Private Bank

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CIO Strategy Bulletin

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Marking an Inflection Point in World Markets

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- **Pfizer's announced efficacy for its COVID vaccine of "at least 90%" is a turning point against the pandemic. With nine other vaccines in late stage testing, including some that do not require excessively cold transport and storage, it is more likely than not that broad vaccination of populations will occur in 2021. We would expect announcements on efficacy for at least one other vaccine before the end of 2020. A high efficacy rate for several of these more easily distributed vaccines would be a further signpost for a 2021 recovery, as would broad adoption of vaccinations by individuals.**
- **The emergency use approval of Eli Lily's monoclonal antibody treatment also took place last week, signaling the arrival of potentially more useful treatments for early-stage COVID after Redemsivir was found to have limited clinical effectiveness.**
- **The resurgence of COVID in the US and Europe, though expected, is posing significant immediate economic risks to these economies. We previously forecast a difficult fourth quarter GDP in our projections since April. The economy has entered the November period with greater upward momentum than we expected. Still, it is likely that the coming impact of the pandemic on business will be somewhat greater than we expected due to the lack of a coordinated government response in the US and elsewhere.**
- **The news of treatments for Covid has brought global financial markets to an inflection point. As we wrote last week (Fifty-Fifty: Implications of a Divided Government and Electorate), the "trifecta" for the beginning of a New Economic Cycle includes 1) a conclusive US election, 2) the arrival of viable vaccines and 3) additional fiscal stimulus in the US and abroad. This led a rotation between "COVID-Cyclical[1]" and "COVID-Defensive[2]" assets this past week. There was a 6.2% gain for cyclicals versus just a 0.4% increase for defensives in US markets. During the week the "see-saw" between hope and fear was manifest. When investors are fearful of the rapid rise in COVID, the Nasdaq continues to act defensively (rising in value), but the fall in bond prices and action in Gold also suggest that a transition is underway. The vast majority of institutional clients polled by Citi Equity Trading Strategies believe vaccines will continue to drive rotations within equity market performance (see Figures 16/17), but long-only players have not positioned themselves in this way – yet.**
- **A note of caution. We are not "out of the woods". The number of positive COVID incidences in the Pfizer trials was low (94 at first interim) out of nearly 44,000 participants (half receiving the true vaccine). As we saw in the US election polling, small sample sizes can lead to large deviations in outcomes. Also, as we have pointed out previously on November 1 (An Election, Then an Injection), we do not know how long the protective value of vaccines will be and there is a lot is riding on the production of T-cells in its recipients. Finally, when large populations are vaccinated, it is possible that side effects will arise in materials numbers. Therefore, we must be mindful of the data as it evolves and not assume a straight line for treatments and the nascent economic recovery. There will be many fits and starts. And the scope and timing of the fiscal stimulus package is still very much to be determined.**

[1]*COVID-Cyclicals: Financials, Industrials, Energy, Materials, Real Estate, Consumer Discretionary ex E-commerce.*
[2]*COVID-Defensives: IT, Health Care, Communication Services, Consumer Staples, Utilities, E-commerce.*

Towards a Future *Without* Masks

Someday, we will look back at 2020 images of ourselves and immediately recognize the strange age of COVID by the surgical masks and the distance between family members. Last week, we took the first steps in a "return to a new normal" and received vaccine test results that suggest 2021 will be the year the pandemic ended.

Pfizer and BioNTech were the first pharmaceutical companies to demonstrate the ability to deliver an effective vaccine that will immunize individuals from COVID-19 infections. This coming week, further safety data for the nearly 22,000 who have received the Pfizer vaccine is likely to be released. This should lead to an Emergency Use Authorization (EUA) from the Food and Drug Administration (FDA). Nine other drug makers have COVID vaccines in late-stage clinical trials. We profiled the leaders on November 1 (An Election, Then an Injection). Last week in the US, the FDA also approved a monoclonal antibody therapy from Eli Lily for the treatment of certain patients with mild to moderate cases of COVID-19. The treatment assists the body's immune system to fight the virus. Based on treatments under testing, it is more likely that other COVID treatments and remedies will be released in the coming year.

