Private Bank

CIO Strategy Bulletin

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The Pandemic and The Future of Our Portfolios

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Summary

The pandemic is been a blight on our world, exposing us all to significant health risks and causing social, economic and structural disruptions not contemplated prior to the event itself. The world's responses to the pandemic have varied wildly based on cultural attitudes and political calculations as much on scientific knowledge. In the face of all this, there has been an outpouring of scientific cooperation to identify treatments and to speed their delivery. Technology has acted like a generator in a worldwide power outage, supplying connectivity and massive amounts of data to enable the world economy to function remarkably well. While we have seen major weaknesses of some governments and policy-makers to respond to this disaster with dispassionate assessments and speed, there has been an unprecedented degree of personal resilience and courage in the face of this potent, global threat.

As we track markets, policies and the adaptability of consumers and businesses, we see that the worst-case health outcomes from the virus itself are abating. This week, published scientific data confirmed that the virus has become more contagious and less virulent. Better treatment protocols, small improvements in available medicines, containment practices and simply wearing masks have reduced the likelihood that outbreaks will overwhelm hospitals.

We also see the effectiveness of government stimulus (rather than industrial shutdowns) in countering the deepest impacts of the COVID recession. Reflationary monetary and fiscal policies have been successful in providing bridges over what could have been a Depression. Our daily and weekly data suggest that mobility has returned much faster than we might have thought likely just three months ago. And consumers continue to spend and to substitute one purchase for another.

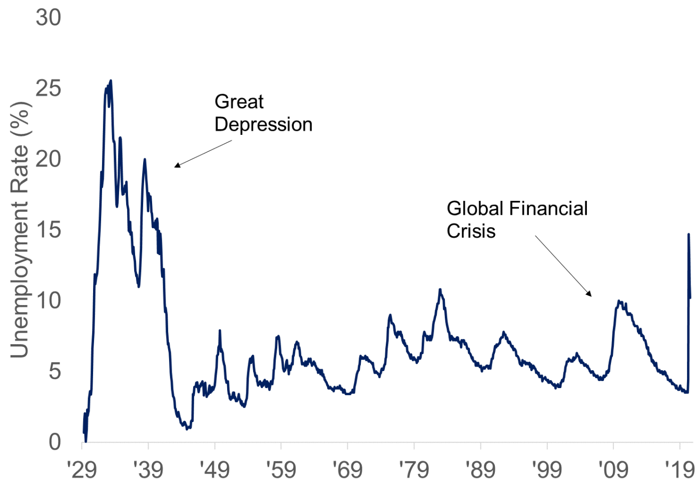
Because of all this, the stock markets are telling us that we have much to look forward to. The most negative tail risks have been "taken off the table". That said, being a passive investor ignores certain realities that deserve recognition in portfolios. And that's what the purpose of the work of the OCIO office at Citi Private Bank is, to steer you and your portfolios in the right direction given what we know and what we are experiencing, hence this Bulletin.

Historical Precedents and Singular Experiences

Many times, historical comparisons are useful in explaining what has happened and what will happen. There are patterns in recessions and recoveries that can be identified and extrapolated. However, there are also unique attributes within events and these must be seen and understood in order to best navigate markets.

This pandemic recession has many atypical characteristics. The recession itself was induced as a reaction to COVID-19, an external threat. Thus, governments staged a rolling shutdown of the world's economy as a means to mitigate the spread of the disease. The ensuing contraction in GDP was unprecedented, save for the Depression and unemployment rates shot up to levels indicative of a major recession or worse **(see Figure 1)**.

Figure 1: US Unemployment Rate



Source: Haver as of August 22, 2020.

