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# CIO Strategy Bulletin

# ASSET ALLOCATION FOR RAPIDLY EVOLVING MARKETS

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### Summary

- As market condition change and they are evolving quickly in the US it is important to change what is in portfolios to reflect a variety of possible outcomes.
- We have increased our portfolio exposure to intermediate US Bonds by 4%. At a 2% or even 2.5% yield, the real return is likely to be marginally negative for the coming decade. This would not make such bonds an especially attractive investment. But these days the attractiveness of US Treasuries as a portfolio risk hedge is increasing, not decreasing.
- Fiscal stimulus, unusual consumer spending patterns, disrupted production and labor displacement together, created the atypically large inflation we are experiencing just now. When we look at spending through the end of 2021. however, we see that inflation-adjusted consumer goods expenditures have fallen 5% after reaching a peak last April. With fiscal stimulus in the rear-view-mirror, we believe inflation will peak over the next couple of months as supply begins to catch up to demand.
- We left intact specific equity over-weights in global healthcare, cybersecurity/fintech and payments, strong dividend growers in large caps globally, and China. These Global Investment Committee (GIC) moves reflect our views on where relative value can be found in equity markets and where we expect stronger and more secure returns to come from in this transitional market environment.
- As the inflationary boom ends, and the Fed possibly over-reacts, a peak in long-term yields may
  also define the trough for higher quality US growth stocks. When rates do peak, and we think that
  may be sooner than many expect, the pressure on growth stocks is likely to abate. While timing is
  never clear with foresight, this could plausibly be after the Fed's first interest rate increase,
  particularly if it takes bold action with a 50-basis point increase
- Please also see our <u>CIO BULLETIN SPECIAL REPORT: HONG KONG'S FIFTH COVID WAVE</u> contained herein.

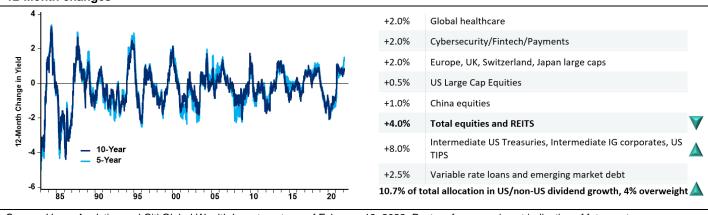
## **EVOLVING MARKETS, CHANGING ASSET ALLOCATION**

We have always written that market timing is a fool's game. It is virtually impossible to predict the worst and best days of markets. At the same time, as market condition change – and they are evolving quickly in the US – it is important to evolve what is in portfolios to reflect a variety of possible outcomes.

With a rapid 150 basis point gain in intermediate duration US Treasury yields over the past 12 months – the majority of the gain seen in any Fed tightening period since the 1980s – our Global Investment Committee raised its weighting in lower risk medium-duration fixed income holdings by 4 percentage points last week (figures 1 and 2). Here's why...

Figure 1: US 10- and 5-Year Note Treasury Yields, 12-Month changes

Figure 2: Largest Overweights



Source: Haver Analytics and Citi Global Wealth Investments as of February 18, 2022. Past performance is not indicative of future returns.

#### WHY A BIT MORE IN BONDS?

For the first time since July 2019, 10-year Treasury yields pierced the 2% level in early February. Our Outlook 2022 forecast anticipated 10-year US yields above 2% this year. We think the yield could average 2.5% in a sustained expansion period. At 2% or even 2.5%, the real yield is likely to be marginally negative for the coming decade. This would not make bonds an especially attractive investment.

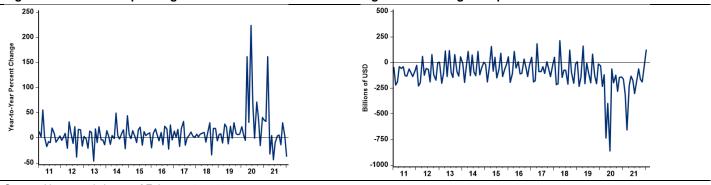
Yet, these days the attractiveness of US Treasuries as a portfolio risk hedge is increasing, not decreasing. For example, if the Fed "engineered" an economic downturn in the US with abrupt and severe monetary tightening, risk adverse investors would likely drive yields down again, making bonds a worthy risk hedge in portfolios.

