

# CIO Strategy Bulletin

March 21, 2021

## Looking Over the Horizon

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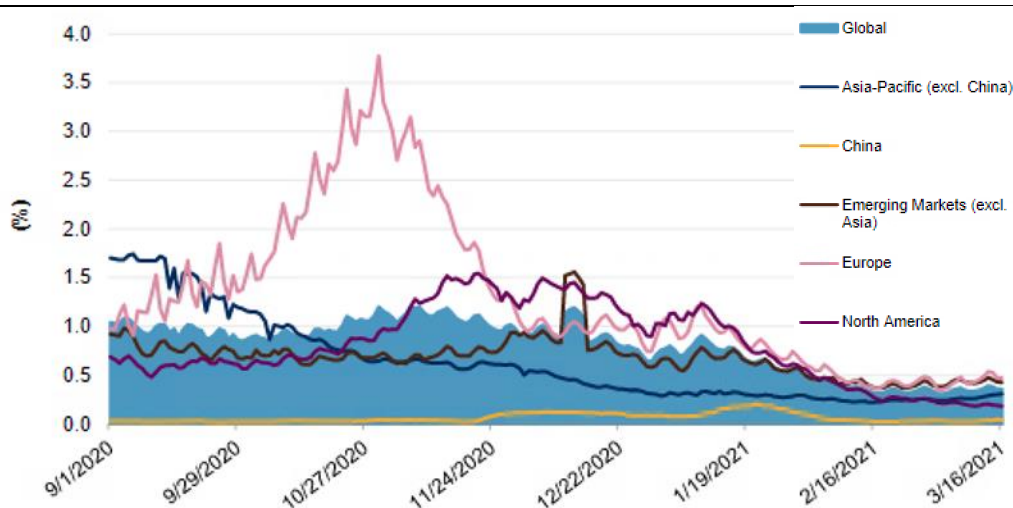
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### The New Economic Cycle

Even as Europe and Brazil struggle with a third-wave of Covid, the pandemic is ebbing on a global basis. Vaccines are being delivered at an ever faster pace and their efficacy is demonstrable. With five billion doses already scheduled to be produced, expect fewer instances of Covid, fewer hospitalizations and many fewer deaths.

**Figure 1: Growth Rate of COVID-19 Confirmed Cases (Five-Day Moving Average)**

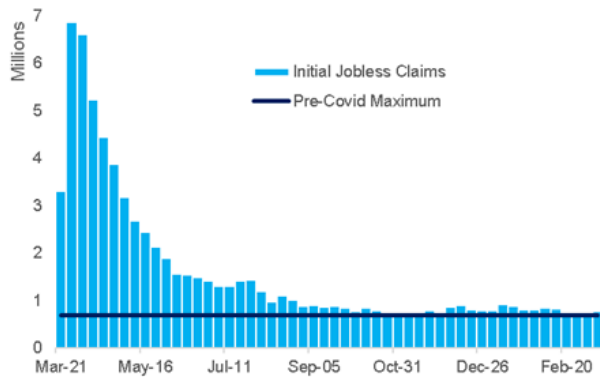


Source: Johns Hopkins University Center for Systems Science and Engineering as of March 16, 2021.

So, you may be wondering why the passage of a \$1.9 trillion stimulus bill in the US was necessary and what it means for the economy and markets. One need only study Figures 2 and 3 to understand President Biden's rationale. Even as the stock market signals "recovery", the unemployment data suggest "misery". Over the past year, jobless claims have

remained stubbornly high. In fact, if one looks back over 70 years of data, the worst 49 weeks *ever recorded* would have occurred over the past year. There have been 82 million job loss claims during this period, equal to over half the total labor force in the United States. While many of these “job losses” were temporary, due to repeated closures and re-openings from schools to stores, claims of this magnitude across the US were only seen previously in the worst months of the Great Financial Crisis. Additionally, the current moratoriums on evictions, pauses on student loan interest, and Federal loans to small businesses have allowed the economy to prioritize consumption during the crisis but are crutches that will be removed as the economy starts to stand on its own again.

