

# CIO Strategy Bulletin

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## The Inevitable Rise

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**Summary:** Equity markets are consolidating after a severe drop and sharp rebound. Though the index performance appears “too good” given the collapse in the global economy, markets are more discerning. Certain industries were more deeply impacted than others: US auto production was near zero in April, an all-time record low. Retail sales fell by a record amount as stores were forced to close. Air travel was down 95%. But early signs suggest sharp “snap back” effects from reopening that will be dramatic. Just as Chinese auto sales returned to normal levels in just four months, so too shall many US companies. We see “green shoots” across much of the US, from housing, to miles driven, to outdoor dining. In time, the rapid resumption of economic activity is likely to surprise investors and allow some of the more beaten down components of world equity markets to revive. In this issue, we explain the depth of the decline, the inevitable rise and where investors might look to find hidden value.

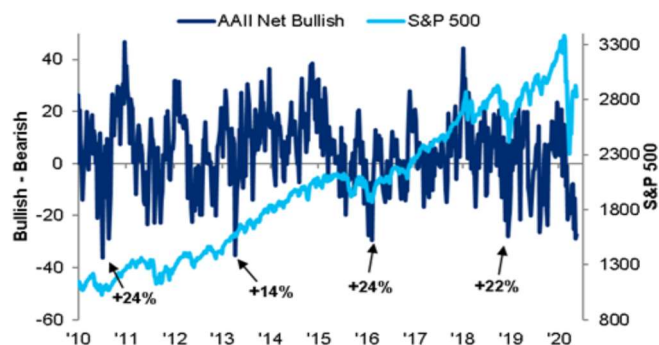
## One Index, Two Markets: COVID Cyclical vs COVID Defensives

After falling 35% to March 23 and then rising more than 30%, world equity markets fell this past week.

Equity markets usually reflect where the economy is soon headed. It is therefore striking that markets have been able to see beyond the current record-breaking economic declines. Strikingly, investor sentiment is nearly as bearish as we’ve ever observed and has become more bearish as markets rallied (see Figure 1). Pundits have explained the rebound as investors “chasing the rallies” due to a “fear of missing out”. Yet, our client portfolios are dramatically overweight cash, much more than at any time since the Global Financial Crisis period. For now, many investors have missed the rally, especially if they were sellers in March. Investor bearishness and fear remain a contra-indicator.

We are harboring no doubts about the accuracy of our near-term profit forecasts that show a 60%+ year/year **decline** in the April-June quarter. These results will be much worse than the first quarter just reported. But the severe second quarter losses will be **concentrated in certain industries and certain companies**. In the US, earnings losses will be worst in the sectors with the greatest job losses. The leisure and hospitality, retail, education and health workers accounted for more than 60% of the 20.5 million job losses in April (see figure 2). The level of “leisure and hospitality” jobs – think restaurants and hotels – fell nearly 50% in a month. But just as they were displaced, millions of these employees could be recalled within a mere two months time.

**Figure 1. US Investor Net Bullish Sentiment vs S&P 500**  
(arrows show subsequent 12-month returns)

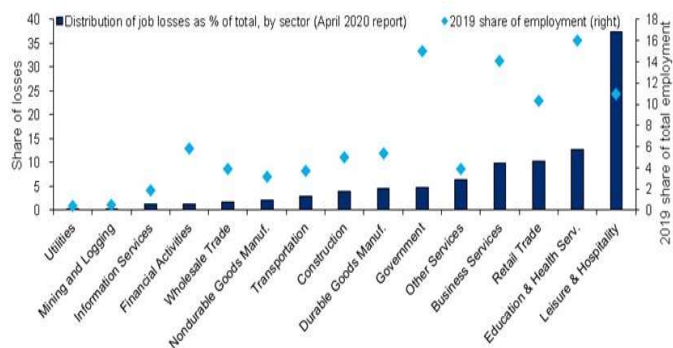


Source: Haver Analytics, CPB OCIS as of May 8, 2020

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All forecasts are expressions of opinion and are subject to change without notice and are not intended to be guarantees of future events.

