



## Citi Global Wealth Investments

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### The inescapable (but hopefully mild) recession

- **Investor confidence at all-time low points to looming recession:** Consumer and businesses are turning more pessimistic as we head into winter, with record high inflation, slowing demand and increasing costs. While government energy subsidies might limit the extent of the contraction, a recession is unavoidable in 2023.
- **High EU inflation and slowing real growth, not a great mix:** Inflation hit all-time high of 10.7% YY but shows some signs of peaking this quarter. Real GDP growth will likely continue to soften and will probably turn negative before the end of 2022 and decline throughout the first half of 2023. The ECB is facing the arduous choice of hiking into a recession, likely bringing its policy rate to a broadly neutral level of 2% in December, with more hikes to come.
- **UK: Fiscal policy uncertainty will hopefully dissipate and rekindle investors' appetite for gilts** – PM Rishi Sunak, who replaced Liz Truss in late October, and Chancellor Jeremy Hunt are working behind the scenes to close the country's £35bn fiscal gap. Markets have recovered from the tumultuous mini-budget announcement from former Chancellor Kwarteng, with sterling rebounding against the dollar and euro while gilt yields declined. For global investors, we stay underweight UK fixed income but see it as an investment opportunity for local investors.
- **Equity Outlook:** The 3Q-22 earnings season started positively, but firms have begun to warn of tough times ahead and point to margin compression due to inflationary pressures. Most of the underperformance in Europe ex-UK equities has been mainly driven by an increase in real rates, slowing demand and growth. As we worry that earnings downgrades have yet to be incorporated into valuations, we remain underweight Europe ex-UK equities.
- **Special Feature: Is Europe Ready for Winter?** Europe goes into the winter period with high storage levels and diversified supplies. The biggest unknown is the average level of seasonal temperatures. The much higher price of energy, lower levels of economic activity and efforts to conserve energy will also play a part in lowering demand. While further mutualization of debt issuance in the EU could be agreed to mitigate the cost of energy imports for the more vulnerable countries with higher funding costs, Europe still faces clear tail risks.

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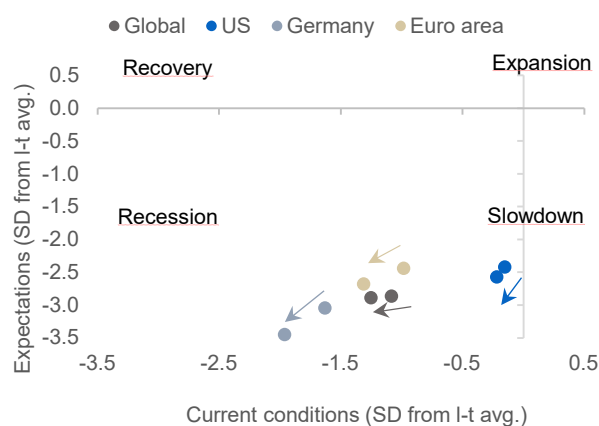
## Widespread and deep pessimism means that a recession is coming

The Sentix composite measure of investor confidence for the euro area fell by 6.5 points to 29-month low of -38.3 in October. The record low was a print of -42.9 in April 2020 when economic activity was suffering enormously from the widespread closure of businesses due to Covid-19 pandemic restrictions. The current conditions measure declined to -35.5 (1.3 standard deviation below its historical average), while the expectations measures slipped to -41 (2.7 standard deviations below). This is the lowest reading since the all-time low of -2.8 standard deviation seen in November 2008 during the Great Financial Crisis. Note that all countries are being tarred with the same brush, with clear declines in the scatter plot from September to October, and that Germany is the clear underperformer (**Figure 1**).