**Figure 2: Initial Jobless claims and Pre Covid Maximum**



**Figure 3: Nonfarm Payrolls and Initial Jobless Claims**



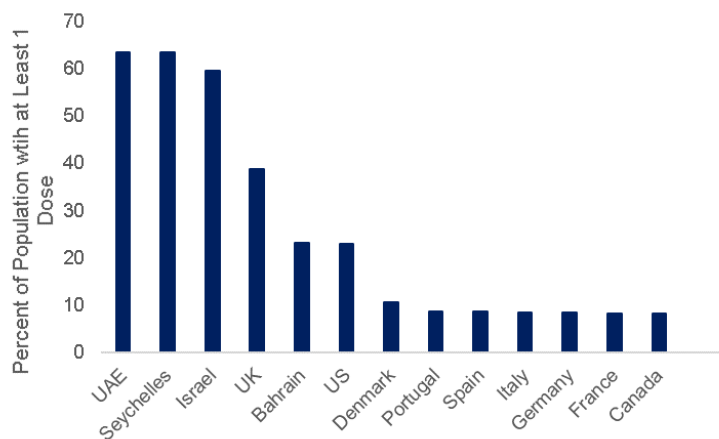
Note: Shaded regions are recessions, initial jobless claims are inverted. Source: Haver Analytics as of February 26, 2021 Past performance is no guarantee of future results. Real results may vary

The passage of three emergency measure to support the economy has been broadly successful in shielding wide portions of industry and services from what might have been a depression. Yet, the end of the pandemic will not mean a quick return to normal. According to rating agency S&P, “Additional credit deterioration, albeit slower, is expected in 2021, especially for sectors whose revenue generation prospects have not yet meaningfully improved. There is tremendous variance of recovery prospects across different corporate sectors. We still believe it will take until well into 2022 or, in some cases, 2023 and beyond for many sectors to recover to 2019 credit metrics.” (S&P Covid Heat Map, 2/17/2021).

## An Uneven Global Recovery

In Europe, poor vaccination progress in the EU contrasts sharply with the UK. Though the EU government blames new virus variants and questions of vaccine efficacy for Covid’s continued progress, it is more likely the slow speed of vaccine delivery that has allowed the virus to maintain the upper hand, prompting a set of new lockdowns and further travel restrictions. Recent European airline travel data suggests that the expected summer recovery in travel and leisure is unlikely to be substantial. It may take until the fourth quarter for Europe to see a major travel recovery and 2021 airline passenger travel may reach just 40-50% of 2019 levels.

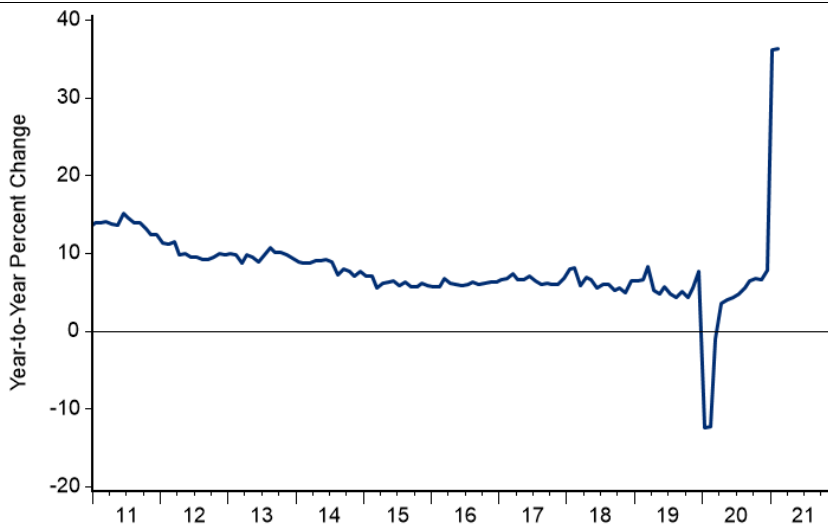
**Figure 4: Percent of Population with at Least a First Vaccine Dose**



Source: Haver Analytics as of March 21, 2021.

In China, where the early impact of the pandemic was worst, industrial output in 2021 was 35.1% higher than in the comparable January and February 2020 period and 16.9% above the same period in 2019. Present growth targets anticipate a 6-8% increase in GDP for 2021 and more foreign investment than the US. And, as we wrote on [March 14th](#), China will be a major import/export beneficiary as the world economy reopens.

