Citi Global Wealth
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Better macro, but bank worries resurface

SUMMARY

- **Energy picture continues to improve towards the end of the heating season** – Limited upside risks to natural gas prices despite growing confidence that the path for economic activity in Europe has improved.
- **Upside surprise in activity data suggests recession will be avoided in 2023** – composite PMI levels in 1Q-23 are consistent with real GDP growth around the 2% annualized mark. We lift our EU 2023 GDP growth forecast from 0.1% to 0.8%.
- **Recovery in demand forecasts stalls and credit creation grinds to a halt** – Further gains in demand forecasts would be a necessary condition for businesses to turn more optimistic about their capex and hiring plans. Tighter bank lending standards are likely to result in a net decline in the flow of loans to the private sector.
- **Euro area inflation falls to 13-month low but core rises to a record high** – HICP fell to 6.9% YY in March from 8.5% YY in February, but core climbed to 5.0% YY from 4.8% YY, respectively. Central banks are likely to slow down the pace of rate hikes.
- **UK: Skirting recession while inflation struggles to fall** – Although the UK economy remains 0.6% smaller than its pre-pandemic level, there are signs of improvement. We also raise the UK 2023 GDP growth forecast from -0.5% to +0.2% but worry that the Bank of England might have to keep interest rates stable for longer.
- **European equity strategy** – Year-to-date European equities are continuing to outperform most developed markets when measured in both local currency and dollar.
- **Fundamentals remain strong for the European Financials sector –** For 2023, consensus EPS expectations have been revised upwards meaningfully to around 30.3% YY for European financials up from 14.3% YY in December 2022.
- **On balance, European banks' commercial real estate (CRE) exposure looks manageable**, averaging 6.4% as a percentage of total loans. Even if non-performing loans (NPLs) were to increase from record lows and affect regional banking markets where the CRE exposure as a percentage of total loans is high, we believe that the MSCI European Banking index will not be strongly affected.
- **Absolute valuations for EU financials and banks sectors have significantly de-rated** over the past month in response to growing concerns about financial institutions on both sides of the Atlantic. Despite the current cheapness, we do not think that these are compelling entry points. Given the volatility and uncertainty surrounding financial sector names and in particular banks we would rather stay cautious as sentiment remain fragile.

Better macro, but bank worries resurface

The month of March has been marked by a resurgence of some banking sector woes, prompting a repricing of the expected path of central bank tightening in the face of growing financial stability concerns. In recent week, data has on balance continued to surprise to the upside, suggesting that recession should be avoided, while inflation pressures are beginning to ease.

Year-to-date European equities are continuing to outperform most developed markets when measured in both local currency and dollar. Against a backdrop of positive data surprises, the euro strengthened versus the dollar and was relatively stable against the pound and Swiss Franc. Despite some fragilities in some parts of the global banking system, we do not believe that systemic risk will arise in the European banking system.

Energy picture continues to improve towards the end of the heating season

Sunday's announcement by OPEC+ of a 1.6million barrel per day (bpd) cut to production in the face of weaker demand is bad news for the global economy as it will create more inflationary risks at a time when global central banks are fighting hard to be compliant with their price stability mandates. Brent crude futures rose by more than 5% to around US$84.5 on Monday 3 April. If higher oil prices were to persist, demand and corporate profits are likely to be negatively affected, adding to some of the downside risks in terms of global economic activity.

During the first quarter, confidence about the likely path of European economic activity has improved thanks to continued declines in the price of electricity and natural gas. In the four weeks to the end of March, electricity futures for January 2024 were 3.2% lower than a year earlier, while natural gas futures were up 18.7% (**Figure 1**). These dynamics illustrate the progress that has been made by governments since the summer of 2022 to protect businesses and households, while diversifying natural gas supplies to Europe.

Thanks to a relatively mild winter and significant energy savings, Europe is in a much more comfortable position as the heating season draws to a close (**Figure 2**). EU natural gas storage is well above levels experienced in recent years (56% of capacity as of March 26, compared to a five-year average of 34%), suggesting that there should be limited upside risks to natural gas prices unless industrial sector demand were to increase markedly. This is clearly not the signal being conveyed by manufacturing PMIs which fell to a five-month low of 47.3 in March, extending the series of sub-50 prints to nine months.

