Private Bank

CIO Strategy Bulletin

April 10, 2021

How to Profit from COVID-Driven Market Inefficiencies

David Bailin, Chief Investment Officer
Steven Wieting, Chief Investment Strategist and Chief Economist
Malcolm Spittler, Global Investment Strategy
Jorge Amato, Head – Latin America Investment Strategy
Jeffrey Sacks, – Head, EMEA Investment Strategy
Ken Peng, – Head Asia Investment Strategy
Shan Gnanendran, – EMEA Investment Strategy
Maya Issa - Global Investment Strategy

Summary

- **There is only one COVID pandemic. Yet, world markets price different scenarios for the recovery from the virus across regions. This leaves opportunity for investors who can look beyond today's discordant news.**
- **We believe that abundant vaccines and near-term reopening efforts will overcome economic divergence. In short, underperforming equity markets should catch up.**
- **Forward-looking investors should be skeptical of today's assumptions, including "US COVID exceptionalism, which presumes that US equity outperformance will continue. We are bullish on the US growth outlook, but believe this is now significantly embedded in equity valuations.**
- **A peak in US (and eventually European) vaccinations will send doses to the emerging world.**
- **The Eurozone and Brazil are likely beneficiaries of a full COVID recovery, though markets doubt this. Other parts of Latin America and North Asia could lag for longer as "COVID's losers", but even these will close the gap as 2022 unfolds.**

Fear, Hope, Inefficiency and Opportunity

April marks the anniversary of the 2020 global economic shutdown, the most severe dislocation **ever** in the world economy. The low in global mobility occurred about a year ago (see figure 1), when people were panicked and home bound. That period also marked a global low in financial market confidence in the future. World equity markets bottomed in late March 2020 after a 32% drop. Approximately half a billion people globally were unable to work (at least briefly) during the shutdown. A record 21 million US jobs were lost. It was a dark and uncertain time.

As we look at the world one year later, we see a remarkable set of events unfolding. Effective vaccines for COVID have been developed and are being distributed globally, though unequally. This was the fastest development of a vaccine in human history. According to epidemiologists we consult with, incidents of severe or fatal reactions to those vaccines has been the lowest on record. Equity markets in the US and around the world have rebounded markedly, though unevenly (see figure 2).

In our view, looking at equity markets around the world, one would think there is more than one pandemic. US equity markets have risen 30% from the end of 2019, the ***pre-COVID*** period. Chinese markets have risen 29% from the end of 2019, as well. Yet, looking at **all** other markets, there is a large performance divergence between the US and China and the "rest of the world". Gains elsewhere have been half as much overall. Some regional markets show net losses.

Figure 1: Global Mobility (Discretionary Activity)

Note: GDP weighted retail and recreation visits. Source: Haver as of April 9, 2021.

Figure 2: US and Non-US Equity Total Returns

Source: Bloomberg as of April 9, 2021. Note: Indices used are MSCI US Index for 'US Equities' and MSCI All Country World ex-US for 'Non-US Equities'.
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.

Economic Expectations and Realities

The simplest explanation for the US rebound is the expectation of a policy-driven economic boom and a rapid, vaccine-enabled recovery from COVID. As we discussed last week, we believe investors are likely to get that economic boom. Unlike our relatively more cautious posture during 2018-2019, we now invest with a more positive assessment of US economic risk. We see the probability of a coming US recession as very low given that one has just concluded.

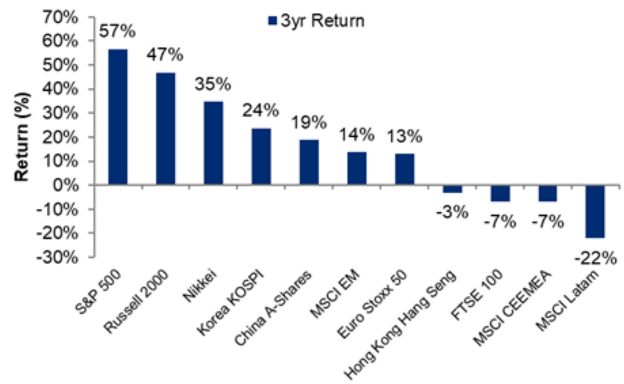
The simplest explanation for the rebound in China is its early, intensive management of the health care crisis. This allowed for a less profound macro stimulus than in other economies. China has recovered more quickly than any other large economy and is likely to be an early beneficiary of the global growth still to come. Though we maintain a "neutral" position on China (neither under- nor overweight), we see a positive outlook for its economy and a very low chance for a near term contraction or crisis.

