

CIO Strategy Bulletin

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Finding Growth for Portfolios in the Post-COVID World

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Summary

- A sharp rally in November pushed the Russell 2000 measure of US small and mid-cap shares up 18.3%. The positive reaction to the rollout of effective COVID vaccines over the coming year has generated a rotation in market strength to the victims of the pandemic. The world economy is highly likely to normalize over the second half 2021, and we still see strong returns for segments of global markets in the year ahead (see [The New Economic Cycle: Investing for a Post COVID World](#)).
- Some investors wonder if the rotation has already gone too far. Our measure of the most impacted COVID equities is still down 20% in 2020-to-date, lagging the strongest COVID beneficiaries by 70%. Is it all too much? A lasting period of easy monetary policy and a merely incipient economic recovery is not a likely time for overall markets to retrench significantly. There will of course be setbacks. Few months are likely to see as powerful returns as November 2020.
- Our 2021 theme “Exploiting Mean Reversion” is a reference to asset prices, not a fixed period of time. If investors show unmitigated confidence in post-COVID normalization, then opportunities in “COVID Cyclical¹” may be closed in mere months. If there are significant doubts and setbacks, the opportunity will last longer.
- The Future is Electrifying. There are technologies and industry sectors that show strong growth potential and were never deeply connected to the COVID shock. With the impending entry of Tesla into the S&P 500 on December 21, we examine how the broader trend of electric vehicle adoption will remake the auto industry and alter the landscape for decades to come, much as e-commerce has fundamentally changed retailing.
- In 2014, Norway had an EV sales fraction that looks very similar to the level that currently prevails in the European Union. However, with the help of local incentives, the EV market share in Norway has quadrupled, with a full elimination of Internal Combustion Engine (ICE) vehicle sales likely within only a few years. In 2021, we expect market forces to replace much of the work that governments like Norway have done with regulation.

¹ We classify COVID cyclical as the global Materials, Energy, Industrials, Financials, Real Estate and Consumer Discretionary (ex-E-Commerce) sectors.

- While a number of the European automakers have sizeable shares of the EV market, it is Tesla and the new Chinese entrants that have seen the fastest sales growth more recently as the transition to EVs cannibalizes traditional automakers' larger ICE sales.

Green Shoots After The Pandemic

This past week, we released our **Outlook 2021** entitled [The New Economic Cycle: Investing for a Post COVID World](#). The report highlights three overarching themes that inform how we are building portfolios for the post-pandemic period. These are [Exploiting Mean Reversion](#), [Financial Repression](#) and [Unstoppable Trends](#). Our themes encapsulate four critical observations for 2021-2022:

- The global economy will recover more quickly and robustly from the COVID recession than after a more typical, severe downturn. The virus was an exogenous shock, whose effects were far more unevenly spread than in other crises. Parts of the global economy were largely spared and some benefited mightily. Governments will provide the necessary fuel to support a broad recovery. Employment and spending will rebound faster as a result.
- The mispricing of securities caused by COVID will be significantly reversed. The present extent of the mispricing is underappreciated and presents an “alpha creation” opportunity that seldom appears in markets this broadly.
- A period of structurally low interest rates is upon us. When rates are held below normal levels for extended periods of time, the value of cash and many fixed income investments is “repressed.” Earning negative real returns in large parts of a portfolio is harmful.
- Innovation is accelerating as is the adoption of technology that will generate great value for investors and society. Environmental, social and governance solutions will direct capital to companies whose actions are consonant with values that will make the world healthier. The four “unstoppable” trends we see are [Greening the World](#), [Hyper-connectivity](#), [Asian Development in a G2 World](#) and [Increasing Longevity](#) ([See Unstoppable Trends](#)).

What Mean Reversion Means For Portfolios

Our theme “Exploiting Mean Reversion has a “shelf life” of one-year ahead.

What has already happened in the past month with the release of strong vaccine efficacy studies is a sharp rally in our basket of “COVID cyclical” equities. These stocks represented roughly half the world's *pre-COVID* market capitalization. Most are companies in businesses struggling through the temporary COVID shock. With the S&P 500 up a very strong 10.8% in November, COVID cyclicals outperformed this by a further six percentage points.

