

CIO Strategy Bulletin

May 3, 2020



The Virtues of Being a Professional Investor (Or... Why It Is Time To Stop Being a Market Timer)

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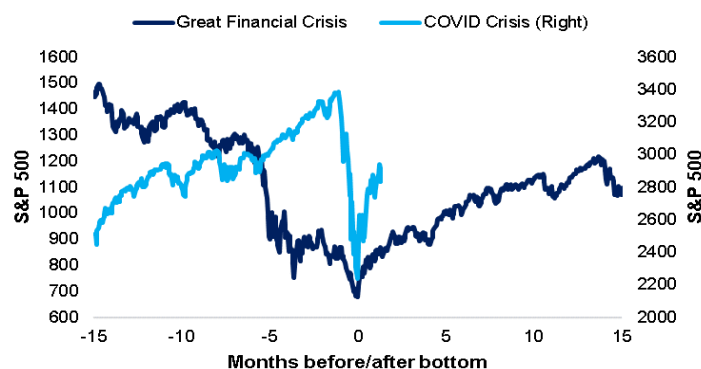
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Summary

This CIO Strategy Bulletin is about [What to Add to Portfolios](#) and [When to Add To Portfolios: Getting Fully Invested](#). U.S. shares ended the month of April with their greatest monthly gain since 1987 (+12.7%). And they did so after 28 million US workers filed an unemployment claim in the last six weeks. As we discussed in our [April Quadrant](#), financial markets *always* lead the economy, with asset prices themselves a forecast of the future (**see Figures 2-3**). We expect that the re-opening of the US and other economies in Q2 will begin a partial recovery in 3Q. The pace of job destruction in recent weeks has been 15 times as rapid as the Global Financial Crisis and the degree of re-employment will be an important indicator of the trajectory of this recovery. As we have published, this road to normal will not be fast *nor* “V” shaped. We think it will take 36 months for the US to achieve 4Q2019 earnings again. While valuations early in a recovery cycle should be higher than in periods near an economic peak, we believe that if the EPS recovery falls short, large cap US equities as an asset class will struggle.

In markets (**see Figure 1**), severe recessions and recoveries have their own paths. But we do not think that the 2020 COVID recession is simply a 40% decline and 30% recovery as our mid-year GDP estimates show. There will be more volatility and new opportunities for investors to add more to their Core portfolios, even as there are some sectors, regions and “unstoppable trends” to add to portfolios *today*.

Figure 1: 2008/09 and 2020 Market Selloffs



Source: Haver as of May 1, 2020. Indices are unmanaged. An investor cannot invest directly in an index. For illustrative purposes only. Past performance is no guarantee of future results. Real Results may vary.

There are at least three significant risks on the horizon. One of the most accurate [models of the COVID-19](#) pandemic expects that the US will experience more virus impacts as the economy re-opens – more than markets expect. We also see political risks rising in the US pre-election. According to press reports, President Trump suggested that COVID19 emerged from a Chinese laboratory. EU Commission President Ursula von der Leyen noted there should be inquiries into how it emerged, as well. If this is a political pretext for trade protectionism or other ominous efforts at “striking back” at China, they may be poorly timed. Many have compared the trade war of 2018/2019 to the 1930 “Smoot Hawley” tariffs that exacerbated the Great Depression. A resumption of a trade war now, in the face of the COVID collapse would, in our view, be dangerous to markets. And finally, if policymakers veer from their single-minded focus on restoring economic growth by, for example, ignoring fiscal imbalances in States, it will not take much to unnerve a fledgling market recovery.

Figure 2. Real GDP 2007-2010 vs S&P 500



Source: Bloomberg; Citi Private Bank OCIS as of May 2, 2020

Figure 3. Real GDP 2018-2021Est vs S&P 500



Source: Bloomberg; Citi Private Bank OCIS as of May 2, 2020

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What to Add to Portfolios

Amidst the most volatile markets in history, with annual or bi-annual returns being made or lost in a month, patient investors have an advantage over traders: time to invest and patiently harvest a return. While the recent gains have been too strong for us to recommend adding to all large cap US equities -- the market-leading “digital disruptors” continue to go from strength to strength for now -- there are many recommendations you can add wisely add to portfolios. These include:

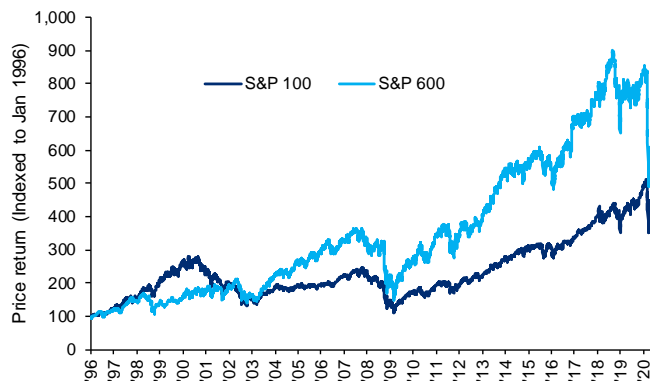
- 1) Small and Mid-Cap US Equities
- 2) Asian and Latin American Emerging Market Shares
- 3) US Municipal Bonds (for those able to take advantage of preferred tax treatment)
- 4) Structures that Monetize High Levels of Expected Volatility.

Small and Mid-Cap US Equities

This past month, we moved to overweight US SMID shares for the first time in more than five years (while keeping our overall global equity weighting neutral.)

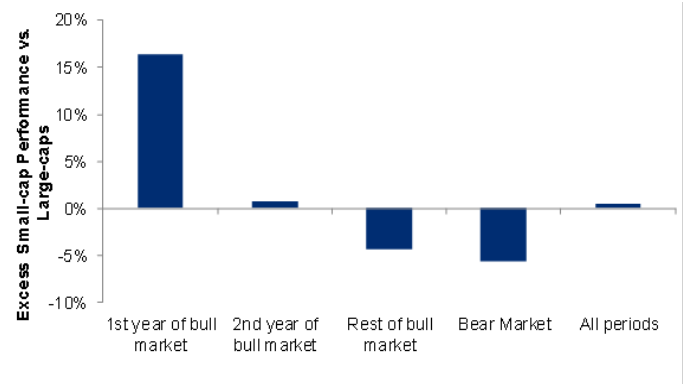
Why would we want to take some risk on firms that have fewer resources than the best capitalized household names? First, it's the opportunity to offer new goods and services, and gain market share from those that already dominate. As **Figure 4** shows, over time, smaller, higher risk firms generate higher investment returns than large firms with their reduced growth opportunities. But what attracts us now, is that the strongest outperformance of small and medium-sized companies typically occurs early in an economic recovery cycle (**Figure 5**).

Figure 4. S&P 100 large cap vs S&P 600 SMID



Source: Haver Analytics as of May 1, 2020

Figure 5. Russell 2000 vs S&P 500 performance



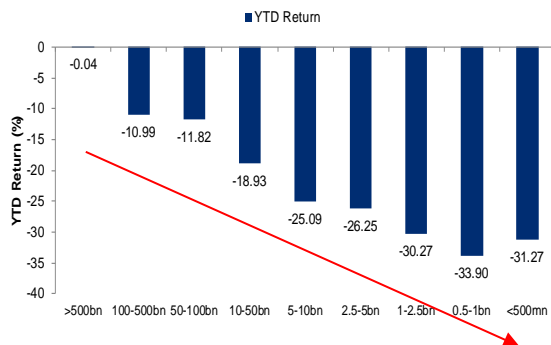
Source: Haver Analytics as of May 1, 2020.

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Our preference is to invest in currently profitable, strategically well-positioned SMID firms. We see the most numerous of these opportunities in the healthcare sector, which is far less economically sensitive.

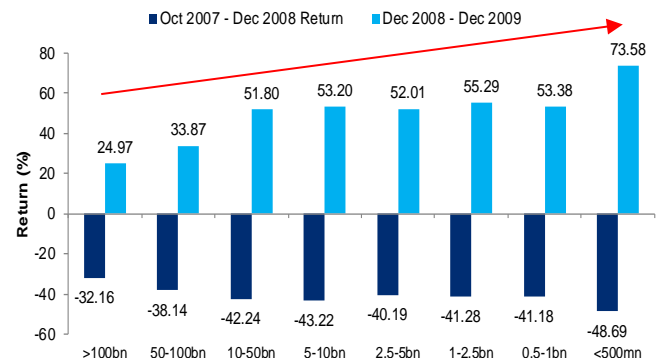
The Covid collapse has been particularly harsh to SMID compared to past downturns, with US SMID shares trailing the S&P 500 in the year-to-date by 13%. As **Figure 6** shows, market cap has been the single largest factor explaining returns in US equities this year. As **Figure 7** shows, SMID also underperformed during the Global Financial Crisis, but not to the same severe extent as in 2020.