Figure 1: Energy market normalizes

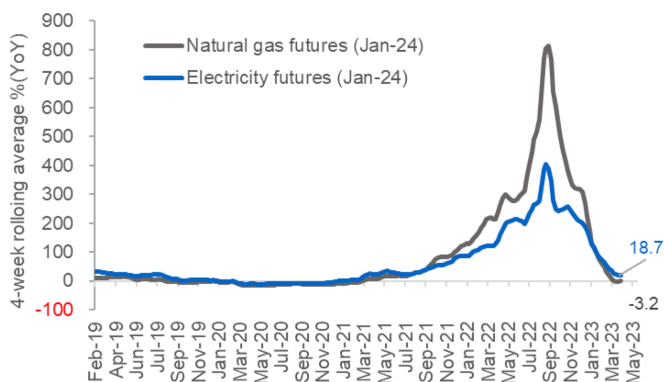
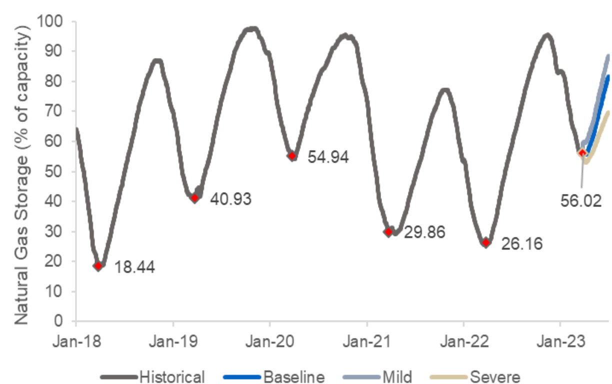


Figure 2: Natural gas storage levels are high already



Source: GIE, Aggregate Gas Storage Inventories and Citi Global Wealth Investments, as of March 28, 2023.

Upside surprise in activity data suggest that recession will be avoided in 2023

The euro area flash composite output measure surprised to the upside in March, gaining 2.1 points to a 10-month high of 54.1, a level that has historically been consistent with real GDP growth around the 2% annualised mark (**Figure 3**). After real GDP was unchanged in 4Q-22 according to Eurostat, it seems likely that a euro area recession will be avoided at the start of 2023.

There is now a clear contrast of performance between the globally exposed manufacturing sector, which is held back to some extent by the inventory cycle and still relatively elevated energy prices, and the domestically orientated services sector. Against such a backdrop, we would expect the European Central Bank (ECB) to pay more attention to the performance of services – the largest sector of the economy – given its obvious consequences on wage settlements at a time when unemployment remains close to historical lows.

Periphery countries such as Italy and Spain appear to be performing strongly, more in keeping with France instead of the clear underperformance in Germany. We think that these figures will likely reinforce the ECB's message that the economy is proving resilient to the interest rate hiking cycle, with firms operating in the services sector enjoying a solid period of expansion.

As economic activity most likely grew in the largest EU countries in 1Q-23 and worries about energy scarcity fade into the background, the time is right to add to our forecasts for EU and UK GDP in 2023, lifting the annual averages from 0.1% to 0.8% and from -0.5% to +0.2%, respectively. We no longer believe that real GDP will decline for two consecutive quarters in the first half of 2023. Instead, we estimate that economic activity will be more likely to flat-line or expand marginally in 1H-23 before some modest acceleration in 2H-23. We keep our 2024 GDP forecast unchanged at 1% for both the EU and the UK (**Figure 4**).

Figure 3: PMIs surprise to the upside in 1Q-23

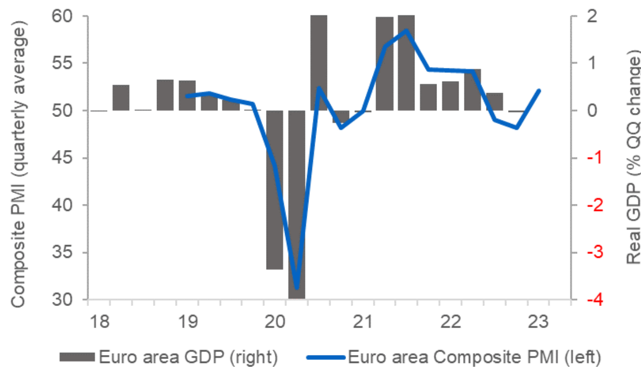
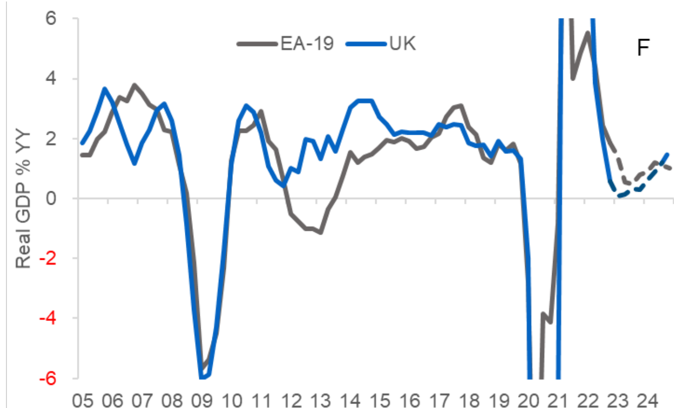


