Private Bank

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CIO Strategy Bulletin

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D-Day

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Summary

- **Like armies landing on five Normandy beaches on D-Day (Utah, Omaha, Gold, Juno and Sword), the arrival of the five initial vaccines (Pfizer, Moderna, AstraZeneca, Johnson & Johnson and Novavax) will mark the beginning of the end of Covid-19. There are now five billion incoming "landing craft" that are likely to return the world to a new normal and the full start of a New Economic Cycle in 2021**
- **Given that the vaccine manufacturers presumed success and planned for the delivery of billions of doses, it is likely that we will see the end of the global Covid-19 pandemic around mid-year 2021, with a sharp broadening out of the world economic recovery in the second half of 2021. Our view is that the sources of fuel for the industrial, services and trade recovery we are about to experience are larger than investors expect.**
- **Markets anticipate events and so must we. When you're in the business of managing assets, the decision to "go overweight" risk assets is one the CIO looks back on to study their success or failure. This past week, the Citi Private Bank Global Investment Committee (GIC) raised its allocation to global equities by a further 3%. With the changes, CPB is 9.5% overweight global equities, including a 2% overweight to REIT assets. We also remain 1.5% overweight to gold as a risk hedge, while our global fixed income weightings were reduced from -7% to -10%.**
- **Though we have pivoted portfolios to cyclical shares and underperforming non-US markets, we are not expecting a fundamental retrenchment in the "digital economy." The equity markets we are overweight are collectively 14% below record highs, with only the US small and mid-caps sectors having rebounded to new highs so. Even a partial recovery in assets we are overweight, such as REITS, could generate double-digit returns from current levels. Our preferred markets across Europe and in Southern Asia will be major beneficiaries of a return to trade normalcy under a Biden administration. And these equity markets are big laggards relative to China.**
- ***Special Section:* Answers to Your Recent Questions**

Five Billion On The Way

Covid-19 is a plague. The Spanish Flu (1918-20) killed more people than WWI. And Covid, unchecked, would likely have killed as many as died in battle in WWII.

When the history e-books are written, Covid-19's defeat will have begun on November 9th with the first announcement of a highly effective vaccine. Another shot in the arm followed on November 16th. And there will be many more. Like armies landing on five Normandy beaches on D-Day (Utah, Omaha, Gold, Juno and Sword), the arrival of the five initial vaccines (Pfizer, Moderna, AstraZeneca, Johnson & Johnson and Novavax) will mark the beginning of the end of Covid-19. These moments reflect the extraordinary power of the human mind and the technologies it has developed to defeat a potent, global and invisible enemy. And unlike the recession that followed WWII, when US unemployment reached 7.9% in 1949, these same technologies formed a bridge over the economic chasm that Covid might have been. US unemployment is currently 6.9% and is falling even before the first dose is delivered. There are now five billion incoming "landing craft" that are likely to return the world to a new normal and the full start of a New Economic Cycle in 2021.

"Putting Your Money Where Your Mouth Is"

Over the past two weeks, the initial results of two COVID-19 vaccine studies have been released. Both vaccines were more effective than the base case expectations of medical scientists and epidemiologists. Given that the manufacturers presumed success and planned for the delivery of billions of doses, it is likely that we will see the end of the global Covid-19 pandemic around mid-year 2021, with a sharp broadening out of the world economic recovery in the second half of 2021. Our view is that the sources of fuel for the industrial, services and trade recovery we are about to experience are larger than investors expect. Fifteen percent of the world's economy will reopen fairly quickly. The ultra-easy monetary policy that has flooded the world with capital will see its full effect. Supply lines and factories hampered by the rules and limitations of the pandemic will produce at 100% or more of capacity to refill inventories. There may even be shortages of seats on airlines bringing their planes back on line. Imagine if everyone who postponed a purchase or a trip decided to act at one time. This may be the story of late 2021 or 2022.

Somewhat ironically, the stock market is telling us that this is much more likely to happen than not. How else can one explain the recently rally in the hardest-hit economic sectors while current global economic activity remains severely depressed? Yet, the ability of investors to believe in the future as we see it takes time. For fear to be replaced by greed, one has to see results, millions of people being vaccinated, the reopening of sports stadiums filled with fans and the smiling faces of grandchildren hugging their grandparents without a mask. Yet, by then it will be too late to profit from the start of the New Economic Cycle. Markets anticipate events and so must we.

