



Citi Global Wealth Investments

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# CIO Strategy Bulletin

## Working Overtime: Our Views on Inflation and Earnings

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### Summary:

#### The Inflation View

- Investors expect the current environment to persist. Cash-heavy consumers, supply chain bottlenecks, labor dislocations and pandemic-shortages are not going to be permanent fixtures of our economy. Similarly, investors believe that inflation caused by the extraordinary events of 2020-21 will remain. That is unlikely.
- Inflation in the coming decade will trend higher than in the decade past. The current CPI inflation view embedded in TIPS is +2.6% per year. We consider that a good proxy for forward US inflation.
- A combination of higher future inflation and persistently lower interest rates creates a poor forward environment for fixed income investors. Over the past decade, the US 10-year Treasury note's total return after inflation was **+5.1%**. Using US Treasury Inflation Protected Securities (TIPS) as a proxy, the real total return of the 10-year Treasury is likely to be **negative 10% over the coming decade**.

#### The Profits View

- Almost half of the S&P 500 reported Q3 earnings. 82% of the 244 firms exceeded their estimates with an average beat of 11%. Analysts continue to under-estimate the strength of the earnings recovery after an 11% profit decline in 2020. We expect estimates to continue to be revised higher for the remainder of the year. Outside the US, two-thirds of European companies have beat consensus thus far. A growing percentage of global earnings downgrades can be found among Chinese firms, as investors price in a deceleration in China's macro situation
- Improving EPS growth in 2021 pulls forward growth from 2022. We forecast an 8% EPS growth rate for the US and world in 2022 vs 45% in 2021. However, upside "surprises" in 2021 make downgrades to EPS estimates in 2022 less likely. **In short, 2022 earnings performance looks more certain, not less.**
- The Consumer Staples sector has posted the second slowest growth rate of all sectors in the current reporting period with shares lagging the S&P 500 by about 16 percentage points in the year-to-date. In 2021, these firms had stable sales and incurred sharply rising costs. The 2022 outlook for such shares should improve if costs stabilize, as we expect. Meanwhile, the doubling or more in profits for commodity-related sectors over the last year seems set to slow in the year-ahead.

## Seeing Inflation Everywhere? You're Not Alone

Though we are living through unprecedented times, the present sources of disruption will not be sustained. The pandemic collapse of 2020 was a short-term event. And we believe the present Covid boom will also be, at most, an 18-month phenomenon (see **Figures 1-2**).

Yet, it is similarly a phenomenon that investors take today's news and assume it will all continue into the future. When the pandemic brought the global economy to a literal standstill, people expected a multi-year depression, deflation and persistent unemployment. And now, cash-heavy consumers, supply chain bottlenecks, labor dislocations and pandemic shortages are also assumed to be permanent fixtures of our economy. And investors similarly assume that the inflation caused by the extraordinary events of 2020-21 will remain.

### Understanding Inflation

Inflation is the outcome of persistent excess consumer demand relative to supply. It is a problem measured in currencies used for commerce. When the price of cars or aluminum rise, that is not inflation. It is a relative price change. Only when the number of dollars it takes to buy a complete representative basket of consumer goods and services rises persistently, do we see inflation. This allows for substitution effects. Only when inflation is persistently high and/or accelerating does it signal a future economic breakdown.

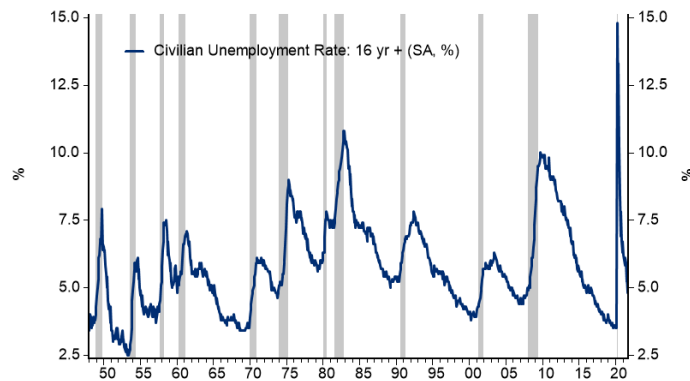
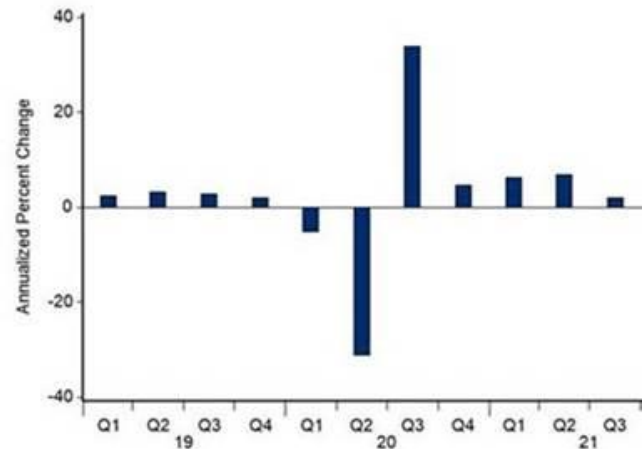
In our [Outlook 2021 discussion of Financial Repression](#), we noted that inflation in the coming decade will trend higher than in the decade past. We noted that a combination of higher future inflation and persistently lower interest rates would create a poor environment for fixed income investors for some time to come (see **Figure 3**). Over the past decade, the US 10-year Treasury note's total return after inflation was **+5.1%**. Using US Treasury Inflation Protected Securities (TIPS) as a proxy, the real total return of the 10-year Treasury is likely to be **negative 10%** over the coming decade.