Figure 4: Recession should be avoided in 2023



Sources: Haver Analytics, Eurostat, UK Office for National Statistics and Citi Global Wealth Investments, as of April 3, 2023.

Recovery in demand forecasts stalls and credit creation grinds to a halt

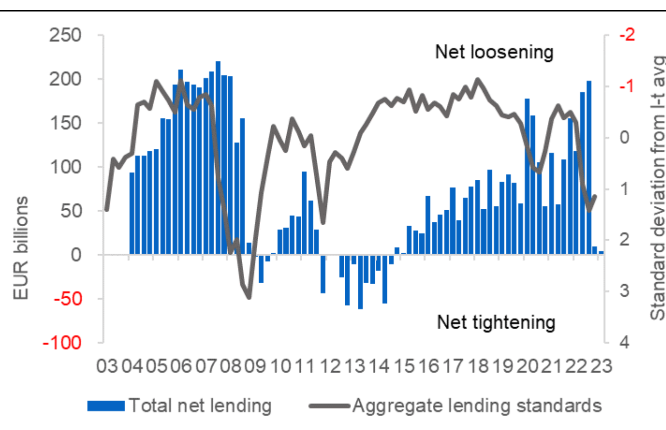
While the European Commission survey for March confirmed that the euro area had probably avoided recession in 1Q-23, both the euro area and EU Economic Sentiment Indicators (ESI) lost 0.3 points (pt), falling to three-month lows of 99.3 and 97.4 respectively. The euro area ESI averaged 99.5 in 1Q-23, its highest level since 2Q-22, suggesting that real GDP growth is unlikely to have been negative at the start of 2023.

Three of the five sectors, retail (-1.2pt), industry (-0.6pt) and construction (-0.6pt) recorded some declines in March, while sentiment was largely unchanged in services and for households. Among the largest EU economies, the ESI rose by 2pt in Italy to 104.6, by 0.9pt in the Netherlands to 98.3 and by 0.7pt in France to 98.0. In Germany (-0.1pt to 97.9), Spain (+0.1pt to 99.7) and Poland (+0.3pt to 90.3), the ESI was essentially stable.

Importantly, the recovery in demand forecasts has stalled in the last two months, with the index now treading water around 0.5 standard deviations (SD) below the historical average (**Figure 5**). Further gains in this measure would be a necessary condition in our view for businesses to turn more optimistic about their capex and hiring plans. Given the likely further tightening in bank lending standards during the second and third quarter of 2023, we struggle to see much more upside in economic sentiment in the short-term, unless there were to be a further sharp decline in selling price expectations (**Figure 5**), which hit their lowest level in 18 months in March to +2.2SD. Selling-price expectations are now the lowest in industry (+1.2SD), followed by construction (+1.6SD), services (+3.9SD) and retail (+4.8SD). Note that although employment expectations softened marginally in March, at +1.0SD they remain comfortably above their long-term average, suggesting that a marked slowdown in wage growth is unlikely in 2023, which will likely keep core inflation elevated.

Figure 5: Demand forecasts are levelling off

Figure 6: Credit creation is slowing dramatically



Sources: European Commission, European Central Bank and Citi Global Wealth Investments, as of March 28, 2023.

As banks turn less optimistic about the economic outlook, a larger net proportion of banks look set to tighten their lending standards. The consequence will likely be a further reduction in the amount of credit available to the private sector (**Figure 6**). Total net lending to the euro area private sector by monetary and financial institutions stood at €5bn in the first two months of 2023 combined. This was the smallest amount since 1Q-15.