**Figure 2. Three sector groups account for over 60% of job losses in April**



The US stock market is driven by ever-more dominant large cap technology and digital services firms virtually built to be “COVID Immune.” These few and mighty firms have posted year-to-date share price gains. When sophisticated and famous investors are pointing to high stock prices, they are likely focused on what we call “COVID Defensives.” These companies are in specific industries including Information Technology, Healthcare, Staples and E-Commerce that have dramatically outperformed in the US market and globally. COVID Defensives now represent 57% of world market capitalization, a four-decade high share of value.

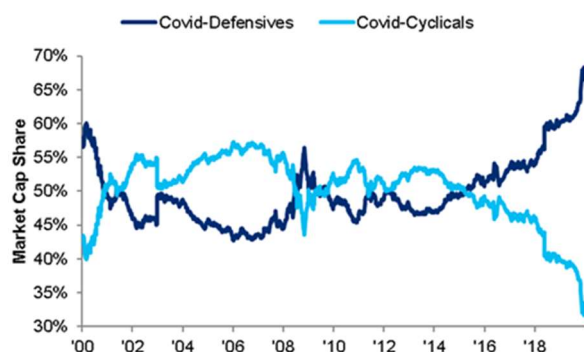
The fact that the S&P500 hasn’t moved in lock step with Main Street makes sense. For investors, the strong performance of COVID Defensive equities and the equally strong performance of other large cap companies reflect the success of policy makers as well as important and fundamental changes in market leadership.

Our Citi Private Bank [\*\*“Unstoppable Trends”\*\*](#) reflect “COVID Defensive” outperformers (please see [Outlook 2020 Themes section](#) and [Citi Global Multi-Equity Portfolio](#)). These include:

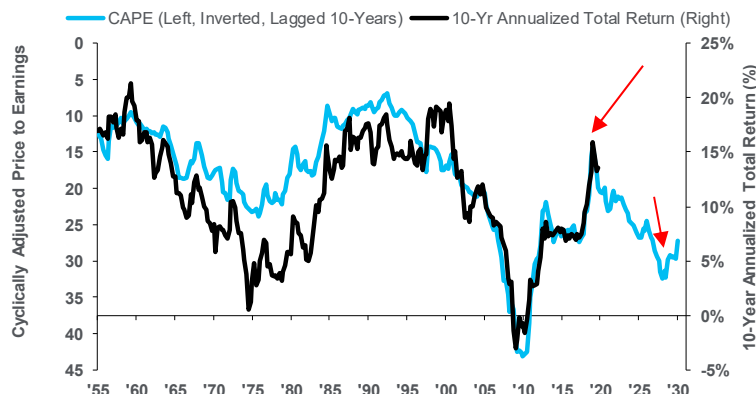
- “Digitization”: the many forms in which economic activity is moving into virtual space;
- “Invest in Longevity”: Even more than other periods, a health pandemic demands higher healthcare spending;
- “Asian Development”: Stay tuned this election season as China has outperformed in 2020; and
- “The Next Energy Revolution”: With lockdowns destroying energy demand, the traditional fossil fuel-laden energy sector has been the worst performing industry this year.

We continue to recommend that investor portfolios reflect these long-term enduring growth themes. That said, those looking for extraordinary future returns from a market depression have been shut out by policymakers focused on the public wellbeing. Our own estimates for *US large cap* share prices now point to only a *moderately stronger* 10-year return outlook than was likely from early 2020 highs (see Figure 4).

**Figure 3. US “COVID Cyclicals” vs “COVID Defensives” – Shares of Market Cap (%)**



**Figure 4. S&P 500 Cycle Adjusted Valuation and Subsequent 10-Year Return**



Source: Haver Analytics, CPB OCIS as of May 8, 2020.

Note: Largest 5 US firms by market cap are Covid Defensives: MSFT, AAPL, AMZN, GOOGL, FB. US Covid defensive sectors are IT+Amazon, Healthcare, Staples, Communications Services, Utilities. Covid Cyclicals are Energy, Materials, Industrials, Discretionary, Financials, Real Estate. The stocks are shown for illustrative purposes only and do not represent the performance of any specific investment. This is neither a solicitation to buy nor a recommendation to sell any of the aforementioned securities. Past performance is no guarantee of future results, and future results may not meet our expectations due to a variety of economic, market and other factors. All forecasts are expressions of opinion and are subject to change without notice and are not intended to be guarantees of future events.

