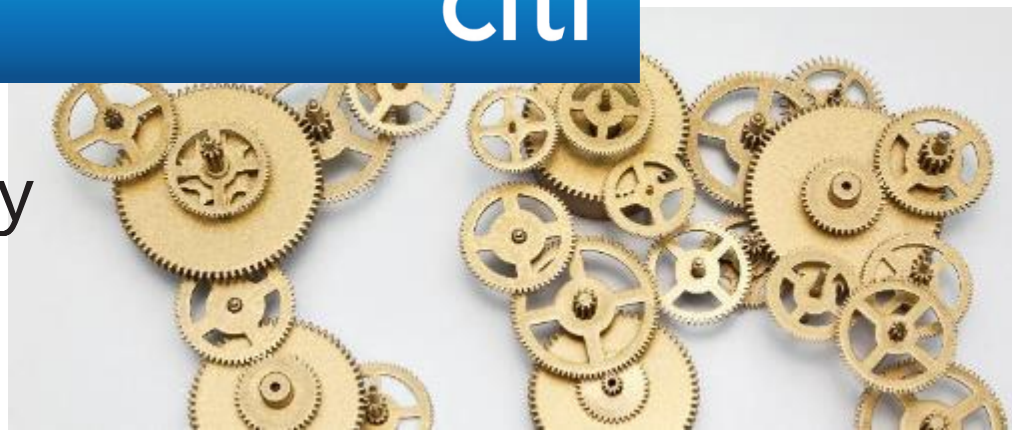
Private Bank



# CIO Strategy Bulletin

June 21st, 2020

## A Pandemic Pause Amidst the Recovery:
### Finding Value in Value Equities

**David Bailin**, Chief Investment Officer
**Steven Wieting,** Chief Investment Strategist and Chief Economist
**Malcolm Spittler**, Global Investment Strategy
Maya Issa and Shan Gnanendran contributed to this report

### Summary

- **We believe that the improving financial conditions, supportive macroeconomic policies, improving sentiment by consumers and business suggest that the new economic recovery will endure. We expect financial market volatility to remain high as investors process the many powerful cross-currents and uncertainties we face.**

- **The global stock markets had a "pandemic pause" last week because the spread of COVID-19 remains a major threat to people and economies. Bearish sentiment among US investors is explainable, in part, by concerns about reopening of the economy and the increased incidence of the virus rising across the country. We would point out that that bearish sentiment can also be a contra-indicator for markets.**

- **We recommend studying the unusual pattern that the economy and markets are demonstrating. Cyclical equities, which are predominantly value rather than growth stocks, industrials instead of technology, have become unusually undervalued. We would point out that recent election cycles have also favored value over growth, even though both have appreciated after elections.**

### The Recovery

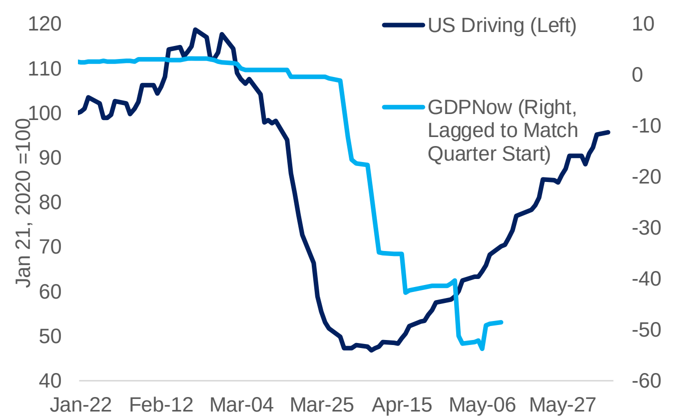
When we look at the "data" we see critical elements of a V-shaped recovery. The snap back in economic activity is clear. US manufacturing rose 3.8% in May after a record April plunge. Sentiment by manufacturers surveyed by the Federal Reserve Bank of Philadelphia indicates optimism hit a 28-year high. US retail sales posted a 17.7% gain in May, the largest monthly rise in history. Homebuilder sentiment jumped 21 percentage points in June after building permits jumped in May. And people are driving again, getting "on the road" at 95% of normal levels for this time of year. This activity confirms our thesis that after an exogenous shock, there will be a partial "return to normal" that is faster because (1) the economy was healthy before the pandemic began and (2) the fiscal and monetary policy support was both massive and timely.

