

CIO Strategy Bulletin

April 12, 2020



Pandemic Investing 102 -Turning the Economy Back On: Expectations and Realities

David Bailin, Chief Investment Officer

Steven Wieting, Chief Investment Strategist and Chief Economist

With contributions from Malcolm Spittler, Joe Fiorica, Kris Xippolitos, Ken Peng, Jorge Amato, Joe Kaplan and Maya Issa

Summary

This week a detailed, two-part Strategy Bulletin... The shortest/deepest recession, the most volatile month for the S&P 500 on record, and a one-month bear to bull market swing. Consumers are afraid, and governments are looking at how to reopen their economies to stave off further damage.

Part One explains what is priced into markets versus the practicalities and complexities of “turning the economy back on”.

With substantial support from the Fed and Treasury, analysts and markets are looking far ahead and perhaps over the worst of the earnings declines. Citi Private Bank forecasts a -40% GDP decline in 2Q with earnings down 65% year-to-year.

Part Two presents Citi Private Bank’s economic assumptions and looks at the market implications. We provide GDP estimates for the global economy, estimated S&P earnings and what this means for portfolios.

As we look at expectations of global investors and the realities of turning the world economy back on, country by country, our detailed observations suggest a more volatile road ahead. The likelihood that the downturn will be short and predicable appears modest given the circumstances.

Part One – High Investor Expectations in a Period of Great Uncertainty

Market Expectations

While March 2020 was the most volatile month on record for the S&P 500 and saw the steepest decline in modern history, April has remained quite volatile but broadly positive for risk assets. The abbreviated trading week ended April 9, 2020 saw the fastest increase in stock prices in any week since 1974 – this in the face of total US unemployment claims of 15 million over just three weeks.

The S&P 500 is +25% from its March 23rd low. It is higher than it was 11 months ago. And it is down just 14% from January 1st. Only 12 days into what we expect to be the shortest and deepest recession in US history (possibly starting and ending in the same quarter), markets have already gone down 34% and up 25%, as if an entire business cycle had been concluded successfully.

As we noted in [last week's bulletin](#), total unemployment in the US could rise from under 4% to 20% during this quarter as estimated Q2 GDP falls by 40%. And Citi Private Bank is not alone in its dark view of global economic activity in the US and Europe for Q2 2020 and beyond.

Figure 1: Equity Market Declines Associated with Recessions over Past 100 Years

Recession Start Date	Recession End Date	Market Top		Peak To Trough (Return)	Peak to Trough (Days)
		Before / During / After Recession	Before / During / After Recession		
12/31/1920	7/31/1921	Before	After	-46.6%	660
5/31/1923	7/31/1924	Before	During	-18.5%	224
10/31/1926	11/30/1927	Before	During	-9.4%	84
8/31/1929	3/31/1933	During	During	-86.2%	989
5/31/1937	6/30/1938	Before	During	-54.5%	386
2/28/1945	10/31/1945	During	During	-6.9%	19
11/30/1948	10/31/1949	Before	During	-29.6%	1111
7/31/1953	5/31/1954	Before	During	-14.8%	252
8/31/1957	4/30/1958	Before	During	-21.6%	446
4/30/1960	2/28/1961	Before	During	-13.9%	449
12/31/1969	11/30/1970	Before	During	-36.1%	543
11/30/1973	3/31/1975	Before	During	-48.2%	630
1/31/1980	7/31/1980	During	During	-17.1%	43
7/31/1981	11/30/1982	Before	During	-27.1%	622
7/31/1990	3/31/1991	Before	During	-19.9%	87
3/31/2001	11/30/2001	Before	After	-49.1%	929
12/31/2007	6/30/2009	Before	During	-56.8%	517
		Average		-32.7%	470

We already did this

Source: Haver Analytics through April 10, 2020

What gives? ¿está bien? 这对您有意义吗？

In the simplest terms, one can say that investors now expect that major US companies will emerge from the coming recession with minimal damage to their long-term profitability. Given the stimulus packages already announced (with more to come, in our view) and the Fed's bold and deep actions – including this week's interventions in the high yield and municipal bond markets – investors have decided that “fighting the Fed” is a fool's game.