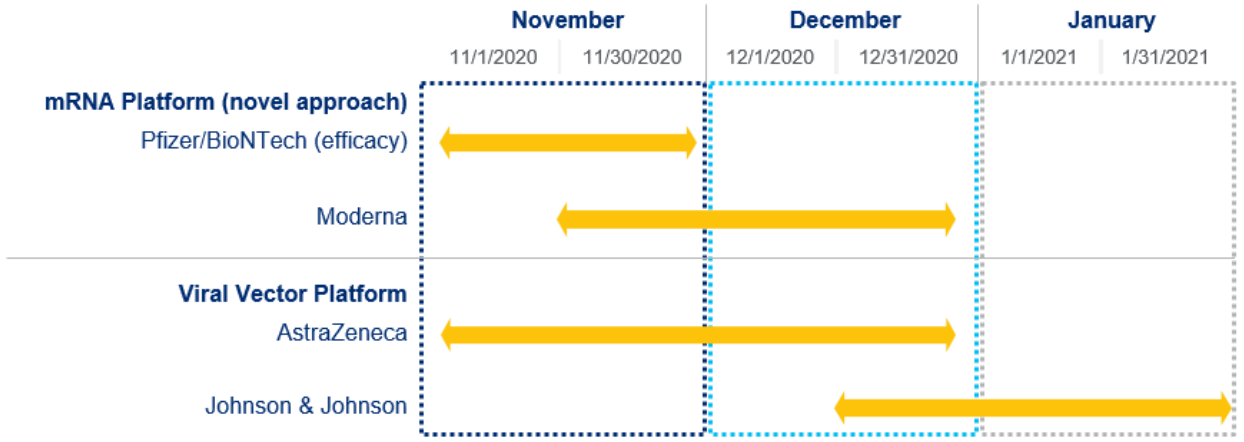
On Monday, November 9, world financial markets rocketed higher on the news of a Pfizer vaccine with an estimated efficacy rate "of at least 90%." Given that the base case expectation of epidemiologists for efficacy was around 70%, this was above expectations. The FDA had previously said it would approve a vaccine that was at least 50% effective.

The Pfizer efficacy news means that the possibility for broad, global treatment of COVID-19 is here. The Pfizer vaccine and others are in large-scale production pre-emptively, to allow for mass vaccinations, if and when government approvals are received. Pfizer estimates 50 million doses will be available before year-end 2020 and up to 1.3 billion doses in 2021.

While markets are thrilled at the news, we advise a level of caution and skepticism. We are not "out of the woods" yet. The number of positive COVID incidences in the Pfizer trials was low (94 at first interim) out of nearly 44,000 participants. As we saw in the US election polling, small sample sizes can lead to large deviations in outcomes. In addition, as we have pointed out previously, we do not know how long the protective value of vaccines will be and a lot is riding on the production of T-cells in its recipients. Finally, when large populations are vaccinated, it is possible that side effects will arise in materials numbers. So, we must be mindful of the data as it evolves and not assume a straight line to economic recovery. There will be many fits and starts.

One impediment that markets have underestimated is the complexity of distributing the Pfizer vaccine. Pfizer's vaccine requires very cold temperatures for storage (-70C or -94F) and duel doses over a month's time. While included in the drug maker's production estimates, these are extremely difficult logistical requirements. The level of coldness required is so great that significant investment in "cold storage supply chains" by global governments is necessary. Some potential - though not yet fully proven - vaccines from AstraZeneca, Johnson & Johnson and others will not require such extreme temperatures for distribution and storage. **A high efficacy for one of these more-easily distributed vaccines would be another beneficial news event in the battle to end the pandemic.** We would expect announcements on efficacy for at least one other vaccine before the end of 2020 **(see Figure 1)**.

Figure 1: Timeline for Expected Vaccine Efficacy Announcements in the US



Source: Citi Private Bank Investment Strategy and Citi Investment Management as of November 15, 2020. All forecasts are expressions of opinion and are subject to change without notice and are not intended to be guarantees of future events.

Greater Confidence in Our Bullish World View

Our base case economic outlook for the world is a 4.2% growth rate in 2021 following a 4% drop in 2020. We assume winter difficulties with COVID still lie ahead. Social close industries such as tourism will remain deeply depressed at the start of 2021. Certain economic activities that lag behind - such as new commercial construction of office buildings and hotels - will continue to drop in the coming year. Yet, as the spring unfolds, there should be a broadening in economic activity that will brighten throughout the remainder of 2021, leaving the world economy in synchronous recovery through 2022. **The vaccine news raises our confidence that the second half 2021 will see a sharp acceleration in "social close" services activity, broadening and strengthening economic growth. In short, a New Economic Cycle – away from the mere "opening and closing effects" of 2020 - will begin to take hold over the next 3-6 months.**

A robust recovery will have immediate benefits and tax certain industries. The new normal will mean families living apart or in isolation will be able to come together again. One can imagine a huge pent-up demand for travel at a time when airlines will have insufficient flight schedules. It takes time to bring flight capacity back online. We can see a glimpse of this by looking East, in the recovery of air travel in China, where COVID is already virtually absent because of successful social restrictions and monitoring. The rebound in Chinese domestic travel has been double that of the US recovery since April **(see Figures 2-3)**.

