Citi Global Wealth Investments September 26, 2021

CIO Strategy Bulletin

Excessive Worrying May Be Costly for Investors

David Bailin, Chief Investment Officer and Global Head of Investments
Steven Wieting, Chief Investment Strategist and Chief Economist
Ken Peng, Head, Asia Pacific Investment Strategy
Joseph Fiorica, Head – Global Equity Strategy
Malcolm Spittler, Senior Economist

SUMMARY

- **Evergrande is one giant roller coaster of a real estate company. But why would its potential default spark a global selloff? The answer is worrying. In our view, worrying is a form of confirmation bias, the human tendency to aggregate information or "facts" into what must certainly happen next. In this CIO Bulletin, we assess the worry points impacting investor's thinking.**
- **One worry is that US equity valuations are "too high". While US valuations are among the world's highest, they have been propelled by record earnings that have legitimized this year's stock performance. Even in the face of a small US corporate tax rate hike, the next two years are likely to see operating profits rise by 7-8% per year in the US and globally.**
- **Looking back over 73 years of data, US equity total returns averaged 10.8% in the 12 months after an early-cycle growth peak. Returns were positive in 8 of 9 of those periods. In the second year of US economic recoveries, S&P 500 EPS have risen more than 10% in every case save one since 1960.**
- **See the "Summary of Portfolio Actions" at the end of the Bulletin for possible recommendations that avoid worrying and diversify portfolios for the coming second stage of the global recovery.**

Contagion?

Just before you reach the top of a roller coaster, the designers of the ride slow the ascent of the cars, add some chilling, banging noises on the chain lift and leave you suspended in air before the inevitable plunge to come. Such was last Monday (9/21/2021), when investors feared that the default of a single Chinese real estate company could send financial markets the world over into a descent like 2008. Investors sold everything that day from soybeans to tech stocks. A 34% jump in S&P 500 implied volatility was coupled with much higher prices for potential downside hedges. The doomsayers used phrases like "a Lehman moment" to add sound effects to their flashing, bright red trading screens.

Not so fast.

Evergrande is just one company, albeit a large one. With more than 200,000 employees today, the conglomerate has 1,300 property projects in 280 cities and assets worth 2.3 trillion yuan ($340 billion). China Evergrande Group owes over 600 billion yuan ($89 billion), with more than this owed to its supplier and contractors. Across China, Evergrande's activities support 3.8 million jobs in construction, electric vehicles, health clinics and even theme parks. In 2017, Evergrande's founder, Xu Jiayin, was China's richest entrepreneur.

Riding the Wall of Worry

Evergrande is one giant roller coaster of a real estate company. But why would its default spark such a global selloff? The answer is worrying. Perhaps you are experiencing this tickertape… Valuations are unsustainable. The pandemic will never end. The US Government will shut down. Inflation is unrelenting. Taxes in the US will crush stocks. The Fed will tighten too fast. That's quite a list. In fact, making such a list is a form of confirmation bias, the human tendency to aggregate information or "facts" into what must certainly happen next. So, let's take a closer look at this ride, known as the "Wall of Worry" and ask ourselves whether we are, in fact, ready to plunge into a Bear Stearns-style abyss.

Are Equities "Too High"?

US equity valuations are among the world's highest, propelled by record earnings that have legitimized the rally (see CIO note two weeks ago.)   Corporate profits already reached a record high in the first half of 2021. Signs point to a peak in "cyclical momentum" in the US and wider world economy. We expect that EPS growth will slow substantially over the coming two years. Nonetheless, even in the face of a small US corporate tax rate hike (see Fiscal Trifecta), the next two years are likely to see operating profits rise by 7-8% per year in the US and globally[1].

History provides some interesting context for our views. Looking back over 73 years of data, US equity total returns averaged 10.8% in the 12 months after an early-cycle growth peak[2]. Returns were positive in 8 of 9 of those periods (see Quadrant). In the second year of US economic recoveries, S&P 500 EPS have risen more than 10% in every case save one since 1960.

Never Ending Covid?

COVID infections remain high in the US and world at large. In the Fed's comments this week, they noted that, "the sectors most adversely affected by the pandemic have improved in recent months, but the rise in COVID-19 cases has slowed their recovery." But the fact is that the pandemic is generating less and less restraint on overall economic growth as people and businesses adapt. Looking at the data, we see a sharp rise in infections in the US and slowing infections elsewhere. Even the face of COVID, it is clear that people are returning to normal activities levels as is evident in the retail and recreation data from Google. These activities show a 95% return to pre-pandemic levels. (see Figures 1 and 2.)