When we look at bottoms-up earnings expectations for the S&P 500, we see that research analysts have modest expectations for earnings declines in 2020 (-9.4%), followed by a sharp recovery in 2021 (+19%). We view these estimates as far too optimistic, with downgrades on the horizon as the realities of a severe economic contraction materialize. With Q1 earnings season beginning in the US this week, we are likely to see many companies withdraw full-year guidance altogether given significant uncertainty involved in forecasting profits during such an unprecedented economic environment.

As markets tend to look out 6 months or so, it appears investors expect a sharp recovery in economic activity at the end of 2020. This will require much of the temporary unemployment to, in fact, be temporary. Further, markets are assuming the health impact of COVID-19 will be “past peak” after June 30th and that any subsequent “second wave” will not disrupt the expected return to economic normalcy.

Lastly, markets are assuming that consumers and small businesses remain reasonably optimistic and that demand for goods and services will be resilient, driving a speedy profits recovery. Thus, as we see it today, the stock market is pricing in a return to normal in a foreseeable timeframe with few hiccups along the way.

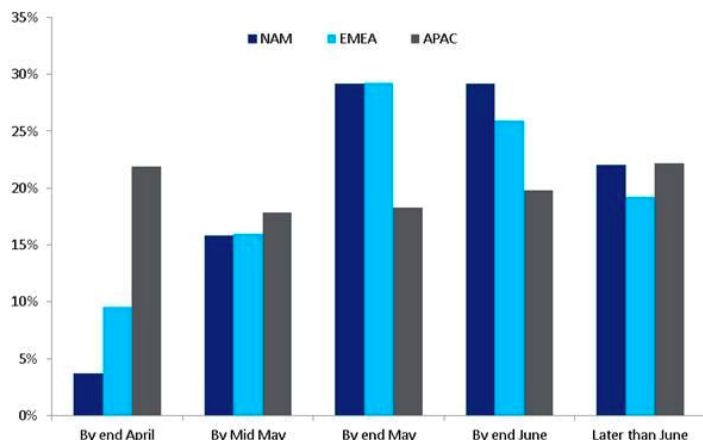
We are a bit skeptical.

In fact, we believe that the way governments “re-open” their economies (whether they follow the proper steps and precautions) and the speed with which they do so (slow and steady will be better than fast and furious), will determine the quality of the recovery as well as save lives. Mistakes in this regard can not only change the trajectory of the global economy, but also cause more fatalities and social instability.

When Do People Expect Their Economies to Reopen?

On April 7th, Citibank's Institutional Clients Group completed a survey of over 4,400 clients and asked them when the majority of business in their country would be open. 55% of respondents were in North America, 27% in Europe/Middle East and 18% Asia Pacific.

Figure 2: When do you think the *majority of your* country will be 'open for business' again (shops, offices, restaurants etc.)?



Source: CETS, Citi Velocity. Total respondent count 4464. April 9, 2020.

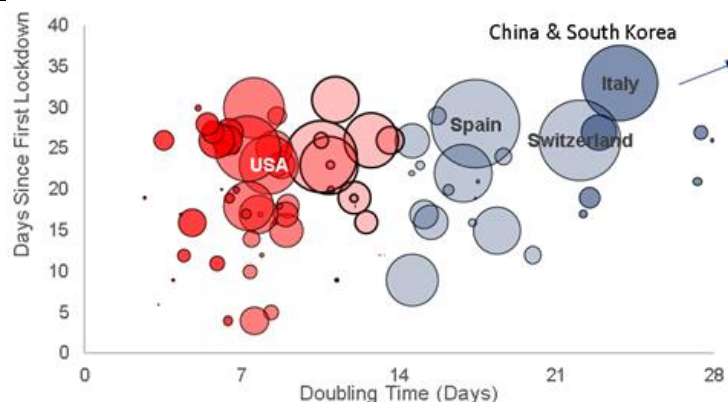
58% of Asian respondents, 49% of North American respondents and 56% of EMEA respondents said that by May 31st – precisely 49 days from today – they would expect the majority of businesses to be open. Fewer than 20% in total expected it would be “later than June” for their economies to reopen.

