Private Bank

citi

CIO Strategy Bulletin

October 19, 2020

East vs. West: A Contrast in Covid Costs and Economic Outcomes

David Bailin, Chief Investment Officer
Steven Wieting, Chief Investment Strategist and Chief Economist
Ken Peng, Cecilia Chen, Joe Fiorica, Malcolm Spittler, Shan Gnanderan and Maya Issa contributed to this Bulletin

Summary

- **The difference in the "cost of Covid" between the West and East is dramatic and visible. A surge in US deficit spending -- from 5% of GDP to 15% in 2020 -- has been required to achieve economic stability thus far. China has not needed to provide as much fiscal and credit support given its handling of Covid.**
- **In 2020, China's shutdown, reopening and economic results provide useful " forward guidance" on patterns for later recoveries in Western economies. For example, Hong Kong and Singapore have resumed flights in a "safety bubble." This illustrates a positive future path for beaten-down services industries across the world by mid- to late 2021.**
- **China will derive certain advantages from its handling of the pandemic. That said, China has its own set of headwinds. We think that exposure to Asian growth and equities is an essential part of a forward-thinking portfolio. Structural changes in how the East and West compete will make the development and deployment of that portfolio complex, but beneficial for investors.**

In the West…

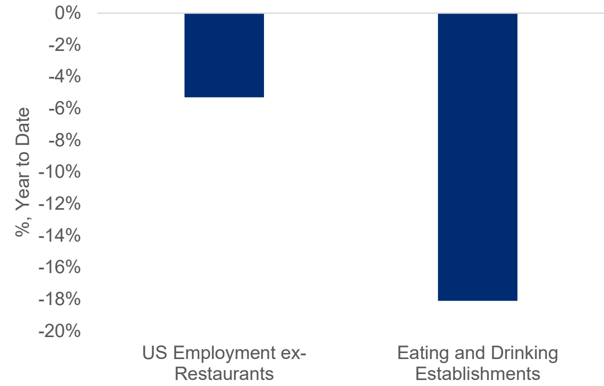
The rise of a major second wave of Covid in the United States and Europe was widely anticipated. It comes after a summer reprieve. With restaurants open, low levels of disease and fiscal stimulus filling gaps in personal and business balance sheets, individuals resumed much of their normal activity **(see Figure 1)**. The airwaves also provided a distraction, as the US election took center stage.

COVID 19 has dealt disproportionally large, negative impacts on certain industries, sectors and workers. The crisis for the most-impacted individuals stands apart from the larger economic performance **(see Figure 2)**.

The summer lull came amidst an economic recovery whose strength surprised everyone. The world's equity markets through October 12 had recovered all but a fraction of their Covid losses. And the labor market was similarly strong. Over the past 5 months, job gains in the US exceeded virtually every forecasters' estimates.

Figure 1: Global Mobility – Retail and Recreation

Figure 2 : US Jobs – Restaurants vs Overall ex-Restaurants



Source: Haver Analytics as of October 19, 2020.

In Europe, employment levels fell far less than in the US and subsequently did not rebound substantially. In the US, we believe real GDP rebounded at a double-digit pace (+25%) in the third calendar quarter following a 32% drop. GDP movements in Europe in Q2/3 showed the same pattern but with even greater amplitude. (Note: data both lag and are reported differently.)

In short, it has been a positive surprise that a US labor market recovery since the April peak in fiscal transfer payments has endured and that a positive self-reinforcing dynamic to the recovery **(see Figures 3-4)** was established.

