Private Bank

CIO | Update

Our Best Advice

David Bailin, Chief Investment Officer, Citi Private Bank February 2019

"Good advice is always useful. Great client relationships are established by providing good advice over time." – David Bailin

Snapshot

- The most current economic data and market action confirm our "Outlook 2019" view that global growth is slowing, with no recession on the horizon. This is a positive environment for moderate equity appreciation. We recommend that clients remain invested, add to "Core" portfolios and revisit our Opportunistic investment ideas.
- For discretionary clients, we rotated portfolios in mid-January, buying more equities at lower prices. We also tilted discretionary portfolios more toward Asian equities and Emerging Market debt, areas that benefit from lower US rates and stability in the US Dollar.
- Clients should actively endeavor to build a broad domestic and global bond portfolio that should provide good relative yields without a significant risk of rates rising materially. With the USD peaking, both USD and local currency bonds should benefit.
- We see several ongoing dislocations that present opportunity for investors. In particular, Asian equities, Emerging Market debt (US and local currency), Asian debt (USD), Asian Tech and Global Health Care.
- Remaining disciplined in the face of volatility and paying close attention to the signal (the "data") rather than the noise (the "daily news") is wisest.

Our Current Thinking and Recommended Client Actions

2017 was a year of market euphoria. 2018 was a reset of market valuations relative to global growth concerns and Fed policy.

The sky was falling in December 2018 – "The worst December since 1931" – and the sun has never been brighter in January 2019 – "The best January since 1987".

Perhaps our best advice is to stop watching the news! It is often useless information that drives bad investment behaviors. Fund flow data confirm that advised, retail clients all over the world sell when sentiment is bad and buy when enthusiasm is high." As we presented in our Outlook 2019 presentation, advisor sentiment is a terrific contra-indicator.

In 2019, our strongest view – the one we expressed in our Outlook 2019 – is that global growth is slowing, but that there is no imminent global recession. We recommend that clients stay invested and add to "Core" portfolios. We expect 2.5% growth in the US, 6+% in China and 4.5% in the emerging markets. That's slower growth than in 2018. Given that the Fed has raised rates 9 times since 2015 and there is no new tax stimulus in the US, this makes sense. We do see China taking steps to stimulate their economy in a counter-cyclical way, however, and that is incremental good news.

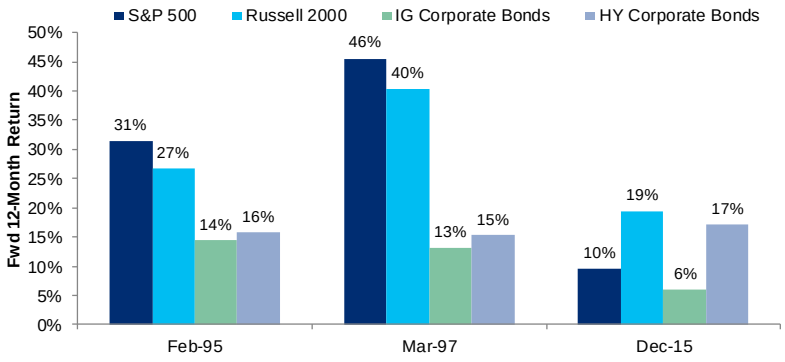
For discretionary clients, we rotated portfolios in mid-January, buying more equities at lower prices. This past week, the Global Investment Committee (GIC) met and we tilted discretionary portfolios more toward Asian equities and Emerging Market (EM) debt where we see the potential for significant value ahead (See Opportunistic and Opportunistic Portfolios and latest GIC Asset Allocation Announcement)

We still see the ability for clients to make attractive returns on their "excess cash" by gaining exposure to short-term US investment grade credit. We put our own tactical cash fully to work. What we *do not recommend* is market timing. In fact, when we look back in a few years, those who sold in 2018 will have damaged their portfolios and return profile.

We expect equity markets in Asia and the emerging markets more broadly to perform well and the US to eventually make new highs. This is even as they remain more volatile than in 2017. This experience is a return to normal levels of historical volatility (which we are not used to yet). In addition to fundamental reasons for this view, we also presented clear evidence that except for three "Black Swan" moments over the last 60 years (1973, 2000 and 2008), the traumatic 2018 year-end swoon is likely an indicator of good returns ahead for the next 12 to 24 months.

