

CIO Strategy Bulletin

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More Volatility and How To Position Portfolios For It

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Summary

- When markets have been strong in the face of uncertainty, the difference in implied versus actual volatility presages periods when more volatility may be realized.
- This is a New Economic Cycle and it is just six months old. The larger economic recovery is still almost entirely ahead of us. In a post-Covid world, many unloved stocks should see a substantial recovery as industries most impacted by the disruption of social distancing are relieved of their constraints. This reflects the medical and associated economic realities of COVID.
- See also our **Special Report: Brexit and Then What? (In detail below)** As the pandemic and Brexit terms are resolved, the attractiveness of British shares is likely to become clearer. We believe that accumulating UK equities and Sterling into weakness and in tranches over the rest of 2020 may be beneficial.

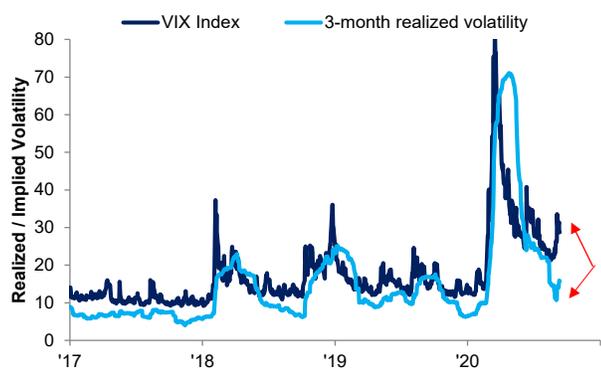
Why Expect More Volatility?

Global economic conditions have never changed faster than in 2020. The pandemic rages on in the US, India, Mexico and Brazil and elsewhere. In contrast, economies have rebounded faster than expected after a rolling worldwide economic shutdown in spite of the virus. After an initial plunge, stock markets in the US and China have registered strong gains, with varying increases for the others that trail behind.

Until recently, investors have enjoyed an unusual degree of stability for the news environment we live in. When we look at implied volatility versus realized volatility (what people expect will happen versus what is happening to asset prices), we see a disconnect (**see Figure 1**). A high level of implied volatility most often implies that investors are *fearful*, positioned cautiously, and hedging downside risk. This is the type of behaviour that can make for *stronger* equity market gains. However, at present, when markets have been *strong in the face of uncertainty*, the present difference in implied versus actual volatility presages periods when more volatility may be realized.

How can one potentially benefit from this? First, we would strengthen, not shed, core portfolios. We would add components to make them more resilient to endure through the shifting landscape. Second, for suitable investors, implied volatility can be harnessed to create attractive entry points to buy assets more cheaply. When Implied volatility is *already higher* than that of its underlying asset class, it is cheaper on a relative basis and can be “sold” to capture possible returns.

Figure 1: Implied Volatility vs. Realized S&P 500 Volatility



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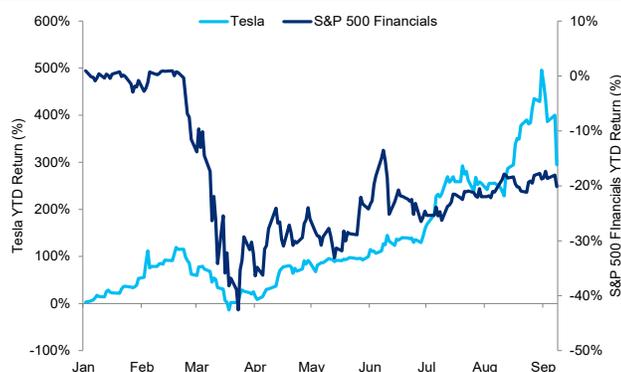
Whiplash

Last week, many investors and publications were “shocked” when the year’s best performing major US index - the Nasdaq-100 – fell 11% from its record high. At last week’s low, the large-cap technology-laden index was still up 29% in the year-to-date. The index’s record high - up 40% year-to-date – was achieved only in the prior week. For example, Tesla, the best performing large-cap tech-related US firm, dropped 34% from its prior week-record. This included a -21% day, with *no major fundamental developments* for investors to consider. At its low last week, Tesla shares were still up 295% for the year.

