with the EU yet, Brexit is no longer an overhang holding back investment in the UK. There is also better domestic political stability, and increasingly less likelihood of lower rates. Valuation and inflows support our advice to keep accumulating into weakness.
- **European equities overweight.** The poor vaccine rollout is expected to improve in 2Q21. Italy's new PM Draghi, the former European Central Bank (ECB) chairman, is positive for Italy and also more broadly for all the periphery countries and for European solidarity. The ECB continues to support the bloc's economy and bond prices. The Biden presidency should be a net positive factor for Europe. Alternative energy is a powerful long-term growth driver, supported by increasingly aggressive government initiatives.
- **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.**
- **High yield corporate bonds offer selective opportunities**, even after the 27% price rally from March 2020's lows. In an environment of "financial repression," the average yields of 3.0% look attractive versus cash and other areas of the fixed income universe.

Both the UK and EU to have GDP growth and earnings recoveries this year

We expect GDP growth in the UK to rise by 3% this year, after a first quarter fall of around 4%. Europe will also have a negative first quarter before a recovery starting in the second quarter to give a 4% GDP growth upturn for the year. There are five drivers: vaccine progress, government support, central bank support, Asian import demand, and a likely gradual pickup in the services sectors.

1. **Vaccine progress**

The UK's vaccination progess this year has been far more impressive than its virus containment process last year **– figure 1.** The early procurement of at least 400 million vaccines from seven suppliers, has led to an impressive 27 million vaccinated so far, and one-third of all adults so far, with realistic targets of vaccinating all over-50s by the end of April and all adults 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.

Reflecting this progress, yesterday the UK PM Boris Johnson announced a "cautious but irreversible" plan to gradually ease lockdown restrictions in the coming months in four stages. This will begin with schools re-opening on 8th March, and conclude with all businesses resuming operations and lifting of all restriction on 21st June. While the clear timeline will support consumer and business confidence, there remain uncertainties. In particular, it is still unclear how much social distancing will be needed after 21st June. Secondly there is uncertainty as to how effective the vaccines are in reducing transmission of Covid-19. Thirdly, further virulent virus mutations are an ongoing possibility.

In Europe, after a slow start, there are now firmer signs of a more aggressive vaccine procurement programe from the European Commission. For the BioNTech/Pfizer vaccine, they have purchased another 200 million vaccines to take their total purchased to 500 million, with an option for a further 100 million. For the Moderna vaccine, another 150 million vaccines have been purchased which takes their total purchased to 310 million, with an option for a further 150 million next year. The distribution and vaccination process is expected to be slow for the next month before improving in 2Q21.

2. Government support

The UK budget deficit continues to rise to peacetime highs as the chancellor had already committed to £300 billion fiscal spending ahead of next week's budget. We expect the Chancellor to extend some of the emergency measures (in particular, the furlough scheme, cheap company loans, property stamp duty holiday, and company rate holidays) at least until mid-2021. We are not expecting fiscal retrenchment in this budget, although the Chancellor is likely to indicate the future possibility of this. The first stages could be rises in capital gains and corporate taxes. There could be mention of long-term infrastructure spending plans and growth areas within alternative energy especially wind energy.

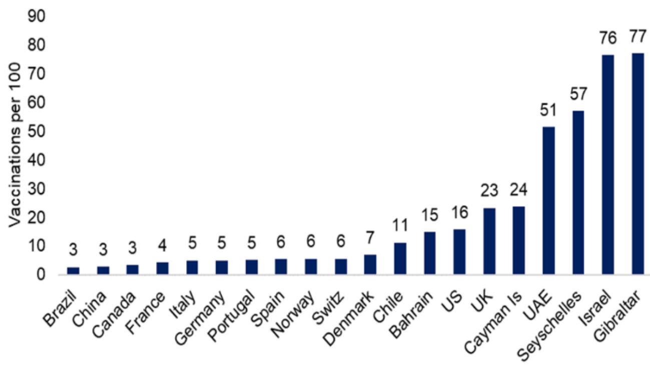
In Europe the issue to focus on is the distribution and spending of the Euro 750 billion EU Recovery Fund. Italy is the largest recipient, with a Euro 200 billion allocation, yet PM Conti's government collapsed due to the lack of consensus-building around how to spend the money. We are very encouraged that ex-ECB head Mr Draghi is now the Italian PM of a government of national unity. His spending plan has been broadly accepted by all parties. In the medium-term, his appointment should also be positive for wider Europe, as he is a credible voice for EU solidarity. This view is shared by the market, with a strong rally in all periphery sovereign bonds as well as in the firm Euro support.