Figure 6. Year-To-Date US Equity Performance By Market Capitalization



Source: Bloomberg as of May 1, 2020

Figure 7. Pre- and Post Global Financial Crisis Returns By Market Capitalization



Source: Bloomberg as of May 1, 2020

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Asian and Latin American Emerging Market Shares

Asia and Latam represent a barbell of lower and higher risk opportunities in emerging markets. We've made room for these equity overweights in our asset allocation by underweighting shares in Europe, the Middle East and Africa for reasons we discuss in our [April Quadrant](#).

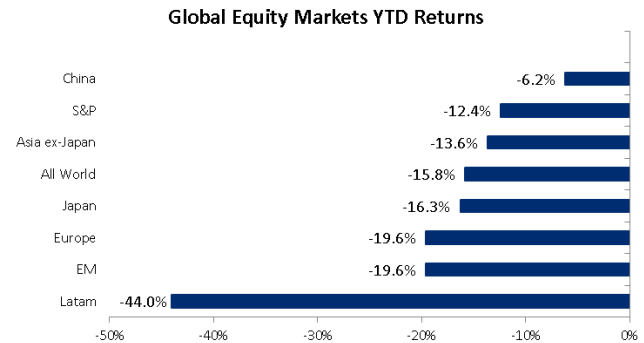
Asia is an "unstoppable trend", a region that presents a durable, long-term growth opportunity, with relatively stronger companies and national balance sheets. As a consequence, these shares have fallen less in 2020, particularly in China where the collapse and recovery from Covid-19 has been first. Nonetheless, China equities are still depressed by the trade war of 2018-2019 and only regained their footing prior to the COVID hit. Some other Asian markets have weakened more than China's and their valuations imply even stronger future returns (**Figure 8**).

Latin America's equities are the poorest performing in the world (**Figure 9**). Here, weaker national balance sheets and poorer responses to the pandemic trail Asia. However, LATAM valuations are now deeply depressed. Shares are valued near 2008 crisis lows while currencies, adjusted for inflation, have fallen to mid-1990s levels. Given Mexico's strategic importance to the US economy and given Brazil's recovery potential, current valuations present compelling intermediate term investment opportunities.

Figure 8. Asia Equity Valuations Mostly Depressed

	Current Forward PE	PE % Rank over 15 years	Implied 12m returns
Indonesia	12.1	12%	36%
Philippines	11.9	3%	30%
India	15.1	20%	24%
Hong Kong	15.1	22%	18%
Singapore	11.7	6%	15%
China	12.5	58%	11%
Japan	13.0	13%	9%
Malaysia	15.6	40%	8%
Asia ex-Japan	13.1	59%	6%
Thailand	14.8	68%	6%
Taiwan	16.4	96%	-8%

Source: Bloomberg and Citi Private Bank OCIS, as of Apr 10, 2020

Figure 9. Latam Equity Worst YTD Performer in USD

Source: Bloomberg as of May 1, 2020

We use MSCI indexes for each country and sector and rank forward price to earnings (PE) over the available 15-yr history. We then use those historical rankings relative to the Current Forward PE to gauge what 12 months forward returns might be. All forecasts are expressions of opinion and are subject to change without notice and are not intended to be a guarantee of future events. Past performance is no guarantee of future results. Real Results may vary.

Municipal Bonds for US Taxpayers

At the lower end of the risk spectrum, we continue to favor intermediate duration US Treasuries among the world's government bond markets (**Figure 10**). That said, for US-taxed investors, municipal bonds have seen a significant rebound in market liquidity and functioning, but not a full restoration. The value presented by "munis" relative to US Treasuries is compelling (**Figure 11**). The Federal Reserve has begun supporting municipal borrowers directly in an unprecedented way. However, Senate Majority Leader Mitch McConnell set the market back with comments suggesting states use "bankruptcy" channels to deal with fiscal imbalances due to the pandemic. We believe state and local governments will not only get added Federal support, but their own taxing and spending authority would be used to repay debts long before default became a serious threat.

