CIO Strategy Bulletin

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Fiscal Stimulus, a Shot in Every Arm, and Market Volatility

David Bailin, Chief Investment Officer
Steven Wieting, Chief Investment Strategist and Chief Economist
Joseph Cordi, Citi Investment Management
Malcolm Spittler, Global Investment Strategy
Joseph Fiorica, Head of Global Equity Strategy
Jorge Amato, Head of Latin America Investment Strategy
Ken Peng, Head of Asia Investment Strategy
Joseph Kaplan, Global Investment Strategy

Introduction

Too much good news? That's hard to believe in a world where Covid spread is raging and about 15% of the global economy is on life support.

With the likely arrival of another $1-2 trillion US fiscal shot in the arm, a President-elect determined to give everyone a faster shot in the arm, and an efficacious single-dose vaccine from Johnson &Johnson (J&J) that requires just one shot in the arm, we see a faster end to the Pandemic, and the beginnings of a sharp economic upturn in Q2 2021.

Yet after two months of remarkably positive news on medical breakthroughs and potential stimulus, markets have likely begun to consolidate gains before the full and lasting expansion we expect. There has been a remarkable recovery in some Covid-impacted assets and much less movement in others. For example, US small cap equities (up 28% since end 2019) and Latin America stocks (-14% since end 2019). Defensive, interest-rate-sensitive assets have held their value during the past quarter despite rising long-term US rates. Chinese shares have outpaced their Southeast Asian counterparts by 40% since the start of 2020. In short, we see momentum having carried some trades beyond near term expectations.

We have long expected a peak in the US dollar that would carry it lower over time. However, such declines rarely take place without interruption. The decline in the dollar is now a consensus trade that is at risk. With the expected passage of a huge stimulus bill, the added US Treasury borrowing may displace some flows that would otherwise finance other borrowers and raisers of capital. In our view, the Federal Reserve is unlikely to accelerate bond purchases with newly created money. Ordinarily, stepped up US borrowing might lower the value of the US dollar. However, there are huge short dollar positions on right now, precipitated (in part) by the decline in interest rate differentials between the US and foreign markets last year.

Given these equity market divergences and strong consensus positioning in the USD, we believe that there may be counter-trend rebounds in the US exchange rate. And we also believe that short-term volatility in consensus equity trades like semiconductors and electric vehicles is likely. For some of the best-valued investments, such as Emerging Market shares, post-Brexit UK equities, and global dividend payers including quality Financials, setbacks should be viewed as buying opportunities.

In short, even as we inform you of a bolus of vaccines and a caffeine jolt of US stimulus, we also warn of more near term volatility. <u>None of this changes our 18-24 month view for the economy or markets</u>, but a few dark macro-economic clouds are imminent. There are some inexpensive ways to potentially hedge this risk.

Three "Shots in the Arm"

More Stimulus

US President elect Biden proposed a third, much larger economic support package, which if passed in the state presented, adds the capacity to address immediate needs with enough aid to address a longer-lasting crisis if needed. It would extend unemployment benefits, provide $370 billion in funding assistance for state, local and territorial governments and public transit systems, provide $170 billion to open and schools open and numerous other subsidies for low income families. The aid for states and cities avoids cuts to public health, safety and education programs that are likely to be curtailed due to lower tax revenues and an inability to borrow due to limits on municipal issuance and market access. Many of these plans directly impact employment as education and government are large employers and under great stress. It would also send income support payments of $1400 to most US households, adding to $600 payments already approved. If passed, this part essentially duplicates the stimulus steps of 2020, but in a larger way.

While extraordinarily expensive, the plan would have lasting benefits for government and business, by shifting debt burdens to the federal government leaving state and local government agencies as well as private businesses less indebted post-Covid.

More and Better Vaccines

- After approvals of vaccines from Pfizer, Moderna and several from China that will find use in emerging markets (US Stimulus, UK Fear and Asia's Post-Covid Ascent), regulatory approvals of vaccines from Johnson & Johnson and AstraZeneca in the US and Europe are pending. These appear positioned to succeed in the developing world given their less stringent storage requirements. **J&J's vaccine approach is a single dose**. If effective, this can accelerate the speed of positive impact on restraining the virus and known variants across the world.
- In light of the impressive earlier clinical data, we expect J&J's Phase 3 COVID vaccine trial to illustrate safe and effective results as soon as next week. This would be another catalyst for global recovery as it would add another 1 billion doses in 2021.

