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CIO Strategy Bulletin

The expansion will endure: Putting Our Ideas Into Action

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OUTLOOK 2022: SUSTAINING RETURNS IN A NEW MARKET ENVIRONMENT

In the weeks leading up to the release of our Outlook, we all learned that the pandemic will persist well into 2022. The hope that 8 billion vaccinations and widespread population exposure to the Delta variant would be sufficient to subdue COVID turned out to be false when Omicron struck. At the same time, we are convinced that the global economic recovery that is now underway will endure and ultimately outlast the pandemic. In short, we believe that the world economy and equity markets have not peaked and have the potential to grow.

At the same time, the investment environment is changing. The pandemic-era economic collapse and rebound will not be repeated. Neither will the emergency monetary and fiscal easing steps. We are entering a new phase of the recovery, what we call “mid-cycle”. We believe that the middle part of this recovery portends a normalization of the economy, where the demand relationship between goods and services stabilizes, supply chain and labor issues abate, and central bank policies move away from crisis management.

We expect:

- Global GDP growth to slow but remain solid – **figure 1**
- COVID impacts to gradually abate via more exposure, vaccines and effective treatments
- US Inflation to retreat to 3% by the end of 2022 and trend at 2.5% in the coming decade
- Interest rates to remain low or negative, with US cash yields averaging 1.6% less than inflation over the coming decade
- For 2022, expect public market equities to potentially provide a total return of 7%-9% with global fixed income returns of -1%-0%.
- Expect the US dollar to rise modestly against major trading partners.

Given these views, our actionable ideas for 2022 include:

- Emphasize less cyclical, higher quality assets in sectors with sustained growth; shift from lower quality assets that have rebounded sharply from COVID impact.
- Identifying stronger quality companies with leading positions in secular growth industries
- Overweight dividend growth strategies in both US and non-US portfolios
- Lean toward equities over fixed income, as accepting negative real returns from many bonds seems a poor choice.
- Exploit volatility for income and to invest in industries at lower entry points.
- Build larger alternative investment positions for suitable investors.

Figure 1: Our outlook for real GDP (%)

	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: Haver and OCIS, as of 30 Oct 2021. All forecasts are expressions of opinion, are subject to change without notice, and are not intended to be a guarantee of future events.

A TIME OF MACRO POLICY TRANSITION

As large-scale stimulus ends, the fundamental drivers of economic growth become predominant (see figure 2). In 2021, the addition of stimulus at a time when underlying economic recovery was strengthening led to an ugly "side effect" -- consumer product shortages and spiking inflation. In part, the cure will take place as stimulus fades and as central banks return to normal policies. Still, our confidence in continued expansion at a slower pace speaks to the brilliant adaptability of industry and individuals, paired with the power of technology. "Digital everything" continues to substitute for "being there" in person (see figure 3). The pandemic economy has generated numerous lessons in how to produce everything more efficiently.

Figure 2: US Federal Spending $Billions

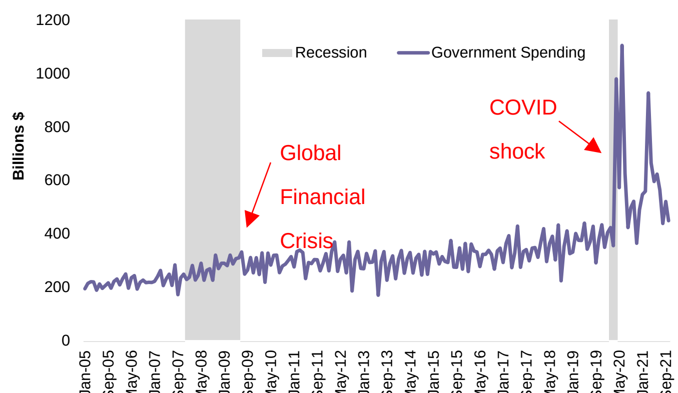
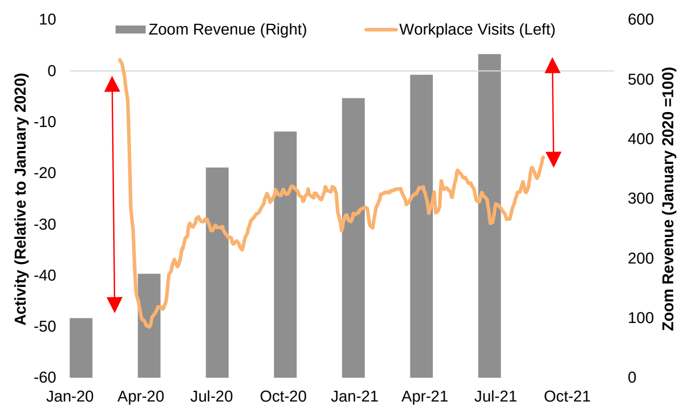


