Private Bank

CIO Strategy Bulletin

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Pandemic Investing 101: Actionable Insights After a Historic First Quarter

David Bailin, Chief Investment Officer
Steven Wieting, Chief Investment Strategist and Chief Economist
With contributions from Joseph Fiorica, Malcolm Spittler, Charlie Reinhard, Kris Xippolitos, Shan Gnanendran, Joe Kaplan, Maya Issa, Cecilia Chen

Summary

PANDEMIC INVESTING 101: If the virus completes its first global cycle by summer, this recession would potentially be both the shortest and deepest in modern history. Thus, if Q2-2020 is as bad as we suspect, the bottom of this recession will occur sometime within the next 90-120 days. Pandemic Investing is likely to require us to make faster decisions with less information than we have been comfortable with before. History strongly suggests markets don’t bottom when investors feel brave and confident, but rather when they don’t believe gains are possible. As such, we think clients should be prepared to invest into the eye of the COVID storm.

WHERE TO FIND VALUE IN DIVIDEND EQUITIES: In a post-COVID-19 world, we revisit the value of dividends. New investment dollars should first be allocated to the firms least impacted by the COVID-led economic crisis. This is even the case when taking into account the fact that such shares have seen much smaller price declines than the most impacted industries. Firms that overlap our “unstoppable trends”, including healthcare (“invest in longevity”) and Information Technology (“Digitization”) seem likely to sustain some measure of growth.

A QUARTER FOR THE HISTORY BOOKS: Lots of record breaking and none of it good. The 30% decline on the S&P 500 from its February peak marked the swiftest correction in history at 22 days. We saw massive outflows from municipal bonds, indiscriminate selling of even AAA corporate bonds, and wide bid/ask spreads in mortgage securities guaranteed by the US government. Global high yield bonds declined 15% and investment grade credit indices fell 5.4%. For these markets (and many others), such returns marked the worst quarter to start a New Year on record.

GDP DATA AS PRESENTED WILL OVERSTATE REAL GROWTH: It is clear that this pandemic presents an exogenous shock that will cause an unprecedented, extremely deep short-term economic collapse. Even if the Q3 2020 rebound we expect takes place, real US GDP would only be back to early 2017 levels. It would therefore take a couple of years at minimum to return to the late 2019 output level.

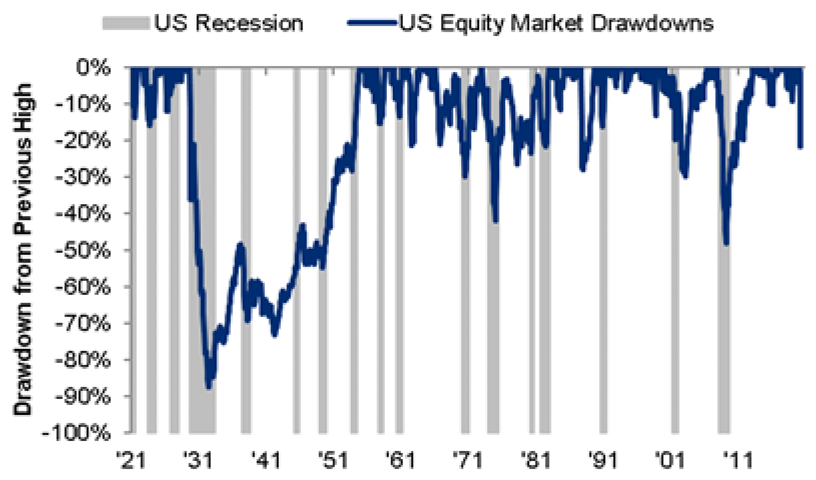
Pandemic Investing 101

Everyone wants to know when to "put money to work" or, if they were being very honest, "when will we hit bottom?" in 2020. To understand what's different and what's not about "Pandemic Investing" we need to understand the circumstances we face presently in an historical context. Let's use the United States as a baseline.

