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# CIO Strategy Bulletin

## How to Manage Through a Longer End to the Pandemic

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**SUMMARY**

- **The infectious "Delta variant" is changing the dynamics of the pandemic and the contours of the global recovery. In our view, to "Reconnect the World" and achieve a full, global economic recovery, the spread of COVID will have to be better controlled. This is unlikely before year end.**
- **We agree with Chairman Powell that the recent, unusual inflation surge will abate and that core inflation will be at a slower pace a year from now once COVID distortions fade. What's highly notable is how strongly financial markets have accepted this view.**
- **The premium level of US yields over other developed markets and the latest COVID developments now argue for at least a modest reversal higher in the US dollar.**
- **A setback in the fight against COVID could see the US and China markets outperform again, with "growth" shares feeling the added relief from COVID-blunted interest rate pressures.**
- **We do not want investors to react to or chase short-term COVID distortions in markets. There will be many surprises that will challenge the confidence of investors from the pandemic. The time is ripe to upgrade the quality of assets in our portfolios and to seek sustainable drivers of returns in the face of what are likely to be more volatile markets.**

## The Virus Is Outsmarting Investors

The battle against the pandemic remains more than just a "background" factor for markets. Just two weeks ago, we highlighted the recovery in global mobility that mirrored the reduction in COVID infections. Since then, the tide has started to turn negatively with the rapid spread of the infectious "Delta variant" changing the dynamics of the pandemic and the contours of the global recovery. This partially explains a drop in global interest rates that also has its roots in the slowing pace of the recovery after the "peak reopening" we have likely experienced (please see our Bulletin of June 27, 2021).

## A View of the Pandemic from Cambridge, Massachusetts

In an interview with Citi Global Wealth on Friday July 16th, 2021, Dr. Michael J Mina, Professor of Epidemiology and Immunology at Harvard T.H. Chan School of Public Health, believes that the global outbreak of COVID continues to follow an expected path, with new variants appearing regularly as the virus mutates. The Delta variant represents the most prevalent of these. To date, existing vaccines most often prevent COVID due to Delta, but there are instances where vaccinated patients have tested positive for COVID after exposure to the Delta variant. This recently appeared to have happened with some New York Yankees baseball players and Texas Democratic legislators. Most of these patients have limited or no symptoms. But such infected patients are still able to transmit the mutated virus.

Dr. Mina expects that there will be more cases of COVID in the US this summer and that it will accelerate further this fall, especially among the unvaccinated and the elderly who have received vaccines but have waning immunity. The Delta variant, therefore, is likely to cause medical concerns and media hysteria even as herd immunity is within reach in the US. LA County announced mask wearing requirements again Friday and similar changes in policy globally should be expected. Therefore, it seems almost certain that hospitalizations and deaths are set to rise again before finally abating as the pandemic likely ends in Spring 2022.

The rise of nationalism since the 2008/2009 financial crisis has impaired the ability for governments to coordinate effective global action against the pandemic. Uneven vaccine distribution and use, unfocused vaccination efforts, differing views of the risk of the pandemic and misinterpretation of data are evidence of this. To truly put the pandemic behind us, policymakers will need to consider stronger actions to put the most effective vaccines in the arms of the majority of the world's population.

Pharmaceutical companies are suggesting that boosters for COVID will be necessary and there is some hesitancy to accept that view. The US federal government via the CDC has given the "all clear" as regards mask wearing and testing too early, Dr. Mina notes. This has given people overconfidence relative to the seriousness of COVID risks. Future vaccines may try to anticipate the possible variants of COVID, but encouraging mutations in the lab is a very risky business.

There remains a remote possibility that another variant will arrive that may be significantly more resistant to the vaccine, creating the possibility for a "pandemic within a pandemic," says Dr. Mina. This worst-case scenario would require the development of billions of new vaccines and have very serious ramifications for the global economy. Dr. Mina believes that the best action to prevent this is rapid, worldwide vaccine distribution to stop transmission and the consequent likelihood of mutations. In short, as COVID lingers, so does uncertainty about the timeline to the end of the pandemic.