All sorts of esoteric excuses were given for the Nasdaq’s historically modest drop. This included a recent surge in options contracts and speculative trading by Softbank. (This made investors in the publically traded firm wonder if it remained focused on long-term venture investing or instead has joined the “fast money” crowd). To us, a simpler explanation makes the most sense. Momentum buyers fled when their chips were laid bare on the table. Such short term “buyers” took profits on some of the biggest share-price-gainers of the year. With less impressive upward movement to chase, these and other speculators see less reason to buy now.

Away from tech, many other shares were off only moderately during the one-week slide. For example, US financials lost 3.4% during the six-day Nasdaq “correction” (**see Figure 2**). We have written before that COVID has divided markets into two groups of “loved and unloved” assets (**see Figure 3**). But investors may not realize that this observation leads to a not so obvious conclusion: shares of firms that have thrived on Covid’s social-distance requirements will likely see little or no benefit from a broader economic recovery. In other words, they may be at peak in performance right now. In a post-Covid world, the *unloved* stocks should see a substantial recovery as industries most impacted by the disruption of social distancing are relieved of their constraints. This reflects the medical realities of COVID.

Figure 2: Tesla vs. S&P Financials



Source: Bloomberg as of September 10, 2020. For illustrative purposes only and is neither a solicitation to buy nor a recommendation to sell.

There are no certain, immediate medical solutions in hand for the virus. In fact, the world (at least the northern hemisphere) must brace for a possible reacceleration of the disease as colder weather pushes populations indoors during the influenza season. Widespread flu symptoms may create stronger conditions for the spread of COVID. On September 2nd, Anthony Fauci, Director of the National Institute of Allergy and Infectious Disease, said that the number of daily coronavirus cases in the United States is “unacceptably high” heading into the fall season. The US is experiencing more than 35,000 new cases a day, whereas Fauci suggested that a number below 10,000 would have been optimal. Last week, Dr. Christopher Murray, the head of the Institute for Health Metrics and Evaluation at the University of Washington cited their analysis that predicted that the total U.S. death toll could top 410,000 by January 1st assuming the current mask wearing and social distancing trends continue. Murray was quoted by CNBC on 9/12 stating, “We are facing the prospect of a deadly December, especially in Europe, Central Asia, and the United States.”

Figure 3: Global Covid Cyclical and Defensives as % of World Equity Market Capitalization



Source: Bloomberg as of September 10, 2020. Note: Covid-defensives include information technology, health care, communications services, consumer staples, utilities and e-commerce sectors. Covid-cyclicals include industrials, financials, consumer discretionary excluding e-commerce, real estate, energy, and materials sectors. . Past performance is no guarantee of future results. Real results may vary.

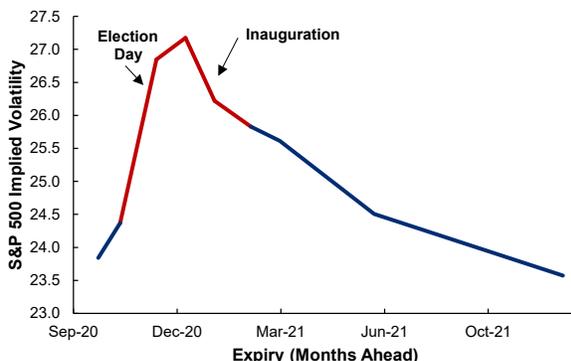
The fact that we have not seen the COVID Cyclical begin to “mean revert” toward the defensive shares reflects the strong possibility of worsening pandemic realities as winter approaches. Similarly, the 15% drop in certain crude oil benchmark prices over the past three weeks has been an important signal that the profit-taking in technology shares does not foretell an immediate rotation into cyclicals. Lower oil prices suggest there is no immediate surge in transportation fuel demand that would come in a post-Covid period.

Sources of Expected Higher Volatility

The US Election

The election is a major source of higher stock market volatility. Implied volatility in US equity markets is priced about 12% higher by the November 3rd US election day and then rises another 3% in the month beyond (see Figure 4). Back in the same months of the 2016 election season, the so-called term structure of volatility indicated little concern among investors about the forthcoming election.