For now, we do not assume that the Fed will move that drastically. We expect a natural slowing of the US economy. This will be led by a marked decline in US federal government spending due to the absence of further Covid stimulus. We think spending in 1Q 2022 will fall 42% from 2021 if the government just returns to pre-Covid spending levels. (Actual data for January 2022 showed federal spending down 37% from January 2021.) At the same time, the US posted its largest budget surplus for any January period on record (see figures 3-4). This is a marked change from the period in which the Federal government was injecting stimulus. It is now withdrawing.





Figure 4: US budget surplus/deficit



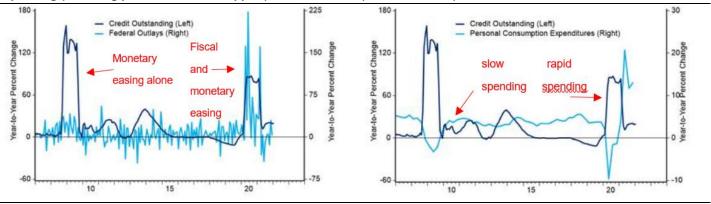
Source: Haver analytics as of February 16, 2022.

#### UNDERSTANDING THE POST-COVID ENVIRONMENT

The COVID pandemic reshaped consumer preferences. The extraordinary fiscal stimulus led a spending boom for consumer goods. Nominal consumer spending rose 12.1% in 2021 (see figures 5-6). This excessive spending was the key difference from the Quantitative Easing period of 2008-2009. At that time there was no direct support for consumers. This time, with money in their pockets and many people at home, unable to travel or return to their places of work, they spent excessively on goods.

Figure 5: US Federal Reserve credit vs Federal government spending (including personal income support)

Figure 6: US Federal Reserve credit vs consumer spending (nominal dollars)



Source: Haver analytics as of February 16, 2022.

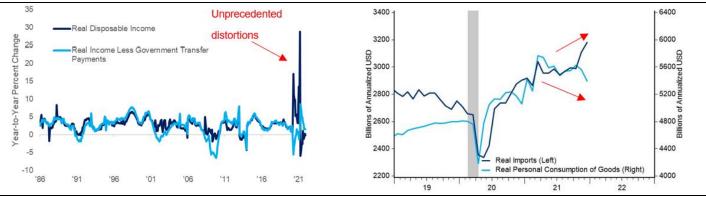
We would remind readers that money printing alone does not cause inflation. Excessive money spending does. And when you add unusual spending, disrupted production, shipping shortages and labor displacement together, you get the atypically large inflation we are experiencing just now.

The period of Covid support for US taxpayers is now behind us. The last COVID stimulus checks were issued almost a year ago in March of 2021. When we look at year-over-year spending, we see that inflation-adjusted consumer goods expenditures have fallen 5% after reaching a peak last April. Still-depressed spending on services managed to grow a stronger 4% since April 2021. Overall, real consumer spending grew a mere 0.4% in the eight months through December 2021. Therefore, excessive consumer spending is not driving inflation further (see figures 7-8).

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Figure 7: US real disposable personal income and real income less transfer payments

Figure 8: US real consumer goods spending and real imports



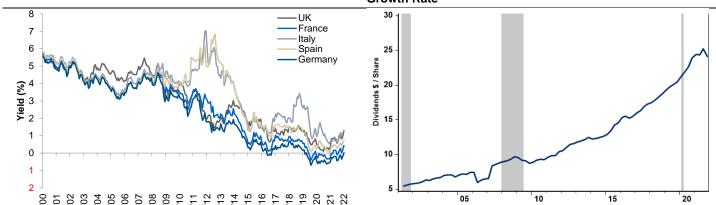
Source: Haver analytics as of February 16, 2022. Note: Shaded region is recession.

#### MAINTAINING SPECIFICITY IN EQUITY ALLOCATIONS

Our readers will also note that we left intact specific equity over-weights in global healthcare, cybersecurity/fintech and payments, non-US developed markets large caps and China. These GIC moves reflect our views on where relative value can be found in equity markets and where we expect above-average returns to come from in this transitional market environment.

Figure 9: European Sovereign 10-Year Yields

Figure 10: US Pharmaceutical Dividend Payments: Shares Yield 2.5% on average, Dividends have 6.5% YoY Historic Growth Rate



Source: Haver Analytics as of February 16, 2022. Note: Shaded areas are recessions. 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. S&P 500 Pharmaceutical used for proxy in Figure 10.