Figure 3: US Government Transfer Payments of Income

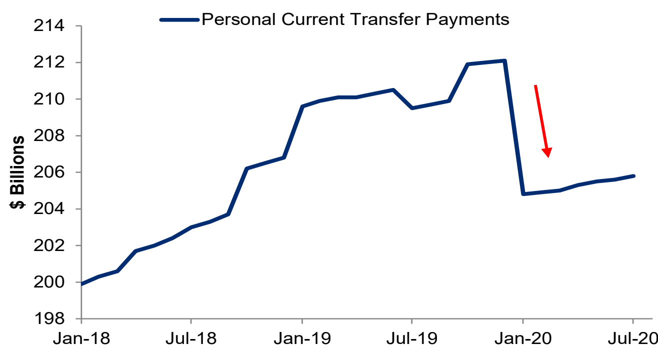
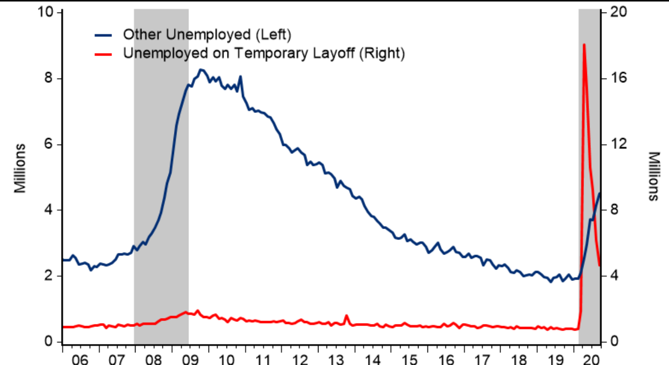


Figure 4 : US Temporarily Unemployed vs Permanent



Note: Shaded regions are recessions. Source: Haver Analytics as of October 18, 2020.

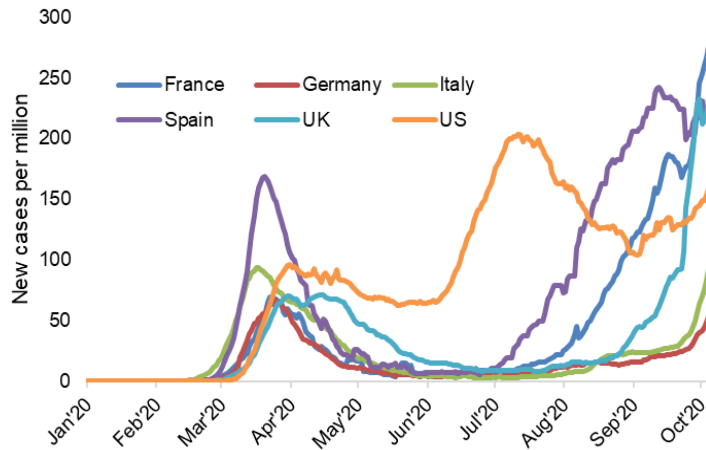
Low Winter Fuel and High Winter Covid

The "fuel" for the US labor market recovery is now running low. On a net basis, 14 million workers who lost jobs on a temporary basis as a result of the April shutdown have already been rehired. If we normalized this data, only 4 million would remain to be rehired. 33% of the job gains in the past five months were at bars and restaurants, and as winter weather arrives, we see net employment gains slowing toward zero by year-end 2020, assuming there is no additional fiscal action to preserve jobs or stimulate hiring. This is unfortunate and unnecessary.

For example, there is $130 billion in unallocated Paycheck Protection Program funds that could easily be re-directed to help the US economy immediately. There would be enough money to renew the $600-per-week federal supplements for unemployment insurance for nearly two months. And there would be enough capital to help US airlines outlast the pandemic. (The industry has requested an additional $25 billion to avoid job cuts.) Spent over two months, the $130 billion in unspent PPP funding **alone** could provide a 3% annualized boost to US GDP during the period.

But Covid is regaining momentum in the US again, with the pickup broadly but being led by Midwestern states in particular **(see Figure 5)**. Turning to Europe, the initial effectiveness in reducing COVID infections to negligible levels in the summer has sadly given way to much higher case rates and absolute infection levels than in the US. While infection rates in Italy are rivaling the March surge, the rise in France and the UK are dramatically higher than in the late winter. We expect this to hold back the region's recovery, but we do not expect a "shelter in place" response like the one that collapsed the world economy at the end of 1Q.

Figure 5: COVID Infection Rates per Million Europe, UK, US



Source: Haver Analytics as of October 16, 2020.

Amid the COVID surge, the UK continues its dispute with the EU. Once again, the opportunity for a political compromise is present. UK Prime Minister Boris Johnson has, however, repeated his threat that the UK will prepare to leave the EU's single market and customs union at the end of the year without an agreement in place. This of course would leave many flare points - such as the Irish border with the UK - to create added political risk amidst a pandemic. This is not the recipe for optimal economic or public health.

