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Citi Global Wealth Investments

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Learning to Stay the Course

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Market Action Summary

- Last month, our Global Investment Committee (GIC) continued on a path of gradually reducing aggregate portfolio risk globally. We made a net reduction of 1% in emerging market equities overall. Yet within this move, we added back a small overweight to China after the nation's share markets had dipped significantly into the red for the year.
- That's when the other shoe dropped. China's broad equity market dropped more than 13% at the start of last week. Shares dropped as much as 31% from their February high before recovering slightly.
- The proximate cause of the rapid correction was a state decision in China to demand that private education providers operate on a non-profit basis. This led many, particularly foreign investors, to expect the same treatment for much larger parts of China's economy such as the property and healthcare sectors.
- While recent actions from Chinese authorities have scared off foreign investors, their actions and statements argue for a continuation of competitive internationalization. National priorities within technology and clean energy seem highly unlikely to see similar treatment as the education sector.
- Locally-listed China shares have fallen to a trailing price/earnings multiple of 13X, or just above half the valuation of US shares on the same basis. China is at the center of the world's most rapidly growing region, with the economic development powering an unprecedented surge of new middle class incomes.
- Since 2009, Chinese equities have returned 9.2% even after 2021's decline, slightly exceeding 30% since February. In the past 3 corrections exceeding 30%, returns 12-months ahead have averaged 11%, and 17% after 18 months.
- For certain medium-risk portfolios, we recommend Chinese equities at a 5% holding level. To build more resilient portfolios, we have long argued for diversification from idiosyncratic country risks. Regionally-diversified equity portfolios have a history of stronger results than "home-only" portfolios when a crisis hits. For global investors, it's important not to look backward at strong gains in markets, but forward when corrections present opportunity.

New Selloffs Present New Opportunities

In late January 2021, our Global Investment Committee (GIC) eliminated overweight[1] positions in US small and mid-cap shares and local Chinese shares, among other changes in both equity and fixed income allocations. As always, the GIC reallocated to investment assets that we believed would provide higher returns relative to the particular risk. Adding to global healthcare shares – which seemed oh-so-boring at the time – largely offset our other equity reductions (see figure 1).

At the time, we heard from many investors who preferred to ignore the reallocation. To paraphrase them, "things were looking up." After all, China's total return was 29% in 2020. US small and mid-cap shares had gained 19% despite falling 42% within the year.

Yet it is critical to look forward, not backward. What we saw in early 2021 was that the shares of less-well-capitalized US firms had surged for most of a year, reversing their outsized losses. This is the typical early-cycle pattern which doesn't suggest long-term outperformance (see figure 2). In China, policymakers were beginning to sharply curtail credit growth. This would slow its economy and expose weaker credits, including those owned by the state. As such the GIC took action to reduce risk in these small asset classes. As figure 3 shows, their returns had been sharply higher than broad global equities.

Soon after, with autocratic expediency, China moved fast to regulate its technology firms which were accumulating a large concentration of economic power. This was driving inequality and social concerns, just as in the US and Europe.

Figure 1: Chinese Equities, Russell 2000 and Global Healthcare

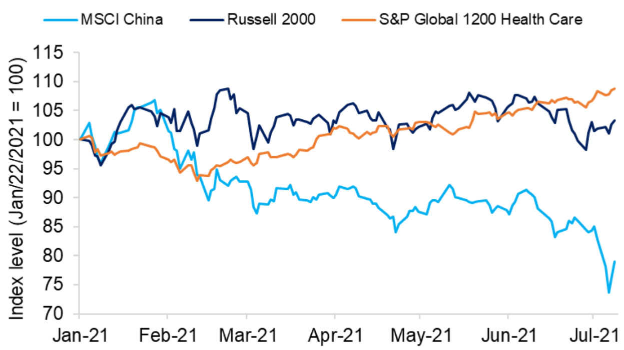
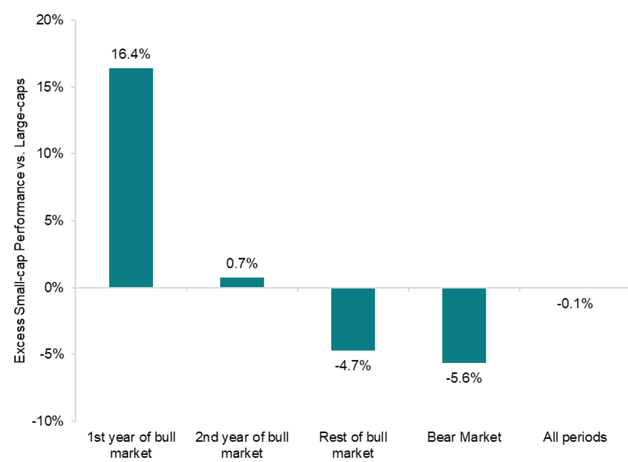