Across much of the world, shopping centers, amusement parks, concert venues and cinemas will be filled customers and children again in the second half 2021. We expect that many will be unusually cheerful.

The global economy will rebound more quickly, but unevenly. For example, while the labor force has seen a recovery of more than half the jobs lost to the COVID collapse of early 2021, nearly 4 million remain out of the US labor force compared to the pre-COVID period **(see Figure 4)**. In addition to the normal growth in the working age population, a safe work environment and safe schools will allow for an unusually strong pace of recovery in world economy. Both supply and demand can recover together. In the event that demand remains strong, one can expect a more rapid improvement in employment markets, creating a beneficial economic cycle.

Figure 2: China's domestic air travel

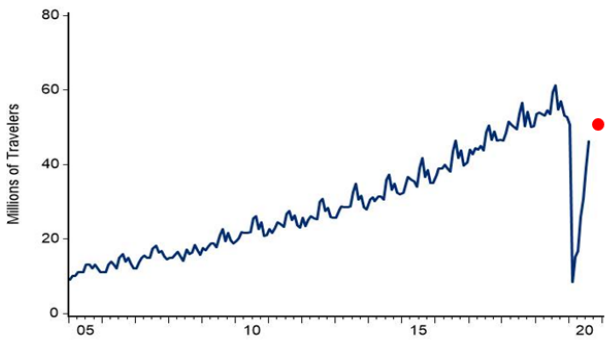
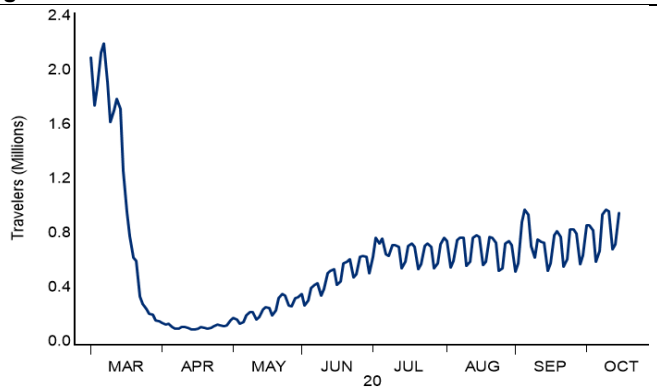
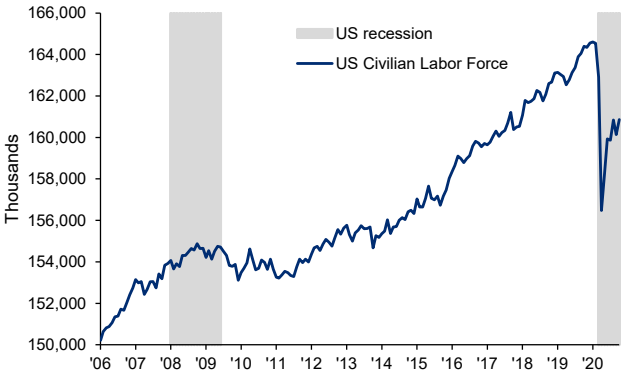


Figure 3: US domestic air travel



Source: Haver Analytics as of November 12, 2020. Note: Red dot denotes early November Airline Industry data. All forecasts are expressions of opinion and are subject to change without notice and are not intended to be guarantees of future events.

Figure 4: US Civilian Labor Force



Source: Haver Analytics as of November 12, 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. Past performance is no guarantee of future results. Real results may vary.

COVID Moved Every Asset Price As It Arrives and Its Departure Will Do The Same

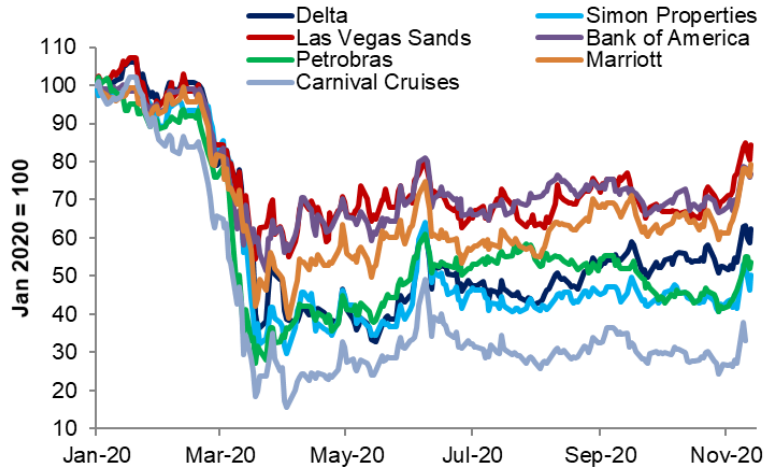
There is perhaps no other observation more important for investors that this for 2021. COVID's arrival starkly divided the world's asset prices, boosting roughly half and sinking the remainder. This division is understandable given the nature of the health crisis. Moreover, the divergence has not been diminished by the impact of falling interest rates and fiscal action to support the economy overall.

