Private Bank

CIO Strategy Bulletin

May 2, 2021

Earnings and the End of Euphoria

With a Special Section on SPACs: Write Me a Blank Check

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Summary

- **A robust Q1 earnings season so far reinforces our optimism that the COVID recession is behind us. Over 85% of S&P 500 companies have exceeded expectations for Q1 earnings so far, beating EPS estimates by 22% on average.**
- **The relatively muted market response this week to a much stronger than expected quarter for tech profits (S&P 500 technology ended the week 2% lower) is indicative of high expectations as earnings revisions come back to earth.**
- **While many management teams have highlighted rising input costs as a potential headwind to margins, we view these price increases as largely temporary and related pandemic-driven distortions in global supply chains. This is why we expect that though there will be near term inflation in commodities and goods, these are unlikely to persist.**

US Recession in the Rear-View Mirror

Watching this Q1-2021 earnings season, one can be comfortable stating that the US recession is behind us. Looking at the data representing 68% of the S&P 500, we see revenues growth of 12% and earnings rising by 46%, 20+% above estimates (Figure 1). We highlighted before this earnings season that single stock analysts tend to be too conservative early in economic cycles (Figure 2). If earnings momentum from Q1 continues throughout the rest of this year, 2021 EPS will surely exceed the 25% growth expectation heading into 2021. Technology, Materials and Consumer Discretionary companies were the sector leaders. They are also large beneficiaries of the distorted Coved economy (see Figure 3)

Figure 1: Share of S&P 500 companies beating estimates

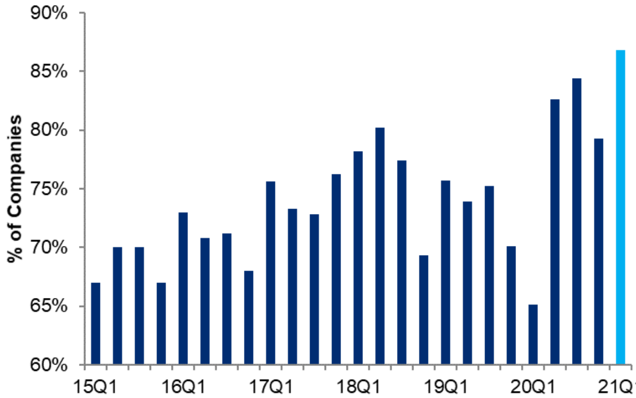
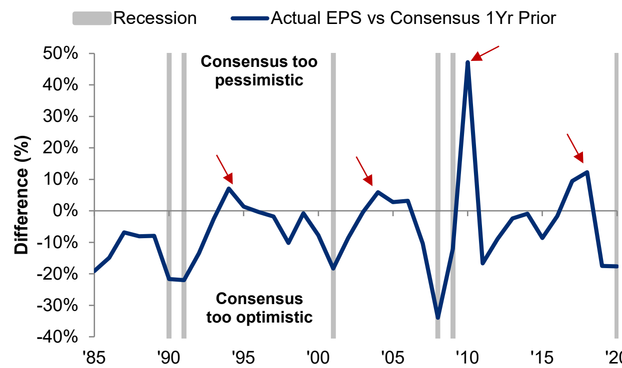


Figure 2: Actual EPS vs Consensus 1 Year Prior



Source: Refinitiv and Haver Analytics as of April 30, 2021. All forecasts are expressions of opinion and are subject to change without notice and are not intended to be a guarantee of future events. 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.