In May, US employment rose by a record 2.5 million after a much larger plunge in April of 20.7 million. This was despite a high level of layoff activity that continued through last week. In April, a record 78% of those losing jobs expected it to be a temporary furlough and it now appears returning workers are outnumbering the job losers. These strongly recovering data points should help many investors understand how equity markets have so quickly collapsed and rebounded. The economy is following the same pattern.

**Figure 1: Year-to-date US Retail Sales and Industrial Production**


Source: Haver Analytics as of June 15, 2020

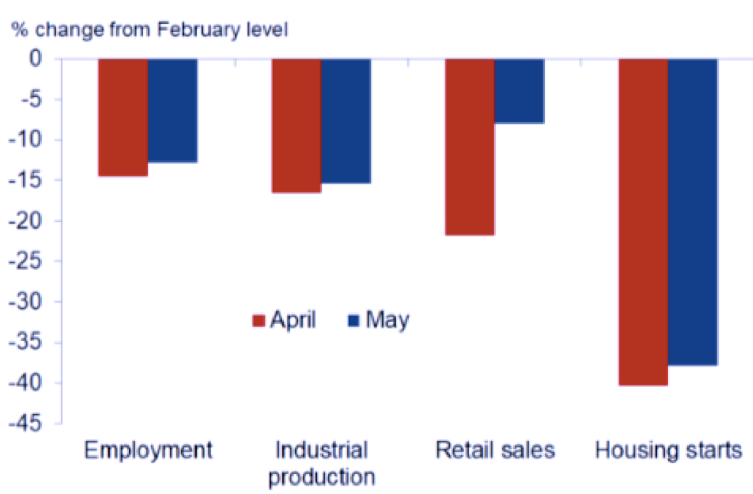
**Figure 2: US Miles Driven Index (Apple Data, Seasonally Adjusted) vs Atlanta Fed "GDP Now" Measure**




Source: Haver Analytics as of June 15, 2020.

But, the "V" we see is lopsided, with a sharp down stroke and a mild upstroke. Following a strong initial rebound, the recovery pace will quickly slow. And that's because there are large elements of our economy that cannot come back quickly or, in some cases, for a time at all. Flying, sport and music events, restaurants and personal services are all deeply impacted. We also see negative impacts on imports and exports that portend a slower recovery after the initial bounce. You can see how far we need to come back by comparing April and May data (Figure 3 below.)

**Figure 3: April and May data compared to February level**



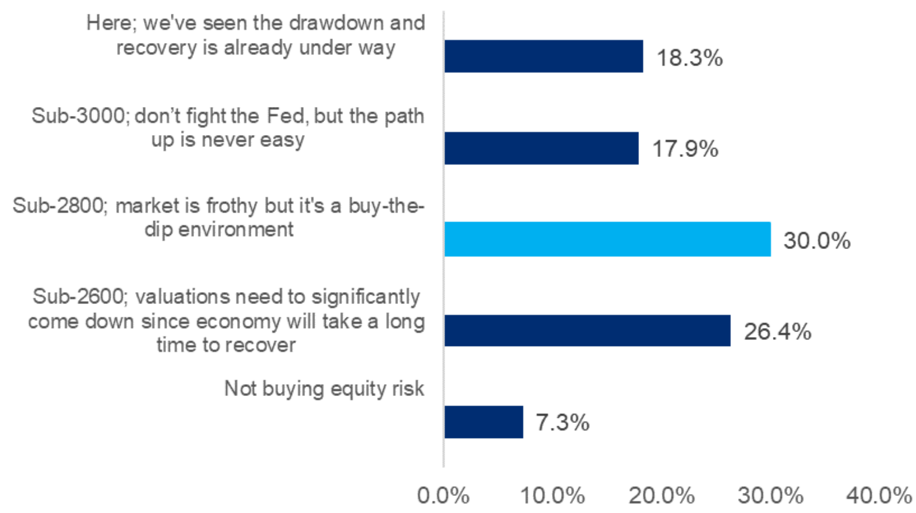

Source: Oxford Economics/Haver Analytics as of June 19, 2020.