Figure 1: Daily New COVID Infections: US, World Ex-US

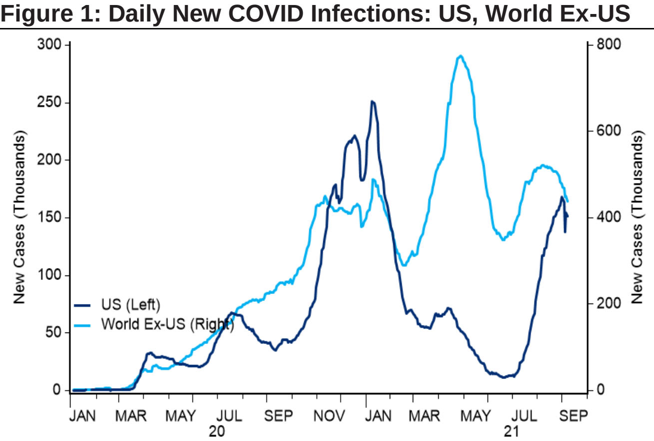


Figure 2: Daily Global Mobility: Retail and Recreation Sites

Source: Haver Analytics and FactSet as of September 23, 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.

[1] All forecasts are expressions of opinion and are subject to change without notice and are not intended to be a guarantee of future events.

[2] Source: Haver Analytics.

Globally, 6.1 billion vaccine doses have been administered (Our World in Data, 9/23/2021), with 2.6 billion people fully vaccinated. Major developed nations have reach 60% vaccination levels and billions of COVID doses are still being shipped and administered. While it is certainly possible that a new variant resistant to the vaccine will emerge, the possibility diminishes as vaccination rates rise and other mitigation strategies, including frequent testing, are maintained.

Taxes Will Kill the Economic Recovery?

We expect that the passage of any legislation will result in manageable changes in taxation for US corporations. The rise in taxes may have less impact that the face value of 5.5% when allowing for tax offsets that the current proposals contain (see Fiscal Trifecta). We also believe that it is more likely than not that the debt ceiling debate will not generate the market turmoil last seen in 2011. (Figures 3 and 4.)

Figure 3: Higher Tax Rates Expected Across the Board When, How Much?

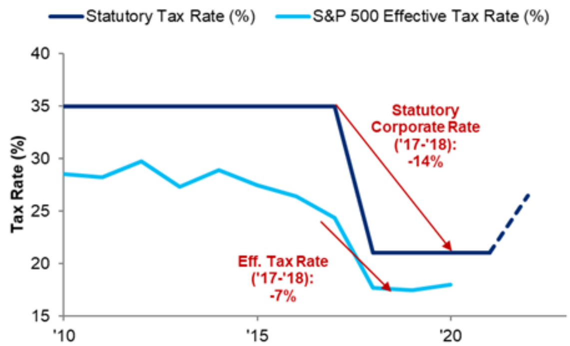
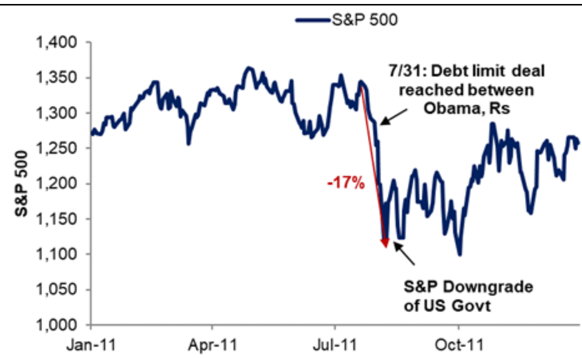


Figure 4: Will the US Debt Ceiling Be Pushed to the Brink Like 2011?



Source: Haver Analytics and FactSet as of September 23, 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. . All forecasts are expressions of opinion and are subject to change without notice and are not intended to be a guarantee of future events.

The Fed's Path is Too Aggressive?

When Chairman Powell noted that tapering "may soon be warranted", he was simultaneously sending two messages. On the one hand, he was noting that the economy was nearing the point where the Fed will pare back its bond purchases reflecting data showing that the US and global economy continue to strengthen. These are steps to diminish easing, not raise rates. He was also deliberately avoiding making decisions while Washington, DC was embroiled in political and legislative hankering. Powell also said the Fed will not be pulled into rate hikes or abrupt action due to bottlenecks and supply shortages which are not of the Fed's making.

