

CIO Strategy Bulletin

August 31, 2020



Double Header: “Redefining Value” and “Opportunity: Brazil”

David Bailin, Chief Investment Officer

Steven Wieting, Chief Investment Strategist and Chief Economist

Joe Fiorica, Head – Global Equity Strategy

Jorge Amato, Head – LATAM Strategy

Malcolm Spittler also contributed to this Bulletin

Summary

The pandemic will likely abate in 2021 with the arrival of vaccines and treatments. As [we have noted](#), it is time for portfolios to be positioned to take advantage of the likely rebound in many impacted sectors and countries. This week we focus on how to understand “Value Investing” in today’s market and highlight Brazil as a key region with significant recovery potential.

Value investing has an 85-year history of outperformance, but its track record has been abysmal since 2009. As companies use technology and software rather than physical assets to invest in their growth, balance sheets are not the sole place to identify value anymore. We suggest four places *beyond the balance sheet* to help investors identify value in 2020 and to avoid paying too much for it.

Value and Brazil are hand in glove. As the world’s 9th largest economy and a victim of COVID comparable to the US, Brazil offers a compelling investment thesis just now. The hunt for “Value” is a global one and the emerging markets are stores of value. With above average growth rates due to an evolving middle class as well as world-class companies and exposure to commodities, we believe Brazil is poised for a rebound in its equity markets.

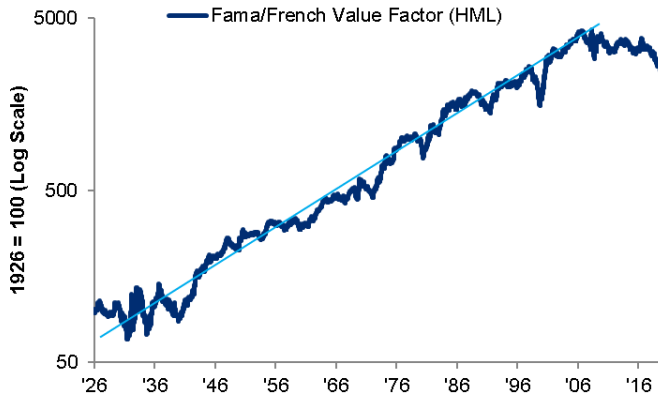
Redefining Value

Not Your Parent’s Value Anymore

Until recent years, Value Investing, or investing in stocks with a low market price relative to accounting book value, had a nearly 85 year history of outperformance (**Figure 1**). The conceptual underpinnings of Value Investing based on Eugene Fama and Kenneth French’s empirical findings are straightforward: if one buys stocks that are cheap relative to their fundamentals and sells those that are expensive, the rotation from expensive to cheap will generate above index performance.

Starting around 2010, this “tried and true” investment strategy started underperforming and that underperformance has accelerated during the pandemic. And yet, we find ourselves presently making the same call to rotate from “growth” to “value” to generate “alpha” in portfolios. Does that make sense in 2020? Is there a long-term premium for lower valuations in a market where the largest and priciest shares have routinely outperformed?

Figure 1: Fama/French Value Factor Performance since 1926



Source: Fama and French as of August 30, 2020.

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The Old Definition of Value is Failing

We believe that defining value in the prism of accounting book value is misaligned with the realities of today's economic environment. Changes in the way established companies run their businesses, with an emphasis on investments in technology/software that can be expensed or depreciated rapidly for tax purposes, and less investment in longer-lived traditional property plant and equipment is a factor (**Figure 2**). So are accounting practices, tax reform and accelerated depreciation. Another factor is low interest rates that have steadily declined since the Great Financial Crisis. These have affected the value of equities (and dividend equities) relative to bonds and have required that a lower discount rate be applied to future earnings of companies with rapid growth trajectories, but low or non-existent profits (**Figure 3**).

Figure 2: Firms are increasingly focusing investments on software and other intangibles

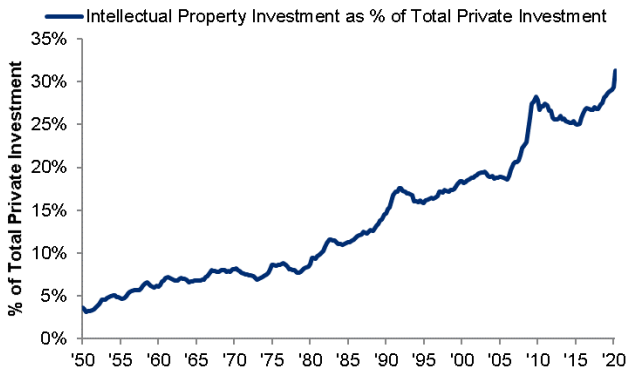
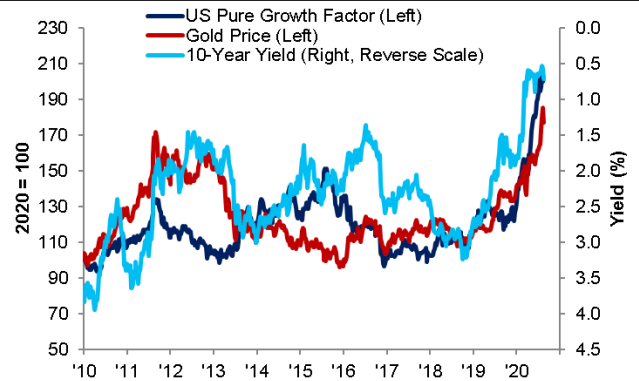