The rally in COVID cyclicals has naturally generated great worry from those who claim the rebound has already gone too far, too fast. As figure 1 shows, a segment of the most COVID-impacted firms we call “stay at home” remain 20% below their January 2020 levels. Their performance gap to the COVID Boom “stay at home” shares has fallen to 70% from a peak near 100% during the late summer. Even at present levels, this is nearly un-heard-of dispersion, driven almost entirely by the pandemic and the policies used to treat it. Similarly, the outperformance of the US large cap tech sector (as seen through the NASDAQ 100 versus the US small cap sector) has shrunk from +42% to +30% (see figure 2).

The **naysayers** - the “we have already missed it crowd” - never invested in the rebound that is underway. They are generally those who are under-invested in the most impacted sectors relative to their target allocations. They need to be wary. We think large cap US equity returns will be mid-single-digits in the coming 12 months. And we also believe that the economic recovery from the COVID shock will hardly be a further boost for technology shares that have benefited from sector's immense usefulness in coping with the pandemic. This is why we are neutral large-cap US shares, but overweight the many regions and sectors that have yet to fully recover from the shock.

As we noted in our latest [Quadrant](#), “old economy” industries won't suddenly become long-term outperformers as they recover from the shock. But similarly, tech leaders won't always enjoy a “pandemic premium.” As figure 2 shows, large cap US tech leaders were outperforming consistently long before COVID. There is a high likelihood that “hyper-

connectivity” enablers in the telecom equipment, cloud computing and digital services industries will fundamental outgrow other sectors once the COVID distortions have passed. Yet these include significant constituents that will experience a “cooling off” period after rapid returns in 2020. Meanwhile, there are other technologies and industry sectors that show strong growth potential and were never deeply connected to the COVID shock (less impacted either positively or negatively).

Figure 1: Citi “Stay at Home” vs “Leave Your Home” Basket and S&P 500

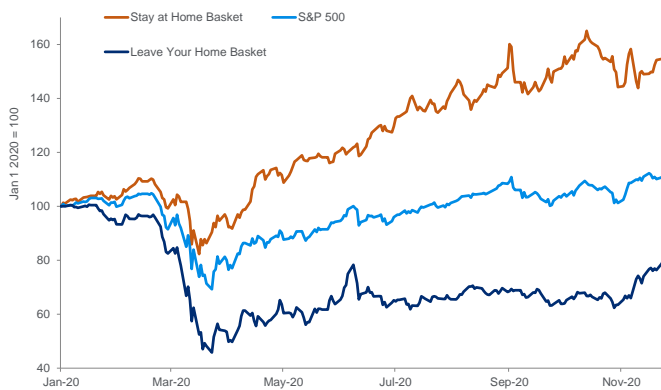


Figure 2: Nasdaq 100/Russell 2000



Source: Bloomberg as of December 4, 2020. Note: “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 Citi Research 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. 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.

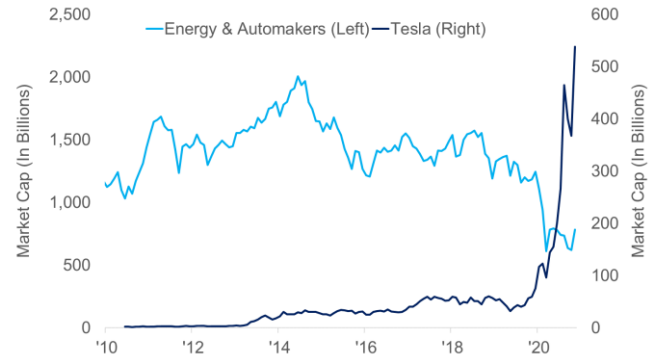
Where the New Growth Can Be Found

Before the pandemic would ground the world’s air fleets, sinking petroleum in the first half 2020, green energy was already impacting the economics of fossil fuels. This made the Energy sector the worst performer of the past five years.

A COVID healthcare solution and OPEC restraints may help the energy sector to a respite in 2021. However, as we discuss below, the longer-term prospects for a green energy industry – from both demand and supply sides – look highly promising. This was even before the now increasing likelihood of government support most clearly in the European Union and China.