## Aftershocks

We expect financial market volatility to remain high as investors process the many powerful cross currents and uncertainties we are experiencing.  We believe that improving financial conditions, supportive macroeconomic policies, improving sentiment by consumers and business suggest that the new economic recovery will endure.

To understand the likelihood of further volatility, one need only look at the sentiment of investors.  (Figure 4.)   Citi Equity Trading Strategy surveyed more than 1,800 global institutional investors last week. The survey skewed bearish with over half of participants looking for a drop below 2800 or 2600 before buying equities.   In spite of the obvious dip-buying mentality in the data, one third of respondents are comfortable owning stocks at or close to these multiples.  Interestingly, looking just at North American respondents, only 11% of US investors were buyers at current market levels, with 62% of them waiting for either 2800 or 2600.   This bearish sentiment among US investors is explainable, in part, by concerns about reopening of the economy and the increased incidence of the virus being experienced across the country.  We would also point out that that bearish sentiment can also be a contra-indicator for markets.

**Figure 4: Where are you a buyer of equity risk (using S&P 500 as a proxy)?**

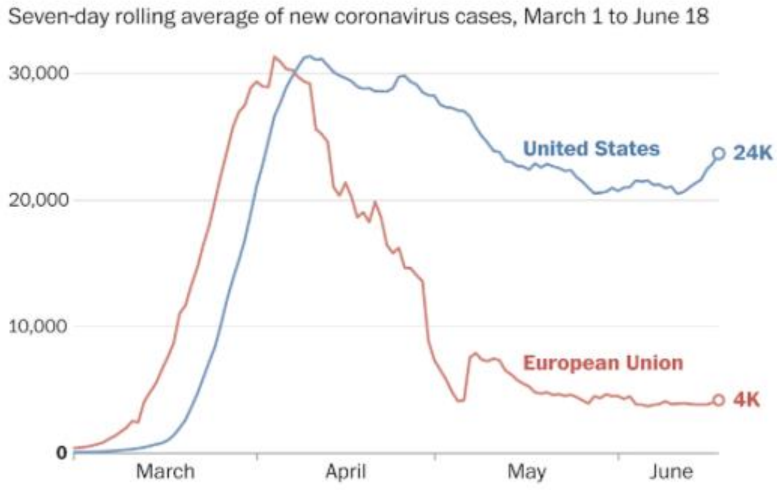



Source: Citi Equity Trading Strategy as of June 19, 2020.

## A Pandemic Pause

The global stock markets had a "pandemic pause" last week because the spread of COVID-19 remains a major threat to people and economies.  The US approach to the pandemic is also looking markedly different than Europe and Asian responses.  How different?  Have a look at Figure 5. The US is "reopening" having never successfully mitigated the disease.

**Figure 5: Coronavirus cases in the United States have not fallen as much as in the European Union**




Source: Johns Hopkins University as of June 19, 2020.

The United States came out of lockdown over six weeks on a rolling State-by-State basis. As individual States emerge from the first-order effect of lockdowns, the result has been a uniform, major jump in economic activity, but an acceleration in the spread of the virus across half the country. This is in stark contrast to Europe whose plans to mitigate the virus are more centralized and consistent.

## Apple and China React Quickly

This week we read that Apple is closing stores in four states in the U.S. As of June 20th, Arizona, Florida, North Carolina and South Carolina will shutter locations to protect employees and customers. These locations happen to be where the seven-day average of new coronavirus infections has risen the most recently. Apple previously closed its stores in China and then globally as the pandemic took root and it had been reopening stores as the level of disease in various placed abated.

Beijing announced its first domestically transmitted coronavirus case in the past two months last week. Then, using contact tracing, it rapidly identified a market in Beijing's southeast as the epicenter of an outbreak of 155 cases. Though this is a small number of cases in a city of 22 million people, China promptly cancelled 1,200 flights, closed schools that had just reopened a month ago and began rapid testing of hundreds of thousands of people. Just two weeks ago, the Chinese had suggested that its success in containing the coronavirus could be a model for the world. Apparently, the virus had other ideas.