In a contemporaneous FirstInsights survey (April 9th) 87% of US consumers surveyed now saying they are worried about the Coronavirus, while 60% of US consumers feel that stores should reopen by the end of May, 2020. “It’s clear that people are getting antsy and ready to get back to some form of normalcy, including shopping in-store.”

Governments Think Otherwise

In contrast with market participants and consumers, who desire/expect a rapid return to normal, country and state governments are still extending their expected period of “lock downs”. Why? Looking across the world, we see strong signs that lockdowns are slowing the growth of infection (see figure 3). Those countries who stay the course see rates of infection fall meaningfully.

Figure 3: Virus Growth Rate Slows as Lockdowns Extend (Bubble Size Denotes Infection Rate Per Capita)



Source: Citi Private Bank (OCIS) and Haver as of April 11, 2020.
Note: Bubble Size reflects number of cases per Million citizens.

Figure 4: Lockdown – An end in sight?

Country/State	Start of Lockdown	Initial Days	End Lockdown?
Italy	3/9/20	open ended	"at least May 3rd"
Spain	3/14/20	open ended	"expected May 10th"
California	3/19/20	open ended	extended to 5/15
New York State	3/20/20	open ended	"six weeks to peak"
UK	3/23/20	open ended	"at least 2 months"
India	3/24/20	21	
Soth Africa	3/26/20	21	
Russia	3/30/20	open ended	

Source: Citi Private Bank (OCIS) and Wikipedia as of April 11, 2020.

Interestingly, the data suggests that United States has an advantage if it chooses to use it. By acting sooner than some European countries, it can learn from the decisions taken by them. However, to the extent that the US sees itself as “winning the war”, a rush to reopen the economy may make the US a test case.

Observation 1: The stark divergence between consumers, market participants and government leaders when it comes to setting a date for ending the severe societal and business constraints designed to mitigate COVID health impacts indicates that a “return to normal” may take longer than investors expect.

Policy “Best Practices” For Turning The Economy Back On

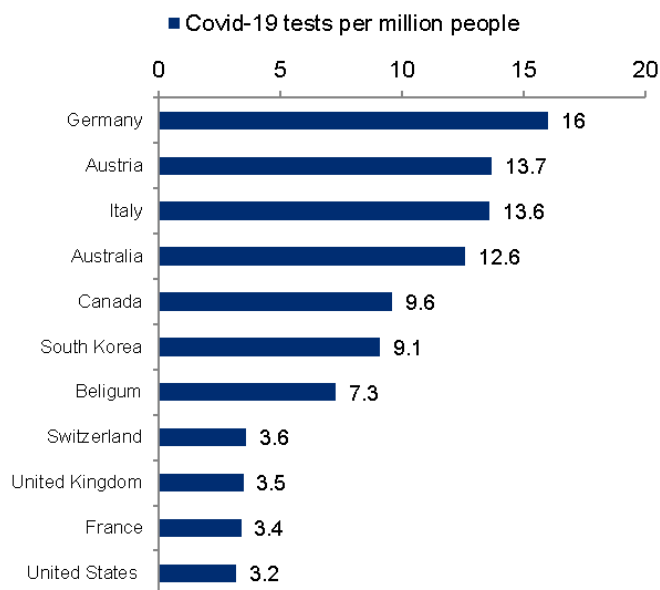
Harvard Business Review (HBR, April 1) presented four steps that the United States (or any country) would need to take to reopen its economy safely.

1. Health systems must be past their peak of initial infections and be able to manage a second wave of disease;
2. Sufficient testing must be available to identify those who are sick (to avoid spread) and those who have had the virus (presumed immune);
3. Personal protection equipment must be available for returning workers; and
4. Continued social distancing measures must be maintained.

HBR states that, “If these conditions are met, we propose allowing people to return to work who have recovered from the virus, have demonstrable immunity, are under age 65, and have no complicating medical conditions. The first group includes those with asymptomatic and previously symptomatic patients who are now virus-free.” A second group would, “include those who test negative for current infection, a test that would need to be repeated at regular intervals. Both categories would need to be verified.”

The HBR steps require both capacity and consistency. There have to be accurate tests for COVID and its antibodies, delivered in sufficient quantities quickly with results recorded in databases that allow governments to make decisions contemporaneously. Individuals would have to be willing to share information about their location and activities, maintain certain social protocols and subject themselves to further testing in order to maintain their “status” as able to work. As we can see below, the UK and the US are already far behind in their testing practices. And the broad availability of serological testing for COVID-19 possible immunity does not yet exist.