The current CPI inflation view embedded in TIPS is +2.6% per year. We consider that a very reasonable estimate of the inflation rate the Federal Reserve will target and deliver over the next 10 years. This level is higher than the Fed's formal 2% preferred inflation measure, but is consistent with the Fed's goal of "overshooting" given the persistently low inflation of the past decade. We also believe it is consistent with a desire to gradually reduce government debt levels at the expense of bondholders.

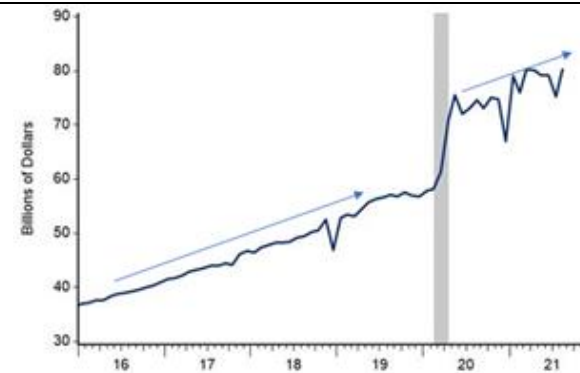
The Fed believes its preferred inflation measure is a more accurate indicator of true inflation because it allows for greater substitution effects. As consumers substitute less expensive products for those rising in price, the Fed's preferred measure (the "personal consumption expenditures deflator") captures their behavior and thus rises less than the Consumer Price Index.<sup>1</sup> TIPS, one of our only high quality bond overweights, compensates investors with the higher CPI rate.

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<sup>1</sup> The composition of both inflation measures does adjust in time as products become obsolete and consumer preferences change. The time of the rebalancing process and exact composition vary. The difference in the historical growth rate of the two measures has been 0.3% per year over a long history.

**Figure 1: US Unemployment Rate (%)****Figure 2: US Real GDP Seasonally Adjusted Annualized Rate (%)**

Source: Haver Analytics as of October 28, 2021. Note: Shaded regions denote recession.

**Figure 3: US 10-Year Treasury Note Yield vs CPI Y/Y%****Figure 4: US E-commerce Retail Sales (billions of \$)**

Source: FactSet and Haver as of October 28, 2021. Note: Shaded regions denote recessions.

## When “Just in Time” Means “Not on Time”

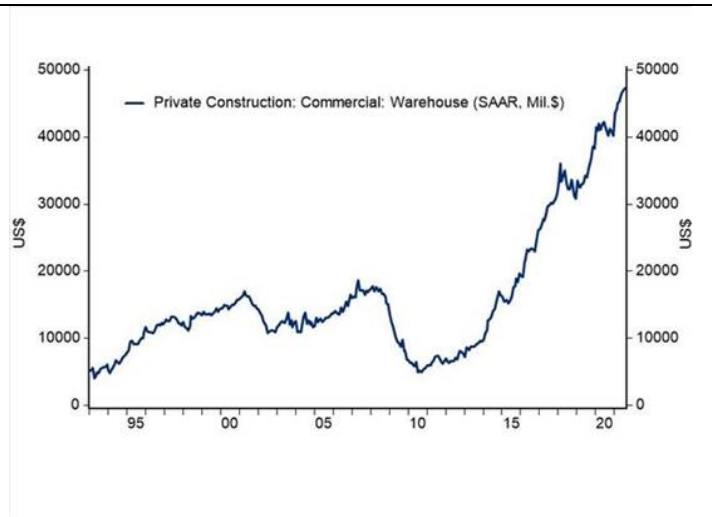
*“Americans are demanding more deliveries, and as a result, many things needed are becoming scarce...The crunch has been extreme in the weeks leading up to Christmas, but it’s a year-round phenomenon.” - NBC News, Dec. 23, 2019.*

Logistics were difficult before COVID shut down factories and congested ports around the world. Shortages of some items existed before the Federal Reserve’s massive easing and the issuance of Federal income payments to 85% of US households. In 2019, “empty shelves” were the result of a massive shift in the way retail commerce was being conducted. Simply put, digitization allowed more accurate ordering from factories as on and offline retailers matched buying behaviors with goods production and delivery. This reduced “speculative” inventories accumulating in “big box” retail stores.