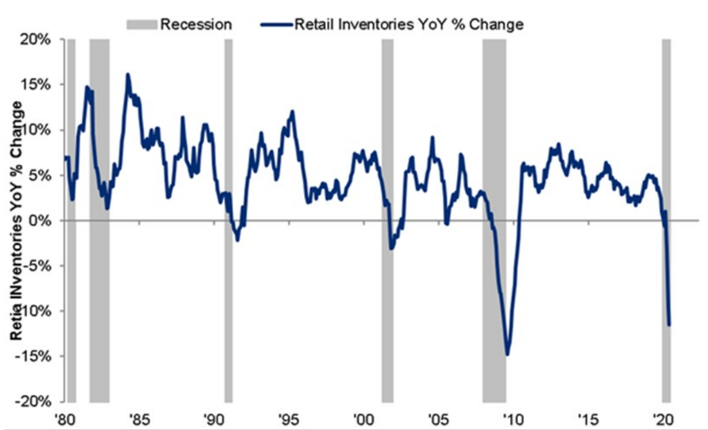
The generally good health of the world economy pre-COVID and rapid fiscal action by governments fueled a rebound in global activity that has been extremely sharp, V-shaped in fact. But the nature of the virus itself has created winners and losers heretofore unseen in prior recessions and recoveries. Socially close industries, including travel, hotels, entertainment, health care, retail and the like were hardest hit and will stay so until effective treatments are achieved and made available, up to a year from now. Technologies that enable entire companies and industries to work from home are booming. So are their stocks **(Figure 2)**.

Figure 2: Stay at Home vs Leave your Home Basket

Source: Bloomberg as of August 22, 2020. "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.

In a locked-down environment, we are also learning a lot about consumer behavior and substitution effects. For example, when people cannot save, they nest and improve their homes. And when in-person retail is in a funk, e-commerce booms. Substitution effects have been so robust that they caused supply chain disruptions and inventory depletions. Just this month, Citi Private Bank took down its 2020 GDP forecasts and increased its 2021 and 2022 growth rates acknowledging that in many industries, businesses are unable to refill pipelines given the extent of the demand. To give perspective, overall end-consumer inventories are plunging **(see Figure 3)**. 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. We have pent-up demand during a pandemic.

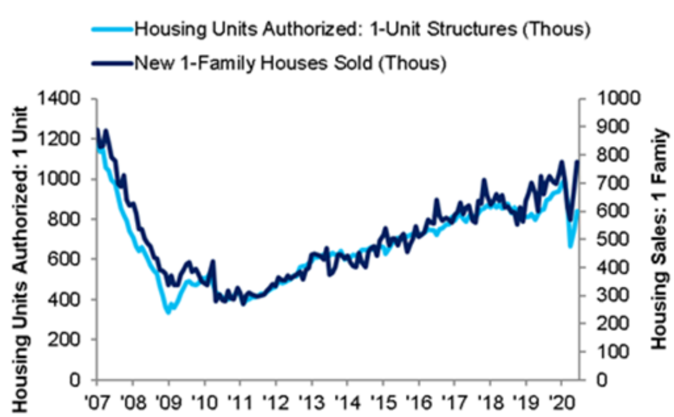
Figure 3: YoY Change in US Retail Inventories (Last data point is June)



Source: Haver as of August 22, 2020.

Demand for housing has proven particularly well poised for recovery. In the 2008-2009 recession, housing demand was stunted for years after its pre-recession excesses. Not so in 2020. Single-family existing home sales have risen 8% above year-end 2019 levels. Yet there's significant room for further growth with the number of sales per-US household down 32% from 2005's peak **(Figure 4)**.

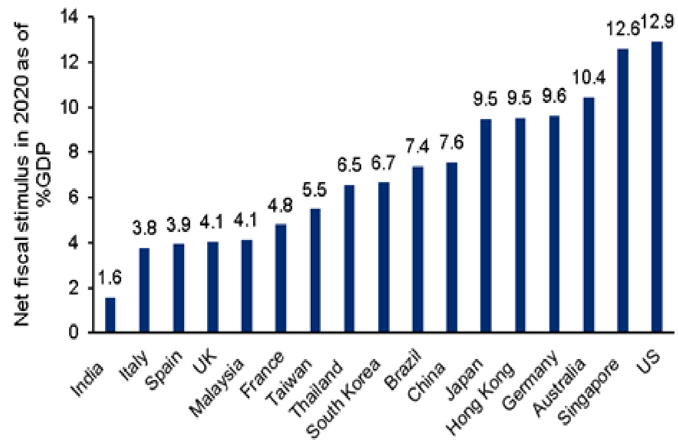
Figure 4: US Single Family Housing Starts



Source: Haver as of August 22, 2020.

