Private Bank

CIO Strategy Bulletin

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A Look Ahead: News Moving Markets

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Facts, Extrapolations, Opinions and Consequences: A Look Forward From Recent Events

On an April 20th podcast, Marc Lipsitch, Professor of Epidemiology at Harvard, noted that in his field there are (a) facts, (b) informed extrapolations from comparable events (pandemics) and (c) opinions/speculation. We think the same is true for markets and economic forecasting.

An Underwhelming Earnings Season is Underway

So, let's begin with our earnings forecasts and actual earnings for Q1 2020. As you can see below **(Figure 1)**, we expect a major reduction in earnings in 2020, followed by a partial recovery in 2021. On the right you can see the initial report of Q1 earnings **(Figure 2)**. With about 22% of companies reporting, we see flat YoY revenues and earnings down 22%, more than 9% below estimates. As we wrote in The COVID Tug-of War, market leadership has depended on a handful of mostly technology shares. The most sensitive of those leaders to current conditions are Google and Facebook who are dependent on digital advertising revenues for growth and profitability. After Netflix reported blowout number last week following a strong rally, its share price slid modestly. This means that expectations for it and other leaders are quite high.

Figure 1: US Large Cap Corporate Profit Assumptions

	S&P EPS	Growth Rate
2018	163	23.6
2019	165	1.0
2020	107	-35.0
2021	135	26.2
2022	162	20.0

Source: Citi Private Bank (OCIS), Haver Analytics as of April 24, 2020.

Figure 2: Initial Q1 earnings for US companies

	# Rep |	Mkt Cap Reported		Sales ($B)		Earnings ($B)	
Sector	Total	% Sector	% SPX	% Surprise	% Growth	% Surprise	% Growth
Real Est.	2 | 31	10%	0%	10.7%	20.1%	3.8%	19.8%
Info Tech	11 | 71	10%	2%	2.7%	7.0%	7.4%	17.5%
Utilities	2 | 28	17%	1%	(4.8%)	5.2%	5.8%	11.5%
Cons Staples	5 | 33	32%	3%	1.4%	3.7%	6.7%	9.7%
Materials	2 | 28	10%	0%	0.0%	(16.1%)	(2.6%)	6.2%
Health Care	10 | 60	36%	5%	2.4%	5.4%	10.3%	5.1%
Comm Serv.	4 | 26	17%	3%	(2.3%)	(2.0%)	4.2%	3.1%
Energy	5 | 27	12%	0%	(3.3%)	(5.6%)	(5.0%)	(2.5%)
Cons Disc	6 | 63	4%	0%	1.0%	(10.6%)	21.9%	(2.7%)
Industrials	17 | 72	24%	2%	1.0%	(4.4%)	9.5%	(16.2%)
Financials	37 | 66	57%	6%	(0.3%)	(0.4%)	(34.7%)	(51.4%)
SPX	101 | 505		22%	0.3%	0.5%	(9.2%)	(22.0%)

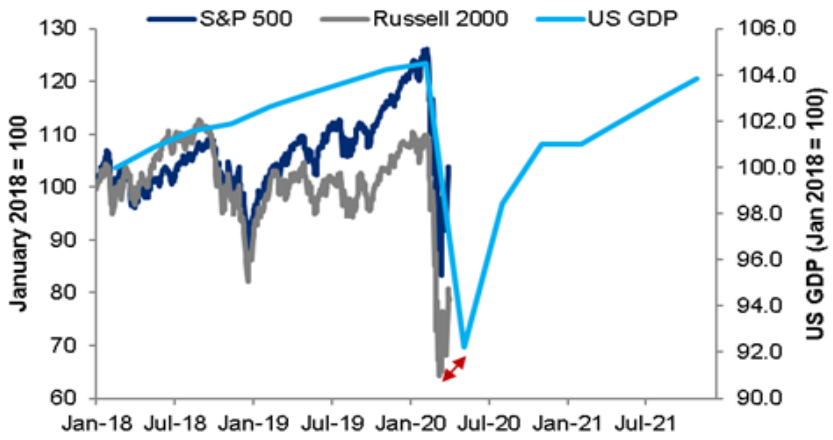
Source: Citi Equity Strategy, Bloomberg as of April 24, 2020.

Note: Surprise means actual vs consensus expectations. All forecasts are expressions of opinion and are subject to change without notice and are not intended to be guarantees of future events.