Figure 3: US interest rates and growth stocks



Note: The S&P 500® Pure Growth index is a style-concentrated index designed to track the performance of stocks that exhibit the strongest growth characteristics by using a style-attractiveness-weighting scheme. Source: Haver Analytics and Bloomberg as of August 30, 2020. 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. For illustrative purposes only. Past performance is no guarantee of future results. Real results may vary.

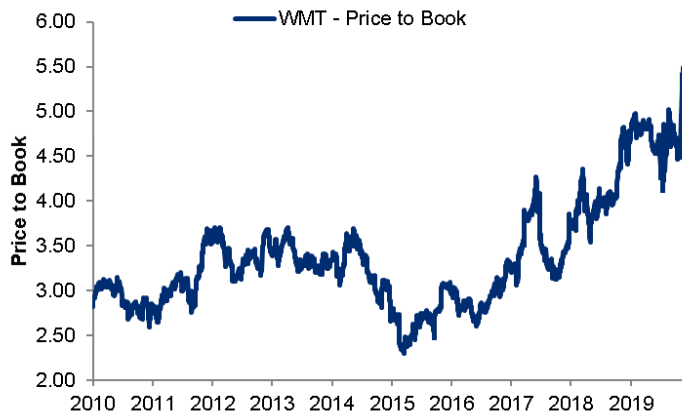
Two Examples

To understand why the definition of value needs refinement, we need only look at two long-established American companies whose strategies are now reflected differently in their price to book value: Walmart and Honeywell.

While it is relatively straightforward from an accounting perspective to value all of Walmart's stores nationwide, how should an investor think of fair value for its emerging e-commerce business? The growth of Walmart's e-commerce business, which is enabling it to keep up with Amazon in the retail space, has driven its price to book value from 2.5x in 2018 to over 5.0x today (**Figure 4**). Does this mean Walmart is now overvalued? Or is its accounting book value a bad indicator of fair value based on the company's increasing share of earnings from online activity?

As another example, in recent years, industrial conglomerate and recent Dow Jones addition Honeywell has been increasingly focused on complementing its industrial portfolio with technology to support its customers. It recently acquired Intelligrated, a warehouse automation platform that it cross-sells to its distribution and warehouse customers as a complement to its hardware business. The integration of software with hardware to develop a “platform” offering both goods and services is inherently intangible and requires a deeper level of company analysis than can be done via simple valuations screens.

Figure 4: Walmart’s Price to Book as Online Platform Develops



Source: Bloomberg as of August 30, 2020.

For illustrative purposes only. This should not be construed as an offer of, or recommendation of companies discussed.

The Re-Definition of Value

Today’s value investors cannot rely on simply “buying cheap stuff” from a balance sheet perspective and expect to generate outsized returns. Instead, we believe there are new factors that can identify where “value” is for certain companies. These include:

- The ability to pay and grow dividends;
- Insensitivity or ability to benefit from rising rates;
- Cyclical exposure to economic cycles;
- Geographic exposure to markets with above-average economic growth; and/or
- Identifying likely earnings growth through margin expansion (and not overpaying for it)

Thus, we are evolving the pure “book value” definition of value and enhancing it with criteria that allow us to identify which “cheap” companies may prosper in the future by virtue of their “relative value” – attributes that should demand a higher premium relative to companies that are cheap on an asset value basis. No one indicator can tell us everything about a company’s relative attractiveness. Instead, we believe a combination of strong balance sheets, promising growth prospects, and an alignment of fundamental factors all help us determine which sectors and companies are poised to potentially outperform in the period ahead.

Finding Value in the COVID “Losers”

We have written at length about how COVID-19 and related lockdowns have created winners and losers from this crisis. Among the areas most impacted by COVID, we can identify sectors and companies which fall cleanly within our enhanced definition of “value”. US banks, which boast strong balance sheets and are likely to benefit from a rising rate environment, look attractive at significant discounts from pre-COVID levels. Outside financials, elements of the industrials and consumer discretionary space are also likely to rebound along with a global economic recovery. At a regional level, we see value outside the US, particularly among European and Latin American equities that remain at multi-decade discounts to US shares.

How to Play the New “Value”

We recommend the following four strategies to consider when investing for “value”:

1. Dividend growth stocks: “Dividend growers” are established firms with a proven track record of increasing payouts for shareholders over multiple economic cycles. That consistency of growing dividends has materialized in stronger long-term returns for both US and global firms (**Figure 5**). Given questions over the sustainability of dividend programs in this virus-driven downturn, dividend growers have underperformed firms that are not “burdened” by paying dividends year-to-date (**Figure 6**). We believe that firms that can sustain dividend growth as well as continue to fund business expansions are likely to emerge from this crisis stronger and more resilient. In short, they are good value!