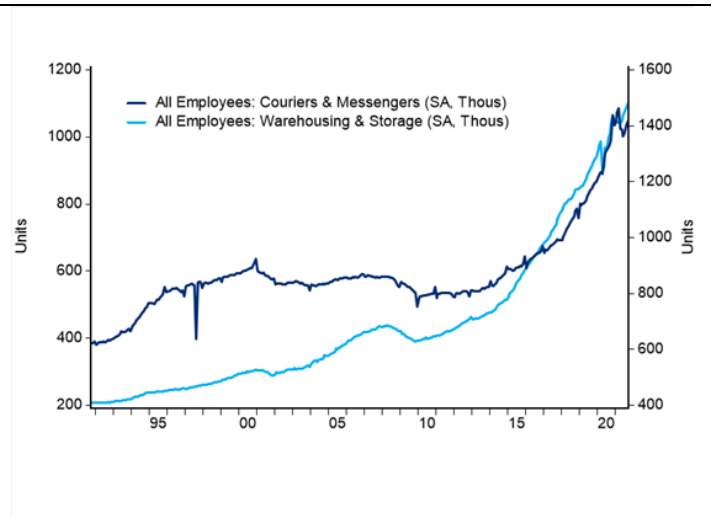
At the same time, when stores reopened for in-person shopping, e-commerce sales continued to vault higher as consumers sought the conveniences and better pricing enabled by digital commerce. The pandemic sharply accelerated a previous trend by many years (See **Figure 4**).

The transformation in retailing can be seen in both the levels of investment in real estate and technology associated with “just in time” deliver of more and more products. Before COVID shutdowns made e-commerce a necessity, the rate of employment in sectors benefiting from this trend was 2x other sectors (see **Figures 5-6**). What’s happening today, is a further massive shift in retail commerce that had no excess capacity to deal with the tidal wave of activity from the pandemic.

**Figure 5: US Construction Spending: Commercial Warehouses**



**Figure 6: US Employment: Couriers & Deliveries (LHS), Warehousing (RHS)**



Source: FactSet and Haver as of October 28, 2021.

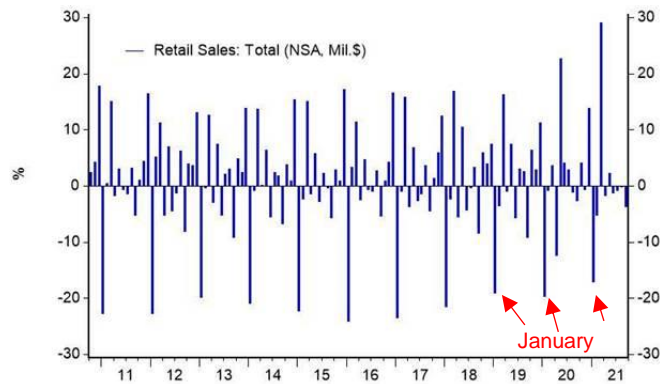
## Inflation is Not Due to Christmas

For observers looking at present delivery times as an indicator of long-term inflation, we note that present trends contain powerful and typical seasonal factors. At the moment, seasonal demand is nearing its annual holiday peak. While finding drivers, couriers and warehouse workers will be a problem for everyone, retailers will be particularly impacted by shortages from the year end gifting period (see **Figure 7**.)

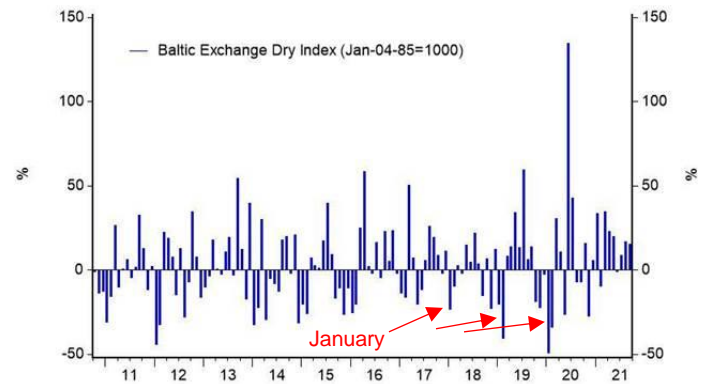
Large increases in purchases in November/December will then give way to normal slowdowns in the New Year. We see this in **international shipping rates for cargo that are normally affected by peak seasonal demand**. As Figure 8 shows, dry cargo shipping costs have routinely collapsed in the New Year period once holiday merchandise has been delivered.

The pattern we are seeing now is an exaggerated version of “normal”. That said, shipping costs are one small piece of the cost structure of goods. Shipping costs are not, in and of themselves, inflationary, just a component of prices that vary throughout the year. Only persistent excess consumer demand relative to supply is inflationary. **See the difference?**

**Figure 7: US Retail Sales Month/Month % Change Before Seasonal Adjustment**



**Figure 8: Global Water-Borne Dry Goods Shipping Rate Month/Month % Change**



Source: FactSet and Haver as of October 28, 2021.

## Distortions to the Economy Are Not Evidence of Inflation

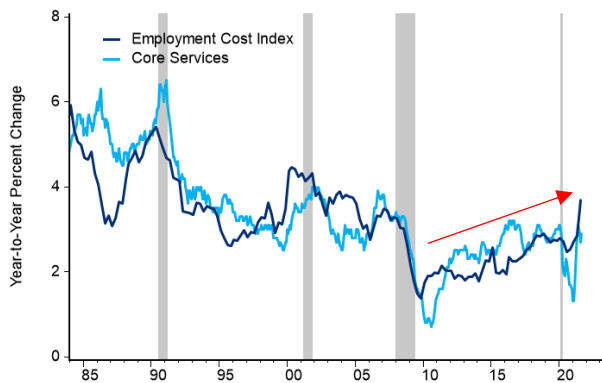
The unprecedented shifts in economic demand and the “work from home” requirements of the pandemic have led to a mismatch between available workers and the skills required in the pandemic economy. For example, the absence of vaccines for school-aged children left labor in short-supply broadly. But particular sectors like transportation and trade saw labor demand zoom (also in **Figure 6**) with limited labor supply response.