Looking at the data, we can make two additional observations. The first is that flooding the world with stimulus – particular income supports to consumers - can been highly effective in sustaining demand and mitigating economic damage **(see Figure 5)**. Whereas monetary policy had historically been the more potent tool, this time around fiscal spending seems to have been at least as much a contributor. The second is that for large segments of the economy and population it is business as usual when it comes to spending. For example, with rates low and incomes supported, home buyers are out in force and housing inventories are being depleted. Lumber prices are up 97% in 2020, as a result. Overall US retail sales through July hit a record high, 3½% annualized above the end of 2019.

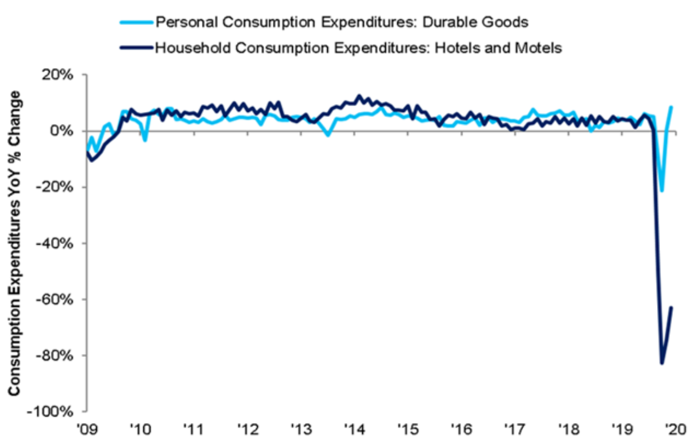
Figure 5: Current Year Fiscal Support by Economy as % of GDP



Source: Bloomberg, Citi Private Bank Investment Strategy as of August 20, 2020

However, we can also see that the pandemic and health care policies (or a lack thereof) will create limitations for the overall economy to recover in full. For example, in US States that have had large numbers of COVID cases, hospitalizations and deaths, the ability of the economy to recover in full is truncated. In particular, the types of activities that can recover are deeply constrained **(see Figure 6)**.

Figure 6: US Consumer Spending: Hotels vs Durable Goods Y/Y%



Source: Haver as of August 22, 2020

Risks, Implications and Portfolio Positioning

As we look to 2021, we expect growth to accelerate and we also expect that medium and long term interest rates will rise. When even a modest amount of inflation returns, rising rates can create risks to the economy and portfolios. For example, as we saw on August 11th, when the Russian vaccine was announced, there was a 2% drop in 30-year US bond prices and a 5% drop in the value of gold. On that day, we received a message. When the starting gun for the next part of our New Economic Cycle is fired, expect that a second wave of growth and higher rates will ensure. Our job is to help investors anticipate such future risks and navigate them.

Markets face two major risks. The first is sustaining the growth that is underway and the second is sensitivity to rising interest rates (please see the latest issue of Quadrant for discussion). For the moment, restraints on growth due to the virus are understood and expected. And low rates can sustain high asset prices even in the face of slower growth. For the moment, our longer-term concerns offset one another.

Citi Private Bank is increasingly optimistic on the state of the business cycle and growth prospects for 2021 and 2022. We expect the US Congress will pass more stimulus as it has done 36 times in the past. And, looking at typical historical precedent, we see supply contracting more sharply than demand presently. For example, we see vehicle sales down, but we see auto production down further. We see new construction unable to keep up with demand. You'll have to wait for certain appliances and carpet styles. And these shortfalls in salable inventory are happening *faster and sooner* than in a typical recovery. We believe this is a global phenomena. While a long and clear data history allows us to make more accurate projections for the US, the rebound will be repeated across the world with varying amplitudes.