## Where the Green Shoots Are or We Will Get Through This

US employment, retail sales and production data for April all made grim record declines. Like China that reported similar statistics in February, we will undoubtedly see declines of similar scope for most of the remainder of the world. Larger declines will still be reported in Europe even as March data and 1Q data illustrated a near record pace of contraction. **If the US were to post monthly job declines as large as April, no one at all would be employed in the US economy in just six months.**

For the many who doubt that the current US recession will be short, consider that past shorter, milder recessions typically resulted in net monthly job declines persisting for about a year or longer. Historical recessions rarely started with the largest declines near the beginning. Yet, this is a different recession, one that has been caused by an exogenous factor. As Figure 5 shows, forcing businesses to purposely shutdown creates quite a different employment, production and retail spending dynamic than a typical recession -- If you force retailers to close and the population to shelter in place, than retail sales are bound to crash.

## The Rebound in China Portends a Strong US Rebound

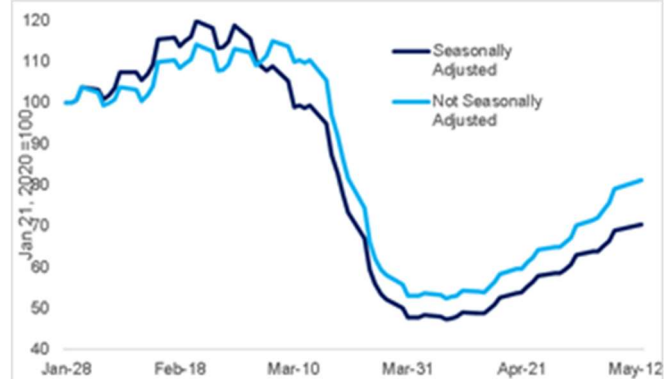
There's no doubt about the severity of the economic crash. But we believe that the data in coming months will challenge investor expectations of continuous declines and a long duration recession. We believe that the green shoots from the re-opening of the economy are already underway. Let's compare the path of the US economy to China, where the largest disruptions took place just two months earlier. As Figure 6 shows, **Chinese production and retail sales are rapidly rebounding.**

**Figure 5: US Retail Sales & Industrial Production****Figure 6: Chinese Retail Sales & Industrial Production**

Source: Haver Analytics, as of May 15 2020.

## Driving Up!

Even accounting for the seasonal variation of improving weather, daily data show US driving has rebounded 20% already as economies begin reopening (see figures 7-8.) US car and truck production fell to nearly zero in April, the lowest pace in history. For auto production, there is literally nowhere to go but up (see figure 9). Large automakers posted severe losses in the 2008/2009 period. We expect the same this year. Yet, it remains a fact that the present pace of auto production would clear inventories at any sales pace above zero.

**Figure 7: US and Chinese Auto Sales****Figure 8: US Daily Miles Driven Index: Apple Data**

Source: Haver Analytics, as of May 15 2020.

Note: Driving data are seasonally adjusted using historical Department of Transportation monthly seasonal factors.

## Oil Up!

Oil is another leading indicator for recovery. This week, the US saw its first weekly decline in private crude oil inventories. As share prices lost a bit of altitude this past week, we found it most interesting that global crude oil prices strengthened over the course of the week (see Figure 10). Crude oil demand is a real-time consumption indicator for the most Covid-battered sector, Transportation.

Of course, the driving data in figure 9 and numerous other indicators show a record decline in demand. Thus, severe global production cuts are needed to avoid shortages of storage space for petroleum. But production cuts, coupled with a return of drivers from Ford to Ferrari can rebalance supply as Citi Research's Forecasts show for the remainder of 2020.