Figure 4: S&P 500 Implied Volatility By Month, Key Election Dates



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Markets are straddling the possibility of a change in government – and all that might imply for future taxation and regulatory differences – while weighing the impacts of a second Trump administration. Further, they may be pricing the impact of COVID and foreign interference as risks to a smooth election. Given the very high expected number of mail-in ballots across the US, it is possible that the results of the US election may not be known on election eve and, if it is a close election, for weeks thereafter.

Stock markets are telegraphing this heightened level of uncertainty. Despite more solid polling for Democratic Candidate Joe Biden than for Hillary Clinton roughly 50 days ahead of the US general election, markets are heading into the 2020 election with far less confidence that they know the result.

Even as so-called “swing state” polling looks decisively in favour of Biden, public sentiment data cannot convince markets to take a confident view of the election outcome. Public approval of US economic policy has fallen 26% during the Covid crisis. If this is a proxy for confidence in the Trump administration’s economic policy, the reading is still 44% **above** the levels reached when first-term incumbent US Presidents lost re-election bids in 1976 and 1992 (see Figure 5).

Similarly ambiguous are other economic data used to predict election outcomes. The US public still views Covid as a discrete, external (“foreign”) shock. With the employment impact of Covid highly concentrated in a few industries such as hospitality and leisure, consumer expectations have fallen far less than unemployment has spiked (see Figure 6). “Concentrated” economic pain may have less impact on the average voter than headline macroeconomic statistics might imply. On the other hand, the rates of illness and death in the US have broadly impacted families across the country.

Figure 5: Approval of US Government Economic Policy and First Term Incumbent Losers

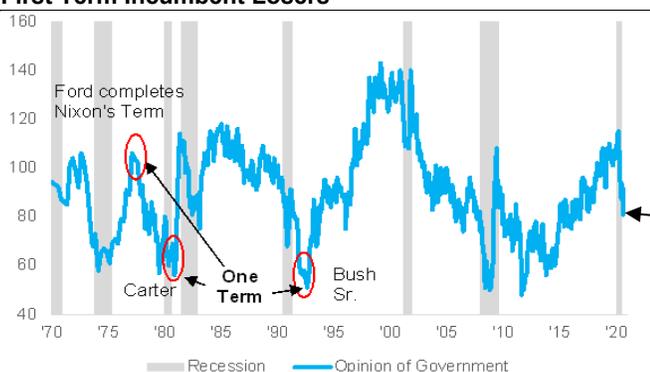
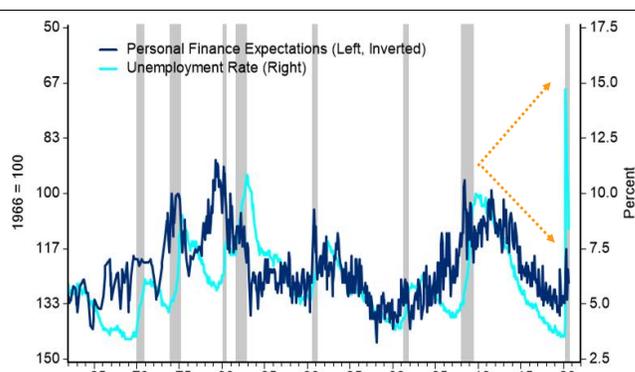


Figure 6: Unemployment rate vs Consumer Expectations



Source: Bloomberg as of September 10, 2020. Note: All forecasts are expressions of opinion and are subject to change without notice and are not intended to be guarantees of future events.

Markets are not, today, betting heavily on one candidate or the other. If markets priced the polls today and the opposite candidate won – as was the case in 2016 – the post-election shock would imply much more than a 3% increase in volatility. That said, we still expect a higher overall level of ambient volatility ahead reflecting the numerous policy, event and political risks that this environment holds.

Questionable Fiscal Support for the US Economy

Last week, we noted stronger-than-expected progress in US employment data through August, despite a drop in fiscal support for the economy since payments peaked in April (see Figures 7-8). However, this fledgling economic recovery has yet to face the Fall/Winter Covid challenge we have written about. Though we have modelled a tough winter-2020 pandemic environment, we have also assumed further US Congressional action to support individuals, businesses and municipalities based on the prior 50 years of history where such support was delivered. Yet, as the election draws closer, the likelihood of such support becomes smaller.