Figure 3: Earnings Scorecard by Sector

	# Rep |	Mkt Cap Reported		Sales ($B)			Earnings ($B)		sorted	Sector Perf.
Sector	Total	% Sector	% SPX	Curr	% Surprise	% Growth	Curr	% Surprise	% Growth	Apr 12-Apr 30
Utilities	9 | 28	44%	1%	28	(9.5%)	5.8%	5.0	9.3%	20.1%	2.6%
Cons Disc	25 | 63	65%	8%	213	4.0%	28.9%	18.7	35.6%	215.6%	1.0%
Energy	12 | 23	70%	2%	159	4.2%	1.2%	5.9	29.9%	(18.7%)	3.5%
Financials	55 | 65	80%	9%	278	5.8%	11.5%	81.6	37.7%	166.3%	2.9%
Materials	13 | 28	49%	1%	61	2.2%	16.8%	7.0	9.4%	111.0%	3.5%
Health Care	37 | 62	74%	9%	313	0.7%	13.6%	52.4	5.7%	27.1%	2.8%
Cons Staples	14 | 32	55%	3%	103	4.0%	7.6%	16.7	9.0%	11.5%	0.4%
Comm Serv.	12 | 26	61%	9%	209	4.0%	15.0%	42.4	13.4%	36.2%	2.0%
Info Tech	32 | 75	67%	17%	235	7.6%	25.6%	63.2	20.8%	46.2%	(0.9%)
Real Est.	20 | 29	83%	2%	23	0.9%	6.7%	2.7	(8.3%)	3.1%	5.4%
Industrials	53 | 74	77%	6%	239	3.1%	(3.2%)	14.2	21.7%	(17.9%)	1.1%
SPX	282 | 505		68%	1860	3.7%	12.2%	310	20.2%	53.6%	1.4%

Source: Citi Equity Trading Strategy as of May 1, 2021. Note: SPX sectors are sub-sectors of the S&P 500 index. All forecasts are expressions of opinion and are subject to change without notice and are not intended to be a guarantee of future events. 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.

Market Reaction: Ho Hum

Stock prices did not move much last week, indicating that these "great" results were anticipated. Market favorites like Apple and Microsoft both sold off 2-3% despite reporting much stronger-than-expected headline results**.** The S&P 500 average for April was up 5.2% and the Nasdaq 5.9%. Earnings revisions into next year were the bright spot of the week, with the consensus S&P earnings for 2022 rising to $208, while the dark clouds were the numerous tax proposals that would raise corporate and personal tax rates back to pre-2017 levels.

Markets to Technology Shares: What Have You Done for Me Lately?

While some COVID-winners come back to earth, the broader technology space – and particularly big tech – have delivered another strong quarter (Figure 4). Demand for smart phones, digital ads, and online shopping were mega-trends before COVID and will continue to be after the pandemic ends. In our view, the relatively muted market response to another solid quarter (tech ended the week 2% lower) is indicative of extended expectations (Figure 5). For example, the chip shortage that has halted supply chains globally has been a temporary boon for semiconductor margins, though we are wary that "double ordering" could ultimately punish lead times once supply backlogs get worked out in the coming months. Meanwhile, strong digital ad spending reflects a world where most white-collar workers are still working remotely, while competition in the cloud remains intense.

Figure 4: Dispersion in tech performance

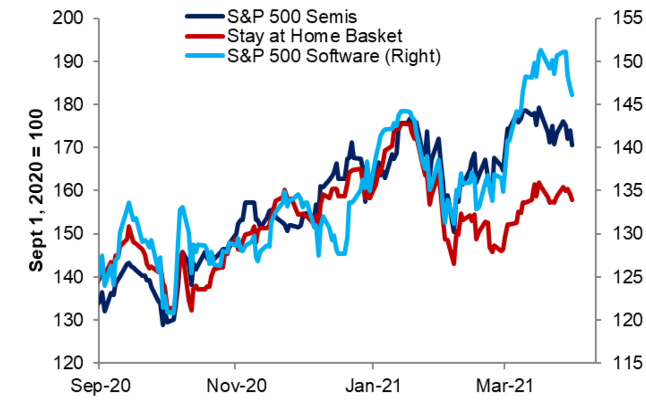
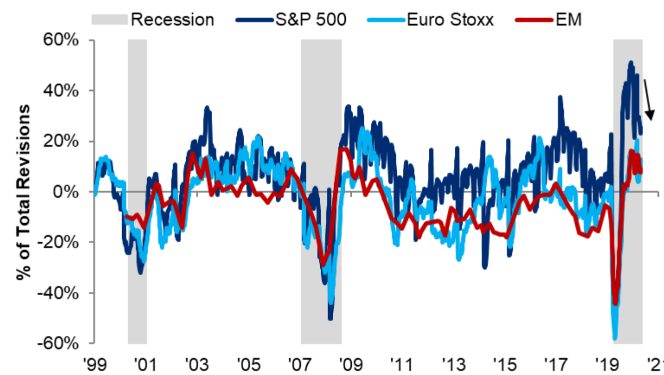