Implications – Economy Gets More, Financial Markets Less

- The impact of stepped up US borrowing and spending may have a stronger positive impact on the economy in 2021 than on financial markets after their surge in 2020. Financial markets, as usual, were and will be forward-looking.
- If the vaccinations in the US and many other countries accelerate as distribution bottlenecks clear, we doubt every dollar of the Biden stimulus plan released last week will be spent.
- Increased volatility in certain equity markets, including setbacks in areas we like for the next 18-24 months, are more likely at this moment. One source of that volatility is the consensus trade to short the US dollar. This has built up buying momentum in emerging markets equities wherever fundamentals have been strongest, such as North Asia.

Biden To The Rescue: Plan Elements Wise and Foolish

There is certainly no better time than now to spend to vaccinate the public and end the pandemic. The same goes for helping the workers and industries that cannot operate during a pandemic. A short-term government "safety net" has never been more timely than during this public health crisis. US employment is, after all, more than 10 million jobs lower than this time a year ago. Macro levels stimulus in a depressed economy has great merit, as long as it does not become habitual. There is, after all, no such thing as a free lunch in economics.

But there are un-wise aspects to the plan, as proposed. As **Figure 1** shows, Biden's added stimulus proposal includes a long-term Democratic goal of a $15 per hour national minimum wage. At a time when many thousands of US small businesses are clinging on for survival, more than doubling the national minimum wage could not be more poorly timed, in our view **(see Figure 2)**. A sudden jump to $15 minimum wage levels could doom many jobs in the poorest of Southern US states where $15 is roughly equal to the median wage, rather than the minimum. Puerto Rico's median wage in 2019 was just over $10 per hour, and a sudden $15 minimum without some other subsidy could represent a substantial economic shock. To be clear, 32 US states already mandate a minimum wage higher than the national $7.25. Census data shows roughly 2/3rds make at least $15.00 per hour with the median and average near $20 and $30 per hour respectively. This leaves 90% of minimum wage workers already earn more than the Federal minimum.

Biden's plan also include a favorite Republican stimulus. The Earned Income Tax Credit (EITC) encourages labor force participation by making low wage jobs more palatable with tax subsidies. But, like the $15 minimum wage, it has potentially distortive and negative impacts for the economy overall as it helps attract workers to low paying positions at the cost of taxpayers.

The new Biden approach to stimulus is otherwise politically astute in many ways. President Trump argued for $2,000 per family stimulus checks, and received significant Republican backing for this proposal along with near unanimous Democrat consent. The $1400 payments would simply match the Trump total, with $600 payments already on the way.

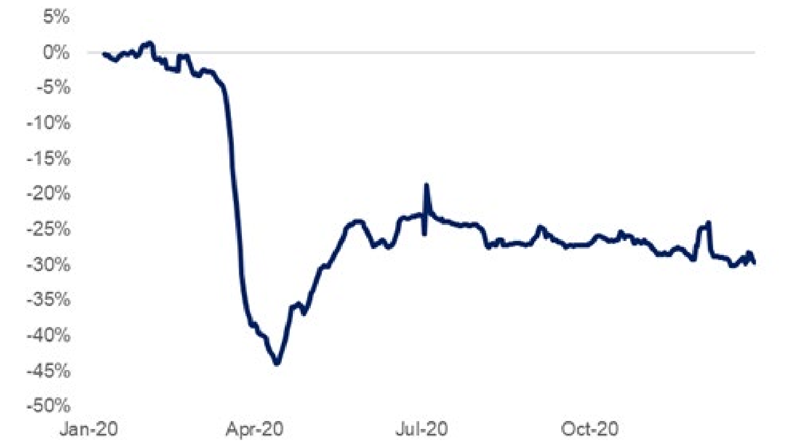
The Biden plan is also a contingency plan. Given our optimism over vaccines and distribution, we actually doubt that the US will spend as much as Biden proposes ($1.9 trillion). Yet, the mere fact the plan is overfunded creates a safety net for the economy itself.

