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Europe Strategy

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Recessionary settings to hasten disinflation?

- **Economic activity closer to bottoming out** – In the very short-term, real GDP is likely to remain close to zero. While a technical recession remains possible this winter if euro area GDP were to fall in 4Q-23, we doubt that it will be either deep or long, given the relative stability in three of our composite forward-looking indicators.
- **Monetary policy transmission dampens demand for loans** – The ECB's October bank lending survey showed that credit standards had tightened further across all loan categories and that demand for loans by firms and household had continued to decrease noticeably. Looking ahead, we would expect a positive credit impulse to signal some gains in economic activity.
- **Labour market softening to add to broadening disinflation signals** – With employment expectations softening and the PMI survey's composite measure of employment slipping into negative territory, the private sector is likely to continue shedding labour in coming quarters, which is likely to translate into a slower rate of growth in negotiated wages.
- **Central banks on hold at peak rates, rate cuts coming into focus by mid-24 –** A further normalisation of inflation expectations is likely to be a necessary condition for such a scenario to materialize in the late spring or early summer of 2024. We agree with current market pricing that Bank Rate will probably start falling around the middle of 2024, and that Bank Rate would likely fall by around 75bp to 4.50% by the end of 2024.
- **Equity strategy** – European ex-UK and Swiss equities exhibit strong positive performance 12 months after last Fed hike but show negative performance 12 months after last domestic central bank hike. UK equities display much less sensitivity to both Fed and BoE rate hiking cycle.
- **Fixed Income strategy** – European and UK bond yields fall significantly, 12 months after the last rate hike by the ECB and BoE, respectively. Plenty of opportunities presenting itself in the European and UK bond market. This analysis continues to support our view that European and UK bonds are back and should be a source of potential solid return over the next 12-18 months.

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Europe: recessionary conditions to accelerate disinflation?

Economic activity in Europe is likely to broadly stagnate in the second half of 2023. Record rates, rising geopolitical risks in the Middle East, and limited fiscal policy visibility are fueling economic uncertainty, making businesses more cautious about hiring and investments, while households are reluctant to loosen their purse strings against a backdrop of attractive savings rates and elevated inflation. Although we still judge the balance of risks to be slightly skewed to the downside in the short-term, the conditions for a rebound in economic activity in the second half of 2024 are moving into place. Accelerating disinflation should allow central banks to consider some rate cuts, likely helping investors to grow their appetite for risk.

Economic activity closer to bottoming out – The manufacturing PMI output measure was unchanged at 43.1 in October, signaling a contraction for the 17th consecutive month. Paradoxically, we think that this negative piece of news is another step closer to the end of the manufacturing recession. Indeed, quantities of purchases have been declining for 16 months, supplier delivery times have been shortening for 9 months and stocks of finished goods have been shrinking for 6 months. All these factors suggest to us that a bottom should be in sight soon, and that the next couple of quarters will likely paint a more positive picture.

In the very short-term, real GDP is likely to remain close to zero, as illustrated by the flash estimate of euro area 3Q-23 GDP which fell by 0.1% QQ after a gain of 0.2% QQ in 2Q-23. (**Figure 1**). Compared to the same quarter last year, real GDP slowed to 0.1% YY in 3Q-23 from 0.5% YY in 2Q-23. This is a challenging economic environment, but not one that resembles the much deeper falls in GDP associated with the Great Financial Crisis, Europe sovereign debt crisis or the COVID-19 pandemic. PMI composite new orders and future output measures stand at -1.5 standard deviation (SD) and -1.0SD below their long-term averages, while the composite employment measure slipped below the 50 level for the first time since January 2021.

We think that a better proxy of the level of economic activity is provided by the European Commission's economic sentiment survey, spanning five sectors and the 27 countries of the European Union. For the euro area, economic sentiment eased marginally in October, posting a 0.1-point (pt) drop to a 35-month low of 93.3, reinforcing our view that the downward momentum in business activity is softening at the start of the fourth quarter (**Figure 2**).

