Private Bank citi

Citi Global Wealth Investments July 25, 2021

CIO Strategy Bulletin

The "*Quality Shift*" is On

David Bailin, Chief Investment Officer and Global Head of Investments
Steven Wieting, Chief Investment Strategist & Chief Economist
Joseph Fiorica, Head, Global Equity Strategy

SUMMARY

- **Over the past 18 months, both highly speculative growth stocks and deep value "reopening" names have led the market higher.**
- **As we enter a mid-cycle period of somewhat slower, but sustainable growth, we are recommending a "Quality Shift" toward those equities that present more attractive valuations and can deliver both income and capital growth in a moderating expansionary period**
- **We see value in US and International "dividend growers". We also see a brighter future for Chinese equities after a recent period of underperformance due to regulatory uncertainty and fiscal tightening.**

What We Are Adding to Portfolios Now

Cases of the delta variant of COVID-19 are rising just after we have reached "peak growth" in the global economy. Neither of these major issues are crises, but both suggest that important shifts in portfolios are necessary as we enter a mid-cycle period of somewhat slower, but sustainable growth (please see our latest *Quadrant* for further discussion). With bond markets trading at historically expensive valuations, we continue to favor equities that present more attractive valuations and can deliver both income and capital growth in an expansionary period.

Consistent with this view, we are making a major "Quality Shift" as we move past the last 12 months that favored Covid-recovery and mean reversion equity trades. **We are increasing allocations to large cap US equities and China and reducing other emerging market and real estate exposures. We are also shifting toward "dividend payers" and will recommend, for moderate risk portfolios, a 10% exposure to equities that demonstrate consistent dividend growth, split between US and non-US shares**.

Understanding the "Quality Shift"

During the pandemic, quality has taken a back seat for many investors amidst reopening anticipation. At various points over the past 18 months, both highly speculative growth stocks and deep value "reopening" names have led the market higher (Figure 1). Investors and markets were able to look past worst-case Covid scenarios and found companies whose equity valuations were just too cheap. During early cycle periods, it is common to see those names most punished during a downturn recover the most in percentage terms, leading to short-term underperformance of more "**boring**" dividend growers and traditional market leaders. This trade is largely over now.

Our present moves have one goal: to **boost** portfolio quality. We define quality equity investments as companies in certain regions and sectors, who seek to deliver superior, but stable profitability, while continuously growing payouts to shareholders. Outside of "reopening periods", investing with a quality lens has outperformed passive equity investing over the past 25 years (Figure 2).

Figure 1: Annual returns for dividend growers and the Nasdaq

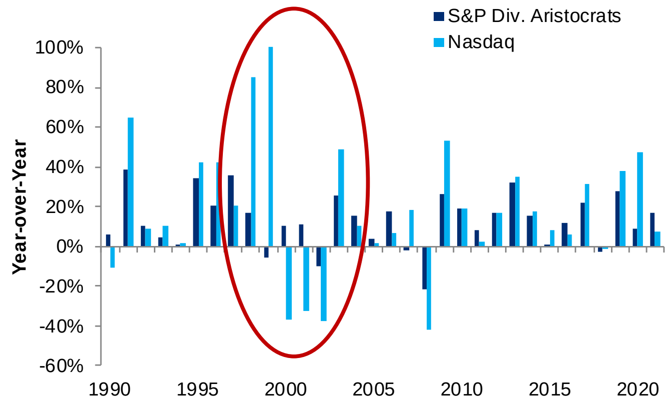
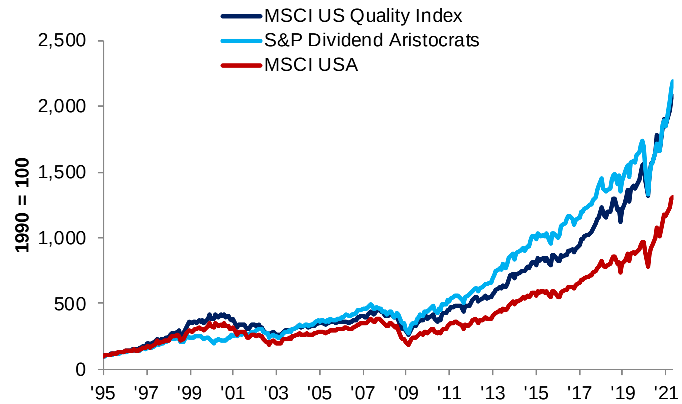