## Reasons to Be Wary: The United Kingdom

The most notable and concerning resurgence of COVID has been in the UK. This is because the UK is second furthest along among larger developed countries in vaccinating its public (see figure 1). Despite the government's well-organized efforts, infections in the UK have surged to their highest level since January 2021 (see figure 2).

**Figure 1: Share of Adult Population With at Least 1 Vaccine Dose by Country**

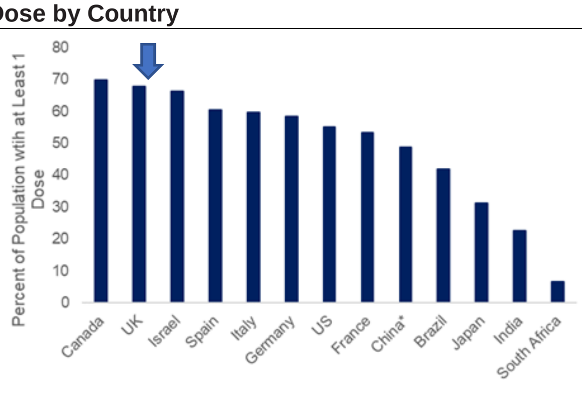
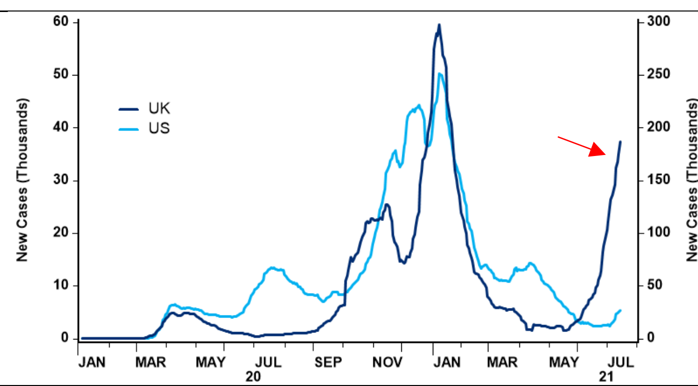



**Figure 2: New COVID Infections: US vs UK**




Source: Haver Analytics as of July 15, 2021.

News reports suggest infections are spreading fastest among the unvaccinated population in the UK. But available public data to support this assertion appears insufficient to prove that the rise is only among the unprotected.

The surge in new infections is very recent and it will take a month or so to see the lagged impact on the UK health system. To date, data on hospitalizations and fatalities show a sharp reduction in *severity* of the present rise in infections, consistent with a spread among healthier individuals (see figure 3).

Throughout the pandemic, severity has correlated to age and "co-morbidity." Older individuals in the UK were prioritized for the earliest vaccinations. Therefore, the latest available data showing rising infections among the 50-69 aged cohort suggest a new pattern is emerging. Only the 70+ population has seen a reduced rate of new infections relative to younger groups. This is the group where vaccinations are most complete (see figure 4). As of now, the UK plans a full reopening of its economy with vaccinations proceeding and "herd immunity" likely if the spread is rapid among the young and unvaccinated who remain. This is the path the US is following.

**Figure 3: UK Fatalities Per New COVID Infection**

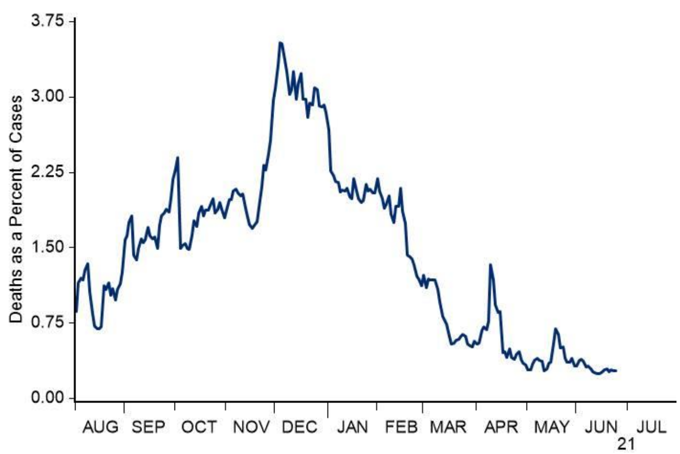
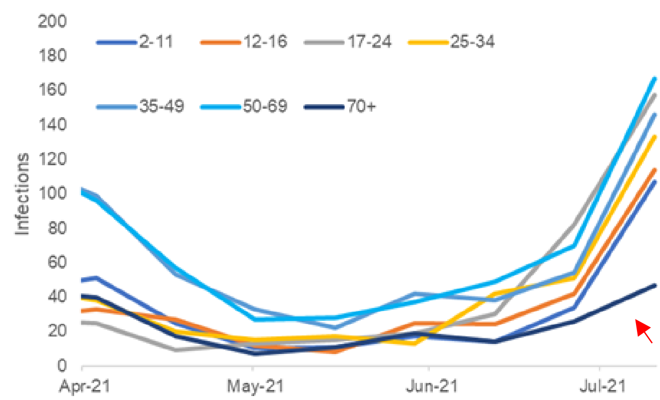