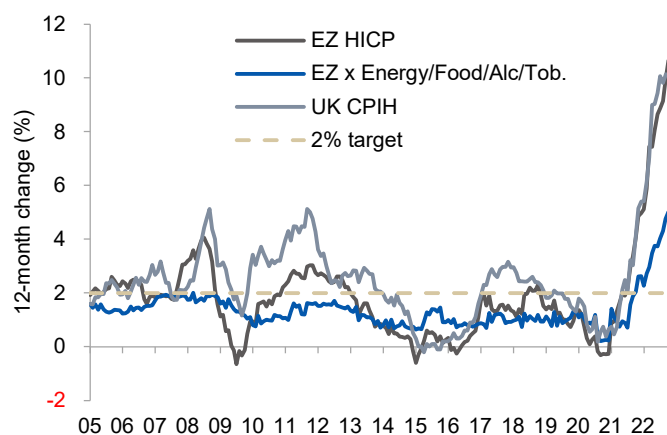
There is widespread evidence of declining business confidence across Europe and of spluttering goods exports. But the final phase of the adjustment has not begun yet as labour markets remain very tight and the export picture still shows positive, albeit very soft, growth. If one takes Germany for instance, the extent of the drop in manufacturing confidence and the importance of manufacturing in terms of employment in one of the global economy's most successful exporting nations means that it is only a matter of time before the labour market softens also. Businesses are turning more pessimistic about expected levels of demand, and record high inflation is eroding household's real disposable incomes, meaning that discretionary spending is likely to be the victim of the cost-of-living crisis that is spreading across the continent.

Countries' best efforts to use fiscal policy to tackle the energy crisis (go to our Special Feature on page 7) might limit the extent of the recession in the next few quarters, but there is a clear lack of coordination at the EU level for common solutions to a problem that a very large majority of the 27 member states cannot solve on their own. The lack of agreement on a natural gas price cap after months of discussions illustrates that difficulties that the EU is facing when trying to respond in a coordinated manner, even without the need to address the need for solidarity. Progress on this front might be a necessary but not sufficient condition for international investors to look at the attractive valuation of European asset more favourably.

**Figure 1:** Pessimism is global by Germany underperforms



**Figure 2:** Inflation rates yet to peak, hitting domestic demand



Sources: Sentix, Eurostat, ONS, Haver Analytics and Citi Global Wealth Investments as of November 3, 2022. 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.

## Inflation climbs to all-time highs as GDP growth softens across the board

Euro area inflation rose to a new-all time high of 10.7% YY in October, while economic activity expanded at a slower pace of 0.2% QQ in the third quarter of 2022. All price sub-categories saw an acceleration in inflation pushing the core inflation (excluding energy and food prices) aggregate to a record high of 5.0% YY in October from 4.8% YY in September. Services inflation increased to 4.4% YY from 4.3% YY and non-energy industrial goods inflation to 6.0% YY from 5.5% YY.

The pace of economic growth is softening in the euro area where GDP rose by 0.2% QQ in 3Q-22 after a 0.8% QQ gain in 2Q-22. Euro area (EU-27) GDP growth has halved to 2.1% YY (2.4% YY) in 3Q-22 after 4.3% YY in 2Q-22. GDP splits to

be released on 15 November will likely confirm that services sector activity expanded markedly during the summer as the economy functioned more normally, but that the external demand picture softened, impacting the manufacturing sector. While most forward-looking indicators suggest that inflation should peak soon, real GDP growth will likely continue to soften and will probably turn negative in 4Q-22 and decline throughout the first half of 2023. Europe looks set to experience a recession because of record-high energy prices, continued geopolitical worries and damaged confidence.

Record high inflation prints and the risk of further upside in the autumn against a backdrop of flat-lining GDP will likely require the European Central Bank (ECB) to hike rates by at least 50 basis point (bp) to 2%, close to its neutral level at its December 15 meeting, but possibly by up to 75bp for a third successive meeting in case of a further increase of its projected inflation profile ([Europe Strategy Bulletin – October 27, 2022](#)) We are confident that the resulting tightening in financing conditions, decline in the availability of credit and contraction in domestic demand should be enough to lower inflation in the course of 2023, especially if the ECB were to decide to reduce its balance sheet by selling assets in the spring.

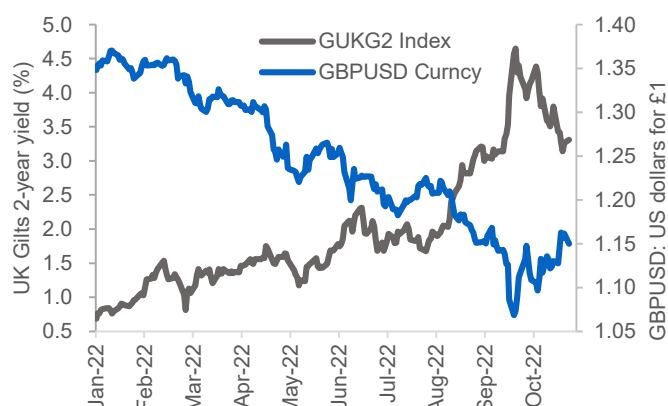
## UK: hard choices ahead for new PM Sunak, as austerity beckons