Lending to households also slowed to 3.2% YY in February from 3.6% YY in January. From a monthly net lending perspective, households continued to borrow, but the three-month net flow of loans stood at €23.1bn, its lowest level since May 2020. For non-financial corporations, net lending contracted by €15bn in the three months to February, reducing the annual growth rate from 6.1% YY in January to 5.7% YY in February. Such a trend does not bode well for hiring or investment decisions in coming months.

Monetary policy tightening is contributing to the fall in money supply and credit growth rates. A lot of attention will continue to be paid to these dynamics in 2Q-23 to determine if lending standards are being tightened too aggressively. If this were to be the case, one could envisage an earlier end of central bank rate hikes.

Euro area inflation falls to 13-month low but core rises to record high

The euro area flash inflation estimate fell to a 13-month low of 6.9% YY in March from 8.5% YY in February. Compared to the 7.1% YY consensus forecast, this downward surprise is further evidence that inflationary pressures are diminishing, helped by the fact that energy inflation has also turned negative to -0.9% YY for the first time since Feb-21. Core inflation, however, rose to a new record high of 5.7% YY, matching consensus expectations, reflecting another increase in services inflation to a new peak of 5.0% YY in March from 4.8% YY in February. Labour market data for the month of February showed that the total number of unemployed in the euro area had fallen by 59k, while the jobless rate remained at all-time low of 6.6% according to Eurostat.

Evidence of diminishing price pressures is becoming more compelling. For instance, German import price inflation (2.8% YY in February) fell below export price inflation (6.6% YY), highlighting the terms-of-trade shock reversal. This will be one the factors that should support the euro and will also contribute with a lag to a likely dampening of import price pressures. Euro area producer price inflation fell to a 19-month low of 13.2% YY in February. With industry selling price expectations continuing to normalise producer prices should quickly fall back into single digit territory and contribute to much lower prints in non-energy industrial goods inflation.

Using seasonally adjusted data from Haver Analytics, and focusing on a short-term frequency, consumer prices are increasing at a rate of 3.8% and core inflation is climbing by 6.1% on a three-month annualised basis in March (**Figure 7**). Such readings are obviously too high for the ECB to take comfort from, and we would expect most Governing Council (GC) members to indicate that further rate hikes would likely be needed to bring down inflation towards the 2% target. Yet, these measures confirm that the peak of the inflation wave is behind us, likely giving the GC some scope to reduce the size of future monetary policy tightening decisions.

Figure 7: Inflation pressures are softening

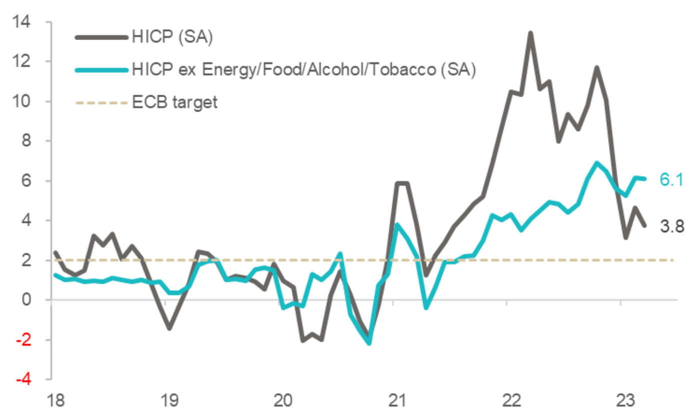
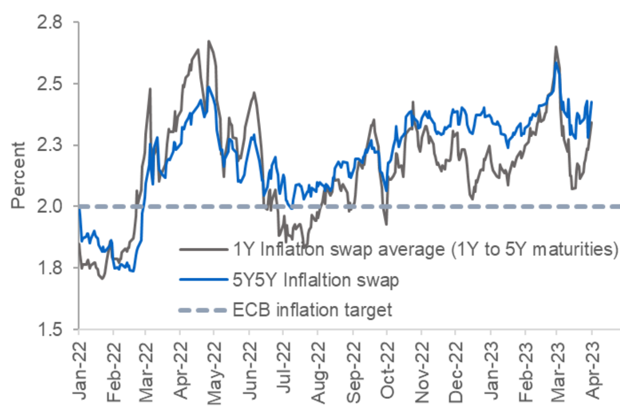


Figure 8: But remain too high for comfort



Source: Eurostat and Citi Global Wealth Investments, as of March 28, 2023. 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.

