



Citi Global Wealth Investments

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CIO Strategy Bulletin

Investor Psychology in the Age of COVID: Is Slower Growth “Bad”?

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SUMMARY

- **Record high share prices have been “legitimized” by record high profits. The huge corporate profit gains of the past few quarters were critical in sustaining this equity market rally.**
- **We disagree with other analysts who say that the broad equity valuations are highly troubling. Present global equity valuations – unlike the late 1990s period – are very different from US valuations. Non-US equities trade at a 25% valuation discount to the US overall. US “value” shares also trade at a similar discount. Both measures are close to their long-term average valuation. Only Tech shares are expensive, but have much higher sustainable growth rates.**
- **Even with all the earnings news, investors remain worried. With the tailwinds of stimulus fading, the Federal Reserve set to reduce the amount of emergency credit it has been pumping into the economy, a resurgence of COVID and worries about rampant inflation, investors are asking themselves “Can This Go On?” – Can equity prices move even higher?**
- **We are far from an economic peak. Absolute EPS gains averaging 7% to 8% in the next 2 years are consistent with positive equity returns. Expect further new records highs ahead, but with gains made at a slower pace with higher levels of volatility.**
- **During periods like this -- where earnings growth is strong, but slowing -- intra-year corrections become more prevalent. They also tend to be shallow. Market timing is a very bad idea during such periods. Corrections are typically short and subsequent returns tend to outweigh the “anxiety” of volatility.**
- **Strategies to improve the quality of portfolio assets, focus on the total return from equities including dividends and diversify portfolios to specific emerging markets and to specific segments, are all ideal for this environment. Such a strategy may reduce portfolio drawdowns if and when they do occur, while capturing much if not all of the upside as the economic expansion continues.**

You Would Be Hard Pressed to Believe This Story

You would be hard pressed to believe this story. The world is hit by a pandemic for which it is woefully underprepared. The global economy is shutdown, literally, sending billions of people into their homes fearful that their grocery deliveries might kill them. Stock markets around the world crash, with the US -32%, China -15% and emerging markets -35%. The Federal Reserve and other central banks rush in with buckets of money to make sure that markets continue to function while governments step in to create programs to flood the world with even more cash.

People then go “back to work” without leaving their homes. With planes grounded, subways empty, stores shuttered and ballparks silent, the economy accelerates back to life. Bedrooms become trading rooms. Schools send curriculums to parents who become teachers. Zoom and Facetime replace conference rooms. Hospitals overflow with patients, filling ICUs. The evening news ticks off how many people are dying each and every day. George Floyd is murdered setting off national riots in a number of countries and a recognition that racism is endemic. Vaccine developers race to save the world and a company that’s never turned a profit emerges as one of a handful of players who introduce a life-saving Covid vaccine 270 days from the start of the shutdowns. The housing market booms. The US election takes 66 days to decide with threats that the President won’t leave the White House due to unsubstantiated claims of voting irregularities. Washington DC sees the storming of the Capital on January 6th, but the election is certified, and President Biden takes office.

You Would Be Hard Pressed to Believe This Recovery

You would be hard pressed to believe this recovery during a pandemic. From the US market low point with the S&P 500 at 2237, equities have risen by 101%, surpassing the previous high of 3379 in February 2021 by 33%. The Nasdaq did even better, rising 122% since its low point. Job losses, which at one point totaled 22 million including temporarily laid-off workers, have abated leaving the current unemployment rate at 5.2%. Wages have risen by 17% from April 2020. Corporate profits have literally never been higher, with S&P 500 EPS at mid-year 2021 up 30% from the pre-COVID period. And US household savings are at 10% of personal income, leaving plenty of fuel in the consumer tank. 10-Year US interest rates, meanwhile, are just 0.8% above their lows, and banks are lending as fast as they can to businesses eager to grow.

Where Did those Returns Come From?