**Figure 4: New UK COVID Infections By Age Group**




Source: Haver Analytics as of July 15, 2021.

## And Around the World…

Global infection rates have now begun to climb again as the majority of the world's population remains unvaccinated. That's true for the US, as well. In our view, to "Reconnect the World" and achieve a full, global economic recovery, the spread of COVID will have to be better controlled. This is unlikely before year end. (see figure 6). The news should be a wakeup call for governments to re-double their vaccination efforts to reach remaining populations and speed the inclusion of children in vaccinations programs.

**Figure 5: New COVID Infections: US and Global Ex-US**

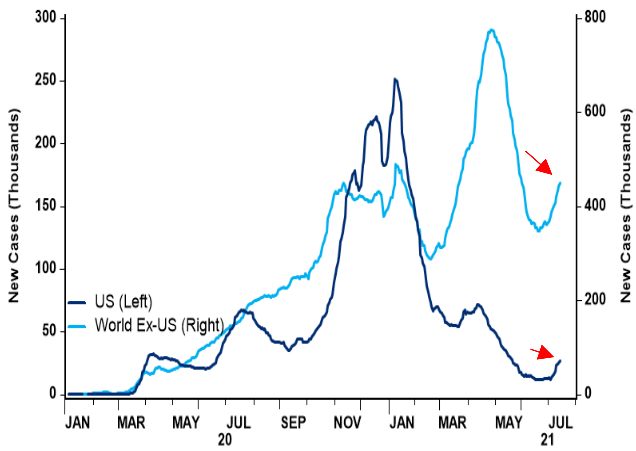
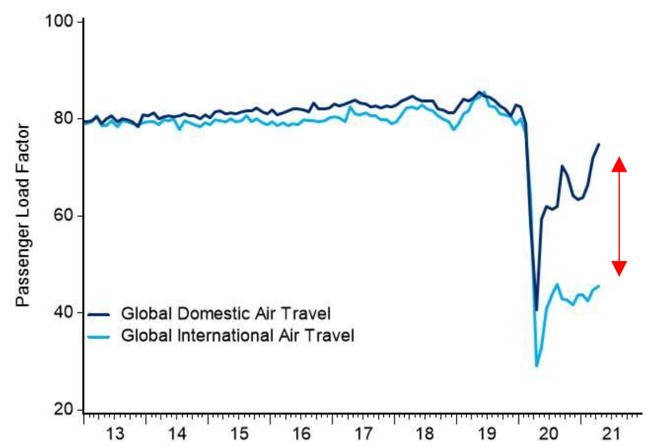
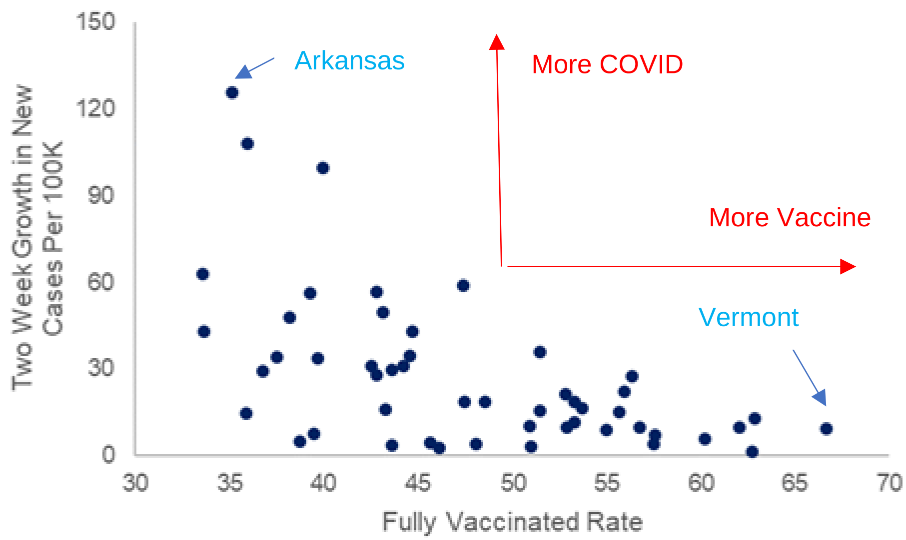