3. Central bank support

The Bank of England (BOE) is still considering a reduction in the deposit rate from +0.1% to flat or even negative. While still possible, the chances are lessening. The BOE Chief Economist Haldane has recently said the economy is "like a coiled spring" with particular reference to the possibility of the £125 billion of savings build up during the pandemic being released. With this and with input prices edging higher (leading to January inflation rising by a greater than expected 0.7% y/y), we still have high conviction that a rise in the deposit rate is most unlikely while pandemic pressures persist and with ongoing scarring likely. The BOE has increased its asset purchase program by £150 billion to £795 billion, and could still add to this if necessary.

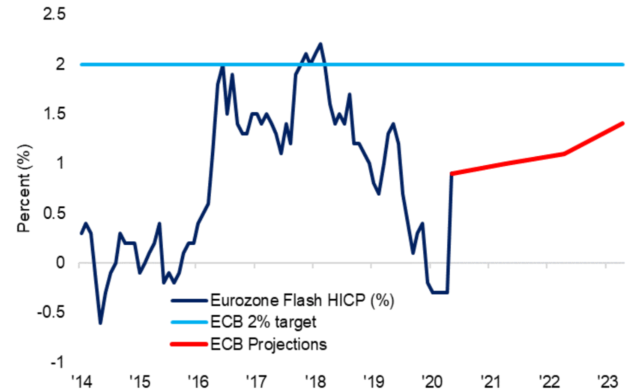
The ECB's €1.35 trillion Pandemic Emergency Purchase Programme (PEPP) was recently increased by €500 billion. The program's duration was also further extended by nine months to at least March 2022, with maturing PEPP bonds reinvested until at least 2023. Targeted Long-Term Refinancing Operations (TLTROs) were also increased, with three additional loan programmes announced and the window for the lowest rate extended to June 2022. We don't expect a deposit rate change when the ECB meets on 11th March. Even as European inflation expectations started rising in November 2020, with 5y5y Euro yields now 15 bp above their November level, there remains a significant gap between projected inflation and the ECB policy objective of 2% core inflation. The inflation uptick is restricted to the manufacturing sector and is not expected to be sustained while services remain weak – **figure 2.**

Figure 1: Strong UK vaccine progress



Source: Bloomberg as of February 20 2021.

Figure 2: ECB core inflation projections (%)



Source: Bloomberg as of February 10th 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. For illustrative purposes only. Past performance is no guarantee of future results. Real results may vary.

4. Asian import demand

As Asia has contained the virus relatively well, its economies have recovered over recent months. China has led globally in terms of the rebound in global trade activity. China's import growth recovered sharply in late 2020, with imports booming from a 16% decline in early 2020 to over 10% now. 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. The UK and Germany have particularly significant exposure to Asia with approximately 14% and 15% of exports respectively. The chart below shows how closely China correlates with German export expectations **– figure 3.**

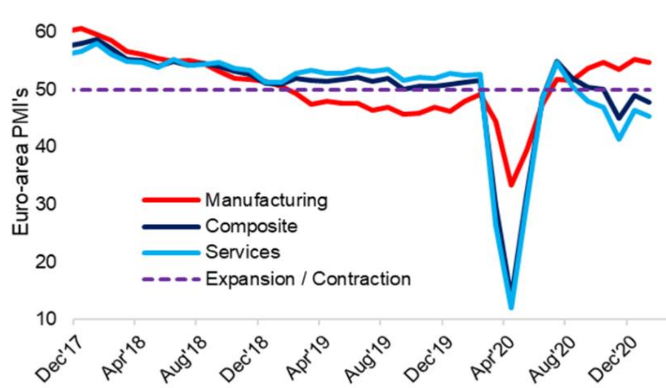
5. Gradual pickups in services sectors expected