Figure 2: Dividend growth and balance sheet quality tend to outperform over the long run



Source: Bloomberg as of July 22, 2021. Circle highlights 1998-2003 period when Dividend Aristocrats delivered much more stable returns than the Nasdaq. MSCI Quality Index identifies stocks with high scores based on three fundamental variables: high return on equity, stable YoY earnings growth, and low financial leverage. Dividend Growers proxied using S&P Dividend Aristocrats Index. 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.

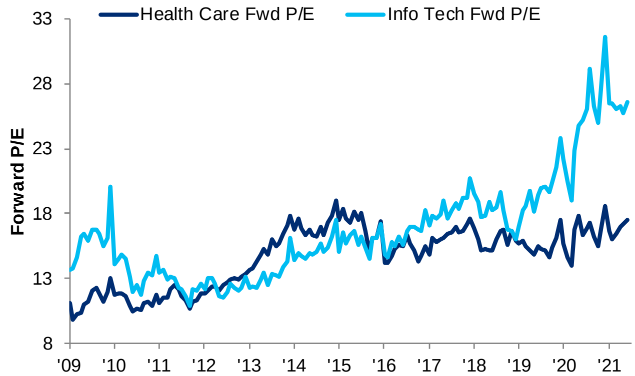
What Are You Thinking? US Large Caps Can Lead Again

As part of our "Quality Shift", we are increasing our allocations to US large cap shares while remaining underweight in riskier and more highly leveraged US small and mid-caps. We know what you are thinking! How could we add to larger US companies given where valuations and indices are? While there is no denying that S&P 500 valuations measured by P/E ratios are not cheap on a historical basis, they are fairly valued when compared with high quality US bonds. Using that comparison, quality equities are trading at average levels. When you consider the forward EPS of such shares and subtract the bond yield, the relative value of such equities becomes clearer. In simple terms, these shares will likely benefit from their earnings growth and higher future payouts relative to low yielding, fixed payment bonds (see Figure 3).

This strategy requires selectivity. That is why we have concentrated a significant portion of our US tilt toward the health care sector. Health care trades at a deep discount to other compelling growth equities and offers potential downside protection to boot (see Figure 4)

Figure 3: S&P 500 earnings yield vs US bond yields

Figure 4: S&P 500 Health Care vs IT Valuations

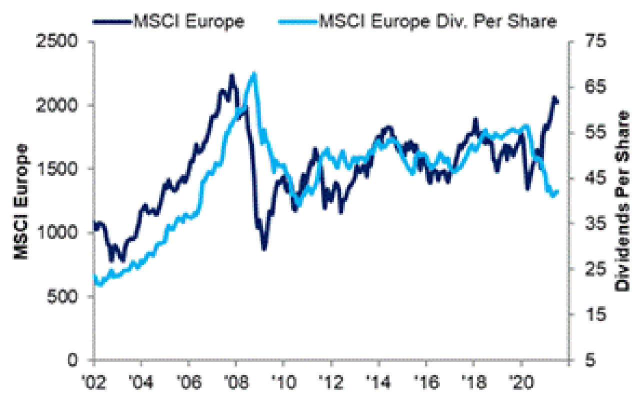


Source: Factset as of July 15, 2021. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Past performance is no guarantee of future results. Real results may vary.

