

CIO Strategy Bulletin

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Resilience and Adaptation: Why the Global Economy is Poised for Accelerating Growth

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Summary

- Consumer goods inventories are plummeting in the US and elsewhere. Thus, we believe a larger recovery in industrial activity and trade is likely on the horizon. We have raised expected global GDP growth rates for 2021 and 2022 along with corporate profit estimates in line with this view.
- The sharp economic rebound from the March/April shutdown across the world is over. While the US added 1.8 million jobs in July, this is likely to be the largest gain for some time. Accordingly, we have revised down 2020 global GDP growth slightly.
- An effective vaccine and/or monoclonal antibody remedy is likely to be announced 1H2021. Cyclical industries and most small and mid-cap stocks are not priced for the ensuing economic rebound.
- History suggests that the US Congress has “written the book on brinkmanship”. We continue to expect Congressional action to support the US recovery.

Had COVID-19 Hit in 2008...

Imagine if the COVID-19 pandemic had occurred in 2008, amidst the mortgage crisis. Then, slow congressional action, weak banks and a less-developed digital infrastructure would have left the world in a depression rather than a financial crisis. In 2020, the same technology that keeps family members staring at their smartphones during dinner has demonstrated its societal value and economic power. How many more people would have died without digitally enhanced grocery and food delivery? Without telehealth, how many more people would have been exposed to the virus by seeking in-person treatment at hospitals? In terms of treatment, how long would it have taken to produce viable vaccines and monoclonal antibody remedies in 2008? And regarding information, imagine if the world didn't know what was coming. So many towns and countries mitigated the impact of the virus as a result of what they learned minute-to-minute online this year.

Digitization has allowed society to be more resilient and adaptive. Advances in medical research are, in fact, more likely to deliver effective treatments and/or a vaccine much faster, with our subjective assessment that there is 75% probability Covid can be suppressed in 2021 (see further discussion below). And, as we have written before, what is now “defensive” in markets are technology companies whose businesses benefited through the increased use of their essential services.

The net effect has been a global economy that has **endured the pandemic shock better than** many would believe by just reading the headlines. Weaknesses in Federal governance is clear. Social inequalities have been exacerbated. Yet, the most brutal economic impacts of COVID-19 have been focused on certain sectors. Travel, hospitality, entertainment, restaurants and personal services have been crushed. These are major observations of the pandemic era. But where there has been digital substitution and innovation, the economy has been surprisingly resilient because of it.

Economic Insights

As we have emphasized, the downturn in the US and global economies in Q2 was due to policy decisions to shut down entirely, to close businesses and schools and to end travel by insisting people stay at home. **This was a one-time event and is not being repeated.** So, when economies were re-opened, the rebound was massive, resulting in record large increases in retail sales and employment through June. The “June momentum” will allow for a rebound in US GDP in Q3 with certainty. For example, US consumer spending in June was +27% (annualized) above the full quarter pace, meaning a very large gain in real 3Q GDP is literally “baked in the cake”. US 3Q GDP will be +25% (annualized) by our estimates.

Yet with better US pandemic preparedness, the 33% drop in GDP in the second quarter could have been avoided. Still ahead, we have always predicted a challenging Q4 due to an expected “Second Wave” of the virus and modeled our estimates accordingly. While Q3 will see a huge economic “bounce off the bottom”, the failure to contain the virus in the US is creating greater disruptions to the economy than were necessary. As we discussed in the CIO Bulletin of July 19 [Wave 1 Virus Acceleration Requires Wave 2 Stimulus](#), it has also resulted in the need for more government monetary and fiscal support. We are seeing:

- Daily data on credit card use shows the May/June sharp rebound in US consumer spending has been arrested (see Figure 1.)
- Looking forward, US employment gains following July’s 1.76 million are very likely to slow further. There is even the potential for some small monthly declines in employment.
- Mobility has stopped improving (see Figure 2), but in a tentative positive development, the virus appears to be slowing in the US states that have most recently seen a surge (see Figure 3).