Look closely that the many COVID "victims" whose equity prices remain depressed even as broad US equity indices reach new record highs. **As Figure 5** shows, large financials have recovered less than some hotels and casinos, firms whose core businesses are most directly impacted by health restrictions. Given their inherent leverage, bank equities trade in line with the *very worst* of the COVID-impacted industries, rather than broad credit conditions across the economy.

The COVID-driven divergence is also clear in credit markets. "COVID cyclical" industry credits have suffered compared to COVID defensives, but have seen a sharp rise in value in the past week. Some local emerging markets and *most* commercial real estate credits have seen losses this year despite falling government bond yields and easing US monetary policy. This was driven solely by COVID's impact. These are the creditors that stand to recover from COVID's departure **(see Figures 6-7)**.

Here is the second half of that "most important observation". COVID's departure should boost a larger number of US and global equity sectors than many may expect.

Figure 5: Examples of COVID Impact Across Equities In Various Global Industries



Source: Bloomberg as of November 15, 2020. For illustrative purposes only. This should not be construed as an offer of, or recommendation of companies discussed. Past performance is no guarantee of future results.

Figure 6: US HY spreads, COVID Cyclicals vs Defensives

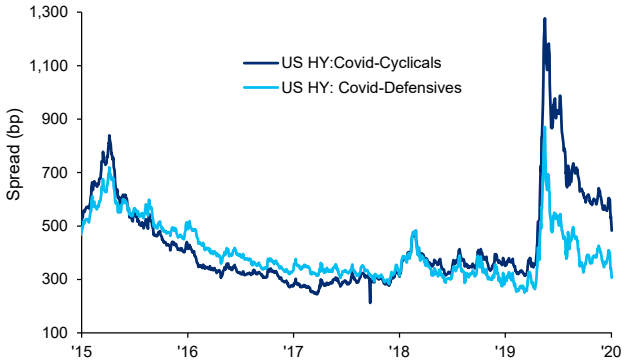
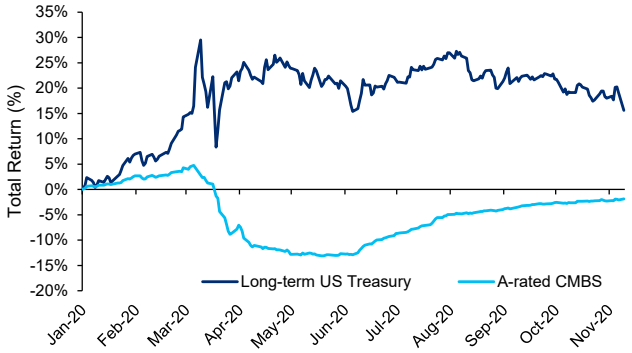


Figure 7: Long-Term US Treasury vs A-Rated Commercial Mortgage-Backed Securities (CMBS)



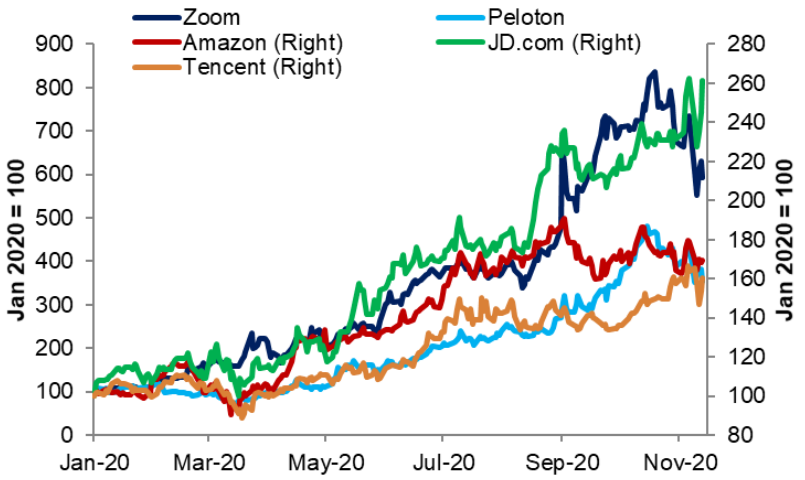
Source: Bloomberg Barclays Indices as of November 12, 2020. COVID-Cyclicals: Banks, Basic Materials, Capital Goods, Airlines, Energy, REITS, Consumer Cyclicals. COVID-Defensives: Telecom, Technology, Utilities, Consumer-non cyclicals. Indices are unmanaged. An investor cannot invest directly in an index. 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 call beneficiaries of the pandemic "COVID defensives". Most obviously, these include video conferencing, media, home gaming and e-commerce firms that have seen growth boosted by the nature of the crisis **(see Figure 8)**. Gains in these sectors have been more