Looking more deeply at relative performance, we believe US large caps have earned their stronger valuation compared with similar European shares. As one can see in Figures 5 and 6, the focus on and ability to drive consistent dividend growth over the past 30 years sets US shares apart. US companies have demonstrated stronger dividend growth rates when compared with both Europe (and Japan). US dividends compounded at a 6% growth rate, while Europe has delivered just 3% growth in payouts since 2002. Investors have learned to (rightly) pay up for US shares in an expectation that this outperformance in dividend growth will continue.

Figure 5: S&P 500 vs Dividends per Share

Figure 6: MSCI Europe vs Dividends per Share



Source: Bloomberg as of July 22, 2021. Note: S&P Dividend Aristocrats Index identifies companies that have consistently grown dividend payouts for at least 25 consecutive years. 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.

Understanding Measurements of Quality

It turns out that US equities are a “better place to be” during crises like rising virus cases. The S&P 500 is a remarkably diversified index and that happens to make it more defensive. This year, the index has been dragged higher by COVID-cyclicals as vaccinations ramped up in the US. But we expect that quality will win the day. Looking at measurements of quality, US large cap shares score highly across many of our key “quality” metrics. When assessed for profitability, leverage levels, earnings stability and their track record of dividend growth, US shares simply stand out (Figure 7).

Figure 7: Quality screen by equity region and size

Region	ROE ('22E, %)	Region	Oper. Margin ('22E)	Region	Net Debt to EBITDA	Region	Earnings Stability (Std. Dev.)	Region	10yr Div. Growth (CAGR)
US	19.8	Asia ex-Japan	24.5	EM Asia	0.41	Asia ex-Japan	13.4	US SMID	15%
Latam	17.6	Latam	24.1	CEEMEA	0.83	US	13.9	US	8%
UK	13.5	CEEMEA	23.1	Latam	1.07	UK	16.2	EM Asia	3%
CEEMEA	12.9	US	17.6	US	1.24	EM Asia	18.3	CEEMEA	2%
EM Asia	12.8	EM Asia	15.6	Europe ex-UK	1.39	US SMID	19.6	Japan	2%
US SMID	12.5	UK	15.5	Asia ex-Japan	1.55	Europe ex-UK	20.5	Europe ex-UK	1%
Europe ex-UK	12.1	Europe ex-UK	14.8	UK	1.59	CEEMEA	26.8	UK	0%
Asia ex-Japan	10.5	US SMID	10.4	US SMID	1.94	Latam	37.9	Asia ex-Japan	0%
Japan	8.7	Japan	9.3	Japan	2.10	Japan	51.9	Latam	-3%

Source: Factset as of July 22, 2021. Shown for illustrative purposes only. Past performance is no guarantee of future results.

The "Quality Shift" has a Deliberate Dividend Growth Bias

In moderate risk client portfolios, we recommend investing 10% of assets in global shares with a consistent track record of growing dividend payouts. This can be split evenly between US and non-US shares, as the characteristics that enable a firm to consistently deliver capital to shareholders is typically agnostic to jurisdiction.

We recently highlighted the opportunity presented by dividend growth equities. Their ability to grow dividend payouts combined with the reinvestment of dividends in the equities themselves has been a superior strategy to value or growth since 1994 (Figure 8). Though the more recent period (Figure 9) has seen dividend payers lag the broader index, the mid-cycle period we are entering will, in our view, favor the stable growth in earnings and dividends that are likely to be achieved by "Dividend Aristocrats".