Figure 1: Daily US Credit Card Spending

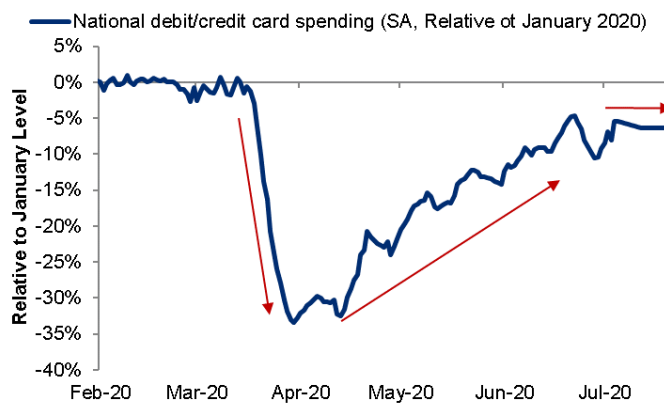
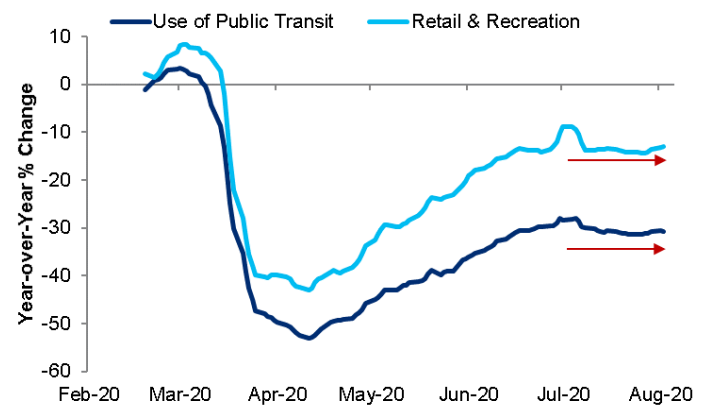
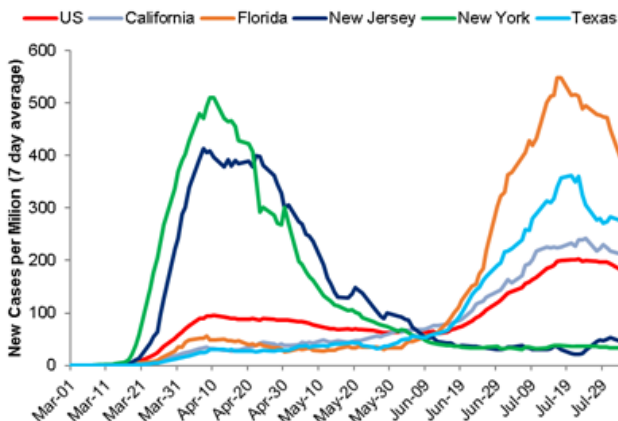


Figure 2: US Mobility Data: Transit, Retail and Recreation



Source: Bloomberg and Haver Analytics as of August 4, 2020.

Figure 3: Weekly New Covid Infections by US State



Source: Haver Analytics as of August 4, 2020.

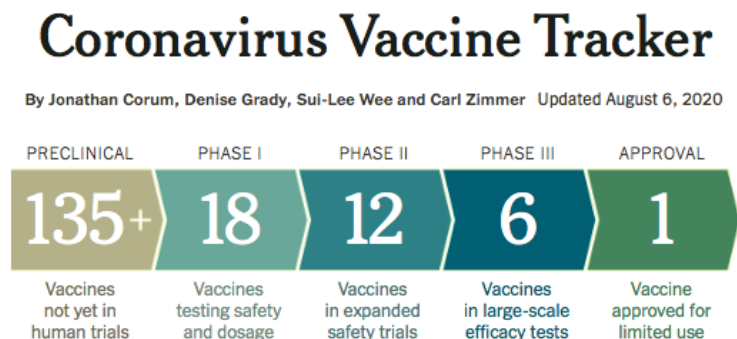
When we look at the areas where the virus has run rampant, Florida, Texas, California and South Carolina, we see that the setback in economic activity in the worst affected states has been modest compared to the “engineered collapse” of March/April. The poor health care response in the US has delayed a fuller economic recovery we might have seen otherwise. But delayed does not mean “reversed”. In other words, our expectations remain that the overall US economy and employment will continue to improve slowly month over month, albeit at rates that will be disappointing relative to what they could have been had the public been required to wear masks and had taken social distancing seriously. And, until the pandemic ends, there is a natural limit to the recovery itself as we have written before ([July 5th CIO Bulletin](#) and [July Quadrant](#)).