Figure 7: US Job Openings vs Employment



Figure 8: US Government Transfer Payments to Individuals



Source: Bloomberg as of September 10, 2020.

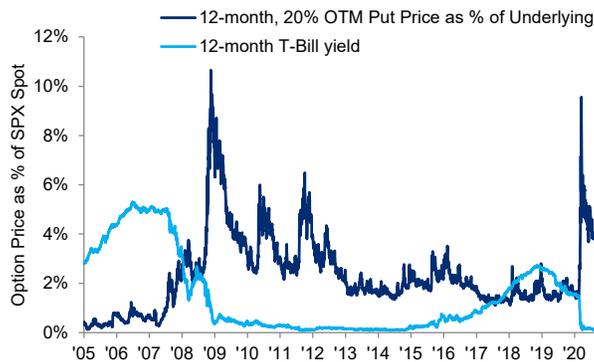
The Limitations of Central Banks

So far, Central bankers and finance ministers have succeeded in avoiding a self-reinforcing spiral of downward economic momentum in response to Covid. A large part of this has come from boosting broad financial conditions to help absorb the shock while preventing deflation from setting in. As government debt burdens have swollen to finance this “bridging cost,” central banks are working hard to make the spending easier, reducing key policy rates toward zero or below.

The fact that the economy has rebounded more strongly in the less impacted industries demonstrates unanticipated resilience. But there are also numerous economic tensions that are rising at the same time. Low rates can create asset bubbles by making it easier to discount future earnings growth (and revenue growth) to justify higher stock prices. But when Covid ends and that growth does not materialize, asset prices can quickly and painfully adjust.

Furthermore, though there is a predominant view that central banks actions have stamped out volatility, implied (future) volatility in many asset classes remains higher than historic averages. This is true for fixed income markets. What if growth accelerates further than expected when effective treatments for the virus are announced and widely distributed? Perhaps this explains the disparity in implied equity volatility and the 12-month Treasury bill yield. (see Figure 9).

Figure 9: 12-month S&P 500 Implied Volatility 20% Below Current Spot Price vs 12-month US Treasury Bill Yield



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Potential Benefits From Higher Volatility

- Seek balanced core portfolios. Today, given the gains in defensive shares, including technology, many portfolios are not balanced. Therefore, rotating portfolios into cyclical shares, small and mid-cap stocks, under-performing foreign markets and more “value-oriented” growth assets makes sense. At the most basic level, investors need to avoid market timing. Do not assume that huge gains in concentrated investments are “easy” to sustain.

- This is a New Economic Cycle and it is just six months old. The larger economic recovery is still almost entirely ahead. The “unloved” Covid cyclical sectors are likely to have stronger returns over the next 12-18 months when markets normalize. Underweighting expensive fixed income markets with negligible or negative yields may be beneficial to portfolios.
- For qualified investors, higher implied volatility is a way to capture attractive relative yields. The potential benefit that can be harnessed from heightened implied volatility (**again see Figure 9**) is “above market”.

Special Report: Brexit and Then What?

Britain is dealing with three storms, the pandemic, Brexit and the sustainability of its nascent economic upturn. We believe this is likely to constrain UK asset prices, despite attractive valuations. However, as these storms recede and resolve, the attractiveness of British shares are likely to become clearer in 2021. So our advice is to accumulate UK equities and Sterling into weakness and in tranches over the rest of 2020.

The UK’s second quarter GDP growth fell by 20%, among the steepest declines across all developed markets. At the start of the pandemic, there was an uncertain government response further delayed by the UK’s lockdown. The pandemic hit the UK’s services sector hard and that represents 82% of the UK economy. Thus, economic weakness was pronounced and widespread. Once the government reacted, the early market rebound off a depressed base was dramatic (**Figure 10**), led by strong Bank of England (BoE) and government stimulus measures. The BoE reduced the base rate twice to 0.1% and expanded their quantitative easing program to £300 billion. The government spent around £35 billion on its furlough program, another £135 billion on deferred taxes, announced subsidized loans for stressed companies, and offered guarantees on £350 billion of company loans.

Given the realities of the pandemic and the strong, but late monetary and fiscal responses, we expect a 6% fall in GDP growth this year, followed by a 3% rise in GDP growth in 2021.