**Figure 5: Chinese Industrial Production has Rebounded**



Note: January and February data are combined to account for the changing date of the Chinese new year. Source: Haver Analytics as of March 21, 2021.

## The Impact of “Big Stimulus” on Portfolios

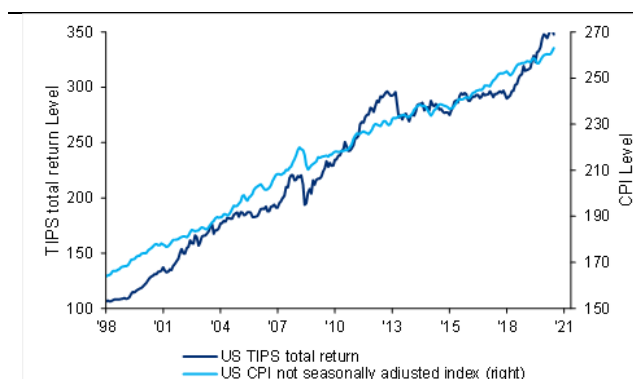
**The uneven US recovery will be made far faster by the passage of history’s largest fiscal stimulus (14% of US GDP).** We expect US growth at 6% or above in 2021. Looking across the world, global growth may eclipse 5% this year and sustain a 4% rate through 2022 or longer. Thus, we have made some changes to portfolios at the Global Investment Committee, even as our 60/40 (equity to bonds) portfolios maintain a substantial (+10%) tilt toward equities relative to bonds.

- We have raised tactical allocations to UK shares, pushing up both our global equity and bond allocations slightly. UK equities have been hamstrung by their disproportionate exposure to cyclical industries, but with political

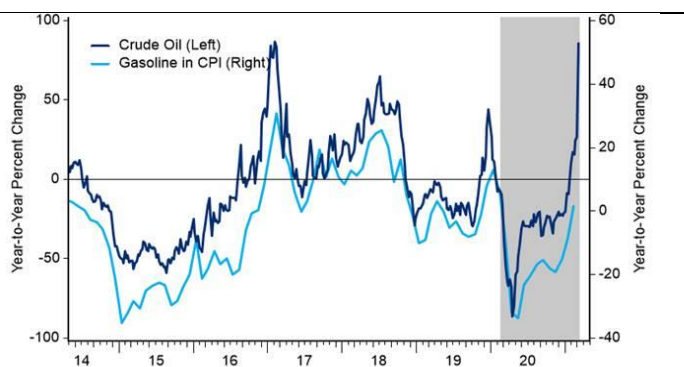
uncertainties behind them, UK valuations look cheap. Shares trade at 14X 2021 EPS with a 4% average yield. Further, strong trade exposures and a rebounding domestic economy should support UK equities across sectors. While UK equities have performed in line with emerging markets (EM), the country has a far lower negative correlation to movements in the US dollar than EM.

- We have eliminated our overweight to Gold, though over the longer term we will revisit this decision as/when central banks seek higher inflation to ease debt burdens. Since 1985, gold has risen more than 20% during six periods, and fell more than 20% in four cases. The sizeable gains for gold through 2020 reflected a peak pace of US monetary easing. This leaves both gold and bond valuations vulnerable this year.
- We have increased our exposure to TIPS (US Treasury Inflation Protected Securities), as we believe that the TIPS inflation benchmark may trend higher than the Fed's preferred inflation gauge. We expect near-term inflation to spike, with US consumer price inflation (CPI) likely to rise above 3% annualized for the remainder of 2021. US TIPS holders will directly receive this inflation compensation, but lose a smaller amount of accrued principal. The Fed's higher inflation target – to make up for the past decade's shortfall in hitting that target – should benefit TIPS holders. In short, we see TIPS as a low risk asset within our deeply underweight global fixed income allocation.