The immediate income stream from healthcare/pharmaceuticals yields more than the world bond market even before accounting for long-term dividend growth (see figures 9-10). As another example we discussed in the last *Quadrant*, the profit and revenue outlook for the cyber-security software sector appears to be the most secure of all groups within the technology sector. We believe emerging financial technology is a secular growth trend that has been deeply discounted in the early 2022 selloff.

In addition to our thematic positions in equities at 4% of portfolios (pharmaceuticals, cybersecurity, payments and fintech), we are also about 4% overweight benchmarks in large capitalization dividend growth shares – counting both US and non-US holdings. We believe these well-capitalized firms, with profit levels high enough to allow the most consistent increases in dividend payments, have outperformed in the defensive market of recent months. Seek to both reduce overall equity risk and leave a concentrated focus on what we see as the most valuable

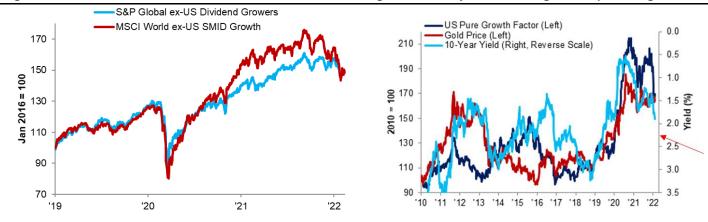
income-generating equities, we further reduced small and midcap shares in both non-US and US markets again in the past week (see figure 11).

Finally, we believe the broader correction in US growth stocks could have further to run. Thus, we recommended portfolio hedges in the CIO Bulletin two weeks ago.

As the boom ends, and the Fed possibly over-reacts, a peak in long-term yields may also define the trough for higher quality US growth stocks. When rates peak, and we think that may be sooner than many expect, the pressure on growth stocks is likely to abate. While timing is never clear with foresight, this could plausibly be after the Fed's first interest rate increase, particularly if it takes bold action with a 50-basis point increase (see figure 12).

The bottom line is that we do not believe that this is an environment for lasting high inflation.

Figure 11: Non-US SMID Growth vs Non-Us Dividend Growers Figure 12: US 10yr Yield vs US growth equities & gold



Source: Bloomberg as of February 16, 2022. 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. Russell 1000 Growth for US pure growth proxy in Figure 12. Red arrow points to the potential peaking of the 10Y yield.



# CIO BULLETIN SPECIAL REPORT: HONG KONG'S FIFTH COVID WAVE

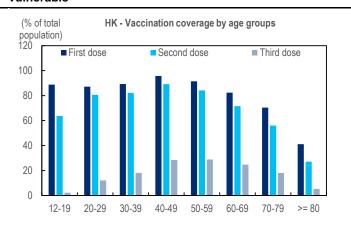
While most of the world is seeing the Omicron wave subside, Hong Kong is experiencing its worst outbreak since the start of the pandemic. The daily increase in confirmed cases surged to over 6000 on Feb 17, up from about 100 just two weeks earlier during the Lunar New Year (the peak in July 2020 was just 173). The number of deaths rose to 36 over the past 10 days. Hospitals are overwhelmed, with some operating at over 100% capacity. In the weeks after the Lunar New Year, severe restrictions have been placed on dining, entertainment, sporting activities and services. Gatherings are limited even in private homes. These have curtailed mobility in a way similar to the initial pandemic response in 2020 (see figure 13).

The majority of reported deaths were elderly and unvaccinated individuals, some with prior conditions. Fewer than half of the 70-plus age group have gotten two doses of vaccines (figure 14). Yet, it was the death of two children that struck a nerve. Both children were brought to the hospital with severe symptoms, missing the most critical time for treatment.

Figure 13: As HK's new cases hit record, mobility is being limited to a similar extent as in 2020

Figure 14: Less than half of those above 70 in HK have gotten two doses of vaccines, making them the most vulnerable





Source: CEIC, WHO, Citi Research, as of Feb. 17, 2022

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Facing this unprecedented crisis in Hong Kong, President Xi made a public announcement for Hong Kong to strictly enforce "dynamic clearance" to bring the situations under control. The next day, media reported on a plan for compulsory testing of all 7.5 million population in Hong Kong. Because of capacity limits in Hong Kong, China plans to send medical staff from Shenzhen to help with testing. The compulsory testing is planned to begin in early March and those who refuse may be fined HK\$10,000 (about US \$1,280).