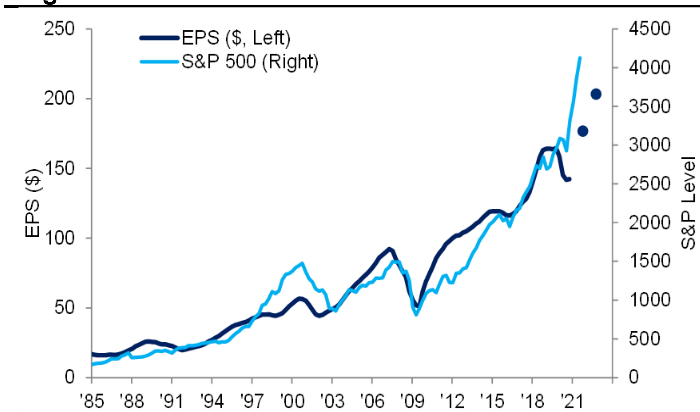
Figure 5: Global earnings revisions



Source: Haver Analytics as of April 30, 2021. Note: "Stay at Home" basket includes names identified to benefit from COVID-related disruptions and a shift to working from home. 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.

Though we are long-term bulls for unstoppable trends, we do hear the market asking in the short run: So, what have you done for me lately? When handicapping our expectations for share prices going forward, we must consider how differently the market has performed during this Covid recession given the speed of the strong earnings recovery. Indeed, markets in the US have risen well ahead of expectations for earnings this year and next year, which will heighten the importance of earnings delivery relative to the upgrades to guidance that are likely to be written in the coming quarters (Figure 6).

Figure 6: Actual EPS vs Consensus 1 Year Prior



Source: Haver Analytics as of April 30, 2021. Note: Blue dots indicate forecasts EPS levels ($). All forecasts are expressions of opinion and are subject to change without notice and are not intended to be a guarantee of future events. 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.

We have already seen some signs of the market adjusting to excessive expectations, particularly among "digital beneficiaries", companies that were able to accelerate their growth during the pandemic lockdowns. Shares of popular streaming services and telemedicine companies fell following their Q1 results over the past few weeks, confirming that the excess activity from the pandemic is likely at an end. As investors adjust to the reality of a reopening economy, we would look to buy dips in some of the "stay at home" stocks that are likely to benefit from permanent alterations in the way services are delivered in the post-pandemic world.

Different Recessions, Different Recovery Trajectories

The recession of 2008/2009 was "internally driven" as deregulation, the issuance of excessive mortgage credit, insufficient bank capital and the collapse in housing prices caused bank failures, consumer bankruptcies and a stock market collapse. The stock market dropped by nearly 60% over 18 months between 2007 and early 2009. Looking back now, we see that EPS in 2010 (the first full year of the last recovery) was up 38% and rose further in 2011 and 2012 – 14% and 6% respectively. The enormous dislocations of the Global Financial Crisis gave rise to the largest quarterly gain in S&P 500 EPS in 4Q 2009, a whopping 209%.

The Covid recession of 2020 was exogenous, as an unprepared world suffered a pandemic. The market plunged 34% from mid-February to late March 2020, but rapid government actions including both fiscal stimulus and monetary actions were able to "bridge" the crisis. Though the trajectory of earnings is comparable to those of 2010, the recovery is far faster. As we look at Q1 2021 earnings results, they have *already exceeded* Q1 2019 levels by 13%. This partially explains why current stock prices for the S&P 500 presently exceed the YE2109 level by 30%.

As we look out, what is quite similar between this brief, but deep recession and the last one is EPS estimates for 2022 and 2023. S&P 500 EPS are on pace to rise 13% and 9%, very similar to the second and third years of the prior major economic crisis. This will be despite a likely one-time distortion from a corporate tax increase, indicative of a decelerating but strong underlying economic growth path.

It is worth reminding readers that in previous recovery cycles over the past 60 years, EPS gains tended to start slowly and accelerate over time. Over the course of the past 8 cycles - including the "double-dip" recession of 1980 – first year recoveries have averaged a 7% EPS gain, with the second year gaining 15% and the third year gaining 14% on average. This is why the present economic recovery from Covid – with US employment still 5.5% below peak levels – argues for sustained confidence.