**Figure 6: US CPI Index and US Treasury Inflation Protected Securities Total Return**



**Figure 7: Crude oil prices vs Gasoline input of US CPI reading, YoY%**

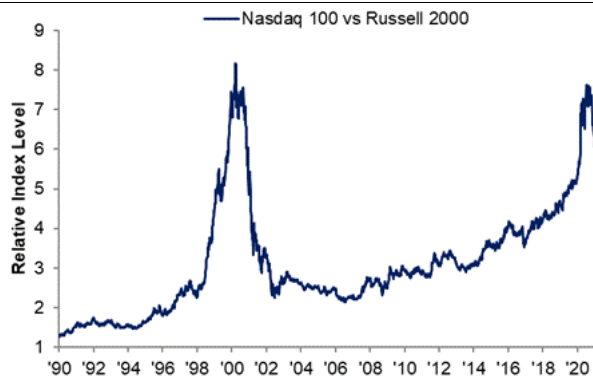


Note: Shaded region is a recession. Source: Haver Analytics as of March 18, 2021. All forecasts are expressions of opinion and are subject to change without notice and are not intended to be a guarantee of future events. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only.

As we wrote in the latest [Quadrant](#) the questions of whether the boom in growth will help or hurt equities must be answered with: it depends on which ones. The rise in bond yields is now forcing equity and credit investors to assess valuations with less rosy eye coverings. Rising discount rates are having a larger negative impact on investments with the frothiest valuations. In the past six months, US “value” shares have outperformed large cap growth shares by 14.5 percentage points. This follows outperformance of growth shares by 11.5 percentage points over the prior six months. This is one of the reasons why we have added to our overweight allocation in UK shares, a “lagging cyclical” which is discussed in detail in the latest [Quadrant](#)

Why should we ever expect relative performance and valuation extremes to change? Give that we exploited a mispricing in the US with an overweight to small and mid-cap stocks from April 2020 to January of this year for an 80% gain, we wondered if the UK would rebound similarly. While we don't expect a similar return for the UK as the US, we think the timing and recognition of its economic rebound is lagging. Thus, investors who might have missed out on the rebound opportunity we saw in US small and mid-cap shares can now consider the same anomaly in the UK. (see Figures 8 & 9.)

**Figure 8: US Large Cap Tech (Nasdaq 100) Relative to US Small Cap Cyclical (Russell 2000)**



**Figure 9: S&P 500 Relative to UK FTSE 100**



Source: Bloomberg as of March 6, 2021. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. 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.

## Equities Stronger than Bond Yields Higher

For equity markets overall, we don't believe a 120 basis point rise in yields is "worth more" than the 27% gain in global EPS expected in 2021, even after last year's strong rally.<sup>1</sup> However, it should limit this year's overall global equity returns to mid- or high single digits (please see [Outlook 2021](#) for discussion). This raises the importance of asset allocation in returns this year (including selecting the right sectors and country markets) even as tactical opportunities become harder to identify.

By 2022, when we expect a 12-15% EPS gain for both the US and larger world, the valuation compression should be significantly (if not completely) behind us. If realized, US equities would be valued at about 20X 2020 EPS (on average) based on current prices. This is moderately high by historic standards, but not in relation to interest rates and our current targets for them. In contrast, consider that one still pays 58X current year cash flows for a 10-year US Treasury note. Outside the US, the valuation of shares would be about 14 to 15X, in line with long-term averages, while non-US bond market valuations are higher than in the US.

Within equity markets, the same positive factors driving "mean reversion" in interest rates are still boosting the outlook for "COVID cyclical" industries. While we are reasonably optimistic about continued EPS gains for the "COVID Defensive" tech sector, we've long expected "COVID cyclicals" to rebound from their depressed 2020<sup>2</sup>. In contrast, the tech-laden NASDAQ enjoyed sharp outperformance in 2020 with a 43% return vs 19% for both US and Global equities overall.

Performance is generally shifting to "mean reversion" cyclicals that we favor as interest rates rise (see figures 10-12). Just as financial theory would suggest, the abrupt rise in interest rates is pushing down higher valued "growth" equities more than lowly valued shares that are expected to be most profitable today, rather than in the distant future (see figure 13). For investors, this means emphasizing:

- Cyclical and value over technology and growth;
- A reduce exposure to Gold;
- Leave your home shares that will directly benefit from the reopening of leisure, travel, retail, entertainment and service businesses;
- Foreign shares in markets where Covid is still at pandemic levels; and
- Emerging Markets in places where demographics favor a rapid rebound.