Europe is an excellent example of where we may see growth exceed expectations. It has been a very long time since we've seen expected Eurozone growth of +4%, but we believe this may *underestimate* its rate of recovery 2021 given how severe the Eurozone's 2020 contraction has been. The history of European post-recession rebounds shows that strength tends to build rather than "rocket." Given the nature of this shock and the improving European policy response, we see the likelihood of a sharp jump in economic activity increasing.

In contrast, as figure 7 shows, both gold and US growth stocks have risen sharply and similarly in scope this year as rates have fallen. The rise in gold (an investment with no yield or duration) has been almost perfectly proportional to the fall in real US yields. And the rise in tech shares has been disproportionate to the rise in earnings that they have generated **(see Figures 7 and 8)**. Falling rates (the "discount rate") and contractions in "social close" industries - are major factors for the increase in prices of gold and tech shares. This is why we have lowered our recommended exposures to gold and US treasuries while setting recommended constraints for the share of portfolios that should be in US growth stocks given our post-Covid economic outlook.

Figure 7: US-10 Year Yield, Gold & Growth Stocks

Figure 8: US Growth Stocks: Price-to-Book and Price-to-Earnings Ratios

Source: Haver Analytics and Factset as of August 22, 2020. Gold is the - London Bullion Market Association (LBMA) Gold Price index. 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.

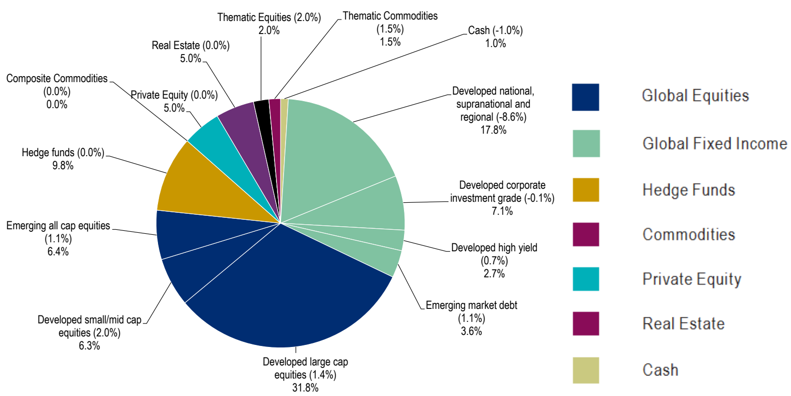
To explain how we are anticipating future market dynamics to play out, below are Citi Private Banks most recent portfolio changes. Please note, this shows the strategic and tactical asset allocations for a moderate risk portfolio including alternatives (PERE) The Quant Research & Global Asset Allocation (QRGAA) team creates strategic asset allocations using the [CPB Adaptive Valuations Strategy (AVS)] methodology on an annual basis.

- Global Small and Mid-Capitalization Shares – Increased Overweight
- Europe Large Cap Shares – From Underweight to Overweight
- US Small and Mid-Capitalization Shares – Decreased Overweight
- US High Yield - Increased to Overweight
- US Treasury Short- and Intermediate Maturities – Decreased to Neutral

And here are our allocations for a moderate risk portfolio including alternatives (PERE) – **See Figure 9**:

Figure 9: Medium Risk Global Asset Allocation Including Private Equity and Real Estate

- Global Equity: 44.5%; +4.5% Overweight
- Global Fixed Income 31.2%; -7.0% Underweight
- Thematic; REITS 2% Overweight
- Gold; +1.5% Overweight
- Cash; -1.0% Underweight
- Private Equity and Real Estate; 10% Strategic Weight

