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Citi Global Wealth Investments

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We expect further equity gains in 2022

Summary

- **European ex-UK equities remain neutral, UK equities overweight.** The region is currently seeing a rise in COVID cases, however further extreme widespread lockdowns hindering mobility are unlikely. Economic growth is slowing but remains on an uptrend. Central banks will gradually provide less support. On the other hand, there is positive corporate earnings momentum, only modest global ownership of the region and undemanding valuations. The region has high exposure to quality companies with strong balance sheets which should support shareholder distributions.

- **Underweight fixed income**. Even after the recent pickup in yields, the region's aggregate investment grade benchmark yield is still only 0.04%. As the European Central Bank (ECB) and Bank of England (BOE) start tapering asset purchases, there is little valuation support for sovereign bonds particularly. On a selective basis, there are opportunities in UK investment grade corporate bonds, euro-denominated Tier 1 capital securities and non-bank issuers including loans. EU green bonds are a developing asset class that could also offer potential opportunities.

- **Sterling preferred to euro, both unlikely to sustain rallies versus the US dollar.** Positioning in both currencies is not over-extended and next year could benefit from the resumption of inflows into the region. Sterling should be resilient as the BOE moves towards a rate hiking cycle from December. The euro is unlikely to sustain rallies as the ECB remains accommodative longer than other major central banks. It may even test the downside as opinion polling for the April French presidential election enters focus.

- **Divergence between market pricing of likely central bank actions.** The BoE is likely to raise its bank rate by at least 10 basis points (bps) at its December meeting, while the ECB is unlikely to raise its deposit facility rate from -0.5% before the second half of 2023 at the earliest.

- **The German coalition-building process has led to an agreement between the social democrats, greens and the liberal parties**. This is broadly positive, but implementation of their diverse policy priorities will be challenging.

- **The UK government is considering invoking Article 16 of the Northern Ireland protocol in early 2022**. This could increase uncertainty about the future status of the EU-UK trading relationship.

Contents

Equity outlook – Selective opportunities could be significant in 2022

The UK market valuation of 11.8 times prospective earnings remains at a significant discount to the global average of 18.3. This discount was partly established during the acrimonious four-year Brexit negotiation period and increased during the early stages of the pandemic due to the FTSE 100 index's low exposure to the technology sector. While Brexit challenges remain (see page 8), the worst-case scenario has been avoided. The united cabinet and parliamentary majority should enable PM Johnson to gradually start implementing key areas of the Conservative manifesto as COVID eases, with increasing focus on investment in northern England and more alternative energy commitments. This may continue to encourage foreign direct and portfolio investment in the UK, which in turn is likely gradually to close the valuation discount of listed companies.

In recent months, the level of mergers & acquisitions (M&A) activity in listed UK companies - both large-cap and mid-cap - has noticeably picked up (see our EMEA Strategy Bulletin of August 16 for more on the topic.) This was partly driven by foreign acquirors, a sign of corporate confidence returning as well as acting as a catalyst for unlocking some of the value in the market.

The average UK dividend yield is the highest of all developed markets at 4.2%. There are increasing signs of many blue-chip firms looking to use their cash piles and strong cashflows to raise their payouts further, as well as announcing share buyback programs, which could enhance returns on equity. While the current projected average EPS growth is only 2.5% for 2022, compared to 82% this year, there is upside potential to forecasts in key areas like financials.

European markets have had an excellent year-to-date, with the Stoxx 600 index rising by 20.2%. This has been due to two factors, which have previously been concerns for investors but less so this year. Firstly, GDP growth surprised on the upside in 2Q21 after a slow start to the vaccine program at the start of the year. Next, growth momentum was sustained in the third quarter. Secondly, this year has been a period of low political risk, with the key German election avoiding a result that could have hurt the market, and with more signs of EU unity reflected in the establishment of the Recovery Fund.

Our recent reduction in European equity from overweight to neutral was part of a wider global reduction in the size of our global equity overweighting. This occurred as Chinese economic data started to turn downwards. A key engine of European growth – German exporters – are particularly exposed to any slowdown in China. The current fourth wave of COVID is not likely to lead to widespread lockdowns but could still deter investors looking to add to their European market weightings.

We envisage market consolidations in European markets around these levels over the coming weeks, with decent average dividend yields of 3% offering support. Next year's average EPS growth expectation of 7.7% is in line with the global average and is expected to drive markets higher. Selective opportunities could be significant next year, as the region has many quality companies that have established brands, strong management, and rising returns on equity from depressed levels.