## "Irrational Behaviors" In the US

In contrast to China and Apple, four factors have impacted the US response to the pandemic:

(1) The lockdown of the US took place hesitatingly and regardless of the level disease in a given location. Thus, for those who locked down in a town or state where there was little disease, the reaction seemed overwrought. In places where the virus was prevalent, the strict measures worked effectively and compliance with social distancing and masks afterwards is higher.

(2) In the US, the coronavirus became a political issue. The federal government contradicted the assessment of its own scientists, criticized the Centers for Disease Control and withdrew from the World Health Organization. The counts for testing, hospitalization and even deaths were called into question. Marc Lipsitch, Harvard epidemiologist, said he presented some of his research to a White House group in the early stages of the U.S. response. He noted, “I think they have cherry-picked models that at each point looked the most rosy and are fundamentally not engaged with the magnitude of the problem.” Thus, rather than acting holistically, the “economy” and “preventing disease” became opposing objectives. In the Wall Street Journal last week, Vice President Pence said the US was “winning the fight against the invisible enemy” in spite of a rise in cases in 22 states. In contrast, Anthony S. Fauci said, “I don’t like to talk about a second wave right now, because we haven’t gotten out of our first wave.”

(3) An absence of fear: In an interview with Nicolas Taleb this week, he identified a “Black Swan” in the US response to the pandemic. He said, “I think we reacted too late. I was expecting that we humans would have a natural paranoia that makes us cut losses early. To give you an example, in the Middle Ages, as soon as cities suspected that a caravan or ship would have any possibility of harboring a sick person, they established a quarantine. They took no chances. Our society is over-intellectualized. Our grandmothers understood (the threat) better than we do. So, in a way, we have had some kind of a backward evolution in our understanding of tail risks.”

(4) Without truly understanding the extent and likely length of the pandemic, US leaders and polarized constituents are ironically experiencing fatigue associated with the early response. As one Washington Post reporter noted, “Facing uncertainty and economic pain, they have fallen back, choosing to surrender rather than sacrifice.”

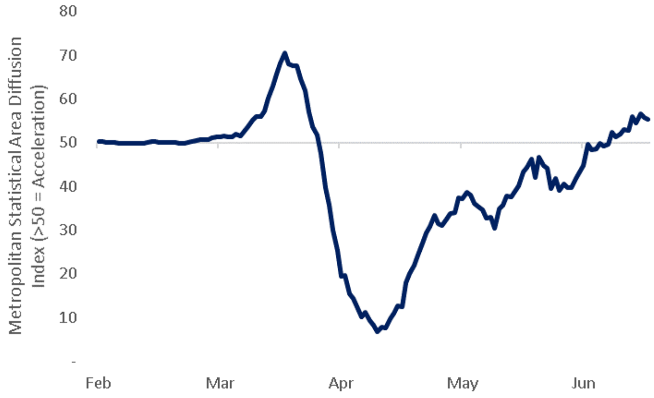
## Risks and Implications

Citi Private Bank has established a proprietary "COVID Diffusion Index" that allows us to look at the early trajectory of Covid-19 in socially and economically linked communities across the country. Viruses don't pay attention to city, county or national borders. Metropolitan Statistical Areas (MSAs) are defined by the Census as significant population clusters that are integrated economically and socially. This is exactly the definition we want to watch for Covid outbreaks, as we saw in New York City, there were no barriers to illness between Manhattan, Brooklyn or Queens, nor between the City and the tightly coupled surrounding counties across multiple states.

Going from counties to MSAs we drop from 3,143 counties to 392 MSAs. And yet, we capture more than 80% of the nation’s GDP in those MSAs. We follow the ISM manufacturing and nonmanufacturing index methodology of looking at acceleration and not level, or even growth rate. This gives our index the virtue of signaling when the country is going in the right direction, versus the wrong direction, even if levels or growth rates have not yet swung. Any MSA that has seen case count growth increase in the latest week, versus the prior week will pull the index up, towards a maximum of 100 (all MSAs accelerating), likewise slowing increases will pull the index towards 0 (all MSAs decelerating).