Banking sector worries have been center stage in March. European Central Bank (ECB) President Christine **Lagarde** delivered the keynote speech at "The ECB and Its Watchers XXIII" conference in late March, stressing that the European banking sector is "*resilient, with strong capital and liquidity positions*" while noting that "*in view of recent financial market volatility, we are ready to act and provide liquidity support to the financial system if needed and to preserve the smooth transmission of monetary policy*". At the same time, she reiterated that "*there is no trade-off between price stability and financial stability*," arguing that the ECB stands ready to act to preserve the smooth transmission of monetary policy.

Lagarde nevertheless explained that the ECB is likely to take decisions on interest rates on a meeting-by-meeting basis. While indicating that the future monetary policy path will depend on **i)** staff inflation projections, **ii)** the dynamics of underlying (core) inflation (and those of wages), **iii)** monetary policy transmission, President Lagarde was clear that more restrictive credit conditions are part of the mechanism to rein in excessive price pressures.

Despite high uncertainty about the impact of the banking turmoil on financial institution's lending behaviour, we think that most GC members agree that core inflation remains too high. Furthermore, the inflation swaps market suggests that the ECB has done enough to regain control of inflation in the medium term (**Figure 8**).

April PMI reports, with the final estimates to be released on the morning of the 4 May ECB monetary policy meeting, will be crucial to determine the size of the next hike. On 2 May, the ECB will also release its April bank lending survey giving a clearer picture of the quantity, prices and conditions of loans make to the economy in 1Q-23 and

expectations for 2Q-23. We continue to think that two more 25 basis point (bp) rate hikes are likely to be delivered at the 4 May and 15 June monetary policy meetings, likely implying a terminal deposit facility rate of at least 3.5%.

UK: Skirting recession while inflation struggles to fall

The United Kingdom narrowly avoided a recession in 4Q-22, with GDP expanding by 0.1% QQ after a flat reading in 3Q-22. Yet, the UK trails behind most developed economies for its recovery with real GDP still 0.6% below its pre-pandemic level, a combination of much higher-than-expected inflation, earlier monetary policy tightening and adverse fiscal conditions (**Figure 9**). As the UK is a large importer of energy, elevated commodity prices impacted terms-of-trade significantly in 2022, adversely affecting GDP growth.

After the Bank of England (BoE) increased Bank Rate on 11 occasions (from 0.1% in Dec-21 to 4.25% in Mar-23), the UK housing and mortgage markets have been hit hard. Yet, mortgage approvals rose from 39.6k in January to 43.5k in February, the first increase since August 2022, pointing to a potential stabilisation in the UK housing market in coming months/quarters.

Figure 9: GDP levels vs. pre-pandemic

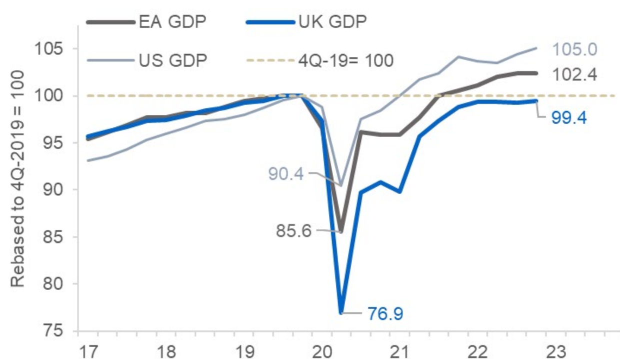
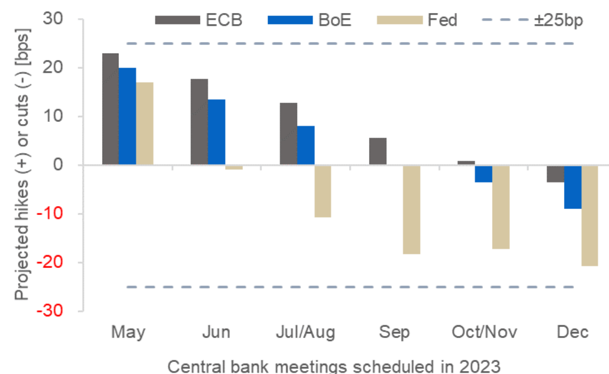


Figure 10: Rate hiking cycle coming to an end



Source: Eurostat, UK Office for National Statistics, US Labour office, Bloomberg and Citi Global Wealth Investments, as of April 4, 2023.