Earnings outlook – Staying positive due to high beta to global growth

Europe has been an unloved region for past the five to six years. This is partly due to the lack of growth companies within the MSCI Europe index and its heavy weightings in the old economy sectors, such as commodities and financials. However, there has been a gradual shift taking place, with a larger portion of the index now comprised of luxury goods companies, technology, and renewables.

The earnings story in Europe ex UK and UK remains positive. As the economy reopened, the first half of 2021 saw the best earnings results in at least 20 years. The consensus is that annualized EPS for Europe ex UK and UK are likely to end the year 56.9% and 82% higher, respectively. There were, of course, dispersions within this at the country and sector levels. Looking forward to 2022 and 2023, consensus estimates for EPS growth remain strong at 5.8% (Europe ex UK) and 6.9% (UK) year-on-year. In addition, UK EPS growth we believe will be higher than the consensus EPS growth forecast of 2.5%YY for 2022 and 3.3% for 2023. The sector contribution to the UK consensus 2022 EPS is largely from the Healthcare (21%

YY), Consumer Discretionary (24.5%YY) and Energy (18.4%YY) sectors. Throughout 2021 analysts EPS upgrades for Europe have continued to be revised upwards and we believe going into 2022 the same will occur.[1]

In addition, European companies generally have a high beta to world growth. This has dampened the European export outlook in the current quarter, as Chinese growth has slowed. Looking forward, this should be a positive factor as China's slowdown eases next year.

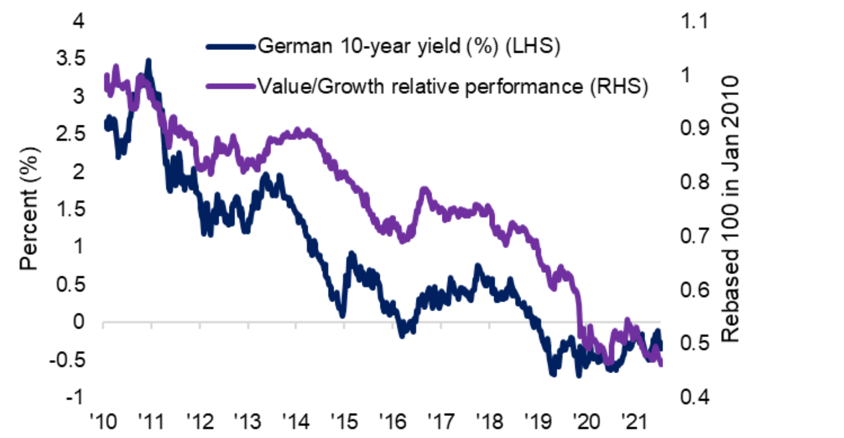
Sector outlook – Focused on COVID recovery and normalisation of supply

We see selective sector opportunities. Sectors set to deliver double-digit earnings growth year-on-year are energy, consumer discretionary, industrials, healthcare, and IT. Despite the short-term supply pressures some of these sectors might be facing, the continued recovery from COVID and the likely abatement of supply side risks in the first quarter of 2022 could drive earnings within these sectors.

As the bull market matures, we increasingly favour quality companies at the global level. Europe has many quality companies with robust balance sheets, well-tested management, and strong brands. They have a focus on growth areas, pricing power to offset cost increases and scope to raise dividend pay-outs. Within the sectors we favour, we see clusters of quality in:

- **European financials** especially European banks, which make up most of the financial sector. These had positive third quarter 2021 earnings, beating consensus expectations for the sixth consecutive quarter. Lower provisions for bad loans, stronger fee income and trading were the main forces at work here. Earnings momentum continues on an upward trajectory and the upward pressure on rates may help drive higher net interest margins and profitability. The potential continued momentum of declining provisions, as well as increasing fee income from trading and M&A activity, could drive stronger earnings for the next 12 to 18 months for the sector. Financials remain cheap at 0.9 price-to-book on average even after almost doubling in share price this year.