During recent lockdowns, economic downturns have been much less severe than in 2Q20. This is because there has been improved adaptation from more European factories, shops, and consumers. This is reflected in the manufacturing rebound. However preliminary PMI reports for February are showing ongoing weakness in services. In Germany the manufacturing PMI rose to 60.6, ahead of the 56.5 forecast, while services fell to 45.9 compared with 46.5 forecast. France showed a similar result. Our expectation is that inventory rebuilding still has further to go, and services should pickup with more vaccine momentum, driven also by high savings levels, low rates, and substantial pent-up demand. While social distancing and confidence are unlikely to rebound fully quickly, the second half should see a steady recovery in services – **figure 4.**

Figure 3: China leading German export expectations

Source: Bloomberg as of February 20 2021. Li Keqiang Index: Measures Chinese economic output using a composite of railway cargo volumes, electricity consumption and new loans. All forecasts are expressions of opinion and are subject to change without notice and are not intended to be a guarantee of future events. For illustrative purposes only. Past performance is no guarantee of future results. Real results may vary.

Figure 4: Services to pick up



Source: Bloomberg as of February 10th 2021. Sectors represented by the European Markit PMI manufacturing, services and composite indices.

Post-Brexit there are two main areas of ongoing EU-UK uncertainty:

1) The "rules of origin" clause states that all goods must be able to demonstrate that they "originate" in the EU or the UK. So, UK goods need to contain approximately 50% UK content for most products in order to qualify for zero tariffs. UK firms that trade with the EU need to analyse their supply chains and industrial processes to ascertain if their products qualify for tariff-free access. Absent documentary evidence, their products face potential tariffs.

2) Services are not covered by the trade deal. Services account for 80% of the UK's economic output, with the EU accounting for 42% of the UK's services exports in 2018. Financial services are the biggest component of this, contributing 10% of UK output. The sector contributes 10% of all UK tax receipts. In 2019 the UK exported about £60 billion of financial services, of which about £25 billion went to the EU.

   Currently, there is no deal in financial services. The UK has lost its "passporting rights," which allowed UK firms to sell financial products to EU customers. Both sides are working towards a memorandum of understanding by the end of March 2021, which will outline the potential for an "equivalence" agreement. "Equivalence" is formal recognition from the EU that UK laws governing the financial services sector are of the same standard as the EU's, and would mean UK banks having some access to EU customers. Even then, however, the EU would retain the right to withdraw equivalence rights at any point and with very little notice.

   At present, there are temporary waivers in the critical areas of clearing and securities settlement. The governor of the BOE has stated that having no deal on financial services would be preferable to the UK's becoming a "rule-taker." This indicates that we should not expect these negotiations to be any easier than the hard-fought negotiations for the goods trade deal.

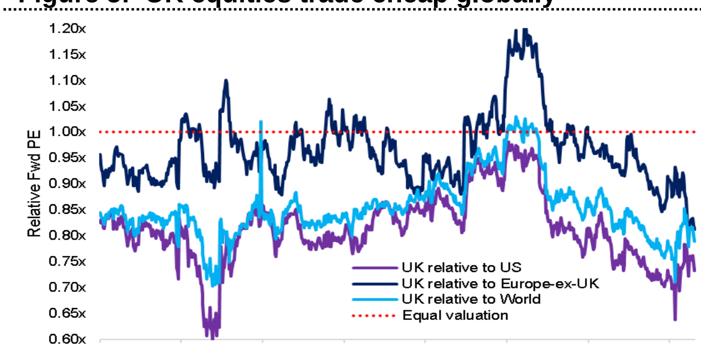
There are five reasons to overweight both UK and European equities

1. Valuations are attractive in absolute and relative terms

In absolute terms, the UK's 15x and Europe's 18x average prospective multiples remain attractive relative to the global average of 21x – **figure 5.** The multiples look sustainable with record low rates keeping discount rates low. In addition, they are supported by expected average 2021 EPS growth of 40% and 31% in the UK and Europe respectively.