The UK government is sending strong hawkish messages ahead of the autumn statement on 17 November when the Chancellor of the Exchequer will update the previous government's fiscal plan. Prime Minister Rishi Sunak and Chancellor Jeremy Hunt are planning to plug the £35bn UK fiscal gap by increasing taxes. In line with the Conservatives' 2019 manifesto, it is likely that Sunak and Hunt will not increase income tax or national insurance (NI), but instead propose a freeze on income tax and NI thresholds for two more years, with the potential of further extensions. In addition, the PM and Chancellor are reported to be mulling a plan to increase windfall tax on oil and gas companies. We think that part of the signalling is to reduce the likelihood of an outsized hike of up to 100 basis points to the 2.25% Bank Rate.

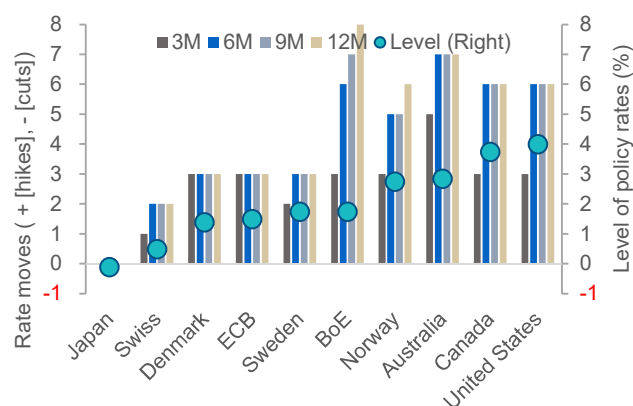
With regards to spending cuts, PM Sunak is considering freezing the overseas aid budget for over two years, which could provide £4bn of savings per fiscal year. Press reports suggest that 'everything is on the table', from tax hikes to spending cuts, including perhaps large-scale capital expenditure projects such as high-speed rail (HS2), to plug the fiscal gap and to ensure medium-term stability in UK public finances.

Markets appear much more relaxed about the already-announced fiscal measures and promises of budgetary rectitude in coming weeks. Sterling has recovered some of its lustre against both the dollar (Figure 3). Gilt yields have also fallen from their highs seen a month ago. Gilt yields are now incorporating the possibility that the Bank of England (BoE) will not hike as aggressively as feared following the announcement of the 'mini-budget' by former Chancellor Kwarteng. The BoE will likely continue to tighten monetary policy until inflation peaks, likely staying on a short and sharp hiking cycle ([EMEA Strategy Bulletin – November 3, 2022](#)).

**Figure 3: Renewed confidence in UK public finances**



**Figure 4: A sharp and short interest rate hiking cycle**



Sources: Bloomberg and, Citi Global Wealth Investments as of November 3, 2022. 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.

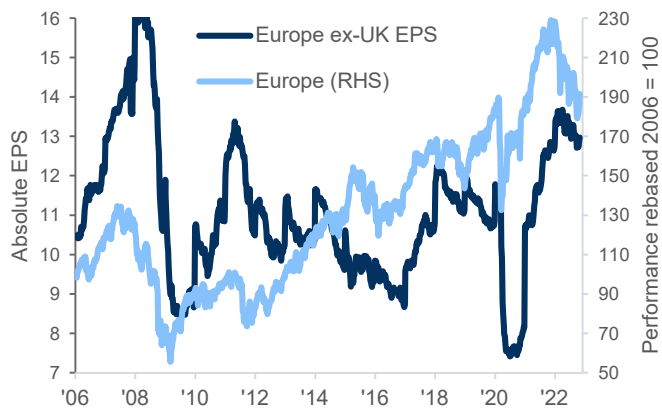
## Equity outlook

The 3Q-22 European earnings season has kicked-off positively. To date, around 53% of the Stoxx 600 firms have reported their results. The share of firms indicating positive earnings growth stood at 60% versus 56% in 2Q-22. Most of the positive earnings growth stories emanated from the energy and banking sectors. Although we are only halfway through the reporting season, the omens point to another positive quarter.