The demand-side rebound in the economy is driving employee compensation higher (see **Figure 9**). Pandemic-specific labor shortages caused by parents forced to stay home and people moving to new locations are the causes. Rising employee compensation (unlike the rise in prices for commodities) sustains demand growth. A major fear for those who believe that today’s higher level of inflation will be sustained is that compensation will continue to rise at pandemic rates.

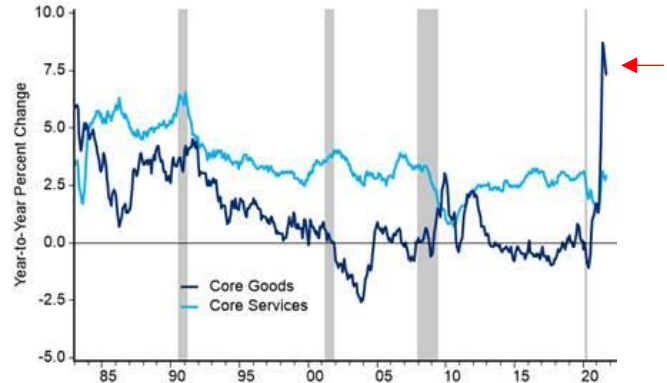
The price of labor is more closely linked to services prices than to goods prices. (The labor input share of services costs is roughly twice that of goods.) To assess the risk of persistent inflation due to wage increases, one must therefore look at the relationship between compensation and the pricing of services (again, see Figure 9). We can see that US compensation and domestic services prices have remained *very closely linked* and in an uptrend.

**The largest driver of US inflation measures now are goods prices that have temporarily risen sharply due to their substitution with expensive imports (Figure 10).** This unprecedented spike in goods prices is an abnormality. When people could not consume services, they bought more goods. This will not persist indefinitely, particularly because of the long-lived nature of the strongest component of these purchases – durable consumer goods.

**Figure 9: US Employment Cost Index and CPI for Services Ex-Energy Services Y/Y%**



**Figure 10: Core CPI: Goods vs Services Y/Y%**



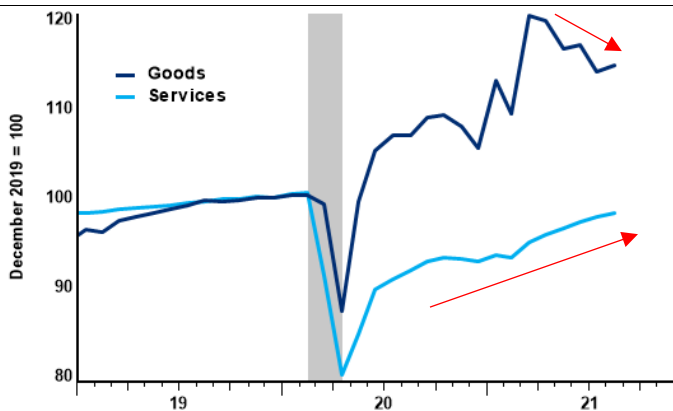
Source: Haver Analytics as of October 29<sup>th</sup>, 2021. Shaded regions are recessions.

## Expect 3% CPI inflation in 2022

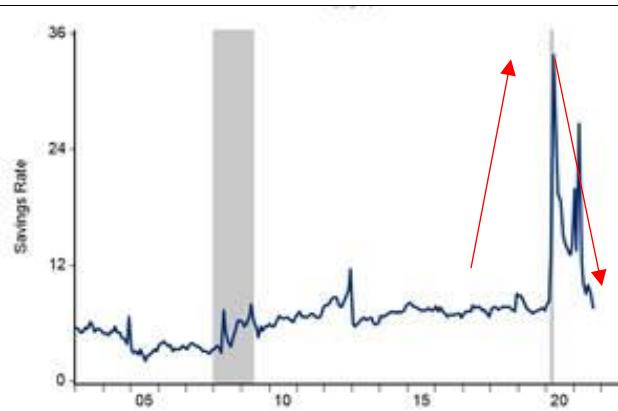
Inflation is newsworthy when we see ships lining up at congested ports or pictures of empty new car lots. But higher goods demand is already clearly moderating (Figure 11). The surge in unit purchases of home electronics, housing related durable goods, new and used autos early in 2021 all seem very unlikely to repeat. “One-off” payments to households in early 2020 and 2021 are over. Following stimulus checks in 1Q 2021, personal income has fallen by \$3.4 trillion. This is the primary driver of the collapse in the US personal savings rate from an unusually high level (Figure 12), suggesting the stimulus spending boom is non-recurring. In contrast, services have further to grow simply to return to 2019 levels.

As goods demand falls and services recover, we see the one-time, broad rise in compensation driven by the pandemic as broadly supportive for consumer demand over several years, but *not* indicative of an inflationary bubble.