Our muted expected growth could be increased, but there are four main concerns:

1. Some emergency fiscal measures are coming up to expiry and the government’s subsequent plans are not clear. For example, unlike France and Germany, the UK has not yet extended its furlough program, which is due to end on 31st Oct 2020.
2. As the French and German governments have further expanded their emergency fiscal programs in recent weeks (in each case to around 9% of GDP), the UK’s chancellor of the exchequer is worried more about the rise in the fiscal deficit to over £350 billion this year (about 17% of GDP). He has hinted at the possibility of tax rises in his autumn budget, including a rise in the corporate tax rate from 19% to 24%. This could be premature and harmful relative to the EU given the fragility of the early economic recovery.
3. As in the US, the pandemic in the UK is showing signs of resurgence, with the likelihood of further government restraints on social distancing in the coming weeks.
4. There is now renewed and heightened uncertainty with regard to the EU trade negotiations.

These four factors in combination are holding back confidence of UK consumers and businesses (**Figure 11**), as well as potential foreign investors. This is also reflected in both the stock market with the Covid Cyclical upturn losing momentum (**Figure 12**), the market valuation remaining relatively attractive (**Figure 13**), and in Sterling which remains cheap in real-exchange rate terms (**Figure 14**).

Figure 10: United Kingdom PMI, by industry

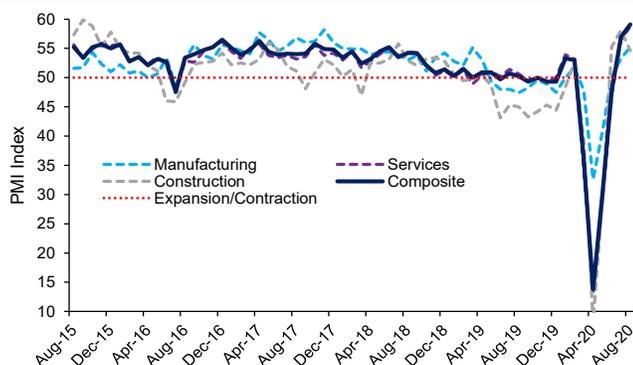
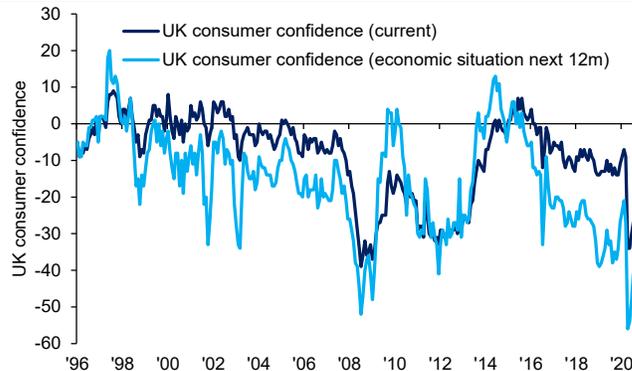


Figure 11: UK consumer confidence



Source: Bloomberg as of September 10, 2020. Note: PMI is the Purchasing Managers’ Index. 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. Past performance is no guarantee of future results. Real results may vary. All forecasts are expressions of opinion and are subject to change without notice and are not intended to be guarantees of future events.

Figure 12: Europe v UK Covid cyclicals

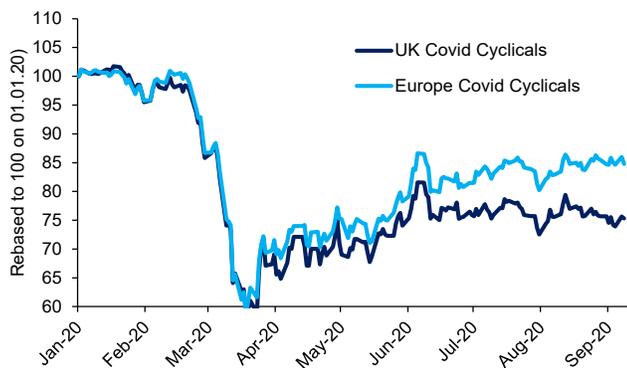
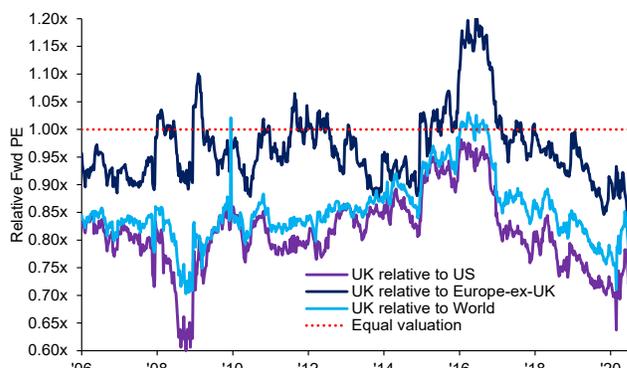