The "Long Wait" to January

With the US election now 14 days away, the probability of a second large-scale fiscal relief package is near zero (please see our note from last week *The US Election and the Economy: Double, double, toil and trouble*). Disputes between Congressional Republicans, Democrats and the administration make a pre-election breakthrough highly unlikely. Therefore, a revised national healthcare strategy and macro policy stimulus in the US will in all likelihood await a new Congress in January. So much for emergency management.

The UK, meanwhile, continues internal debate rather than renew initial stimulus. Apart from countries like Germany that are gradually relaxing long-lasting austerity measures, the EU has set in motion a larger stimulus through transfer payments to the most impacted countries. But these will only impact the region in full over the course of 2021.

"Staying the course" was an important rallying cry for central banks and finance minsters during the crisis of 2008/2009. Since the health crisis has not been dealt with decisively, it means economic pressure this winter will require additional macro stimulus. Stimulus treats the symptoms of the pandemics effects on the economy rather than the pandemic itself.

Asia's Different Kind of Medicine

On the other side of the world, Covid infection rates have remained dramatically lower in much of Asia **(see Figure 6).** One may attribute this to cultural differences, experience with regional epidemics, as well as overt controls over public movement, testing and tracing. A centralized, disciplined and enforced government response to Covid in large parts of North- and East Asia remain in place and effective.

Figure 6: COVID Infection Rates by Country – Asia Largely Avoid the Surge

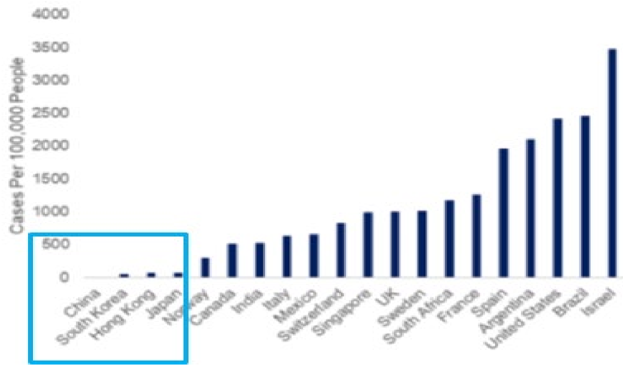
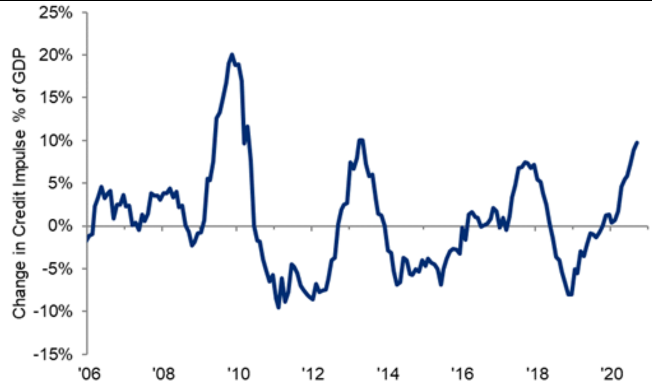


Figure 7 : China Local Currency Loan Growth Year-on-Year %



Source: Haver Analytics as of October 18, 2020. Note: Blue box points out Asia countries.

As a result of this strategy, China has been able to mitigate economic impact without turning to as dramatic a "money printing" approach used by western economies. In other words, through intensive Covid mitigation, China is will spend less to recover than the West will. Of course, China has used some macro policy steps to ease, including significant increases in public infrastructure investment. If we look at incremental changes in credit growth in the Chinese economy (the so-called "credit impulse"), we saw a far more dramatic easing by China in the 2009 crisis than in 2020 **(see Figure 7)**. The earlier steps created credit quality and debt sustainability issues as worries for investors. While problems remain, to date, China has managed this with a focus on growth quality over rapidity.

The difference in the "cost of Covid" between the West and East is dramatic and visible. While China's general government budget deficit has growth from 4.7% of GDP in 2019 to 5.3% in early 2020, a surge in US deficit spending, from 5% of GDP to 15% in 2020, has been required to achieve economic stability thus far.