Figure 10. US Yield Premium to Foreign Bonds

Source: Bloomberg Barclays Indices as of May 1, 2020

Figure 11. US Muni and Treasury TEY yields

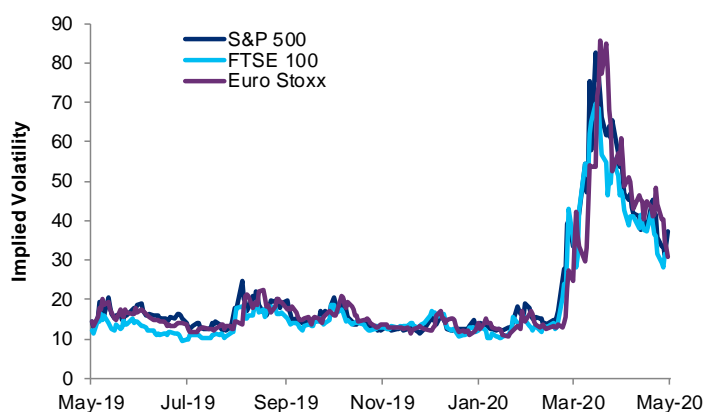
Source: Bloomberg as of May 1, 2020. Note: (TEY) Tax equivalent yield uses Federal tax rate, Affordable Care Act (ACA) and average state i tax rate, for US Treasury it uses average state tax rate.

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Structures that Monetize High Levels of Expected Volatility

While we have undoubtedly observed normalization in equity market volatility, the comparatively high VIX (currently at ~37) is still 65% higher than its 2019 average. **Figure 12** below, showing 12 month implied volatility, helps provide some perspective across major equities markets.

Figure 12: Implied volatility across equity markets



Source: Bloomberg as of May 1, 2020. Indices are unmanaged. An investor cannot invest directly in an index. For illustrative purposes only. Past performance is no guarantee of future results. Real Results may vary.

We believe that slightly longer dated equity volatility is worth harnessing. Qualified investors may consider extending the duration of your dollar denominated investments in developed markets to capture the performance of the markets during the recovery. Capital markets strategies may be a way to enter this market. This extended duration provides ample opportunity for meaningful progress with a medical solution in terms of vaccines, testing and social distancing etiquette. And, of course, economic recovery.

In a deeply depressed interest rate environment, qualified investors may want to consider structured notes for some portion of their combined fixed income and equity allocation, given how they can harness volatility and generate compelling yields.

When to Add To Portfolios: Getting Fully Invested

Over the past five weeks, with lots of cash in their pockets, investors have asked if this is the time to invest. Embedded in their question were emotions, greed and fear. The greed factor relates to the investor's belief (or their wish) that the markets would again hit the low of March 23rd when the S&P 500 hit 2,192 intraday. If the market hit that low again or even retraced most of the recent rapid gains, investors say they would put money to work. The fear factor is an investor's belief that it would be unwise to invest today. If they buy, investors fear markets will fall to new lows.

Fear not!

- As we have discussed, there are many compelling opportunities in today's market that offer profit opportunities at today's prices.

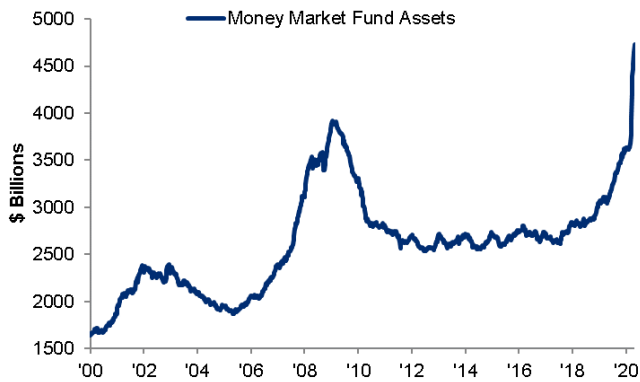
And here is another piece of good news.