Worried About Inflation? Headlines vs. Realities

There is a lot of talk about rising and unusual inflation. During recent earnings calls, many consumer goods companies referencing rising inflation pressures. As an example, Proctor and Gamble stated that they missed earnings estimates due to higher than expected freight and raw material costs. "This bottom-line outlook includes headwinds of… more than $200 million after-tax of higher freight costs. Commodities are now forecast to be a headwind of approximately $125 million after-tax… The commodity cost challenges we face this year will, obviously, be larger next fiscal year." Proctor and Gamble, believes they will be able to pass these higher costs on to consumers, partially disguised as product innovation. In our view, quality companies with strong competitive advantages should be able to do so.

But the larger questions about inflation are around its persistence and whether it is unusual at this point in an economic recovery. We would make two critical observations. The COVID economy is highly distorted and consumer goods remain in unusually high demand. With services revenues muted due to global "stay at home" distortions, consumers shifted spending to consumer goods and demand went through the roof. This depleted inventories and the availability of some merchandise. We expect a normalization of consumer demand for goods with the reopening.

With the unusual demand for goods, supply chain issues and the need to refill inventories, it should be no surprise that there have been commodity price pressures (Note, however, that the price of a hotel is still 8% below a year ago but finally firming). Looking at historical precedents, we note that the gain in commodity prices is not without precedent. Gains were even stronger in 2010 and we went on to a decade of diminished inflation. And looking even more deeply at the data, we see different scales of price gains for simpler commodities than for advanced commodities. The latter have a much higher (and stable) labor content in value creation. As you go up the value chain, prices are more and more stable (Figure 7 & 8). This is why we expect that though there will be near term inflation in commodities and goods, these are unlikely to persist at high levels. Thus, we are not basing our asset allocation and sector preferences around temporary pricing distortions.

Figure 7: Core Crude Materials/Core Final Wholesale Goods

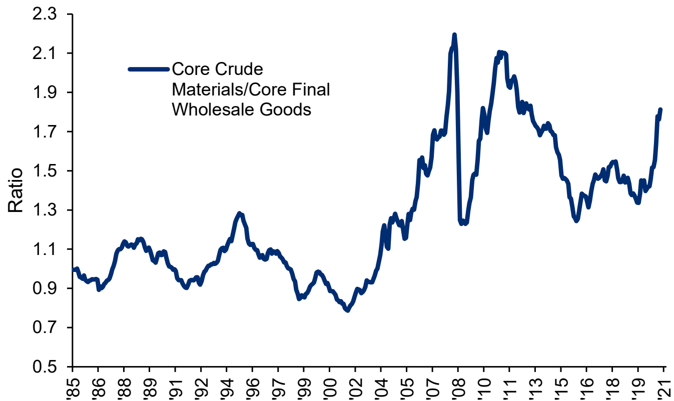
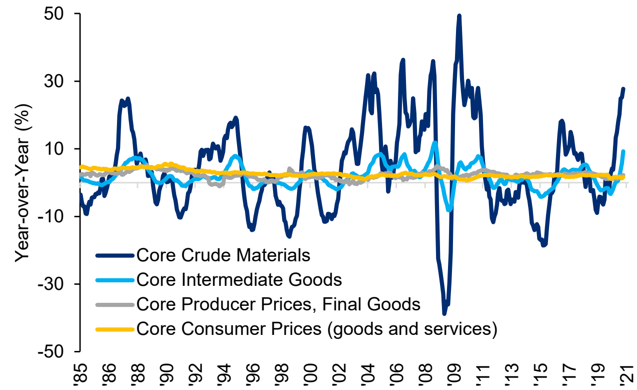


Figure 8: Measures of inflation at different points in the value chain



Source: Haver Analytics as of April 30, 2021. Note: Core Crude materials and Core Final Wholesale Goods (left chart) and Core Intermediate Goods (right charts) are components of Producer Price Indices (PPI). 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.

Final Earnings Season Observations

The rapid stock market rebound has been validated by the equally rapid rise in revenues and earnings we have and are seeing in Q1 2020. Markets priced in the post-Pandemic recovery, at least in the US. Looking at 2022 earnings projections relative to stock prices today, we believe that markets are anticipating further substantial good news and it is more likely than not that companies can deliver. That said, future returns expectations for the S&P 500 are normalizing and so should investor expectations.