Figure 3: Zoom meetings vs workplace visits in person



Source: Haver Analytics and Factset as of December 10, 2021.

SLOWER GROWTH AFTER PEAK GROWTH CAN BE POSITIVE FOR PORTFOLIOS

The narrow, concentrated impact of the pandemic on the economy along with broad-based stimulus allowed for a sharp recovery in the year past. Earnings for S&P 500 firms exceeded their 2019 levels by 26% in 2021. Reflecting higher earnings and future earnings growth expectations, the US and global equity markets ended November 2021 42% and 29% (respectively) above their December 2019 levels. Looking forward, we expect EPS growth of 7% on average in the next two years. With "peak cyclical momentum" behind us, we believe this argues in favor of a shift toward stable, defensive industry exposures, but not a decline in net equity exposure (see figure 4-5).

Figure 4: Industrials vs Healthcare Revenue Growth Y/Y%

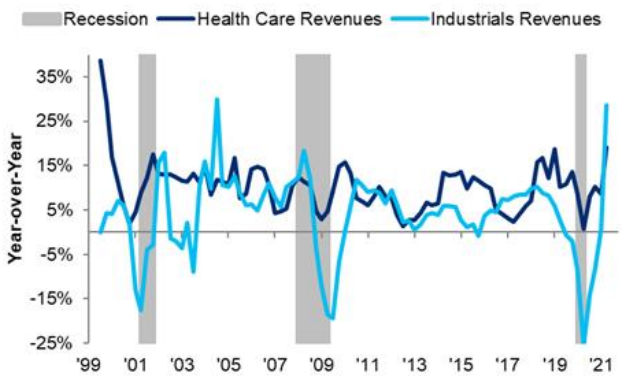
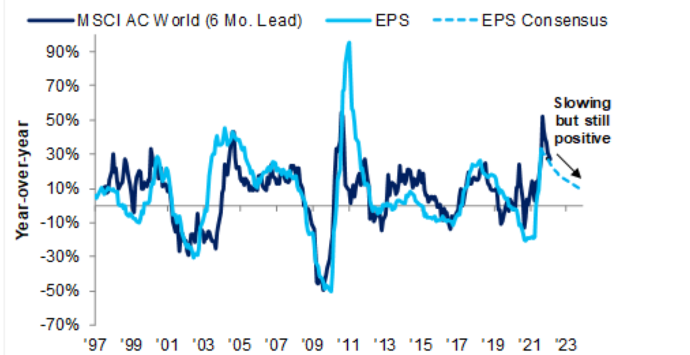


Figure 5: Expect slowing but positive EPS growth after 45% surge in 2021



Source: Factset through 1 Oct 2021. Equity price changes are lagged 6 months to align with EPS. The period of 2H 2021-2023 is the bottoms up consensus of analysts. 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.

A SHIFT TO LONG-TERM LEADERS

What worked in portfolios during the rebound phases will not work in the normalization period.