Figure 1: President-elect Biden Proposed Stimulus

President-elect Biden Announces American Rescue Plan	
Increased stimulus payments	Additional $1,400/ person to eligible recipients (on top of $600 payments approved by Congress in December -- for a total of $2,000)
Enhanced unemployment aid	Increase from $300 to $400/per week, and extend through September
Rental assistance and eviction moratorium	$25B in rental assistance for low- and moderate-income households who have lost jobs (in addition to the $25B provided in December); Another $5 billion for renters to pay their utility bills and $5 billion to help states and localities assist those at risk of experiencing homelessness; Extend the federal eviction moratorium through September
Child care & child tax credits	Create a $2B emergency fund and add $15 billion to an existing grant program to help child care providers; Expand child care tax credit for one year so that families will get back as much as half of their spending on child care for children under age 13
Increase of tax credits	Boost the Child Tax Credit to $3,600 for children under age 6 and $3,000 for those between ages 6 and 17 for a year, made fully refundable; Raise the maximum Earned Income Tax Credit (EITC) for a year to $1,500 for childless adults, increase the income limit for the credit to about $21,000
Assistance for small businesses	$15B for new grant program for small business owners, separate from the existing Paycheck Protection Program; $35 billion investment in some state, local, tribal, and non-profit financing programs that make low-interest loans and provide venture capital to entrepreneurs
Aid for states and schools	$350 billion to state, local and territorial governments to keep their frontline workers employed, distribute the vaccine, increase testing, reopen schools and maintain vital services.
Increased support for vaccines and testing	$20B in a national vaccination program; $50B in testing, providing funds to purchase rapid tests
Increase national minimum wage	A $15 hourly minimum wage
Help for the hungry	Extend the 15% increase in food stamp benefits through September, Another $3B in food assistance, and $1B in nutrition assistance; Partner with restaurants to provide food to needy Americans and laid-off restaurant workers
Subsidies for health insurance premiums	Subsidize through September the premiums of those who lost their work-based health insurance
Restoration of emergency paid leave	Reinstate the paid sick and family leave benefits through September 30; 14 weeks of paid leave for people sick or quarantining, or caring for a child whose school is closed

Source: Bloomberg as of January 15, 2021. All forecasts are expressions of opinion and are subject to change without notice and are not intended to be a guarantee of future events.

Figure 2: Number of US Small Businesses Open Relative to January 2020 Baseline



Source: Tracktherecovery.org and Womply as of January 15, 2021.

It's Early Days for the Vaccine Rollout

The speed of the vaccine rollout will vary across different regions world. Initially, the timing of the rollout will depend upon regulatory approval for the vaccines. In the months ahead, the supply and ability to administer doses will be gating factors. Thus, country specific factors such as geographic size and health care system fragmentation will determine outcomes. Israel was able to vaccinate approximately 20% of its population in three weeks and is demonstrates how a strong coordinated response, coupled with early supply agreements, can transform the shape of the recovery. That said, the worldwide vaccine rollout is in its very early days **(see Figures 3 and 4)**.