Where COVID Treatment Development Stands Now

Since the outbreak of COVID-19 and its global spread in February, there has been a global response from the scientific community to develop treatments for the virus. These fall into two broad categories, vaccines and monoclonal antibodies. Vaccines are designed to create immunity from COVID or to reduce symptoms of the virus by preparing the immune system for viral exposure. Monoclonal antibodies will target specific viruses and offer effective treatment for a limited period of time. There is an extraordinary level of scientific and commercial activity in both vaccines and monoclonal antibody development. These are novel and not repurposed medicines. A summary [can be found here](#).

To date, governments have spent more than \$9 billion to sponsor company research and trials for the development and testing of candidate vaccines as well as \$2.5 billion to prepare for production, storage and delivery of the vaccines. These include major programs in Europe, China and Russia. Based on the latest data, there will be several Phase 3 trials completed in Q4 and Q1 2021 and there are several vaccines whose Phase 2 trials have gone well enough that scientists feel confident one or more of the vaccines will be effective. Setting aside the political value of declaring victory against COVID in 2020, it seems reasonable to assume that effective vaccines and monoclonal treatments will be available in 1H2021. The subjective probability of that is 75% based on the limited published trial results, the number and amount of resources being applied to the efforts, and the worldwide cooperation among many scientists and corporations (see Figure 4).

Figure 4: Key Developments Toward a Vaccine



Source: New York Times, August 6, 2020.

No one is certain about the percentage of the population that must be vaccinated to gain “herd immunity” but the researchers believe at least 50-70% of the population will need protection to get there. That will not happen in 2020. The ability to distribute a viable vaccine and monoclonal treatments in 2021 will, however, move markets. The announcement of a truly effective treatment will mark the “end of the pandemic” for investors, in our view, and markets will price a full recovery in this “New Economic Cycle” (see our [Mid Year Outlook](#)).

Understanding 2020 and 2021: What a Post-Covid Recovery Will Look Like

We are increasingly **optimistic** on the state of the business cycle and growth prospects for 2021 and 2022. Cable news continues to focus on the “fiscal cliff” in the US as federal unemployment supplements have yet to be renewed. But let’s recall the 36 times the US Congress has renewed such benefits in the past.

Supply and Demand Surprises

In a typical recession, production and trade (supply) is reduced more than demand (see Figures 5 and 6). In the brief, sharp “COVID Recession” we are now in, this pattern has been exacerbated. First, we had a complete economic shutdown. In Q2, auto production, for example, fell toward zero for the first time in 99 years. Demand during that time also went down sharply, but car buying did not fall nearly as much. **This type of behavior is resulting in a significant and growing inventory shortage across many industries.**

As Figure 7 shows, overall end-consumer inventories are **plunging**. At current production rates, retail inventories will continue dropping through the third quarter. We believe this will restrain US GDP through year-end, but it will be a driver of a future recovery in industrial activity and trade. This is not just a US phenomenon. While a long and clear US data history allows us to make such projections more accurately, the shortages and the consequent rebound in production to meet sales will be repeated across the world with varying amplitudes.