- Markets do not go straight up and stay there. We do expect opportunities for investors at lower overall levels than 2830.

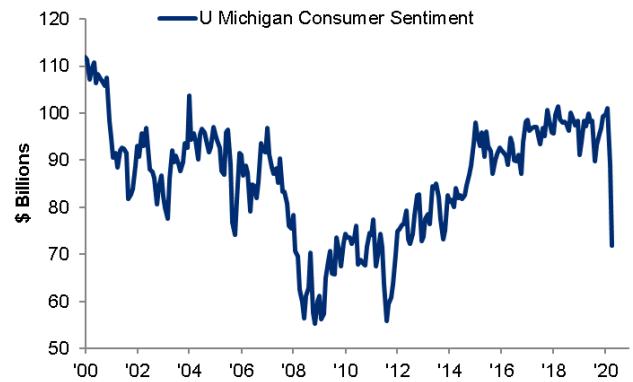
Here is how to think about markets and investing so you can commit to markets even if you have not done so sufficiently.

A Time To Reflect on Investor Behavior

Conflicting investor sentiment (greed/fear) is leading to bad investor outcomes. Let's look at the facts. In the name of "safety", investors have held large cash balances from 2009 to now. Today, there is more cash in our client accounts than ever before. More broadly, global investors liquidated assets and added cash in late February and early March 2020. They did this for "good reason" – swooning confidence. Here is what this looks like graphically.

Figure 13. Money Market Fund Assets

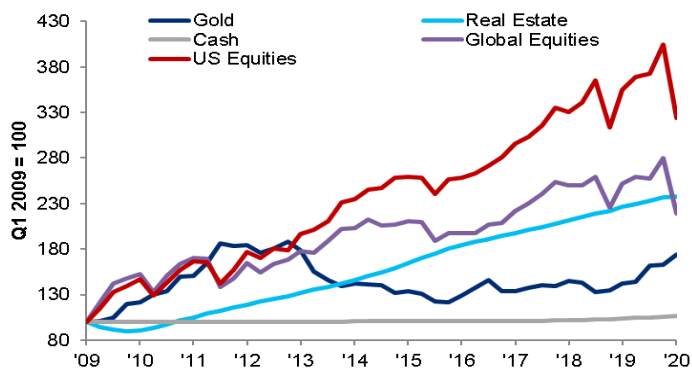
Source: Bloomberg as of May 1, 2020

Figure 14. US Consumer Confidence

Source: Bloomberg as of May 1, 2020.

The COVID-19 pandemic has caused economic confidence to fall very rapidly, though not to the lows of 2009. As a result, investor confidence in equities as a class of investment has fallen, too. (Real estate is the only asset class where sentiment improved over the past eight years.)

Looking at the performance of global and US equities, versus real estate, gold and cash from 2009 and 2012 to now, we can see that what individuals feel about the markets is very often wrong. Investor beliefs and the results achieved did not coincide.

Figure 15. Returns since 2009

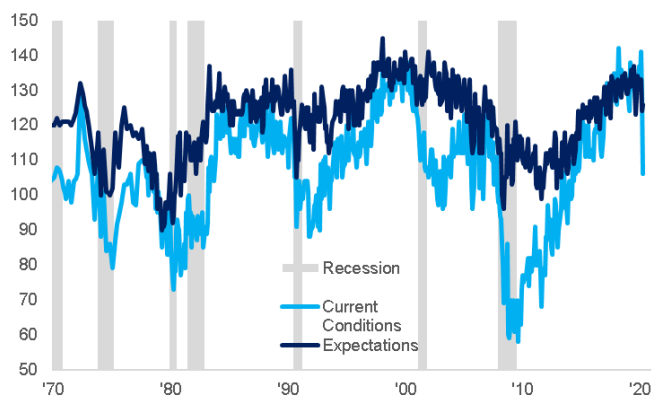
Source: Bloomberg as of May 1, 2020. Note: National Council of Real Estate Investment Fiduciaries Property Index (Real Estate), S&P 500 (US equities), MSCI World (Global equities). Indices are unmanaged. An investor cannot invest directly in an index. For illustrative purposes only. Past performance is no guarantee of future results. Real Results may vary.

