

# CIO Strategy Bulletin

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## New Year, New Economic Cycle, New Opportunities

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### Summary

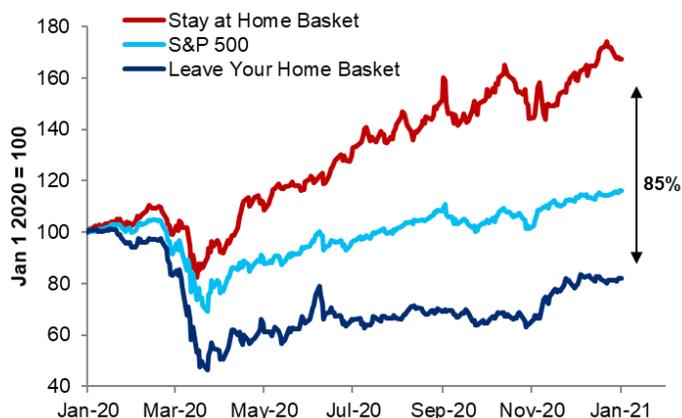
A few months ago, we wrote that the “trifecta” for the beginning of a New Economic Cycle would include a conclusive US election, the arrival of viable vaccines globally and additional fiscal stimulus in the US and abroad. We also noted that a healthcare solution to COVID had the greatest potential to restore economic activity to its full potential, making further macro stimulus less necessary. All of these events are “in the books”. As a result, we expect a sharp acceleration in “socially close” services (everything from travel to retail) and a broadening of global economic growth over the course of this year. This will mark the full start of the New Economic Cycle as we discussed in [Outlook 2021](#).

The global economy will recover more quickly and robustly from the COVID recession than from a more typical, severe downturn. The virus was an exogenous shock whose impacts were spread unevenly. Parts of the global economy were largely spared Covid’s effects and some benefited mightily. Governments are providing the necessary fuel to support a broad recovery. In response, global employment and spending will rebound faster than in a “normal” downturn as a result. As markets have begun to reflect this outlook, investors should be especially mindful of these observations:

- A period of structurally low interest rates is upon us. When rates are held below normal levels for extended periods of time, the value of cash and many fixed income investments is “repressed.” In our view, accepting negative real returns in large parts of a portfolio is harmful. In contrast, the backdrop for equities and real assets is strong. Wise users of leverage in private equity and real estate will also be beneficiaries of this extended low interest rate environment.
- The legacy of the pandemic will be a reminder of just how much innovation has changed the contours and dynamics of the world economy. The end of the pandemic will further accelerate Innovation and the adoption of technologies that will generate great value for investors and society over the decades to come. And all of these are investable possibilities.
- In the near term, movements in asset prices caused solely by the COVID shock will be reversed rapidly. The present extent of the mispricing is underappreciated and presents an “alpha creation” opportunity that seldom appears in markets this broadly. In particular, markets across Europe, Southern Asia and Latin America will be major beneficiaries of a return to trade normalcy after lagging sharply relative to the US and China in 2020.

We would remind readers of our best 2020 observation regarding Covid Cyclicals and Covid Defensives. Covid changed the price of every security on its way in and the price of every security will be similarly altered by Covid's departure. Though we have seen initial, strong out-performance of the "Leave Your Home" shares, the rebound of these shares relative to the "Stay at Home" basket remains only one-third complete. (See Figure 1.)

**Figure 1: Performance divergence between stay at home and leave your home baskets**



Source: Bloomberg as of December 31, 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. 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.

Markets anticipate events and so must wise investors. Yet, the ability of investors to believe in the future scenario we have developed takes time. At the margin, investors have 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 sans masks. But, to profit optimally, investors should act well before the full impact of the trifacta's impact is experienced.

## The US

The S&P500 went from peak to trough in 175 days in 2020. Since the pandemic low, the benchmark is up 68% as investors enthusiastically embraced COVID beneficiaries. For the year, the index was up 15%.