concentrated. For the largest and most innovative companies already experienced strong growth before the pandemic, the crisis underscored their essential nature as a substitute for other business models, accelerating their growth rates and adoption.

We do not fear a deep and lasting retrenchment in demand for these technologies and services. However, we caution that their future growth rates will slow, perhaps materially, during the "return to a new normal" phase as the revenues from prior rapid adoption will plateau for a while and then may resume their previous trajectory. For some tech companies, the end of pandemic will mark a more difficult period as consolidation in areas such as telemedicine, video conferencing, food delivery and online retailing, for example, is likely **(see Figures 9-10)**.

Figure 8: Examples of COVID "Tailwinds" Across Technology, Gaming & Leisure Equities



Source: Bloomberg as of November 15, 2020. For illustrative purposes only. This should not be construed as an offer of, or recommendation of companies discussed. Past performance is no guarantee of future results.

Figure 9: E-Commerce Share of US Retail Sales % of Total

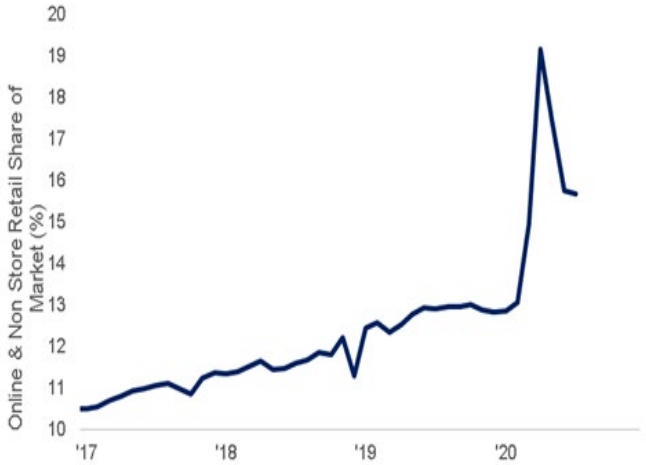
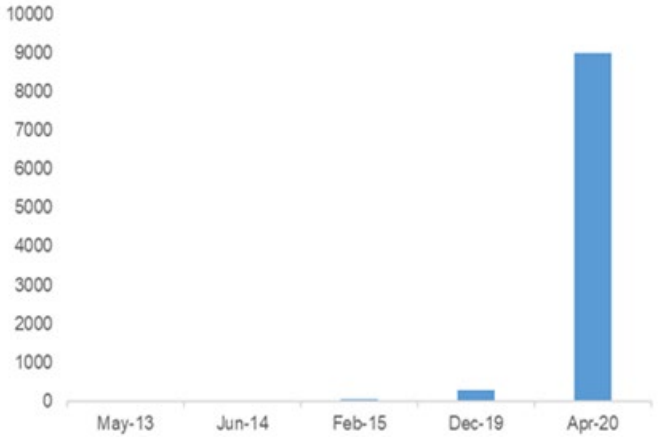


Figure 10: Zoom's COVID Boom: Millions of Meetings Globally



Source: Haver Analytics, Zoom as of November 12, 2020. For illustrative purposes only. This should not be construed as an offer of, or recommendation of companies discussed. Past performance is no guarantee of future results.

IT's strongest innovators – when they can be identified - can almost always be bought and held in truly long-term portfolios. Expecting the shares to be immune to temporary corrections, however, ignores history. Even the world's most highly valued and successful tech firm, Apple, has twice has a decline of more than 80% in the past three decades before reaching new heights of glory. The rise in NASDAQ 100 to an extreme high compared to COVID-impacted US small caps now seems to be at an inflection point **(see Figure 12)**.