Small and Mid-Cap Stocks: An Alpha Opportunity

Unlike the Great Financial Crisis where stocks moved in tandem during the initial recovery in markets, in 2020 there is a large gap between large cap stocks, the market leaders, and the small and mid-cap stocks **(Figure 3)**. We think this is due to the value placed by investors on strong balance sheets in highly uncertain times. Nonetheless, such a valuation discrepancy highlights an area that can add "alpha" to portfolios in the future. Expect large cap gains to move in line with market averages, but the small and mid-cap (SMID) sector has a "catch-up" catalyst, in our view, because too many of them have been beaten down and will recover when the world's economies turn back on. The historical Global financial crisis (GFC) data suggests that the greater likelihood is that stocks will rebound in line with their declines **(Figure 4)**. You can see below that size matters in the COVID crisis. In 2020, returns have been even more bifurcated by size than the GFC **(Figure 5)**.

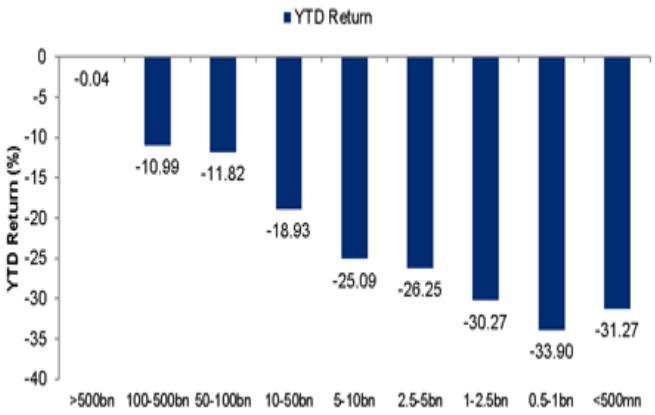
Figure 3: Real US GDP 2018-2021 Estimate vs S&P 500 and Russell 2000 Indexed



Source: Haver Analytics, Bloomberg as of April 24, 2020. All forecasts are expressions of opinion and are subject to change without notice and are not intended to be guarantees of future events. Past performance is no guarantee of future results. Real results may vary.

Figure 4: US equity performance by market cap, during the global financial crisis

Figure 5: US equity performance by market cap, year-to-date



Source: Haver Analytics, Bloomberg as of April 24, 2020. Source: Haver Analytics, Bloomberg as of April 24, 2020.
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Munis: Will congress let states go bankrupt?

During a Fox News interview on Wednesday, April 22, Senate Majority Leader Mitch McConnell stated he has no plans to pass legislation to provide additional funding to states and local governments who he said are trying to "take advantage" of the coronavirus to get help with their expanding deficits. He followed by saying he favored "allowing states to use the bankruptcy route." His comments have drawn sharp responses from state and local officials, as well as concern from some municipal bond investors.