Figure 5: Dividend Growers, Payers, and US Equities

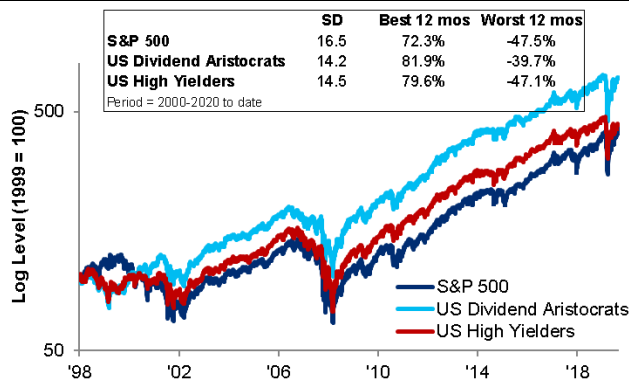
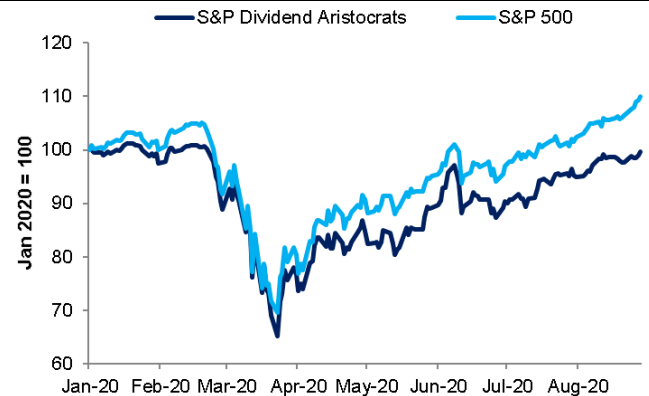


Figure 6: Performance of Dividend Growth Stocks YTD



Source: Haver Analytics and Bloomberg as of August 30, 2020.

Note: The Global and S&P 500 Dividend Aristocrats include only those index members which have consistently increased dividends for at least the past 25 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. Index returns do not include any expenses, fees or sales charges, which would lower performance. For illustrative purposes only. Past performance is no guarantee of future results. Real results may vary.

2. Growth at a reasonable price (Low PEG stocks) – The concept of “growth at a reasonable price” (GARP), or investing in growth stocks without overpaying for them, was made prominent by Peter Lynch of Fidelity Investments over 30 years ago. The strategy involves balancing a firm’s valuation with its growth prospects, only paying a higher multiple if an investor expects higher growth in that firm’s profits. A GARP strategy allows analysts to avoid both “value traps” and overpriced growth stocks, tending to perform well when momentum and low rates are not the predominant factors driving markets. Certain GARP strategies have led to outsized returns versus both value and growth over the last 25 years (**Figure 7**).

This investment strategy tends to be biased towards reasonably valued cyclical shares, a segment we expect to outperform as the global economy recovers over the next 12-18 months.

Figure 7: S&P Value, Growth, and GARP Indices



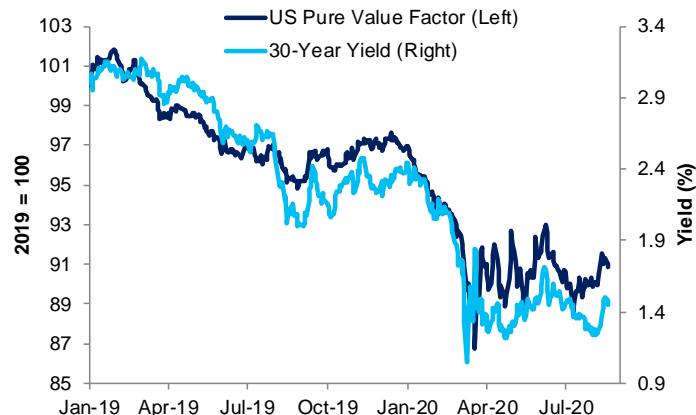
Source: Bloomberg as of August 30, 2020.

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3. Companies less sensitive to rising interest rates - Value stocks typically have higher near-term earnings and cash flow yields, unlike growth stocks that are valued based on potential (but not certain) cash flows far out into the future. This dynamic makes value stocks much less dependent on a low discount rate to fuel valuations, and therefore value tends to be less sensitive to interest rate shocks. Given our expectation for a re-rating of growth expectations in the next 12-18 months as virus-related

worries abate, interest rates should rise from current levels, driving value outperformance of growth in such a scenario. Classic value sectors like banks, as well as insurance companies and higher-beta mortgage REITs, are likely to benefit most if interest rates do rise from current levels.