During the initial rebound from the pandemic collapse beginning in 2020, we suggested exposure to "COVID cyclicals."[1] Investors who followed our recommendations such as buying airline equities – or entire country markets such as Brazil – did well. There were strong returns, such as the 120% annualized gain since April 2020 in hotels, resorts and cruise line operators. These were one-time events and will not be repeated. They were only possible because of the abyss create by the COVID recession.

As we enter the "mid-cycle" of this recovery, we prefer strategies that seek to beat long-term average returns in equity markets using two approaches. The first is by investing in firms that consistently lead their industry and within industries whose share of total economic output is growing. Many of these relate to "unstoppable trends" such as the secular rise in healthcare demand or the digitization of the economy as macro-level examples of "secular growth industries." We want to avoid exposures that are suffering long term transitions or declines, such as traditional autos or oil drilling. They face gradually diminishing growth but are still exposed to cyclical booms and busts – **figures 6 and 7**.

The second approach to outperform long-term average equity returns is to invest in firms that sustainably grow income distributions to shareholders. US firms with the most consistent dividend growth have outperformed the

[1] Energy, materials, consumer discretionary (ex-e-commerce), industrials, financials, real estate

S&P 500 – itself the world's strongest performing large equity market – by about 60% in the last 30 years – **figure 8**.

Some firms with compelling business opportunities prefer to abstain from dividend distributions and instead deploy cash on expanding operations. However, when a firm balances growth, investment and payouts effectively, their dividends are a highly valuable baseline for investors – **figure 9**. In other words, firms must have extraordinary potential growth opportunities to be able to ask investors to forego dividends, that have cumulatively driven half of long-term equity market returns.

Given their potential to deliver sustained outperformance over time, we categorize both these types of equities as "long-term leaders."

Figure 6: Digitization leaders' sales growth

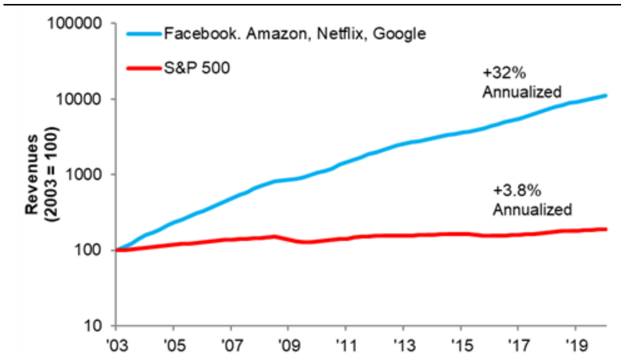


Chart shows revenues of S&P 500 Index companies and those of Facebook, Amazon, Apple, Netflix and Google rebased to 100 as of 2003. Indices are unmanaged. Source: Haver, as of 19 Nov 2021. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Past performance is no guarantee of future results. Real results may vary. This should not be construed as an offer of, or recommendation of companies discussed

Figure 7: Healthcare's importance grows as autos shrink

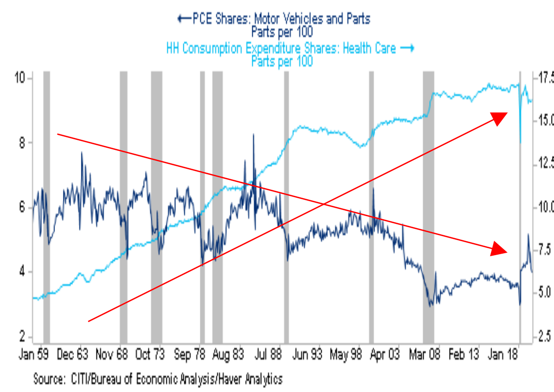
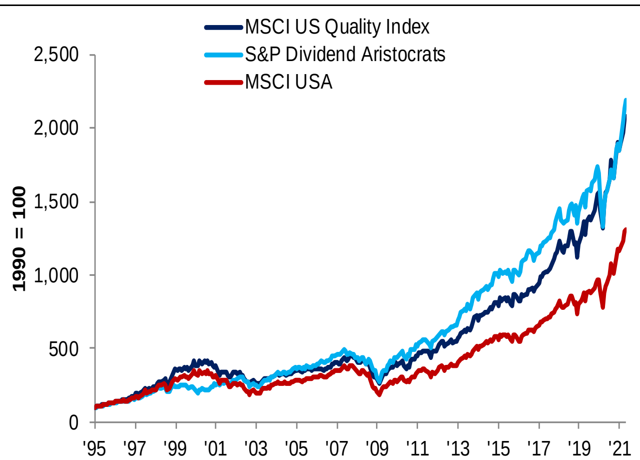