When you're in the business of managing assets, the decision to "go overweight" risk assets is one the CIO looks back on to study their success or failure. This past week, the Citi Private Bank Global Investment Committee (GIC) raised its allocation to global equities by a further 3%. With the changes, CPB is 9.5% overweight global equities, including a 2% overweight to REIT assets. We also remain 1.5% overweight to gold as a risk hedge, while our global fixed income weightings were reduced from -7% to -10%.

These are significant allocation changes in light of current health conditions that, in the West, look rather bleak. The pandemic is raging (58.3 million confirmed cases globally, and 1.4 million deaths – *Bloomberg as of Nov 22, 2020*) and it is likely to do so through the winter. As such, we think markets can be volatile until the spring. In the US, there are governance challenges due to the hesitancy of the Trump Administration to acknowledge the result of the Presidential election and there is likely to be political paralysis prior to the seating of a new Congress. The Trump Administration is already taking steps to limit the Fed's remaining emergency powers. None of these issues will collapse the economy as we saw with the indiscriminate plunge of March/April. Setbacks are likely, however, given that confidence in the markets is fragile.

It is worth repeating that we are not “out of the woods”, yet. The number of positive COVID incidences in the Pfizer trials was low (94 at first interim) out of nearly 44,000 participants (half receiving the true vaccine). As we saw in the US election polling, small sample sizes can lead to large deviations in outcomes. Also, as we have pointed out previously, we do not know how long the protective value of vaccines will be and there is a lot is riding on the production of T-cells in its recipients. Finally, when large populations are vaccinated, it is possible that side effects will arise in material numbers. Therefore, we must be mindful of the data as it evolves and not assume a straight line for treatments. There will be many fits and starts.

Where the Overweights Are

Within the equity overweights, we are focused on “Covid Cyclicals”, the areas of the market that have underperformed during the pandemic. Those cyclical stocks have responded to the arrival of the vaccine exactly as we expected. “Covid Cyclicals” have outperformed “Covid Defensives”[1] by nearly 600 basis points so far in November. Yet, a massive dispersion gap driven by the pandemic still exists and we expect that gap to close in the coming year. To mark this simple to see, note that the NASDAQ 100 has outperformed US SMID by 30% in 2020-to-date and certain EM equities by 50%. The particular equity markets we are overweight are collectively 14% below record highs, with only the US small and mid-caps sectors having rebounded to new highs so far. Even a partial recovery in assets we are overweight, such as REITS, could generate double-digit returns from current levels. Markets across Europe and in Southern Asia will be major beneficiaries of a return to trade normalcy under a Biden administration and their equity markets are big laggards relative to China.

Figure 1: Nasdaq 100 vs Russell 2000

Source: Bloomberg as of November 20, 2020. . Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Past performance is no guarantee of future results. Real results may vary.

Though we have pivoted portfolios to cyclical shares and underperforming non-US markets, we are not expecting a fundamental retrenchment in the “digital economy.” There will be no tech collapse similar to 2001-2002, a period which marked a new tech-led recession. Instead, we expect software, “apps,” digital content and services to remain on a gentle, upward outperformance slope, gaining share of the economy over time. Our larger point here is that the sectors we prefer during the period when Covid departs are more likely to generate attractive returns. When rates rise, as we expect they will over 2021, tech stocks tend to return to more moderate return levels (see figure 2).

[1] *COVID-Cyclicals: Financials, Industrials, Energy, Materials, Real Estate, Consumer Discretionary ex E-commerce.*
COVID-Defensives: IT, Health Care, Communication Services, Consumer Staples, Utilities, E-commerce.

Figure 2: US 10-Year Treasury Yield vs. IT Sector

Source: Bloomberg as of November 20, 2020. For illustrative purposes only. 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.

To illustrate the valuation gap between the high flying Covid-Defensives and the most beaten down Covid-Cyclical industries, you can see that the laggards are still 35% lower on the year, while the winners are up by 45% (see figure 3). In mortgage REITS, a full recovery could take until 2022 or longer. But a partial recovery – while earning a 7% dividend yield, could eclipse a 30% return in the coming year. This would rival NASDAQ's gain of 2020 (see figure 4).

We hope that investors will be mindful of our recommendations in non-discretionary portfolios. For opportunistic investors, these overweight suggestions can be timely additions to Core holdings.