The Future is Electrifying

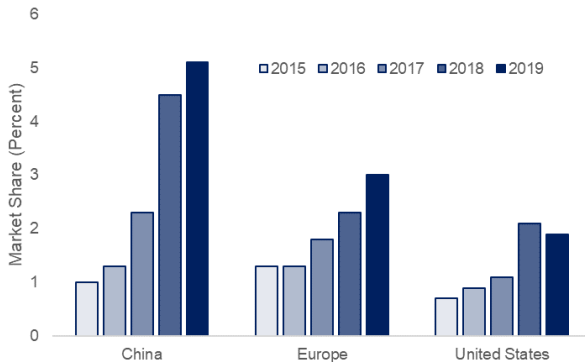
In [Outlook 2021: Greening the World](#) we highlighted that market forces have taken the driver seat from government mandates in energy supply. Likewise, we discussed how the shift to renewable sources of energy will require dramatic changes in efficiency and electrification. With the impending entry of Tesla into the S&P 500 on December 21st as a lens, we examine how the broader trend of electric vehicle adoption will fundamentally remake the auto industry and alter the landscape for decades to come, much as e-commerce has fundamentally changed the landscape of the retail world (Figures 3 & 4).

Figure 3: Department Stores and the Rise of E-Commerce**Figure 4: Traditional Automakers, Energy and the Rise of Electric Vehicles**

Source: FactSet as of December 4, 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.

Though electricity has been a lower cost way to power a vehicle for years, until recently these vehicles required substantial subsidies to be on cost parity with traditional internal combustion engine vehicles (ICE). We look at Norway as a case study to see what can happen with market share when electric vehicles cost less to purchase than Internal Combustion Engine (ICE) vehicles.

In most of the world, electric vehicles make up only a small fraction of new vehicle sales, with China standing out as a notable leader among larger economic regions (Figure 5). But even in the face of a dramatic hit to auto sales from Covid-19, EV sales are set to close 2020 with record growth. By October, global electric vehicle sales (plug-in hybrid plus full battery electric) were up 21% year-to-date, which would already be the fastest growth rate on record for the segment. Also in October, the Plug in Electric share of all vehicles sold stood at 4.9% of monthly sales, raising the year-to-date share to 3.5%, up from 2.5% in 2019.

Figure 5: Market Share of New Plug-in Light Vehicles

Source: Office of Energy Efficiency and Renewable Energy as of November 20, 2020.

Norway Sets The Example (Yes, Oil Exporting Norway!)

As Covid-19 has taught the world through its excruciating impacts, exponential growth can take something that looks very small into a world-shaking change. In 2014, Norway had an EV sales fraction that looks very similar to the level that currently prevails in the European Union. However, with the help of local incentives, such as exemption from VAT taxes, and lower registration fees, electric vehicles quickly became less expensive than their ICE competition (See Figure 6). In the past seven years, the EV market share in Norway has quadrupled, with a full elimination of ICE vehicle sales likely within only a few years.

In 2021, we expect market forces to replace much of the work that governments like Norway had to do just 7 years ago. Rapid declines in the price of battery packs are likely to do for the world what incentives did for Norway, dramatically improving the economics of buying an electric car as well as driving increased profitability for EV manufacturers (See Figure 7).

Figure 6: Norway and European Union Electric Vehicle Market Share

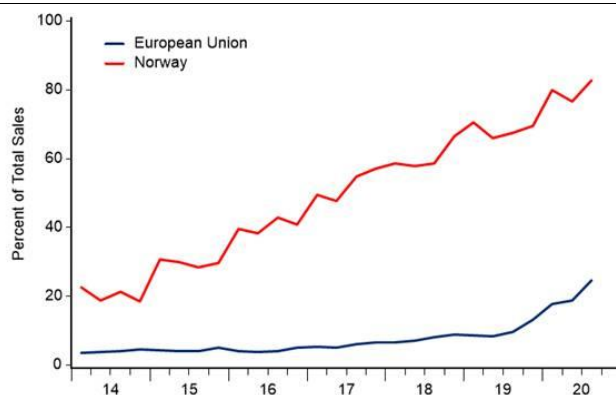
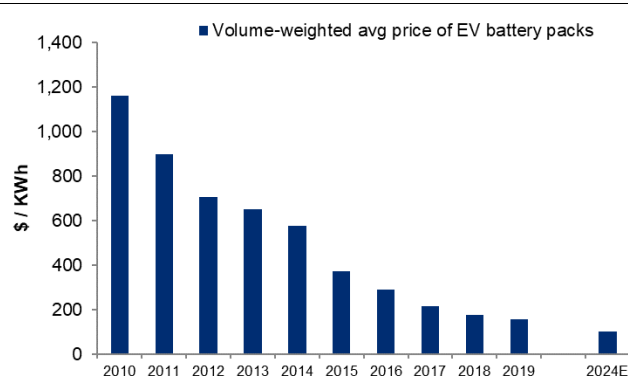


Figure 7: Average Battery Costs have Fallen 87% in a Decade



Source: Haver and Bloomberg New Energy Finance as of December 4, 2020.