Figure 1: If bond yields rise, value could outperform growth



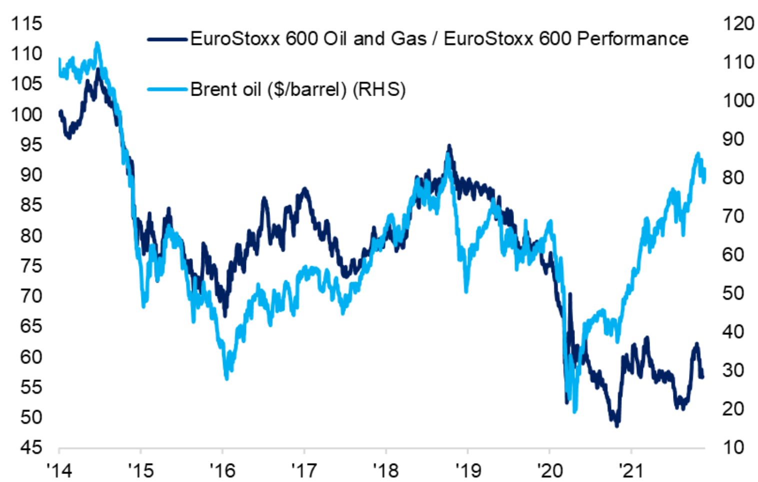
Source: Bloomberg as of November 25, 2021. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Past performance is no guarantee of future results. Real results may vary.

[1] Source: Citi Research, Bloomberg, Factset as of November 19, 2021. Note: **Cyclically Adjusted Price-to-Earnings ratio (CAPE)** is a valuation measure usually applied to the equity market. It is defined as price divided by the average of ten years of earnings (moving average), adjusted for inflation. As such, it is principally used to assess likely future returns from equities over timescales of 10 to 20 years, with higher-than-average CAPE values implying lower than average long-term annual average returns. *Note: The above data are compiled based on companies in MSCI AC World Index. The market capitalization for regions, markets and sectors are free-float adjusted. P/E, EPS Growth, P/B, Dividend Yield and ROE are aggregated from Factset consensus estimates (calendarized to December year end) with current prices. NM = Not Meaningful; NA = Not Available. 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. All forecasts are expressions of opinion and are subject to change without notice and are not intended to be a guarantee of future events.

- **European healthcare** – we favour healthcare at a global level for its consistent revenue and profit growth throughout cycles, but also its share price underperformance during the pandemic. The longer-term outlook for the sector remains strong. Consensus EPS forecasts for healthcare of 2022 and 2023 are 9.9% and 10.4% respectively, versus Citi's global consensus EPS expectation of 7 to 8% for the next two years. In valuation terms, the sector continues to be in line with global valuation of around 18 times 12-month forward earnings.[1]
- **European green energy** – alternative energy continues to be a major topic for global leaders, especially after COP26 climate talks this year in Glasgow. After two weeks of negotiations there were several breakthroughs, as some of the pact kept contentious proposals including the "phase down" of coal power for plants that don't use carbon-capture technology. This was a first in mentioning coal usage and went beyond G20 pledges. Subsidies to fossil fuel will also be reduced. Countries were told to come back with new strengthened climate plans next year.

Europe has always led the way in these discussions globally and as countries transition to a greener economy, certain European energy companies will likely benefit in the medium to longer-term. We see potential opportunities in both mature energy companies that are exposed to alternative energy, as well as in midcaps focused on alternative energy. Meanwhile in the short-term, some traditional energy companies have significantly underperformed the oil price rise – **see Figure 2** – presenting short-term trading opportunities.

Figure 2: Oil & gas equities and surging crude price diverge



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Central bank update – Clear shorter-term dichotomy between BoE and ECB

Market pricing of likely central bank actions continues to differ markedly between the Bank of England (BoE) and the European Central Bank (ECB). **Figure 3** shows that the BoE is likely to increase Bank Rate in coming weeks, we think by at least 10bp at its December meeting. However, we struggle to envisage a realistic scenario in which the ECB could be in a position to start lifting its deposit facility rate of -0.5% before the second half of 2023 at the earliest.

One of the main reasons for this disconnect is the difference of momentum in inflation. The UK Consumer Prices Index including owner occupiers' housing costs (HICP) is already well above the BoE's 2% target. This is true even when using a more conservative measure of inflation such as the 2-year annualised change to avoid the huge pandemic-induced swings. Inflation expectations are also at much greater risk of taking off than in the euro zone. On **figure 4**, the UK's HICP measure stands at 2.3% year-on-year versus 1.9% year-on-year for the Eurozone HICP and only 1.1% for the core HICP excluding food, energy, alcohol, and tobacco.