While a technical recession remains possible this winter if euro area GDP were to fall in 4Q-23, we doubt that it will be either deep or long, given the relative stability in three of our composite forward-looking indicators: selling-price expectations (+0.6SD above its long-term average), employment expectations (+0.5SD) and demand forecasts (-0.6SD).

Figure 1: PMIs signals downside risk to activity

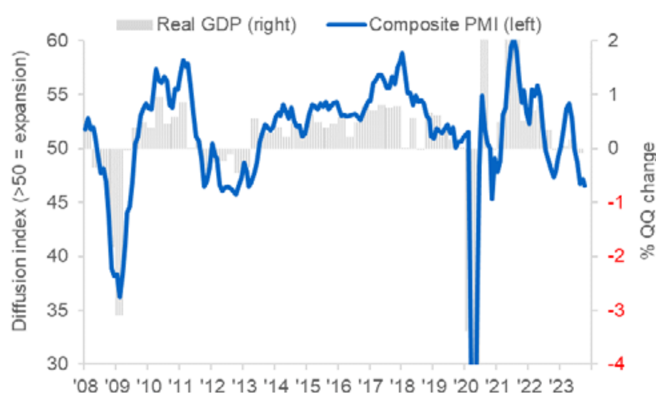


Figure 2: Very muted growth but no recession?

Sources: Eurostat, Haver Analytics, European Commission and Citi Global Wealth Investments, as of Nov 3, 2023. ESI stands for economic sentiment indicator.

Monetary policy transmission dampens demand for loans, but credit impulse likely to turn less negative – The European Central Bank (ECB)'s October bank lending survey showed that credit standards had tightened further across all loan categories due to higher risk perceptions related to the economic outlook, borrower-specific situations, lower risk tolerance and lower liquidity positions. The demand for loans by firms and households continued to decrease noticeably, driven mainly by higher interest rates, lower fixed investment for firms, lower consumer confidence and deteriorating housing market prospects for households. Banks indicated that the ECB's focus on reducing its balance sheet was a contributing factor to the tightening, while the positive impact of the much higher monetary policy rate on their net interest rate margins is expected to abate gradually. Looking ahead to 4Q-23, banks anticipate a further, albeit more moderate, tightening of lending standards (**Figure 3**). Turning to the demand for loans, expectations point to a likely deterioration driven primarily by a reduced appetite for borrowing by firms.

Figure 3: Little appetite for credit adds to disinflation

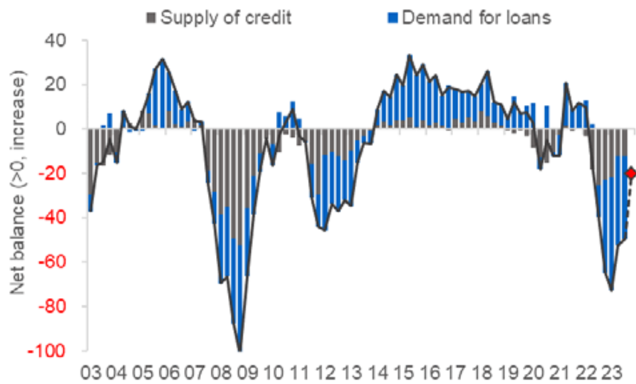
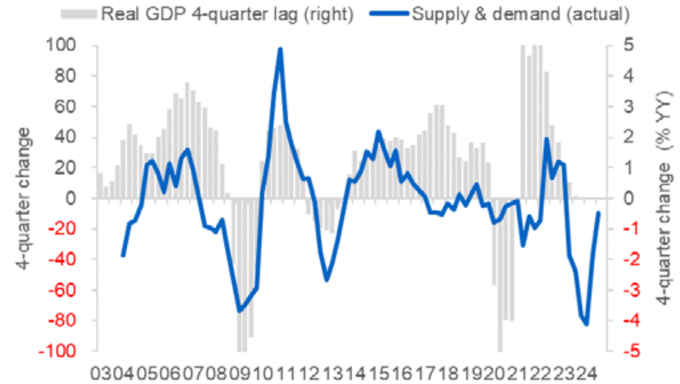


Figure 4: Credit impulse should turn positive in 2024



Sources: Eurostat, European Central Bank and Citi Global Wealth Investments, as of Nov 3, 2023.