Since 1920, there have been 17 recessions and one depression. Each of these were accompanied by a fall in stock prices, save for WWII[1]. The depth of the fall in stock prices ranges from 7% to 75% and the timing of the declines from 4 months to 33 months (**see figure 1**.)

[1] Equities also did not fall in the brief 1980 recession, but fell hard in the one that took place in 1982. Some economic historians view this as a single event as the Fed suppressed demand to fight inflation.

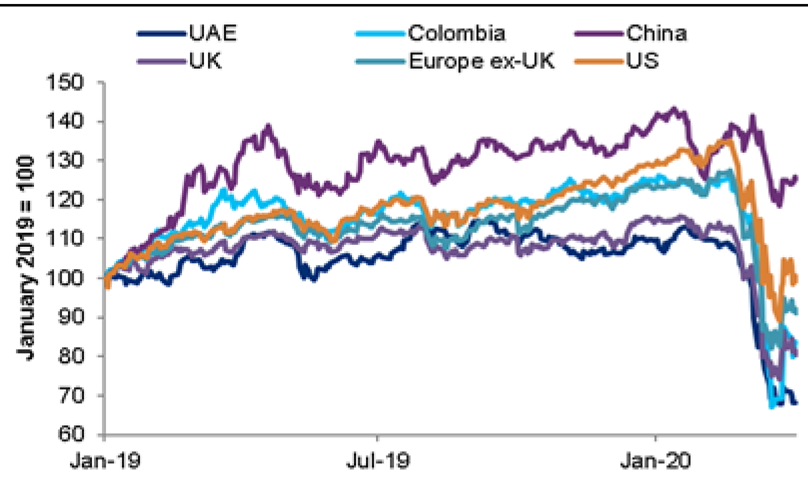
Figure 1: Recession/Depression Peaks and troughs and US share Price drawdowns



Source: Haver Analytics through April 3, 2020

The speed of the decline **(see below section - *A Quarter for the Record Books*)** is what stands out about this Covid-19 sparked recession. (And, let's be clear, we are definitely having one now across the globe as businesses are forced to close.) In markets, investors dumped shares and bonds, even gold and US Treasuries, to gain access to cash. The desire for cash in the bank was in part panic and in part the need to meet obligations, whether redemptions from funds or the need to have sufficient cash on hand to make payrolls. Thus, we have seen an unprecedented, rapid revaluation of the market due to the nature of the exogenous shock, COVID-19 and its stealthy, scary impact on societies and economies, rich and poor. (**Figure 2**).

Figure 2: Equity market revaluation



Source: Haver Analytics through April 3, 2020

Though we have written about the fact that the recovery post-COVID will be challenging with many unknown secondary and tertiary obstacles, we cannot ignore the fact that the basic math of recessions and recoveries matters. In simple language, markets have historically bottomed before recession was over, save for the dot.com bubble period. We have estimated a huge decline in GDP for this quarter, with US output perhaps falling at a 40% annualized rate if 25% of workers are idle in the quarter (please see Balancing Risks and Opportunities As The Pandemic Accelerates). But we also predict a rise off the bottom when individuals no longer need to be at the extremes of social distancing. This is likely to be in Q3 with some acceleration in improvement in Q4 2020. If the virus completes its first global cycle by summer, this recession would potentially be both the shortest and deepest in modern history. Thus, if Q2-2020 is as bad as we suspect, the bottom of this recession will occur sometime within the next 90-120 days.

Investing in and around recessions is hard because how we **feel** about the economy after a recession officially ends is **'bad'**. The recovery from recessions is typically uneven, consumer and business confidence is low and capital is allocated very carefully. Markets don't typically reach prior peaks until well after a recession ends and a new expansion is well established.