While our return expectations for US shares are more muted, there are still many areas of global stock markets where the US level of rationality is not evident. We remain confident that the level of vaccinations will increase globally, which will provide momentum for the global economic recovery through 2022. There are many areas of the global where optimism is not the base case. Regional equity markets like Brazil, the UK, and Southeast Asia have significantly underperformed, and have not yet priced in a post-COVID world. While the earnings recovery in some of these regions may lag the US by a few quarters, we expect that non-US earnings will still out-pace those in the US in both 2021 and 2022.

Finally, though interest rates are presently stable around 1.60% for the US ten-10 year, we expect that as the global economy catches up to China and the US, rates are likely to normalize at or above 2%. Thus, it is still better for investors to “lean in” to equities, as our present GIC recommendations reflect. Our recent adjustments to portfolios indicate where the better overweights are.

Write Me a Blank Check: Special Section on SPACs

- **The SPAC gold rush has subsided. Investors need to act with care and analysis to discern the quality of different offerings.**
- **The opportunities presented by the explosion in SPAC issuance vary widely for different types of investors and different stages of the SPAC life cycle:**
  - **The economics for SPAC sponsors, direct IPO investors, and providers of private capital can be quite compelling, while individual investors should seek quality SPAC managers trading near issue price.**
  - **Post-merger company fundamentals vary widely. Once the SPAC has merged with its target, much of the firm's potential value has already been extracted by early investors, leading to underperformance of de-SPACs on average versus the Russell 2000. Some de-SPACs have no proven track record, while others may be future leaders in key areas like fintech, clean energy, and biotech.**
- **The regulatory slowing in the SPAC market is likely a good thing for sustainability. The excesses could have become a larger problem for financial markets if gone unchecked. However, when money is easy (as the Fed reiterated at its meeting this week), it will always find a home.**

Write Me a Blank Check

The popularity of the term "SPAC" grew markedly in the last year or so. Increased investor access to exciting startups, promising leadership in growing industries like online gaming or electric vehicles, emerged early last year after mergers with Special Purpose Acquisition Vehicles, or SPACs, surging in price even as the pandemic battered broad equity markets (Figure 9). The initial success of early 2020 SPAC mergers – when a SPAC finds a company to merge with its referred to as "de-SPAC" -- led to a surge in SPAC issuance, with over 500 blank check companies applying to list shares publicly in the last 12 months in the US, raising over $150bn in capital (Figure 10).

Figure 9: Two popular de-SPACs that started a revolution

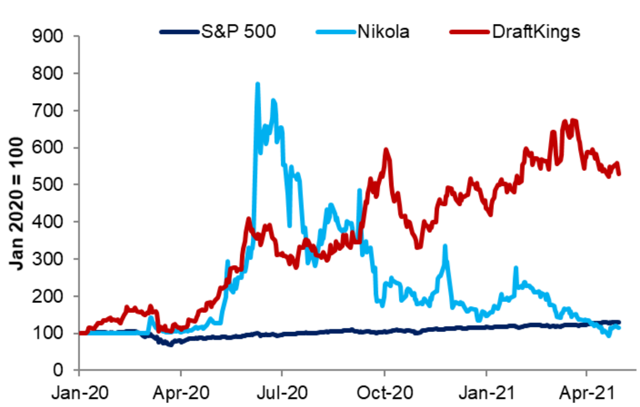
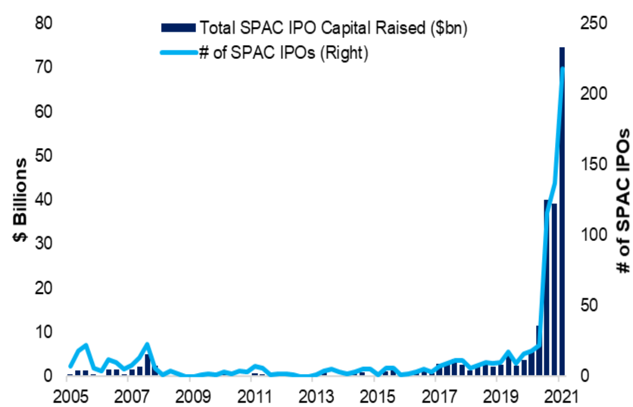


Figure 10: US SPAC Issuance



Source: Bloomberg as of April 30, 2021. Past performance is no guarantee of future returns. Real results may vary. For illustrative purposes only. This should not be construed as an offer of, or recommendation of companies discussed.