As shown on **Figure 4**, while negative net balances continue to paint a challenging situation, the 4-quarter change in the combined measure of expected supply of credit and demand for loans improved to its highest level in six quarters. If the same level was maintained in 4Q-23, it would also show a positive impulse that ought to signal some improvement in loan volumes from the near zero levels of the last six months. This should be a signal of meaningful improvement of economic activity either in the late spring of 2024 or by early summer at the latest**.**

Labour market softening to add to broadening disinflation signals – In September, the euro area jobless rate rose by 0.1 percentage point (pp) to 6.5%. bouncing along the historical bottom of 6.4%. In the three months to September, the total number of unemployed people rose by 94,000, translating into the largest increase since the pandemic. With employment expectations softening and the PMI survey's composite measure of employment slipping into negative territory, the private sector is likely to continue shedding labour in coming quarters and likely to translate into a slower rate of growth in negotiated wages (**Figure 5**).

Figure 5: Labour market tightness set to ease

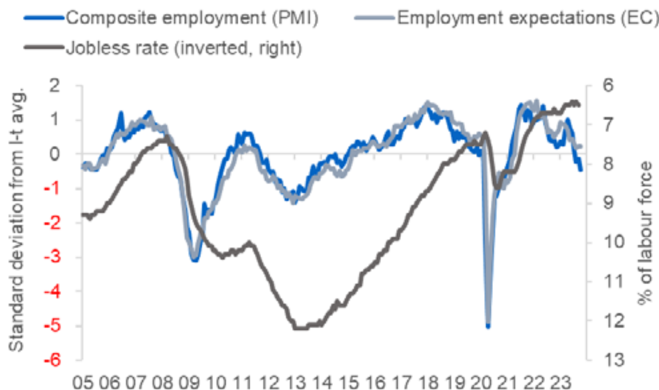
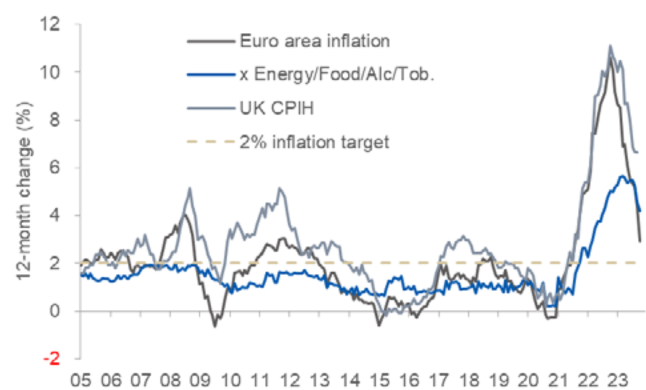


Figure 6: Inflation should continue to soften into 2024



Sources: Eurostat, European Commission, UK Office for National Statistics, and Citi Global Wealth Investments, as of Nov 3, 2023.

The flash estimate of headline euro area inflation fell from 4.3% YY in September to 2.9% YY in October. This much lower-than-expected print (the consensus forecast stood at 3.1% YY) saw the annual rate of inflation drop to its lowest level since July 2021 (**Figure 6**). This entry point for the fourth quarter also compares favourably with the 3.3% YY 4Q-23 forecast embedded in the ECB's September macroeconomic staff projections. Core inflation eased from 4.5% YY in September to 4.2% YY in October, its lowest level since July 2021. On a seasonally adjusted and annualised basis, the three-month average increase stood at 3.7% for headline inflation and 2.8% for core inflation, well below their respective peaks of 10.5% and 6.4% in November 2022. Inflation moderated in all sector splits. Food, alcohol and tobacco inflation slowed from 8.8% YY in September to a 17-month low of 7.5% YY in October. Energy deflation accelerated from -4.6% YY in September to a 41-month low of -11.1% YY in October.