Figure 3: Eurodollar, Euribor and Short Sterling Futures

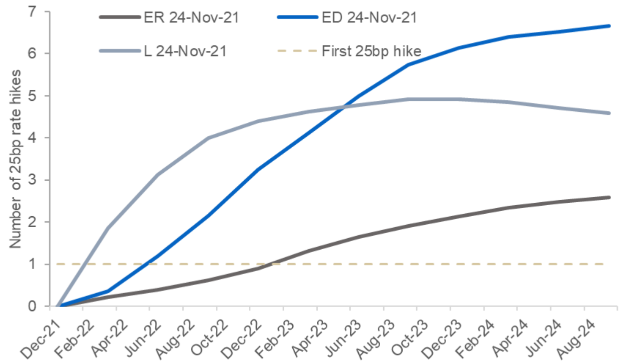
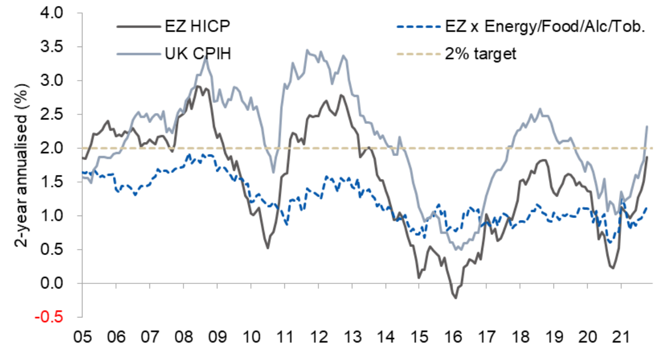


Figure 4: Inflation trajectories



Source: Bloomberg, Haver Analytics as of November 24, 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.

We think that the ECB's Governing Council is preparing to announce at its 16 December monetary policy meeting that:

i. the Pandemic Emergency Purchase Program (PEPP) will end after March 22
ii. the ECB will likely further taper PEPP net asset purchases in the first quarter of 2022 and
iii. interest rates will not go up in 2022 and will be unlikely to go up in 2023

The resurgence of COVID-19 cases is likely to be viewed as a small drag on economic activity – see next section – and high inflation seen as a headwind to household expenditure growth. However, the jury is still out about the degree of monetary policy accommodation that will be needed as it remains dependent on the HICP inflation trajectory in 2023-24. As a likely compromise in December, we see a high probability that the "open-ended" €20bn-a-month Asset Purchase Programme (APP) is replaced by an adjusted APP. This could be worth up to €40bn a month but only until the end of 2022, or by an envelope2, with the ECB most likely to retain the option of doing more if necessary.

COVID update – Watching possible emergence of new variant closely

Europe finds itself again at the epicentre of the global pandemic. A country such as Austria has seen cases rise so fast that the government has announced a full national lockdown for at least 20 days, with schools closing for two weeks. It has also become the first European country to make vaccinations mandatory from January 2022. Germany is also seeing a sharp increase in new COVID cases, with the latest incidence rate now at an all-time high on **figure 5.** While the situation looks still under control in countries such as Spain, there are growing concerns in eastern Europe where vaccination levels remain much lower than the average.

Unsurprisingly, high and rising levels of vaccination are proving to be a key determinant in the fight against COVID-19 and its more aggressive Delta variant. Cases rose very sharply in Israel this summer, for example. However, an aggressive vaccine booster campaign to address the declining level of immunity – initially targeted towards those who had received their first doses in early 2021 – has proved very successful in driving down the number of cases and the incidence rate below 50. The inverse relationship between the cumulative number of first and second vaccine doses administered per 100

[2] The term 'envelope' refers to a total sum of money allocated to the Asset Purchase Programme (APP) over a specific period rather than a fixed targeted monthly amount of net asset purchases.

persons and the equivalent ratio for the COVID vaccine booster to the incidence of Covid cases nevertheless shows clear differences between countries – **figure 6**.

With more vaccines likely to be produced, distributed, and injected to the global population in the coming months and quarters, we think that a higher trajectory for economic activity in the medium term will be established. It is clear from a mobility data perspective that the rising incidence of COVID is likely to be a headwind in the next few months and probably throughout the winter, even if the quick turnaround in Israel during the summer offers some encouragement. Falling mobility suggests that there will be some economic damage. If hospitalisation levels were to increase more noticeably and further restrictions follow, it would certainly impart a greater downward bias to our short-term outlook for GDP, especially in a country such as Germany, where there are already issues with some political uncertainty due to the coalition-building exercise and the importance of the Chinese slowdown on the business cycle.