In our view, the huge corporate profit gains of the past few quarters were critical in sustaining this equity market rally. Record high share prices have been “legitimized” by record high profits. While shares in industries with COVID-impacted profitability have not fully recovered (**Figure 1**), shares that have performed best have seen profits boom. In the case of technology shares, some of the rapid revenue and profit growth is due to Covid’s impact (**Figure 2**).

Figure 1: US Airlines: EPS and Share Prices

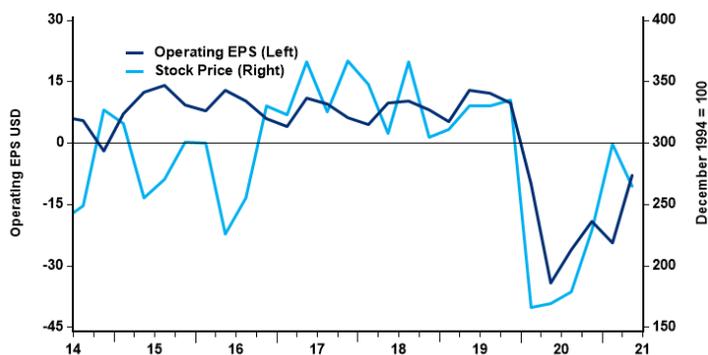
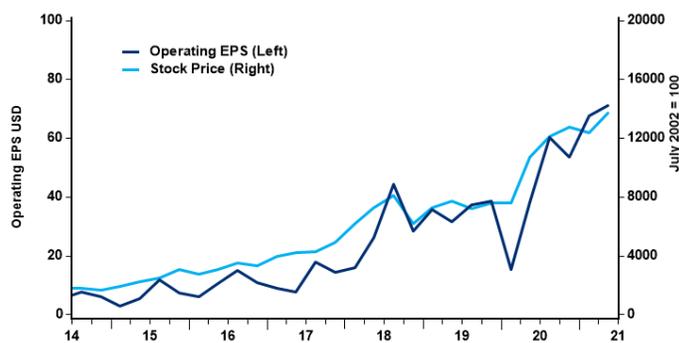


Figure 2: US Internet Retailers: EPS and Share Prices



Source: FactSet as of September 9, 2021. Past performance is no guarantee of future results. Real results may vary.

We Expect Growth to Continue at a Slower Pace

We believe that the EPS growth pattern in 2022-23 is likely to follow a similar path to 2011-12. After a 38% EPS gain in 2010, large-cap operating profits rose 14% further in 2011. This was despite US real GDP growth slowing to 1.6% that year. In 2012, EPS growth slowed to “just” 5%.

S&P 500 earnings rose to a record high as of mid-2021 and seem likely to be up more than 45% for the full year (**Figure 3**). During the height of the “COVID collapse” in calendar 2020, EPS for large cap firms fell just 22%. US and Non-US consensus EPS estimates now show that record profitability is likely again in 2022, with projected gains of 8% overall (**Figure 4**). In fact, the expected momentum in earnings at the end of 2021 suggests that the 8% average forecast for 2022 may still be somewhat conservative. However, the gains in 2023 should slow slightly more than consensus expectations, but still grow.

Figure 3: S&P 500 vs EPS, Consensus Estimates

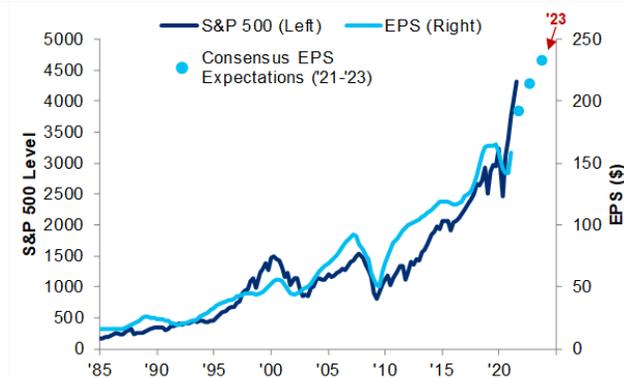


Figure 4: 2021-2023 Consensus EPS estimates and P/E

Year	USA			World ex-USA		
	EPS (Level)	EPS (Y/Y)	P/E	EPS (Level)	EPS (Y/Y)	P/E
2020	141		27.1	15.3		21.8
2021	202	43%	22.5	22.7	49%	15.7
2022	220	9%	20.6	24.2	7%	14.7
2023	238	8%	19.1	25.7	6%	13.8