Figure 1: UK relative valuations



Source: Bloomberg as of September 10, 2020. Note: Covid-defensives include information technology, health care, communications services, consumer staples, utilities and e-commerce sectors. Covid-cyclicals include industrials, financials, consumer discretionary excluding e-commerce, real estate, energy, and materials sectors. 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. Past performance is no guarantee of future results. Real results may vary. All forecasts are expressions of opinion and are subject to change without notice and are not intended to be guarantees of future events.

Figure 14: GBP (Sterling) Real Effective Exchange Rate (REER)



Source: Bloomberg as of September 10, 2020. Note: +1/-1 is the level of standard deviation from the average. 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. Past performance is no guarantee of future results. Real results may vary. All forecasts are expressions of opinion and are subject to change without notice and are not intended to be guarantees of future events.

What Type of Brexit Will There Be?

There were signs of pent-up demand for UK assets just after the UK's December 2019 election and before the start of the pandemic, which has been held back further but is still there. Given that the on-going economic and Covid-19 concerns are also seen throughout the developed world, the key factor in unlocking some of the pent-up demand and lessening the valuation gap of UK assets is Brexit clarity.

Having formally left the European Union on 31st January 2020, the UK is next due to leave its one-year transition period on December 31st 2020. During the transition, the UK's trading relationship, financial contributions, and legal obligations has been the same as they were during its formal membership. With just over three months to go – and with the attention of both sides having focused on the COVID-19 pandemic over recent months – the critical period of final negotiations has arrived. The UK seeks an outline trade deal by the mid-October EU Council meeting. In reality, the hard deadline might be a few weeks after that. A trade deal would need ratification by the UK and all 27 EU parliaments before the end of this year.

Above all, the UK is seeking EU market access while standing its ground in wanting to be treated as a sovereign nation. The EU is standing its ground on preserving EU integrity, particularly reflected in their "level playing field demands". The UK and EU trade negotiators have now ended their 8th round of discussions. After a promising start, with compromises from both sides (the EU dropping its insistence on a significant European Court of Justice role, and the UK agreeing to accept a single agreement rather than their preferred multiple sub-agreements), there is now stalemate. Posturing, brinkmanship, and headline risks are rising.

One contentious issue is fishing rights. Specifically the issue is what rights EU fisherman will have to the UK's Exclusive Economic Zone after Brexit, which could stretch as far as 200 nautical miles from the UK coastline. There are around 75 species of fish in the zone, including staples of the European diet like sole, mackerel, and herring. The UK is also incentivised to reach a fishing rights

agreement, as it runs a trade surplus with the EU in fish. The UK also depends on the European single market for sales of some of its most lucrative species like scallops and langoustines. The EU would like to “uphold” its existing fishing rights on a perpetual basis, while the UK wants to break free from the EU’s Common Fisheries Policy and instead establish quotas based on “zonal attachment” (where the fish are) with an annual review.

The other main contentious issue relates to the EU wanting a “level playing field” on labour, environment, state aid, and competition rules, in exchange for UK market access to the single market. Of these, state aid and competition have become much more important during the pandemic as both sides have dramatically increased their emergency government support programs for companies.

Brinkmanship?