Figure 5: COVID-19 tests per million people



Source: Statista, April 8, 2020

The HBR guidelines are very high bars for most societies and their governments. In China, where a single party can dictate policy, utilize intensive surveillance and centrally/regionally manage business and social activity levels, these steps can be rigorously imposed. In the US, the Federal Government has been unwilling to dictate when States should lock down, let alone what common practices they must follow in managing the pandemic to the benefit of the country at large. The European countries fall in between the US and China re central policy, while certain LATAM countries, like Brazil and Mexico, have not taken sufficient steps to prevent a Wave 1 COVID calamity.

Observation 2: The fact that there will be wide policy divergences as “economies are turned back on” is an indication that the most optimistic outcome for a broad global economic recovery over the next six months is unlikely.

US Politics, Health Policy and Economics

Before the US has even reached peak COVID-19 impact under 44 state lockdowns, there is a shift in discourse emanating from Washington about just how fast the country can “get back to normal.” Facing a severe economic downturn just six months before a Presidential election and cognizant that the bi-partisanship which allowed for the rapid passage of a \$2.3 trillion aid bill may not last, the White House is pressing forward with plans to speed America back to work.

At the same time, experts like Harvard Professor Mark Lipsitch noted that “the characteristics of COVID-19 might require a cyclical flux between strict social distancing and viral resurgence, on and on, perhaps until 2022.... If everything goes right, (including) massive testing and quarantines of the ill, and aggressive social distancing, it will be possible to keep numbers down and maybe shorten the timeline. But, Lipsitch said, he didn’t see any of that underway.” (Wired, *The Mathematics of Predicting the Course of the Coronavirus*, 3/30/2020).

The “re-opening” calculus involves putting lives at risk. According to projections released by the Departments of Homeland Security and Health and Human Services on 4/9/2020, had the government done nothing, US death from COVID-19 would have reached 300,000. With a 30-day shelter-in-place policy followed by steady-state mitigation, their estimate of US fatalities was 200,000. More recent calculations by other non-government agencies, show expected US deaths falling to 100,000 or less given the strident practices of states and their willingness to extend mitigation beyond 30 days. But one point is clear. “It’s enough to say that if we were to stop (mitigation) at the national level May 1, we’ll see a return to almost where we are now sometime in July”, noted Christopher Murray, the director of the IHME at the University of Washington.

Observation 3: In the absence of central policies on testing, tracking and social policy, it seems likely that the US government will encourage states to re-open parts of their economies sooner than health policy makers and epidemiologists would recommend. While recognizing that there is no risk-free moment to re-open, a quick restart without proper oversight carries special risks for consumers. A premature return to normal life followed by a return of the virus could reduce consumer confidence and lead to a deeper recession and higher interim unemployment.

As we look at expectations of global investors and the realities of turning the world economy back on, country by country, our observations suggest a more volatile road ahead. The likelihood that the downturn will be short and predicable appears modest given the circumstances.

Part 2 - Citi Private Bank’s Updated Economic Assumptions and What They Imply for Markets

In last week’s [bulletin](#), we highlighted our presumed path for the US economy in the second quarter and third quarter 2020 periods. We believe a record 40% annualized pace of decline will occur in Q2 followed by a 30% rebound in Q3. We noted that the intentional closures of businesses and social interactions followed by a reopening would make for both the shortest and deepest recession in history. If correct, the US economy in Q32020 will still be running 6% lower than Q1 2020, a deeper decline than the low point during the Global Financial Crisis (GFC) of 2008/2009.