Figure 8: US Pure Value Factor vs 30-Year Treasury Yield



Note: The S&P 500® Pure Value index is a style-concentrated index designed to track the performance of stocks that exhibit the strongest value characteristics by using a style-attractiveness-weighting scheme. Source: Bloomberg as of August 30, 2020.

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4. Economically sensitive sectors and regions that are cheap relative to COVID-winners – Europe and parts of EM are historically cheap relative to the US for a variety of governance and structural factors, including their high correlation to the value factor (Figures 9-10). These regions tend to be much more sensitive to economic growth and are more likely to outperform as the global economic engine restarts. Contributing to this dynamic, we expect a weakening dollar to support non-US shares.

Figure 9: Growth vs Value Correlation to Regional Equity Indices

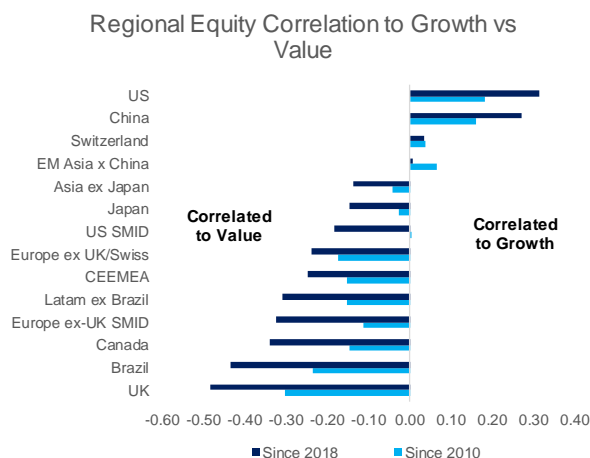
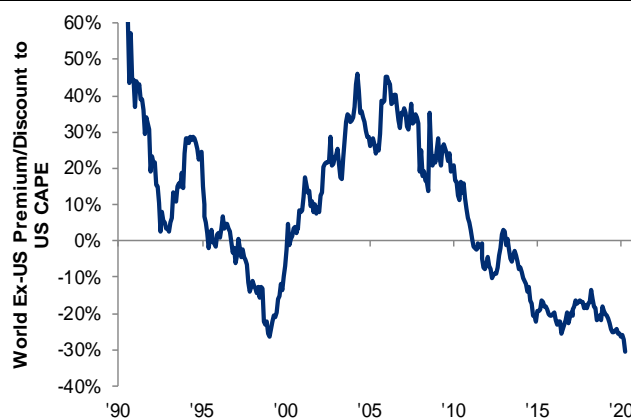


Figure 10: US vs Non-US Relative Valuation



Note: CAPE is the Cyclically Adjusted Price to Earnings Ratio. Source: Bloomberg as of August 30, 2020. 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. For illustrative purposes only. Past performance is no guarantee of future results. Real results may vary.

Identifying the New Value

As we look beyond COVID, we see potential from certain sectors and regions that have underperformed so far this year. These sectors and regions have associated catalysts that might suggest a re-valuation is in order.

- As US companies consider diversifying supply chains out of China amid continued tensions between the world's two largest economies, we believe countries in southeast Asia and Latin America could see a boost in foreign investment.
- Reshoring back to the US and government-driven infrastructure spending may benefit certain small and medium sized manufacturing companies in the US.
- Banks will be able to reduce the level of loan loss provisions sooner than many think because of the nature of this particular recovery. As long as governments remain supportive throughout the rest of 2020, banks are well-positioned to move on from this crisis much stronger than they were following the Great Financial Crisis.

Conclusion

As we have written previously, we expect cyclically oriented “value” shares to outperform as we look ahead towards the end of the pandemic and the availability of effective vaccines and treatments. While we do not expect an imminent rise in interest rates, a repricing of growth expectations as economies eventually move on from COVID is likely [to mean higher yields and a steeper yield curve in 2021](#). This market dynamic is likely to benefit traditional “value” sectors like banks and insurance companies, while boosting growth-sensitive regions like Latin America, Southeast Asia, and Europe that remain depressed relative to their US peers.

In our view, we see Value Investing more broadly than a simple accounting-based strategy. We think value needs to be re-considered and new definitions applied. This involves doing more work than simply comparing current prices to accounting book value. We therefore recommend a thoughtful rotation of portfolios, taking some gains in fully priced growth shares (or investing cash still sitting on the sidelines) to fund the opportunities we have outlined herein. In our view, it is increasingly likely that the winners of the last 8 months are unlikely to outperform in the next 1-2 years of this New Economic Cycle.