Governments Are “All In” on Green Transportation

Even as market forces will dominate the trend toward EVs, governments are set to accelerate the trend further. Here are their plans and impacts.

United States

- While President-Elect Biden may have limited ability to create a national “green policy”, some states are already taking action independent of the federal government. In addition to financial incentives by many individual states, California, the US’s largest state for Auto sales, announced in September a ban on new ICE vehicles starting in 2035.

China:

- China announced a 1- year plan to convert its domestic fleet to new energy vehicles, ratcheting up green stimulus.
- Joining a number of developed markets, China has stepped up its green economy pledges in recent weeks. We expect electric vehicles, battery technology, renewable energy, selective materials, charging stations and telecommunication infrastructure to be potential beneficiaries in the long run.
- Following the release of 14th Five-Year Plan (FYP), China’s State Council announced the 2021-2035 plan for new energy vehicles (NEV). The proposal has mapped out a long-term development landscape for NEV and its related infrastructure in China, with a target of increasing sales of NEVs to approximately 20% of total auto sales by 2025 and reducing the average consumption of energy to 12.0kwh/100km. NEV sales in China have already risen for three consecutive months, with a gain of 68%/y/y in Sep. The potential upside for NEV in China still looks attractive.
- Emphasizing on innovation, integration, opening-up and market orientated approaches, the NEV proposal would serve as a key implementation for the “low carbon economy” and “urbanization 2.0” initiatives raised by 14th FYP, which calls for carbon neutral by 2060.
- The plan has reinforced China’s fiscal support for charging stations, with a potential amount up to as high as \$900bn--- an investment proposal announced in earlier Oct to support power grids with focus on areas of electric vehicle chargers and new digital infrastructure. This area alone would amount to ~1% of real GDP per year, with additional stimulus in other segments of the NEV supply chain likely. Other supportive measures announced this year include extending the fiscal subsidies for NEV to 2022, profit compromise from the corporates and local government support.

Europe

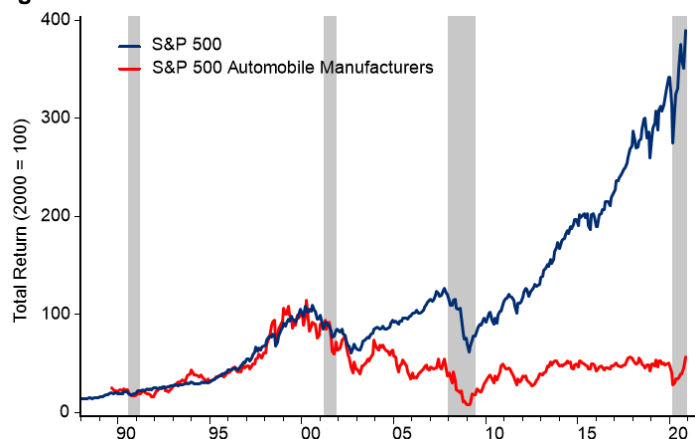
- The UK announced last month it is accelerating its EV adoption plans, bringing forward the banning of petrol/diesel car sales to 2030. EU targets are yet to be brought forward (i.e. currently banning of petrol/diesel sales in 2040), with current legislation targets focusing on a reduction in carbon emissions by 37.5% by cars and 31% by vans by 2030. We suspect that EU targets will be brought further forward as the achievability of nearer dates becomes clearer.
- While Europe is actually the second largest electric passenger market globally with over 1.8million registrations in 2019, it only accounts for 3.6% of newly registered passenger vehicles (up from 2.5% in 2018), with significant divergences at the country level.
- In addition to cheaper economics and subsidies, Norway leading the way is also driven by the fact that it has banned all sales of petrol/diesel cars by 2025 (this was announced in 2017), which saw the EV market boom in the years after. We could see a similar boom in the UK following its 2030 announcement, and thereafter in Europe. Places like France and Germany are also seeing huge subsidies as well as strict new EU emissions caps, which will inevitably push consumers towards EVs even faster than just market dynamics would achieve.