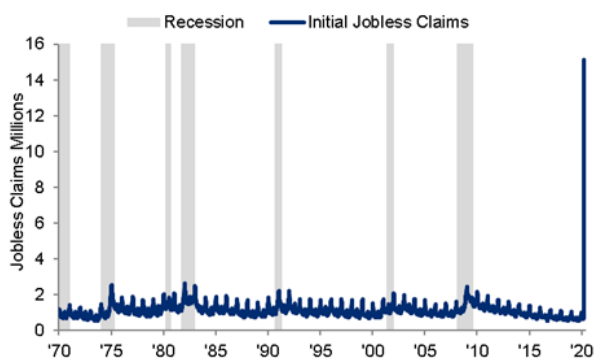
This week, we fill out further assumptions for the economic path forward across the world. While quantifications are difficult and uncertain under the circumstances, the price of every asset price is itself a forecast. Understanding the forecast assumptions will help us understand what is “baked into” equity prices and credit markets yields. Of course, as facts come in, we will adjust our future assumptions and let you know as we do.

Demolition is Always Faster than Rebuilding

Here are our key assumptions:

1. During the second quarter of 2020, 25% of employed workers in western economies are unable to work. They will have been furloughed, fired or retained but not at work. In the third-quarter, we estimate one half of these workers resume work.
2. COVID-19 continues to shutter more economies through May 2020. Social distancing restrictions are lifted in waves across the world beginning at the end of Q2.
3. COVID-19 infections accelerate globally again in the winter of 2020. This causes a stall in global growth, but not a full shutdown. We assume there is no vaccine until mid-2021 or later.
4. Travel, tourism and supply chain disruptions hamper growth unusually through much of 2020 and 2021. Global travel restrictions remain intense. We expect international travel to remain more than 50% below Q4 2019 levels by the end of 2020.
5. Certain industries, such as commercial construction and automobile manufacturing, continue to weigh on the recovery pace as real estate utilization remains low and demand for new vehicles remains tepid.
6. Retailers, small businesses, restaurants and leisure industries are deeply impacted. Many are closed permanently. Related credit defaults spike.
7. Monetary and fiscal policy actions are large and rapid compared to past crisis episodes. This significantly limits the period of depressed economic activity, but doesn't offset a near-term drop in GDP or EPS (see figure 6).
8. The US unemployment rate jumps to about 15% at mid-year with a larger number outside the labor force than the measured unemployment rate will show. The jobless rate should fall significantly as businesses are allowed to reopen. However, we still see the US unemployment rate near 8% at the end of 2021. This compares to 3.5% as the crisis began.

Figure 6: Initial Jobless Claims (Three Week Moving Sum)



Source: Haver Analytics through April 10, 2020. All forecasts are expressions of opinion and are subject to change without notice and are not intended to be guarantees of future events.

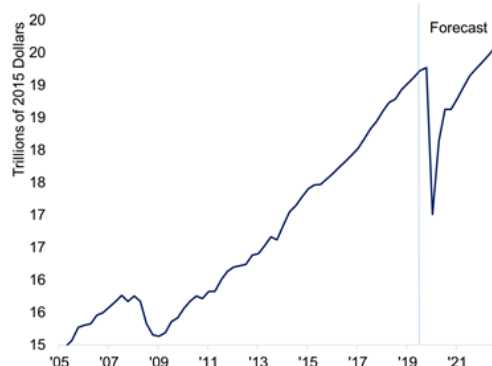
Given these assumptions, our forecast assumptions across regions using annual data are shown in figure 7. For the US, the 4.3% full year drop in GDP for 2020 compares to -2.5% in 2009, which had been the largest decline since World War II. Using quarterly data, the US GDP level would exceed the 1Q 2020 peak **nine quarters later** in 2Q 2022 (see figure 8). The GFC rebound took 14 quarters, but started with a full year of mild recession before the financial crisis. By comparison, the 2001 recession took four quarters to make a net gain, with earlier recessions requiring 4-6 quarters.

We expect that European economies will decline more than the US due to their larger dependence on both trade and tourism and a less robust fiscal response, particularly in the Eurozone. While China will likely see a massive rise in domestic stimulus, it will continue to struggle with a virus-induced trade shock materially larger than the one created by the trade dispute with the US.

Figure 7: Global and Regional Real GDP Growth Assumptions (Percent)

	2020	2021	2022
China	2.0	5.0	5.0
US	-4.3	3.6	2.8
EU	-8.0	1.5	2.0
UK	-6.0	2.0	2.0
Global	-3.0	2.8	3.3

Figure 8: US Real GDP Level (Trillions of 2015 US Dollars)



Source: Citi Private Bank Office of the Chief Investment Strategist as of April 10, 2020.