Figure 8: US Dividend Aristocrats vs growth and value style

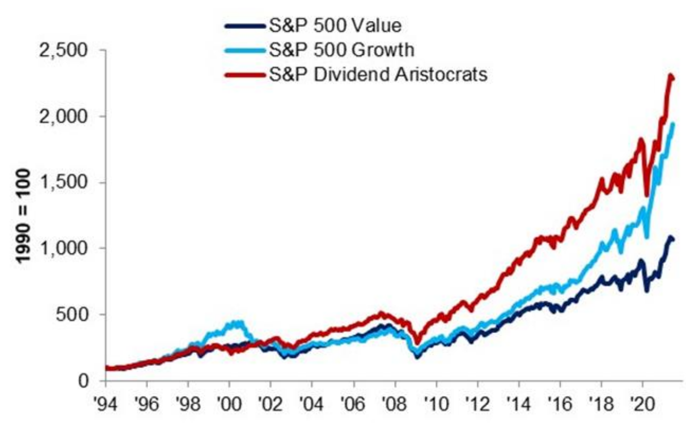
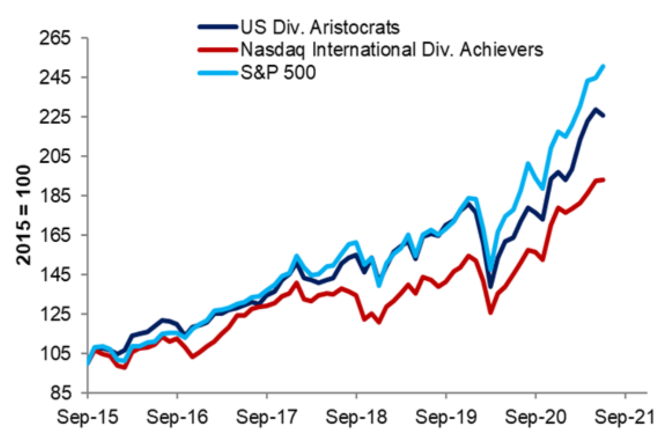


Figure 9: S&P 500, US Dividend Aristocrats, and non-US Dividend Achievers



Source: Bloomberg as of July 22, 2021. Note: S&P Dividend Aristocrats Index identifies companies that have consistently grown dividend payouts for at least 25 consecutive years. 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.

Back into China

Within emerging markets, we are adding a small overweight to Chinese equities after a difficult first half of 2021. Since January, when we recommended a reduction in exposure to China, Chinese shares have underperformed nearly every other regional equity market. Investor sentiment presently remains quite dour following a string of negative credit events, harsh regulatory actions against big tech platforms and concerns around the delisting of ADRs.

Amidst this negative backdrop, we believe we are nearing a turning point in the Chinese credit cycle, as policymakers shift from tightening to easing (Figure 10). As we published in a note earlier this month, domestically-listed shares in sectors like financials and industrials stand to benefit directly from recent Chinese moves to expand credit and boost the domestic economy. Meanwhile, even though we expect tougher tech regulation to continue for some time, we ultimately believe that the establishment of a regulatory framework to deter monopolistic behavior, especially among fintech and other companies with strongholds on consumer data, will be a net positive. Managements will have clarity about the contours of acceptable practices and those that follow them will see more moderate, but sustained growth over the medium term.

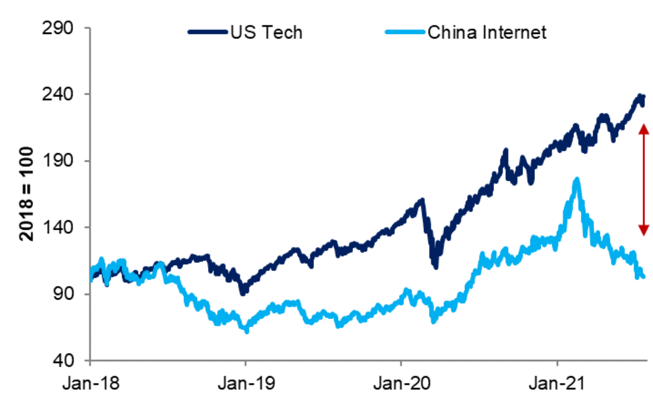
We also like the return profile of Chinese tech shares relative to the US. Despite a lot of similarities between US and Chinese tech giants, the returns in Chinese tech have significantly lagged their US counterparts since 2018 (Figure 11). We believe this can change in the years to come.

Our view on China comes with two important cautions. First, we believe that the growth rates of early leaders in Chinese e-commerce, digital media, and fintech are unlikely to be sustainable. This is not, by itself, bearish as we have seen revenue growth slow in US big tech slow in recent years as their products saturate the global market. But in industries like clean energy, Chinese firms remain at an earlier point in their growth cycle and enjoy heavy government support. In these spaces, significant growth in the years ahead is likely as decarbonization and electrification are only just taking off in China.