Another potential indicator of good returns ahead is the historical data on what happens when the Fed "pauses" before the yield curve inverts – as they just did. As you can see, the one-year returns after a Fed "pause" are positive.

US Equity & Fixed Income Returns When the Fed Pauses Before Inverting the Curve



Source: Factset, as of January 2019

Though the Federal Reserve has reversed course dramatically over the past month, from hawk to dove, it is the actual economic data that determines outcomes. With employment very high in the US, UK and Germany, there is simply not that much more fuel for above-trend growth across the developed world. The recent US government shutdown and "trade wars" have dampened corporate sentiment and investment, but only modestly so far. In fact, this past Friday, we saw that US employment remained strong in the face of the shutdown. Earnings growth has also slowed, in part due to lower than expected oil prices which have dampened income in energy and related industries. **All that said, our February 2019 message calls for slower growth to year-end and not recession – a positive environment for moderate equity appreciation, particularly for emerging markets that are sensitive to US rate and exchange rate pressure.**

And What of Bonds?

We have seen US bonds hold their value in the face of equity appreciation in 2019. That means that bond investors anticipate slower growth and an absence of

inflation, too. **This is a constructive environment for our clients.**

We see a series of opportunities for fixed income investors including short-term US corporates, consumer asset backed securities, and while riskier, emerging markets debt. This means clients should actively endeavor to build a broad domestic and global bond portfolio that should provide good relative yields without a large risk of rates rising materially. With the USD peaking, both USD and local currency bonds should benefit.

Opportunities and Opportunistic Portfolios

The parallel Core and Opportunistic portfolio strategy recommended by CPB is worth highlighting just now. By having a Core portfolio, clients can withstand the market volatility and even add to "Core" when major dislocation occur. We have shown why that is valuable in "the Case of the Missing Black Swan."

The recent rally in US equities did not erase poor equity market action elsewhere around the globe. We see several ongoing dislocations that present opportunity for investors. In particular (all as of February 1, 2019):

- Asian equities (up 7.3% in January, but down 15% over the past 12 months/forward P/E 12)
- Emerging market equities (up 8.8% in January, but down 13.5% over the past 12 months/forward P/E 11.7)
- Asian USD debt: Average credit ratings of BB+ and yields of 4.5%
- Emerging Market non-USD debt: Average credit ratings of BBB and yields of 5%

There are also real opportunities reflecting our dominant themes available just now (all as of February 1, 2019):

- Asian Tech (up 7.8% in January, but down 17.5% over the past 12 months/forward P/E 11.6)
- Global Health Care (up 5.2% in January, up just 2% over the past 12 months/forward P/E 16.3)

As you can see, there are "opportunities" to add to Opportunistic Portfolios, and these examples do not include attractive Private Equity/Real Estate and Hedge Fund opportunities in less correlated asset classes and strategies.

Conclusion

Market action in early 2019 is reminiscent of the recovery we saw in markets after 2016's "fear, not fact" swoon. Though earnings data for Q4 2018 were average, there is ample evidence that markets in the US, China and EM are more resilient that people expect. With the Fed "pausing" to reflect on the data we are reading, there is better balance reflected in their actions. Bond markets anticipate that we are at or near the end of the tightening cycle and foreign central banks have not signaled any differently. Absent a shock that derails the global economy – like a material worsening of the global "trade war" – the intermediate future for investors is constructive. This provides a window to add to "Core" portfolios and to invest further in some parts of the market that are potentially undervalued given our view of rates and slower, but steady growth in the US, Asia and emerging markets. These views are consistent with our Outlook 2019 projections for growth that are now being supported by actual global economic data.

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Upper medium grade (Strong)	A	A	A
Medium grade	Baa	BBB	BBB
Not Investment Grade			
Lower medium grade (somewhat speculative)	Ba	BB	BB
Low grade (speculative)	B	B	B
Poor quality (may default)	Caa	CCC	CCC
Most speculative	Ca	CC	CC
No interest being paid or bankruptcy petition filed	C	D	C
In default	C	D	D

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