Figure 2: Small caps historically perform best in first year of bull market (1987 to present)



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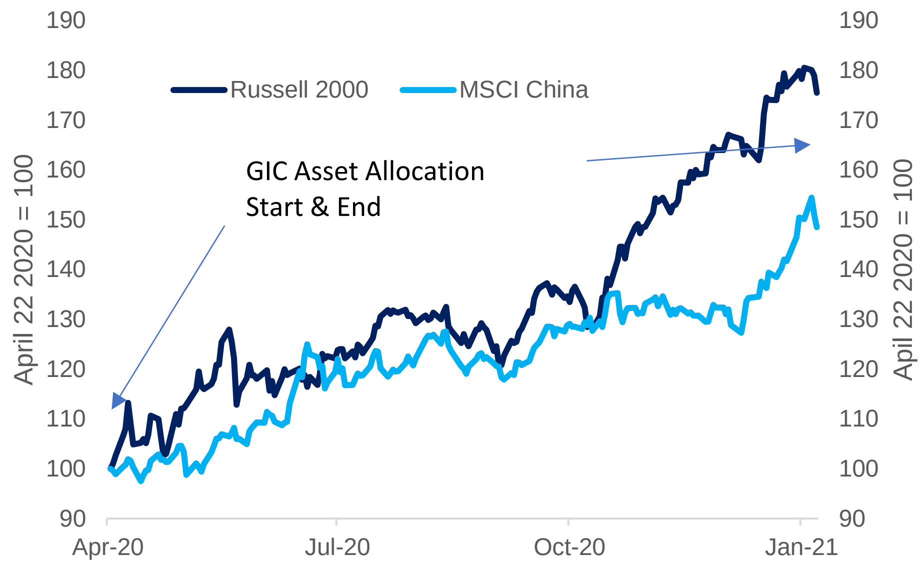
[1] Overweights are position sizes in excess of global benchmark allocations. See our latest GIC AA and Portfolio allocation for both Strategic Portfolios and their tactical benchmark.

Figure 3: GIC's Overweight Position Start and Finish to Overweight's in China and US SMID in 2020



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Don't Wed Your Winners

Last month, our GIC continued on a path of gradually reducing aggregate portfolio risk globally (please see our latest *Quadrant*). We made a net reduction of 1% in emerging market equities overall. Yet within this move, we added back a small overweight to China after the nation's share markets had dipped significantly into the red for the year – underperforming world equity markets by 23 percentage points since January.

That's when the other shoe dropped. China's broad equity market dropped more than 13% at the start of last week. Shares had dropped as much as 31% from their February high. Yet once again, investors seem "wedded to their winners" and unwilling to see a decline in markets as a potential opportunity.

The proximate cause of the rapid correction was a state decision in China to demand that private education providers operate on a non-profit basis. The news came after several other prominent interventions by the Chinese government that at least temporarily scuttled IPO plans from what many believe are "national champions." This led many, particularly foreign investors, to expect the same treatment for much larger parts of China's economy such as the property and healthcare sectors.

It's clear that housing affordability is a much stronger Chinese government priority than profits for developers. Yet among the shares that have now fallen hard are Chinese strategic priorities such as semiconductors, clean energy, and artificial intelligence. These sectors will need profit incentives to innovate and compete globally in our view. We expect Chinese authorities will reach the same conclusion.