Second, we urge caution in investing in certain US-listed American Depository Receipts (ADRs). Both the US and Chinese governments have, for different reasons, signaled concern around the current structure of US listings of Chinese companies. **We therefore recommend investing directly in mainland (A-Shares) and Hong Kong (H-Shares) listed names** that face much less regulatory scrutiny. Most of the major US ADRs have already set up dual listings in Hong Kong. Thus, making use of active managers who can address opportunities locally is logical. By focusing on those sectors most likely to benefit from domestic easing, while avoiding or underweighting names currently in the government's regulatory crosshairs, China could potentially provide outperformance.

Figure 10: China equity forward P/E vs new credit as % of GDP

Figure 11: China vs US tech



Source: Bloomberg as of July 22, 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. All forecasts are expressions of opinion and are subject to change without notice and are not intended to be a guarantee of future events

What We Are Selling: Early-Cycle Winners

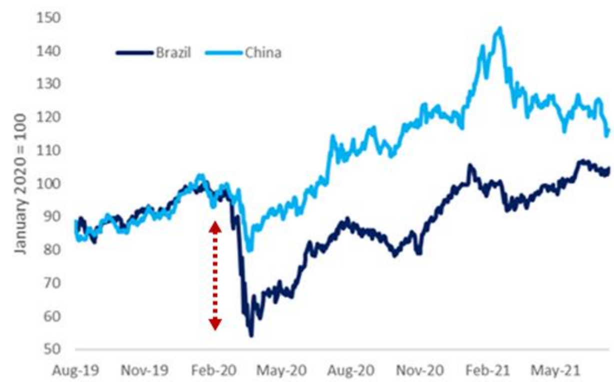
Latin American Equities

Our upgrades to the US and China came at the expense of two COVID recovery allocations that, in our view, have largely run their course. Latin American equities are up 63% since we initiated an overweight in April 2020. While their performance lags most other regions since 2019, we see more risk than opportunity ahead. A largely unvaccinated population in major countries like Mexico and Brazil is worrisome. In addition, political uncertainty ahead of Brazil's presidential elections next year may be met with foreign investor skittishness, common ahead of tumultuous elections in EM countries (Figure 12). In addition, Latin American equities benefit from global growth that will normalize in a post-

Covid world: 70% of their market cap is made up of COVID-cyclicals. And that figure is even more extreme in Brazil, where 78% of the equity universe is concentrated in cyclicals like materials, financials, and energy. Thus, the probability of outperformance relative to China as we enter a mid-cycle economy is low (Figure 13).

Figure 12: Brazilian Bovespa YoY Returns

Figure 13: China vs Brazil Equities



Source: Bloomberg as of July 24, 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. COVID-Cyclicals: Financials, Industrials, Energy, Materials, Real Estate, Consumer Discretionary ex-Amazon.

REITs

We have also reduced our thematic allocation to Equity REITs. We were early in our positive view on REITs when in June of 2020 our Global Investment Committee went overweight global equity and mortgage REITs as part of a series of tactical moves to position portfolios for a post-COVID world. Since then, the equity REIT sector has delivered 39% in total returns since, led by much more significant returns in COVID-impacted sectors like lodging and retail (Figures 14-15).

We see the recovery in COVID-impacted equity REITs as nearly complete, though we still favor certain sub-sectors like cell towers, data centers, industrial warehouses, residential, and health care given their long-run positive attributes for portfolios (see Equity Strategy bulletin for a deeper dive). We prefer active REIT management, as we believe avoiding certain office and malls REITs likely to face structural challenges in 2022 and beyond is recommended.