The US is now seeing an acceleration of the virus in areas all across the country, with more locations now accelerating than decelerating (Figure 6). But not all MSAs are the same size, as revealed by the Los Angeles MSA which alone accounts for nearly 4% of National GDP, so we calculate what percent of US GDP is represented by the MSAs that are currently seeing accelerating COVID 19 growth.

**Figure 6: Citi Private Bank COVID Diffusion Index**




Source: Johns Hopkins, Census Bureau and Citi Private Bank Office of the Chief Investment Strategist as of June 21, 2020. Index created is proprietary in nature and not found using third party entities.

We asked Dr. Michael Mina, PhD, Assistant Professor of Epidemiology and a core member of the Center for Communicable Disease Dynamics, what a negative tipping point for the virus in the US might look like. He said, "I think the tipping point is when the places that are trying to control the infection, lose control. If one State, say Massachusetts, gets cases to below two per hundred thousand and (due to infections in other states) you keep getting new infections in that State. The moment that hospitals cannot deal with the caseload, society falls apart. You cannot have an 80-year old with a broken hip going to a hospital knowing that their risk of getting COVID is 20%."[1]

As you can see from this excerpt of the underlying data for the CPB model, there are many places in the US right now with infection rates at 2% or above, levels considered dangerous for acceleration and hospital overload. (Figure 7.)

[1] The opinions expressed by the third party above are those of the third party. These opinions may differ from the opinions expressed by Citigroup or its affiliates. All expressions of opinion are subject to change without notice and are not intended to be a forecast of future events or a guarantee of future results.

**Figure 7: COVID-19 Diffusion Index - Data excerpt**

| Metropolitan Statistical Area (MSA) | Cases | GDP Share | Current Growth Rate | Prior Week Growth | New Cases to ICU Beds | Cases Past 2-weeks Per 1000 Residents | Retail & Restaurant Traffic (% of Baseline) |
|---|---|---|---|---|---|---|---|
| PHOENIX-MESA, AZ | 30,474 | 1.2% | 7% | 5% | 14 | 3.4 | -22 |
| TAMPA-ST. PETERSBURG-CLEARWATER, FL | 9,678 | 0.8% | 6% | 4% | 5 | 1.6 | -19 |
| ORLANDO, FL | 7,436 | 0.7% | 6% | 4% | 6 | 1.4 | -35 |
| SAN ANTONIO, TX | 6,582 | 0.6% | 6% | 3% | 0 | 1.3 | -16 |
| AUSTIN-SAN MARCOS, TX | 8,622 | 0.7% | 5% | 3% | 5 | 1.6 | -23 |
| HOUSTON, TX | 25,743 | 2.2% | 3% | 2% | 4 | 1.2 | -17 |
| CHARLOTTE-GASTONIA-ROCK HILL, NC-SC | 13,090 | 0.8% | 3% | 3% | 14 | 2.1 | -19 |
| RALEIGH-DURHAM-CHAPEL HILL, NC | 9,519 | 0.7% | 3% | 3% | 8 | 1.8 | -26 |
| RIVERSIDE-SAN BERNADINO, CA | 21,737 | 0.9% | 3% | 3% | 7 | 1.5 | -23 |
| FORT LAUDERDALE, FL | 10,837 | 0.5% | 3% | 2% | 6 | 1.6 | -29 |
| SALT LAKE CITY-OGDEN, UT | 9,509 | 0.6% | 3% | 2% | 0 | 1.6 | -11 |
| ORANGE COUNTY, CA | 9,988 | 1.3% | 3% | 2% | 4 | 0.8 | -34 |
| LAS VEGAS, NV-AZ | 11,052 | 0.6% | 3% | 2% | 4 | 1.3 | -19 |
| DALLAS, TX | 22,032 | 1.8% | 3% | 2% | 5 | 1.2 | -17 |
| OAKLAND, CA | 7,164 | 1.1% | 2% | 2% | 3 | 0.6 | -47 |
| FORT WORTH-ARLINGTON, TX | 8,744 | 0.6% | 2% | 2% | 3 | 1.0 | -12 |
| NASHVILLE, TN | 13,135 | 0.6% | 2% | 2% | 4 | 1.8 | -16 |
| PORTLAND-VANCOUVER,OR-WA | 4,032 | 0.8% | 2% | 2% | 2 | 0.4 | -27 |
| MIAMI, FL | 25,080 | 0.8% | 2% | 2% | 7 | 2.1 | -33 |
| CINCINNATI, OH-KY-IN | 6,464 | 0.6% | 2% | 1% | 3 | 0.7 | |
| LOS ANGELES-LONG BEACH, CA | 81,709 | 3.8% | 2% | 2% | 8 | 1.0 | -34 |
| KANSAS CITY, MO-KS | 5,922 | 0.6% | 2% | 1% | 1 | 0.6 | -5 |
| SAN DIEGO, CA | 10,484 | 1.2% | 2% | 2% | 0 | 0.6 | -33 |