**Figure 9: US Car and Truck Production**



**Figure 10: S&P 500 vs Brent Crude Oil Daily**

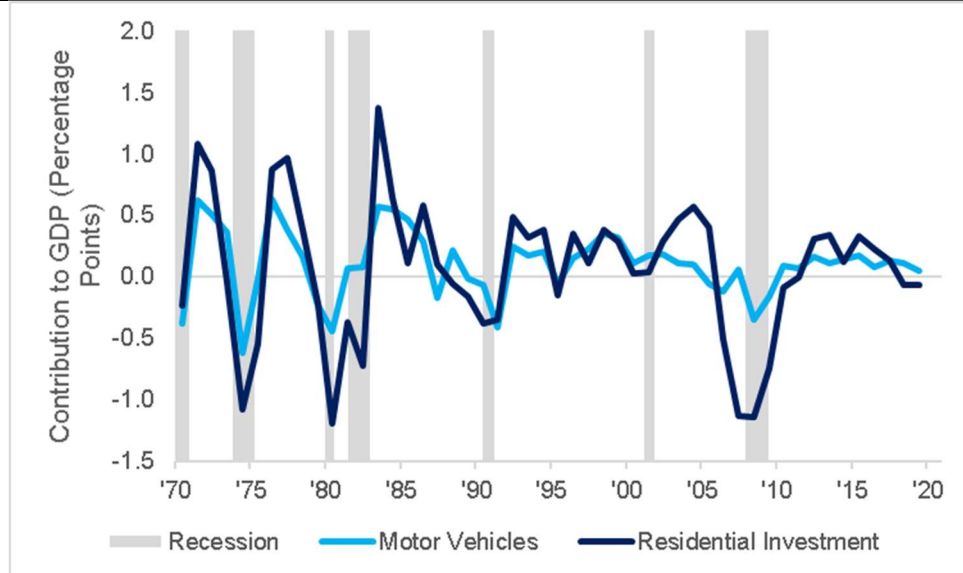


Source: Haver Analytics and Citi Research, as of May 15 2020. Citi Research Estimates noted in Fig. 10 are as May 15th. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Index returns do not include any expenses, fees or sales charges, which would lower performance. For illustrative purposes only. Past performance is no guarantee of future results. Real results may vary.

## Housing Up!

The US is among the most clearly cyclical economies. It has by far the greatest breadth and historical continuity of data to study. This history shows Housing and Autos to be key sectors driving recession and recovery in most cases (see figure 11). We believe that the rebound in Chinese auto sales, with April 2020 data equal to production in December 2019, is indicative of what we will see in the US. Similarly, housing should move through a sharp, short, shock.

**Figure 11. US Home Construction and Vehicle Sales Contribution to GDP %**



Source: Haver Analytics as of May 8, 2020

The real estate industry, which still requires substantial social interaction at its heart, has been disrupted near-term by COVID. But the lack of “boom” during the decade past is a reflection of relatively tight lending standards. Banks have slightly tightened lending standards (Figure 12), but they never eased sharply in the past decade’s recovery. While that made for a poor recovery after the Great Financial Crisis, it speaks of a more rapid recovery now. The pre-Covid low level of home sales hasn’t taken a remarkable hit thus far, as weekly loan applications data suggest (see figure 13).



**Figure 12: US Net % Banks Tightening Lending Standards for Home Mortgages**



**Figure 13: US Mortgage Purchase Applications**



Source: Haver Analytics, as of May 15, 2020.

In fact, the outlook for home sales and single-family construction is really dependent going forward on jobs returning. Given that 60% of job losses occurred in industries that are among the lowest paying, US job losses are falling more significantly on renters than potential buyers. Meanwhile, the employment data also showed 80% of workers who lost jobs reported that they are on temporary furlough (see figure 14). While the actual number is bound to be somewhat lower, in past downturns, this number was never higher than 25%. Thus, we still think there will be a rebound in housing demand in 2021, perhaps one stronger than expected.

### **The Green Shoots Face Risks: COVID Up!**

As the world re-opens, we will face an ugly, but real trade-off between health outcomes and the speed and depth of the economic recovery. We know that different countries are responding with different policies. As we have written before (see [The COVID Tug-of War](#)), the ideal policies are centralized and contain testing, tracing, sustained social distancing, identification of “hot spots” and actions to mitigate same, as well as corporate and business actions to mitigate the spread of disease in the workplace. To the extent the government, corporate and business actions are coordinated, the ability to manage the disease and the economic reopening are more likely to result in better outcomes for both: a faster economic recovery and fewer cases and deaths.

The opposite is also true. Absent coordination on economic and health policy, the disease will rebound, first in pockets and then in larger clusters until there is a place, perhaps a city or a business, which cannot function given the level of disease and the impact on its health system. This is a major risk to confident markets. While we expect a “second wave” of the disease, we have not assumed this will result in another lockdown that collapses the economy.