Figure 5: US Vehicle Production vs Domestic Vehicle Sales

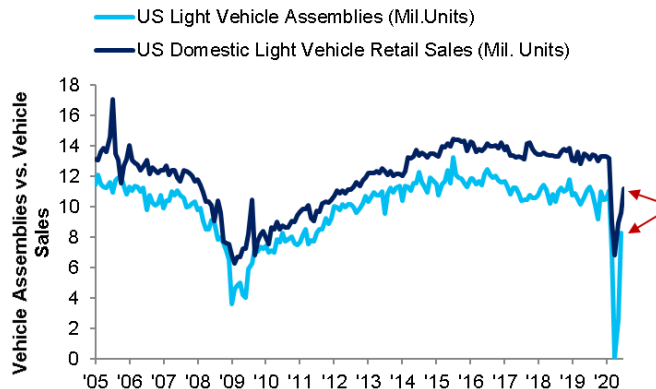
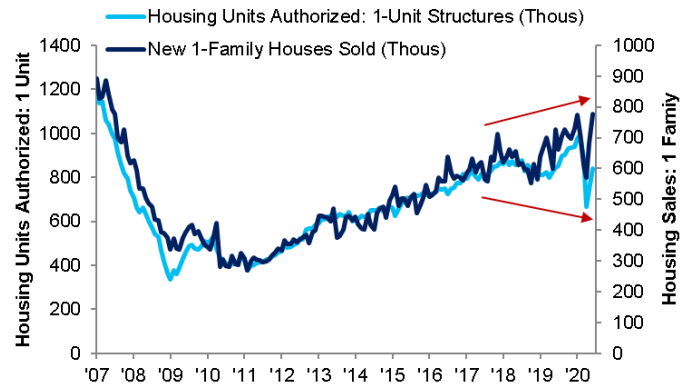
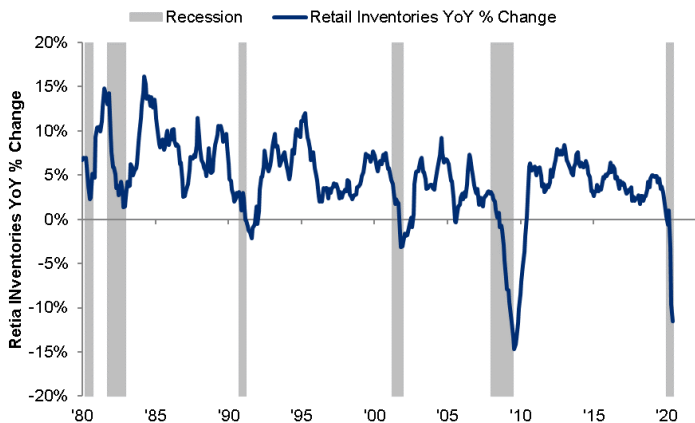


Figure 6: US New Home Sales vs Building Permits



Source: Haver Analytics as of August 4, 2020

Figure 7: US Retail Inventories through June 2020 – Falling further Beyond



Source: Haver Analytics as of August 4, 2020.

More Global Growth Than Expected: Revising GDP and Earnings Upwards

Based on all this activity, we have made a few material changes to our GDP estimates and S&P 500 EPS estimates (Figures 8-10.) Here are some highlighted differences.

It has been a very long time since we've seen Eurozone growth of +4%, but such a gain or more is quite likely for 2021 given that Europe did very poorly in 2020 and the Eurozone approved large fiscal transfers to the most depressed member states for the coming year. The history of European post-recession rebounds shows strength builds rather than “rockets.” Most economists expect a massive jump

in euro-growth. Yet, markets are aligned with a view of “building strength” at best. Given the nature of the shock and the improving European policy response, we see the chance of a sharp jump in the European economies, something that is not yet priced into markets.