More recently, strong vaccine efficacy studies fueled a sharp rally in our basket of "COVID cyclical" equities. From November 1 to December 31<sup>st</sup>, the S&P 500 was up 14.9% while COVID cyclicals outperformed the index by a further 6 percentage points.

Our overall market view is positive, with an expectation that large cap US equity returns will be mid-single-digits across 2021. That said, we think that there are sectors and strategies that will significantly outperform the benchmarks.

There remains a large group of naysayers who believe the "market is too high" and/or that they have "missed it". We do not think that view is consistent with the fact that 39% of all companies listed on the S&P ended in the red. As an example, the US financial and real estate sectors fell 4.9% and 6.4% in 2020, despite massive interest rate declines which revalued most asset prices higher. Together, these two sectors lagged 21.2% this past year, with a recovery from the COVID pandemic ahead. They represent areas of real value when we look out 12-18 months.

Technology-related shares will still offer strong secular growth opportunities within segments and deserve a full, long-term allocation, as discussed further herein. However, these are not “recovery plays” from the COVID shock as they proved to be safe havens in 2020. Their higher current valuations reflect their resilience.

## The UK

Average UK EPS growth is expected to rebound by at least 25%, in 2021 with further upside potential given the recent trade agreement. On a relative basis, UK equities are very cheap, trading at around a 35% discount to the US market as fears of Brexit impacted paralyzed investors. The 3% average UK dividend yield is higher than any other developed country and offers significant advantages over the average UK fixed income yield. The UK market capitalization composition is also very attractive given our view that cyclicals will outperform at the beginning of a New Economic Cycle, with almost 60% of the indices in cyclical value sectors including financials, energy, materials and industrials

## The EU

In our view, investors likely underestimate the economic and market value of a combination of increased EU government spending and monetary financing. The European Central Bank significantly expanded the scope of its credit easing steps over the past weeks. Further, the ratification of a pan-EU Recovery Fund and budget means there will be higher than expected Eurozone GDP growth in 2021 (potentially above 5%) reflecting the additional stimulus above what individual countries are able to achieve.

## China

China's market led returns among Emerging Markets in 2020 with a USD total return of about 34%. However, this gain started from a restrained base in 2018 and 2019 as the US trade war and cautious domestic policies held back markets. China has recently benefited from a massive rise in demand for its exports as western consumers shifted their consumption patterns to housing and electronics-related merchandise. In addition, China's domestic consumption of services has recovered faster than any other region reflecting their successful centralized management of the pandemic. While Chinese shares likely won't be the EM leader for a second year, they should progress further in 2021.

## The East

In general, non-US markets fared worse from the COVID shock and lagged US equities by 9.8 percentage points in 2020 despite lower starting valuations. Both shorter-term dislocations and under-valued long-term growth can be across EM.

Our favorite emerging markets can be found in the East. Supply chain diversification from the west and rising demand from China leaves most of Asia in a “win-win” situation in 2021. Exports to China have already begun to pick up. Travel and tourism were battered in much of Asia and will eventually follow the factory-sector recovery. The large ASEAN region saw its equity markets fall 9% in 2020, lagging China by a massive 43%. The broadening of Asia's equity market recovery in 2021 seems likely to be a major story for the year ahead.

## Major Trends for Investors and Investing

### ESG and Why It Matters

Environmental, social and governance investing will direct capital to companies whose actions are consonant with values that will make the world healthier. We expect more viable battery and solar technology to displace fossil fuel over time, much the way petroleum displaced whaling in the 19th century. Consider this: the Energy sector was the worst performer of the past five years. Furthermore, Covid itself will change how we work and where we work, again setting in motion a range of opportunities for investors. And finally, and most importantly, we are entering an era where companies will be measured on factors well beyond pure financial metrics. This will influence investors and, in turn, companies who seek to build strong institutional and retail followership will heed their demands for better governance.