In the meantime, we should be grateful that the macroeconomic policy response to the crisis was much better than the lack of advanced planning or uneven government reactions to the pandemic.

## **Investing for the Year Ahead: The COVID-Cyclicals and SMID Sectors We Like**

Warren Buffet did not see an opportunity to buy assets broadly in his most recent public filings. This differed sharply from 2009, when markets were deeply depressed and offered exceptional value most anywhere (See [Powell 1](#), [Buffett 0](#)). This COVID-led recession is different. There has been a sharp economic decline, a rapid fall in equity prices, a huge anticipatory response by governments and a stock market rebound. Some months ago, we compared the incipient shutdowns to a “national strike”, one that is now ending as economies re-open.

Expectations for recovery will help make recovery a reality. Here are three such ideas: Homebuilders, Automation and Financial Services and Software.

### **The Home Builders**

Spring is normally home-buying season. With lean inventories, high employment and low interest rates, the Spring of 2020 was poised to be a strong home buying season. Instead, COVID-19 closed sales offices and kept buyers at home. But unlike 2008, where the housing crisis was at the epicenter of the recession, this is a health crisis with deep and uneven economic impacts. Builders are running leaner inventories, land portfolios are well managed, balance sheets are healthier and consumer creditworthiness is quite good. Yet, we will be reading about mortgage defaults and forbearances among existing homeowners. So, why should one consider buying the homebuilders?

- **Demand is High:** Demographics favor home builders as higher birth rates from 1945-60 and 1985-95 (the Boomers and Millennials) translate into more buyers. The younger cohort are having families while the older segment is downsizing, but seeking a high quality life. Boomers have more savings than any other segment and homeownership among Millennials has begun to rise. .
- **Housing Supply is Low:** The existing homeowner vacancy rate is at the lowest level since 1994 and the inventory of existing homes for sale is as low as it has been for 30 years. Limited land supply and rising construction costs are also limiting the availability of new homes
- **Industry Leaders are Strong:** Homebuilding leaders do not have liquidity or credit issues and have credit facilities to meet their 2020/21 obligations.
- **Rates are Low:** Low mortgage rates create affordability. Mortgages are plentiful for qualified buyers and banks are eager lenders. Lending standards typically get tighter during recessions and that will provide some headwinds for marginal buyers.
- **Stocks are Attractively Priced:** The four industry leaders are trading at 1.1x their tangible book value versus a five-year average of 1.65x. The four are down an average of 30% from their recent highs. Assuming that 2021 EPS recovers as virus fears subside, we would expect homebuilders to rebound from current levels. .

**Figure 14: Homebuilders Return YTD**



**Figure 15: Home Builders Debt to Equity**



Source: Factset, as of May 15, 2020.

Past performance is no guarantee of future results. Real results may vary. The chart shows the performance of a basket of homebuilders stocks (DHI, PHM, NVR and LEN) on an equal weighted basis. 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, and future results may not meet our expectations due to a variety of economic, market and other factors. Real results may vary. This is neither a solicitation to buy nor a recommendation to sell any of the aforementioned securities.

## Automation

Many predict that the COVID19 pandemic will change our lives forever. Our view is slightly more conservative. We expect many parts of the economy to return to their pre-virus normal when a vaccine is identified and introduced broadly. However, what has changed permanently in our view is the pace of technological adoption. COVID has catalyzed between five and ten years' worth of technological adoption in a very short space of time. Within just a few weeks and months, huge swathes of the workforce moved to work almost exclusively from home, students who were used to being in school every day switched to e-learning from one day to the next and we all became more reliant on e-commerce, food delivery, online gaming, streaming and even virtual doctor's visits.

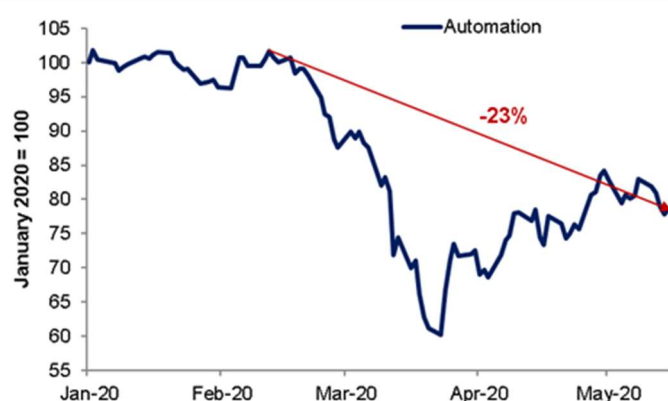
Of course, these trends were underway before the pandemic. In many cases, our view has held exposure to key stocks

linked to these themes. . The pandemic, however, has turbo-charged many of these trends. Part of this rapid acceleration is in the area of automation; the greater use of technology and machines in the manufacturing process. We expect that this trend still has considerably further to go. Here is why:

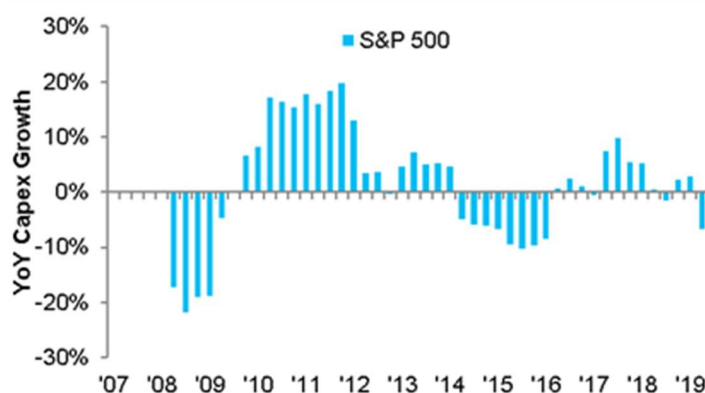
- **Deglobalization:** Bringing supply chains closer, especially in high cost manufacturing economies, is a boom for automation. As tensions between the US, Europe and China rise due to new political and competitive realities, the demand for capex including technologies that enhance productivity will rise exponentially.
- **Productivity Will Matter More Now:** Notwithstanding likely productivity losses thanks to the ongoing pandemic, we believe that we are on the cusp of a new phase of productivity gains globally, driven by advances in automation and robotics themselves. Manufacturing, customization and speedier delivery are all aided by the use of automation.
- **Robots Don't Get Sick:** Populist headlines have often focused on the extent to which manufacturing jobs are at risk both from immigration as well as automation. Having just experienced a record surge in unemployment completely unrelated to either, the narrative has shifted to how can greater automation help insulate the economy from similar shocks in the future.

You would have expected that leading automation stock would have rebounded quickly, but that has not been the case (see Figure 16). The near-term catalyst driving these trends we think will be the unleashing of pent-up corporate capex. Companies' capital expenditures have been subdued in recent years, even before COVID19, due to uncertainties around trade wars and politics (see Figure 17). As capex ramps up again in late 2020, we expect it to focus disproportionately on automation.

**Figure 16: Automation Stocks YTD**



**Figure 17: S&P 500 Capital Expenditures**



Source: Factset, as of May 15, 2020.

Past performance is no guarantee of future results. Real results may vary. The chart shows the performance of a basket of Automation stocks (6954 JP, HEXAB SS, KGX GR, HON) on an equal weighted basis. 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, and future results may not meet our expectations due to a variety of economic, market and other factors. Real results may vary. This is neither a solicitation to buy nor a recommendation to sell any of the aforementioned securities.

You can see why we like this sector by comparing important financial characteristics. Despite lower debt levels and higher profitability, automation companies have performed just slightly better than the broader Global Industrials sector. Given these firms' orientation towards future innovation in the "industrials technology" space, we would expect these types of business models to outperform in the new economic cycle. (see Figure 18.)

**Figure 18. Automation Basket Leverage, Profitability, and Performance**

Sector	Debt to Equity	Oper. Margin	YTD Return
Automation Basket	61.38	18.02	-20.95
Global Industrials	118.92	9.24	-24.21
Global IT	60.17	17.23	-1.04

Source: Factset and Citi Private Bank OCIS as of May 15, 2020

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## Financial Software and Services

When most of us think about Fintech, we typically think about payments companies such as PayPal or Square, companies that have streamlined the transfer of money or improved the customer experience at the point of sale. These companies are visible with strong branding in many cases. And their stock have performed well, even recently.