Beware Traditional Auto Makers

With the expected conversion of much of the global fleet to EVs in the coming decade, we believe the most forward-looking traditional automakers will ultimately maintain their market share through a re-thinking of their upcoming product offerings. In fact, Chinese carmakers have taken the lead in this regard, while others in the West have struggled to gain market share in the early innings of “auto electrification” (please see [Asian Development in a G-2 World](#)). Though we believe some traditional automakers have time to capitalize on this unstoppable trend, some will ultimately share the fate of department stores, movie rental companies, and other retailers who have struggled to keep up with evolving customer demands for innovation.

In the US, the current constituents of the S&P 500 Automakers sector have been slower to ramp up production of electric vehicles for US consumers, with GM recently looking to the M&A market in an attempt to bolster its EV credentials. A financial crisis, a relative lack of diverse product offerings, and weak profitability has earned traditional US automakers a negative total return over the past 20 years (see figure 8). Investing in US autos will soon grow more complicated when Tesla joins the S&P, as it will suddenly account for more than 85% of the S&P 500 Autos Sector and nearly 2% of the broader index. This inclusion will mean that many investors who own funds that track the S&P 500 may suddenly have far more exposure to Tesla and in effect the US EV maker segment.

Figure 8: S&P 500 and Auto Manufacturers Total Returns



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

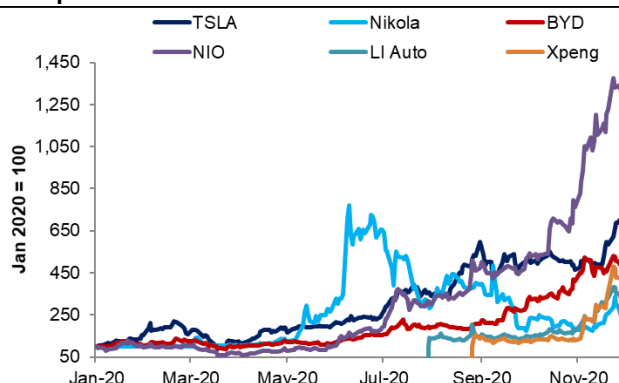
The Chinese EV Example

Despite a punishing year from Covid for Automakers, markets have taken notice of growth in Chinese EV makers; with the backing of large scale Central government plans for a green recovery (See Figure 9). In the US, Tesla's success has led to a surge in IPO and M&A activity in the space, with potential EV-focused competitors entering public markets along with some more questionable ventures (See Figure 10). As we have seen countless times throughout history, exciting new trends can attract lots of new capital towards an idea, which can drive both innovation and experimentation – ultimately improving outcomes for consumers through competition. We see this already among this year's new entrants to the EV space, with Tesla “copy-cats” competing with more “asset-light” models in an effort to improve on the less profitable business models historically espoused by some more traditional automakers. Some of these “experiments” will of course fail.

Figure 9: Auto sector performance by country region since 2019



Figure 10: Excitement over EV growth has spurred strong share performance and a number of IPOs in 2020



Source: Haver and Bloomberg New Energy Finance as of December 4, 2020. The companies are shown for illustrative purposes only and are not a recommendation to buy or solicitation to sell any of the names shown. 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.

A G2 World Faces a Greener Future

While a number of the European automakers have sizeable shares of the EV market, it is Tesla and the new Chinese entrants that have seen the fastest sales growth more recently as the transition to EVs cannibalizes traditional automakers' larger ICE sales. Notably absent from the top ten EV Global Brands are any traditional US or Japanese automakers as those segments have struggled to find a foothold in a post-ICE world (see figure 11).

Figure 11: October 2020 Year-to-date EV Market Share (Top 10)

Tesla	17%
Volkswagen	7%
BYD	6%
BMW	6%
Mercedes	4%
SGMW	4%
Renault	4%
Volvo	4%
Audi	4%
Hyundai	3%

Source: Bloomberg as of December 4, 2020. The companies are shown for illustrative purposes only and are not a recommendation to buy or solicitation to sell any of the names shown.

China accounted for half of the global NEV (new energy vehicle) sales in 2019 and its share is likely to remain at over 50% of the global market in the next five years (See Figure 12). China's 2025 target of increasing sales of NEVs to ~20% of total auto sales, if realized, would mean 4.8mn units of NEV sales by 2025, with an average annualized growth of 37%. While NEV sales were temporarily disrupted by the COVID-19 crisis in 2020, 2021 could be a catch-up year for the space, with new sales expected to rebound 70% year-to-year in 2021 from -14% in 2020. Automakers are planning to launch over 300 battery electric and plug-in hybrid electric vehicle models in the next three years in China in order to stay compliant with regulatory targets.