**Figure 11: Real Consumer Spending on Goods and Services**



**Figure 12: US Personal Savings Rate (%): Government Income Transfers Fell \$3.9 Trillion Since March**



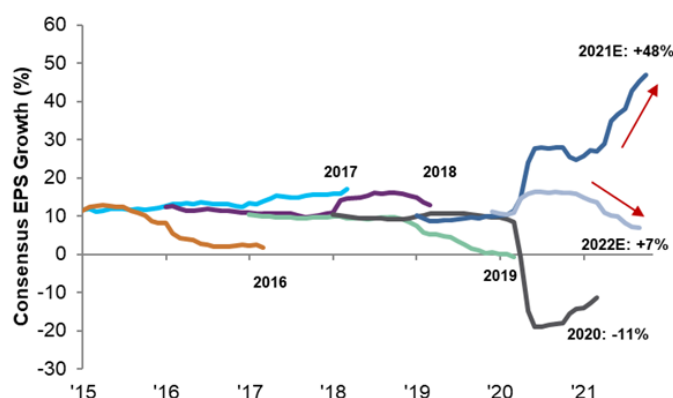
Source: Haver Analytics as of October 29, 2021. Shaded regions are recessions.

## What the 3Q Earnings Pick-Me-Up Means

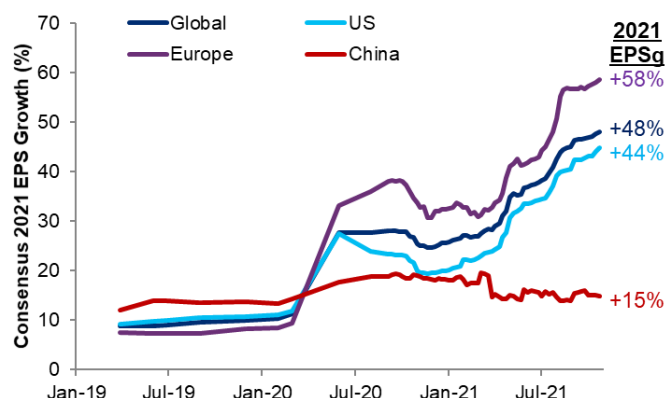
It has been a good week for equity analysts and the companies they follow. Almost half of the S&P 500 reported Q3 earnings. 82% of the 244 firms exceeded their estimates with an average beat of 11%. The size and breadth of their outperformance is consistent with results from the strong first half of 2021, as analysts continue to under-estimate the strength of the earnings recovery after an 11% profit decline in 2020. Overall, estimates look to continue to be revised higher for the remainder of the year.

Outside the US, the earnings story is mixed. While not all European firms report quarterly, those that do are on track for 52% YoY growth for the quarter. Two-thirds of European companies have beat consensus thus far. And, further afield, a growing percentage of global earnings downgrades can be found among Chinese firms, as investors price in a deceleration in China's macro situation in Q3 and Q4 of 2021 (**Figures 13**).

**Figure 13: Global Equity Consensus EPS Estimates**



**Figure 14: 2021 Consensus EPS by Region**



Source: FactSet as of October 28, 2021. 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. Past performance is not indicative of future returns. For illustrative purposes only.

## Over the Horizon

As 2021 continues to surprise to the upside, we are seeing EPS growth estimates for 2022 falling modestly due to several factors (**Figure 14**). As we discussed in [Quadrant Growing Pains \(October 21, 2021\)](#), China's slowing growth will have an impact on global GDP growth in 2022. The absence of further pandemic stimulus will similarly cause an expected deceleration in growth rates. The combination will mark a return to normal in markets as EPS growth slows toward 8% next year from a 45% estimated gain in 2021 (see **Figure 15**.)

**Figure 15: Citi Global Wealth GDP Assumptions for 2021-2023**

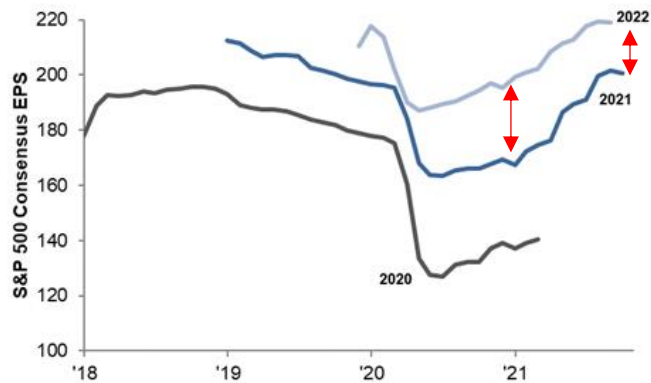
	2020	2021	2022	2023
China	2.4	8.0	4.5	5.0
US	-3.4	5.5	3.5	2.6
EU	-5.9	4.8	3.9	2.4
UK	-9.7	6.0	4.2	2.5
Global	-3.2	5.6	3.8	3.5

Source: Citi Global Wealth Office of the Chief Investment Strategist and National sources, Haver Analytics and FactSet as of October 19, 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 views/ forecasts are expressions of opinion and are subject to change without notice and are not intended to be a guarantee of future events.

As for earnings projections, some of the dynamic in estimate changes is mechanical. There tends to be a lag between earnings season and subsequent analyst upgrades. A stronger 2021 EPS level will make achieving consensus 2022 targets easier, not harder. And overall, we are seeing early 2022 EPS estimates rising along with 2021 estimates amid this better than expected Q3 earnings season (**Figure 16**).

**Figure 16: Consensus EPS Estimates**



Source: FactSet and Haver as of October 28, 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. Past performance is not indicative of future returns. For illustrative purposes only.