A noticeable feature in 3Q-22 is that many firms' earnings statements contain warnings of margin pressure ahead, due to high inflation feeding through to input and labour costs, as well as a global slowing in demand. We think that firms are preparing investors for a more negative picture in early 2023, when they announce their outlook for the year ahead and report on 4Q-22 earnings. These are likely to show disappointing results as cost pressures start feeding into firms' balance sheets.

European earnings-per-share (EPS) is generally a lagging indicator relative to European equity performance. However, it seems that EPS has now peaked with some early indication of a rollover (**Figure 5**). Since most of the European equity underperformance this year has mainly been driven by rising real rates (**Figure 6**), we believe that there is probably more downside from a deteriorating earnings picture for European equity performance in the next few quarters.

**Figure 5:** European EPS is rolling over after peak



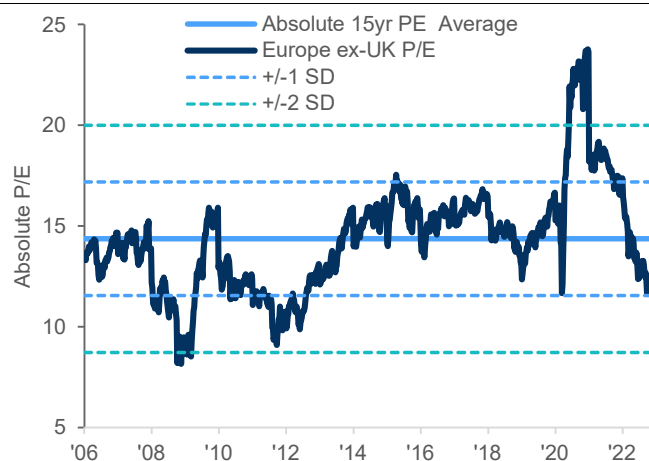
**Figure 6:** European underperformance driven by real rates



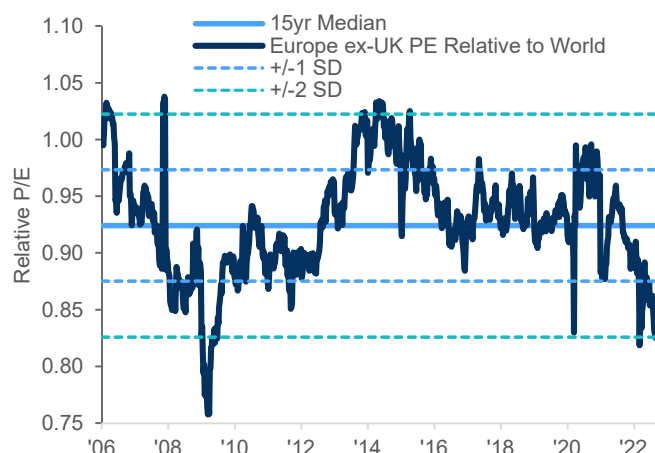
Sources: Bloomberg and Citi Global Wealth Investments, as of 28 October 22. Past performance is no guarantee of future returns. Real results may vary. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Past performance is no guarantee of future results. Real results may vary.

Valuations remain cheap and could even cheapen further both on a relative and absolute basis for Europe ex-UK equities. The European equities price-earnings (PE) ratio stands 1 standard deviation (SD) below its 15-year average on an absolute basis (**Figure 7**) and 2SD below its 15-year mean relative to MSCI World (**Figure 8**). However, the relative cheapness of European equities on their own does make it a compelling entry point. We would need to see a clear improvement in fundamentals, including a decline in both energy supply risks and inflation, before stepping in again to buy.

**Figure 7:** European absolute valuation is cheap



**Figure 8:** European equities is significantly discounted relative to world equities



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However, we feel that we are entering a new structural regime, in which interest rates will be higher for longer, on the basis that inflation might be slightly above than the ECB's 2% medium term target. We see opportunities that could arise around the middle of 2023 after the worst of the winter period is over and central banks have completed their tightening cycle. This could be when European equities are likely to find a bottom and transition to an early-stage recovery cycle. For the time being, we remain underweight European ex-UK equities, but we continue to favour European quality companies that offer resilient earnings growth in an environment of scarce and/or negative growth.