On the regulatory front, China's actions will indeed represent costly requirements for fin-tech firms and technology platforms to dampen monopolistic behavior and protect consumer data. As we discussed in our *Mid-Year Outlook*, the strategic dissonance between the US and China represents one of three significant risks to the world economy. Disputes between the "G-2" have now moved from the arena of trade to the regulatory/financial realm. As such, the risks for asset holders depend in part on where investors are domiciled and the particular listing structure of the Chinese entity.

In return for these risks, locally-listed China shares have fallen to a trailing price/earnings multiple of 13X, or just above half the valuation of US shares on the same basis. While no individual investor *must* own Chinese equities, the world's second largest economy is a global influence that cannot be ignored. China is at the center of the world's most rapidly growing region, with the economic development powering an unprecedented surge of new middle class incomes (see figures 4-5).

Figure 4: Emerging Asia as % of World GDP and IMF Estimates through 2026

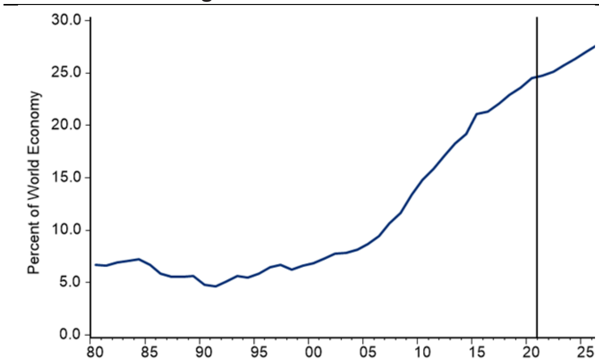
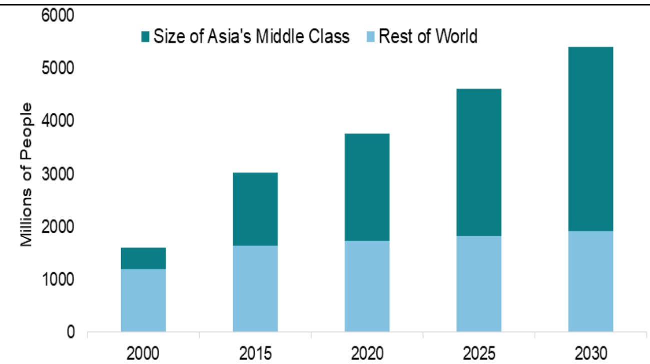


Figure 5: Historical and Estimate Growth of the Asia's Middle Class



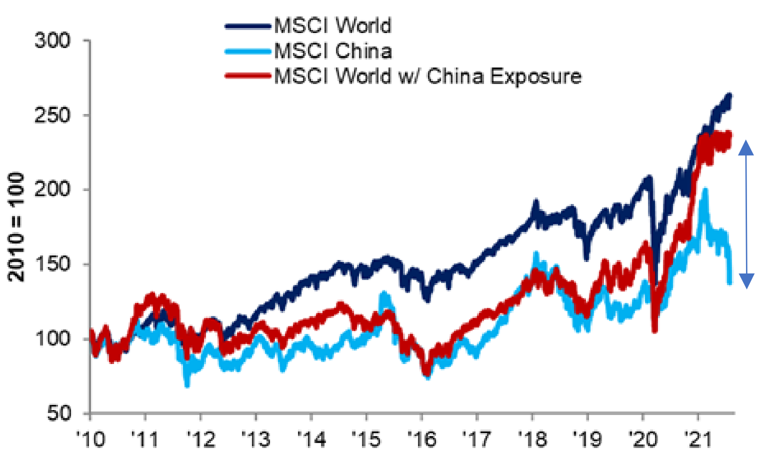
Source: International Monetary Fund (IMF), Bloomberg and Haver Analytics as of July 30, 2021. . All forecasts are expressions of opinion and are subject to change without notice and are not intended to be guarantees of future events.

Are There Two China Economies?

Having a point of view on China's economy is critical for all global asset classes. Therefore, among the most interesting developments is the sharp recent divergence in the performance of local China equities compared to the shares of foreign firms that derive a large share of their sales and profits in China (see figure 6).

We believe the divergence largely stems from the newly negative sentiment regarding future regulatory burdens on Chinese business, which supersedes fears over growth. The relative outperformance of foreign firms suggests investors believe they will somehow escape the same regulatory impact. This is despite the issue being a frequent concern for foreign firms in the past.