Figure 3: Snapshot of current vaccine dose percentages, by country

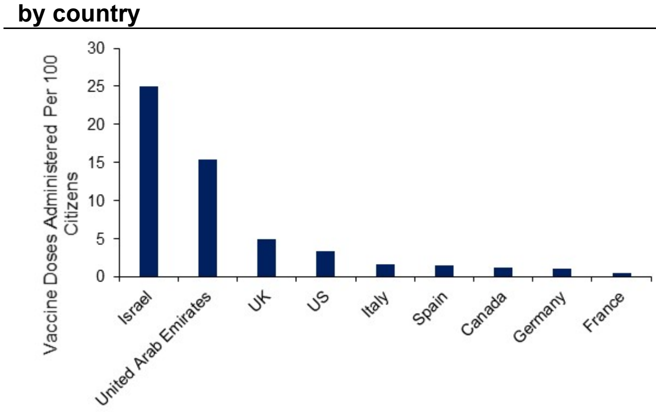
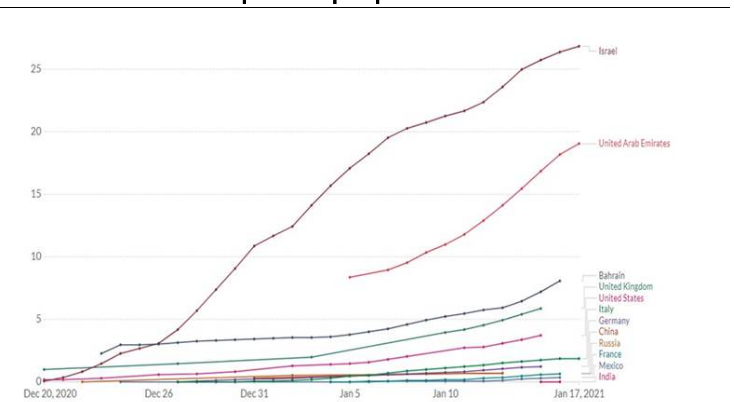


Figure 4: Growing cumulative number of COVID-19 vaccination doses administered per 100 people



Source: Our World Data as of January 17, 2021. Note: Data is counted as a single dose, and may not equal the total number of people vaccinated, depending on the specific dose regime.

American Covid deaths make up 20 percent of the worldwide total (which just crossed 2 million) despite being just over 4% of the world's population. To date, the FDA has granted Emergency Use Authorization (EUA) for two vaccines. Based on current data, forthcoming supplies will enable more than half of the US population to be vaccinated by the end of the second quarter and 100% by year end. Shortly, this will become a distribution issue. How quickly the supply can be administered?

Our analysis estimates that as much as 25-30% of the US population to date may have been infected by COVID-19. In order to reach herd immunity, a substantial percentage of the population will need to be vaccinated. Unfortunately, the vaccine rollout in the United States has thus far been disappointing **(see Figure 5)**. As the eligible population increases and the retail channel is utilized, we expect a dramatic improvement in the number of vaccines administered each day. CVS, for example, has recently stated they have capacity to administer nearly 1 million vaccines each day in their pharmacies.

Figure 5: Overall US COVID-19 Vaccine Distribution and Administration

Total Doses Distributed	Total Doses Administered	Number of People Receiving 1 or More Doses	Number of People Receiving 2 Doses
30,628,175	11,148,991	9,690,757	1,342,086

Source: CDC as of January 17, 2021.

President-Elect Biden is likely to implement additional changes that further accelerate the rollout. As part of his stimulus proposal, he earmarked $20 billion dollars for a national vaccination program. Biden has a goal of administering at least 100 million shots in his first 100 days. While the US is unlikely to reach the threshold for herd immunity by the end of the second quarter, an increasing percentage of the population will have protection (through infection or vaccination), perhaps more than 50%. This should meaningfully reduce the rate of transmission and largely reopen the economy. We expect the US to reach herd immunity late in the second half of the year.

Europe's Rollout

For the United Kingdom and Europe, the trajectory of the vaccine rollout is less clear. The UK approved the vaccines from Pfizer-BioNTech, Moderna and AstraZeneca. The European Union approved the vaccine candidates from Pfizer-BioNTech and Moderna, and we expect AstraZeneca's vaccine to be EU approved in the coming weeks. As of January 6th, the EU procured over 1 billion doses cumulatively from AstraZeneca, Pfizer-BioNTech and Moderna. The rollout across different European countries will likely not be uniform due to different health care systems and public perception about vaccines. However, the EU should have enough vaccines delivered for all adults by the end of 2021.

Widespread regulatory approvals of vaccines from Johnson & Johnson and AstraZeneca are likely to help end the worldwide supply bottleneck. Additionally, they appear positioned to succeed in the developing world given their less storage requirements. In light of the impressive earlier clinical data, we expect Johnson & Johnson's Phase 3 COVID vaccine trial to illustrate safe and effective results as soon as next week. This would be a catalyst for global economic growth as it would add another 1 billion doses to the global market in 2021. Overall, there will continue to be an influx of clinical data readouts that may accelerate our vaccination efforts by increasing the number of vaccines and supply on the market.