## Special Feature: Is Europe Ready for Winter?

- The war in Ukraine and the imposition of tough sanctions on its perpetrator have accelerated Europe's switch away from Russian fossil fuels, including natural gas. Europe goes into the winter period with high storage levels and diversified supplies.
- The biggest unknown for the next six months is the average level of seasonal temperatures. The much higher price of energy, lower levels of economic activity and efforts to conserve energy will also play a part in lowering demand.
- While some further mutualization of debt issuance in the EU could be agreed again to mitigate the cost of energy imports for the more vulnerable countries with higher funding costs, Europe remains vulnerable to clear tail risks.

### Europe has diversified its natural gas imports and the winter could be mild

Russia's decision to cut natural gas supplies to Europe has turned Moscow into an increasingly marginal partner (**Figure 9**). From its position as Europe's top gas supplier in January 2022 with around 38% of supply, almost double the amount entering the EU in the form of liquified natural gas (LNG), Russia's share has fallen to around 10%.

If the 2023 winter weather turns out to be much colder than on average, Europe could quickly burn through its stock of natural gas, given that the maximum storage capacity is around 26% of annual consumption and the six-month period from October to March normally represents 64% of annual consumption.

The good news so far is a slightly warmer-than-average winter beckons, suggesting lower than normal withdrawal of natural gas from storage. The European Centre for Medium-Range Weather Forecasts and Copernicus, the European Union's Earth observation programme, indicated that their climate model sees a higher probability of mild temperature and that Europe is likely to avoid an unusually cold winter.

Interestingly, the same prognosis also applies to temperatures along the US East Coast which are expected to be above average. This would reduce the likelihood of any disruption to the flow of US-produced gas being shipped to Europe.

**Figure 10** shows that Europe's ability to avoid rationing the consumption of natural gas will greatly depend on how temperatures behave in the coming winter.

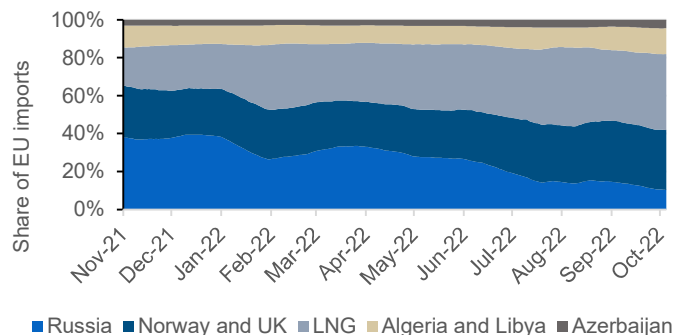
Europe's energy supply is much more diversified than 12 months ago

LNG is now the largest source of natural gas imports.

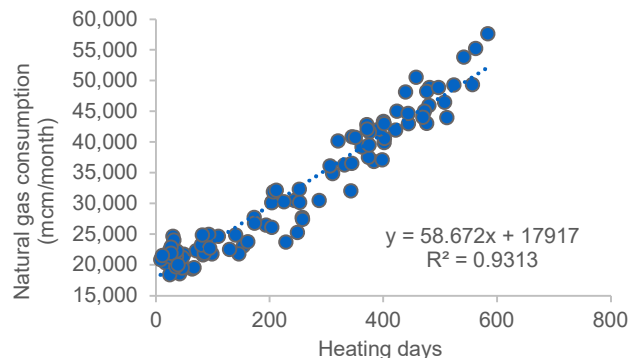
Russia's share has fallen to 10% and will continue to shrink

Weather forecasts suggest that Europe could enjoy a mild winter

**Figure 9: Russia has gone from being the largest supplier of natural gas to Europe in Nov-21 to fourth in Oct-22**



**Figure 10: Warm winter = fewer heating days, meaning a much lower consumption of natural gas**





### Three scenarios: mild, baseline and severe

To illustrate a likely range of situations that Europe could be facing this winter, we present three stylised scenarios (Mild, Baseline and Severe) depicting possible outcomes from the level of gas stocks across the EU, and their potential consequences in terms of economic activity, inflation and central bank reactions.

In mid-October, Europe is going into the heating season with a relatively high level of gas stocks, with its total storage capacity around 91% full. Note that these levels can probably increase by up to 1.5 percentage point to the end of the month.