Figure 6: Chinese Equities, Global Equities, Global Equities with High Chinese Revenue Exposure



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Ultimately, one needs to take a point of view on how China will manage its economy. Will it use competition and private profit incentives to grow in the areas it has set as priorities? (Among them, semiconductors, clean energy and artificial intelligence). Will China instead seek to grow with an entirely socialist economic model?

Statements from Chinese officials do *not* argue for a return to the China of the 1950s-1960s. While recent actions have scared off foreign investors once again, their actions and statements argue for a continuation of competitive internationalization. Strong regulatory constraints will be seen in sectors that affect the living conditions of the broad public. These areas include education, housing and certain elements of healthcare.

Constraining profits has a history of backfiring for governments who seek both stable prices and rising supplies of goods and services for consumers. It is the profit motive that incentivizes both innovation and production. We don't think China will be spared from this quandary. However, the range of investment opportunities in China's economy are not limited to intensely-regulated sectors. For many shares, valuations now reflect a far less rosy profit outlook (see figure 7).

With the sharp recent selloff, Chinese shares have fallen 31% at a low point last week from their February high. Including this drop, total returns in China's equity markets have still been 9.2% annualized since 2009 through July 2021. During the post-Global Financial Crisis period, China's equity market has fallen more than 30% in three other periods before 2021. Once this threshold has been breached, subsequent 12-month returns were 11% over, while 18-month returns were 17%.

We don't believe investors have been wholly irrational in questioning the outlook for Chinese firms given macro policies ranging from regulation to monetary policy restraints. We do suspect they have been a bit too indiscriminate, however.

Importantly, we don't believe China's policymakers have simply given up on their pursuit of economic growth and development. We believe tightening credit policies have been more significant than generally recognized in slowing Chinese consumer spending this year. The need to "discipline" errant borrowers can't be allowed to permanently damage the financial system and the capacity to grow (please see "China: The Non-Profit Tantrum" for a detailed discussion of recent events).

As is typical, too much tightening will give way to easing (see figure8). This has paved the way for market recoveries during the decade past, and we expect the same will hold now.

Figure 7: China and US Tech Sector Comparison

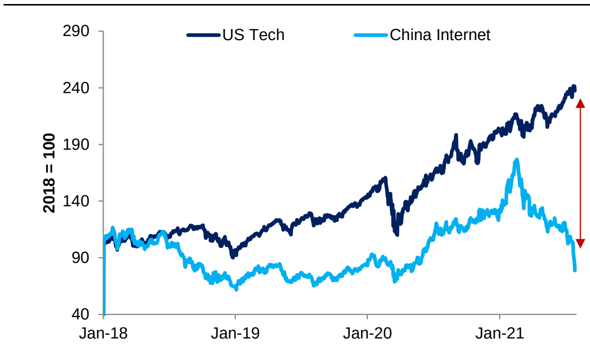
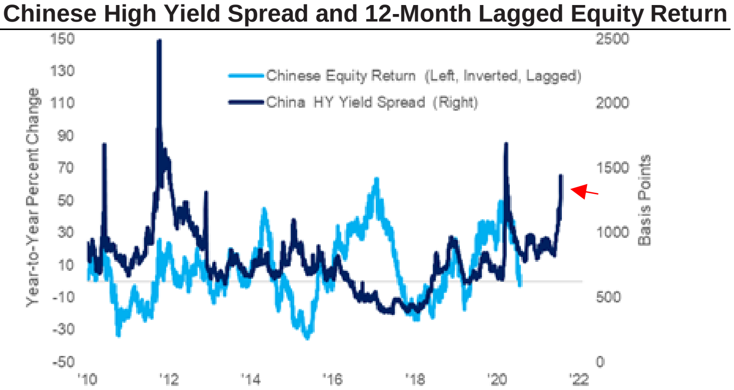


Figure 8: Credit Crunch Harms Markets, Precedes Rebounds: Chinese High Yield Spread and 12-Month Lagged Equity Return



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Let's remember, it's 5% for medium risk portfolios

The strategic competition between China and the US carries global risks, but as we noted above, China's economy sits at the heart of the world's most rapidly growing region. With the influence of China's economy felt throughout world industry and markets, it simply can't be ignored.