As supplier delivery times shorten and producer prices fall (-11.5% YY in September), further disinflation in consumer goods prices is only matter of time. We think that small outright declines in the price of goods are possible in the first half of 2024 versus the 19-month low of 3.5% YY registered in October. Services inflation is also softening, from 4.7% YY in September to a 9-month low of 4.6% YY in October, even if the deceleration is happening more slowly given continued labour market tightness.

Central banks on hold at peak rates, rate cuts coming into focus by mid-24 – The [ECB hit the pause button on 26 October] after 10 meetings of consecutive rate hikes, leaving the deposit facility rate at 4% (**Figure 7**). The Governing Council (GC) argued that inflation having been "*too high for too long*" mattered more than downside GDP growth risks due to lower demand from the forceful pass-through of the tight monetary policy stance. Although the GC is not ready to discuss yet any significant shift in its monetary policy stance (including whether to change its balance sheet management strategy), we strongly believe that the direction of the next interest rate move is likely to be down. A further normalisation of inflation expectations is likely to be a necessary condition for such a scenario of rate cuts to materialize in the late spring or early summer of 2024.

With the deposit facility rate at a record high of 4.0%, the drop in spot inflation to 2.9% YY in October meant that real rates turned positive for the first time since February 2015. At 1.1%, real rates are well above its historical average of -4bp, illustrating how tight the ECB monetary policy stance, even if not as tight as implied by the all-time high of 177bp seen in February 2001 (**Figure 8**). Assuming an unchanged ECB policy rate and using the September ECB staff macroeconomic forecasts, real interest rates would rise from -0.5% in September to 1.1% in 4Q-24 and to 2.1% in 4Q-25.

Leaving the deposit facility rate at 4% while inflation softens further would likely impart some further tightening to financing conditions that would likely weigh on economic activity. If GDP growth is already close to flat-lining, it would most likely tip the economy into recession. As inflation continues to moderate, we would be surprised if the ECB GC begins to pay more attention to its tightness of its monetary policy stance and start discussing the conditions that would need to be met to loosen monetary policy at some point in late 2Q-24 or by the summer of 2024.

[The Bank of England (BoE)'s Monetary Policy Committee voted 6-3 in favour of keeping Bank Rate at 5.25%] for a second successive month. The other three members opposing the decision had expressed a preference of another 25bp hike. Updated GDP forecasts presented in the November monetary policy report showed a feeble UK economy skirting recession with real GDP expected to be flat in 3Q-23 and gaining 0.1% QQ in 4Q-23. While inflation is anticipated to decline from 4.75% YY in 4Q-23 to 3.1% YY in 4Q-24 and to 1.9% YY in 4Q-25, the key message was the intention to pursue a restrictive policy for a long enough given the still elevated level of underlying inflation and some expected delays in the unwinding of second round effects in domestic prices and wages. We agree with current market pricing that Bank Rate will probably start falling around the middle of 2024, and that Bank Rate would likely fall by around 75bp to 4.50% by the end of 2024.