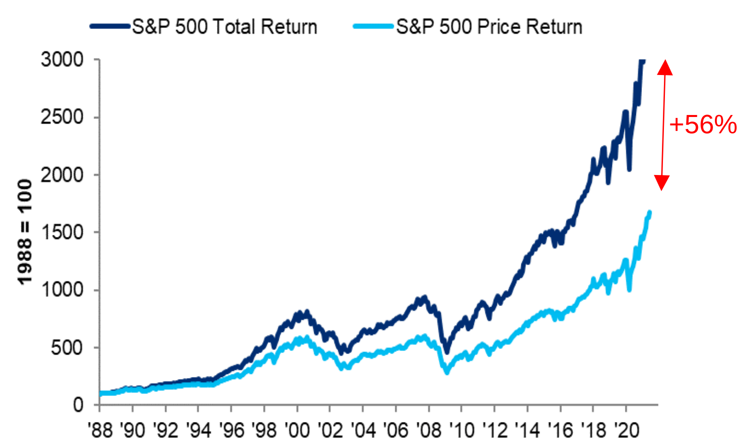
Chart shows personal consumption expenditure (PCE) for healthcare and motor vehicles & parts, both as a proportion of total PCE. Source: Haver, as of 19 Nov 2021.Note: Grey areas in chart are US recessions. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Past performance is no guarantee of future results. Real results may vary.

Figure 8: Quality and dividend growers have outperformed



Source: Haver, as of 19 Nov 2021. 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. See Glossary for definitions.

Figure 9: The power of reinvested dividends



Source: Haver, as of 19 Nov 2021. 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.

UNSTOPPABLE TRENDS

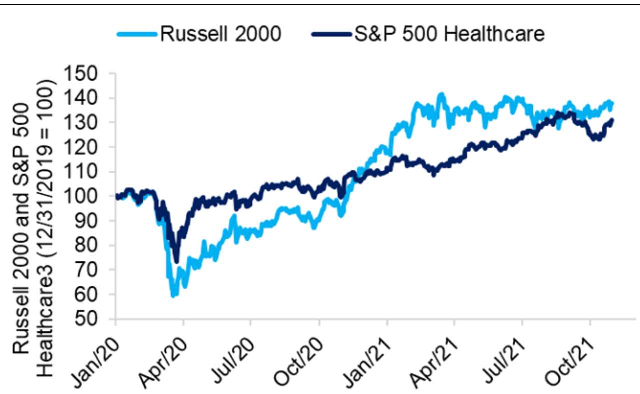
As we discuss throughout Outlook 2022, our recommendation is that investors align their portfolios toward the drivers of sustainable returns. This led us to change allocations during 2021. For example, we reduced holdings of volatile, leveraged small cap firms that enjoyed an exaggerated recovery from depressed levels. We reinvested in the generally more stable growth and value offered in the healthcare sector – **figure 10**. Now, we want investors to consider doing more.

Accelerating global healthcare demand goes hand in hand with an aging world population, with the United Nations projecting a doubling in the size of the over-65 population within less than 30 years. The growth of this demographic is more than four times faster than expected growth in the world's total population. With science enabling longer lives – and ever-increasing demand for the related healthcare services – we consider "Increased longevity" an Unstoppable Trend – **figure 11**.