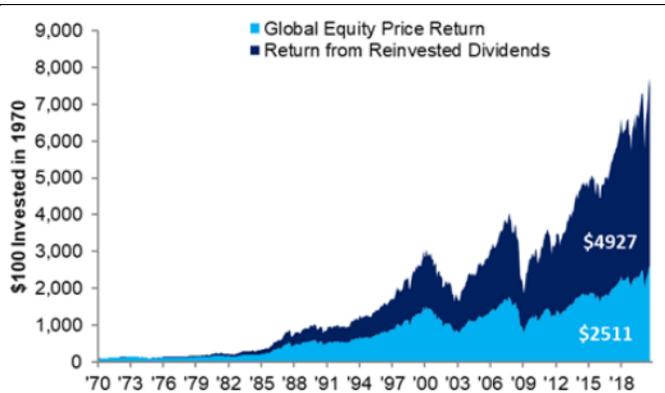
While green energy was already impacting the economics of fossil fuels, the necessity to address climate change has ushered in a whole new set of investment opportunities. In fact, 2020 may be viewed as the year when the world finally decided to reverse climate change. At the center of the EU's economic recovery plan is the new Green Deal. China, the world's largest producer of greenhouse gas emissions made its own net-zero pledge. In the US, expectations are high that President-elect Biden will make "going green" a major priority and to seek incentives for US companies who participate. For investors, this is a tipping point that is good for the world and may be very good for portfolios positioned accordingly.

## Dividends to Pay Big Dividends

As the COVID pandemic winds down, both the presently-depressed firms that rebound and those that provided "defensive growth" during the shock will see diminished influence on markets. The highest valued, speculative growth shares are also at risk if and when bond yields rise enough to attract investor interest at the margin. As this happens, we will refocus portfolios on quality income generation in equity markets.

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. As you can see (Figure 2) most investors do not realize that the value of portfolios has been deeply and positively impacted by the reinvestment of dividends. This represents more than 50% of total returns since 1970.

**Figure 2: Global Equity Price Return and Return Including Reinvested Dividends**



Source: Bloomberg as of December 31, 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. 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.

## Technology Shares in the Post-Covid Period

In a post-Covid world, technology investors in need to become more selective. There is a high likelihood that "hyper-connectivity" enablers in the telecom equipment, cloud computing and digital services industries will fundamental outgrow other sectors after COVID. However, the "pandemic premium" for large-cap tech is likely to fade and cause a "cooling off" period after rapid returns in 2020.

Consolidation in areas such as telemedicine, video conferencing, food delivery and online retailing, to name just a few sectors, is likely. With that said, the "digital share" of the world economy is only growing, and does not face a recession as it did when tech stocks collapsed in 2000 (see figures 3-4). Long-term investors need to navigate this period of IT outperformance. Nonetheless, technology shares still offer some of the best opportunities for sustained growth.

**Figure 3 S&P 500 Information Technology Sector Share of Market Cap and EPS**



Source: Haver Analytics as of December 16, 2020

**Figure 4 Intellectual Property (i.e. Software) Share (%) of US GDP**



## What We Are Watching and Thinking About

### The US Senate Run-Offs

With Joe Biden winning the Presidency, with or without a divided Senate, the world will experience a pronounced change in the tenor of US politics and economic policy. Nonetheless, the Georgia Senate runoffs are the critical focus of US politics. While we do not see a stark leftward move in the US government, two Democratic wins in Georgia would create a broader set of possible outcomes in US domestic policy including greater COVID relief, tax increases, infrastructure spending and regulatory reforms.

That said, we have already see the passage of the compromise \$900B aid package during the “lame duck” session of Congress, indicating (at least momentarily) a tiny thawing of partisanship and a teeny bit of pragmatism. As we wrote two months ago, the idea that Congress would “do nothing” and that compromise was impossible seemed far too simplistic. In our view, markets are still undervaluing just how effective a divided US government may be in achieving bi-partisan compromise. Without a “deep blue wave,” Biden’s ambitions on infrastructure investments, tax increases and income redistribution will be modest and more balanced. This allows for a “centrist” block to develop to implement more focused and modest economic proposals.