Market Expectations and Realities

If one looks at recent equity market activity (March 1, 2021 to April 9, 2021) there has been an uptick in European and US performance and a decline in Chinese and HK shares. Looking back over the past three years, however, one sees a very different picture, even though it incorporates the entire COVID period to date. US shares – both large cap and small - have sharply outperformed. Thus, we have to ask whether "US Exceptionalism" in markets is likely to continue and, if so, to what degree?

Figure 3: Equity Returns by Region and Type Since March 1, 2021

Figure 4: Equity Returns by Region and Type Latest 3 Years (since April 7, 2018)



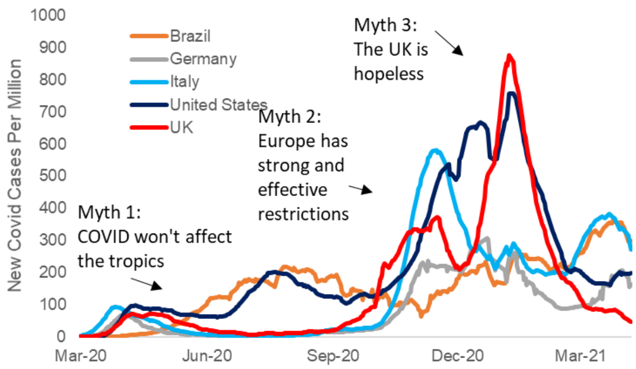
Source: Bloomberg as of April 9, 2021 Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Past performance is no guarantee of future results. Real results may vary.

Proof that Expectations and Realities are Disassociated

False perceptions have dominated the news and markets during the COVID period, perhaps more so due to the tendency that people project what is happening "right now" into the future. The perceptions of the moment as regards the progression of the disease is driven by "today's news." In time, "the news" is often inaccurate, especially as it relates to a new, novel virus. Let us, therefore, recall the absurdity of some expectations from this past year:

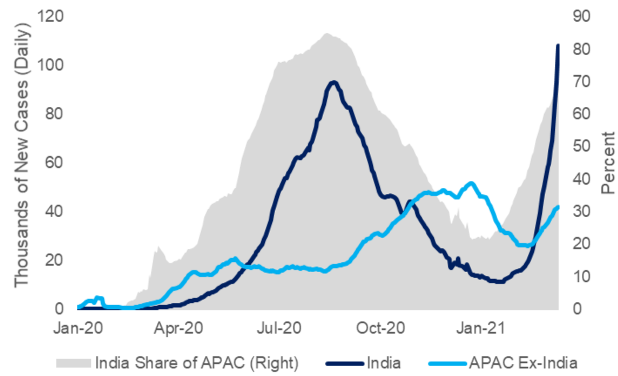
- **In the winter 2020, investors assumed COVID wouldn't impact warm or temperate climates**. Brazil and Mexico's cases didn't surge until the middle of 2020. Now, perceptions are strong that COVID is intractable in Brazil, in particular. Though many other equatorial countries report inconsistent data, the correlation between warm weather and COVID activity is uncertain.
- **Europe would be unusually effective in stemming COVID after the surge of 1Q 2020.** After the extreme and costly lockdown steps in the late winter and spring, especially in Italy, investors believed social distancing and lasting public precaution would leave the US in the worst position among developed economies. The marked summer rise of in infections in Europe then dashed this perception (see figure 5).
- **In late 2020, most observers thought the UK would lag hopelessly behind Europe and the US in addressing the COVID crisis.** At that moment, the UK showed the fastest rise in COVID cases and imposed severe lockdowns. That perception has now been turned completely on its head as vaccinations in Great Britain surged ahead (see figure 7).
- **At the start of 2021, it appeared that India had defeated COVID.** A sharp lull in cases, strong domestic production of vaccines and the "achievement of urban herd immunity" supported this inaccurate view. The International Monetary Fund raised forecasts for India's real GDP in 2021 to +12.5% from 8.8% (see figures 6 and 8). Yet, India's cases have subsequently surged to new records. Now, India has announced a QE program and fiscal stimulus while its currency has plunged.