A Brief Primer on SPACs

Before digging into the implications of the recent surge in SPAC activity, we'll briefly describe what Special Purpose Acquisition Companies are, and how they are shaking up the world of private and public equity.

- A SPAC is a publicly listed "blank check" company, whose sole purpose is to pursue an acquisition.
- SPAC sponsors raise capital via an IPO, using their institutional track record or, in some cases superior marketing abilities, to attract investors.
- In most cases, the companies being taken public are highly speculative and in the very early stages of their development.
- Investors in a SPAC IPO typically receive shares in the SPAC (usually listed at $10 per share) along with warrants which provide additional upside to the investor if the stock trades higher post-acquisition.
- Once capital is raised and the SPAC becomes publicly traded, the sponsor typically has 24 months to find a suitable acquisition target. If the SPAC sponsor cannot identify and complete an acquisition in the allotted search

period, investors receive their initial investment back, with interest. However, the SPAC is highly incentivized to consummate a deal, as they typically receive 20% of shares allocated to the SPAC's portion of the investment in any merger agreement.

- If the SPAC does find an agreeable firm to acquire (usually one that is not yet public), they undergo due diligence, agree on a value, and announce the intention to merge with the company. In larger deals, the SPAC can sometimes bring in additional equity, called a PIPE (private investment in public equity), to provide certainty of capital to consummate the transaction and bolster the target company's balance sheet.
- If the SPAC merger is approved by shareholders, the newly consolidated company (de-SPAC) will trade with a new ticker and the blank-check SPAC will cease operations. Often SPAC sponsors and key PIPE investors will receive board seats or other preferred deal terms.

Performance Across the SPAC Life Cycle: The Earlier the Better

Given the types of industries that attract most SPAC sponsors, it is perhaps unsurprising to see SPACs – even before they have announced any plans to merge with another company – trade in line with long duration growth equities (Figure 11). Throughout much of 2020 and into January of this year, low rates and significant fiscal stimulus contributed to strong rally in technology, clean energy, and biotech shares, as investors took advantage of a goldilocks scenario in markets. SPACs largely benefitted from this long duration equity rally until mid-February, when a spike in Treasury yields and a re-emergence of cyclical value equities took some wind out of the growth stock trade.

During the most extreme period of growth stock euphoria, it was not uncommon to see SPACS trading well above cash value (when the stock price exceed the $10 per share the SPAC has raised), even before their sponsors had announced any potential deals (Figure 11). With no knowledge of whether the sponsor will ultimately find a merger, such extreme pricing was always unsustainable, and the return of gravity in the space is a welcome sign for fundamentals-based investors. With that said, the sheer number of SPACs still seeking a transaction – 534 with $179 billion in capital – has led to bidding wars and significant overvaluation of some targets, which is ultimately to the detriment of SPAC shareholders.

Indeed, the performance of de-SPAC companies like DraftKings and Nikola is illustrative of the wide range of returns delivered by post-SPAC public companies. One academic study found that in every year since 2010 de-SPACs have underperformed the Russell 2000 on average.[1] Even with a much larger sample size since 2020 and a number of high quality sponsors joining the SPAC party, the trend of underperformance has continued, with de-SPACs delivering negative returns since October 2020 versus a 52% return for the Russell 2000 over the same time period (Figure 12).