#### REACTIONS TO MAINLAND INTERVENTIONS

There are two types of reactions to the news of Mainland intervention. Some media reports focus on the potential loss of privacy, highlighting the fact that some people in Hong Kong don't want to be tracked, tested or vaccinated. This has impeded the progress toward reopening between Mainland and Hong Kong.

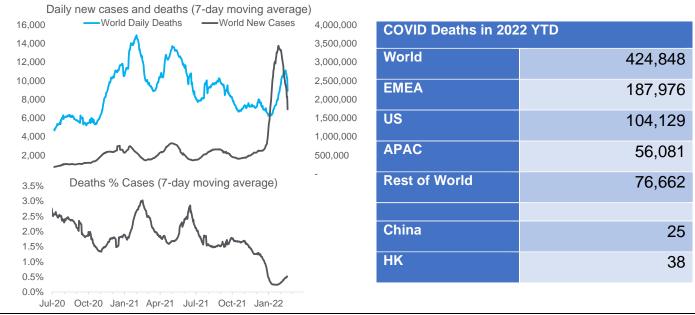
The other view is that delayed preparations for the overwhelming demand on the medical system that was predictable from before the Lunar New Year. Hong Kong clearly needed more capacity for medical goods and services, as well as supply chain security.

There is also intense criticism of the COVID-zero policy, challenging whether such extreme measures are necessary when the mortality rate had fallen from 3% a year ago to about 0.5% (figure 15), but is still five times the rate of the common flu. Looking at 2022 data, it is clear that China has avoided the outcomes experienced worldwide.

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Figure 15: The surge in Omicron cases did not bring a similar surge in deaths, but the mortality rate of 0.5% is still five times the rate of the common flu

Figure 16: Omicron related deaths started to rise at the start of 2022. Since then, 425,848 have perished globally, while 63 passed away in China/HK under "dynamic clearance" policy



Source: Bloomberg, as of Feb. 17, 2022 Source: Bloomberg, HK01, as of Jan. 17, 2022

#### REOPENING THE HK CHINA LINK

It is not lost to the Chinese authorities that as the virulence of the coronavirus falls, a zero-case policy is becoming less sensible for the economy. On February 12, China approved Pfizer's Covid-19 pill Paxlovid for emergency use. Some see this as a turning point in the nation's pandemic strategy. But vaccine nationalism is still prevalent, with progress on China's own mRNA vaccine still a focus for authorities.

The Chief Epidemiologist at the Chinese Centre for Disease Control and Prevention—Wu Zunyou—said that multiple teams in China are studying how to improve the country's zero-Covid approach as economic pressure intensifies. Wu said researchers were "certainly able" to roll out new strategies soon, but China is unlikely to simply lift all restrictions like in many Western countries. Any changes to China's pandemic policies would prioritize preserving lives.

In terms of reopening the HK China link, we suspect this would take place in two stages.

- Reopening between Mainland and Hong Kong possibly this summer: This is likely a much higher
  priority for Beijing than with the rest of the world. Most preparations were already made before the
  Omicron wave disrupted the initial trials scheduled to begin last December. One of the remaining
  challenges is the incompatibility between tracking and management systems on the two sides. The
  proposed compulsory testing in Hong Kong would resolve this issue. Thus, if the current wave of infections
  subsides in the spring, a reopening between Mainland and Hong Kong could begin this summer.
- Potential full reopening late 2022 and in 2023: This would require a more formal shift away from
  "dynamic clearance" policy, as noted earlier. Two key milestones would be the use of foreign and Chinese
  vaccines to increase total vaccination rates and the absence of new Covid variants. A full reopening is
  only possible if the risk of impact to the National Party Congress in October is exceedingly low.

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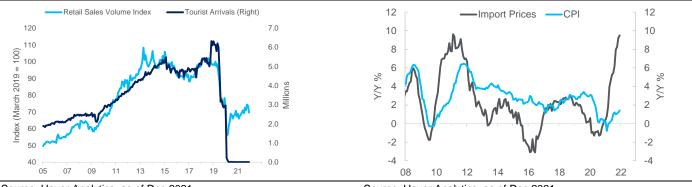
#### IMMEDIATE ECONOMIC IMPACTS FOR HK

The government is preparing a third round of fiscal stimulus for HK. Hong Kong's government is wealthy, due to its ownership of land and substantial reserves. The new round of stimulus would likely include medical expenses, consumption vouchers and subsidies for industries hurt most by the pandemic like retail, entertainment, F&B and hospitality.