Investing After a “Short, Sharp Shock”

As markets have rallied in April 2020, evidence is building that investors view the Covid-19 collapse as a “short, sharp, shock.” This fits the pattern of most “exogenous economic shocks” such as the 2011 Japanese Tsunami/Nuclear disaster or the 2010, or the SARS epidemic centered in China in 2003. The present quarter is most likely the very lowest point of a fast moving recession, with a resumption of growth just beyond. But owing to the unique aspects of the current crisis (see CIO Strategy Bulletins [A Look Ahead: News Moving Markets](#) and [The COVID Tug-of-War: Understanding Market Behavior and Future Risks](#), the path to a full recovery will not be “V” shaped, unlike the majority of economic recoveries.

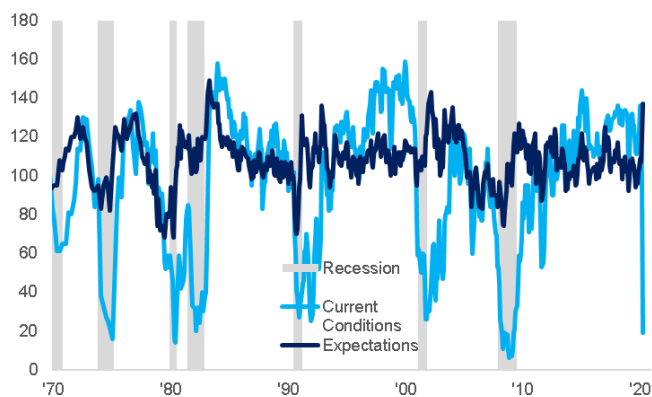
Nonetheless, as **Figure 16** shows, US consumer expectations have indeed stayed more robust than their assessment of current economic conditions. The same is true of businesses worldwide. **Figure 17** shows firms reporting a slump in current business, but expecting recovery. (The dark blue lines are “expectations”.)

Figure 16. US consumer conditions & expectations



Source: Bloomberg as of May 1, 2020

Figure 17. US business conditions & expectations



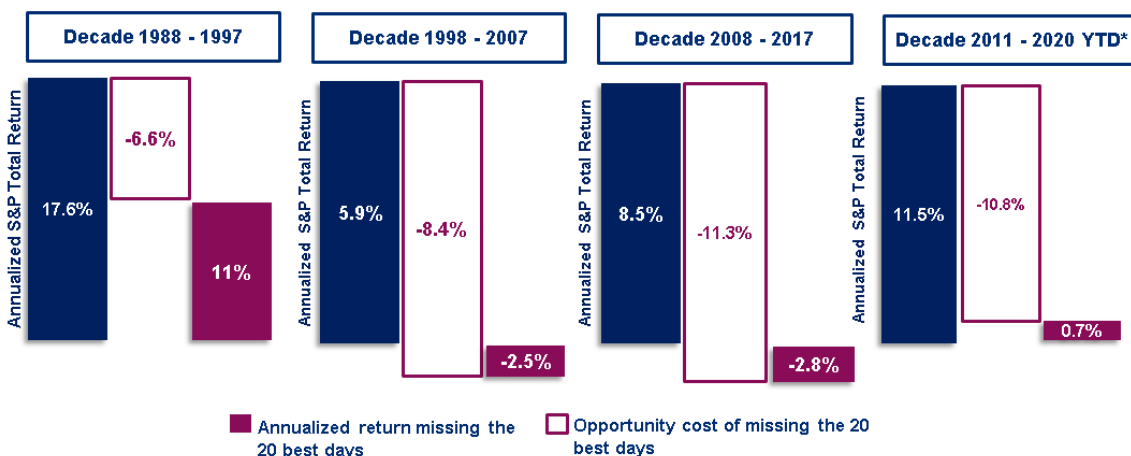
Source: Bloomberg as of May 1, 2020.

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Think Like An Asset Manager

We have made the case that market timing is a bad idea. In fact, it is a core part of Citi Private Bank's Investment Philosophy. First, there is no evidence that any individual investor can be a good market timer. Second, the rise of quantitative strategies that use high frequency trading to capture pennies in split second arbitrage transactions has eliminated any meaningful data arbitrage opportunities. And lastly, missing "very big days" that often follow "very bad days" kills any chance of achieving even market averages. Over four discrete periods, investors who missed only the 20 top days out of a decade have done very poorly.