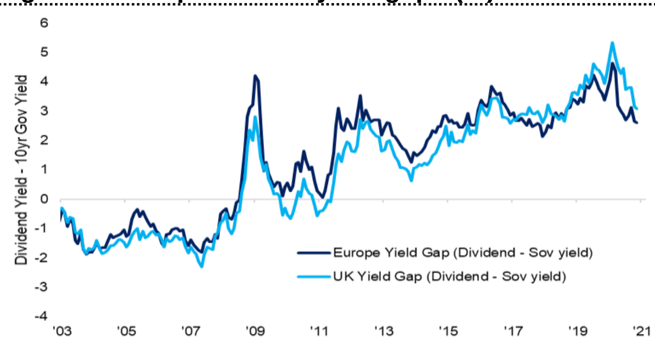
Furthermore in this era of financial repression, equities look particularly attractive versus fixed income. The UK and European yield gaps, measuring the difference between average dividend yields and average investment grade bond yields, are wider than any other region **(figure 6).** The catalyst for the gap to close could be the resumption of dividend payments this year.

Figure 5: UK equities trade cheap globally



Source: Bloomberg as of February 20 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.

Figure 6: Europe and UK yield gaps (%)



Source: Bloomberg as of February 10th 2021. UK and Europe represented by FTSE 100 and Stoxx Europe Index. 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.

2. Political risk is low

The region's growth and inflows from overseas have been sluggish for several years, partly due to ongoing political concerns – Brexit, UK parliamentary division regarding Brexit, weak coalitions, lack of solidarity across the EU27, and the rise of extremist parties. Looking forward, we view these risks as low. We are not expecting market-unfriendly outcomes in the Dutch and German elections this year. The vaccine rollout is raising tensions with the European Commission preventing national strategies for procurement, however by mid-year this challenge will have eased significantly.

3. The ownership levels are starting to rise from low levels

The region's underperformance over the last five years (26% price performance versus the S&P 500 rise of 102%) is reflected in low ownership levels. The lack of sizeable technology sector exposure has been unhelpful. However, the region is now starting to benefit from its substantial exposures to areas increasingly favoured at a global level, cyclicals and value.

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

The EU Recovery Fund will raise 30% of the 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 UK, meanwhile, has a stated aim to become "the Saudi for wind energy".

5. Joe Biden's Presidency is positive for Europe and the UK

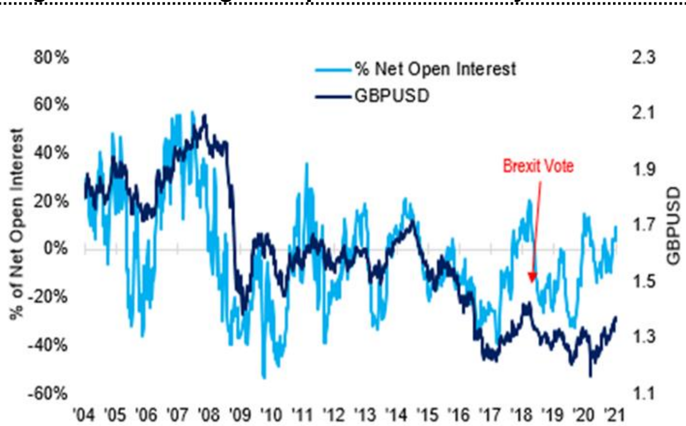
President Biden is proud of his Irish heritage and we expect him to be an Atlanticist President who will quickly reach out to his traditional allies on several fronts. Most critically, we do not expect the simmering trade tensions in several areas – digital taxes, steel and aluminium tariffs on both sides, Boeing and Airbus subsidy disputes, and the US 232 investigation – to escalate. Instead, they are likely to dissipate gradually.