Source: FactSet as of September 9, 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. All forecasts are expressions of opinion and are subject to change without notice and are not intended to be a guarantee of future events. Past performance is not indicative of future returns. For illustrative purposes only.

Absolute EPS gains averaging 7% to 8% in the next 2 years are consistent with positive equity returns, though far from the “rebound pace” of the past year (**Figure 5**). In short, expect further new records highs for equities ahead, but with gains made at a slower pace with higher levels of volatility. If one adds the benefits of dividends, that could drive annual total returns toward 10%. Relative to bonds, if equity returns were just half as strong (+5%), stocks would eclipse bond market returns by an historically normal margin (**Figure 6**). (This assumes long rates do not rise, reducing bond values.)

Figure 5: Global Share Prices (Leading 6-months vs. EPS)



Figure 6: S&P 500 Estimated Earnings Yield Less Investment Grade Yield (%)



Source: Bloomberg, FactSet as of September 9, 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.

Is Slower Growth 'Bad'? Investors Remain Worried.

Even with all the earnings news, investors remain worried. With the tailwinds of stimulus fading, the Federal Reserve set to reduce the amount of emergency credit it has been pumping into the economy, a resurgence of COVID and worries about rampant inflation, investors are asking themselves "Can This Go On?". By "This" investors mean ever-increasing equity prices. By "This" they mean that there hasn't been one market decline in excess of 10% in the US since the COVID-market recovery began. So, let's be clear, in our view 2021's US stock market returns to date are not repeatable.

When growth is moderating, people assume that "slow is the new down". This is the current state of market psychology. Yet, recessions are what drive profits and share prices down sharply, on average, about 30% before recovery. It would be wise for worried investors to remember, therefore, that the US economy has expanded in 86% of the months since the end of World War II and is presently just 16 months into a recovery.

Wherefore Art Thou Volatility?

During periods like this -- where earnings growth is strong, but slowing -- intra-year corrections become more prevalent. They also tend to be shallow. Market timing is a very bad idea during such periods. Corrections are typically short and subsequent returns tend to outweigh the "anxiety" of volatility.

The sources of volatility are likely to come from the day-to-day interpretation of data. Take employment, for example. At the July pace of re-employment, the US would be at "maximum employment" (by the pre-COVID standard) in just 6 months. But looking at the August pace, it would take over two years. Which is it?