**Figure 6: Global Air Travel: Domestic vs International Arrivals**




Source: Haver Analytics as of July 15, 2021.

**Figure 7: US State Vaccination Rate vs Growth in Per-Capita COVID Infections**




Source: Haver Analytics as of July 15, 2021.

## Powell Keeps the Pedal Down Despite Inflation

In Congressional testimony last week, Fed Chairman Jay Powell was grilled by both House and Senate lawmakers over the recent surge in inflation. The semi-annual testimony marks the most strident admonition of a Fed Chairman to “do something” about inflation since the late 1970s. At 5.4% over the past 12 months, US inflation has risen above global emerging markets that typically run a higher trend inflation rate. The upward “surprises” in US inflation have been the largest ever recorded (see figures 8-9).

**Figure 8: 12-Month Change in Consumer Prices: US vs Emerging Markets**

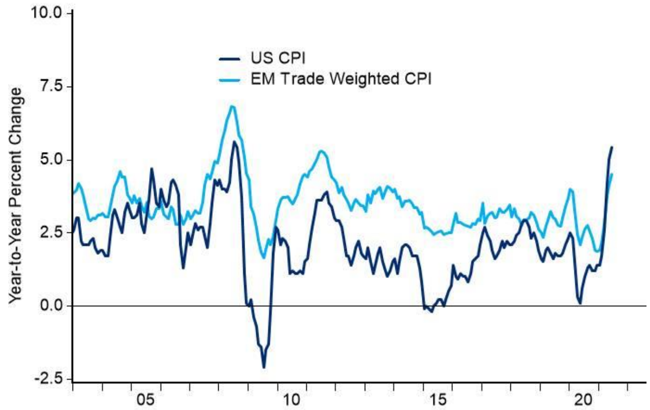


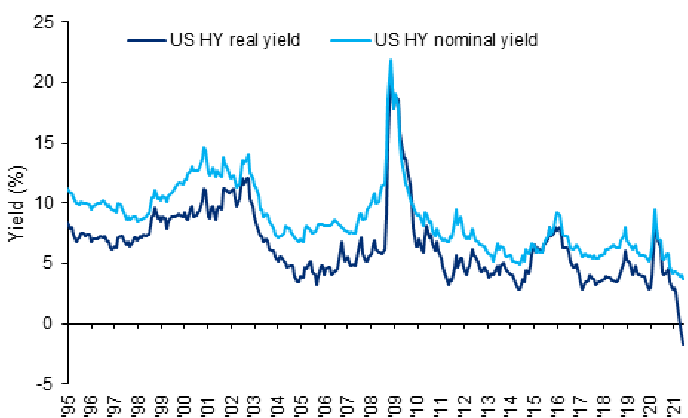

**Figure 9: Citi Inflation Surprise Index: US, EU, Emerging Markets**


Source: Haver Analytics as of July 15, 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.