Figure 3: US 'Stay at Home' vs 'Leave Your Home' Baskets and S&P 500

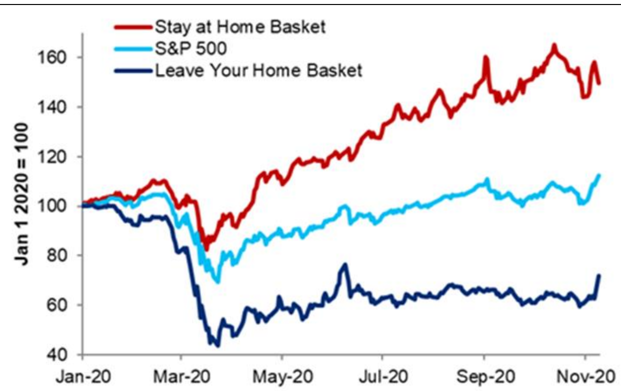

Figure 4: US Mortgage REIT Level Still -38% From February COVID Shock Despite Falling Interest Rates

Source: Haver Analytics, Bloomberg, FactSet as of November 20, 2020. Note: "Stay at Home" basket includes names identified to benefit from COVID-related disruptions and a shift to working from home. "Leave Your Home" basket includes Citi Research 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. These are shown for illustrative purposes only. This is not a recommendation to buy or solicitation to sell any of the names shown.

Answers to Your Recent Questions

During our weekly client calls, we get asked many good questions that we do not have time to answer. So, in the interest of saying "thank you" to all of you, here is a list of these questions and our answers. They are not in a particular order.

Q1: What would be the expected impact on the US economy, when temporary halt to evictions (due to either non-payment of rents or mortgages) end?

A1: Poor fiscal coordination in the US will have a negative impact on the economy at the turn of the year and into early 2021 for several reasons (please see the latest *Quadrant* for full discussion - Quadrant | Now to Prepare for COVID's Departure). The end of the evictions moratorium will likely play only a small part in it. While it is unlikely that the "lame duck" Congress now in session will extend the moratorium – or even extend emergency subsidies for state unemployment insurance - it's possible the new Congress in January will take action before there is much impact.

Importantly, the US economy has been able to grow uninterrupted through October 2020 with stimulus peaking six months earlier. Tracking estimates from the Federal Reserve Bank of Atlanta for the fourth quarter 2020 currently show a 5.6% annualized gain for US real GDP after a record 33.0% rebound in 3Q. We have forecasted a 2% gain for the further quarter since August. Our estimates may "meet in the middle" as COVID's acceleration and greater social distancing requirements slow the economy's upward momentum. However, this would largely impact the first quarter 2021, or at least the start of it. Our current US GDP estimate for full year 2021 of 3.9% is below consensus as it assumes little or no growth for the first quarter, but this really doesn't reflect the sharp economic progress we see for the year as a whole driven by healthcare solutions to COVID. *(Source: Citi Private Bank Office of the Chief Investment Strategist, November 2020)*

Q2: When do you think all this recovery will lead to a change in inflation expectations and, perhaps lead the Fed to raise rates?

A2: As we said in last week's CIO bulletin, a healthcare cure for COVID can spur a rebound in both supply and demand. Inflation is caused by persistent excess demand for goods and services. A supply-side recovery will help mitigate inflation, though we think the rebound in demand will be faster, at first. The Fed's "radical" easing steps of the last cycle following the Global Financial Crisis yielded sub-par inflation for a decade. While we think some of the same forces will restrain inflation, though we suspect that inflation restraints are waning and the Fed will be somewhat more aggressive and persistent in pushing to reach its now upwardly-adjusted inflation target. A rebound in oil and energy costs – which the Fed ignores – could add a full point to headline US inflation in 2021. The Fed wants to assure that tighter financial conditions will not stand in the way of a return to full employment. It is highly concerned about repeating the "taper tantrum" impact of 2013, when interest rates and currencies moved very sharply on the first suggestion of merely slowing Quantitative Easing. The majority of Fed policymakers *do not forecast even a first rate hike during 2023*. We believe this assumption is somewhat too pessimistic for the path of recovery, even counting on the Fed's new interpretation of its inflation mandate. The nature of the COVID-driven global recession is an exogenous shock that suggests a more rapid recovery.

Q3: How will the e-commerce spike affect transportation companies when Covid departs?