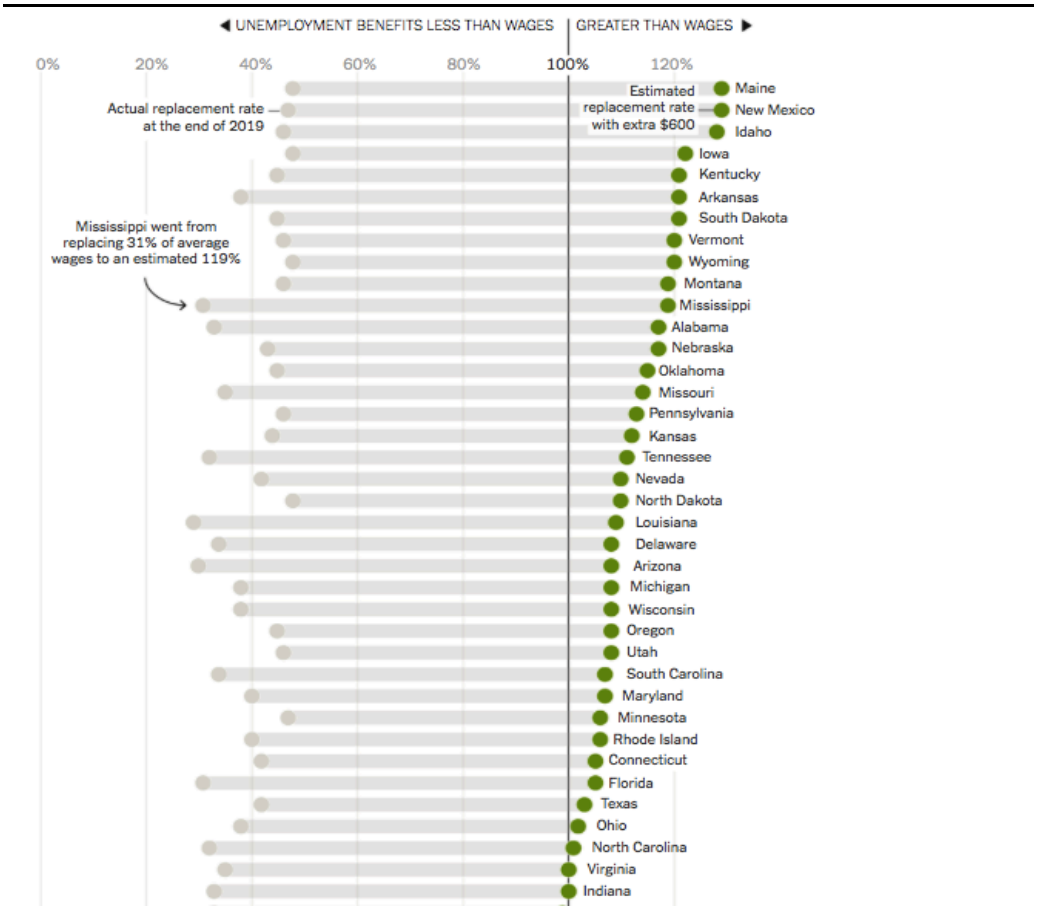
Under current law, states cannot declare bankruptcy. We think this is a clear case of political jawboning during an election year. In response to McConnell's comments, House Speaker Nancy Pelosi had mentioned that a "major package" of aid for state and local government would be in the next stimulus legislation considered by Congress. We also believe that the likelihood of legislation passing to modify bankruptcy laws for municipalities is infinitesimal.

In our view, there is no reason to reduce exposures to US municipal bonds. If anything, we would take advantage of any volatility this news creates. Valuations in municipals remain relatively cheap following the sharp sell-off global markets faced last month. Yield ratios (versus US Treasuries) are a minimum of 150% across the entire curve with greatest value found in maturities 5-years and shorter. While states will likely remain safe, the possibility for smaller, weaker localities to suffer significant credit deterioration is real. That is why we have consistently encouraged clients to build portfolios with a high quality focus and to use specialist managers.

The CARES Act: Pay Me Now and Pay Me Later

When the Congress passed the CARE act, they did a lot for business and individuals. For everyone making under $75,000, there were one-time $1200 checks (with amounts phased out above that income level). In addition, for those who became unemployed, there were additional Federal unemployment benefits that would more than double most State benefits in most cases. It turns out that in half of all States, for many of the 26 million who are filing claims, going back to work will be disadvantageous. They will make more by staying unemployed.

Figure 6: Unemployment benefits as % of actual wages, by State



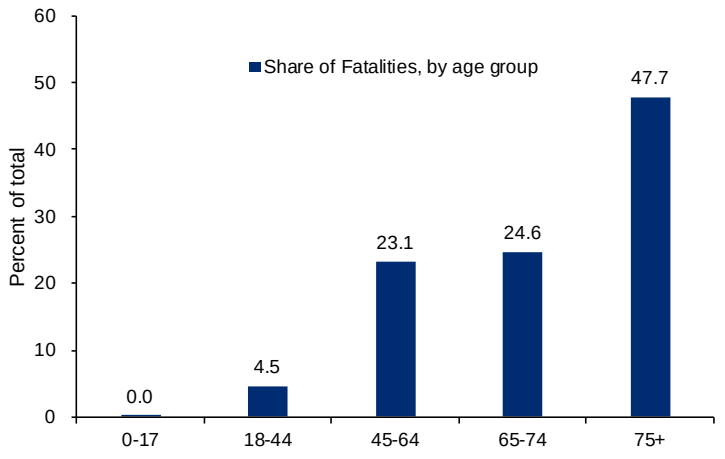
Source: New York Times, Department of Labor Data as of April 25, 2020. All forecasts are expressions of opinion and are subject to change without notice and are not intended to be guarantees of future events.

Now, this is unquestionably positive for the economy. However, it is also creating some perverse outcomes. Many of the unemployed are seeking deferments of mortgage, rent and credit card payments. Arguably, those receiving such generous unemployment should not have been eligible for the deferments until the expiration of the federal program. And many of the unemployment benefit recipients are not taking jobs. Companies may see that employees refuse to come back to work as they get paid more in unemployment insurance than their previous wages, plus an added risk of exposure to the virus. It is possible that labor supply and demand will have an odd equilibrium here.