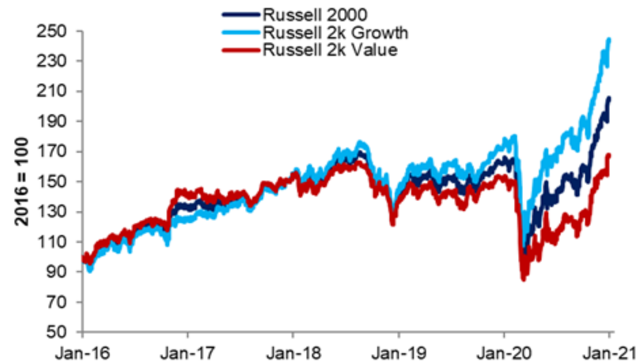
Markets Will Wobble But They Won't Fall Down (in 2021)

The last three months saw strong gains for cyclical assets, though only partially erasing the impact of the pandemic's plunge. During this period, US long-term bond yields rose about 25 basis points. Still, many interest-rate-sensitive assets, such as US growth stocks, performed well **(see Figures 6-7)**.

There are growing divergences between the extent of recovery in assets that can benefit from a "post-COVID world" **(see Figure 8 and our Outlook for 2021)**. These should still be exploited. We also see some greater near-term volatility and risks in markets. This does not change our view of the world economic recovery in the year to come.

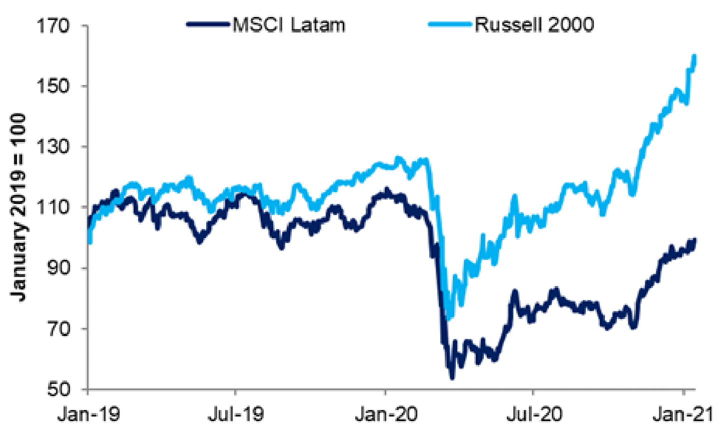
Figure 6: US 10-Year Treasury Yield (Inverted) vs Gold Price and US Growth Factor Return

Figure 7: US Small Cap Growth, Value and Overall Index



Source: Haver Analytics and FactSet as of Jan 15, 2021. Gold is the – London Bullion Market Association (LBMA) Gold Price index; US Pure Growth Factor is the Bloomberg Pure Growth 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. Past performance is no guarantee of future results. Real results may vary.

Figure 8: US Small Cap Equities vs Latin America Equities (in USD terms)



Source: Factset as of Jan14, 2021. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Past performance is no guarantee of future results. Real results may vary.

The outlook for macro policy may soon become more positive for the performance of the economy than financial markets, at least for a short time. We do not believe the US central bank has signed on to monetize a stimulus of *any* size at all that the Congress and President may agree on. Similarly, China's central bank is has not accelerated emergency lending because it's macro economy no longer calls for it **(see Figures 9-10)**.

What this means is that added US Treasury borrowings will displace some flows that would otherwise finance other borrowers and raisers of capital.