A3: Transportation logistics firms have seen sizeable gains in business as COVID has limited in person shopping and consumer spending has shifted to goods from services such as travel. This could persist during the first half of 2021 and there will be no severe let up. However, a rebound in services consumption and in-person shopping should be notable following the end of the pandemic.

Q4: With the US expected to outpace Europe next year economically, why is Citi Private Bank so bearish USD/EUR?

A4: The European Union is unlikely to outgrow the US on a sustained basis given its different mix of industries (less innovation) and slightly worse demographics. Exchange rates, however, are driven significantly by relative inflation rates and other factors. The US dollar strengthened sharply for most of the past decade and the Federal Reserve has now adopted a higher inflation target than other developed economy central banks for the first time (please see our August Quadrant for full discussion - Quadrant | Navigate These Two Risks for Reward). Let's remember that during Japan's long deflation and very poor performance for economic growth in the 1990s and 2000s, the yen was persistently the strongest performer in the world.

Q5: Regarding Brazil, lately we have heard the big deficit increased and could affect Brazil making a pullback, could you please give more color on this?

A5: As long as the fiscal spending debate remains within certain parameters, we view policy fears and volatility as an opportunity to add exposure. Deficit increases have been triggered across the world in 2020 as governments increase spending and debt to try to contain the economic damage cause by the Covid lockdowns. Within Latam, Brazil approved roughly 8% of GDP to support its economy in 2020. This figure is significant but not outside of the magnitude we have seen in other countries of this size.

The reason Brazil's deficit and spending has gained so much attention is because, ironically, the country has a spending cap determined by its Fiscal Responsibility Law (FRL) passed in 2000. This is a hard budget constraint legislation applicable to all levels of government spending regardless of their prior economic conditions and was established to reign in federal and state spending. Investors are concerned that further fiscal spending could break this spending cap. But investors may be missing the point.

The Minister of Finance, as well as several high profile politicians in Congress understand that Brazil's stability depends on the signals they provide to markets and investors. The debate around how to fund Covid support spending has fueled intense political debates. These headline grabbing discussions should actually be seen in positive light, whereas 20years ago the government would have likely monetized the newly created fiscal deficit, the current administrations understand that this is not a viable option and they are trying to work within the rules. There is no question that Brazil will have a larger fiscal deficit next year along with an increasing stock of debt. This spending was necessary to support the economy in 2020, just as it was in the US, Europe and rest of the world. The mechanics by which they fund this spending are important but are not critical to the sustainability of the model itself, where the political sphere understands the importance of fiscal discipline as evidenced by the intense discussion and negotiations.

So while markets will continue to trade volatile on the back of these concerns, and the higher spending will present a challenge for growth, we have a high degree of conviction that policy makers will not embark on an irresponsible path to fiscal spending and are well aware of the challenging dynamics that they must overcome in the coming months.

Q6: What is your outlook on energy: Oil, pipelines, alternatives?

A6: Demand for petroleum transportation fuels took a big hit from COVID and is likely to recover in the coming year. OPEC is showing discipline in holding down production while US fracking has slowed. US output might slow further on environmental concerns in the coming year. Oil's history is essentially one of only boom and bust, and bust occurred in 2020 with a very short period of negative oil prices on a lack of storage. While the coming year should see sustained recovery, as we said in Outlook 2020, the persistent rise in electric vehicles, solar and wind power is gradually decreasing demand for fossil fuels every year. This is imparting a gradual, but persistent downward slope to the economic viability of oil and even natural gas. Alternative energy, conversely, has seen ever-improving technological advances. We expect more viable battery and solar technology to displace fossil fuel in time, much the way petroleum displaced whaling in the 19th century.

Q7: Greece has a business friendly government and is a beneficiary of the EU 750 billion recovery fund. Any ideas on how one plays that?

A7: Greece will be the one of the largest beneficiaries of the EU recovery fund, also supported by its demonstration in recent years of its higher absorption rate of EU funds. Combined with the election of a pro-business party into Government in 2019, political risks in the region are now significantly reduced and the relationship with Europe much stronger following the end of Greece's bailout in 2018. This means that despite Greece starting the crisis with a debt-to-GDP ratio of 180%, greater fiscal flexibility will likely be granted to Greece.