Opportunity: Brazil

Understanding the Booms and Busts of Latin America

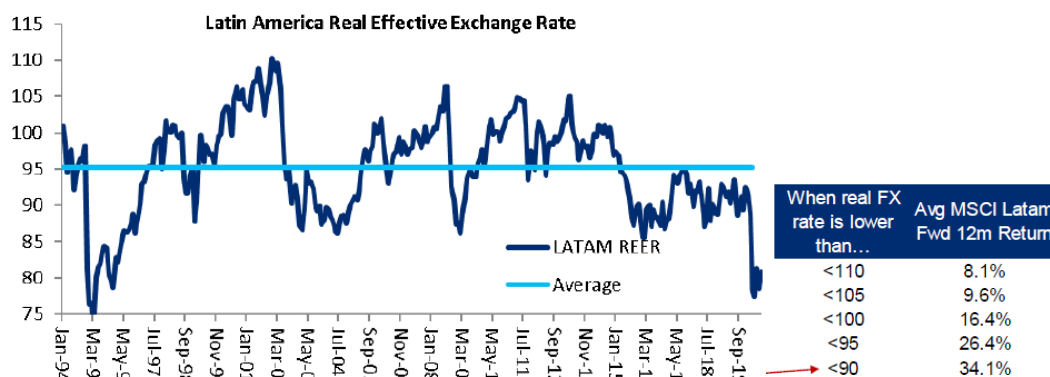
Latin America has not taken part in the global equity recovery – yet. Looking at COVID-19 period, from the February high to the April low, Latam equities experienced a 50% drawdown and were the worst performing regional equity markets in the world. Now, in spite of their 55% bounce (as of 18 August), the Latam MSCI remains down 32% YTD, missing the majority of the recovery seen around the world.

Latam equity markets have always been a cyclical play, dominated by domestic idiosyncrasies, currency volatility, varying access to international capital and exposure to commodity pricing. For decades, many countries operated under an orthodoxy of fixed exchange rates and capital controls that led to booms and busts. In response to fiscally conservative regimes, opposition parties have often promoted irresponsible fiscal policies as a means to attract disaffected domestic voters.

Global shocks have historically had an outsized negative impact on the region relative to other markets. During periods of global distress, the region's dependency on foreign credit markets magnifies capital flows and tends to cause more severe economic contractions than are experienced in developed markets.

Since the early 2000s, macroeconomic policies in Latin America have evolved and become more sophisticated. Policies and practices now include a greater commitment to fiscal discipline, flexible exchange rates, local versus external credit and inflation targeting. These policy improvements have helped Latin America recover more quickly from global shocks, presenting investors with opportunities to profit. In fact, when we look historically at regional real effective exchange rates, periods of stress and undervaluation are now more likely to be followed by robust equity market recoveries.

Figure 11: Latin America Real Effective Exchange Rate (REER)



Source: Bloomberg as of August 30, 2020.

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Latam Returns After Prior Shocks

Averaging the returns from the peaks and troughs of four of the largest market moves of the last 20 years illustrates that Latam equities are the “Ugly Duckling” of crisis periods, averaging 44% return drawdowns. Then, they have historically entered a “Beautiful Swan” period when markets recovered, generating an average 78% upside. However, these transformative periods have never led to more stable markets.

Figure 12: Average Return of DotCom, Global Financial Crisis (GFC), 4Q'18, Covid Crisis

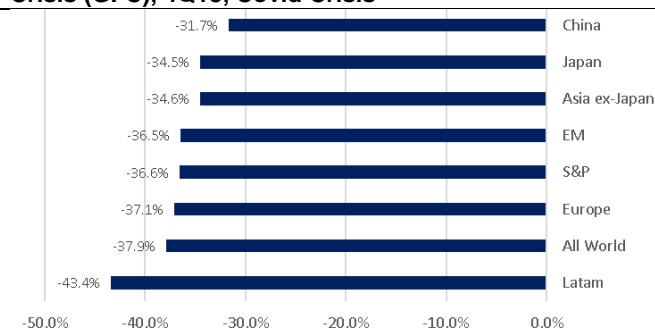
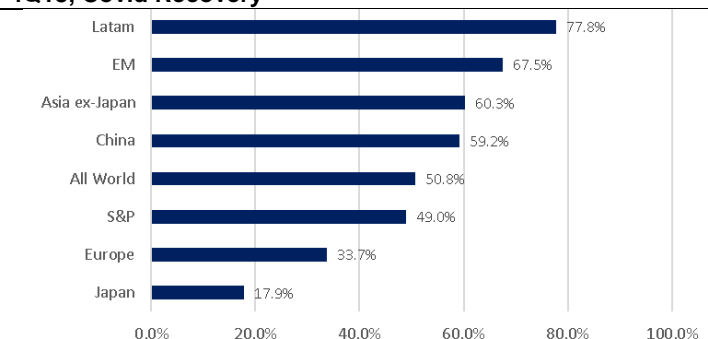


Figure 13: Average Return of DotCom, Global Financial Crisis, 4Q'18, Covid Recovery



Data Range Periods:

	Dot Com	GFC	4Q'18 Scare	Covid Pandemic
Crisis	3/31/00 - 9/30/02	5/30/08 - 3/6/09	10/8/18 - 12/26/18	2/19/20 - 3/23/20
Recovery	9/30/02 - 12/31/03	3/6/09 - 4/8/11	12/26/18 - 3/20/19	3/23/20 - 8/14/20

Note: All MSCI Indices except S&P500. Returns do not include dividends.