Thus, as the vaccines and treatments in market grow, a rotation to "COVID cyclicals" is highly likely to play out. Against the backdrop of high tech valuations, it is crucial for investors to consider that 2021's "alpha" is more likely to be achieved by establishing overweight positions in "COVID cyclicals" across world markets.

Figure 11: Share Prices of US FAANG Stocks

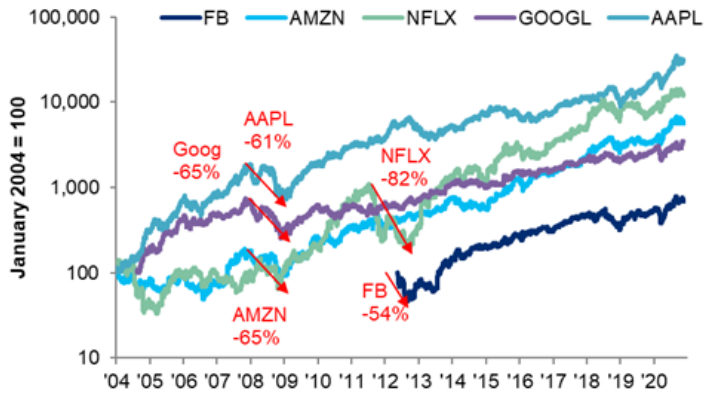
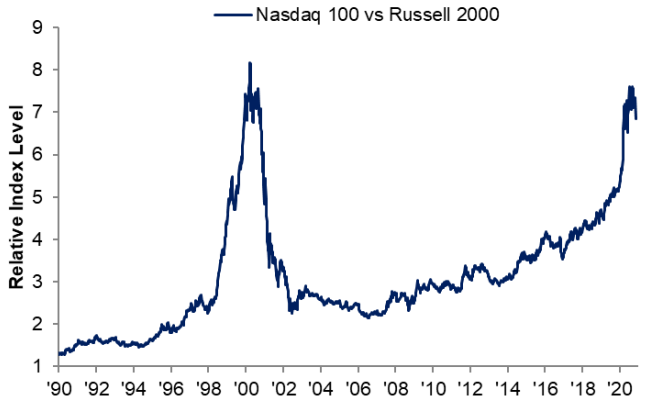


Figure 12: Nasdaq 100 Relative to Russell 2000



Source: Bloomberg as of November 15, 2020. Note: FAANG stands for Facebook, Amazon, Apple, Netflix and Google. For illustrative purposes only. This should not be construed as an offer of, or recommendation of companies discussed. 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.

An Ugly COVID Winter

Against this optimistic economic view for 2021, COVID rages on. The US, for one, has seen new infections sustained above 120,000 individuals per day. While the rate of hospitalizations and deaths from COVID has fallen as a percentage of those infected, the rate of infection has caused large burdens on hospitals and ICUs nonetheless. And the impact of COVID has ripple effects on the standard treatment of other diseases. Treatment rates continue to be impacted by patient concerns of contracting COVID at the doctor's office or infusion center as well as new social distancing requirements that reduce capacity.

The number of COVID deaths reported underestimates the true number. The number of excess deaths provides a more accurate representation of the number of deaths caused by the COVID pandemic. It is a useful figure as it sums all causes of death and measures the excess compared to similar time periods.

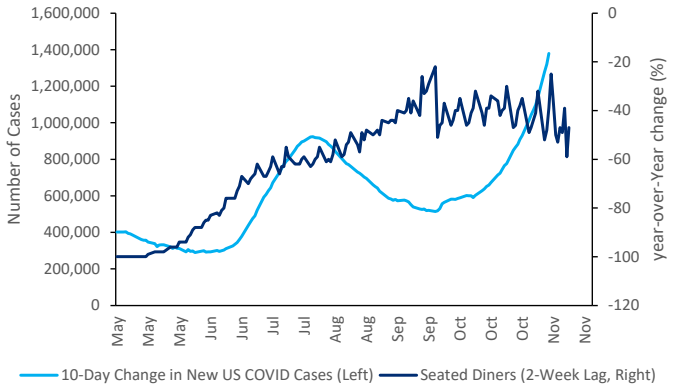
The CDC illustrates this dynamic in a report published on October 23rd. They estimate the number of excess deaths in the United States from January 26th through October 3rd was roughly 299,000. Only approximately two-thirds – 198,081 – of these excess deaths were directly attributed to COVID. Many of the remaining deaths are indirectly related to COVID. These deaths include individuals that passed away from COVID but were not formally tested, as well as those who delayed medical care for other conditions.