Figure 8: Citi Private Bank Global Real GDP Assumptions

	2020	2021	2022
China	2.0	6.0	5.0
US	-4.8	3.9	3.2
EU	-8.0	4.0	3.0
UK	-6.0	3.0	3.5
Global	-4.0	4.2	3.6

Figure 9: Citi Private Bank S&P 500 Operating EPS Estimates

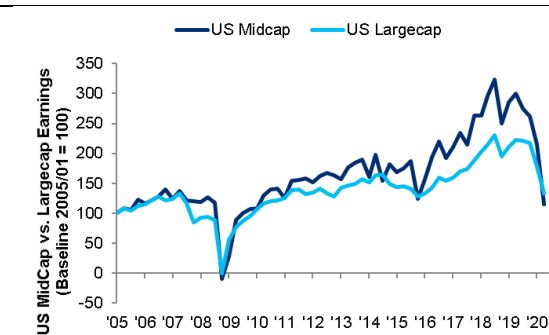
	S&P 500 Operating EPS		US Real GDP % Change	
	Prev	Revised	Prev	Revised
2019	165	164 (+1.0%)	2.2	2.2
2020	107	128 (-22.2%)	-4.3	-4.8
2021	135	153 (+19.5%)	3.6	3.9
2022	162	174 (+13.7%)	2.8	3.2

Source: Factset and CPB OCIS as of August 4, 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. All forecasts are expressions of opinion and are subject to change without notice and are not intended to be guarantees of future events.

Figure 10: Euro Area Real GDP Y/Y% Change (though 2Q 2020) and Mobility Measure



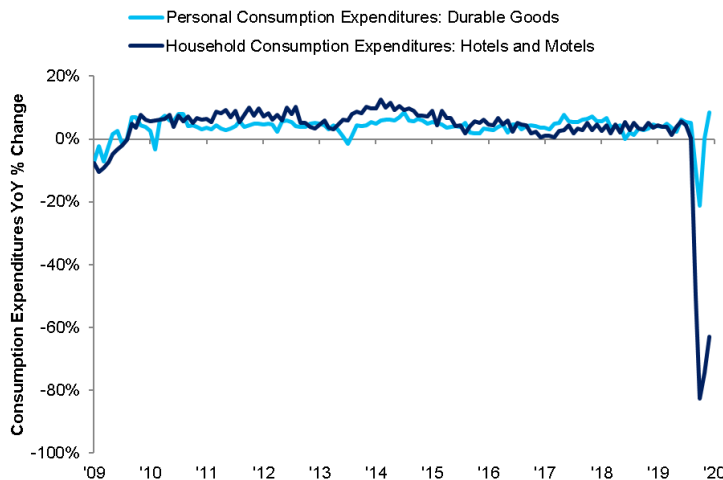
Figure 11: S&P 500 EPS and Mid-Cap EPS through 2Q 2020



Source: Bloomberg and Haver Analytics as of August 4, 2020. Note: LHS = left axis, RHS = right axis. US Large cap proxied using S&P 500, US Mid cap proxied using S&P 400. 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.

As for earnings, there has been an even greater bifurcation in large/small company profits than we had projected. S&P 500 EPS may have fallen a “mere 33%” in 2Q , but US mid- and small-cap firms saw EPS crushed by -70% (see Figure 11). With that said, overall profitability has stayed higher than at the trough of the Global Financial Crisis across the range of market capitalizations. There is a clear depression in travel, tourism and hospitality industries (see Figure 12). However, the “adaptation” to Covid – with digitization and technology helping avoid a much deeper economic shock – means that the deterioration in overall profits was mitigated.

Figure 12: US Consumer Spending: Hotels vs Durable Goods Y/Y%



Source: Haver Analytics as of August 4, 2020.

Market and Investment Implications

With risks in mind, investors who liquidated whole portfolios in March in an attempt to avoid losses – and didn't redeploy cash – have been hurt. Here are the trends we expect going forward.

While interest rates are under downward secular pressure, we believe economic recovery in the coming year will generate US yield curve steepening. This depends, in part, on treatment availabilities for Covid. Once it becomes apparent that widely available treatments can mitigate the worst effects of the virus, we expect a sharp market rotation within equity sectors. Covid – like all other previous epidemics and pandemics in human history – won't last forever (see Figures 13-14).