Figure 9: Fed Keeps to a Steady pace of Bond Buying, While US Treasury to Increase Sales

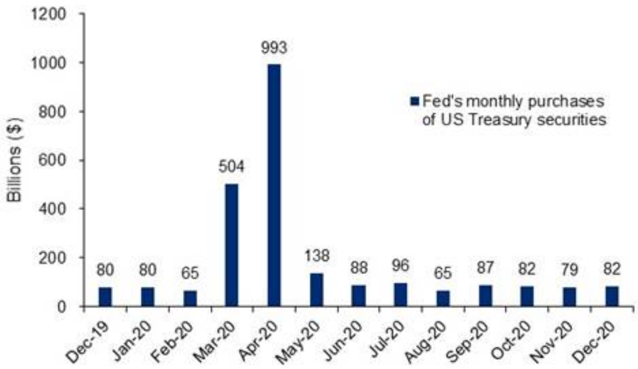
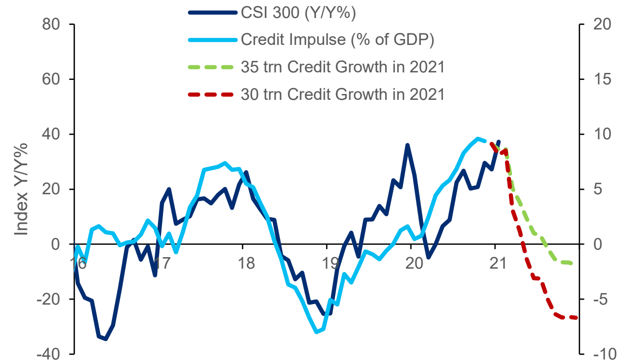


Figure 10: China's Credit Impulse suggest less support for equities from domestic credit in coming months

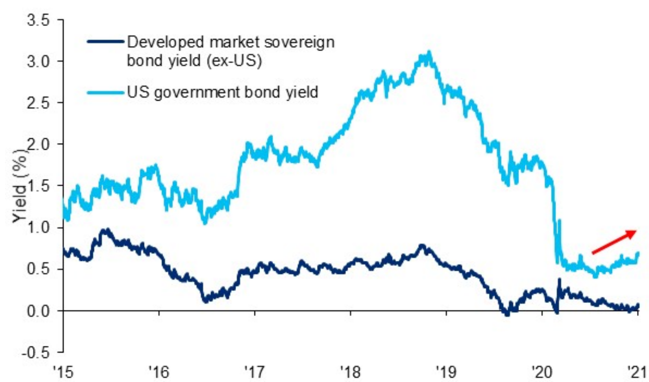


Source: Bloomberg, Haver Analytics as of December 15, 2021. Note: Estimates for right chart based on assumptions of 35tn or 30tn new credit in 2021 and normal seasonal patterns. All forecasts are expressions of opinion and are subject to change without notice and are not intended to be a guarantee of future events. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only. Past performance is no guarantee of future returns. Real results may vary.

Ordinarily, stepped up US borrowing might lower the value of the US dollar. However, as **Figure 11** shows, global investors have already positioned strongly to assume further US dollar declines. They've positioned this way because US interest rates collapsed toward levels abroad. However, US yield differentials have now begun to climb back **(see Figure 12)**.

Figure 11: US Dollar Index and net short futures position as % of open interest

Figure 12: US Long-Term Treasury Yield vs Foreign Composite



Source: Bloomberg Barclays Indices, Haver Analytics as of December 15, 2021. All forecasts are expressions of opinion and are subject to change without notice and are not intended to be a guarantee of future events. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only. Past performance is no guarantee of future returns. Real results may vary.

Strong consensus positioning, with USD short positions to cover, very often leads to counter-trend rebounds in the US exchange rate. This can have negative repercussions for some of the best-valued long-term investments, such as Emerging Market shares **(see Figure 13)**. Fortunately, the gains in EM shares have still lagged behind the weakening in the US dollar to date. We would not expect broad or severe weakness in EM. In fact, we would see a decline as a buying opportunity. Over the short-term, this also suggests that the US dollar itself may provide a useful hedge for global portfolio risks **(see Figure 14)**.