With the likely resurgence of COVID in the weeks ahead, more patients will be deferring both treatment as well as general wellness visits. Several companies, including Merck, have recently highlighted that wellness visits are still below normal levels. These delays will have a lagged deleterious effect, as they will result in the delayed diagnosis of serious conditions. These delayed diagnoses lead to postponed treatment, which may reduce the lifespan of some patients in the months and years ahead. The current situation may be exacerbated if health care systems become overwhelmed.

In a recent study released by the CDC, the prevalence of mask wearing in the United States increased from April to June 2020. However, other mitigation behaviors such as social distancing and avoiding crowded public places did not see the same improvement. Perhaps unsurprisingly, there was a correlation between the usage of masks and age. Compliance was generally lower in young adults (ages 18-29). An August survey conducted by the Pew Research Center found that 85% of Americans regularly wear masks or face coverings when in stores. This represented a significant improvement from June when only 65% of Americans claimed to do so. One of the largest improvements was in young adults. While the exact percentages vary based on the survey, the findings from the CDC and Pew Research Centers are consistent with those reported in surveys that are more recent. There is room for improvement, but mask compliance has improved over the last six months.

As seen by the Open Table data below **(Figure 13)**, the same improvements have not been seen with other mitigation behaviors such as avoiding crowded places. According to data collected by YouGov as of November 9th, the percent of people that are avoiding crowded public places has stayed relatively consistent from early June through October in many countries, including the United States, Germany and France. Given the recent increases in the number of cases, coupled with potential government actions, we expect adherence to other mitigation behavior such as avoiding crowded public places to improve in the weeks ahead.

Figure 13: Open Table US Restaurant Reservations vs US COVID daily infection rates



Source: Haver Analytics as of November 12, 2020.

Where is the Fiscal Cavalry?

As we discussed last week (Fifty-Fifty: Implications of a Divided Government and Electorate), the still uncertain control of the US Senate likely means cooperation between Democrats and Republicans will be even weaker in the so-called "lame duck" session of Congress this month than if either party made a clear win. Vulnerable individuals, small businesses and whole industries will likely have to wait for further assistance until January at the earliest, an unprecedented period for inaction from US policymakers during a crisis. As noted, a vaccine will of course be the most effective stimulus of all, but for families and those unemployed, emergency relief is needed in days, not months.

Broad-based support for the US economy prior to a health-solution by mid-year 2021 would ideally be sized at least $1 trillion for individuals, firms and the local governments required. Even with a control of Congress split between Democrats and Republicans, we still suspect that a post-election accord will be possible. Until then, current economic conditions may still generate rounds of fear among investors and even worse impacts for those in need.

Looking at the impact of COVID on the economy broadly, however, we find European data particularly helpful. COVID the disease is no less infectious. The degree to which it is driving the economic activity, however is lessoning as "shock effects" wear off, an adaptation takes place. As we showed last week, "lock downs" in various European countries are now significantly less extensive than the indiscriminate shutdowns of March and April. In many, schools and factories will remain open.

As **Figures 14-15** show, a far more extensive spread of the virus in certain countries this past month is resulting in less impact on economically-sensitive measures of human mobility. This is true even as COVID varies more sharply across countries. So, even as people adapt to the realities of a resurgence of the disease, they are likely to be more nuanced in changing their behaviors.

Figure 14: COVID Cases Diverge in Europe and UK…

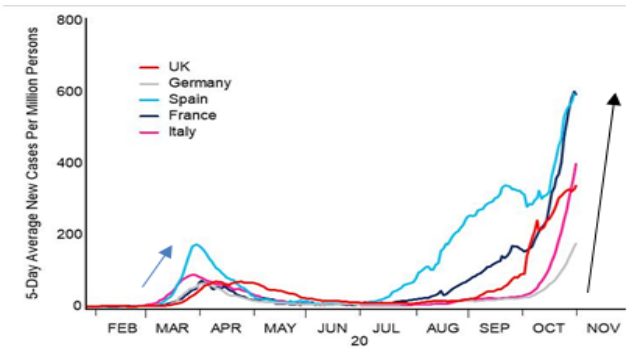
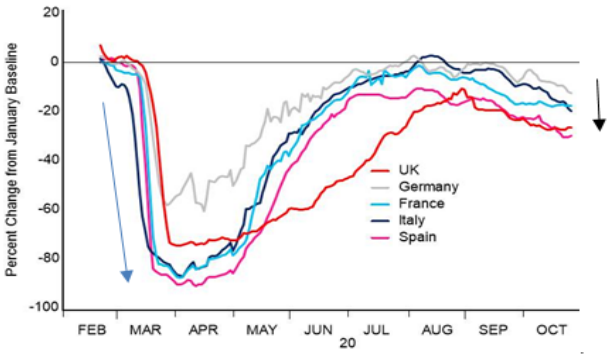


Figure 15: Yet Retail and Recreation Activity Remains Similar



Source: Haver Analytics of November 12, 2020.