All forecasts are expressions of opinion and are subject to change without notice and are not intended to be guarantees of future events.

What Our GDP Estimates Imply for Corporate Earnings

The earnings declines we expect in 2020 are as severe as the GFC even though the cause of the present crisis is exogenous. Figures 9 and 10 show S&P 500 EPS estimates consistent with our economic assumptions. Plotted out quarterly on a year over year basis, the decline and recovery parallels 2008/09. For example, the most severe drops occur in a single quarter, with EPS down more than 65% followed by a more than doubling of EPS in the same quarter one year later as negative events are not repeated. The extent of the expected EPS decline in the “peak crisis quarter” (4Q 2008 and 2Q 2020 respectively), is driven by large losses in a subset of firms while others remain profitable. We expect the dispersion between profits and losses of particular industries to be particularly wide in this recession.

Unlike the GFC, COVID business shutdowns are temporary. However, for a great many small and medium-sized business, such closures have caused them to spend cash at a furious rate simply to sustain their operations and avoid default on liabilities. As noted, EPS growth will vary greatly by industry and company.

Thus, we think these two questions will determine near term stock market performance:

- Will investors look over the 2020 earnings chasm, or respond negatively to the huge drops in EPS and slow recovery?
- Will exceeding the 2019 level of earnings in 2023 be sufficient to sustain valuations?

Figure 9: US Large Cap Corporate Profit Assumptions

	S&P EPS	Growth Rate
2018	163	23.6
2019	165	1.0
2020	107	-35.0
2021	135	26.2
2022	162	20.0

Figure 10: S&P 500 EPS Y/Y% Including 2020-2022 Assumptions



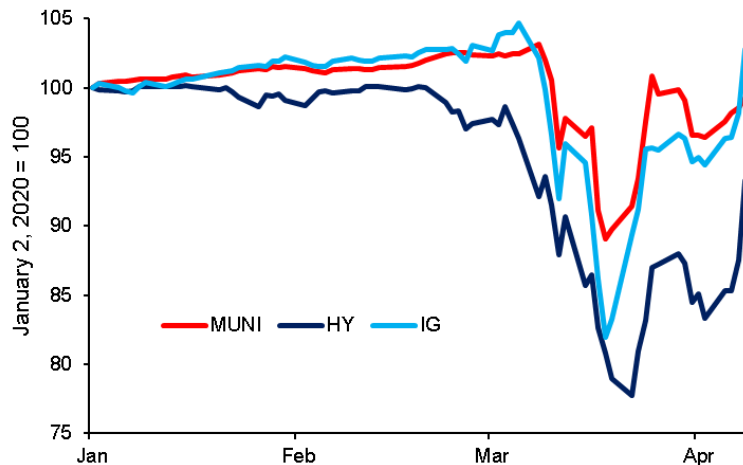
Source: Citi Private Bank Office of the Chief Investment Strategist and Haver as of April 10, 2020.

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The Fed Actions Support Our “Credit Before Equity” Thesis

Late last week, the Federal Reserve continued to act forcefully to limit economic damage, vowing to buy the debt of firms that have been downgraded to below investment grade as a consequence of the Covid-19 impact. This has strengthened credit markets swiftly, and equities indirectly (see figure 11 and [Fed Broadens Credit Easing in “Whatever it Takes Policy”](#)). The Fed’s actions should help put a “higher floor” under many asset prices, even as markets may refocus for a time on the severity of the immediate economic decline in coming months.

Figure 11: US muni, IG Corp and HY ETF prices



Source: Factset through April 10, 2020. For illustrative purposes only. Past performance is no guarantee of future results. Real results will vary. Indices are unmanaged. An investor cannot invest directly in an index.

Implications of our Assumptions and EPS Estimates

At this moment, we believe that the S&P 500 is close to the higher end of its near-term range even with monetary and fiscal policy moving at lightning speed. Durable growth sectors like US large cap healthcare and technology buffer the index significantly as figure 12 shows.