We have previously discussed the underlying causes of the supply/demand mismatches that are largely responsible for this jump in inflation to the highest rate in more than 30 years (See the [May 30, 2021 Bulletin]). The distortions cause by COVID have dramatically altered lives and swiftly re-directed economic activity in unpredictable ways. Unprecedented demand for consumer goods, unrelenting slowdowns in leisure services, work-from-home shifts in the use of offices, lower public transport, higher auto use, and unforeseen changes in the location of ships and containers are but some of the reasons why prices have been shooting upwards. The Fed continues to create $120 billion of new reserves through bond purchases each month. Combine that with huge government stimulus and higher savings rates that encourage purchasing and you have the mix needed for unusual inflation patterns.

We have agreed with Chairman Powell that this unusual inflation surge will abate and that core inflation will be at a slower pace a year from now once these distortions fade. Yet **what's highly notable is how strongly financial markets have accepted this view.** Even sub-investment grade US debt sells at a yield below the inflation rate (see figure 10). It is simply a wonderful time to be an American debtor. And also a risky time to be a bond holder.

**Figure 10: US High Yield Bond Market Yield-to-Worst: Nominal and Real (Real subtracts 12-month Consumer Price Index Change)**




Source: Haver Analytics as of July 15, 2021. Past performance is no guarantee of future results. Real results may vary.

## Understanding US Policy in Light of COVID

The fact that COVID is resurgent and likely to be a rising problem as we head into the third quarter of 2021 is another reason why the Fed remains accommodative. To power through the likely distortive impacts of the Delta variant, keeping the foot on the accelerator makes sense. Remember, Powell received plenty of advice from US legislators to refrain from slowing down the pace of Fed bond purchases even as they complained about inflation.

## The USD Holds After Yields Collapse and Inflation Surge

From a very long-term perspective, the US currency remains highly valued (see figure 12). We've been pessimistic on the US dollar's path since early 2017 after a decade-long surge. The Fed's effectively higher inflation target, outsized US borrowing, and the very high share of US dollars in foreign portfolios are factors that should weigh down the dollar. Most recently, the Fed has reduced policy interest rates to near zero, financed a US fiscal expansion and saw inflation surge above the global pace. So, why hasn't the US dollar fallen below its five-year range (see figure 11)?

The answer is COVID. Central banks have to ease in tandem without frightening away international capital. For the US, the fact that the dollar has remained strong is evidence that it remains a safe-haven during the pandemic's storm. Foreign inflows remain as strong as ever. The premium level of US yields over other developed markets and **the latest COVID developments now argue for at least a modest reversal higher in the US dollar (see figures 13-14).**

**Figure 11: US Major Currency Nominal Dollar Index**


**Figure 12: Inflation-Adjusted US Trade-Weighted Dollar**


Source: Haver Analytics as of July 15, 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.

**Figure 13: US and German 10-Year Government Bond Yield (%)**

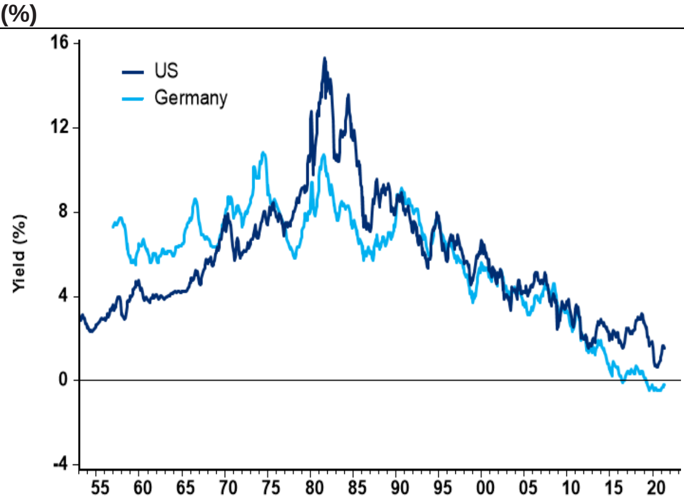
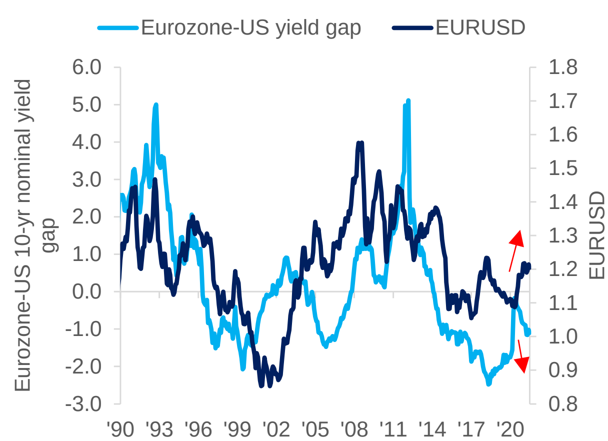