Figure 14: 1 Year REIT returns vs Global Equities

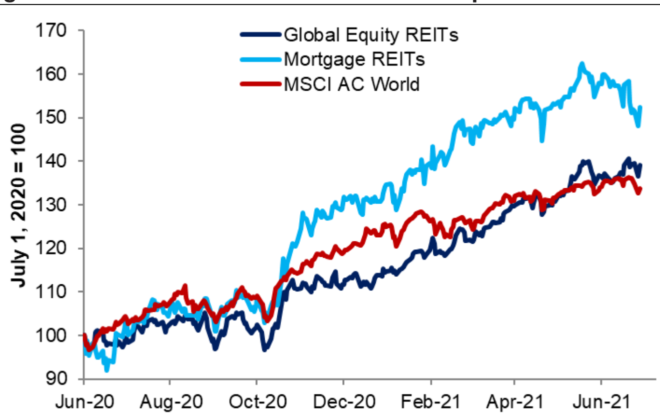
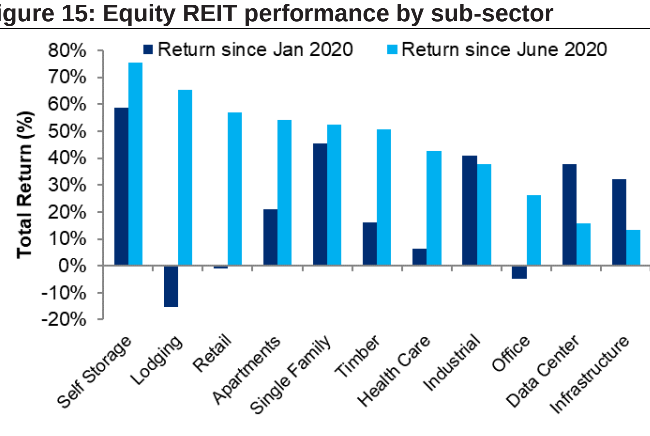
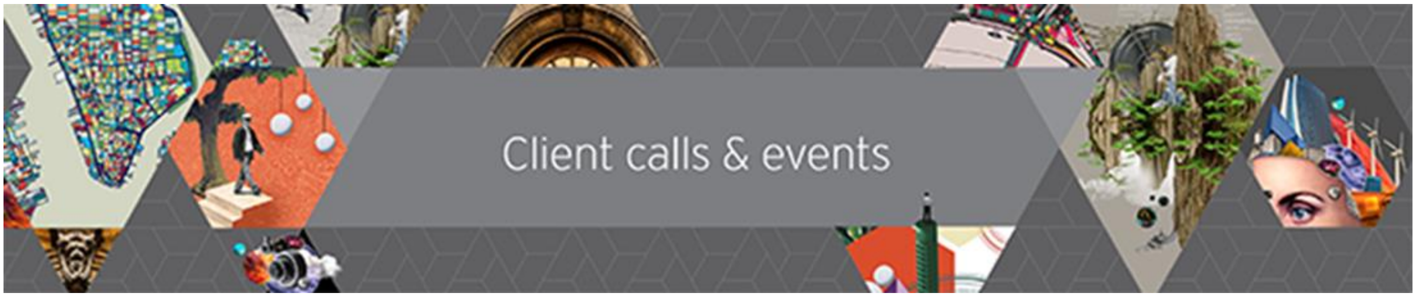


Figure 15: Equity REIT performance by sub-sector



Source: Bloomberg as of July 22, 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.



This email contains promotional materials. If you do not wish to receive any further promotional emails from Citi Private Bank, please email donotspam@citi.com with "UNSUBSCRIBE" in the subject line. Email is not a secure environment; therefore, do not use email to communicate any information that is confidential such as your account number or social security number.

Announced in January 2021, Citi Global Wealth ("CGW") is comprised of the wealth management businesses of Citi Private Bank and Citi's Global Consumer Bank. Through these businesses, CGW delivers Citi's wealth solutions, products and services globally. The unified management and delivery of CGW's wealth strategy represents a further commitment by Citi to become a leading global wealth business. Citi Global Wealth Investments ("CGWI") is comprised of the Investments and Capital Markets capabilities of Citi Private Bank, Citi Personal Wealth Management and International Personal Bank U.S.