Figure 5: COVID Infections per Million Across Select Countries



Source: Haver as of April 9, 2021.

Figure 6: Total APAC and India COVID Cases



Source: Haver as of April 9, 2021.

Figure 7: Ranking Which Countries Have Vaccinated the Largest Share of their Public: Today and 2-Months Ago

	Today	2- Months Ago
Israel	2 ↑	4
United Kingdom	3 ↑	11
United States	7 ↑	18
Chile	11	14
Spain	27	43
Germany	28	51
France	30	39
Italy	34	48
Canada	35	32
China*	38	62
Brazil	40	64
India	52	75
Japan	55	108
South Africa	55	122

Source: Haver Analytics as of April 10, 2021

Figure 8: International Monetary Fund Forecasts for India

	IMF GDP Growth Forecast for India		
	Forecast as of April, 2020	Forecast as of October, 2020	Forecast as of April, 2021
2021	7.40%	8.8%	12.5%
2022	-	8.0%	6.9%

Source: Haver Analytics as of April 2, 2021

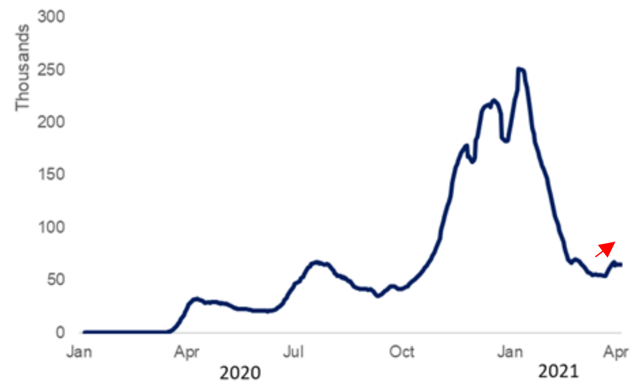
What the COVID Data Suggests

COVID itself has many mysterious elements such as the duration of immunity that today's vaccinations will provide. Its long-term health impact is another puzzle, as is the question as to whether or not new variants might challenge the effectiveness of the current healthcare response. Like every other virus in human history, however, we remain optimistic that humanity can defeat it or, as with the flu, control it adequately. With that said, the actual state of affairs regarding the third (or fourth) wave of the disease is unfolding.

The US has sharply accelerated COVID vaccinations in the past two months. And, correspondingly, the rise in COVID cases in the US of late has trailed behind the new wave across the world (see figures 9-10).

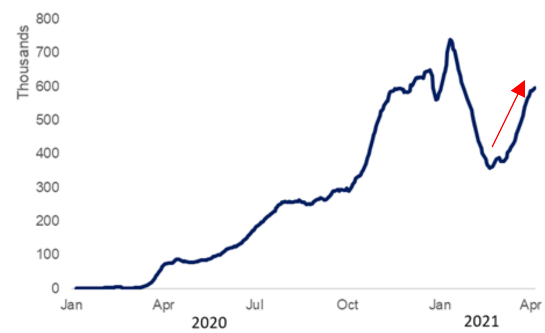
We can see from the data that Europe is also getting its act together. We can also see that even though Chile is doing well in vaccinating, it is also experiencing higher caseloads (see figures 11-12). Thus, what we see is that the anomalies in vaccinations, waves of disease and economic recovery are material. But they are also temporary! For example, we know that as developed markets become more vaccinated, shipments of vaccines will accelerate to other countries that have been less organized in their acquisition and distribution. We also know that when a sufficient population has been vaccinated and/or exposed to the disease, we will see herd immunity levels be reached, leading to marked declines in infections, hospitalizations and deaths from COVID.

Figure 9: US New COVID Infections (smoothed)



Source: Haver as of April 9, 2021.

Figure 10: Global New COVID Infections (smoothed)



Source: Haver as of April 9, 2021.