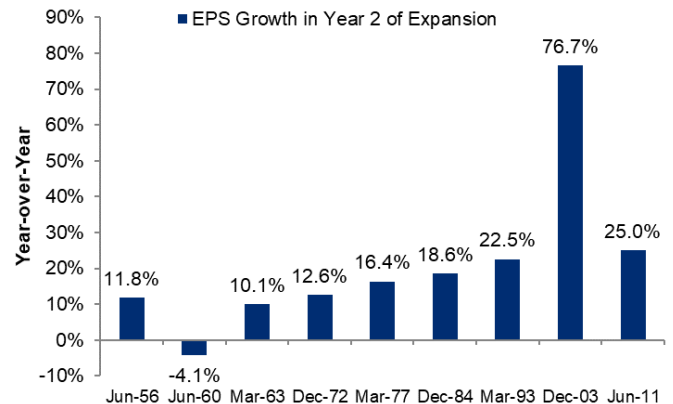
Our optimism for 2022 is buoyed by the strong CEO confidence indicators that foreshadow why the solid 3Q results may extend into 4Q. Despite gloomy headlines, the level of CEO confidence is consistent with further upward EPS revisions. This could mean 2021 EPS north of \$210 per share once the year ends (**Figure 17**). If so, this means that our latest forecasts discussed in the CIO Bulletin just last week would need some further upward revision (See [CIO Bulletin - October 24, 2021](#)). We believe that inventory restocking will offset the reduction in demand for goods and that the abatement of short-term supply chain and energy pressures will also lift 2022 profits.

Typically, year two of an economic expansion is characterized by 10% or higher profits growth. This has been the case in 8 of the last 9 business cycles (**Figure 18**). While the extraordinary strength of 2021 EPS results keeps our 2022 growth estimates conservative, this pattern still looks promising for 2022.

**Figure 17: CEO Confidence and Earnings Surprises**



**Figure 18: EPS growth in 2<sup>nd</sup> Year of Bull Market**



Source: FactSet and Haver as of October 28, 2021. Past performance is no guarantee of future results. Real results may vary.

## A Better-than-Expected 2022

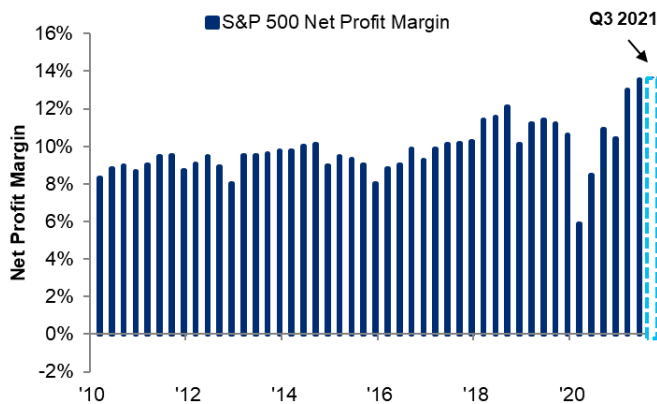
Supply chain bottlenecks, high freight costs and inflation were expected to cause substantial margins pressure for public companies. Despite these concerns, *actual results* indicate that sustained demand and corporate pricing power has been sufficient to maintain comfortable profit margins (**Figures 19 and 20**).

Select firms like a global smartphone leader as well as major consumer products names have reported modestly weaker results over the past few weeks. For these businesses in these sectors, supply chain issues have directly hurt profits due to unfulfilled demand.

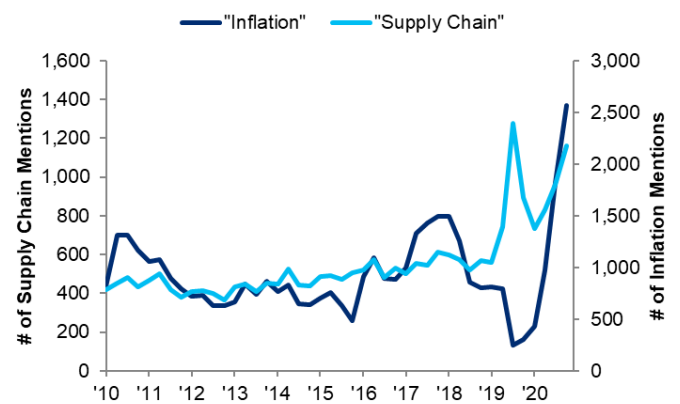
The broader market has rightly shrugged off much of the panicked rhetoric we hear in the Analyst Q&A of earnings calls (inflation, labor shortages, commodity and energy prices, supply matters and the like). Indeed, the S&P is 5.4% higher since banks began reporting earnings 2 weeks ago.

Though we do not expect margins to rise much further, we do believe many firms will be able to continue passing on modest expected price increases to consumers in 2022.