Figure 5: Latest wave of COVID-19 cases

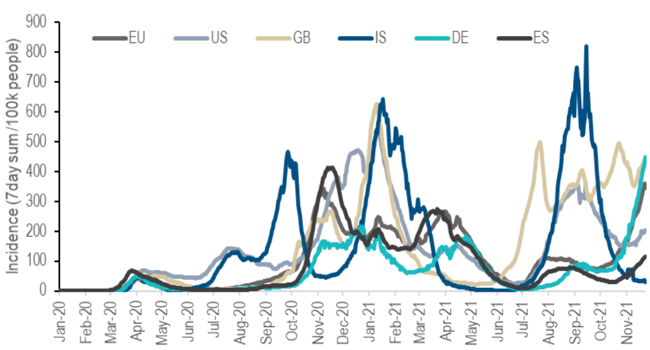
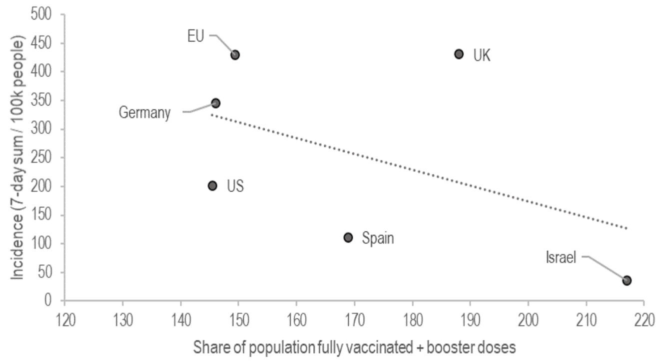


Figure 6: Vaccine boosters may control the pandemic



Sources: Oxford University, Haver Analytics as of November 24, 2021.

Germany update – Some clarity emerges from ‘traffic light’ coalition agreement

A coalition government is forming in Germany. The largest member is the centre-left Social Democrats (SPD) who won the federal elections on 26 September under the leadership of Olaf Scholz (vice-chancellor and finance minister since 2015). They have struck a deal with the Greens and the liberal Free Democrats (FDP), thus forming an administration based on a 177-page coalition agreement. Olaf Scholz will likely become Chancellor, replacing Angela Merkel after 16-years in office. Among the junior coalition partners, the FDP’s Christian Lindner is likely to become finance minister, the Greens’ Robert Habeck to become a “super minister” overseeing the economy along with climate and energy policy, while Green co-leader Annalena Baerbock will likely become foreign minister. We expect next steps should be as follows:

i. the four-year coalition roadmap agreed during the negotiations will require the support of all parties: the Greens are planning to consult all their members, the SPD will hold a party conference on 4 December and the FDP on 5 December;

ii. if all parties approve the proposed coalition agreement, Scholz would likely be elected chancellor in the week beginning 6 December.

After two months of intense negotiations, this is a welcome development, albeit one that creates a precedent since Germany has never experimented with a three-way alliance at the national level before, requiring the coalition to deliver on diverse priorities such as an increase in the minimum wage, focusing on a declining public debt level, while investing aggressively on climate protection strategies. The new administration will be under pressure from day one, with a record number of COVID cases forcing the present caretaker government to mull the imposition of additional restrictions, while the external environment is not particularly favourable. These range from tensions on the EU’s eastern borders, as well as an economic slowdown related to high energy prices and slower growth in China. One of the biggest medium-term unknowns remains the stance that the new coalition will adopt towards Europe. The coalition may be open to some reform of the EU fiscal rules and the degree of cooperation with its key partners, among which France, which will be taking on the

6-month rotating presidency of the EU on 1 January 2022 and will be holding presidential (10 & 24 April 2022) and legislative elections (12 & 19 June 2022).

Brexit update – Recovery continues, but some threats remain

The economic consequences of Brexit and disruption to the UK's supply chains are obvious compared to key trading partners and G7 peers. **Figure 7** shows that UK exports to the EU have just about recovered to the early 2017 levels (101.8 in Sep-21), while UK exports to non-EU countries remain about 7% below those in the first half of 2019 (before a surge in dispatches in the second half of 2019 in preparation for the effective departure of the EU's single market). By comparison, G7 exports are between 10% and 19% above January 2017 levels. Despite difficulties on the trade front, the momentum is improving in terms of retail spending in the run-up to Christmas. UK retail sales rose in October, up by 0.8% month-on-month compared to September. This was the first rise in six months, providing some level of optimism that the UK economy is regaining positive momentum.