Since 4Q-22, consumers and businesses have been feeling less pessimistic despite inflation remaining close to record highs at 10.4% YY in February. Therefore, if UK headline and core inflation remain elevated in April and May, we would expect the Monetary Policy Committee to hike interest rates once more time in this cycle resulting in a terminal Bank Rate of 4.5%. We see a clear risk that the Bank of England might have to keep interest rates stable for longer than the indicative market pricing of a small rate cut by year-end (**Figure 10**).

Strategy

Year-to-date European equities are continuing to outperform most developed markets when measured in both local currency and dollar (**Figure 11**). Against a backdrop of positive data surprises, the euro strengthened versus the dollar and was relatively stable against the pound and Swiss Franc.

The failure of Silicon Valley Bank (SVB) in the US had negative repercussions for European markets, triggering some meaningful divergence between the Stoxx 50 index and some of its sub-sectors, with European financials falling by 6% in March (**Figure 12).** Banks, which account for around 50% of the European financial equity index compared to 30% for insurance and 21% for diversified financials, felt the brunt of the sell-off. Insurance and diversified financial sectors also sold off but to a lesser extent.

Figure 11: Equity and FX market performance

	1M	YTD	1M	YTD
	Local (%)		USD (%)	
Equity indices				
Stoxx 50	1.8	13.7	4.3	15.4
FTSE 100	-3.1	2.4	-1.1	4.5
DAX	1.7	12.2	4.2	13.9
CAC 40	0.7	13.1	3.2	14.8
Swiss	0.1	3.5	2.6	4.4
S&P 500	3.7	7.5	3.7	7.5
MSCI World	3.1	7.3	3.1	7.3
FX				
EURUSD	2.5	1.3		
EURCHF	-0.4	0.3		
EURGBP	-0.1	-0.7		
GBPUSD	2.6	2.1		
CHFUSD	2.9	1.0		

Figure 12: Rate hiking cycle coming to an end

Europe Sectors		
Region	1M (%)	YTD (%)
Financials	-6.6	6.6
Banks	-10.7	7.9
Diversifed Financials	-2.4	7.9
Insurance	-2.7	3.7
Energy	-5.1	0.4
Industrials	3.4	15.1
Consumer Discretio	5.9	21.7
Consumer Staples	6.1	8.3
Health Care	6.6	6.3
Information Technology	8.8	22.7
Communication Services	3.2	17.3
Utilities Sector	6.7	10.1
Materials	1.1	5.2
Real Estate	-7.6	3.6

Source: Bloomberg and Citi Global Wealth Investments, as of March 31, 2023. Returns are in USD terms. 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.

Fundamentals

Despite some fragilities in some parts of the global banking system, we do not believe that systemic risk will arise in the European banking system. While financials could remain under pressure if concerns related to liquidity and/or solvency persist, the downside for large cap equity financials should nevertheless remain limited, due to the implementation of stringent EU banking regulation since the Global Financial Crisis. However, we do see potential consequences arising for smaller, including mid-tier banks, which could suffer from bouts of deposit flight.

Fundamentals remain strong for the European Financials sector. In fact, Financials consensus earnings per share (EPS) estimates have notably been revised up since the end of 2022, boosted by the higher interest rate environment in response to central bank actions. For 2023, consensus EPS expectations have been revised upwards meaningfully to around 30.3% YY for European financials (**Figure 13**) up from 14.3% YY in December 2022, whereas the overall Europe index only stands at 1.3% YY compared to -0.1% YY last December.

Figure 13: European Sector EPS YY growth (%)

	Wgt	EPS YoY % (31 Mar 22)			EPS YoY % (30 Dec 22)		
	%	22E	23E	24E	22E	23E	24E
Europe	**100**	**16.3**	**1.3**	**8.1**	**20.5**	**-0.1**	**6.5**
Energy	6.6	142.4	-23.5	-7.7	143.8	-14.3	-14.3
Materials	7.4	6.6	-22.7	2.6	10.5	-23.5	2.4
Industrials	14.3	18.1	-0.7	11.3	20.5	-2.9	8.8
Consumer Disc.	10.2	12.1	4.9	11.6	20.3	-5.1	10.5
Consumer Staples	13.1	12.2	4.3	9.3	11.0	7.4	9.4
Health Care	16.2	8.4	5.3	12.5	11.1	7.0	11.9
Financials	16.5	-13.4	30.3	11.0	-3.6	14.3	12.1
IT	7.0	3.8	14.8	15.8	4.4	15.7	15.7
Communication Services	3.3	38.7	4.3	10.1	38.7	5.0	10.6
Utilities	4.4	28.0	-3.6	4.8	11.4	10.8	4.9
Real Estate	0.9	-16.7	-38.0	38.4	-8.1	-18.8	6.4