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Latam's previous underperformance is, in part, due to the cyclical nature of the businesses in Latam's benchmarks versus the more diversified developed market indices that have greater exposure to technology issues (**Figure 14**). That said, given our base case scenario for a global recovery in 2021-2022 and our view that “cyclicals” will benefit disproportionately, Latam can benefit strongly (**Figure 15**). This view is consistent with prior periods of extreme under/outperformance. What is different this time are better macro-economic policies and an economic environment far more conducive to a sustained recovery.

The new equilibrium level of regional GDP in a post-COVID world may be inferior to that of 2019, a year of only modest growth. But in a period of very low interest rates, low inflation and stable exchange rates, we have confidence that most Latin American economies will overcome the pandemic and that corporate earnings will rise more than expected.

Figure 14: Normalized YTD High-Current-Low Equity Markets

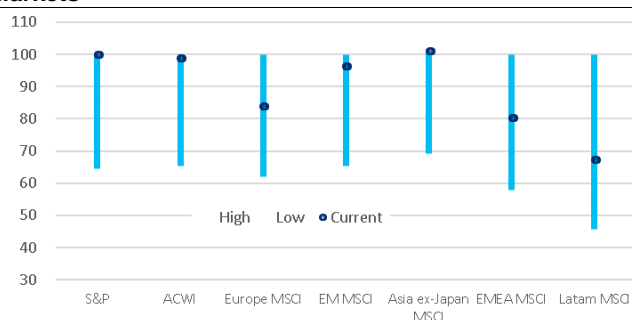
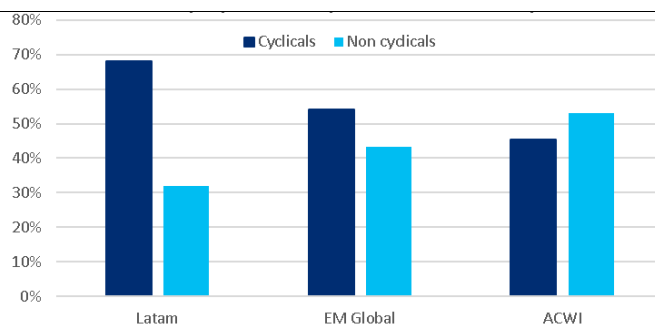


Figure 15: Equity Indices Exposure to Economic Cycles



Note: Cyclical: energy, materials, consumer discretionary, financials, real estate and industrials. Non-cyclical: consumer staples, health care, technology, telecommunications and utilities.

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Brazil Can Lead

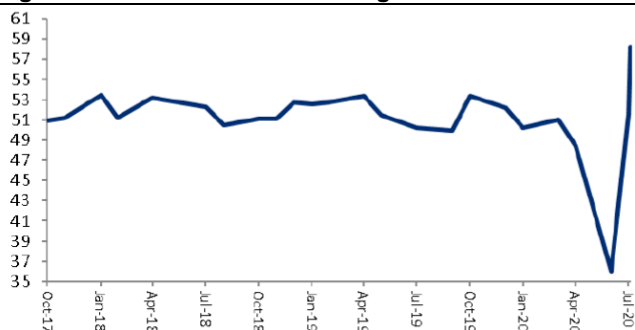
Brazil is our preferred Latam market to play the 2021-22 recovery. Brazil is not only Latam's largest economy, it is the 9th largest economy in the world with close to \$1.8 trillion in GDP. With over 212 million people, Brazil has the 6th largest population and a rising middle class that is driving domestic consumption. Brazil is also home to a number of world-class companies that add up to an equity market capitalization estimated at approximately \$1trn. Together, these are characteristics that pique our interest, a large dynamic economy and a sizable, investable equity market.

Brazil has many parallels with the US with regard to the impact of COVID-19. With nearly 3.5 million confirmed cases and over 110,000 deaths, Brazil is the 2nd worst hit country. The Brazilian GDP is projected to contract by 6.5% in real GDP terms in 2020 and to rebound by 3.5% in 2021.

The Brazilian government has responded aggressively when compared to other countries in the region. The Central Bank has cut rates by 250bp to a record low 2% since the beginning of the year, providing liquidity and a boost to credit. Fiscal support equal to 8% of GDP has been issued and there are ongoing discussions to increase spending.

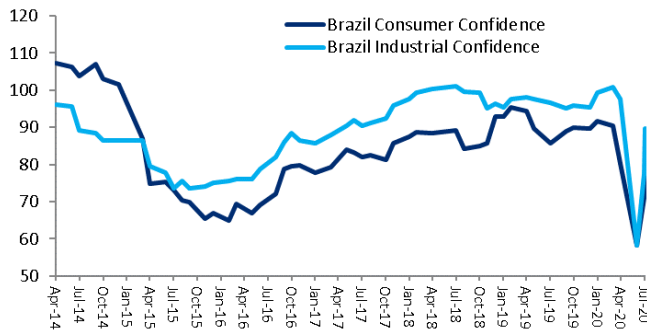
These measures combined with a slow and partial reopening have helped the economy bounce strongly and confidence recover. While we may see a deceleration of the Brazilian recovery in the coming months, we believe that economic activity will accelerate markedly in 2021.