**Figure 14: US Yields Rise vs Europe, Yet Euro Higher vs USD**




Source: Haver Analytics as of July 15, 2021. Past performance is no guarantee of future results. Real results may vary.

## What the Rise in COVID Means for Asset Allocation to Year End

The technological adaptations and tech-heavy weightings of stock markets in the US and China led them to outperform in 2020. A setback in the fight against COVID could see the US and China markets outperform again, with "growth" shares feeling the added relief from COVID-blunted interest rate pressures.

In contrast, we have already seen a decline in global travel and leisure shares, one that may accelerate if the Delta variant spreads globally with the speed it has rebounded in the UK (see figure 15).

Similarly, we can expect that the "COVID cyclical[1]" markets of Latin America and Eastern Europe could also be set back. This may be of less severity, as EM equity valuations haven't rebounded so sharply that a modest US dollar rebound would cause intense correction pressure, particularly if the Fed is not actively tightening (see figure 16). In fact, some of these EMs have yet to feel significant relief from the initial pandemic.

**Figure 15: Citi Stay at Home, Leave Your Home Baskets vs S&P 500**

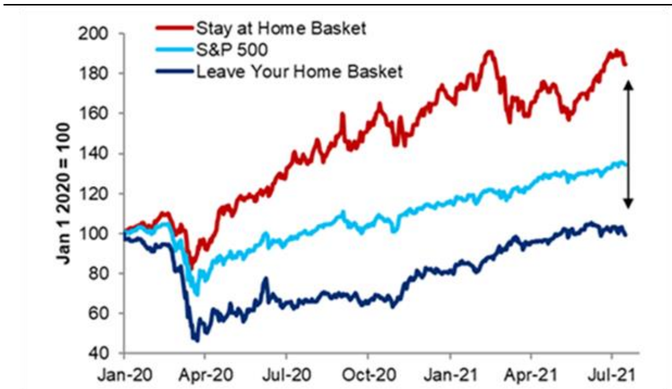
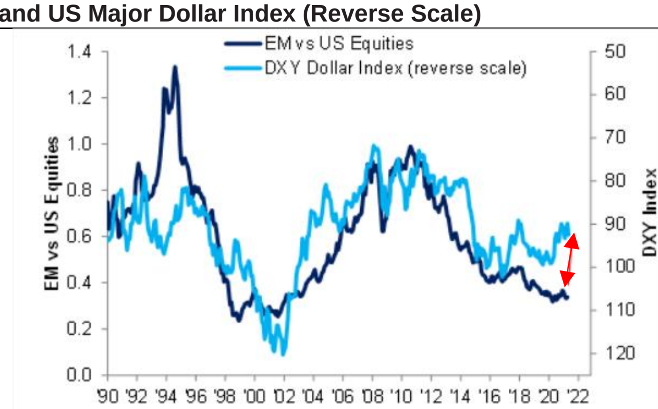



**Figure 16: Emerging Market Equities Relative to US Equities and US Major Dollar Index (Reverse Scale)**




Source: Haver Analytics as of July 15, 2021. "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. Past performance is no guarantee of future results. Real results may vary

## Higher Quality Assets Will Prevail

Truly ending the COVID pandemic globally will likely mark the end of US monetary policy easing and see the Fed act to ensure inflation doesn't become entrenched. The highly sensitive bond and foreign exchange markets suggests it would not take a very large tightening steps for the Fed to achieve this. In our view, a looming tightening cycle beyond COVID does suggest choosing higher quality assets.