Figure 3: Duration and Depth of S&P 500 Declines Larger than 25%

First 25% Decline	Days to Trough	Days to Up 10%	Total Decline After First 25% Down	Return after First 25% Drop 18 Months	24 Months	36 Months
1962, Jun-14	12	15	-3.7%	36%	47%	57%
1970, Apr-28	28	3	-13.7%	17%	33%	34%
1974, Apr-25	161	7	-30.5%	0%	14%	10%
1982, Aug-05	7	8	-2.6%	53%	54%	82%
1987, Oct-19	46	12	-0.4%	36%	52%	36%
2001, Mar-20	15	14	-3.4%	-24%	-23%	-3%
2001, Sep-20	1	14	-1.9%	-9%	5%	15%
2002, Jul-19	82	6	-8.4%	34%	30%	44%
2008, Sep-17	166	3	-39.4%	1%	-3%	5%
Average	**58**	**9**	**-11.6%**	**16%**	**23%**	**31%**

Sources: Haver Analytics as of March 27, 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. Index returns do not include any expenses, fees or sales charges, which would lower performance. For illustrative purposes only. Past performance is no guarantee of future results. Real results may vary.

So, this is what's different than every prior recession:

- **Speed:** Markets in the US fell 34% peak to a *possible* trough in 23 days.
- **Actions:** The Federal Reserve and US Government acted with great clarity to put relief and stimulus in place even before the recession hit, making clear that a recession from an exogenous threat, like a pandemic, was to be treated as a threat to the country itself. We believe more relief is on its way, too.
- **Credit:** Credit markets are normalizing slowly and the Feds commitment (with unlimited Quantitative Easing) is not something an investor can fight, nor ignore. According to Refinitiv, Investment grade bond issuance in March 2020 was the highest ever on record at over $107 billion.
- **Zero Rates:** Cash has been devalued. Global cash yields are near zero. This boosts equity risk premia.

The implications of these facts are quite interesting:

We have been pointing out that the drop in equities has not been large compared to the scope of the economic collapse. We have also viewed the rally back of the past few weeks skeptically. Nonetheless, our economic outlook suggests that either the market bottomed in March or will bottom within the next 90-120 days as the worst of the global collapse unfolds.

There are reasons why Citi Private Bank believes that markets could retest their lows – all having to do with the extent of the damage to the global economy, our view that earnings impairments will last longer and the absence of "investor capitulation" that one typically sees before a rout ends. And there is also an unfolding tragedy in many homes and appearing on televisions that will undoubtedly unnerve investors. In contrast, the bulleted list of "what's different this time" provides ample reasons why (S&P 500 at 2,237 on 23rd March) could be the low. The "we will do what it takes" attitude of governments is itself an unstoppable trend for 2020-2022.

To build core portfolios for the future, we must weigh the evidence of improving conditions against the risk of further weakening. This is where global asset allocation, rigorous analysis of credit dynamics, knowledge of sustainable long-term trends and diversification will serve investors well.

In addition to adding to one's core portfolio, we have suggested a range of opportunistic investments and specific market areas to "add around" core portfolios.   These include allocations to themes such as "Invest in Longevity (healthcare), "The Rise of Asia," and "Digitization" which encompass many of "COVID resistant" industries that were on a path of stronger, sustained economic outperformance. We see market dislocations in bank preferred stock and US municipal bonds as likely to correct higher. More generally, we will also be advising that investors be sellers of some fixed income positions to invest more in equities, and likely before the present recession ends.

Pandemic Investing is likely to require us to make faster decisions with less information that we have been comfortable with before. History strongly suggests markets don't bottom when investors feel brave and confident, but rather when they don't believe gains are possible. As such, we think clients should be prepared to invest into the eye of the COVID storm.