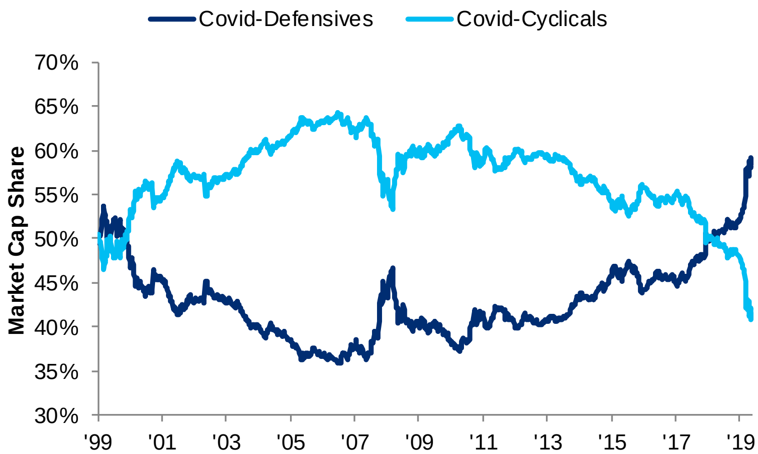
Source: Haver Analytics, Citi Private Bank – Office of the Chief Investment Strategist, June 19 2020.

In the near term, we expect that the pandemic's uneven path and trajectory will continue to present challenges to States and will most certainly contribute to volatility in the markets to the extent there are obvious impacts, like the closing of stores and other businesses previously opened. That said, we think it would take a major regional shutdown to have a meaningful impact on the recovery itself. This is a risk we are tracking closely.

## Reasons to Find Value in Value Equities

In our Mid-Year Outlook (Link) and this week's comprehensive Quadrant release (Link), entitled "Zooming Markets" Require Patience" we continue to emphasize the unusual pattern that the economy and markets are demonstrating. Cyclical equities, which are predominantly value rather than growth stocks, industrials instead of technology, have become unusually undervalued. (Figure 8.)

**Figure 8: Global 'Covid-Defensives' vs 'Covid-Cyclicals'**




Source: Bloomberg as of June 15th, 2020. COVID-Cyclicals: Financials, Industrials, Energy, Materials, Real Estate, Consumer Discretionary ex-Amazon. COVID-Defensives: IT, Health Care, Communication Services, Consumer Staples, Utilities, Amazon. 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.

This week, at Citi Private Bank's Global Investment Committee (GIC), mortgage and equity REIT assets were added to our asset allocation. REIT values are beaten down, as are other regional and sector-level equity overweights the GIC has added to suggested portfolios. The combined forecast yield of the REITS is about 7%, while the short-duration, cash equivalent US Treasury and corporate bonds that were reduced yielded just 0.7%. (Figures 9 and 10.)