Figure 7: Time to take stock, and wait

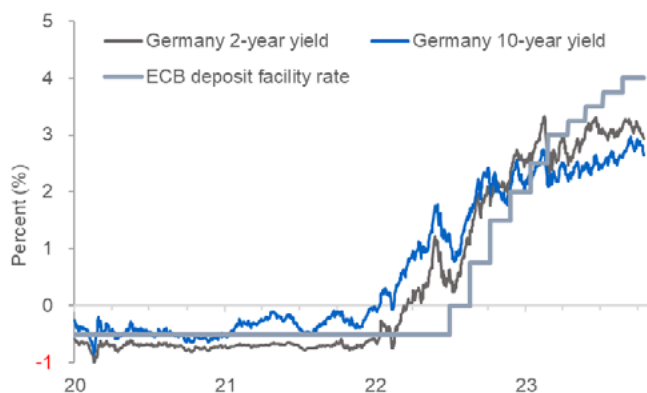
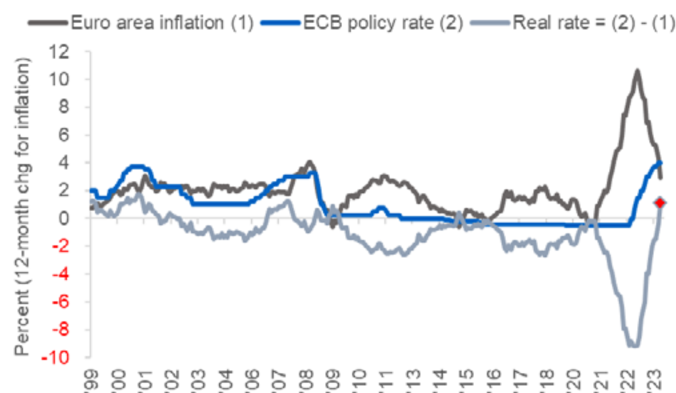


Figure 8: Above the 1999-2007 pre-GFC average



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Strategy

Equity

We believe that the Fed, ECB, and BoE have reached peak rates in their monetary policy tightening cycle. We investigate what happens to European, UK and Swiss equity markets performance in the 12 months following a peak in central bank rates. On average in the next 12 months after the Fed's last hike European equities, measured by the Stoxx 50 index, rise by around 14% (**Figure 9**). However, if we use the ECB's rate path instead, we find that Europe es-UK equities on average decline by around 27% (**Figure 10**). We see some risk that the scale and speed of this hiking cycle could see European ex-UK equities underperform in the next 12 months. This additionally supports our view to remove our slight overweight position in Europe ex-UK equities, to neutral.