**Figure 11: Scenarios for gas stocks suggest that even meaningful disruption could be tackled this winter**

	Injections (+)			Withdrawals (-)			Gas stocks		
	% chg. YY			% chg. YY			(% of storage capacity)		
	Mild	Baseline	Severe	Mild	Baseline	Severe	Mild	Baseline	Severe
Oct-22	-16%	-16%	-16%	-18%	2%	22%	91.2	91.2	91.2
Nov-22	-22%	-26%	-30%	-20%	2%	24%	83.6	81.3	79.0
Dec-22	-22%	-26%	-33%	-13%	1%	15%	72.3	66.8	61.2
Jan-23	-20%	-23%	-34%	-18%	2%	22%	60.5	50.3	40.0
Feb-23	-21%	-25%	-38%	-19%	2%	23%	53.6	40.2	26.5
Mar-23	-26%	-29%	-45%	-18%	2%	23%	52.2	36.3	19.5
Apr-23	-21%	-26%	-45%	-24%	4%	31%	57.7	40.6	21.5
May-23	-16%	-22%	-44%	-25%	4%	34%	68.9	50.8	28.3
Jun-23	-2%	-9%	-38%	-29%	6%	41%	79.8	60.7	34.6

Source: Haver Analytics through October 5, 2022. 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.

Three scenarios to gauge the most likely low point for natural gas storage in spring of 2023

'Mild' and 'Baseline' would rule out any restrictions in terms of consumption

'Severe' would require a very hard winter and some supply disruption

Europe could find it harder to rebuild gas storage levels quickly in 2Q-23

The mild scenario (grey line on **Figure 12** below) references a situation in which Russian gas volumes are minimal (10% of last year's volumes in November and a 99% cut in volumes in 1H-23 vs. 1H-22) as Russia imposes maximum pain when countries need to re-build their gas storage. Although other sources of supply, including LNG, increase by 10%, injection volumes would still shrink by 18%.

With gas prices around 60% higher in the first three weeks of October compared to the same period last year and assuming a mild winter, we estimate that demand for gas could fall by around 13% in the nine months to June 2023. In this scenario, the lowest point for gas storage is 52% of capacity by mid-March, largely similar to 2020.

The baseline scenario (blue line) references a situation in which imports of gas from Russia is reduced to a trickle and falls to zero by the end of the year and stays there in 2023. With LNG supply expected to increase by 5% YY in the first half of 2023, while other pipelines also delivering between 7.5% to 12.5% more gas in 1H-23 than in 1H-22, injection volumes would shrink by around 23% YY in 1H-23.

For withdrawals, demand for gas is estimated to be in line with the seasonal average since 2018, up around 4% YY, thanks in part to the cap on gas prices disincentivizing most households and businesses from restricting their consumption. In this scenario, the lowest point for gas storage is 36% of capacity by mid-March, a level which we think would be unlikely to trigger any restrictions in overall gas usage.

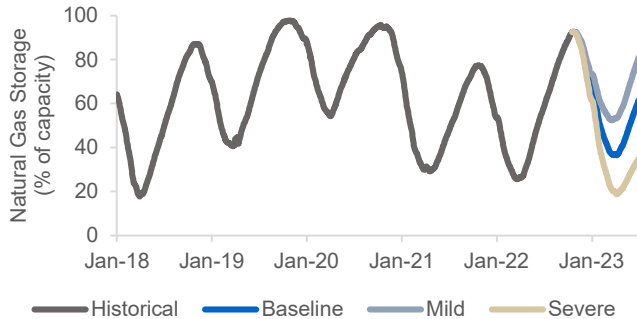
The severe scenario (yellow line) references a situation in which Russian gas provisions stop completely as Europe decides to ratchet up sanctions against Moscow for its escalation of the war in Ukraine and would make illegal to import any gas from Russia. Given the need to model a tail risk, we would also assume that other pipelines could experience some disruption and/or that an aggressive European cap on the price of



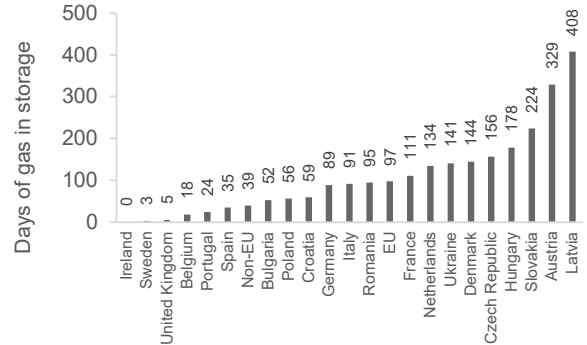
natural gas, could also make it less attractive for any producers to sell to Europe. Injection volumes would likely shrink by around 40% in 1H-23.