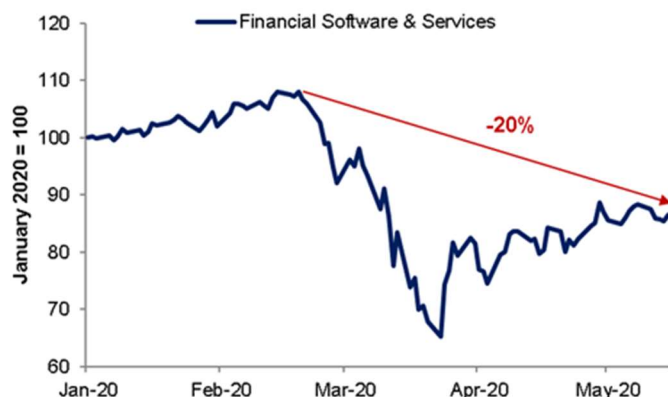
However, the Fintech space is made up of a broad ecosystem of companies, each specializing in a niche, be it Wealth Management, Insurtech or Regtech to name a few. While payments companies have already embedded a lot optimism on the economic recovery, some other branches of the Fintech space - particularly those which have banks as end customers - have traded more like the banks they seek to serve. We believe that their intermediate and long-term growth potential is greater than traditional banks. And thus we think these companies deserve a second look and a higher valuation. Here's why:

- **Banks Must Automate:** With falling interest rates and legacy computer systems that they must maintain, banks need solutions to help them modernize systems more efficiently. Enterprise software and commerce systems will serve as the new plumbing for banks that are unable to develop their own solutions in an efficient manner.
- **Asset Management Matters:** As traditional banking margins shrink, asset and wealth management are becoming a more important source of consistent revenues. Yet, those businesses are also facing margin compression and competition from start-up enterprises that have all-digital capabilities. To create better client experiences and to deliver more information in ways that clients appreciate, companies that have apps and personalized offerings that banks can "plug in" to are being adopted more quickly.
- **Better Core Banking:** Rather than develop any new software, small, medium and now larger banks are using third party providers to harvest and analyze customer data. This allows them to cross-sell products, improve the customer experience and gain wallet share. As banks have to compete with an ever increasing array of incoming disruptors, financial software and service providers are essential, especially in developed markets where digital banking is lagging.

Just as banks have traded down, these financial and software services companies have too. Yet, unlike banks, they do not have balance sheet write-downs to take and do not suffer from pandemic impacts. Banks, on the other hand, will need to accelerate their upgrading of systems and software to generate higher levels of earnings in a lower interest rate environment. That's just what the financial services and software firms need to accelerate their growth.

**Figure 19. Financial Software & Services Basket YTD**

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Source: Factset and Citi Private Bank OCIS as of May 15, 2020

Past performance is no guarantee of future results. Real results may vary. The chart shows the performance of a basket of financial software & services stocks (SEIC, FIS, TEMN SW and FISV) on an equal weighted basis. 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, and future results may not meet our expectations due to a variety of economic, market and other factors. Real

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results may vary. This is neither a solicitation to buy nor a recommendation to sell any of the aforementioned securities.

You can see why we like this sector by comparing important financial characteristics. Financial services and software companies have lower debt levels, competitive operating margins and, despite operating more as tech companies than banks, have performed more poorly than fintech and the information technology software and service industry during this crisis. (Figure 20) We believe the extent of this underperformance is unjustified and presents an attractive entry point.

**Figure 20. Financial Services & Software: Leverage, Profitability, and Performance**

Sector	Debt to Equity	Oper. Margin	YTD Return
Financial Services & Software Basket	53.62	20.01	-14.68
Fintech	73.21	21.18	-5.28
IT Software/Services	78.57	28.26	5.59

Source: Factset and Citi Private Bank OCIS as of May 15, 2020  
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## Conclusion

As the economy reopens, we expect a sharp rebound in economic activity from lows never reached before. While deeply impacted industries will take time to recover, some sectors will bounce back faster than expected. Thus, watching the indices alone will be deceiving and cause investors to wait, when they should be investing. To have a large decline in the indices will require that the COVID-defensives perform poorly relative to investor expectations. Markets are also factoring in the larger and, so far, effective fiscal and policy responses in the US. With an election on the horizon, there are risks on the rise. Nonetheless, for investors with a view of a year or more, some of the more beaten down components of world equity markets contain real value

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