<sup>1</sup> Consider that the capitalized value of a perpetuity would fall 20% if there were a rise of 100 basis points in required returns (the "discount rate") from 4% to 5%, *all else constant*. Empirically, bond yields *don't* rise in isolation. Corporate earnings growth expectations change with yields. Income (i.e. bond coupons or dividends) is also earned during the period when yields change. In a growing economy, the base level of income has a rising trend, changing the market value that is consistent with a steady valuation (the long-term history of US large cap EPS is 6% per year). During periods when bond yields rise most sharply, EPS is typically rising faster, usually rebounding from a drop.

<sup>2</sup> COVID cyclicals: Financials, industrials, energy, materials, real estate, consumer discretionary ex-Amazon COVID defensives: IT, healthcare, communication services, consumer staples, utilities, Amazon.



**Figure 10: 10-Year US Long-Term Treasury Yield, Gold and US Growth Stock Basket**

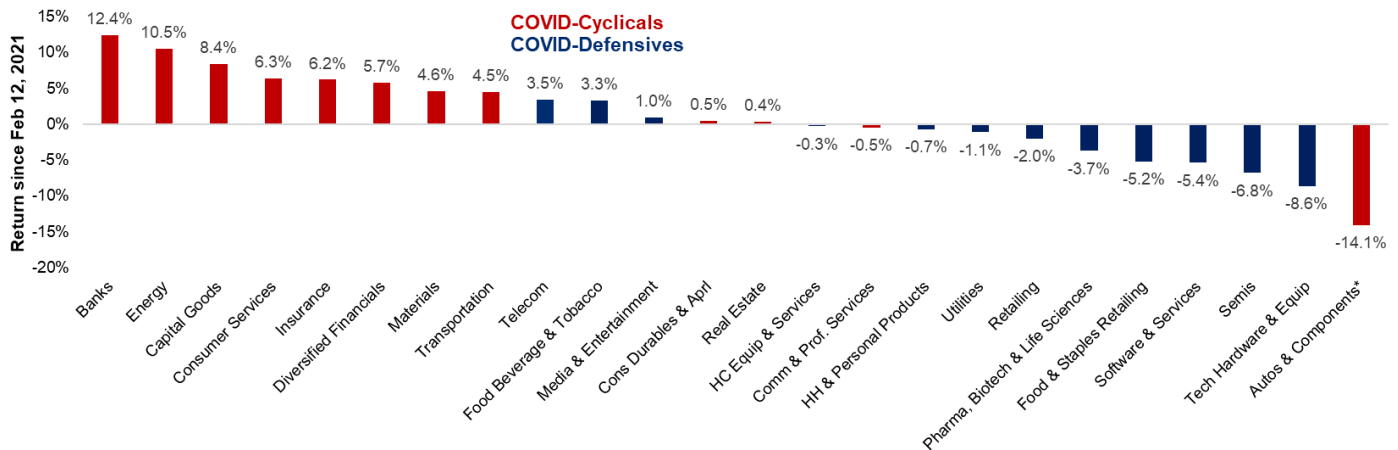


**Figure 11: “Stay and Home Basket” vs 10-Year US Treasury Yield**



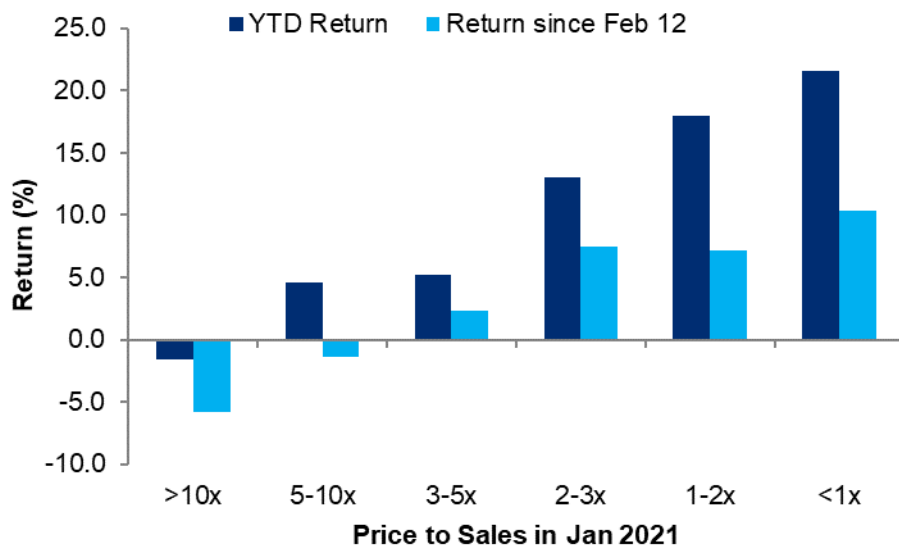
Source: Bloomberg as of March 12, 2021. US Pure Growth Factor proxied using Bloomberg US Pure Growth Index. “Leave Your Home” basket includes Buy and Neutral Rated US names in the following sub-industries: Banks, Industrial Conglomerate, Machinery, Oil Gas & Consumable Fuel, Textiles Apparel & Luxury Goods, Energy Equipment & Services, Hotels Restaurants & Leisure, Building Products, Retail REITs, Construction & Engineering, Leisure Products, Airlines, Multiline Retail. 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.