Final Observations

1. The availability of vaccines and treatments in early 2021 is great news for humanity and exciting news for investors. However, the beginning of the rotation needs confirmation of additional vaccines and treatments, as well as greater safety data for them. All of this takes time.
2. The winter will see a severe impact from COVID across many developed markets. Equities will be volatile, as the optimism for 2021 will be tempered by immediate realities and a lack of clarity regarding government support.
3. Investors should begin adjusting portfolios now and build positions that reflect these events. As this week's Pfizer vaccine news shows, asset prices quickly reprice when positive expectations are confirmed by hard data. Waiting for all of the positive vaccine news or clear political outcomes means paying a higher price for clarity. Diversification across several strategies that may benefit as COVID receded is wise. According to our colleagues in Equity Trading Strategy within Citi's Institutional Clients Group, only "fast money" hedge funds have been reallocating to COVID recovery plays. "Long-only" asset managers have continued to add largely to the pandemic's existing winners and this shows in factor positioning where small caps and "value" shares remain deep underweights. Yet the vast majority of institutional clients who have been polled by Citi Equity Trading Strategies believe that vaccines will continue to drive rotations within equity market performance **(see Figures 16-17)**.
4. The stark differences between the most COVID impacted assets ("COVID Cyclicals") and defensive assets like government bonds and "COVID defensive" equities such as Information Technology suggests markets have NOT priced in a true end of the COVID pandemic. We expect this "mean reversion" to occur in 2021. Before then, a poorly coordinate government response to the pandemic in the West and soaring infection rates will leave markets volatile. Equity markets have historically discounted the "near-future." They will not wholly reprice the recovery from the COVID shock in an instant, and investors should act accordingly.

Figure 16: Equity Market Factor Positioning

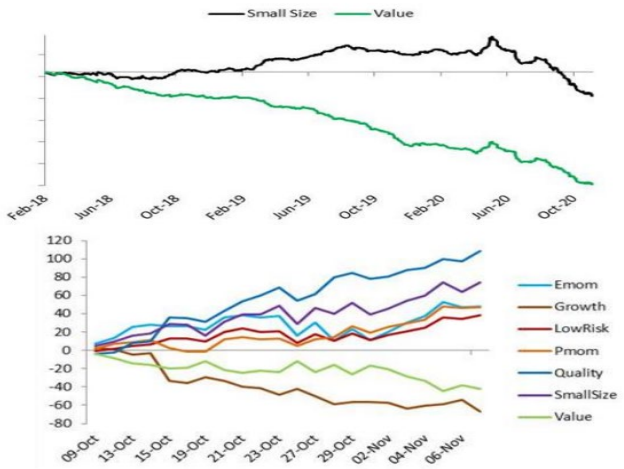
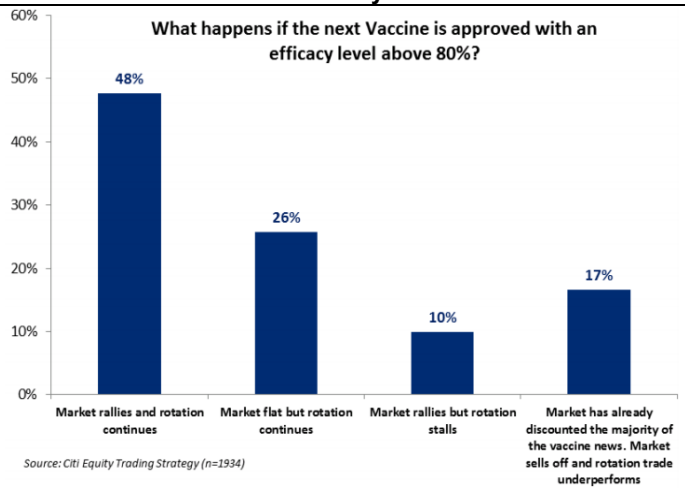


Figure 17: 73% of market participants believe another effective vaccine will further catalyze rotation



Source: Citi Institutional Clients Group, Equity Trading Strategies as of November 15, 2020. Note: The top portion of the left-hand side chart is a magnified view of the same chart below it. All forecasts are expressions of opinion and are subject to change without notice and are not intended to be guarantees 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.