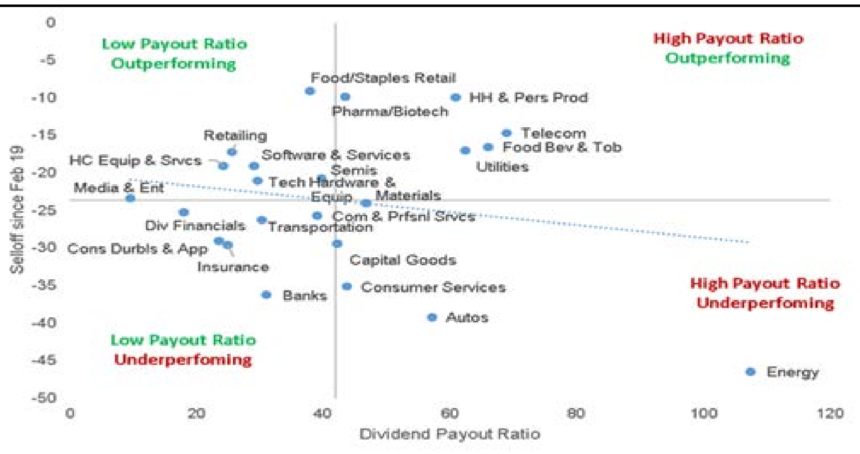
Where to Find Value in Dividend Equities

Consistent dividend growth is among the strongest performance drivers for a firm's shares over the long-term. In the immediate present, we believe firms that can convince markets that dividends are merely secure will outperform. The firms in the most impacted industries will have a more difficult job to convince investors.

In October 2019, we highlighted the long-term performance of firms that consistently raised their dividend payments. Such firms have also historically displayed certain defensive characteristics. However, we also noted that passive strategies can be *backward looking* in this regard. Banks that were strong dividend growers prior to the *Global Financial Crisis* suddenly cut dividends, leaving them out of passive portfolios even after they strongly recovered and raised their payouts. Some energy firms, meanwhile, grew dividends through the last crisis and have been "passively selected" to continue doing so now.   Now, in a post-COVID-19 world, we need to revisit the value of dividends.

To revisit the dividend matter, Citi Private Bank divided dividend payers into four quadrants along with their performance since the Covid-19 crisis went "global" (**see figure 4**). The firms that are outperforming while still paying large dividends sell essentials like healthcare products, food and telecom services. The negatives are in energy, autos and other consumer durables - whether payouts are either high or low. The pay-out ratio is secondary to their products being discretionary, or otherwise impacted by the sharp drop in social interaction.

Figure 4: Performance of Dividend Paying Industries Since Mid-February



Source: Factset through March 31, 2020

How to Invest in Dividend Stocks Going Forward

As markets have corrected sharply lower since mid-February, we continue to argue that new investment dollars should first be allocated to the firms least impacted by the Covid-led economic crisis. This is even the case when taking into account the fact that such shares have seen much smaller price declines than the most impacted industries.

At some point in the future, the most depressed industries will clearly have the highest return prospects from their deeper lows. In the immediate present, we believe firms that can convince markets that dividends are *merely secure* will outperform. Firms that may require government assistance simply can't stay in the positive category for shareholder distributions. This likely includes most travel and transport firms away from key logistics beneficiaries.

Firms that tend to overlap our "unstoppable trends" like healthcare ("invest in longevity") and certain Information Technology industries ("Digitization") seem likely to sustain some measure of growth, dividends and positive fundamental performance generally. (For an interesting near-term portfolio opportunity, please discuss "stay at home shares" with your investment counselor).

While a select few will endure through the crisis even within heavily impacted industries, very large dividend cuts are expected for many within Industrials (transports), Energy, Discretionary (autos) and Materials industries.

Winner: Health Care

Healthcare has been a traditional defensive industry, with positive EPS growth averaging 9% during the past three recessions since 1990, the strongest of any sector. The present crisis is unusual in two respects: 1) the present recession is abnormally severe in scope, likely to drive losses for many cyclical industries as GDP likely contracts at a record pace on the second quarter. 2) The contraction is being driven by a health crisis, requiring stepped up healthcare solutions and in some cases heightened demand for a wide range of healthcare goods and services. Government efforts to restrict healthcare spending will be on the wane in the near-term. The global healthcare sector has seen share prices fall 13% in the year-to-date. This is the mildest of any industry sector, yet it has merely lowered overall sector valuations as there is no fundamental decline in healthcare to consider (at an industry sector level).