Labour demand reached new highs in October, with 1,172,000 unfilled vacancies. At the same time, the unemployment claimant count rate fell to 5.1% in October from 5 6.6% at the start of the year. The UK labour market appears to be taking the end of furlough in its stride and continued to tighten; employment grew by more than expected in the three months to September (**figure 8**). Despite this improvement, hours worked, and headline employment remain below their pre-pandemic levels, down 2.2% and 1.1% respectively.

The potential consistent positive UK data momentum should provide further support for the BoE to raise rates in their next meeting by 15bp to 0.25%. Looking forward into 2022, we believe that the recovery in economic activity will likely continue if the COVID pandemic can be managed successfully. However, we also see some challenges coming from short-term higher inflation acting as a drag on household spending and some likely increase in uncertainty about the future status of the EU-UK trading relationship in the event of the UK government activating Article 16 of the Northern Ireland protocol in early 2022. This would suspend parts of the UK-EU Brexit withdrawal agreement, leading to new talks and raised tensions.

Figure 7: UK and G7 exports values since January 2017

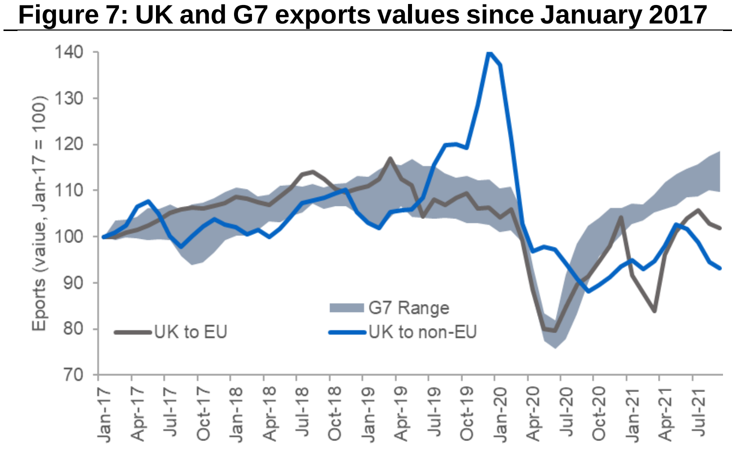
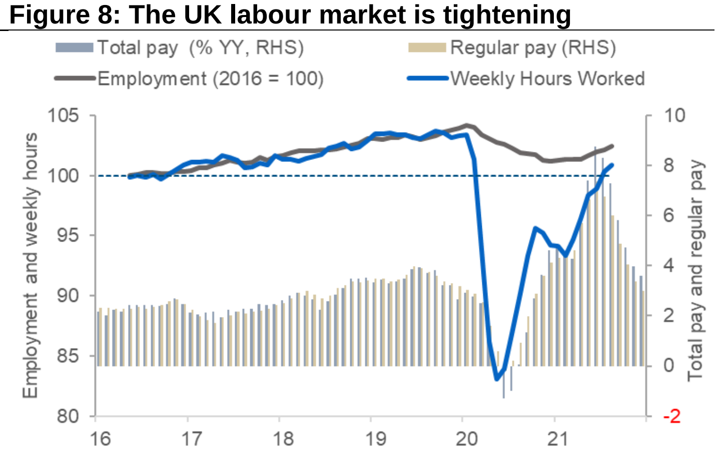


Figure 8: The UK labour market is tightening



Sources: Haver Analytics as of November 24, 2021.

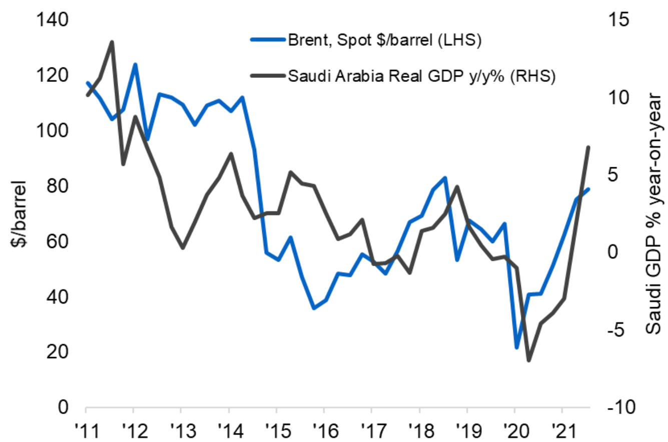
Middle East Update – Expecting rise in investment for energy transition