### The Accelerating G-2 World

In this New Economic Cycle and beyond, our expectation is that the US and China – the G2 powers – are going to compete more actively, openly and fiercely in global economic, political and military spheres. We believe that this ongoing G2 polarization, Asia’s continued rise, and the interplay between the two have important implications for global investors.

Technology has become the key battleground in the G2 divide. We expect the emergence of two separate, rival internets and different technology platforms that overlap in only selected markets globally. Sustaining two separate standards in technology will require greater capital investment in infrastructure and research on both sides. With the rise of Asia and G2 polarization both set to endure, it is likely that allocations to China and Asia will make globally diversified portfolios more resilient.

That said, the next four years are likely to see a very different approach to international engagement with China. President-elect Biden is likely to seek alliances with Western countries to manage issues like intellectual property rights,

access to Chinese markets and fair trade policies. This could be a more formidable approach relative to the prior “America First” strategy that had relatively minor consequences for China.

Finally, China’s is facing some major market-related challenges. Recent heavy-handed actions in capital markets and in the initiation of investigations into tech companies will be a major area of investor concern and focus. This is compounded by recently regulations that will cause the delisting of certain Chinese shares on the NYSE, at least for a time.

**Figure 5: The Features and Implications of G2 Relations**

Scenario	Features	Market implications
Strategic competition (Base case)	<ul style="list-style-type: none"> <li>Moderate escalations in trade and corporate restrictions</li> <li>No real military conflict</li> </ul>	Invest in domestic and regional demand, dual tech standards, extra infrastructure, supply chain relocation
Easing tensions (Bull case)	<ul style="list-style-type: none"> <li>More diplomatic engagement</li> <li>China adapts friendlier foreign policies</li> <li>No escalation in economic restrictions</li> </ul>	Positive global growth, stable international trade
Path to a hot war (Bear case)	<ul style="list-style-type: none"> <li>Proxy military engagement, likely in South China Sea</li> <li>Possible takeover of Taiwan</li> <li>Severe disruptions of supply chains and commercial activity</li> </ul>	Invest in defense, gold, avoid South China Sea exposures

Source: Office of the Chief Investment Strategist, Citi Private Bank, as of 8 Nov 2020. The opinions expressed may differ from the opinions expressed by other businesses of Citigroup Inc., are not intended to be a forecast of future events or a guarantee of future results or investment advice and are subject to change based on market and other conditions.

## The Russian Hack

Though it did not garner long-term headlines, the Russian hack of federal agencies, tech companies (including Microsoft) and critical infrastructure companies in the electric, oil, and manufacturing industries. This breach was of a different breadth and depth than prior hacks and suggests that obtaining and sustaining remote access to critical parts of a nation’s operational infrastructure is not only possible, but real.

Unlike the Russian interference in the 2016 campaign, this was a stealthy 9-month operation that directly compromised the US Treasury and Commerce departments. During this period, the amount of exposed data was extraordinary, covering the pandemic, operation Warp Speed (including proprietary technologies associated with the vaccine) as well as the election itself. We expect that as details become available, the likelihood of a significant response by the US is high. And, in any case, the likelihood and severity of cyber-warfare events has increased dramatically.

The Citi Private Bank “Unstoppable Trend” of digitization included a specific point of view on Cyber Security in 2020. A basket of related securities returned about 44% this past year (see figure 6). Despite this strong performance, cyber-security will be an ongoing priority to allow for safe transit in a world of “Hyperconnectivity” that we foresee in [Outlook 2021 Section 4.3](#).

**Figure 6. Theme performance, regions and sectors, 2020**



Source: Bloomberg as of Dec. 31. 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.

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