Likewise, the digital transformation of the world is set to continue. The potential that investors anticipated during the dot.com bubble that burst in 2000 was realized in the following two decades – **figure 12**. But we believe that there is still further digital potential. Unlike in the late 1990s, though, we do not see excessive or unsustainable expansion in this area.

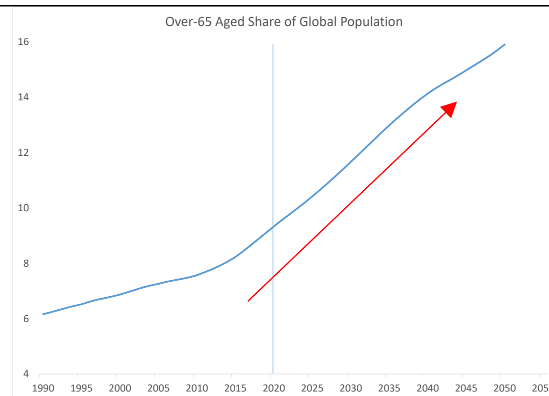
Digitization played a critical role in helping the world adapt to COVID. The mobility and flexible work arrangements it enabled likely saved hundreds of millions of jobs. In doing so, it likely reduced the speed and scope of the pandemic, as it facilitated social distancing. Beyond the extremes and distortions of this period, the digital world is increasingly the "real economy" for more and more of the world's people.

Figure 10 US small- and mid-caps were early cycle leaders



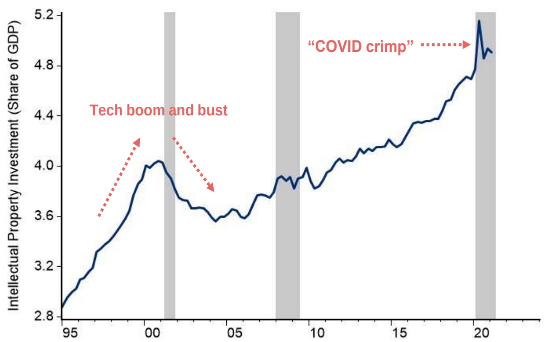
Source: Haver, as of 19 Nov 2021. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Past performance is no guarantee of future results. Real results may vary. See Glossary for definitions.

Figure 11: The world's aging population



Source: Haver, as of 19 Nov 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. Chart shows the percentage of the global population aged over, historic and UN projections.

Figure 12: The growth in intellectual property investment such as software



Source: Haver as of 15 Nov 2021. Chart shows intellectual property investment ex. software as % of US GDP. Shaded areas represent US recessions.

THE CASH THIEF RETURNS

In Outlook 2022, you will once again be reminded that the "cash thief" is on the prowl. While the effect of negative real interest rates may appear mild, cash will be a bigger drag on portfolio returns now than in many prior decades. We estimate than in just ten years' time, every dollar that has remained uninvested have seen its purchasing power shrink to 85 cents. Nonetheless, many sophisticated investors have 20% or more in cash, believing that to be a hedge, safety net or pool to be invested later, at the "right" time. None of this is true.

So, investors should shift to asset classes that have the potential to preserve the purchasing power of their wealth. **Figure 13** shows our Strategic Return Estimates for the coming decade, adjusted for expected inflation. We believe that global equities may produce positive real returns after inflation. After all, equities represent owning "the factors of production": the firms that produce goods and services the world demands. Unlike currencies, goods and services – created by teams of software engineers to commodity miners - cannot be printed by central banks.

For suitable investors, private equity and real estate assets come with the flexibility to time their own exit points at the expense of reduced liquidity albeit with commensurate risk. Negative real rates provide leverage to potentially enhance returns.