Advantage Asia?

The lack of COVID control in the West has at least temporarily played to China's relative advantage. As **Figure 8** shows, the Western travel and tourism collapse and the flight from cities to suburban housing has meant a very large shift in consumption patterns. US consumer purchases of housing and recreation merchandise have surged at the expense of "socially-close" services. Benefiting are products China exports in mass quantities. The shift has arrested a drop in US imports from China due to the 2018-2019 trade war. China's industrial production and broader trade growth have accelerated, with its overall exports to all trading partners are **up 9.9%** from a year-ago in September.

An additional benefit of China's measured approach to monetary stimulus is currency appreciation **(see Figure 9)**. While China is unlikely to resort to indiscriminate boosts across the economy – particularly in real estate markets – currency appreciation does act as a signal for Chinese authorities that it can ease more liberally without fear of capital flight.

To be clear, China's gains do not come at the expense of the world economy. For example, China's imports have jumped to a 13.2% growth rate, outpacing its own exports. This has net benefits for many other countries.

Figure 8: US Consumer Goods vs Services Spending (Annualized)

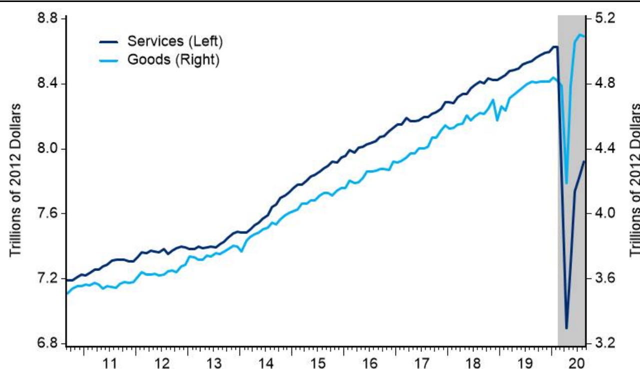


Figure 9 : China Government Bond Yield Premium to US Treasuries vs CNY/USD Exchange Rate

Note: Shaded regions are recessions. Source: BEA, Haver Analytics as of October 18, 2020. Past performance is not indicative of future returns.

What Happens In China Will Happen in the West

China's rebound from collapse at the start of the year signaled a similar recovery for other economies following shutdowns **(see Figures 10-11)**. A now broadening recovery in China provides a reference for what to expect in global services spending in the West post-Covid.

China's *Earlier* COVID Collapse and Earlier Recovery Highlights Future Recoveries Elsewhere

Figure 10: US and China Retail Sales Y/Y%

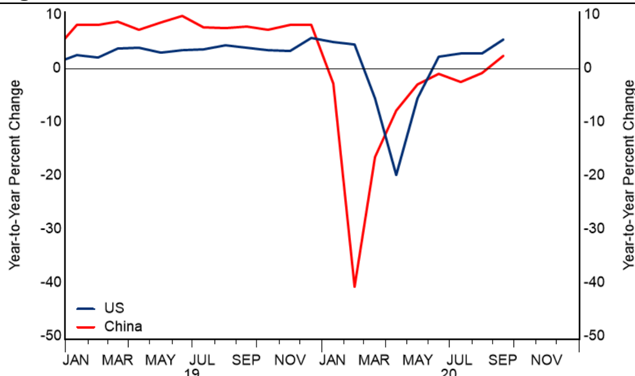
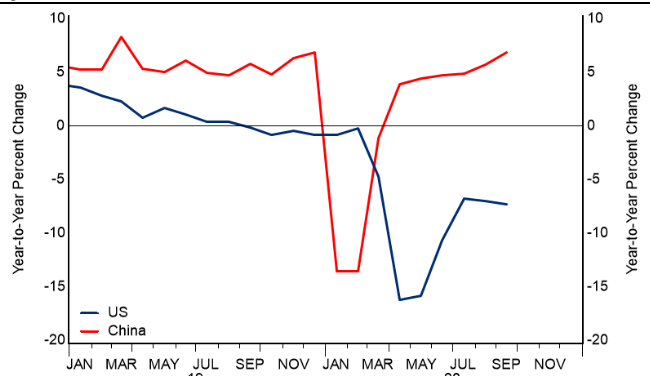


Figure 11: US and China Industrial Production Y/Y%



Source: Haver Analytics as of October 18, 2020.