And What of Those 50/55 and Over?

There is one population that is most impacted by the virus. They need to "stay safe" and limit their exposure to the virus until such time as a vaccine is developed more than other. These are people over 55 and those with pre-existing conditions. As noted in **Figure 7**, COVID-19 is more dangerous and more fatal for people who are older, especially those with certain medical issues.

Figure 7: Fatality distribution by age



Source: Worldometer as of April 26, 2020.
Note: this is a sample taken from New York City data.

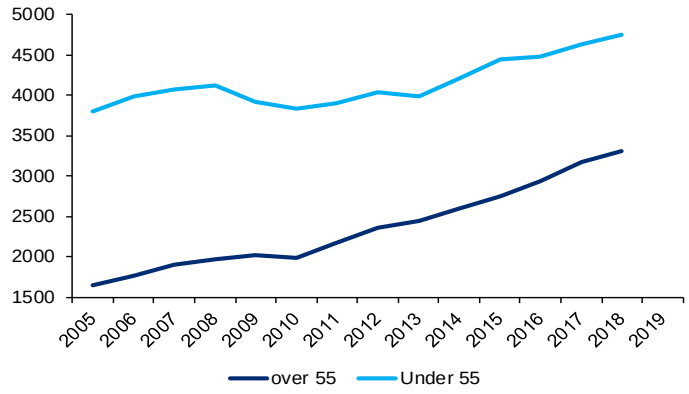
In prior recessions, no one demographic group was more at risk than another. So, let's consider the value of people over 50 in the US as a group to the economy and the recovery to come.

Those over 50 (35% of US population):

- Own more than half of small business in the US;
- Their employees fill 88.6 million jobs which is the equivalent of 44% of total employment;
- Spent $7.6 trillion on goods and services or 56% of all spending; and
- Since the GFC, consumer spending among people 50+ has increased $726B, while spending among people under age 50 has dropped by $238B.
  (Data for four bullets above is taken from the AARP Longevity Report, 2018)

And looking at the Bureau of Labor Statistics data from 2005-18 below, the rate of spending by those 55 and over is growing much more quickly that for those below 55.

Figure 8: Household Spending in Billions of US dollars



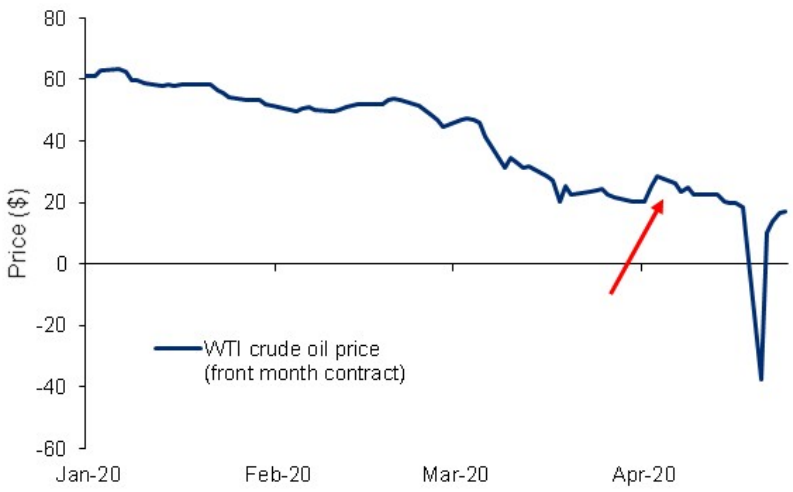
Source: Haver Analytics as of April 25, 2020

As we watch economies reopen, the health of small businesses and the willingness of those 50 (or 55) and over to spend, we believe, will be major factors in the speed of the recover in 2021-2022.

You Won't Be Paid to Drive

Just a few weeks ago, amidst a bitter oil price war conflict between Russia and Saudi Arabia, President Trump intervened. Oil prices had dropped from $22.60 to $15.48 overnight on March 27. American oil CEOs had headed to DC on April 3rd to express their dismay. On Easter Sunday, Saudi Energy Minister Prince Abdulaziz bin Salman and the heads of OPEC+ agreed to cut production 9.7 million barrels per day to resolve their disputes and drive prices higher. Though an agreement was reached, the price barely moved the following week **(see Figure 9)**.