The region has made progress on vaccinations, and as a result the gradual reopening's are helping to ensure that the economic rebounds across the Gulf Cooperation Council (GCC) remain broadly resilient. In addition, expansionary fiscal policies, higher commodity prices and a still-supportive global backdrop have narrowed output gaps, with the region's real GDP back to pre-pandemic levels. The upturn is being led by Saudi Arabia and the United Arab Emirates.

Saudi Arabia's 3Q'21 GDP growth was +5.8% quarter-on-quarter and 6.8% year-on-year (**figure 9**), according to preliminary data from the General Authority on Statistics. The surge in growth was driven by a 9% annual expansion in the oil sector as the kingdom increased production. Short-term economic growth may increase through 2022, led by non-hydrocarbon sectors.

The height of the pandemic year 2020 brought to the forefront the need to plan for a post-oil world. The collapse in oil prices and lower revenues likely significantly delayed longer-term plans to facilitate the energy transition. However last month the UAE became the first petrostate committed to net-zero emissions by 2050, followed by Saudi Arabia by 2060. Reductions in the fiscal breakeven oil prices to the $60 range provide the backdrop to conditions that could facilitate higher investments for the energy transition across the GCC (**figure 10**).

Figure 9: Saudi Arabia GDP vs Oil Price



Source: Bloomberg, Haver Analytics as of November 26, 2021.
Quarterly data through 3Q21.

Figure 10: Fiscal Breakeven Oil Prices

	Average 2000–2017	2018	2019	2020	Projections 2021	Projections 2022
			Fiscal Breakeven Oil Price[2] *(U.S. dollars per barrel)*			
Bahrain	80.2	118.0	99.2	118.2	105.0	106.6
Kuwait[1]	…	53.6	53.7	67.8	65.8	65.4
Oman	…	80.3	67.9	87.6	70.9	60.5
Qatar	44.5	49.3	50.6	48.8	46.5	44.1
Saudi Arabia	…	88.6	81.9	76.6	82.4	72.4
United Arab Emirates	48.7	64.2	61.7	62.5	69.0	66.8

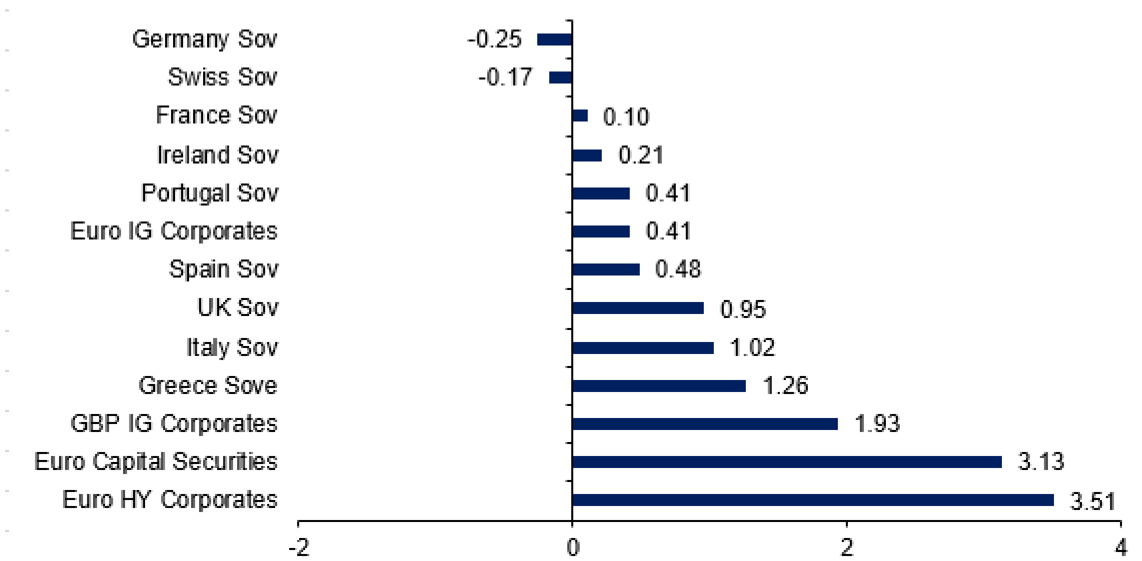
Source: Bloomberg, IMF. National Authorities as of November 25, 2021. Note: [1]Kuwait's fiscal breakeven oil price is before the compulsory 10 percent revenue transfer to the Future Generations Fund including investment income. [2]The oil price at which the fiscal balance is zero. All forecasts are expressions 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..