**Figure 12: “COVID Cyclical” and “COVID Defensive” Share Returns Since 2021 Feb 12 (Start of US Yield Surge)**



Source: Citi Private Bank Office of the Chief Investment Strategist and Bloomberg as of 18 March 2021. COVID cyclicals: Financials, industrials, energy, materials, real estate, consumer discretionary ex-Amazon COVID defensives: IT, healthcare, communication services, consumer staples, utilities, Amazon. 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.

**Figure 13: Poor Get Richer and Rich Get Poorer: US Price/Sales Ratio vs 2021 Returns**

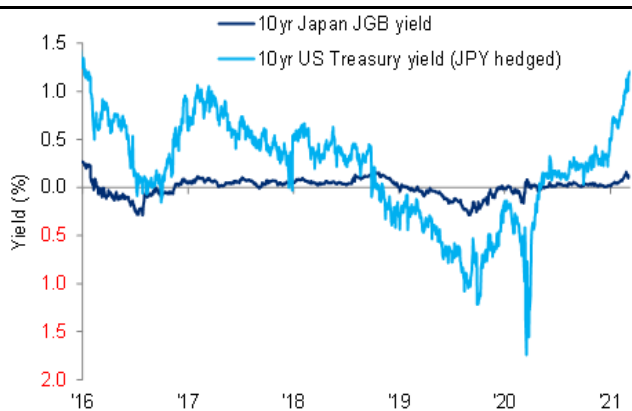


Source: Bloomberg as of March 19, 2021 Note: Using S&P 500 constituents. For illustrative purposes only. This should not be construed as an offer of, or recommendation of companies discussed. Past performance is no guarantee of future returns. Real results may vary. Indices are unmanaged. An investor 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.

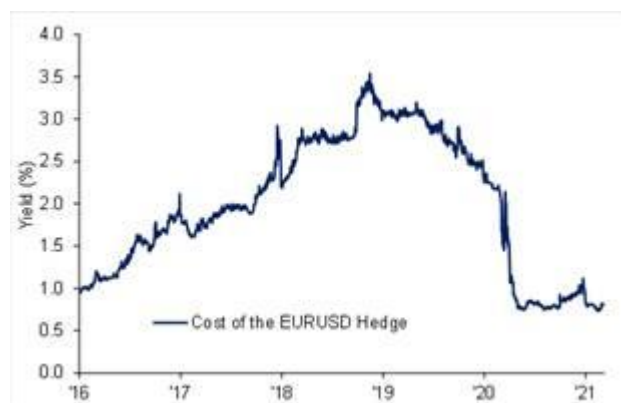
## US Bonds Better for Foreign Investors

With the US yield curve now steep, foreign exchange hedging costs have plunged. Many developed markets bond investors can now earn large premiums to their own bond market by buying US bonds hedged into their own currencies (see figures 14-15). While we still expect upward long-term rate pressures in the US to cause yields to rise 50 bps higher over the next 12 months, for now, the US will help the world by importing goods and the world will help the US by importing American bonds.

**Figure 14: Japanese 10-Year Yield and US Treasury 10-Year Yield Hedged into JPY**



**Figure 15: Cost of Hedging USD into Euros**



Source: Haver Analytics as of March 12, 2021. Past performance is no guarantee of future returns. Real results may vary.