To build more resilient portfolios, we have long argued for diversification from idiosyncratic country risks. Globally-diversified equity portfolios have a history of stronger results than "home-only" portfolios when a crisis hits (see figure 9).

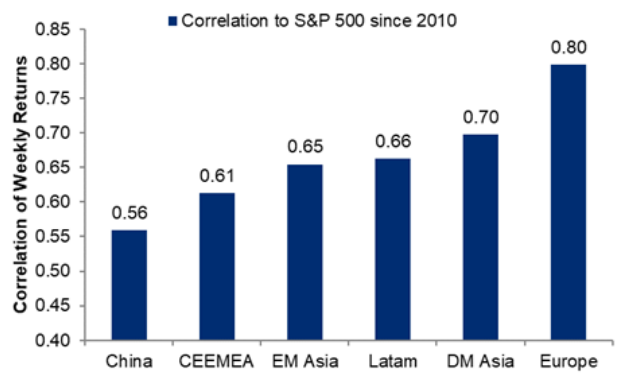
Local calamities are far more common than global recessions throughout history, despite fully global crises hitting twice in the past 15 years.

For investors from Greater China, we would argue in favor of diversification from China's local risks. Meanwhile, global investors should be aware that historically, Chinese equities offer low regional correlation to US shares, and economic dis-integration could lead to even lower correlation over time (see figure 10). This tends to *reduce* overall portfolio volatility and risk.

Figure 9: Global Equity Returns vs Regional Returns in Local Crisis Periods

Regional Crisis	Return during first year of crisis (%)	
Asian Crisis 1997	Asia -28.3%	Global 15.0%
Latam Crisis 1998	Latam -35.1%	Global 22.0%
EU Crisis 2011-2013	Europe -10.5%	Global -6.9%
Commodity Collapse 2015	Latam -30.8%	Global -1.8%
US/China Trade War 2018	China -18.7%	Global -8.9%
Average	**-24.7%**	**3.9%**

Figure 10: Correlation of Regional Market Returns to S&P 500



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NOTE: Country market crisis returns average -24.7% during which global returns average +3.9%.

To help preserve and grow wealth, we advise clients to consider owning highly diversified multi-asset class portfolios. As discussed in our *Mid-Year Outlook*, this means building a portfolio that doesn't seek the absolute highest potential return, but rather one that seeks the highest risk-adjusted return in line with the downside risks that individuals determine they can bear for their portfolios as a whole.

One cannot get the call on every underlying portfolio position correct. Knowing the risks, our position on medium-risk global portfolios, is a total weighting in China equities of about 5%. To seek excess returns that risk assets can generate over the inflation-adjusted return of cash, one has to risk being wrong (see figure 11).

Figure 11: Inflation-Adjusted US Equity, Long-Term Treasury and Cash Returns: Log Scale

Source: Haver Analytics as of July 30, 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. Index returns do not include any expenses, fees or sales charges, which would lower performance. Past performance is no guarantee of future results. Real results may vary.

In our [Investment Philosophy Outlook 2020](), we set forth that ***core portfolio*** wealth should be permanently invested across asset classes that have a long-term performance track record, allowing for a fundamentally-driven estimate or future risks and returns. As figure 12 shows, such an asset allocation portfolio has had above-average absolute returns in every decade we can track. On a risk adjusted basis, it has generated higher returns than any single asset class.[2]

Importantly, what the table also shows, is that no-single region or asset class has had the strongest absolute return for more than a single decade. With US small caps having the highest returns of the last 10 years and US large caps in the second position, perhaps investors should be more concerned if we were *not* diversifying their investment dollars more widely.