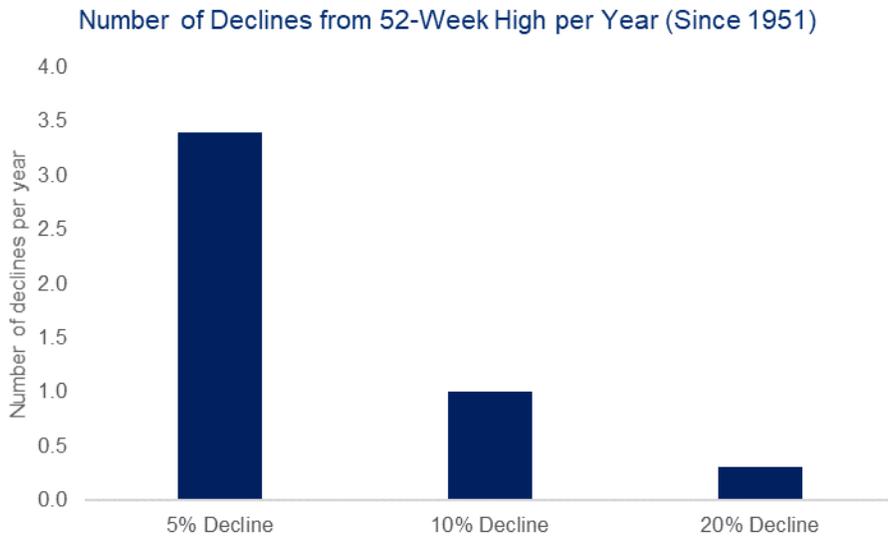
Despite their dubious value in predicting the future, monthly swings in US employment can drive radically different thinking about the path of the economy and policy. For example, there are significant barriers to quickly reaching the pre-COVID employment level. Many unfilled US jobs are not ones that recently unemployed workers have experience to fill. Adding further to the 2.1 million leisure and hospitality job gains in 2021-to-date would require more business reopenings in the face of rising COVID cases and smooth school reopenings. These are just two of the many reasons why employment growth cannot continue to achieve the 700K monthly average growth we experienced during the six months through July 2021.

Tapering and Deceleration

While the Federal Reserve would love to "normalize" monetary policy more quickly, it believes that we are far from an economic peak. Unless growth falters badly, investors in 2022 will have to look ahead to the onset of a policy tightening cycle. The Fed suggests this will once again be historically moderate, as was the case in 2014-2018.

In our view, slowing economic growth in the face of Fed tapering (buying fewer bonds to create liquidity) is a "difficult duo" for investor to understand. A mere reduction in positive growth momentum and less stimulus can result in pullbacks in equity markets that are routine even during expansion years (**Figure 6**).

Figure 6: Frequency of S&P 500 Corrections (1951-2020)



Source: FactSet, Bloomberg as of September 9, 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.

“Over-Valuation” Hysteria

Even as we expect more modest future returns, we disagree with other analysts who say that the broad equity valuations are highly troubling. Present global equity valuations – unlike the late 1990s period – are very different from US valuations. Non-US equities trade at a 25% valuation discount to the US overall. US “value” shares also trade at a similar discount. Both measures are close to their long-term average valuation, which is coming down as EPS grows. **Only US growth stock valuations have risen markedly, and remain less highly valued than the peak of the late 1990s bubble period.** At the same time, US bond yields have fallen by 5 percentage points from the late 1990s bubble period. In our view, low yields in combination with rising EPS make this a very different market environment, one that can sustain equity prices through 2022 (**Figures 7 and 8**).

We don’t see a business cycle peak ahead, only slower growth and more moderate equity returns to come. Our portfolios have already adjusted to moderating growth with several sector-, asset- and regional-allocation changes this year, such as a switch from small caps to higher quality large caps and Latin America to Global Healthcare. What we haven’t seen - as of yet - is a compelling improvement in bond valuations or a severe overshoot in global equities as a whole.

Figure 7: Trailing Price/Earnings: US Growth, US Value and Non-US Equities



Figure 8: Trailing P/E of US, Non-US Equities vs US Bond Yield



Source: Bloomberg as of September 9, 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.

Advice and Action: Maintain a Quality Quota

While we remain bullish equities relative to bonds, we acknowledge that full valuations and concerns around a growth slowdown requires some added defensiveness in portfolios. In this context, as we quickly move to more of a mid-cycle economic environment, we recommend that Core Portfolios retain a quality bias. An up-in-quality equity strategy tends to reduce portfolio drawdowns if and when they do occur, while capturing much if not all of the upside as the economic expansion continues (see **Figures 9 and 10**).