We expect a wide dispersion of market pricing as an uneven recovery unfolds in the economy (see figure 7). Highly concentrated exposures even in defensive industries might be “whipsawed” by market volatility still ahead. Small cap equities have faced much stricter scrutiny from markets, underperforming large caps by 8% since the selloff began, a consequence of highly levered balance sheets and less predictable cash flows. As we noted at the start of our discussion, every asset price is itself a forecast. As asset prices change and economic developments unfold, our views need to adjust.

Figure 12: Which Regional Equity Markets Have Greater Sector Exposure to Covid-19 Collapse?

	Covid Cyclical	Covid Defensives
US	38.0	62.0
DM	45.2	54.8
Global	46.7	53.3
Europe Ex-UK	50.5	49.5
Europe	52.2	47.8
EM Asia	52.2	47.8
Eurozone	56.2	43.8
EM	57.4	42.6
UK	57.5	42.5
Japan	57.7	42.3
Asia Ex-Japan	58.0	42.0
Latam	65.3	34.7
CEEMEA	82.0	18.0

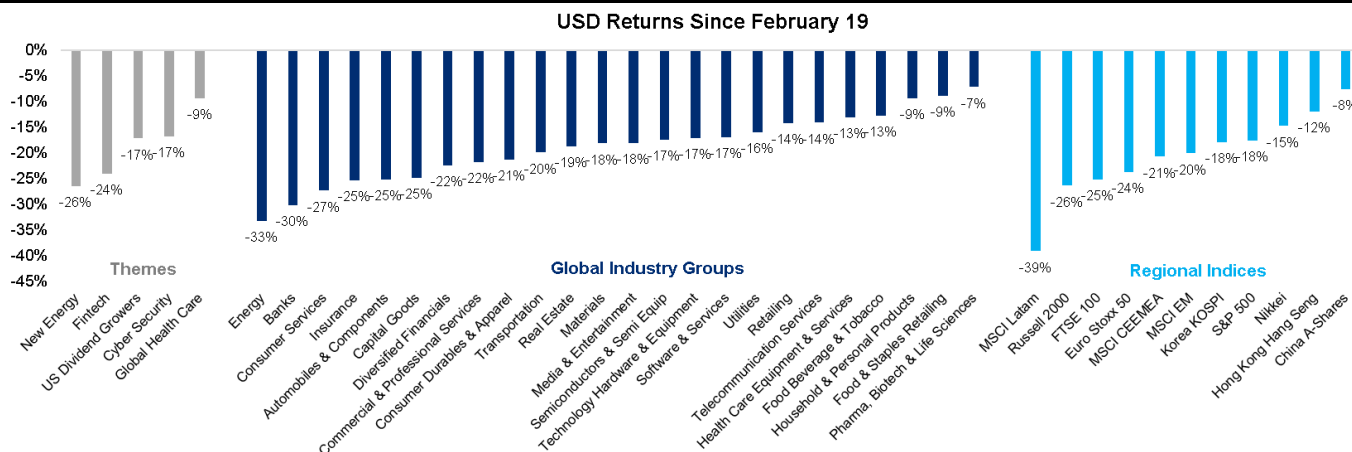
Covid cyclical are energy, materials, industrials, discretionary, financials, real estate
 Covid defensives are healthcare, staples, communications services, IT, Utilities

Source: Factset through April 10, 2020. For illustrative purposes only. Past performance is no guarantee of future results. Real results will vary. Indices are unmanaged. An investor cannot invest directly in an index.

What This Means for Portfolios

In recent weeks, we have argued that investors should allocate to higher quality assets in “Covid-19 defensive” areas such as healthcare, staples, telecom services and digital technology. Many of these overlap our “unstoppable trends” and represent higher quality growth assets for the long run. Even though they have performed better in the recent months – and are therefore less depressed in valuation - we recommend maintaining these positions. The outlook for many “Covid cyclicals,” industries such as autos and hospitality, is still grim. Others, such as US Banks may over-discount eventual recovery. For [Opportunistic Portfolios](#), uncovering undervalued recovery shares (“Covid cyclicals”) seems an increasingly attractive endeavor.

Figure 13: The Wide Dispersion of Returns Reflects Sector Specific Economic Risk



Source: Factset through April 10, 2020. For illustrative purposes only. Past performance is no guarantee of future results. Real results will vary. Indices are unmanaged. An investor cannot invest directly in an index.

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