This week the UK has raised the tensions further, proposing its Internal Market Bill, declaring that if No Trade Deal, then they might override two elements of the Withdrawal Agreement relating to the Northern Irish protocol. The Northern Ireland protocol was agreed alongside the exit deal signed last year. It stipulates that Northern Ireland remains part of the UK customs territory. As such, it can participate in any trade deals that the UK strikes with other countries. Simultaneously, however, Northern Ireland is covered by the EU customs code, thus ensuring no hard border with the Republic of Ireland. The EU is insisting on customs checks on goods entering Northern Ireland from the British mainland, to ensure that the correct tariffs are paid before the goods are moved into the single market via the Republic of Ireland.

The Internal Market Bill would do two things: 1. Give ministers the power to override commitments made in the Withdrawal Agreement to ensure EU customs controls were carried out on all goods entering or exiting Northern Ireland. 2. Give the UK government the right to ignore a Withdrawal Agreement clause that requires Britain to apply the EU’s subsidy and competition policies on all Northern Ireland trade.

While this might be a UK negotiating tactic, it has escalated the negotiation pressures and tensions. We believe that both sides would prefer a trade deal. The need to revive economic growth on both sides is much greater than it was pre-pandemic when the trade talks began. We also believe there is still time to come to an agreement. It is highly likely that the impasse will need to be brokered ultimately with senior heads of state involvement. In particular, Germany has the presidency of the EU council until the end of this year, and Angela Merkel has said that a trade deal is one of her priority focus areas.

Investor Considerations

While the probability of a deal has lessened over the past fortnight, on balance we still think that a trade deal will get agreed. The deal would be a very basic trade deal, and in economic terms not much better than No Deal and WTO terms. A deal would nonetheless be hugely positive in establishing the relationship and framework for on-going discussions on topics like security and the environment.

Both Sterling and UK equities are buys into weakness, in tranches over the coming weeks, aiming to be fully invested by year-end. By that time, there will be better clarity on the long-term economic recovery plan, the second Covid wave impact, and Brexit.

Equities: the low teens multiple of UK blue chips is quite attractive in relative terms and tend to be under-owned by international investors. In addition, dividend payouts in the UK are now stabilizing, indicating an average dividend yield of almost 4%. Within the market, in addition to high dividend yielders we see many COVID-cyclical shares and value-oriented sectors that have underperformed significantly, now displaying attractive opportunities (**Figure 15**). The outlook for small and medium sized companies (SMID) is similarly improving as the domestic economy recovers and as GBP strengthens (**Figure 16**).

Sterling: the recent rally versus the USD has been USD-led, while the GBP-trade-weighted valuation continues to look cheap. There is pent up demand for UK property and equity, and also good appetite for Gilt issuance. So flows into these assets are expected to rise gradually in the autumn, as there is better clarity on the economic recovery plan, the Covid second wave, and most critically Brexit.

Figure15: UK equities, value vs growth

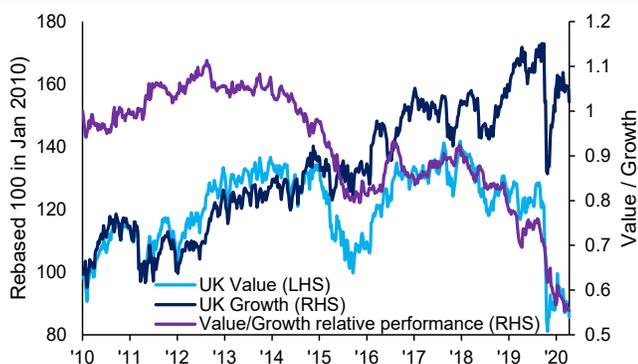
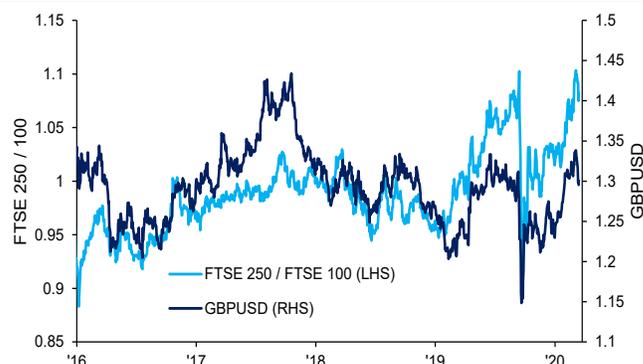


Figure16: FTSE 250/100 v GBP/USD



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