With extremely low COVID infection rates, the latest Golden Week Holiday in China signaled a further "out of door" normalization with sharp recoveries in tourism and leisure activities. Total revenue from tourism has recovered to 70% of pre-Covid levels thus far. Passenger flights in early October appear to have risen to about 90% of 2019 levels (vs 40% for the US -**see Figures 12-13**).

Figure 12: China Airline Passengers Monthly through July

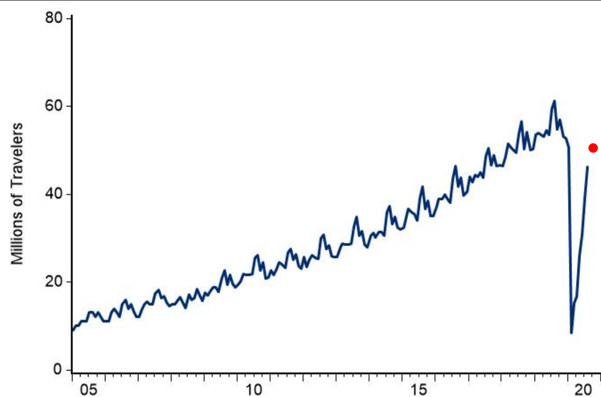
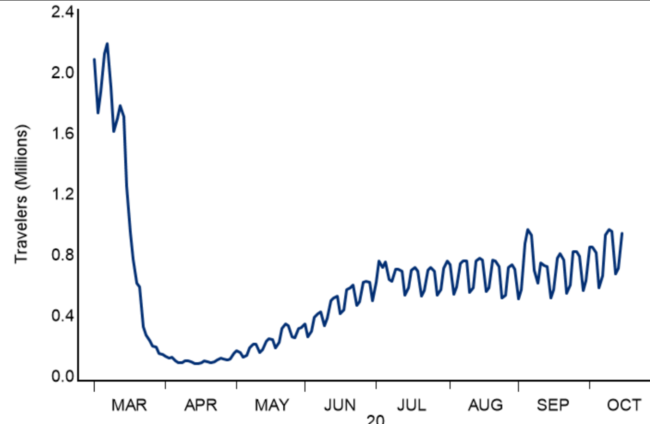


Figure 13: US Airline Passengers Daily. Daily Airline Industry Indications through Early October



Haver Analytics and Bloomberg as of October 16, 2020. Note: Red dot denotes early October Airline Industry data. Source: 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 no guarantee of future results. Real results may vary.

Singapore and Hong Kong, meanwhile, just announced a bilateral "travel bubble." For the first time in almost seven months, the two cities will open their borders to one another without compulsory quarantine. Instead, visitors will be required to provide a negative virus testing result.

Even though the HK-SG route is a small part of the impacted airlines' revenues, Asian airline shares still surged amid otherwise negative global market sentiment. It shows that investors are highly skeptical of airline shares and their prospects for recovery. In our view, this was a dress rehearsal of what it could be like for the global tourism sector when air travel normalizes post COVID.

The US economy for one has been quite "demand strong" with new record highs in consumer goods spending for four consecutive months. As **Figure 14** should suggest, the only thing that has knocked down vacation travel intentions is COVID 19. This leaves a powerful unmet demand for future recovery. The US Savings rate was a solid 7.2% prior to Covid. With the waning of fiscal transfers since April, the savings rate remains almost double that rate now at 14.1%.

Near-Term Portfolio Implications

Though we expect a very bumpy economic road to Spring in the West, it would seem highly impatient and risky to sell off "Covid cyclical"[1] equities now after their Spring 2020 collapse. As **Figure 15** shows, the most impacted equities have still held April lows despite major economic challenges.

We have written that Covid affected the price of every security "on its way in" and that we will similarly see similar major shifts in the relative value of securities as Covid treatments are released and utilized. While there is inherent uncertainty in predicting how markets discount the arrival and availability of a successful Covid vaccine, there is much evidence to suggest that the 15% of the global economy devastated by Covid will experience a snap back.