Powell continued to move the Fed's ball forward at a deliberately slow pace. The Fed will not ease at an unsustainably pace forever. It won't latch on to views that the price instability of the COVID period is the normal state of affairs in the future.

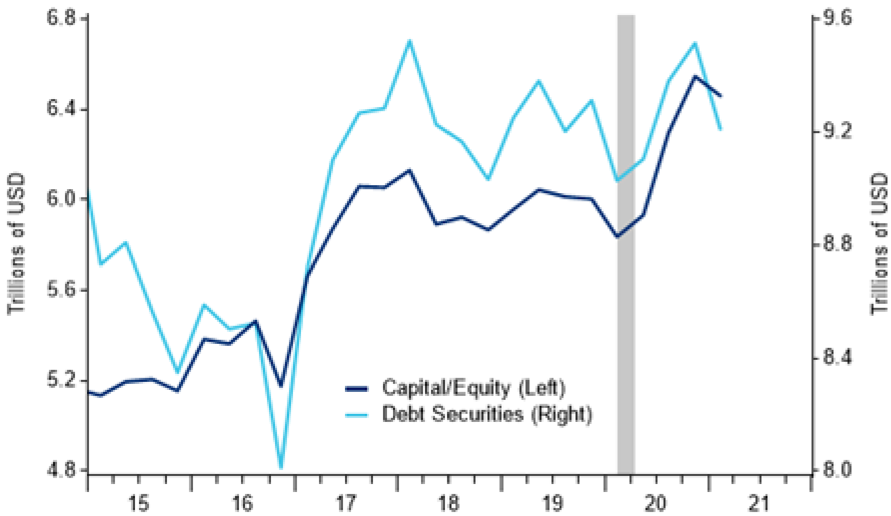
Markets had built up great apprehension over the Fed, fearing what other investors might do if the Fed Chairman stood his ground by merely acknowledging a slower pace of quantitative easing is in the works (tapering.) When he did this, investors shook off the fear and put money to work, with shares higher over the remainder of last week.

As we noted two weeks ago, the particular shares that perform strongest over the short term could wax and wane with perceptions that the Fed will tighten too slow or too fast (See note two weeks ago.) In a more basic way, early cycle Fed tightening is not consistent with recession or plunging shares. During five years of rate hikes and quantitative tightening from 2014-2018, US S&P 500 returns were +11.0% annualized.

Evergrande or Something Worse?

Viewed in isolation, the world's financial exposure to Evergrande – and even the entire Chinese property sector – would actually be an easily manageable shock. Global banks reporting to the Bank for International Settlements (BIS) have increased their risk-absorbing capital to $6.5 trillion in recent years (see Figure 5 and note that BIS data exclude China). Central bank policies globally have already led to the largest de-risking of liabilities relative to bank capital in observable history in the years after 2008. And the Federal Reserve and ECB stress tests show low vulnerability to any Chinese shock consistent with this data.

Figure 5: Global Bank Capital vs Debt Liabilities



Source: Haver Analytics as of September 20, 2021. Gray shaded areas are periods of US recession.

The bigger worry is an apparent willingness of Chinese authorities to sacrifice current growth to squeeze the real estate sector to a point where the cost and availability of capital impact the wider financial system across China. This is challenging our predominant view that the authorities prioritize financial stability and have the means to "ring fence" the spillover. More recently, other issuers in the property sector have seen their shares and bond prices hit severely. Banks and insurer shares have joined the ranks of those exposed to Macau gaming and technology that have suffered China policy-related hits earlier. We believe the market is telling regulators that unless something is done to stop the spillover, more issuers will face default risk.

Containing the fallout from Evergrande is no longer sufficient at this stage, in our view. China's economic growth faltered in August. Retail sales grew only 1% annualized over the past 24 months, partly due to Covid, partly to floods, but significantly due to credit tightening. The impacts of numerous regulatory changes, broad changes across the real estate industry and an absence of foreign investment and confidence may mean sub-6% growth for China in 4Q2021 and into 2022.

Given the growth impact on social stability and income generation for the middle class, Chinese authorities are not likely to tolerate a severe and lasting growth slowdown. A calendar year growth target of 6% for 2022 has been deemed the "minimum." Many forecasters have expected stronger results than this for China in 2022, but that now seems to be a central case. Achieving 6% growth in 2022 is forecasted to come with a stronger second half 2022. Various new sources of stimulus such as infrastructure spending can be ramped up in China, but this will be felt in full with a lag of several quarters.

A China Melt Down?