Figure 12: Returns by Decade for Major Asset Classes From Highest (Top) to Lowest (Bottom)

1950s	1960s	1970s	1980s	1990s	2000s	2010s	Avg 10-Year Return	Risk-Adjusted Return
World ex-US Equities 20.8%	US Small Caps 15.5%	EM Govt USD Bond 14.4%	World ex-US Equities 22.8%	US Equities 18.2%	EM Govt USD Bond 12.9%	US Equities 13.6%	US Small Caps 12.0%	Asset Allocation 0.53
US Equities 19.3%	US Equities 7.8%	US Small Caps 11.5%	US Equities 17.5%	US Small Caps 11.6%	G7 Govt Bond 6.4%	US Small Caps 10.5%	US Equities 11.6%	US Equities 0.49
US Small Caps 16.9%	Asset Allocation 5.4%	World ex-US Equities 10.1%	Asset Allocation 17.4%	Asset Allocation 11.0%	US Investment Grade 6.4%	Asset Allocation 7.7%	World ex-US Equities 10.5%	EM Govt USD Bond 0.43
Asset Allocation 12.1%	World ex-US Equities 5.1%	Asset Allocation 8.0%	US Small Caps 15.8%	G7 Govt Bond 8.0%	Asset Allocation 3.4%	EM Govt USD Bond 6.3%	Asset Allocation 9.3%	US Small Caps 0.38
EM Govt USD Bond 5.3%	Cash 4.1%	Cash 6.5%	US Investment Grade 12.8%	US Investment Grade 8.0%	Cash 2.7%	World ex-US Equities 6.0%	EM Govt USD Bond 8.1%	World ex-US Equities 0.37
Cash 2.0%	EM Govt USD Bond 3.5%	US Investment Grade 6.1%	G7 Govt Bond 12.8%	EM Govt USD Bond 7.7%	US Small Caps 2.2%	US Investment Grade 4.3%	US Investment Grade 5.8%	US Investment Grade 0.18
G7 Govt Bond 0.4%	US Investment Grade 2.4%	G7 Govt Bond 6.1%	Cash 9.1%	World ex-US Equities 7.3%	World ex-US Equities 1.6%	G7 Govt Bond 3.7%	G7 Govt Bond 5.7%	G7 Govt Bond 0.17
US Investment Grade 0.4%	G7 Govt Bond 2.4%	US Equities 5.8%	EM Govt USD Bond 6.4%	Cash 5.0%	US Equities -0.9%	Cash 0.6%	Cash 4.3%	

Source: Factset and Citi Private Bank, Global Asset Allocation Team as of 30 July 2021. Adaptive Valuation Strategies (AVS) is the Private Bank's proprietary strategic asset allocation methodology. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only. Past performance is no guarantee of future returns. Real results may vary. "Asset allocation" in this diagram represents an AVS Risk Level 3 allocation, which includes allocations to equities, fixed income, commodities, cash and hedge funds. Risk levels are an indication of clients' appetite for risk. Risk Level 3 – Seeks modest capital appreciation and, secondly capital preservation. The returns shown were calculated at an asset class level using indices and do not reflect fees, which would have reduced the performance shown. Risk-adjusted return is defined here as the Sharpe ratio. See glossary for definition of terms.

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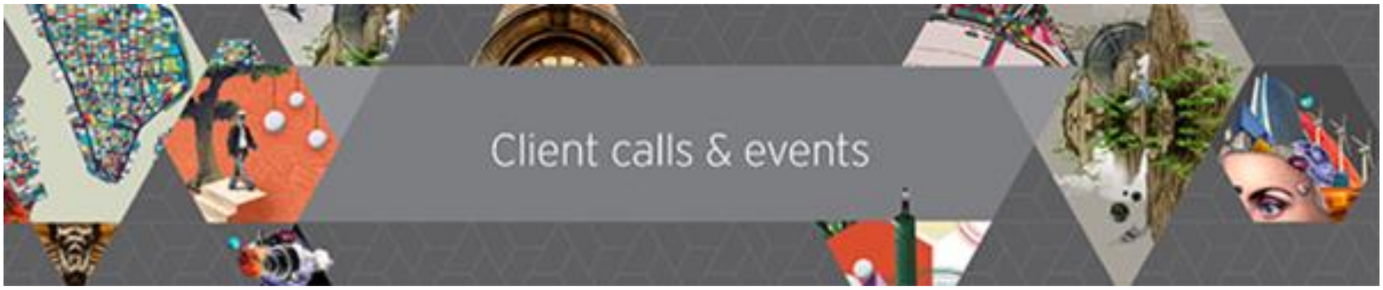
[2] This measure is the so-called Sharpe ratio, or the return of the asset class above the cash yield adjusted for volatility (standard deviation).



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