Figure 12: China Set to Lead EV Sales as well as Production



Source: Bloomberg as of November 20, 2020. Past performance is no guarantee of future results. Real results may vary. All forecasts are expressions of opinion and are subject to change without notice and are not intended to be guarantees of future events.

Top domestic EV players in China include BYD, BAIC, SAIC and Geely, accounting for one third of total global market share in 2019. BYD is also a top EV battery supplier globally (9% of global market share), following CATL (23% of global market share). Seeing the opportunity within mainland China, foreign players have made efforts to increase their shares in the Chinese market by establishing joint ventures with local companies in recent years. Tesla's Shanghai Gigafactory and SAIC-VW's Anting plant will play a critical role in their respective EV strategies. Anting in China and Zwickau in Germany are VW's first plants dedicated to its MEB electric vehicle architecture. Toyota, which lags on EVs, established a joint venture with BYD for BEV (battery electric vehicle) development last year.

Electrify Your Portfolio

The rapid growth in electrification of the auto sector can be seen in publically traded pure play-EV companies, whose revenue growth as a group has topped traditional auto makers for several years, and is expected to increase by more than 50% in 2021 (See Figure 13). Despite high levels of revenue growth already, we believe this trend is only just beginning as pure-play EV shares only make up 2.5% of global public auto company revenues (See Figure 14).

Figure 13: Revenue growth among global Auto Manufacturers

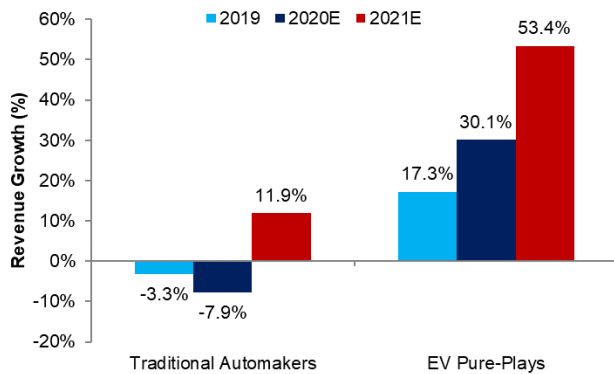
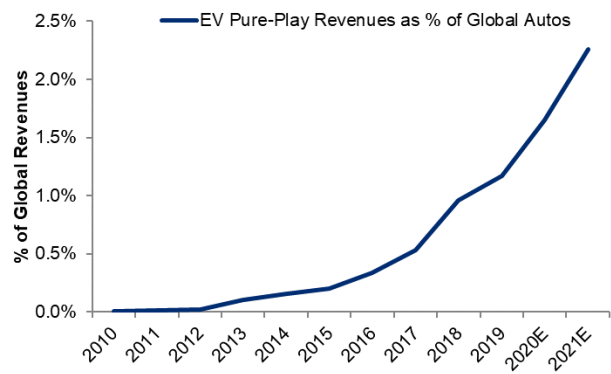


Figure 14: EV Pure-Play Revenues as % of MSCI Global Autos Sector



Source: Factset and Citi Private Bank (OCIO) as of December 4, 2020. Note: Using MSCI AC World Autos Index. Pure-play EV constituents include Tesla, NIO, and Xpeng.

Much less well covered in most US and European investors' portfolios - but perhaps much more promising from both a fundamental and valuation perspective - is exposure to the growing Chinese EV market segment, which are well positioned to serve the rapidly growing Chinese domestic market, and potentially position themselves as low-priced entrants globally. Some of our readers will remember Japanese and then Korean automakers entering the developed market auto world with underpowered low cost options in the 1970s and 1990s respectively. These entrants, which were initially often laughed off, grew to become some of the largest global auto brands, parlaying volume into other more lucrative segments of the auto market.

Here is how to electrify your portfolio.

- Gain exposure to a basket of EV-focused companies, as the significant growth for the segment in the years to come should justify elevated current valuations.
- Selectively retain exposure to traditional automakers aggressively investing in EV buildout in an effort to gain global auto market share. Chinese automakers stand out here as particularly compelling.
- Avoid traditional automakers without a clear focus on or ability to electrify their fleets.

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