In this scenario, a shift to China may also be profitable. With a half year of policy tightening behind it, China's post-COVID equity market performance has only slightly exceeded Brazil's (see figure 17 and our latest *Asia Strategist*). Given China's preeminence, there are reasons to be optimistic that it can again lead markets higher. In short, as we discussed in our *Mid Year Outlook*, evidence is accumulating that the post-COVID world economy is going to be different than the pre-COVID economy – and that will be reflected in both valuations and new market relationships.

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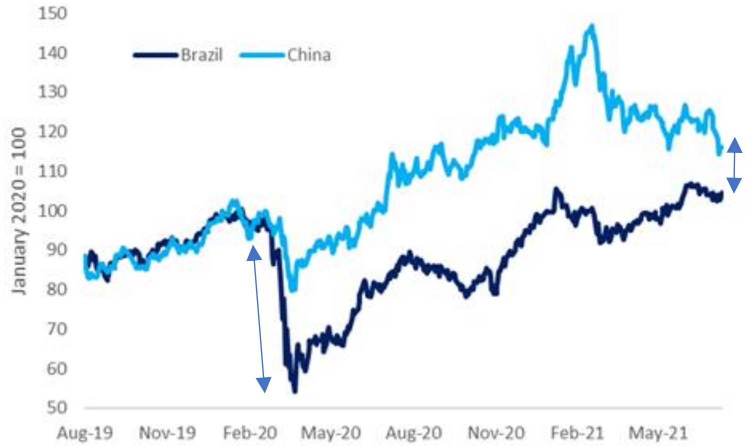
[1] COVID cyclicals are Energy, Materials, Industrials, Financials, Consumer Discretionary (ex-ecommerce), and Real Estate. COVID defensives are Technology, e-commerce, Telecom Services, Healthcare, Staples and Utilities.

**Figure 17 China vs Brazil Local Equity Index**




Source: Haver Analytics as of July 15, 2021. Indices referenced are MSCI Brazil and MSCI China. 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.

## Conclusions

The rapid spread of the Delta variant is likely to be another unwelcome shock for many who naturally hope the world can finally return to "normal." We do not in any way expect an economic collapse or a deliberate shutdown in global markets to address the spread of the disease as we did in 2020. We do expect a longer period of market dislocations and anomalies, higher transient inflation in pockets of the global economy (think used cars and semiconductors), and lower US and global interest rates than one might expect in a normal expansion. The world has learned to adapt and coexist with the virus. However, the rate at which social-close activities can resume and reopen will likely be set back. The already slowing global growth pace will be attenuated.

We do not want investors to react to or chase short-term COVID distortions in markets. There will be many surprises that will challenge the confidence of investors from the pandemic (please see our April 11 bulletin for discussion). The time is ripe to upgrade the quality of assets in our portfolios and to seek sustainable drivers of returns in the face of what are likely to be more volatile markets (please see last week's bulletin for full discussion).

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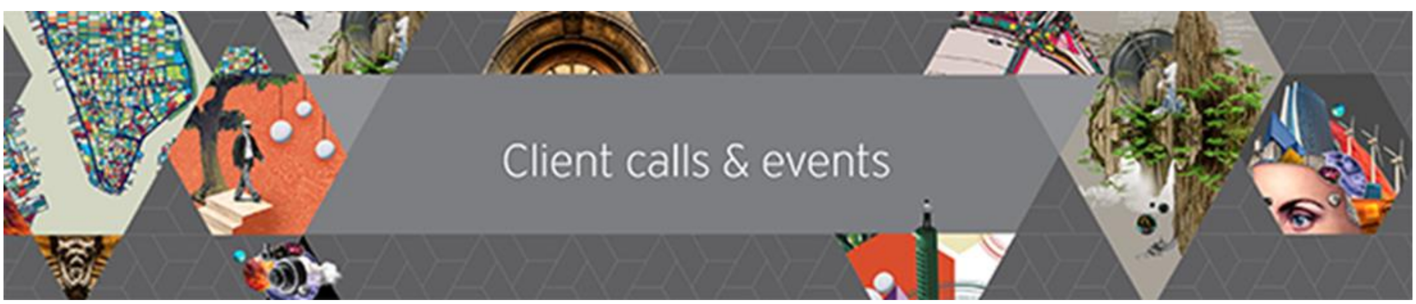

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