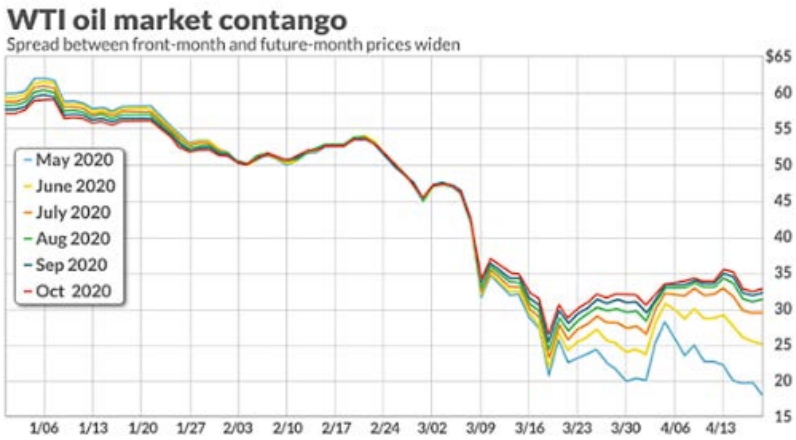
Figure 9: Crude oil price, front month contract



Source: Haver Analytics as of April 24, 2020. Note: WTI is West Texas Intermediate.

On April 20, the oil market provided yet another signal about the near term depth of the COVID recession. Collapsing prices signaled the impact of huge oversupply. A lack of available storage made it nearly impossible to find buyers physical barrels. Futures prices for May delivery went deeply negative (-$38/bbl) for the first time, emblematic of financial dysfunction in commodities markets. In certain grade and delivery locations, storage had become so scarce and expensive that people literally paid to have the oil taken away **(Figure 10)**.

Figure 10: The Collapsing Price of Near Term Oil for Delivery



Source: RBN Energy as April 24, 2020. All forecasts are expressions of opinion and are subject to change without notice and are not intended to be guarantees of future events.

Awash in oil to due to a collapse in demand for gasoline and jet fuel, the near term outlook for oil pricing is poor. Prices will reflect continued distress on record declines demand for transportation fuels. Yet we expect that cuts in production (and likely access to storage in America's strategic petroleum reserve storage) will begin to relieve the overhang. As economies turn back on, demand will rise. Finally, Citi Research expects a sharp reversal higher in crude oil pricing before 2020 ends, though only back to a lower than average level of $40.

Bonds and Stocks in Energy Land

We advise caution and selectivity when investing in energy stocks and bonds (see US Crude Oil Collapses on Lack of Storage). Even high quality issuers with good balance sheets may face credit downgrades due to committed capital expenditures and poor cash flow. While spreads have come in from the wides of March due to Fed intervention, the energy-related default rate was 5.9% globally as of February 2020; 50% of all high yield energy issuers trade at 70% or less of par. Thus, we can expect more distress, defaults and price deterioration for many companies, including in the private equity space.

This past Thursday, Blackstone's credit arm reported a negative 30.3% net composite return on distressed assets for Q1 2020. Losses were driven, in part, by their fund's exposure to energy that remains a deeply troubled sector, according to the company.

In the equity markets, energy has been the worst performing sector. Thus, rebounds are likely when energy prices firm, rig counts stay low and winners begin to consolidate their competitive advantages. We advise not to "buy dividends" in this sector even for companies that have maintained them in the past. These conditions put most dividends at severe risk for reduction or elimination.

We also advise caution when considering the debt of Middle East and smaller Latin America emerging markets countries that are heavily dependent on energy. This includes the debt of companies that are backed by these governments.

While the stronger energy companies globally will eventually bounce-back, and potentially deliver strong returns in that rally, the broader sector seems likely to stay far below the pre-Covid level. The already depressed sector's valuations will not return to prior highs as transportation fuel demand will remain low until there is a Covid vaccine. The sector already suffered from improving fundamentals for alternative energy, such as solar-powered batteries, reducing demand pre-COVID by more than 1% per year, as we noted in Outlook 2020.

Who benefits? Energy consumers in Asia and other importing countries for one; the beneficiaries will have lower costs and capital balances. Another winner are logistics and e-commerce that together are displacing traditional retailers even faster as we face the impact of COVID-19. In this case, we see the shift to e-commerce and delivery of everything as a permanent change (and benefit) associated with the health crisis.