Winner: Technology

The growth stocks that comprise "digitization" (cybersecurity, ecommerce generally and Fintech) tend to be less impacted by the economic crush of COVID-19. Strong secular growers in areas like software have reduced immediate economic losses to this crisis. Ironically, with high valuations and high future growth expectations, these same firms benefit (relatively speaking) from interest rate declines, much like long duration bonds. In contrast, firms that have high current profits and a large exposure to the economy's immediate performance are valued on current dividend payments, which can be cut sharply. Notably, within IT, even within the same industry, the degree of cyclical risk varies sharply. We believe the COVID-19 crisis will generate an unusual degree of dispersion in share prices and credit returns.

Neutral: US Banks

Large US banks voluntarily eliminated share repurchases, giving many the scope to maintain dividends. However, they are unlikely to grow dividends much if at all this year and some (weighted toward small and mid-caps) will inevitably cut.

Negative: European Banks

In Europe, where government assistance to the financial sector continued far longer than in the US (and there is no scope to cut share repurchases), the dividend outlook is worse. Over the last month, dividend futures have priced in an 88% cut in European bank dividends in 2020, and a 71% cut in 2021 dividends. On a market-cap weighted basis, 80% of dividends within the European bank sector have either been cancelled or omitted for 2020 so far. For Asian, the outlook for banks varies significantly by country.

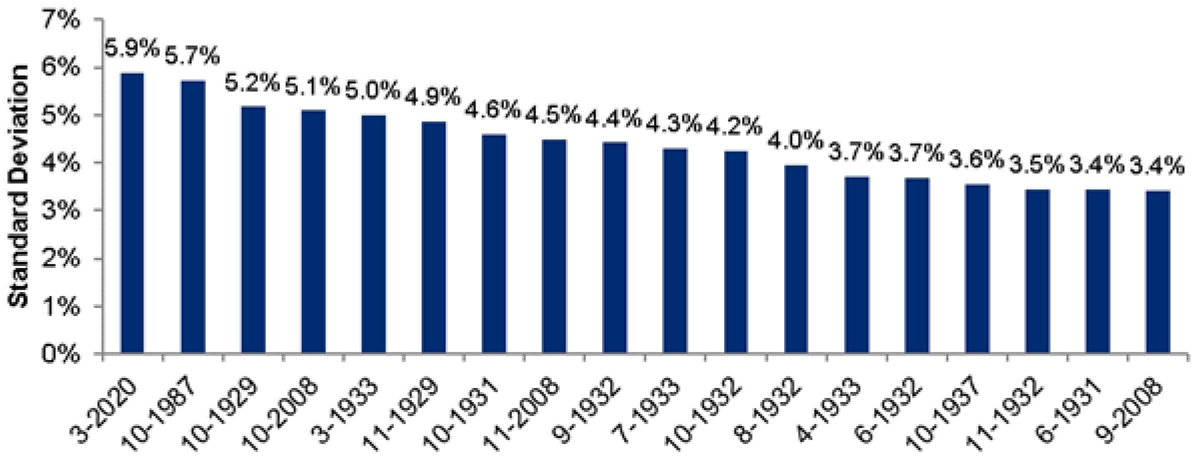
Negative Outlier: Energy

The landscape for energy producers has been technologically challenged by both the US shale revolution and the emergence of alternative energy sources including solar powered batteries (please see Outlook 2020's "Next Energy Revolution"). This is much like the existential technological risk to traditional retailers from e-commerce. Many energy and consumer discretionary firms have paid reliable dividends recently, but most are not in a good place for the crisis now upon us.

A Quarter for the Record Books

Here is what panic looks like. The 30% decline on the S&P 500 from its February peak marked the swiftest correction in history at 22 days. March was also the most volatile month since at least 1929, surpassing the crash of October 1987 (**Figure 5**). Implied volatility, as measured by the VIX, surpassed levels seen during the 2008/2009 financial crisis. We saw massive outflows from municipal bonds, indiscriminate selling of even AAA corporate bonds, and wide bid/ask spreads in mortgage securities guaranteed by the US government. Global high yield bonds declined 15% and investment grade credit indices fell 5.4%. For these markets (and many others), such returns marked the worst quarter to start a New Year on record. Lots of record breaking and none of it good.