Sources: Citi Research, Worldscope, MSCI, Factset. Data as of 31 Mar 2023. Blue means the – the largest negative double digit negative EPS readings for this year. Gold means – sectors we looking to favour this year. Note: The above data are compiled based on companies in MSCI AC World Index. The market capitalization for regions, markets and sectors are free-float adjusted. P/E, EPS Growth, P/B, Dividend Yield and ROE are aggregated from Factset consensus estimates (calendarized to December year end) with current prices.. Past performance is no guarantee of future returns. 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. Past performance is no guarantee of future returns. 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. Past performance is no guarantee of future results. Real results may vary.

Note that as shown on Figure 14 and 15, the financial sector and the banking sub-sector have seen net positive EPS revisions in March despite the banking market turmoil of the past few weeks.

Figure 14: Net positive EPS revisions for Financials

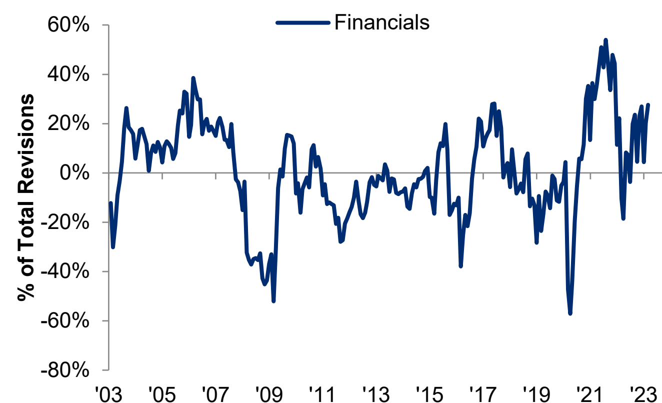
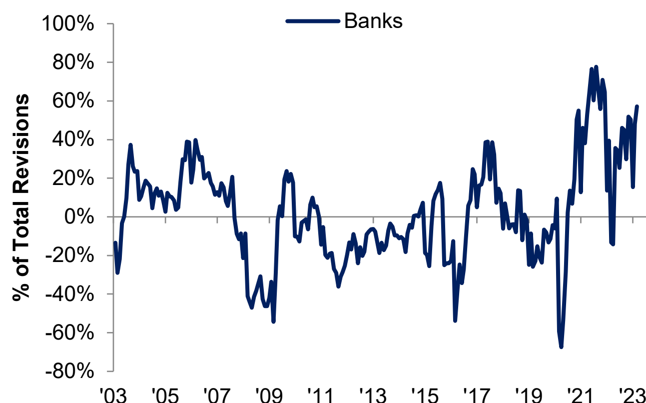


Figure 15: Net positive EPS revisions for Banks



Source: FactSet and Citi Global Wealth Investments, as of March 31, 2023. Past performance is no guarantee of future results. Real results may vary.

Although we have argued that European banking system is in relatively good health on many important metrics such as deposit flows, capital and liquidity ratios, and the outlook for earnings appears more favourable, questions remain about the risk exposure of EU banks to the commercial real estate (CRE) market. According to the European Systemic Risk board (ESRB) report[1], most European countries recorded an increase in CRE loans in 2021 when compared to 2020.

[1] European Systemic Risk Board (ESRB) Risk Dashboard, November 2022 (Issue 42)

The European Banking Authority (EBA) shows that European banks 'CRE loans NPL ratio is on average around 4% (**Figure 16**), but there is significant dispersion around the mean, with much higher levels in the euro area periphery.

Given the likelihood of a further increase in interest rates during the spring of 2023 (as we expect the ECB could increase its main policy rate by a total of 50bp to 3.5%), there could be some upward pressure on NPL ratios across the board, even if a European recession can be avoided.

On balance, European banks' CRE exposure looks manageable, averaging 6.4% as a percentage of total loans (**Figure 17**). Interestingly, lending to the CRE sector is much lower than the average in Spain for example, whereas countries in Northern Europe such as Sweden and Germany for instance have much greater exposure.