Unwinding Evergrande likely won't pose systemic risk in China, much less the world. Chinese equity valuations have retreated in one sector after another, which has historically pointed to enhanced future returns. Nonetheless, the declines for many market leaders have followed deliberate Chinese policy actions. We see the outlook for Chinese macro and micro policy as somewhat less predictable than in the past 10 years. With this in mind, we'd prefer global diversification to concentrated over-weights in Chinese shares, even as macro policies will potentially restore economic growth within 2022.

From Worry to Action!

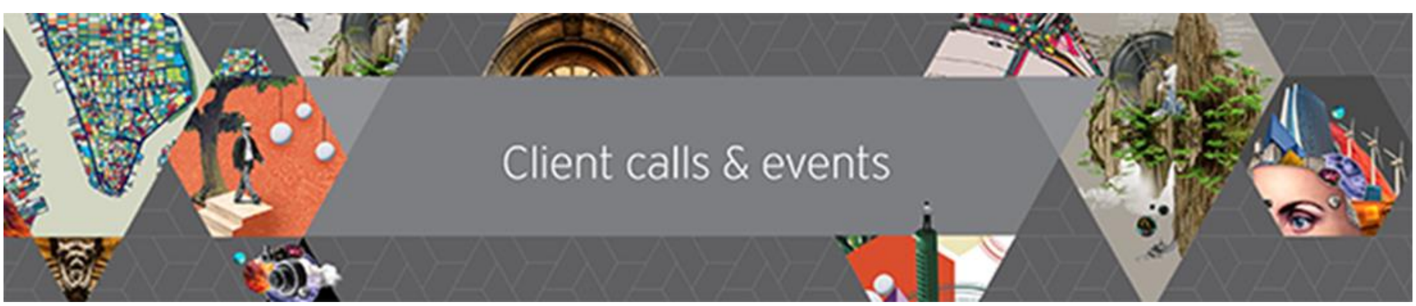
This week, our Global Investment Committee (GIC) met and maintained our allocations to less cyclical, higher quality assets. While we expect moderating financial market returns compared to the past year's pandemic recovery, we don't believe the world economy or equity markets are near a peak or turning point. Global bond yields averaging 1.3% across the risk spectrum remain uncompelling. We remain overweight equities by 8%, underweight fixed income and cash by an equal amount.

Our rationale for these actions is simple. High quality, secular and defensive growth equities have outperformed cyclicals in almost every case following a deceleration in early-cycle economic growth. With our return expectations moderating, we will try to generate potential equity outperformance with the help of robust dividends. We have shifted portfolios toward companies with the ability to potentially grow dividends and earnings.

We expect strong relative returns from US large caps and certain thematic holdings. For example, with slower – though historically still robust – growth expected, we doubled our overweight to the defensive healthcare sector earlier this year. At the same time, we lowered certain emerging market equity holdings, and exposure to sectors that we believe have limited return prospects apart from COVID-related recovery.

Summary of Portfolio Actions

1) **Overweight the "high quality factor."** Firms that raise dividends most consistently lead their industry. They don't outperform in bubble periods or in the first year of recoveries. They provide the most consistent returns over the full cycle. As we emerge from COVID, quality will prevail over cyclicals.
2) **Overweight healthcare.** The cheapest valuation of our "unstoppable trends" is also the least speculative. Periods of underperformance tend to be limited to early cycle "snap backs" in cyclical, indebted sectors
3) **For higher frequency opportunistic trades, consider yield curve steepening allocations over the near-term.** We highlight financials as a near-term beneficiary of Fed tightening views.
4) **For China allocations consider A-shares.** The A-share market has the natural advantage of being more insulated from foreign capital movements. Local benchmarks have higher weights in industries authorities favor and may see greater inflows Chinese savers reallocating from property.
5) **Overweight credit and inflation-linked assets in fixed income.** With yields sub 2% before inflation, keep these allocations at the minimum necessary to dampen overall portfolio volatility to desired levels.
6) **Be a borrower via Alternative Investments. For qualified investors** with rates likely to stay lower for longer, exposure to funds and direct investments that benefit from lower borrowing costs is logical. Private equity, late-stage venture capital and real estate assets are beneficiaries and allow suitable investors to "borrow". Certain hedge funds are also potential beneficiaries of lower carrying costs.



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.

Alternative investments are speculative and entail significant risks that can include losses due to leveraging or other speculative investment practices, lack of liquidity, volatility of returns, restrictions on transferring interests in the fund, potential lack of diversification, absence of information regarding valuations and pricing, complex tax structures and delays in tax reporting, less regulation and higher fees than mutual funds and advisor risk.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