Citi Private Bank and Citi Personal Wealth Management are businesses of Citigroup Inc. ("Citigroup"), which provide clients access to a broad array of products and services available through bank and non-bank affiliates of Citigroup. Not all products and services are provided by all affiliates or are available at all locations. In the U.S., investment products and services are provided by Citigroup Global Markets Inc. ("CGMI"), member FINRA and SIPC, and Citi Private Advisory, LLC ("Citi Advisory"), member FINRA and SIPC. CGMI accounts are carried by Pershing LLC, member FINRA, NYSE, SIPC. Citi Advisory acts as distributor of certain alternative investment products to clients of Citi Private Bank. Insurance is offered by Citi Personal Wealth Management through Citigroup Life Agency LLC ("CLA"). In California, CLA does business as Citigroup Life Insurance Agency, LLC (license number 0G56746). CGMI, Citi Advisory, CLA and Citibank, N.A. are affiliated companies under the common control of Citigroup.

Outside the U.S., investment products and services are provided by other Citigroup affiliates. Investment Management services (including portfolio management) are available through CGMI, Citi Advisory, Citibank, N.A. and other affiliated advisory businesses. These Citigroup affiliates, including Citi Advisory, will be compensated for the respective investment management, advisory, administrative, distribution and placement services they may provide.

International Personal Bank U.S. ("IPB U.S."), is a business of Citigroup Inc. ("Citigroup") which provides its clients access to a broad array of products and services available through Citigroup, its bank and non-bank affiliates worldwide (collectively, "Citi"). Through IPB U.S. prospects and clients have access to the Citigold® Private Client International, Citigold® International, International Personal, Citi Global Executive Preferred, and Citi Global Executive Account Packages. Investment products and services are made available through either Citi Personal Investments International ("CPII"), a business of Citigroup Inc., which offers securities through Citigroup Global Markets Inc. ("CGMI"), member FINRA and SIPC, an investment advisor and broker–dealer registered with the Securities and Exchange Commission; or Citi International Financial Services, LLC ("CIFS"), member FINRA and SIPC, and a broker–dealer registered with the Securities and Exchange Commission that offers investment products and services to non–U.S. citizens, residents, or non–U.S. entities. CGMI and CIFS investment accounts are carried by Pershing LLC, member FINRA, NYSE, and SIPC. Insurance is offered by CPII through Citigroup Life Agency LLC ("CLA"). In California, CLA does business as Citigroup Life Insurance Agency, LLC (license number 0G56746). Citibank N.A., CGMI, CIFS, and CLA are affiliated companies under common control of Citigroup Inc.

Read additional Important Information

Past performance is not indicative of future results. Real results may vary.

Citi and its employees are not in the business of providing, and do not provide, tax or legal advice to any taxpayer outside Citi. Any statement in this Communication regarding tax matters is not intended or written to be used, and cannot be used or relied upon, by any taxpayer for the purpose of avoiding tax penalties. Any such taxpayer should seek advice based on the taxpayer's particular circumstances from an independent tax advisor.

MBS are also sensitive to interest rate changes which can negatively impact the market value of the security. During times of heightened volatility, MBS can experience greater levels of illiquidity and larger price movements.

Important information, including information relating to risk considerations can be found in the link above.

Views, opinions and estimates expressed herein may differ from the opinions expressed by other Citi businesses or affiliates, and are not intended to be a forecast of future events, a guarantee of future results, or investment advice, and are subject to change without notice based on market and other conditions. Citi is under no duty to update this presentation and accepts no liability for any loss (whether direct, indirect or consequential) that may arise from any use of the information contained in or derived from this presentation.

INVESTMENT PRODUCTS: NOT FDIC INSURED · NOT CDIC INSURED · NOT GOVERNMENT INSURED · NO BANK GUARANTEE · MAY LOSE VALUE

www.citiprivatebank.com