Figure 11: SPAC performance vs other high-growth equities

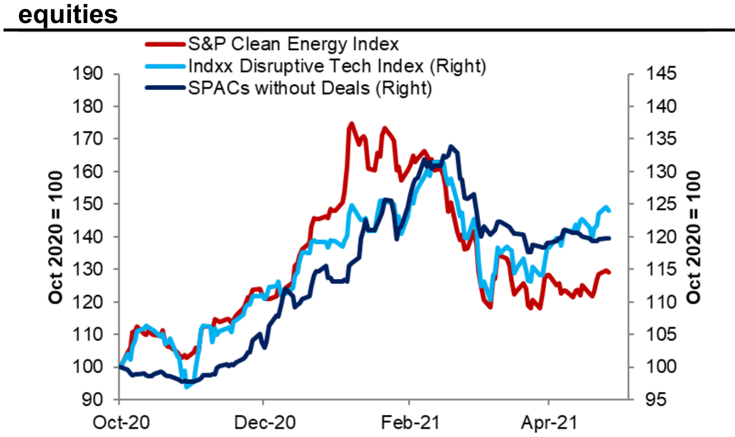
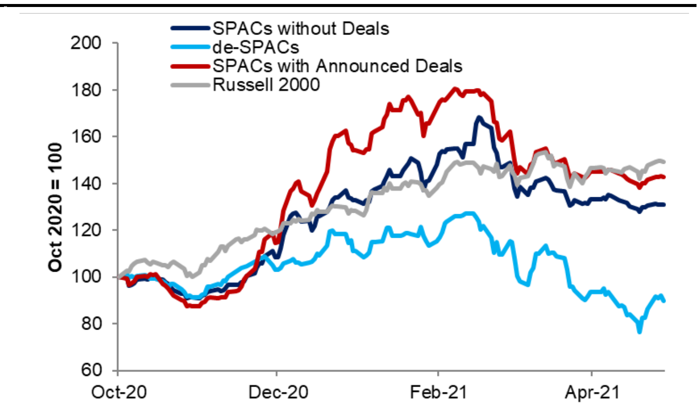


Figure 12: Recent SPAC performance by life stage



Source: Bloomberg as of April 30, 2021. 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.

The goal of most SPAC sponsors is to identify early stage companies in fast-growing areas that can one day claim significant market share in their respective industries. Indeed, most de-SPACs have focused their acquisitions within many of the more promising mega-trends: technology & software, health care & biotech, electric vehicles, clean energy,

[1] Klausner, et al. A Sober Look at SPACs. 2020.

and fintech (Figure 13). With that said, some companies that have merged with SPACs are much less mature than the usual company that goes public through a traditional IPO. Among the 25 largest recent de-SPACs, 40% can be considered “pre-revenue”, often in the prototype stage before going to market in their respective industries (Figure 14). Despite no sales track record, these pre-revenue companies are on average valued at $6 billion.

To some extent, public equity markets have taken on the role of venture capital, without the diversification of a fund. This reality has led to significant share price volatility as public equity investors try to predict (in real time, with daily mark-to-market) a company’s prospects with little to no track record and a great deal of faith in the SPAC sponsor’s due diligence.

Figure 13: Recent De-SPAC business models

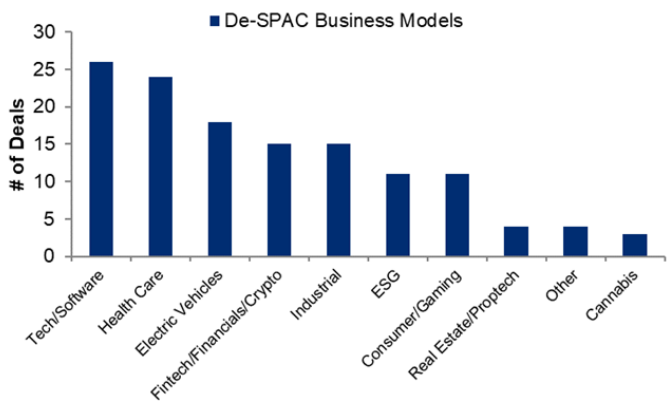


Figure 14: Sales figures for the largest 25 recent de-SPACs

2020 Revenues	Share	Avg Market Cap ($mil)
>$1bn	8%	10,998.40
$100-1bn	28%	7,452.40
$10-100mil	16%	4,209.08
<$10mil	8%	3,417.64
Pre-Revenue	40%	6,119.63

Source: Bloomberg as of April 30, 2021. 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.

The SEC Hits the Pause Button

The surge in SPAC issuance has caught the attention of regulators, and the SEC this month made several moves to slow the pace of new blank check issuance while it investigates the space more closely. As an initial means of slowing new SPAC issuance, the SEC changed the rules around accounting for SPAC warrants, requiring aspiring new SPACs to scrap and re-publish their regulatory filings.