Figure 9: Stoxx 50 performance after final Fed hike

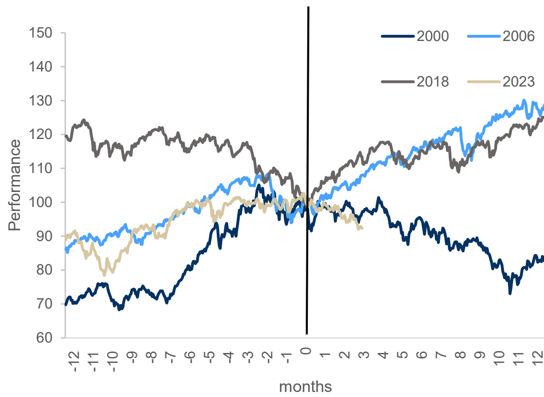

Figure 10: Stoxx 50 performance after final ECB hike

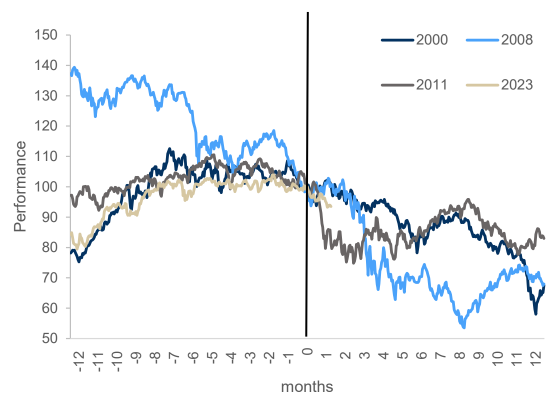

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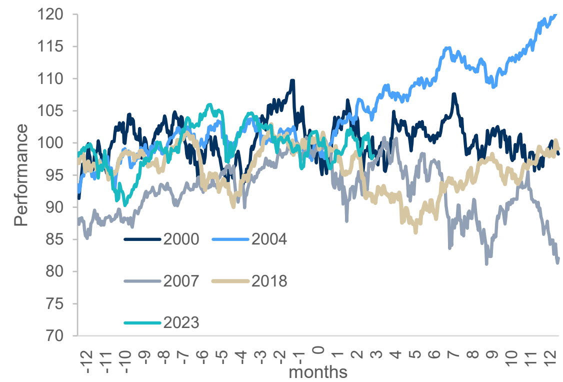
Figure 11: FTSE 100 performance after final Fed hike

Figure 12: FTSE 100 performance after final BoE hike



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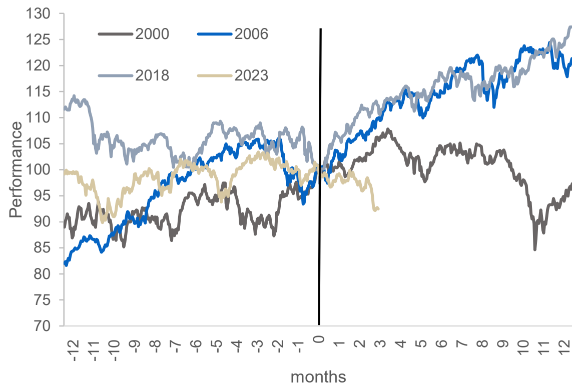
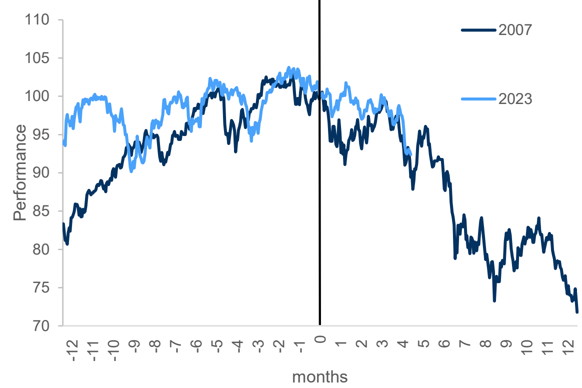
Applying the same analysis to the UK equity market, measured by the FTSE 100 index, we obtain a completely different picture. 12 months after the Fed or BoE's last hike, UK equities are displaying much less sensitivity, rising by around 7% or staying flat, respectively (**Figure 11 and 12**).

With regards to the Swiss equity market, measured by the SMI index, we find some similarities with European ex-UK equities. On average 12 months after the Fed's last hike, the market is up 15% (**Figure 13**), whereas if we were to follow the last hike by the Swiss National Bank (SNB), the Swiss equity market underperforms by 28% (**Figure 14**).

Figure 13: Swiss equity performance after final Fed hike	**Figure 14**: Swiss equity performance after final SNB hike
	

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The combination of fundamental and valuation analysis from our previous publications, and the fact that we are in a different structural regime this hiking cycle round (central banks are also conducting quantitative tightening, for the first time) suggests that, for the next 12–18-months, we should be more cautious about Europe ex-UK, UK and Swiss equities, in line with our GIC neutral recommendation.

Fixed Income

Unlike the equity markets, opportunities are presenting themselves in the European Fixed Income markets. Looking at European government bonds, 12 months after the last ECB's hike, European yields across the curve are significantly lower. 2-, 5- and 10-year yields on average have fallen by 205 basis points (bp), 158bp and 106bps, respectively (**Figure 15 and 16**).

A similar picture applies for the UK gilt market, where 12 months after the last BoE hike, 2-, 5- and 10-year bond yields are lower by 63bp, 85bp and 69bp, respectively (**Figure 17 and 18**).

This analysis continues to support our view that European and UK bonds are back and should be a source of potential solid return over the next 12-18 months. Despite our underweight position in the GIC risk 3 model dollar portfolio, we believe that for European and UK domestic investors, an overweight position in government bonds in their portfolios is warranted.