Figure 11: Share of Population (%) With at Least First Dose of Vaccine

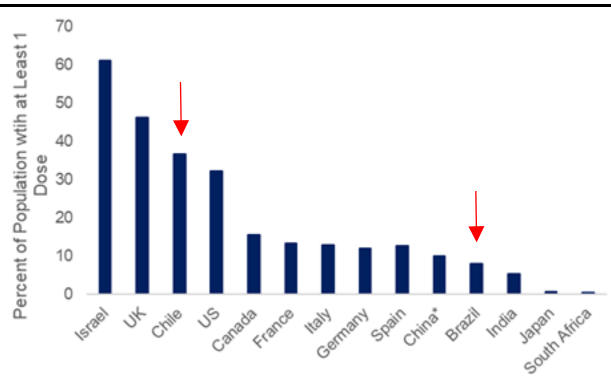
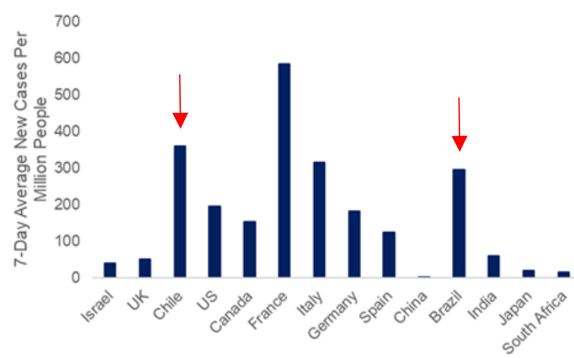


Figure 12: New COVID Cases Per Million (Ranked by Vaccine Rollout in Figure 9)



*Note Chinese data is only available as total vaccine doses per 100. Source: Haver, World Health Organization as of April 9, 2021.

US Exceptionalism?

Just as we can see how wrong expectations can be regarding COVID, it is equally plausible that they are wrong in regards to equity markets. Do relative equity prices make sense in light of the health data? Maybe. We want investors to keep an open mind as to what's possible and what's priced (or not) for the future.

We entitled our Outlook for 2021 "Investing for a Post Covid World" rather than "Investing in a Post COVID World" quite deliberately. The disease itself will eventually come under heel, so forward-looking investors should be skeptical of today's new and strongly-priced assumptions that assume the US will continue to benefit disproportionately from its disappearance (i.e. US Exceptionalism). What do we mean by this?

US markets are enjoying another positive "jolt" to growth expectations from the Biden administration's fiscal expansion plans as we discussed last week. But regardless, we don't expect another 30% equity market drop or another 80% run up to repeat what followed last March's swoon. We believe US fiscal easing will lead the world. And we have correspondingly raised our growth assumptions for the US in line with these views (see figure 13). We also expect interest rates to go higher, perhaps as high as 2.5% for the 10-year once the entire world economy is post-COVID. Thus, our **economic outlook** for the US is bright. That said, though we expect positive US returns, a fair portion of the economic news is "priced in".

Figure 13: Citi Private Bank Growth Assumptions for 2021-2022, %

	2020	2021 (Jan 2021 projection)	2021 (Mar 2021 estimate)	2022	
CHINA	**2.3**	**6.0**	**8.0**	**6.0**	
US	**-3.5**	**3.9**	**6.0**	**3.5**	**Upside potential from fiscal expansion**
GLOBAL	**-4.0**	**4.2**	**5.0**	**4.5**	

Source: OCIS and Factset as of March 28, 2021. All forecasts are expressions of opinion and are subject to change without notice and are not intended to be a guarantee of future events. Indices are unmanaged. Past performance is no guarantee of future results. Real results may vary.

The Bigger Impact Will be From the US to the World

COVID has been a highly potent driver of divergence in international asset market valuations. This is likely because COVID drives important macro policies such as central bank easing actions, government borrowing and fiscal stimulus. As figures 14-15 indicate, currencies such as the Euro and India's Rupee have moved sharply lower against the USD as their COVID infections rose above the US pace. The same is true for Brazil, which significantly explains Latin America's broader exchange rate average lagging behind the rally in commodity prices of late. Yet, these are temporary, not structural, issues. Regional equity markets reflect this poor near term performance.

Defeating COVID for all of humanity in 2022 would be a great reason to rejoice. It would also likely be a driver of "mean reversion" in markets for the assets that were cheap when COVID began. We urge longer-term investors not to be swayed by COVID developments of the moment. As we noted in our latest Quadrant (From Rescue to Rescue, March 19, 2021) we expect the bigger story will be that as US fiscal easing grows, it will strongly "leak out" to boost US imports and foreign economic growth.