More substantively, the SEC is reviewing the rules around SPAC mergers, and in the most extreme case could re-classify such mergers as new IPOs. Such a move would likely significantly limit the ability for more speculative business models to go public, as IPO rules limit the use of forward-looking projections in regulatory filings. At present, SPACs are free to publish forecasts of a target’s future financial situation, even if the company is in early stages of growth (i.e. pre-revenue). To the extent that SPACs have dramatically curtailed late-stage private equity financing in the past 6 months, a clampdown on the types of companies SPACs can merge with would likely reduce some froth in the that segment of the private equity space.

We view the SEC’s role in slowing SPAC’s role as key to the future of the asset class and likely consequential for valuations in private equity markets.

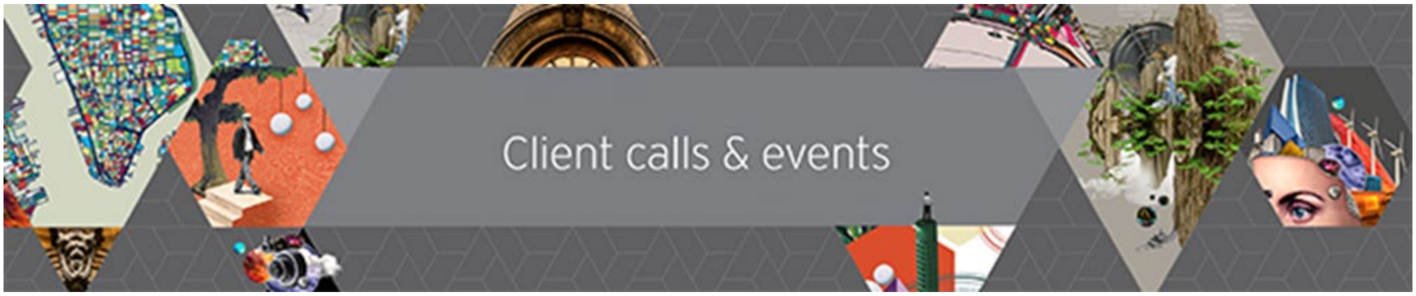
Observations

While the hype around SPACs generated significant returns for some early investors, we see the SEC’s intervention as likely healthy over the long run for both the private equity space as well as for the future of SPACs. We also continue to see opportunities for certain qualified investors in SPACs, though the consistently poor returns of many de-SPACs does make us more cautious about the prospects for less informed retail investors who don’t have access to SPAC IPOs or special PIPE financing terms.

SPAC issuance has dramatically increased in size, which can create potential opportunities for various market participants:

- **For private businesses**, especially earlier-in-the lifecycle ventures with short operating histories but vast prospects, SPACs may present an attractive way to go public as they reduce the time and effort required in a traditional IPO and allow the company to make forward looking projections that are not permitted in a typical public offering.
- **For sponsors**, SPACs present a compelling asymmetric payout structure. They can risk minimal capital (typically a few million dollars) and stand to gain large outsized returns if a deal is consummated (which happens nearly 90 percent of the time).
- **For sophisticated IPO investors with disciplined risk-management**, SPACs offer a highly asymmetric payout structure as well. SPAC shares themselves have a similar return structure to Treasury bills, yet the “bolt-on” warrants enable substantial upside optionality, while SPAC share voting rights enable access to newly public companies by providing the option (but not the obligation) to participate in the de-SPAC process.
- **For individuals,** investment strategies should seek to buy SPACs still searching for deals that are managed by top quality sponsors trading near the $10 issue price. SPACs that have recently gone public tend to trade with warrants still attached, which enables asymmetric upside exposure with limited additional downside. Portfolios of high-quality SPACs can be one way for clients to deploy excess cash. Investing in de-SPACs, meanwhile, should be done in the same way we analyze traditional small cap companies, by weighing fundamentals and valuation to determine whether that business is attractively valued relative to its future growth prospects.

*****SPAC transactions differ from traditional IPOs and have distinct risks associated with them. For example, sponsors may have conflicts of interest so their economic interests in the SPAC may differ from shareholders. Investors should carefully consider these risks. In addition, while SPACs often are structured similarly, each SPAC may have its own unique features, and it is important for investors to understand the specific features of any SPAC under consideration.*****



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