**Figure 9. US Non-Agency Commercial Mortgage Backed Securities Yield vs US Corporate (Both A-Rated, Similar Duration)**

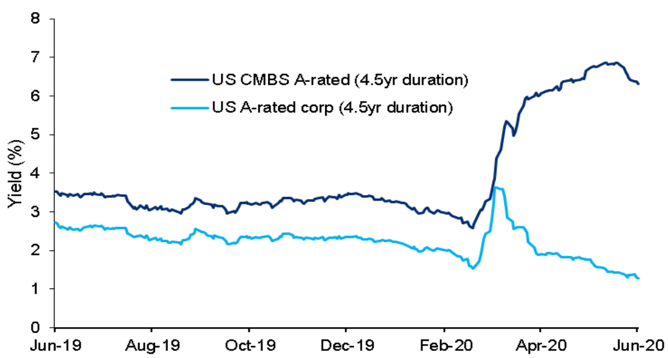
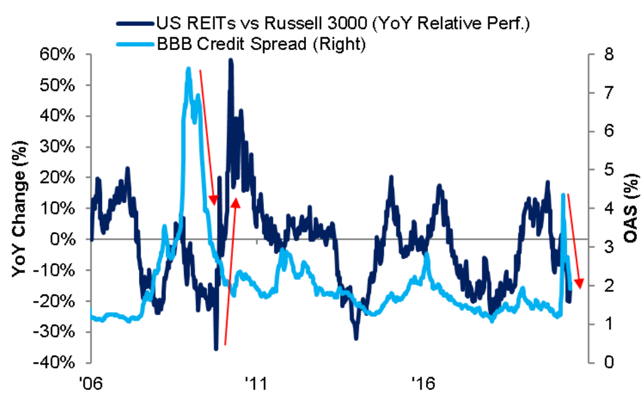


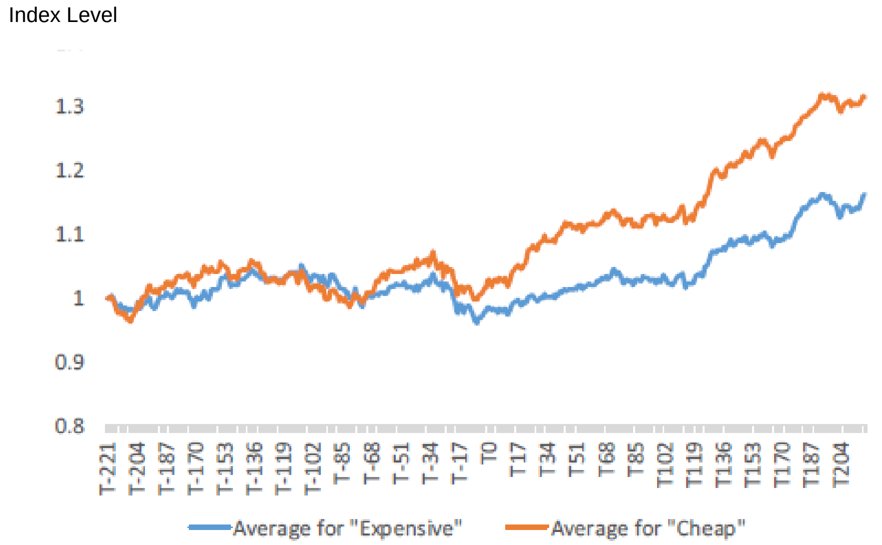

**Figure 10. US REIT/Equities Relative Performance vs BBB-Corp Credit Spread**




Source: Bloomberg Barclays Indices, Factset as of June 15, 2020
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.

We would also point out that recent election cycles have also favored value over growth, even though both have appreciated after elections. As you can see from Figure 11, there has been more appreciation for Value securities in the months after Presidential elections.

**Figure 11: During election years ex-2000, the 'Cheap' leg of Value outperforms the 'Expensive' leg, however they both appreciate**




Source: Citi Equity Trading Strategy. Note: 'T0' represents election time. The data sample takes from 1996, 2004, 2008, 2012, and 2016 US elections.

And finally, on June 26th, the Russell indices will be rebalanced. What you may not know is that they tend to keep the total market capitalization of growth and value sub-indices the same. As the growth names are getting larger and the value names smaller in value, the growth index will be highly concentrated and the value index will become far more diverse, including names of companies with a market capitalization of just $100 million – the lowest value for inclusion since the 2008 crisis. This can have a short term impact on trading this coming week as value names will be bought and growth sold, but for the next year the composition of the indices will allow our views to be more easily expressed.

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