Given this data and our view, we see the weak performance of many emerging market equities and their low valuations as buying opportunities (see figure 16). Recent movements in investor positioning in the US dollar suggest widespread bearishness of 2020 has been substantially, if not completely, reversed, supporting the myth of sustained "US exceptionalism." Yet, the near term hopelessness regarding COVID in certain countries in Latin America and Asia is overblown, given the actual and likely future increases in vaccination activity.

Figure 14: Euro Weakened vs USD as Local Infection Rates Rise Beyond US Pace

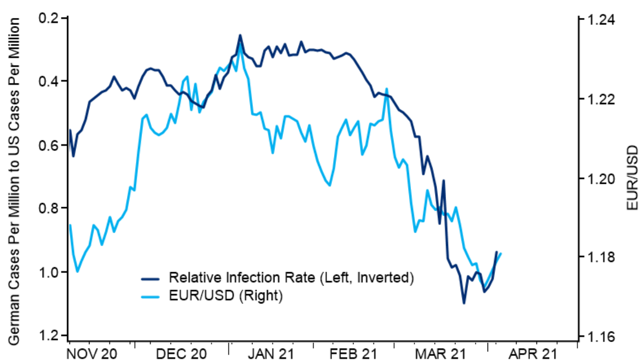
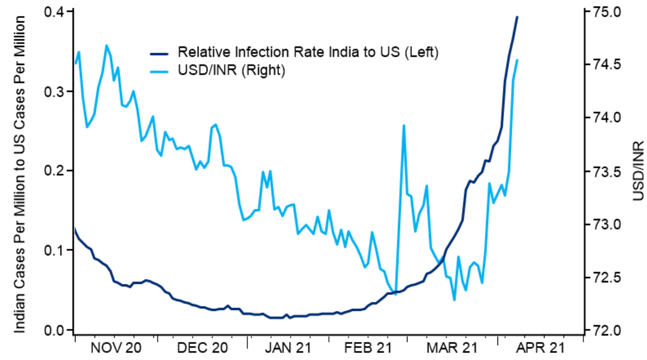


Figure 15: India's Rupee Collapses vs USD as Infection Rate Rises Relative to US Pace



Source: Haver as of April 9, 2021. Past performance is not indicative of future returns.

Figure 16: Emerging Markets Equities Relative to US Equities Vs Real Trade Weighted Dollar Index (reverse scale)

Source: Factset and Haver Analytics as of April 2, 2021 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.

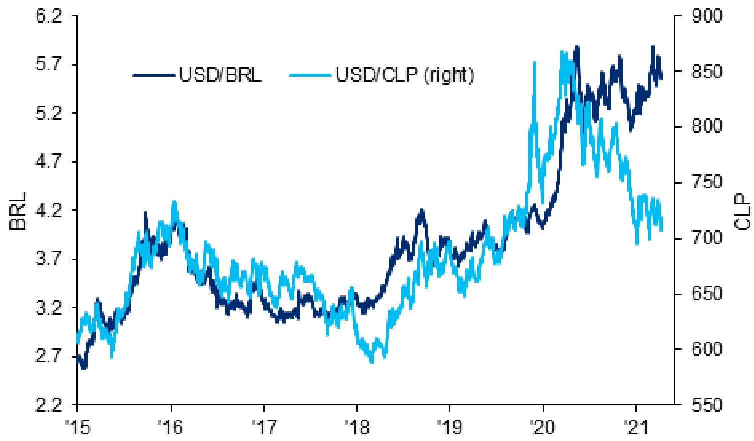
Brazil vs Chile

As noted in figures 11-12 above, data show the Chile has been the most successful Latin American country in vaccinating its public. Yet many may be surprised to see Chile's latest data also shows its per-capita infection rate now *exceeds* Brazil. Let's look at market data.

As figure 17 shows, Brazil's currency has lost about 40% of its nominal value against the US dollar since the start of 2020 while Chile's has gained 6%. Typically, the correlation between Latin America's currencies have generally been quite high apart from periods of extreme political crisis. For example, Brazil and Chile's currencies moved in line with each other even during the period of acute Brazilian political uncertainty with the impeachment of President Dilma Rousseff in August 2016.