Investment Opportunities

1. **Keep accumulating Sterling into weakness**

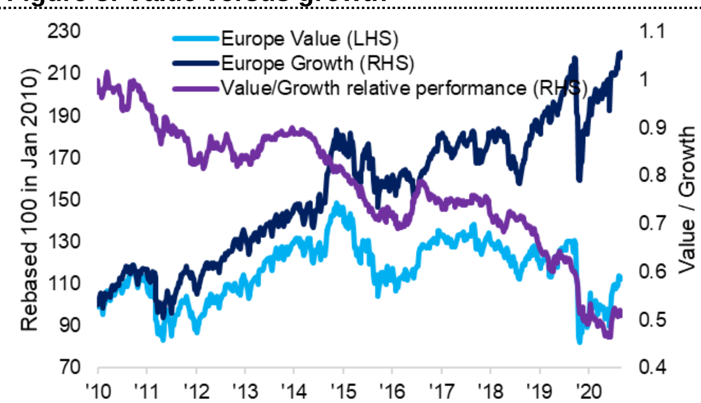
Our advice for the past six months is unchanged – buy in tranches into any weakness – despite Sterling rising 3% YTD versus the USD (5% versus the Swiss Franc and versus the Japanese yen), and despite rising from the March 2020 low of $1.15 to near a three year high of $1.40 – **figure 7**. The next resistance level is expected at $1.42-43. The valuation measured by the real-exchange rate is attractive, 3-month implied volatility has fallen to 7%, and the open interest of 13% is off the lows but not overly extended. In addition, there are early signs of pent-up demand for UK assets (in equities from underweight institutions, in property where the yields are attractive, and in Gilts where the inflation-adjusted yield premium versus US Treasuries is looking more attractive), which could be released as both Brexit and Covid-19 challenges ease.

Figure 7: Sterling net open interest not yet extended



Source: Bloomberg as of February 20 2021. For illustrative purposes only. Past performance is no guarantee of future results. Real results may vary.

Figure 8: Value versus growth



Source: Bloomberg as of February 10th 2021. Value and Growth represented by MSCI Europe Value Index and MSCI Europe Growth Index. 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.

2. **Value sectors including banks starting to outperform**

Yield curves have steepened slightly. This has historically correlated with better relative performance from value relative to growth. This is after a period of prolonged underperformance **– figure 8.**

Our favoured value sector remains financials, down 12% over the last year and a long-term underperforming sector. Steeper yield curves should help profitability, balance sheets are generally strong, and lending growth is expected to pickup. Average valuations at 0.4x average price-to-book value are historically cheap **– figure 9**, with returns on equity expected to rise from depressed levels.

Dividend resumptions may be a key catalyst for the banking sector in 2021. Following suspensions in 2020, both the European Central Bank (ECB) and the UK Prudential Regulatory Authority (PRA) have now allowed dividends to resume in 2021. UK banks can now resume dividend distributions capped at the higher of 20bp of CET1 ratio at end-2020 (or 25% of 2019 and 2020 combined net income), while European banks can pay dividends at the lower of 20bp of CET1 ratio or 15% of 2019 and 2020 combined net income. The latter will therefore be slightly more conservative. While bank dividend payments virtually stopped in 2020 (bank dividend futures were down 93% in 2020), a return to full shareholder pay-out levels will take time however the trend is positive.

Figure 9: Historically low financial valuations

Source: Bloomberg as of February 20 2021.For illustrative purposes only. Banks represented by Euro Stoxx Banks Index (SX7E). 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 10: Europe equities versus industrial production

Source: Bloomberg as of February 10th 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.

3. **"Covid cyclicals" (*) such as industrials and materials are favoured**

While services have lagged, manufacturing across the Euro-area has shown resilience with the February Euro-area manufacturing PMI reading coming in at 57.7. Europe generates 15% of GDP from manufacturing, with Germany and Switzerland holding greater weightings closer to 20%. As **figure 10** shows, the correlation between year-on-year equity market performance and industrial production in the Euro-area is around 0.45.

The recent results season was positive for industrial and material companies, with more beats than misses and more subsequent upgrades than downgrades. Materials companies could see significant earnings and cashflow improvements in 2021 as the cyclical economic pickup gathers momentum. Recent commodity strength bodes well for the materials sector performance. The sector had an average 13% earnings surprise and posted positive earnings growth in 4Q20, which is likely to continue this year.