## Where the Risks Are

### Inflation

Given large distortions to the world economy and record fiscal stimulus at a time of effective vaccinations, headline US inflation in the coming year will likely exceed the long-term rate. The rise in gasoline futures prices alone suggests a greater than-3% twelve-month CPI increase even with no change in the pace of other price gains. Jerome Powell and

Paul Krugman are of the view that long term inflation is unlikely to rise disproportionately, while Laurence Summers and others are more sure that they will. We tend to think that the unevenness of the recovery and the absence of further major fiscal stimulus globally argue for less inflation than some worry about.

### Higher Rates

We would expect 10-year US Treasury yields to average 2.5% in the coming few years, versus 1.72% at present. The adjustment to higher yields will create greater volatility in both equity and bond markets in the US and elsewhere. The Fed's higher inflation target and an eventual normalization of term premia supports our view that 2.5% is a reasonable target for 10-year US Treasury yields over the coming few years. Further as discussed in the latest [Quadrant](#), the Fed's decision to end emergency rules allowing US banks to buy Treasuries with lessened capital requirements may slightly exacerbate bond volatility.

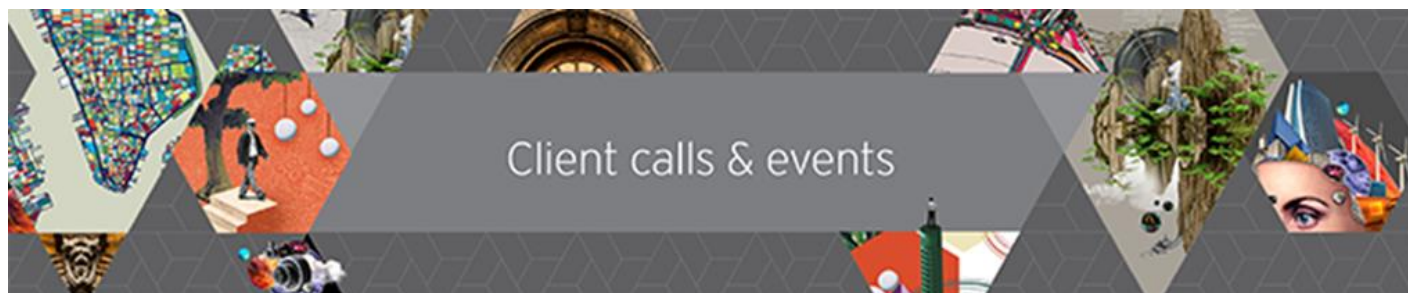
There are some mitigants to higher US rates. Though we remain deeply underweight Global Fixed Income because of record low sovereign bond yields, particularly in Europe and Japan, the difference in yield policy and targets favors the US while it is managing higher deficits. A rise in US bond yields relative to other developed markets and a plunge in hedging costs suggests upward yield pressures in the US may slow. The 13% decline in long-duration US Treasuries in 2021-to-date has also reduced near term valuation risk, as well.

### Growth Equities

We have previously highlighted the negative relationship between real rates and 'long duration' growth equities. As real yields continue rising to less negative levels, we expect expensive tech names to exhibit further sensitivity on a day-to-day basis. Conversely, periods of relative stability in rates would likely allow tech shares to recover some, particularly amid ample liquidity and retail optimism around popular thematic stocks. **Ultimately, a significant selloff among our Unstoppable Trends like renewable energy and cyber security will present an attractive entry point for long-term investors**, but heightened volatility (especially relative to less rate-sensitive reopening stocks) is likely to persist in the short-run.

### Conclusion

As some countries move into a post-Covid reality and other areas languish, wise asset allocation and selection are more important than ever. Meanwhile, the US is embarking on an uncharted voyage using a huge package of fiscal stimulus at a time when the majority of the economy is already heating up. Luminaries of the Democratic party are at odds, with Former Treasury Secretary (under President Clinton) Larry Summers and Nobel Laureate Paul Krugman sparring in interviews on Bloomberg this week. Summers called the current US policy the "least responsible" macroeconomic policy in four decades while Krugman dismissed the concerns completely, noting the relief bill was "definitely significant stimulus but not wildly inflationary stimulus". Whatever the case, we see the need for deliberate and conscientious global portfolio management now more than ever.



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