Figure 13: EM relative to US equities vs the USD index

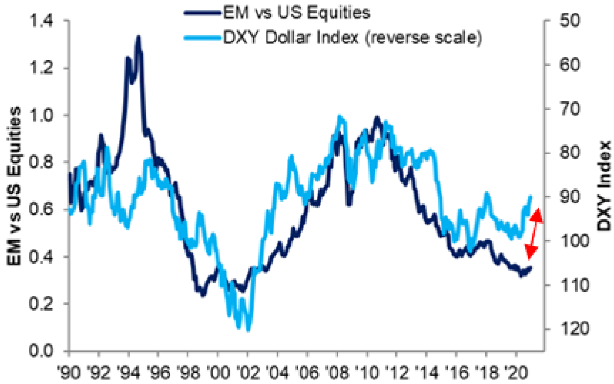
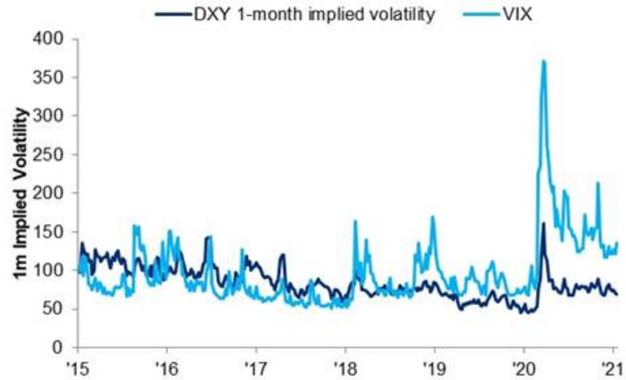


Figure 14: USD Index (DXY) Implied Volatility and S&P 500 volatility (VIX)



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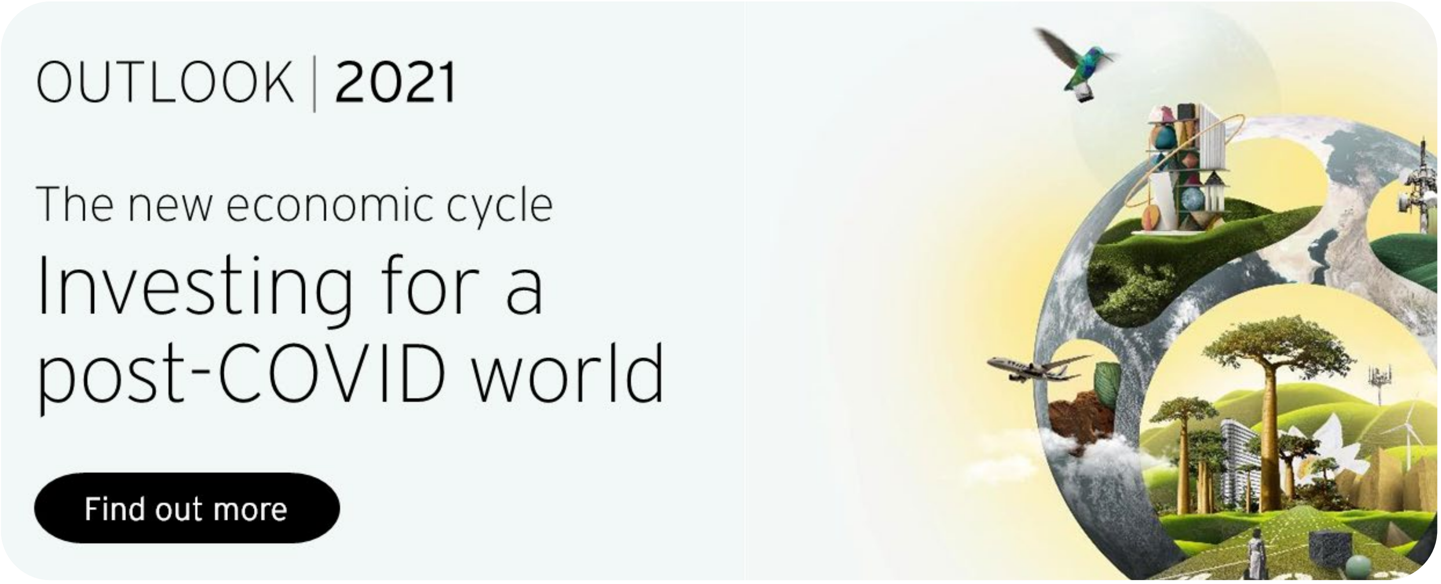

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