Figure 13: The long-term outlook for asset classes after inflation

	Real SRE annualized (%)	Inflation-adjusted cumulative return (%)
Global Equities	1.7	18.40
Developed IG Debt	-0.7	-6.8
Global High Yield Debt	0.1	1.0
Global EM Fixed Income	1.1	11.6
US cash	-1.6	-14.9
Hedge Funds	1.6	17.2
Private Equity	9.1	138.9
Private Real Estate Funds	6.3	84.2
Commodities	-1.0	-9.6

Strategic Return Estimates (SRE) are the Private Bank's forecast of annualized returns for specific asset classes over a 10-year time horizon. Source: Private Bank Quant Research & Global Asset Allocation team. SREs for 2021; Based on data as of 31 Oct 2020; Historical returns for last 10 years as of 31 Oct 2021; Returns estimated in US Dollars; All estimates are expressions of opinion and are subject to change without notice and are not intended to be a guarantee of future events. Strategic Return Estimates are no guarantee of future performance. Past performance is no guarantee of future returns. The index composites for each asset class are described in the appendix. The real SRE deducts our estimate of the Federal Reserve's implied inflation target over a ten-year horizon from the SREs, while the inflation adjusted return shows the cumulative 10 year estimated return. See glossary for definitions.

FINAL THOUGHT AND SUMMARY VIEW ON IMPLEMENTING OUR THEMES

Clients who have followed the guidance provided by Citi Global Wealth Investments during the pandemic period have seen the value of their portfolios perform well. Our timely equity and gold overweights – peaking at 11% earlier this year, now 6% - have seen our medium-risk all asset class portfolio allocations return 11.8% over the past year. These over-weights included specific allocations to small caps, emerging markets and real estate - and subsequent shifts away from these temporary sources of alpha[2]. We call this "**advice to action"**, where our views are carefully vetted and then reflected in the composition of our discretionary and advisory client portfolios. There is no better time than today to revisit our guidance. We urge you to discuss your own specific portfolio and objectives with your Investment Counselor and Private Banker today.

IMPLEMENTING OUR THEMES

Our themes can be introduced to portfolios in many ways, as part of your core portfolio holdings or opportunistically. They span multiple asset classes and can be implemented by proprietary or third-party managers, as well as via capital markets strategies. Here we present a selection of the implementation possibilities that we currently see. Your relationship team and our product specialists stand ready to build thematic portfolios that are suitable for your portfolio and in line with your individual risk profile.

LONG-TERM LEADERS

- Global dividend grower equities
- Quality companies in growing industries, including many linked to our unstoppable trends

BEAT THE CASH THIEF!

- Global dividend grower equities
- Variable rate bank loans
- US Treasury Inflation Protected Securities (TIPS)
- US dollar-denominated emerging market debt
- Preferred securities
- Credit strategies from hedge fund managers and certain registered vehicles
- Capital markets strategies that seek income from volatility
- Diversified global multi-asset class strategies for staying invested rather than market timing

UNSTOPPABLE TRENDS

Digitization: Cyber security

- Specialists in the protection of cloud computing and the "internet of things"

Digitization: 5G and beyond

- 5G, 6G and related technology enablers and beneficiaries including artificial intelligence, telemedicine, autonomous vehicles

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[2] We exclude no assets from this measure in the year through December 3, 2021. Our tactical overweight in gold was held too long into 2021 and was a significant source of negative performance.

- 5G related real estate strategies

Digitization: Fintech

- Payment providers
- Developers of fintech solutions that can be sold to traditional financial institutions

Digitization: Reshaping real estate

- "Build-to-core" e-commerce related real estate, including warehouses, distribution facilities and other properties
- Office investments in high-growth cities

Greening the world

- Electric carmakers, battery makers, infrastructure suppliers and installers, and smart appliance makers
- Other firms at the cutting edge of new energy development, electrification, or energy efficiency
- Enablers and beneficiaries in diverse areas such as food production, cement making and water
- Impact investing in social and economic mobility

The rise of Asia

- China technology
- Re-opening consumption
- Digitization and manufacturing supply chain diversification beneficiaries Southeast Asia

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