Figure 9: Quality Equity Returns vs Passive US Equities

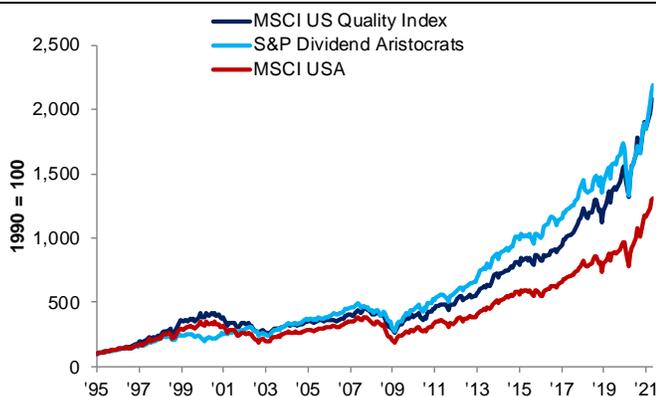


Figure 10: Quality Equity Index Returns and Volatility vs MSCI USA

	Quality	Div. Growers	MSCI USA
Avg Ann. Return	12.6%	12.7%	11.0%
Avg Ann. Volatility	14.4%	13.7%	15.2%
Inf. Ratio	0.88	0.93	0.72

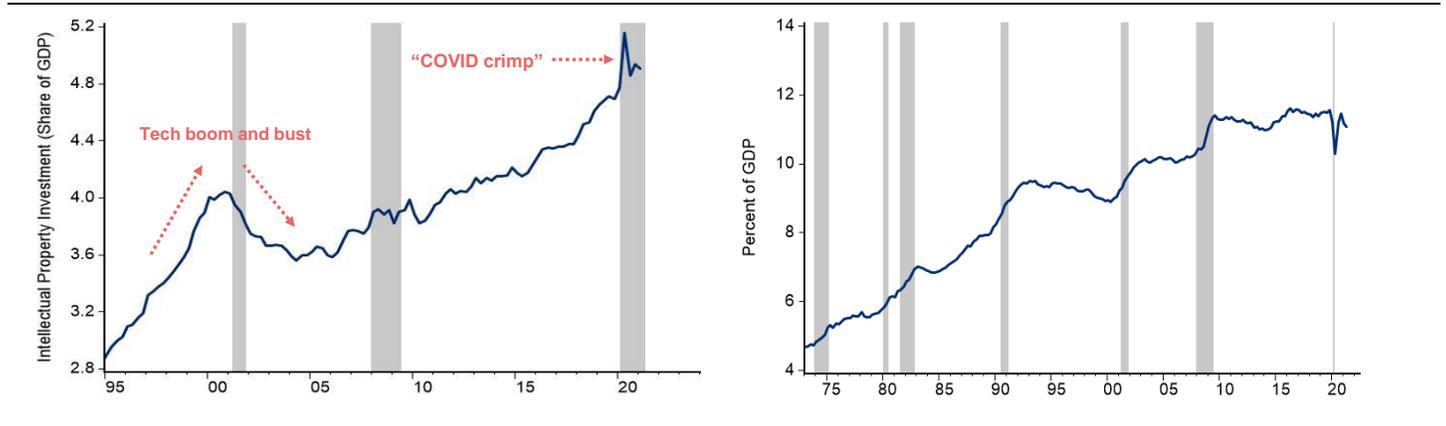
Source: FactSet as of September 9, 2021. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment.

Advice and Action: Seek Industries That Are Set to Grow Faster

While valuations vary greatly for particular investments, we see digital applications and intellectual property gaining share in the world economy at the expense of traditional industries (**Figure 11**). With a relatively low valuation, healthcare also outgrows the economy over time, with aging global demographics, income growth and technology all poised to drive the sector to long-term gains (**Figure 12**).