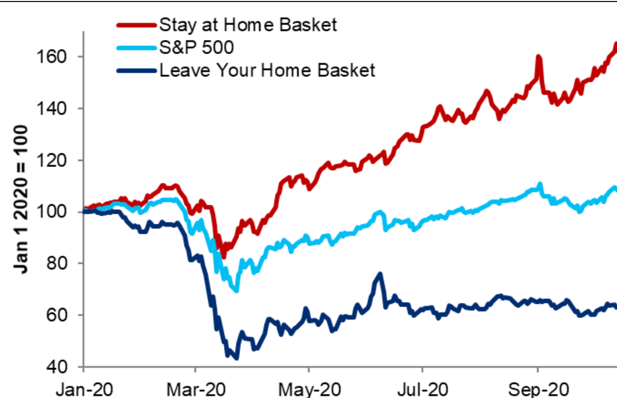
For those seeking to time markets perfectly, do not forget the 30% drop and 30% rebound in broad US equity markets within the first and second quarters of the year. These moves were the fastest bear market and bull market recoveries in history. In short, we reiterate that market timing is not a way to create wealth. It tends to destroy it.

Our broad equity portfolio recommendations are a mix of global Covid Defensives[1] – particularly "unstoppable trends" such as Longevity investments - and Covid Cyclicals with dividend yields well above global bond yields. This of course includes a long-term overweight to Emerging Asia (*Asian Development*, Outlook 2019 for more). Positioning portfolios for faster growth is Asia is prudent on several levels. Given that the need for diversification is greater given where real global bond yields are negative, exposure to Asia will add diversification as the demographic and regional development trends are materially different than in the East.

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

Figure 14: US Consumer Vacation Intensions

Figure 15: "Stay at Home," "Leave Your Home" Equity Baskets vs S&P 500

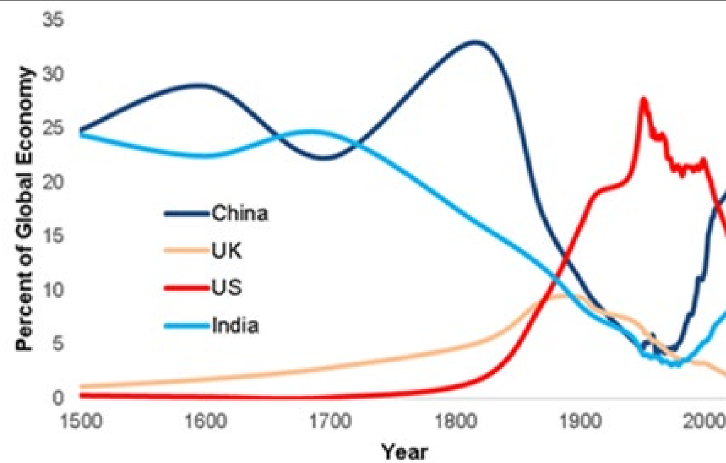


Source: Haver Analytics and Bloomberg as of October 16, 2020. Note: "Stay at Home" basket includes names identified to benefit from COVID-related disruptions and a shift to working from home. "Leave Your Home" basket includes Citi Research Buy and Neutral Rated US names in the following sub-industries: 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. These are shown for illustrative purposes only. This is not a recommendation to buy or solicitation to sell any of the names shown.

Longer-Term Portfolio Implications

In 2020, Fortune's list of the world's top 500 companies has more business from China and Hong Kong than from the US. By reference, there were none on the list 30 years ago. In the context of history, however, China itself still have "room to run", as it shifts from an export-driven economy to a domestic consumption driven one **(see Figure 16)**.

Figure 16: National Shares of World GDP



Source: Madison project, Citi Private Bank OCIS as of October 18, 2020.

China benefited from a huge agrarian population that was able to earn more in urban manufacturing jobs. China was also a low cost producer at a time (after the fall of the Berlin Wall) when other countries were willing to engage in much greater trade without reciprocity. The Chinese on the whole, were a society of savers, not spenders, whose savings were used to finance the industrialization of the country organized by the Government. Finally, China embraced entrepreneurship and wealth creation. China provided incentives that allowed large highly competitive technology and industrial companies to flourish, including access to global capital markets.