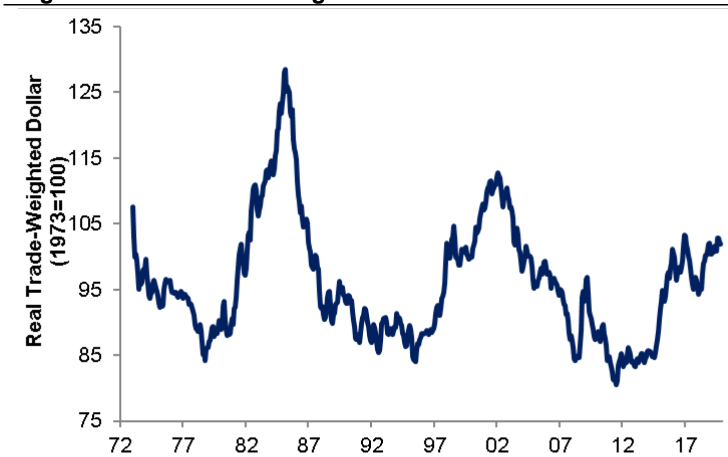


Source: Citi Private Bank Investment Strategy as of August 20, 2020. Figures in brackets are active allocations. All allocations are subject to change at discretion of the GIC of the Citi Private Bank. Risk Level 3 is designed for investors with a blended objective who require a mix of assets and seek a balance between investments that offer income and those positioned for a potentially higher return on investment. Risk Level 3 may be appropriate for investors willing to subject their portfolio to additional risk for potential growth in addition to a level of income reflective of his/her stated risk tolerance

Implications of the Coming Weaker US Dollar

The US dollar has had three distinct long-term bull markets since 1973 adjusted for inflation. **(Figure 10)**.

Figure 10: Real Trade Weighted US Dollar Since 1973



Source: Factset as of August 22, 2020

We believe that the broad US dollar basket peaked in value in early 2017 and we are now expecting a gradual, but somewhat volatile pattern of depreciation over the next 5-10 years against a trade-weighted basket of international currencies. There are four reasons for this view:

- The rise in government borrowing for Covid follows a large rise after the Global Financial Crisis. We do not expect that US policymakers would choose a strong currency and rigid price stability as primary goals as these would require fiscal austerity (through a combination of significantly higher tax rates and reduced government spending) to grow national savings. Thus, we expect that continued low rates will be preferred to mitigate the impact of high debt burdens.

- The US is a large importer of foreign savings and its appetite for capital is likely to rise in the future. The aging of the US population and the accelerating costs of health care benefits creates structural reasons for the need for additional imported capital that is stronger in the US case than others.

- Inflation rates throughout the rest of the world are now no faster than in the US. However, the US trade-weighted dollar index is still higher than lower foreign inflation rates indicate they should be.

- The Fed suggests it will persist with easy monetary policy deep into this New Economic Cycle. This will be a primary means by which the dollar will weaken over the next few years.

What a Weaker USD Means for Asset Allocation

We believe that a long period of strength in the USD has, in part, resulted in this massive valuation discount of almost 50% for Emerging Markets (EM) shares. As we have noted before, US equities hold a record 57% share of total world market capitalization. Emerging market equities have fallen towards to late 1990s lows in relative share of value. Profitability of non-US companies does not explain this. In fact, EM profits have fallen significantly less than US profits in 2020.

Figure 11: US Equities as % of World Market Capitalization and US Trade-Weighted Dollar

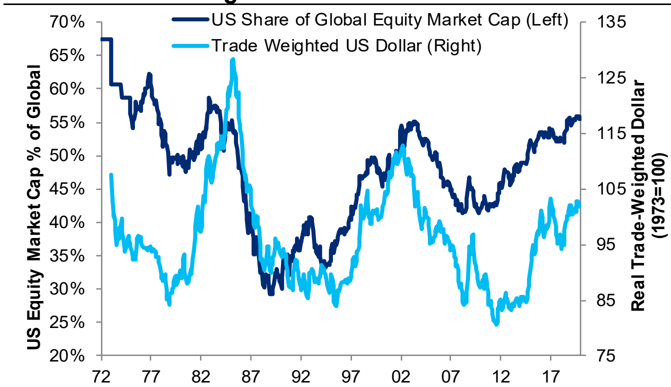
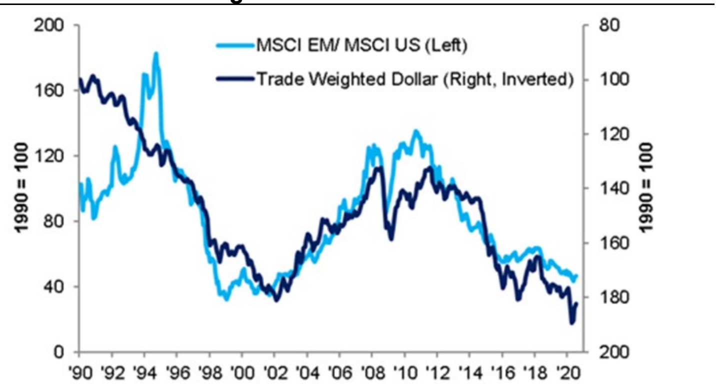