4. **Dividends strategies expected to continue to outperform**

Long-term income investors should revisit dividend strategies in 2021, focusing on sectors and companies with strong balance sheets and reliable cashflows that are able to sustain dividends and potentially also grow dividends. There are three reasons why investors should seek to revisit dividend strategies:

I. Reversion to mean, following last year's underperformance: While dividends are not expected to fully recover to pre-pandemic levels in the coming year, we have high conviction that dividends will rebound from their 2020 lows as GDP growth rebounds, supporting an earnings and cashflow recovery.

II. Dividends being reinstated in 2021. While many companies had cancelled or suspended dividends in 2020, many of these companies have now reinstated their 2021 dividends. The partial resumption of bank dividends (which accounted for approximately a quarter of all European dividends in 2019), will be an important 2021 catalyst.

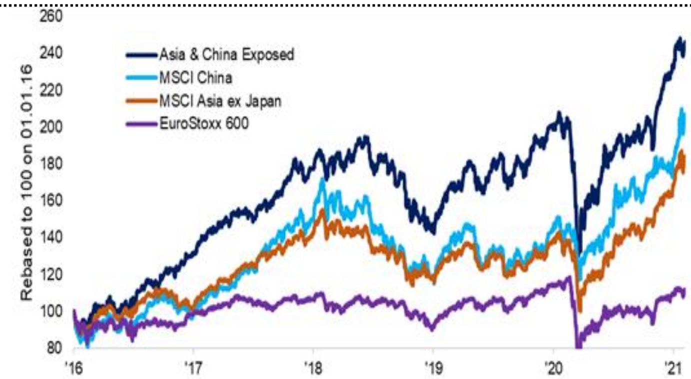
III. Dividend strategies are skewed to "Covid cyclicals" and Value: Dividend-orientated strategies are heavily biased towards "Covid cyclicals", with a market weighting in Europe and the UK of 74% and 65% respectively

Longer term investors should benefit from dividend strategies, given (1) compounded dividends have been the largest contributor to overall total returns in Europe and (2) dividend growers in Europe have shown long-term outperformance characteristics, with overall less volatility. Since early 2003, dividend growers in Europe have provided annualised total returns of 6.9%, versus broader Europe which has returned only 4.2% **- figure 11.**

Figure 11: Dividend growth strategies tend to outperform in the long-term

Source: Bloomberg as of February 20 2021. Dividend growers which have consistently grown their dividends for the past 10 years, represented by the S&P 350 Europe Dividend Aristocrat Index. 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 12: Asia exposed Europe outperformance



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.

5. Asian rebound can support European equities

As discussed in an earlier section, Asia has led globally in terms of the rebound in global trade activity, which bodes well for European exporters to 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. These names on an equally-weighted basis have outperformed over both 1-year and a 5-year periods, outperforming MSCI China, MSCI Asia ex-Japan and broader European equities **– figure 12.**

While performance has been strong, we believe this outperformance has the potential to continue for two reasons:

I. Earnings: Expected 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.

II. Industry composition: Performance 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%.

Given the momentum and our conviction in the Asian rebound story, we believe the outperformance of Asian-exposed European companies can continue, with many potential opportunities still at the single-stock level.

6. European High Yield

European high yield (HY) corporate bonds continue to provide attractive yield opportunities. While yields and spreads have tightened significantly in 2020, Euro HY still offers average yields of 3.0% and average spreads of 310bps. This looks increasingly attractive as investors are increasingly challenged in finding compelling yield opportunities. Despite initial extreme forecasts, defaults in Euro HY have stayed muted, led by lower overall levels of leverage and a small energy sector weighting.

We expect positive momentum to continue in 2021, supported by ECB bond buying of sovereigns and investment grade (IG) bonds trickling down to HY, a hunt for yield, and COVID vaccines supporting risk sentiment. We prefer the risk-reward in the "fallen angels" area, which are former investment grade bonds downgraded to high yield.

(*) "Covid Cyclicals": Financials, industrials, materials, real estate, consumer discretionary. "Covid Defensives": IT, healthcare, communication services, consumer staples, utilities.