Figure 18: Annualized returns by decade



Source: Bloomberg, CPB OCIS. The historical performance shown is based on historical index performance and is gross of any commissions, expense ratios, margin costs, or fees that would reduce the return. For illustrative purposes only. Past performance is no guarantee of future returns. Real results may vary.

When we look ahead, how should one put money to work? Is there one day that's better than the rest? We have written that looking at historical data, when US equities markets are 20% or more down from peaks, adding additional capital is wise and, over the ensuing five years, adds 1% per annum to total returns (see Figures 19 and 20). Well, markets in the US, Europe and China are no longer down 20% from their peak and we are still living at a time of pandemic. So why should one be invested?

Figure 19. S&P 500 Returns Following 20% Declines

Date Bear Market Reached	Fwd 12m Return	Fwd 24m Return
10/21/1957	31%	46%
5/28/1962	26%	45%
8/29/1966	24%	33%
1/28/1970	9%	20%
11/27/1973	-27%	-5%
2/22/1982	31%	39%
10/19/1987	23%	60%
10/11/1990	29%	41%
3/12/2001	-1%	-29%
7/7/2008	-28%	-14%
12/24/2018	40%	
Average	14%	24%
Median	24%	36%
Min	-28%	-29%
Max	40%	60%

Source: Bloomberg as of May 1, 2020

Figure 20. Impact on 5-Year Returns from Buying/Selling after 20% S&P 500 Decline



Source: Bloomberg as of May 1, 2020.

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Let's first start with two facts on what asset managers think. Barron's does a "Big Money Poll" twice a year and while it is not scientific, it does capture asset manager sentiment very well. First, here is how the 107 managers look at current stock valuations.

More than half of money managers think that market s are undervalued vs. 20% that think it is overvalued. That simplistic view masks an important market reality. Currently, there is a massive dispersion of valuation across securities. As we demonstrated in ["When to Add To Portfolios"](#), Citi Private Bank believes the identification of undervalued companies, industries and countries represents the strongest investment opportunity today. And many professional investors agree. Their future confidence is compelling. Only 4% of professional managers are bearish for 2021.

Because markets are forward looking, their recent price action, while "premature" relative to devastating global unemployment, reflects inherent confidence that the world economy will overcome this exogenous shock.

Being Invested

In order to maximize your profits over time, there are three critical steps.

The first is to establish a "Core Portfolio", one that will be maintained over time, through all markets, thick and thin. This portfolio will benefit from rebalancing and asset allocation changes over time. Depending on your risk tolerance, this should be plus/minus 80% of your investment assets. This can (and should) include illiquid investments.

The second is to establish an Opportunistic Portfolio, one that you will use to invest in shorter-term, speculative or dislocated opportunities. This would be the capital one would invest in March 2020, in oil shares when WTI goes negative, in Brazil when shares fall by more than 50% and such – all current and recent events.

And lastly, to do the above, you have to have a cash buffer that allows you to maintain your Core and Opportunistic portfolios. The cash buffer should be separate from the Core and Opportunistic portfolios, but typically 15% or less of their total. However, we recognize that this amount is often not calculated rationally, but rather is a "sleep at night" number.

Getting Invested

It is our view that there are wise investments to buy today. And, as noted in our introduction, there are good reasons why markets may move lower over the next months:

- Greater COVID deaths leading to uneven economic recovery in the US and elsewhere;
- Potential political issues, including greater trade frictions with China that impede a full economic recovery; and
- Any change in the focus of policy makers to do "whatever it takes" to support the economy in the face of the COVID crisis

To be clear, we do not expect a lower close this year for the S&P 500 than March's 2,237. That's because we have seen key US technology leaders perform well in their Q1 earnings season and their fundamental performance should continue to diverge positively from small and medium-sized businesses.

We **do** expect that typical market volatility, surprises by political leaders and the trajectory of the pandemic itself will allow a lower entry point than today's price. It might be 2%, 10% or even 15% lower. Regardless of that "entry point", your job is to "be fully invested" so that your professional Core and Opportunistic portfolios can help increase your wealth over time. That's when you become your own best advisor and investor.

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