As a result, even if NPLs were to increase from record lows, and affect regional banking markets where the CRE exposure as a percentage of total loans is high, we believe that the MSCI European Banking Index will not be strongly affected. This is because of the relatively high share of UK banks (31.1%), French banks (13.2%) and others (18.1%), including Germany.

Figure 16: EU CRE loans NPLs ratio

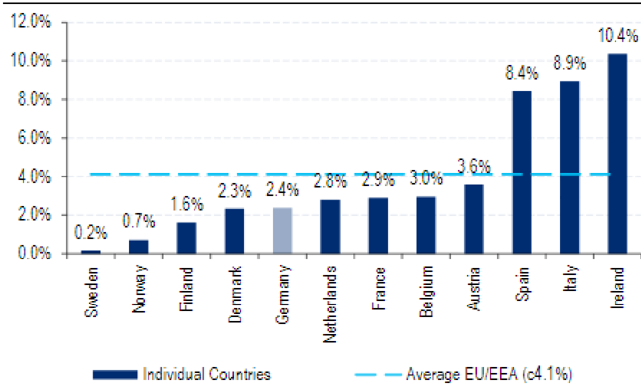
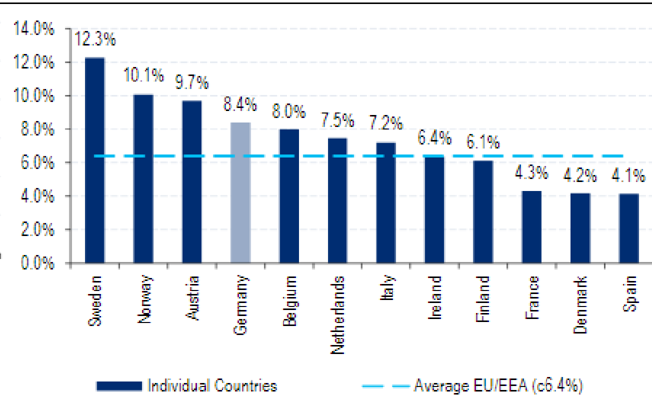


Figure 17: EU Bank CRE loans as % of total loans



Source: Bloomberg and Citi Global Wealth Investments, as of March 31, 2023. Past performance is no guarantee of future results. Real results may vary.

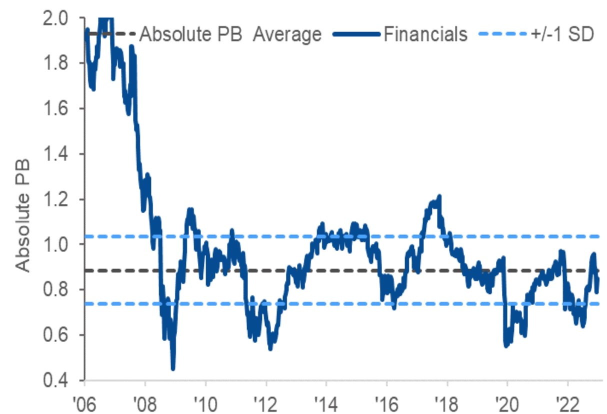
Valuations

Valuation in Europe ex-UK have been cheap since February 2022 (**Figure 18**). Over the course of 2023, we think that European ex-UK equities are likely to see multiple expansion. On an absolute basis European ex-UK P/E has rebounded off its 10-year low in late September and is now closer to its fair-value, even if it derated slightly in recent weeks due to the banking market turmoil.

Absolute valuations for EU financials and banks sectors have significantly de-rated over the past month in response to growing concerns about financial institutions on both sides of the Atlantic (**Figure 19**).

Figure 18: Europe ex-UK nearing 15-year average

Figure 19: Financials PB de-rate slightly



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Even on a relative basis, European financial and bank equities have de-rated relative to the broad European index (**Figure 20 and 21**). Despite the current cheapness, we do not think that these are compelling entry points. Given the volatility and uncertainty surrounding financial sector names and in particular banks we would rather stay cautious as sentiment remain fragile and unexpected deposit outflows could lead to more underperformance in the short term. Although large cap European financials/banks equities should enjoy better fundamentals, they too could be victims of sudden shift in sentiment. With time, investors might be more relaxed about some stability in deposits and the ability of institutions to navigate the higher interest rate environment. This ought to be positive in the medium term. For now, we are comfortable with our neutral on European financial sector and banks.

Figure 20: European Financials relative to Europe have cheapened recently

Figure 21: European Banks trade cheap on a P/B basis

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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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