Figure 12: Emerging Markets Equities Relative Performance vs US vs Trade Weighted Dollar



Source: Haver Analytics and Bloomberg as of August 20, 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.

For many investors, USD assets are a key diversifier of local risk. Therefore, it is highly unlikely that we will eliminate USD assets from portfolios. Yet, our view of the dollar suggests that there are diversification benefits to be captured by owning non-US assets. EM strength this year has been concentrated in Asia, where long-term savings and investment dynamics make the region one of Citi Private Banks "unstoppable trends. In addition, we are also overweight Latin America with its boom/bust dynamics now near the weakest part of this cycle.

Investors should expect their portfolios to move from USD to non-USD exposures over time. Our thinking around this issue is captured in our revised Strategic Return Estimates, as noted below **(see Figure 13)**. Strategic Return Estimates are Citi Private Bank's forecast of returns for specific asset classes over a 10–year time horizon. The forecast for each specific asset class is made using a proprietary methodology that is appropriate for that asset class. Equity asset classes are forecast using a proprietary methodology based on the calculation of valuation levels with the assumption these valuation levels revert to their long–term trends over time. For more info on this, please visit our Strategic Asset Allocation methodology.

Figure 13: Citi Private Bank Strategic Return Estimates and Latest Tactical Changes

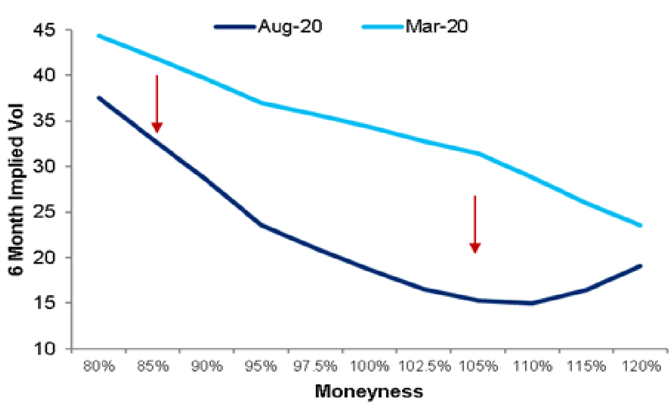
	2020 SREs	2020 mid-year* SREs	Allocation
Higher SREs			
Global Developed Market Equity	5.10%	6.20%	↑
Global Large cap equity	4.40%	5.50%	↑
Global Small/Mid cap equity	9.20%	11.60%	↑
Global Emerging Market Equity	10.90%	11.70%	
Lower SREs			
Global Developed IG Fixed Income	2.10%	1.10%	↓
Developed Government Bonds	1.90%	0.70%	↓
Developed Corporate Bonds	2.70%	2.60%	↓
High Yield	3.50%	5.90%	↑
Global Emerging Fixed Income	4.70%	6.20%	
US Cash	1.80%	0.60%	
Hedge Fund	5.30%	4.40%	-

Source: Private Bank Quant Research & Global Asset Allocation team. SREs for 2020 Mid-Cycle based on data as of April 30, 2020. SREs for 2020 Annual based on data as of October 31, 2019. Strategic Return Estimates are in US Dollars. All estimates are expressions of opinion and are subject to change without notice and are not intended to be a guarantee of future events. Strategic Return Estimates are no guarantee of future performance. Past performance is no guarantee of future returns.