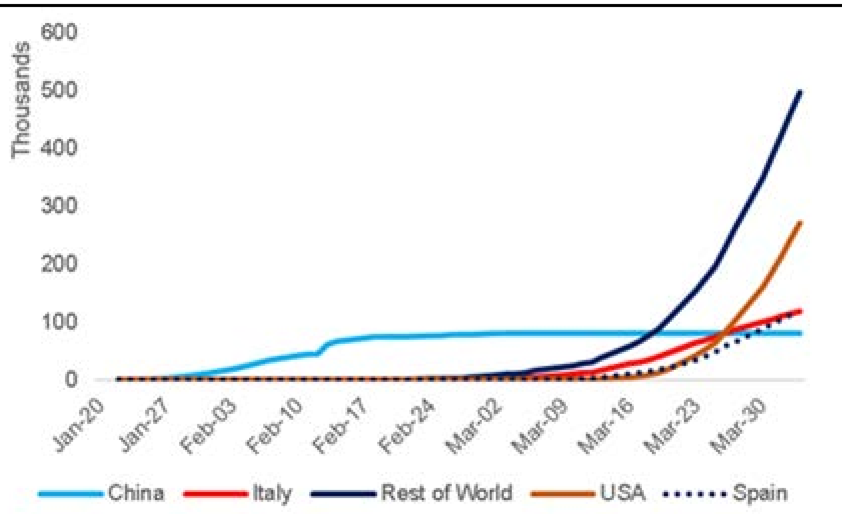
Figure 5: The 20 most volatile months in history



Source: Haver Analytics through April 3, 2020

As the first quarter came to an end, the known number of Covid-19 cases across the world approached one million, with a grim 50,000 deaths **(figure 6)**. The disease has now spread to over 200 countries and every US state. About 75% of US individuals were covered by "stay at home" measures imposed by state governors and mayors. In places where cases had accelerated rapidly such as certain cities in Italy and New York, the growth rate of new infections merely slowed. In Cities such as Milan, Madrid and New York, health care systems were overwhelmed with new patients and peak cases still appear off in the future. A mobile tent hospital was opened in New York's Central Park. Much of the world appears unprepared for similar dislocations.

Figure 6: Global known Covid-19 cases



Source: Haver Analytics through April 3, 2020

On March 23, the Fed announced a series of emergency programs to bring order to bond and money markets. Besides launching the era of open-ended quantitative easing (QE), the central bank also created facilities to ensure a continuity in credit and securitized markets. With the Fed now buying investment grade corporates, this sparked a flurry of new deals. Companies from Nike to Home Depot rushed to raise cash by issuing a record $109 billion of debt in a single week, according to IFR Refinitiv data. This was a bright spot and investors showed great enthusiasm for these opportunities.

On March 29, Congress and the White House passed a record $2 trillion of stimulus, representing 9% of gross national product, directed at workers, small businesses, hospitals, municipalities and ailing industries in need of cash. The relief came just in time, as nearly 6 million Americans filed for unemployment insurance in the last week of the quarter – another negative record since this data began to be collected in the 1960s. Governments across the world are taking similar steps, but with wide variance and likely effectiveness.

As the quarter ended, European Community leaders continued to squabble over the degree of national versus collective responsibility for crisis fighting efforts. Indian President Modi asked for "forgiveness" for the needed quarantine measures among his nation's poor. US President Trump acknowledged that the next couple of weeks would bring grim news on the healthcare front.

How GDP Data Is Presented Will Overstate Real Growth

There is no common definition of a recession. However, it is clear that this pandemic presents an exogenous shock that will cause an unprecedented, extremely deep short-term economic collapse.