The negative consequences of the Covid outbreak are likely to be concentrated in 1Q where Hong Kong's GDP may contract, but we expect this period to be less severe than 1Q 2020 when Hong Kong's GDP shrunk by 5%q/q.

Figure 17: HK's retail sale volume has not yet recovered from Figure 18: HK Inflation is manageable, so long as the import pandemic or unrest

supply chain remains intact



Source: Haver Analytics, as of Dec 2021

Source: Haver Analytics, as of Dec 2021

#### MARKET REACTIONS

The local HK market did not take the compulsory testing poorly. The Hang Seng Index (HSI) actually rose on February 16 when the news broke. Macau gaming names rallied on hopes of re-opening. Pharmaceuticals, financials, and property developers were all up on the day. Hong Kong retail real estate names came off, as the restrictions are directly hurting their businesses, but even those fully recovered the next day.

Investors appear to have greater appetite for relative value, for which Hong Kong remains an exemplary market. HSI price-to-book ratio is at 1.0x, which is at the low end of historical record. Even though this P/B ratio has been trending down for over a decade, as figure 15 shows, it can still stage 20-40% bounces (2012, 2016-17 and 2020 are examples). So, if our reopening expectations are realized, 2022 might be the next occasion.

Figure 19: 4Q GDP Growth was lowest on record when the 2020 pandemic collapse is excluded



Source: Haver Analytics, Bloomberg, as of Feb. 17, 2022. 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.



#### REMAINING POSITIVE ON CHINA

The larger story is the change in policy for China after sharp tightening steps last year. While the Fed embarks on its tightening regime, China is going in the other direction. China has begun to ease its monetary policy after macro-economic and regulatory tightening in 2021 curbed economic growth and hammered stocks. That's why we see Chinese equities as another key way to diversify portfolios (see last week's Bulletin, Revisiting China While Yielding to Oncoming Traffic).

China's fiscal and monetary stimulus is beginning to flow through the economy and is bearing initial benefits. January's money and credit data showed significant credit easing following a signal from policymakers of the need to support growth. China's inflation picture is also more favorable than in the US. Weaker but improving domestic demand has not spawned the type of stimulus-induced buying.

Chinese equities are far more correlated to their domestic credit conditions than to US monetary policy. From 2015-2018 the path of Chinese markets matched credit flows, deeply negative in 2015, positive in 2016-17, and negative again in 2018. As we enter 2022, we expect credit impulse to remain positive, following a trend taking shape since October. This is typically associated with future gains in corporate profits and higher equity valuations (see figure 20).

MSCI China Forward PE Ratio 38 20 Aggregate New Credit % of GDP (Right) Forecast with 11% Credit Growth in 2022 (Right) 36 18 34 32 16 PE Ratio 30 28 26 24 10 22 21 22

Figure 20: Aggregate credit as % of GDP has begun to turn last October, and is likely to support equity valuations in 2022

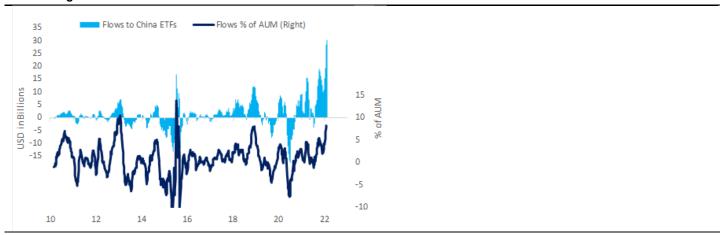
Source: Bloomberg and Haver Analytics as of February 16, 2022. All forecasts are expressions of opinion and are subject to change without notice and are not intended to be a guarantee of future events. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only. Past performance is no guarantee of future returns. Real results may vary.

#### POSITIVE CHINESE FUND FLOWS

Foreign investors have noted the improvement in Chinese credit, attracting funds flows. Since China's Central Economic Work Conference in December, inflows to Chinese equity ETFs have risen by \$30bn over the last eight weeks, the largest on record (figure 21). These inflows amounted to 6% of the ETFs' AUM. These inflows contributed to the comparative resilience of Chinese equities in the year-to-date, even as US stocks corrected.



Figure 1: Inflows to Chinese equity ETFs have reached a record \$30bn in the eight weeks since CEWC, amounting to 8% of the ETFs' total AUM



Source: EPFR, Bloomberg and Haver Analytics as of February 16, 2022. 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.



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