In this tail risk scenario, we assume that even in the event of a jump in prices, demand for gas increases markedly in the event of a much harsher winter than expected by the multi-month weather forecasting models while some countries' energy shield mechanism results in an increase in the gas consumption. This scenario assumes that the consumption of gas in the nine months to June is the highest recorded since 2014, resulting in a 30% jump. Under these assumptions, the below 20% of capacity by mid-March, a situation unseen since 2018. Such a level would likely be dangerously close to that requiring some restrictions in the use of natural gas for non-critical businesses.

**Figure 12: The severe scenario suggests that on aggregate the EU should be able to avoid widespread gas restrictions**



**Figure 13: Some countries will likely be dependent on the kindness of their peers and/or access to LNG**



Source: Haver Analytics through October 5, 2022. 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..

### But tail risks remain

While we believe that there enough gas in Europe, the resource is unevenly distributed. Some countries have less than one month of gas usage in reserves (**Figure 25**). Given that in January, the consumption is typically 50% higher than the monthly average for the year, countries with less than 90 days of storage are the most vulnerable. These could easily find themselves reliant on the kindness of their peers or would need to have direct access to foreign producers/exporters most likely through LNG terminals.

Beyond natural gas, Europe is also more vulnerable from an energy standpoint since France which normally exports electricity to its closest neighbours is going to be a net importer until longer-than-expected maintenance on a significant number of its nuclear reactors is completed. Indications that Russia is stepping up its attacks on Ukraine energy infrastructure ahead of the winter are a timely reminder that Europe remains at risk of suffering from energy shortfalls in coming months.

The sabotage of two Nord Stream gas pipelines in the Baltic Sea in late September is a powerful reminder of some obvious vulnerabilities in terms of its energy infrastructure and of the need for Europe to accelerate its transition towards renewable sources of energy to secure some form of strategic autonomy by acceleration its NextGenEU programme.

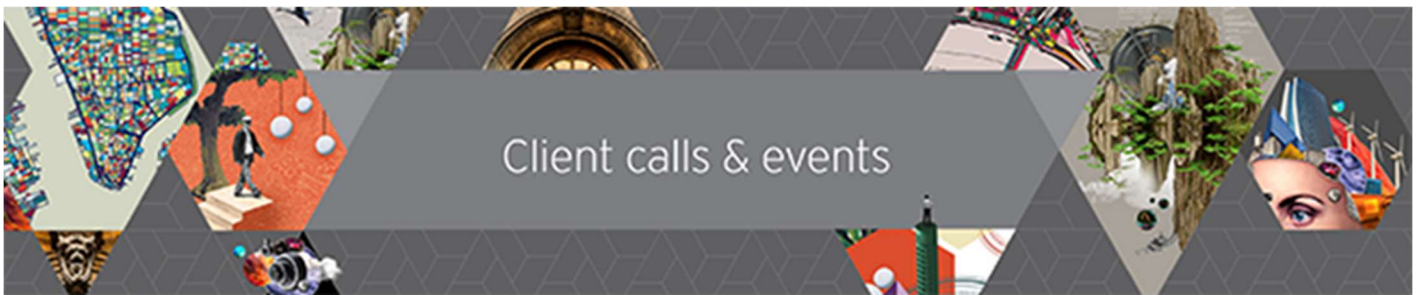
**To conclude**, we think that Europe is as best prepared as it can be for the oncoming winter, with enough natural gas in storage to avoid risk of major rationing, while government actions to protect households and most vulnerable businesses should limit the downside risks to GDP from the high cost of energy. But the balance of risks remains skewed to the downside, especially from geopolitics, while continued monetary policy tightening in the face of very high inflation will certainly weigh on confidence. For the time being we are very comfortable with our underweight bias to European assets.

Gas storage is unevenly distributed

Some countries have very little room for manoeuvre and might have to rely on the kindness of their peers

Electricity shortages remain possible, for different reasons

Critical energy infrastructure at risk of sabotage?



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