Given our views, we reiterate our recommendation to gain exposure to instruments like REITS, Financials, select Industrials and high yield credit in both the US and Eurozone (please see [Quadrant](#)). We view valuations in these “value” oriented sectors as more attractive, and we expect these Covid-cyclical sectors to rebound as the world moves beyond immediate virus-related concerns. Meanwhile, the outlook for European assets continues to improve. The virus is under better control in Europe and the economic data are strengthening. We anticipate further gains in European credit, US high yield corporate bonds, the Euro, Global SMID, and cyclical large-cap equities around the world that offer value and yield, and have not already fully recovered.

Figure 13: US 10-Year Treasury Yield and US Growth Stock Index

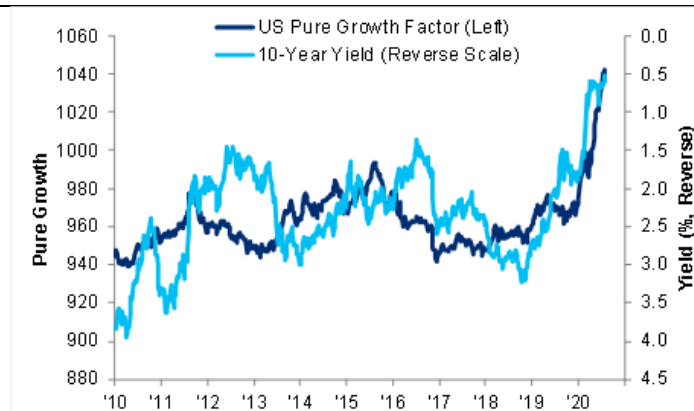
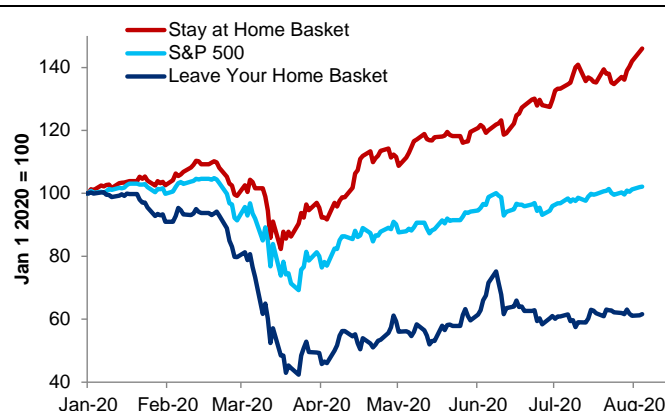


Figure 14: Citi “Stay at Home” Basket vs “Leave Your Home” and S&P 500



Source: Bloomberg and Haver Analytics as of August 4, 2020. Note: “Stay at Home” basket includes names identified to benefit from COVID-related disruptions and a shift to working from home. “Leave Your Home” basket includes Buy and Neutral Rated US names in the following sub-industries: Banks, Industrial Conglomerate, Machinery, Oil Gas & Consumable Fuel, Textiles Apparel & Luxury Goods, Energy Equipment & Services, Hotels Restaurants & Leisure, Building Products, Retail REITs, Construction & Engineering, Leisure Products, Airlines, Multiline Retail. 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.

Technology

The world economy was resilient and adaptive due to the massive maturation of technology companies since 2008. In 2020, they have collectively been the saviors of the global economy. However, as we have previously pointed out, their market values are unusually high and have priced in many years of future growth. Thus, while we are not predicting an imminent tech crash, it is likely that we are entering a period where further appreciation will slow and where other sectors will do better than many expect.

We have also been clear on this point: Overconcentration in technology adds risk to portfolios. We have previously advised limits to concentration (please see [The Dangers of Growth at Any Price and What to do about it](#)). We would therefore suggest an analysis of one's large-cap US tech-related holdings to avoid allocations that exceed 20% of total portfolio wealth. For those with portfolios overweight to tech, there are several strategies to consider, including selling some of those positions to fund a rotation into cyclical shares, hedging against the potential for near-term volatility, or using capital markets strategies to add diversification to portfolios.

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