As we discussed in the CIO Strategy Bulletin of March 15 "Preparing for An Economic Shock and Resuscitation", we assumed that 25% of the workers in US and European economies would be idled within Q2-2020 with non-essential businesses essentially shuttered for most of the quarter. The scope and effectiveness of fiscal and monetary policy actions will ultimately determine the degree to which this is a temporary shutdown or a "shutoff." The severe shock of lost income and reduced activity will certainly mean some permanent losses among marginally capitalized businesses under the best case scenario

But how might this appear in the public data?

Using US data, our hypothesis is that 25% of the workforce could be idle (laid off, fired or temporarily unable to work) within 2Q. When individuals will be allowed to return to work from mandatory shutdowns depends on the virus itself with timing likely to be staggered across the world. If the COVID virus "burns out" fast in the coming quarter, and our illustration turns out to be close to the post-virus reality, we would assume that after a quarterly snapback, factors away from COVID would slow the pace of the rebound in growth.

As US GDP data are reported at an annualized rate (a mathematic approximation that multiplies quarterly changes by 4), we expect a 40% annualized pace of GDP decline in the second quarter. Following the shutdown, if just half these workers get to return to work (including those with existing jobs) in the third quarter, the rise in total hours worked suggests a growth rate of +32%.

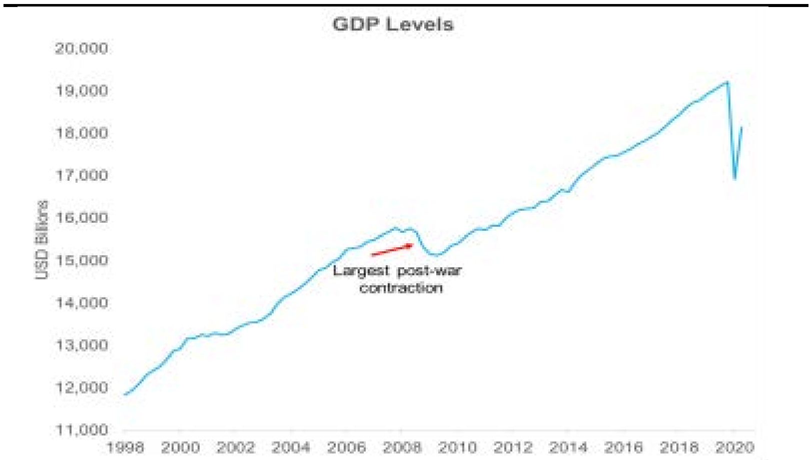
Figure 7: Quarterly US Real GDP Annualized Rates with 1Q-3Q 2020 Assumptions

Source: Haver Analytics through April 3, 2020. All forecasts are expressions of opinion and are subject to change without notice and are not intended to be guarantees of future events.

Take note of the asymmetry of reported economic gains and losses to help investors interpret forecasts. **Figure 8** shows this asymmetry of growth and decline. We would get back only half the lost work, but the two quarterly periods show growth rates fairly close in absolute value.

Even if that 3Q rebound takes place, real US GDP would only be back to early 2017 levels. It would therefore take a couple of years at minimum to return to the late 2019 output level.

Figure 8: US Real GDP Level with 1Q-3Q 2020 Assumptions



Source: Haver Analytics through April 3, 2020. All forecasts are expressions of opinion and are subject to change without notice and are not intended to be guarantees of future events.

Glimmer of Hope

While this is disheartening news and we see many challenges ahead, the path of China's economy is providing room for optimism for the wider world, even if it will not quickly and cleanly throw off its new problems.

As **figure 9** shows, following a record pace of contraction in monthly factory activity in February, growth in China has resumed in March. China's economy this quarter will remain smaller than where it started the year and will face external challenges to its growth from Covid-19 in other countries. Nonetheless, we would assume China's economy reached a low point in 1Q. Tentatively speaking, we can imagine the same pattern in the US and the world at large following a miserable 2Q 2020.

Figure 9: Manufacturing Purchasing Managers Composites Across Major Economies

Source: Haver Analytics through April 1, 2020