Figure 11: Intellectual Property Investment as % of US GDP

Figure 12: Healthcare Spending as % of US GDP



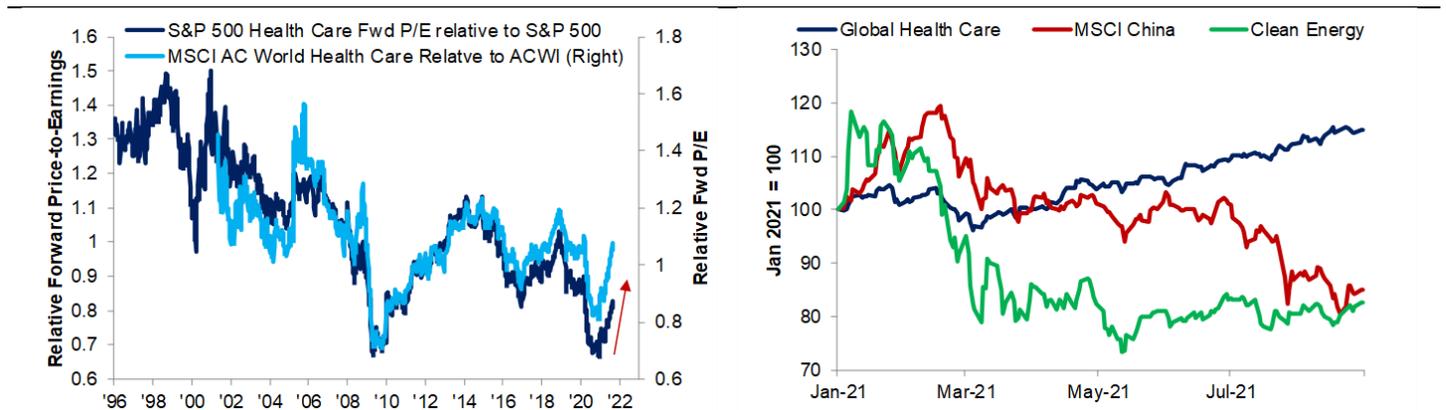
Source: FactSet as of September 9, 2021. Grey areas are periods of recession.

Advice and Action: Healthcare = Growth at a Reasonable Price

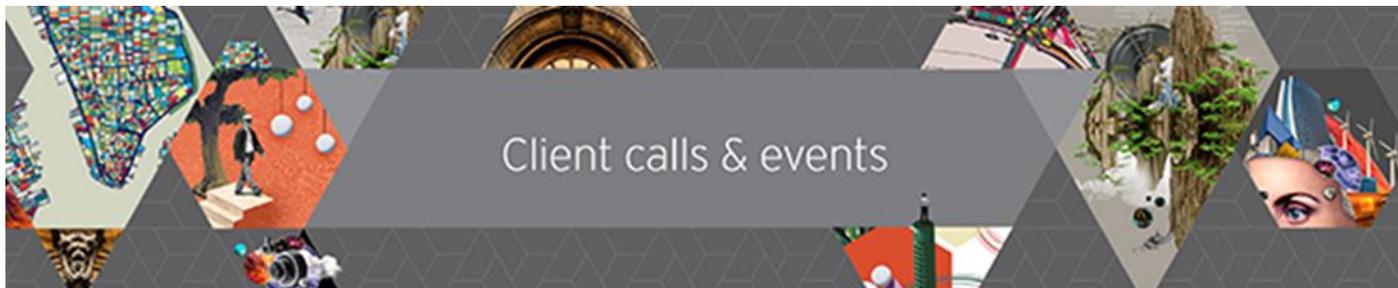
Healthcare remains a rare “growth at a reasonable price” opportunity, though valuations have risen somewhat from multi-decade lows earlier this year when we initiated our thematic overweight (**Figure 13**). The Global Healthcare sector is up 17% in the year-to-date, in line with global equity returns, though has outperformed by 6 percentage points since the beginning of June. While the sector remains cheap versus the broader market, a normalization in the sector’s relative valuation raises the question of whether to diversify some healthcare exposure into other secular growth opportunities that have not performed nearly as well this year (**Figure 14**).

Figure 13: US and Global Healthcare Valuation

Figure 14: Opportunity cost of owning Healthcare vs other secular growers



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