On this basis, Brazil, in spite of political uncertainties and economic doubts, looks cheap relative to the US and certainly the Chile. Further, looking at the typical correlation between commodity prices and the value of Latin American currencies, we see the current anomaly indicating better performance ahead for the region (see figures 18-19).

Figure 17: Brazil Real and Chilean Peso vs USD



Source: Haver Analytics as of April 2, 2021. Past performance is not indicative of future returns.

Figure 18: Brazil's Real Collapses vs USD as Local Infection Rates Rise Beyond US Pace

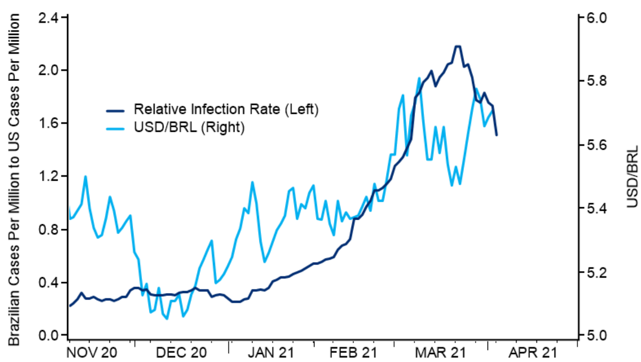


Figure 19: Latin America GDP-Weighted Real Effective Exchange Rate Basket vs CRB Commodity Price Basket

Sources: Bloomberg and Haver as of April 9, 2021. Past performance is not indicative of future returns.

Euro Region: More Attractive Than Markets Believe

There is evidence suggesting investors and forecasters are likely over-playing the durability of COVID developments in Europe. As figure 20 shows, positive economic surprises in the Eurozone have slightly *exceeded those in the UK* despite the new perception that the UK has overcome COVID and Eurozone is now the hopeless case. Among Economic forecasters, optimism on the UK economy is now merely catching up with the Eurozone (See figure 21).

While we've favored UK equities of late given its unusual discount to US markets and its now cleared political clouds, many continental European firms are at the forefront of "green infrastructure" spending trends, healthcare innovation and the eventual re-emergence of luxury travel. Eurozone equities have been shunned by global investors anew as COVID has surged again, but this too will pass.

Figure 20: UK and EU Economic Surprises

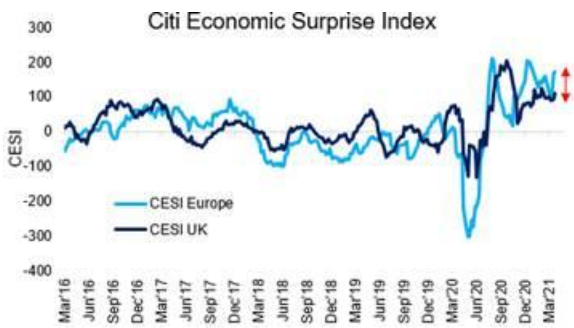
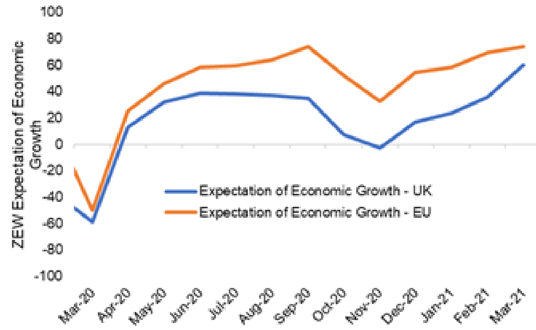


Figure 21: ZEW Survey: Economic Optimism UK vs EU



Source: Haver as of April 9, 2021. Past performance is not indicative of future returns.

Remember The 85% Rule

Equity markets are volatile. Drops of just over 10% occur on average once per year. Yet, monthly equity market returns have been positive around 85% of the time, consistent with the amount of time economies spend expanding vs contracting. With that said, markets are not efficient. As we have discussed here, the tendency for investors to assume that Covid will go on forever or that Brazil will never recover are opportunities for other, wiser investors. For opportunistic investors, we urge investors to consider what's cheap, rather than what markets price as "exceptional."