Two Sides of the Same Coin: Hedging and Getting Long

At quick look at the year-to-date chart of US equity markets suggests that investors confidently bought the dip in late March and never looked back. Driven by IT and Internet names that benefited from COVID-related substitution effects, the S&P 500 reached a new all-time high this past Wednesday. But just below the surface, we see signs of a much more apprehensive equity investor. Measures of implied volatility, which are a crucial input in pricing various forms of hedging (portfolio insurance), remain elevated for contracts that protect against a significant correction in the next 3-6 months. Meanwhile, volatility levels for hedges struck closer to current equity levels have fallen by comparison **(see Figure 14)**. This dynamic may present an opportunity for fully invested clients considering hedging equity portfolio risk ahead of US elections, as well as an interesting entry strategy for those who missed the recent rally and remain underexposed to global equity markets

Figure 14: Implied Volatility in March 2020 and August 2020



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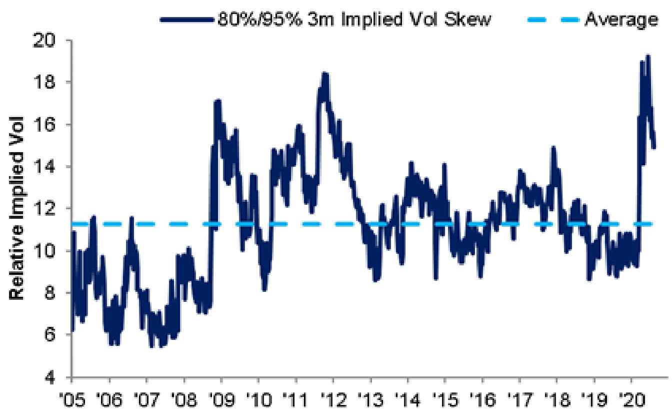
What's The Matter with Skew?

The relative attractiveness of contracts that protect against deep corrections versus those that protect against less severe volatility (or offer greater exposure) is called "skew". When investors are more concerned about deeply negative outcomes, they are often more willing to pay up for so-called "tail risk insurance." While we believe short-term volatility is likely, especially around elections amidst a pandemic, we are not expecting a return to March market lows. Therefore, looking at the elevated pricing of deeply negative tail risk insurance, we believe hedging against just a moderate correction is relatively attractive at current levels. For buy-and-hold investors, frequent hedging can of course degrade long-term returns. However, more trading oriented clients or those with short-term liabilities may find such a strategy useful given their assessment of near-term risks.

Figure 15: 95% / 80% Relative Implied Volatility



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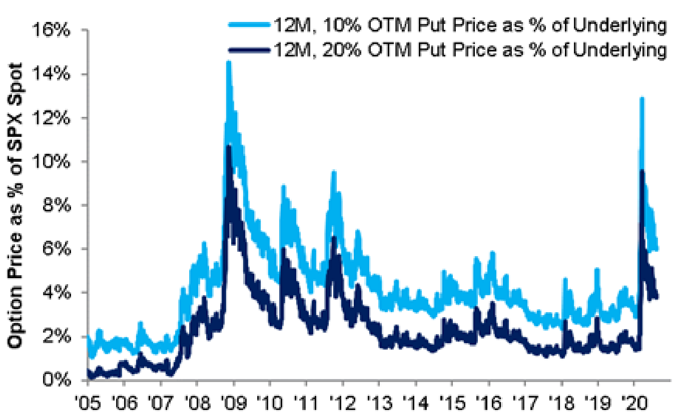
Looking at the opposite trade, for investors who are underweight equities, an entirely different opportunity exists. As we discussed in last week's CIO Bulletin, selling downside volatility can potentially generate yields of 3-6% while providing investors the opportunity to buy equities at a lower level **(see Figure 16)**. Taking this strategy one step further, we believe suitable investors who are under-exposed to equities can use that "premium" to purchase long equity exposure, especially in non-US and emerging market shares, given our expectation for a catch-up trade in those markets as the economic recovery progresses.

Figure 16: S&P 500 Implied Volatility as a % of the Spot Index Price



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