Fixed Income outlook – Valuations stretched, only selective opportunities

We remain cautious and underweight on the asset class, while recognising that there are selective opportunities. Even after the slight increase in yields, the aggregate investment grade benchmark yield is still only 0.04%. Most investment grade (IG) corporate bonds rated "A" or higher are trading on negative yields. Sovereign bond yields have picked up recently but still look expensive as the strong inflation data is unlikely to ease in the short-term and as the ECB prepares to end its PEPP program in March 2022 (**figure 11**). UK 10-year Gilt yields have risen from 0.2% to 0.9%, the biggest move among large

European countries. However, as the BoE adjusts short-term rates and other intermediate duration rates potentially move higher following the Federal Reserve taper, gilt yields relative to other developed sovereign yields may increase somewhat further.

Figure 11: YTD EMEA fixed income yields (%)



Source: Bloomberg Barclays, Bloomberg and The Yield Book, as of 22 Nov 2021. Past performance is no guarantee of future returns. Real results may vary. 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.

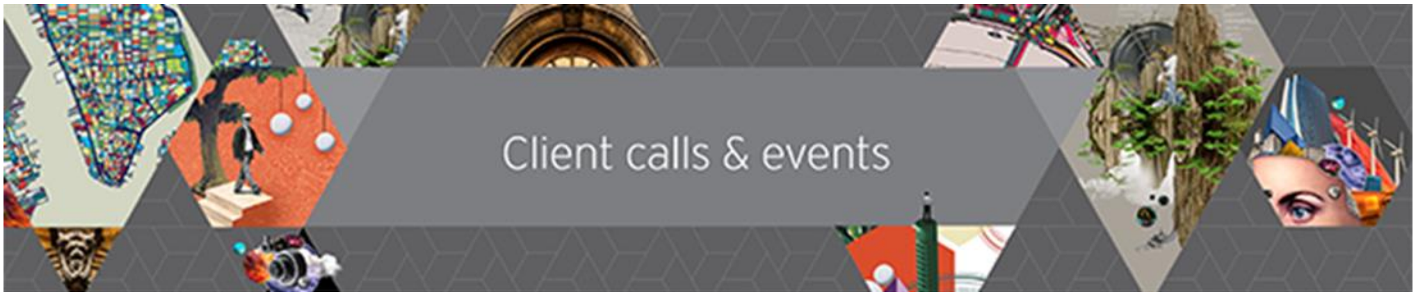
In high yield, both euro-denominated bank Tier 1 capital securities and non-bank issuers including loans offer yields around 3%. They are likely to see their credit metrics supported by the ECB's continuing provision of liquidity through its asset purchases.

In the ongoing environment of negative real rates, EU green bonds represent a new asset class that could also offer potential opportunities. The EU has issued its inaugural green bond by selling €12 billion of 15-year bonds with a yield of 0.45%. The EU's green bonds will be based on the EU's sustainable finance rules, and the capital raised will be used to help finance the EU's €800 billion Recovery Fund, with a process to ensure that the cash is used to fund genuine environmental projects.

Currency outlook – Sterling to be stronger than the euro

The British pound is well-supported at current levels by valuation, pent-up demand for UK assets from global investors and the BoE starting its rate rising cycle ahead the Fed and the ECB. However, rallies will likely be capped this winter, which could be a challenging time owing to higher living costs and rising COVID cases. Disruption from the long-delayed implementation of full post-Brexit customs declarations and controls during 2022 is a further risk to the UK economy. Any long-term upside depends on the government formulating and communicating its post-Brexit and post-pandemic economic vision.

The euro looks vulnerable as the ECB delays tightening monetary policy. Inflation-adjusted eurozone rates do not offer much support to the currency against the US dollar among others. More positively, the eurozone periphery countries are mostly performing well, aided by EU loans and grants. While the German political risks are easing as the coalition is almost formalized, the foreign exchange market will soon start to focus on the potential risks presented by a far-right euro-sceptic candidate winning the April 2022 French presidential election.



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