But China is not without major challenges.

It is no longer a low-cost producer of goods or services. Its labor force has been shrinking as the cost of labor has risen. In China, income inequality has risen along with consumerism. Furthermore, the unequal policies that allowed China to export goods freely to build its state balance sheet have come under great scrutiny. The U.S. and the West are demanding protection for intellectual property, true and fair access to Chinese markets and placing limitations on the use of Chinese technology in global infrastructure. This marks a major shift in the global dynamic for Chinese enterprise.

The Asian Theme in Portfolios

With all that said about China, the "Rise of Asia" continues unabated. In our view, there will be a steady shift in global economic power from West to East, which is likely to continue despite the inherent tensions discussed above. Asia ex-Japan accounted for 26% of global household consumption in 2019, up from 14% in 2009. The region will also see up to 1.5bn additional middle class in the coming decade, as well as an additional 100 large cities of 1 million or more.

In the event that there is a change in the US government in early November, we may see a different and more concessionary Chinese engagement on the world economic stage. If that happens, we may see fewer economic restrictions and tariffs. That shift would allow China to focus on domestic demand and the adoption of technology within its borders. In this scenario, Chinese equities (and Asian equity investments more broadly) will remain quite attractive given their long-term growth prospects. There are *many* promising areas for investment against this backdrop, everything from 5G infrastructure (which will be an East v West G2 opportunity) to the rebuilding of "old" cities and transportation infrastructure. Climate change is a global issue and Asian countries and companies are already playing a major role in the development and installation of infrastructure that changes how energy is produced and consumed. And the Asian consumer will create fertile investment opportunities across ecommerce and in all leisure industries.

INVESTMENT PRODUCTS: NOT FDIC INSURED · NOT CDIC INSURED · NOT GOVERNMENT INSURED
· NO BANK GUARANTEE · MAY LOSE VALUE

This email contains promotional materials. If you do not wish to receive any further promotional emails from Citi Private Bank, please email donotspam@citi.com with "UNSUBSCRIBE" in the subject line. Email is not a secure environment; therefore, do not use email to communicate any information that is confidential such as your account number or social security number.

Citi Private Bank is a business of Citigroup Inc. ("Citigroup"), which provides its clients access to a broad array of products and services available through bank and non-bank affiliates of Citigroup. Not all products and services are provided by all affiliates or are available at all locations. In the U.S., investment products and services are provided by Citigroup Global Markets Inc. ("CGMI"), member FINRA and SIPC, and Citi Private Advisory, LLC ("Citi Advisory"), member FINRA and SIPC. CGMI accounts are carried by Pershing LLC, member FINRA, NYSE, SIPC. Citi Advisory acts as distributor of certain alternative investment products to clients of Citi Private Bank. CGMI, Citi Advisory and Citibank, N.A. are affiliated companies under the common control of Citigroup.

Outside the U.S., investment products and services are provided by other Citigroup affiliates. Investment Management services (including portfolio management) are available through CGMI, Citi Advisory, Citibank, N.A. and other affiliated advisory businesses. These Citigroup affiliates, including Citi Advisory, will be compensated for the respective investment management, advisory, administrative, distribution and placement services they may provide.

Read additional important information.

Past performance is not indicative of future results. Real results may vary

MBS are also sensitive to interest rate changes which can negatively impact the market value of the security. During times of heightened volatility, MBS can experience greater levels of illiquidity and larger price movements

Important information, including information relating to risk considerations can be found in the link above.

Views, opinions and estimates expressed herein may differ from the opinions expressed by other Citi businesses or affiliates, and are not intended to be a forecast of future events, a guarantee of future results, or investment advice, and are subject to change without notice based on market and other conditions. Citi is under no duty to update this presentation and accepts no liability for any loss (whether direct, indirect or consequential) that may arise from any use of the information contained in or derived from this presentation.

© 2020 Citigroup Inc. All Rights Reserved. Citi, Citi and Arc Design and other marks used herein are service marks of Citigroup Inc. or its affiliates, used and registered throughout the world.

www.citiprivatebank.com