Figure 16: Brazilian Manufacturing PMI



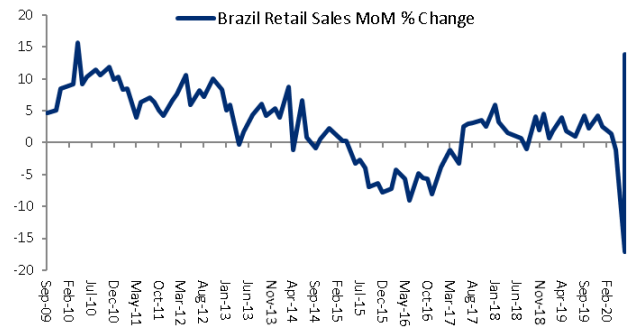
Source: Bloomberg as of August 30, 2020.

Figure 17: The growth in manufacturing is propelled by a growth a consumer and business confidence.



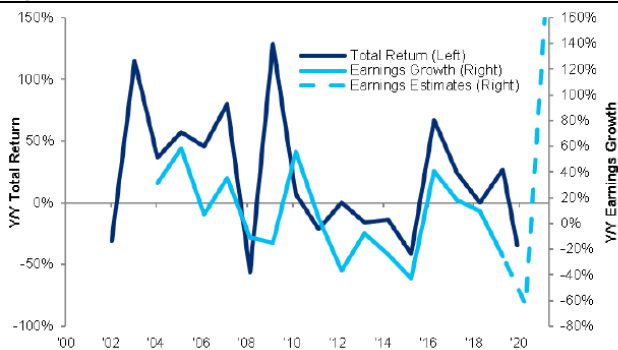
Source: Bloomberg as of August 30, 2020.

Figure 18: We see a similar rise in retail sales providing an underpinning to future growth.



And all of this will impact earnings to a degree not yet anticipated by markets.

Figure 19: MSCI Brazil vs EPS (YoY)



Source: Factset as of August 30, 2020.

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The Brazilian Currency May Magnify Equity Returns for Foreign Investors

The impact of COVID on the Brazilian currency (and most other Latam currencies) has been material. Free-floating currencies act as escape valves for external shocks. In the case of Brazil, the currency depreciated from close to BRLUSD 4 to close to BRLUSD 6, to bounce to current levels around BRLUSD5.50. Unlike previous crises, however, the nominal exchange rate depreciation did not spur inflation. Domestic BRL demand did not collapse and the performance of Brazil's market in domestic currency terms, while negative, was nowhere as poor as returns measured in USD. While this is of little consolation to foreign investors, it is a strong signal that domestic investors view their equity market positively and that a revaluation of the BRL relative to the dollar would be a positive for foreign investors, boosting the total return potential of Brazil for all investors.

Figure 20: Latam Local Rates FX Hedged YTD Returns

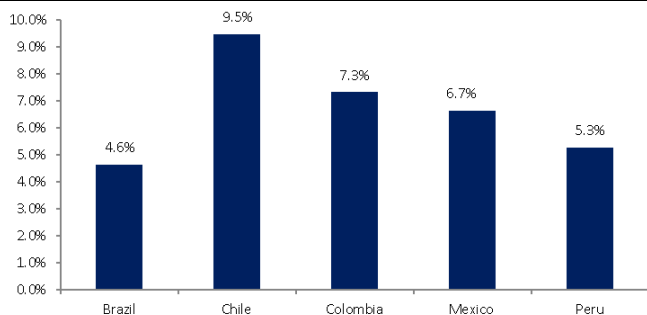
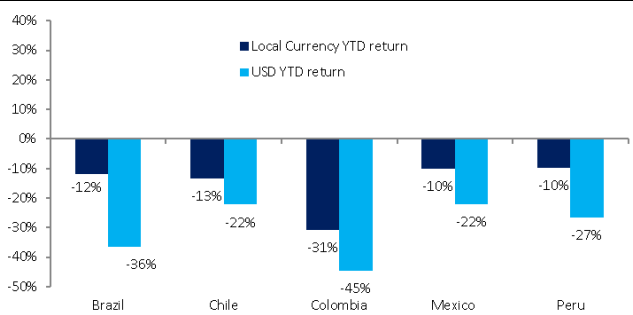


Figure 21: Latam Local vs USD Equity Returns



Source: Bloomberg as of August 30, 2020.

Drivers of Brazilian EPS Growth and Equity Appreciation

As inflationary pressures have remained very low, the brunt of the nominal depreciation has been absorbed by the real effective exchange rate (**Figures 22-24**), providing a large competitive cushion to the economy.

In addition, Brazil's relatively well-diversified export sector should also benefit from higher commodity prices, which are part of our global base case scenario.