Our favored play on Greece is via Greek equities, which have significantly underperformed in 2020, down nearly 25% year-to-date. This has primarily been driven by a large economic dependence on tourism, with broader travel and tourism accounting for approximately 20% of economic output. Greek equities are a prime example of a lagging value opportunity that could be poised to rebound into 2021, supported by vaccine news, a re-opening of broader tourism and hospitality industries and EU recovery fund grants supporting the macro picture. At 63%, "Covid Cyclical" sectors dominate the Greek equity index (of which financials and industrials account for 34%), with the broader Greek equity index trading on a forward 12-month price-to-earnings ratio of 18x.

Q8: Is there no concern about non-performing loans (NPL's) in European banking sector?

A8: Defaults and non-performing loans have remained relatively contained throughout 2020 on the back of extensive government support measures and payment holidays. In its most severe scenario into next year, the ECB have forecasted that NPL's in the Euro-area could rise as high as €1.4 trillion (nearly a trebling of current levels). While defaults will inevitably increase in 2021 as support measures begin to fade, we think that more medium term NPL's will stay relatively contained, with the European banks holding much stronger balance sheets and asset quality improving in recent years.

However, given sizeable divergences in the outlooks between individual banks, especially between countries, we take a more selective approach. Our favored banks are in Germany and Netherlands. The periphery banks hold the greater vulnerability to rising NPL's, with a greater proportion of loans to SME's dominating corporate loan books (Portugal and Cyprus loan books have over a 60% share of loans to SMEs), whereas countries such as Germany and Netherlands are below 30%. Additionally, the size of legacy NPL's is also crucial in looking at the banks' ability to absorb further defaults. While NPL's have fallen across the board, current NPL's as a proportion of total gross loans are again the lowest in Germany and Netherlands (both sub 2%), while the highest are in Italy (6.7%), Portugal (9.4%) and Cyprus (17.1%) and Greece (36.4%). (*Source: European Banking Authority, as of 2019).*

While the sector near term can benefit more broadly from the value rotation and depressed valuations, more medium term we focus on better capitalized banks with strong balance sheets, improving return on equity measures, comfortable Common Equity Tier 1 (CET1) ratios and manageable non-performing loans.

Q9. Is it possible that some equities might start to perform like quasi-high yield credits?

A9: AT&T for example has an average debt maturity profile of 17 years with a lower bond yield than its current stock dividend. Defensive industry dividends have already become bond substitutes for many investors. Given persistent low bond yields, we don't mind adding some exposure. However, our preference is for firms who grow dividend payments routinely in industries with strong growth or cyclical recovery. We believe these dividend payers will be resistant to eventual upward interest rate pressures, unlike utility shares for example.

Q10: Can you elaborate on the manufacturing / distribution of the vaccine and how many doses may we see by the end of 2021?

A10: After the impressive Phase 3 results from Pfizer and Moderna, the conversation has shifted to manufacturing and distribution. Companies are already manufacturing tens of millions of doses before their expected approvals. This decision will help accelerate the number of doses available in the coming months.

Pfizer will likely be the first company to receive an Emergency Use Approval in the United States, which may allow for the vaccination of high risk individuals to start as soon as the middle of December. The company expects to produce up to 50 million doses in 2020. Capacity will continue to accelerate in the months ahead, and Pfizer expects to produce up to 1.3 billion doses by the end of next year. Moderna has stated that they aim to have approximately 20 million doses available for distribution in 2020. This number is expected to increase significantly as well. The company is aiming to produce 500 million to 1 billion doses in 2021. Between Pfizer and Moderna, there may be up to 2.3 billion doses available by the end of 2021.

AstraZeneca has another vaccine candidate worth monitoring. The company will likely announce results for one of its Phase 3 trials in the coming weeks. Management has recently confirmed that they expect to produce hundreds of millions of doses by the end of 2020. Furthermore, Astra has committed to manufacturing approximately 3 billion doses by the end of 2021. If their vaccine candidate proves to be safe and effective, there may be up to 5 billion doses of COVID-19 vaccines produced and available by the end of 2021.

Figure 5: Vaccine production breakdown (millions)

(in MM)	By YE 2020	Total By YE 2021
Pfizer	up to 50	up to 1,300
Moderna	20	520-1,020
AstraZeneca	"Hundreds of millions"	approx. 3,000

Source: Pfizer, Moderna, Astrazeneca as of November 21st 2020. Past performance is no guarantee of future results. Real results may vary.