**Figure 19: Margins on par with H1 2021**



**Figure 20: Mentions of “Inflation” and “Supply Chain” in S&P 500 conference calls 3Q**



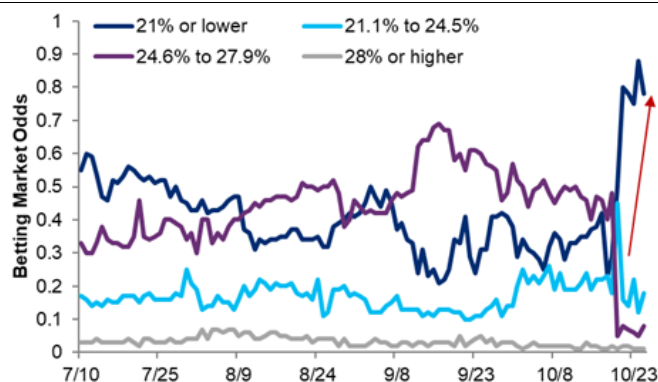
Source: Bloomberg and Haver as of October 28, 2021. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Past performance is no guarantee of future results. Real results may vary.

## Tax Reform Roulette?

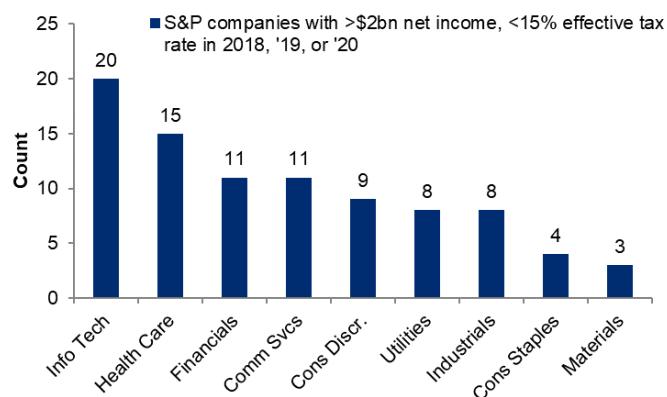
As we refine our estimates for next year's earnings, the corporate tax environment for US firms remains in flux. In recent weeks, moderate Democrats appear opposed to raising tax rates across all corporations (see **Figure 21**). However, as Democrats seek to find funding sources for a “smaller” \$1.75 trillion package, several other revenue raisers have emerged. These include surcharges on the incomes of wealthy individuals, changes to globally generated profits, and perhaps most consequentially for markets, the imposition of a 15% minimum tax on book income.

We see a minimum tax on book income as having a potential outsized impact on mega-cap technology and pharmaceutical firms. These companies that tend to make use of heavy R&D expensing to reduce their tax bills under current tax law (**Figure 22**). While we do not see the imposition of a new minimum tax as an existential risk for investors in these fast-growing sectors, a higher tax bill could trim a few percentage points off of next year's large cap technology earnings. At present valuations, such taxes could make a difference to returns. We also note that depending on the final form of this tax, investment opportunities may arise for smaller software or pharmaceutical firms that may not be subject to the tax due to their relative size.

**Figure 21: Betting Market Expectations for Statutory Tax Rate**



**Figure 22: Firms potentially subject to 15% minimum tax rate, by sector**



Source: PredictIt.com, Bloomberg and Haver as of October 28, 2021. All forecasts are expressions of opinion and are subject to change without notice and are not intended to be a guarantee of future events. Past performance is not indicative of future returns. For illustrative purposes only.

## Should You “Upsize” Global Consumer Staples?

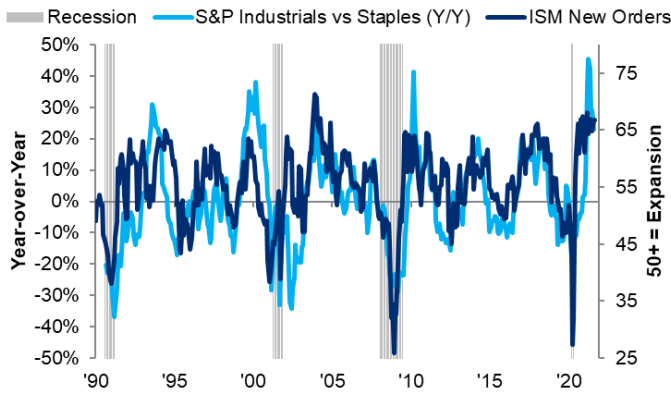
It has been a challenging investment environment in 2021 for investors in global consumer staples. They have been hit by numerous headwinds, including:

- **Rising rates:** The sector typically pays an above-market dividend and trades along with Utilities, REITs and Telecoms as so-called “bond proxies”. In Q1 and then again in September, the selloff in long-duration bonds also saw heavy dividend payers fall in concert.
- **Attention on Cyclical:** Since the announcement of effective vaccines in early November 2020, the equity market leaderboard has been filled with cyclicals like energy, financials, industrials and materials. An environment of sharply rising economic activity typically favors cyclicals over defensives and 2021 was no exception (See Figure 22).
- **Tough 2020 Comparisons:** Amid the onset of pandemic lockdowns in early 2020, populations flooded grocery stores and convenience retailers to stock up on cleaning supplies, toilet paper, and canned goods. A full year of work-from-home for many meant more dishes to wash, more laundry to run, and more rooms to clean. This environment was a boon for household & personal products brands, who saw their earnings grow 3.4% last year despite the sharp economic downturn.
- **Tighter Margins and Supply Chains:** Consumer staples firms generate profits on relatively narrow margins, which make rising input costs quite detrimental to operating leverage. Amid a strong consumption environment, fueled by government stimulus, many higher quality staples brands have been able to successfully raise prices in line with higher freight and manufacturing costs, though earnings growth for the sector are likely to be a more modest 13% in 2021 and just 5% in Q3, trailing just Utilities over both time horizons.