The equity market is trading near 2008 (Global Financial Crisis) and 2016 (crash of the commodity super cycle) lows (**Figure 25**). These levels are consistent with the expected 60% contraction in 2020 EPS but not with the +150% EPS recovery consensus expectations have for 2021.

Figure 22: Latam Nominal and REER% Changes

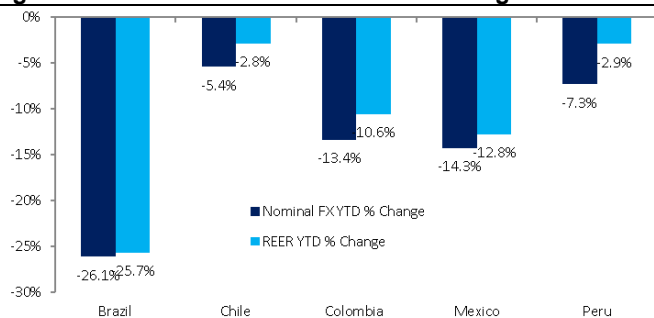


Figure 23: Brazil Real Effective Exchange Rate



Source: Bloomberg as of August 30, 2020.

Figure 24: Brazilian MSCI Return and Growth

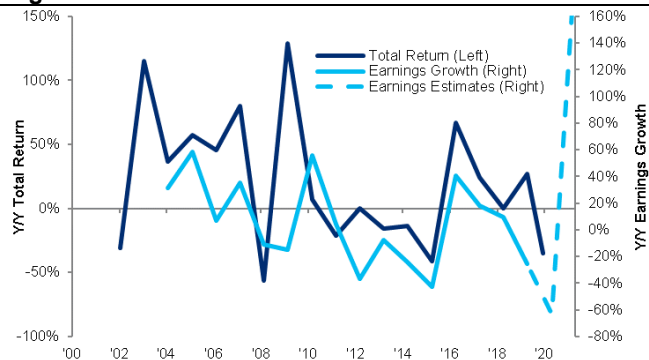
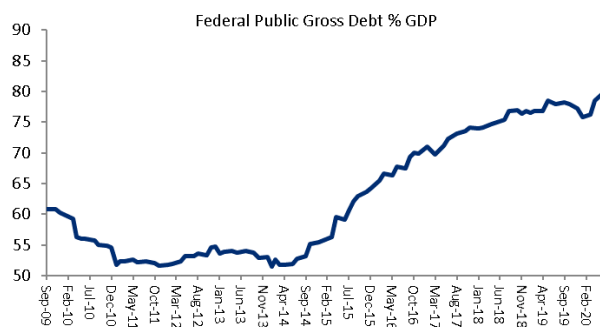
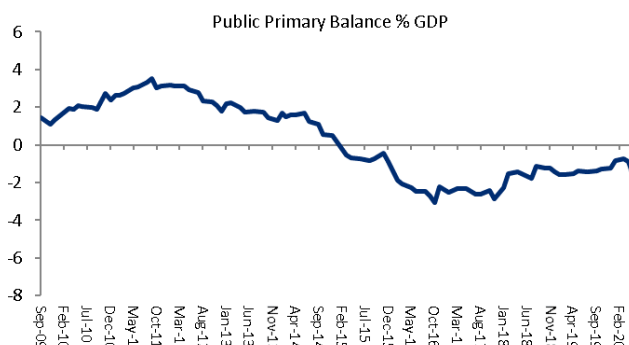


Figure 25: Brazil MSCI in USD



Source: Factset as of August 30, 2020. All forecasts are expressions of opinion and are subject to change without notice and are not intended to be guarantees of future events. 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. For illustrative purposes only. Past performance is no guarantee of future results. Real results may vary.

While we believe these scenarios are reasonable, numerous risks remain. It is possible that politicians and policy-makers lose fiscal discipline. The pressures that Covid fiscal support will place on public accounts will be significant. The economic bottoming and recovery did not come without a high cost. For example, the primary fiscal deficit could balloon to nearly 10% of GDP and the gross public debt could reach 100% of GDP. It will be critical that the administration and the political establishment provide enough signals to the markets that orthodox monetary policy and fiscal resolve will be maintained.

Figure 26: Brazilian Federal Public Gross Debt % GDP**Figure 27: Brazilian Public Primary Balance % GDP**

Source: Bloomberg as of August 30, 2020.

Why Brazil Now?

While we fully recognize the inherent risks of Latam equity markets, we believe current equity levels are fully pricing the ongoing economic and earnings contraction, but little of the recovery. We see reasons that earnings can grow disproportionately in Brazil. The country has the size, economic power, market depth and forward-looking policies that can spur a recovery in consumer and industrial activity not priced into markets. We believe that corporate EPS for 2021 and beyond can materially exceed expectations.

Much like our other calls on global COVID-cyclical equities and small and mid-cap stocks broadly, Latam and Brazilian equities (in particular) will only accelerate their recovery once investors have confirmation that the pandemic will end through vaccines and treatments. Current market pricing, in our view, provides enough of a discount to allow global investors to add exposure to Brazilian equities in their portfolios.

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