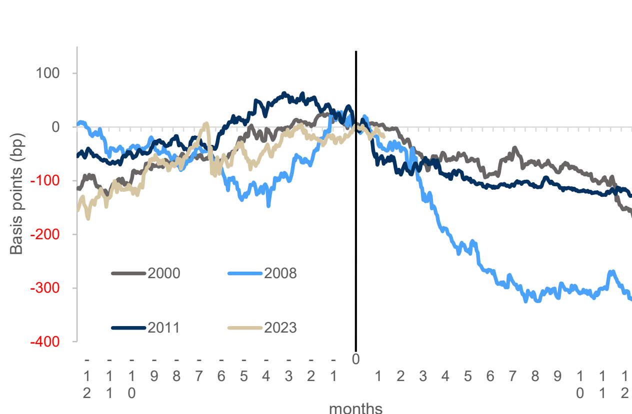
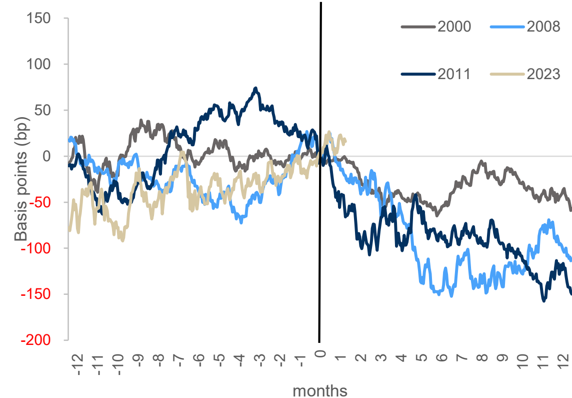
Figure 15: European 2-yr yield performance after last ECB hike	**Figure 16**: European 10-yr yield performance after last ECB hike
	

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Figure 17: UK 2-yr yield performance after last BoE hike

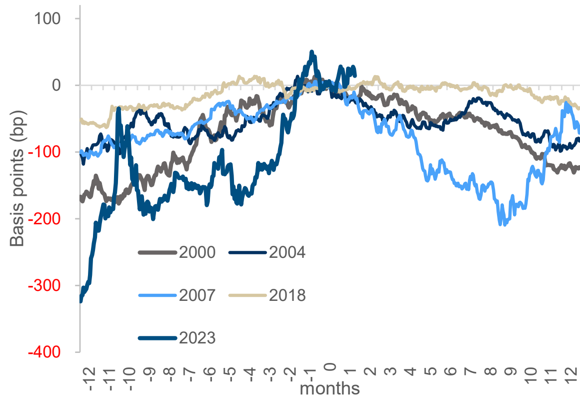
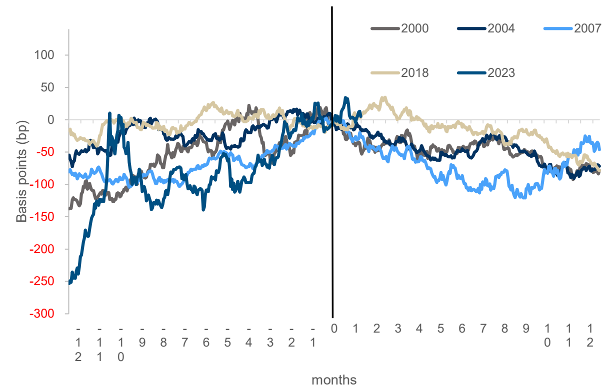


Figure 18: UK 10-yr yield performance after last BoE hike



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Alpha and/or numeric symbols used to give indications of relative credit quality. In the municipal market, these designations are published by the rating services. Internal ratings are also used by other market participants to indicate credit quality.

Bond credit quality ratings	Rating agencies		
Credit risk	**Moody's**[1]	**Standard and Poor's**[2]	**Fitch Ratings**[2]
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

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