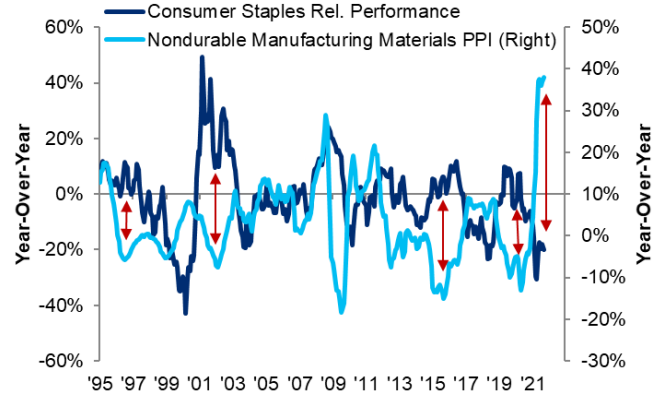
## Their Upside...

We believe that the sharp rise in commodity prices and industrial production appears to be peaking. As order growth moderates, staples have routinely outperformed cyclicals in the subsequent year (**Figure 23**). In addition, subsiding input cost pressures should take some pressure off of staples margins, perhaps leading to a reversal of the sector’s underperformance after a cyclically dominant 2021 (**Figure 24**).

**Figure 23: S&P Industrials Relative to Staples and ISM New Orders**



**Figure 24: Non-durable PPI and Staples Relative Performance**



Source: Bloomberg and Haver as of October 28, 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.

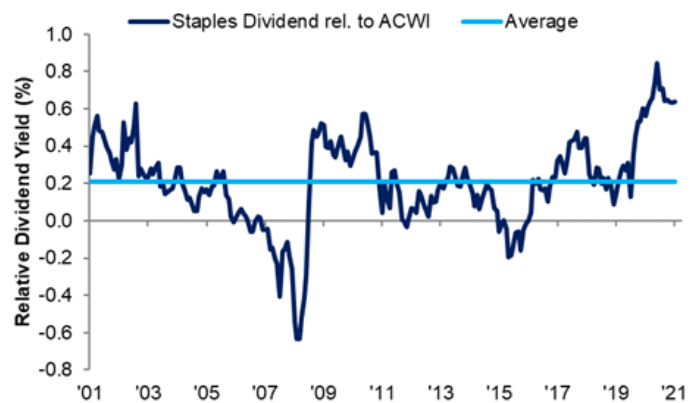
And we believe dividends will attract more investor interest in 2022. Staples are heavily represented in dividend growth indices, which we recommend as a way to boost portfolio quality in a mid-cycle environment (**Figures 25 and 26**). Indeed, Staples also score well across other quality metrics like return on equity and earnings stability, though they tend to operate with tighter margins and higher leverage (**Figure 27**).

As we move our focus towards investing in long-term sustainable business models, we believe a balance between defensives and cyclicals is prudent. As we retain our long-standing overweight to the health care sector, we now believe an increased allocations to staples -- whether via dividend growers or by investing outright in quality consumer brands -- could make sense in portfolios that had previously been tilted towards early-cycle outperformers.

**Figure 25: S&P Dividend Aristocrats Index Sector Weights**

Sector	Weights (%)
Consumer Staples	20.79%
Industrials	17.92%
Materials	13.20%
Health Care	10.14%
Financials	9.86%
Consumer Discretionary	7.60%
Technology	6.13%
Real Estate	4.69%
Utilities	4.64%
Energy	3.42%
Communications	1.37%

**Figure 26: Global Staples Dividend Relative to Global Equities**



Source: Bloomberg and Haver as of October 28, 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.

**Figure 27: Global Quality Screen, by Sector**

Region	ROE ('22E, %)	Region	Oper. Margin ('22E)	Region	Net Debt to EBITDA (ex Fin)	Region	Earnings Stability (Std. Dev.)	Region	10yr Div. Growth (CAGR)
IT	25.9	Financials	26.4	IT	-0.21	Health Care	4.3	IT	14%
Health Care	22.4	IT	21.7	Cons. Discr	0.51	Cons. Stap	7.2	Health Care	7%
Cons. Stap	20.7	Comm. Svcs	20.6	Materials	0.77	Utilities	8.2	Cons. Stap	6%
Cons. Discr	16.6	Materials	18.1	Health Care	1.12	Industrials	18.4	Cons. Discr	5%
Industrials	16.1	Utilities	16.2	Comm. Svcs	1.41	Comm. Svcs	19.4	Materials	5%
Materials	15.9	Health Care	15.6	Energy	1.44	IT	21.9	Industrials	5%
Comm. Svcs	15.1	Energy	12.0	Cons. Stap	1.70	Financials	25.0	Financials	3%
Energy	11.8	Industrials	11.4	Industrials	1.80	Cons. Discr	28.8	Utilities	0%
Utilities	10.6	Cons. Stap	10.5	Utilities	4.47	Materials	32.0	Energy	-2%
Financials	10.1	Cons. Discr	9.9			Energy	45.0		

Source: FactSet as of October 28, 2021.

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