Private Bank

CIO Strategy Bulletin

April 18, 2021

Acrophobia in Markets?

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Acrophobia in Markets?

At moments like these, investors and those thinking about investing may feel as if they are sitting at the top of a roller coaster, fixated on the drop to come, holding tight to the handle bar. US shares have gained 18% since October 2020 when many investors had already assumed markets "had gone too far". Global shares are already at the cusp of another year of double-digit returns (+9.5% year-to-date). While this lowers the scope of the coming-year's return in US markets, in our view, macroeconomic policies and results, as well as vaccine efficacy and rollouts have broadly justified this appreciation. While investors intellectually understand that formulaic "laws of gravity" do not apply to markets, the fear **feels** the same.

Facts, Not Gravity

Over many months, we have provided several historic facts to reduce investor fear. For example, we have written that:

- US equity returns have been positive in roughly 85% of annual periods. This is roughly the same share of time the US economy expands, while contraction periods have averaged 15%.[*]
- Market timing doesn't work. Missing the top 20 days of US equity returns during the past two decades would have reduced annual returns by 10.5 percentage points, producing losses rather than gains.[**]
- Over the past year, missing the single best two days would have reduced the return by a massive 19.3%.
- US and global equity returns average a correction of slightly more than 10% once per year, on average. These declines tend to be shorter and shallower during business cycle expansions.

These factual statements support a simple investing truth. Quality investment portfolios – those that generate strong risk-adjusted returns over time -- require a meaningful, **permanent** level of allocation to risk assets for any given

[*] and [**] Citi Private Bank Global Investment Lab as of April 16, 2021

level of risk tolerance. Yet, we spend a fair amount of time looking at various market valuations and market inefficiencies in these Bulletins. Why is that?
As valuations and forward-looking return opportunities change, our job is to advise clients on asset allocation so that an investor's "core" portfolio can address unusual market conditions, take advantage of return opportunities (and avoid inferior ones), identify market anomalies and call out misplaced investor sentiment, positive or negative.

A diversified portfolio over the past 18 months would have left investors with few regrets. During that time, a 60/40 portfolio including bonds avoided the double-digit declines in equities at the peak of the pandemic fear last March. Since then, the equity portion of the portfolio would have driven a roughly 35% overall return even with a drop in bond valuations this year.

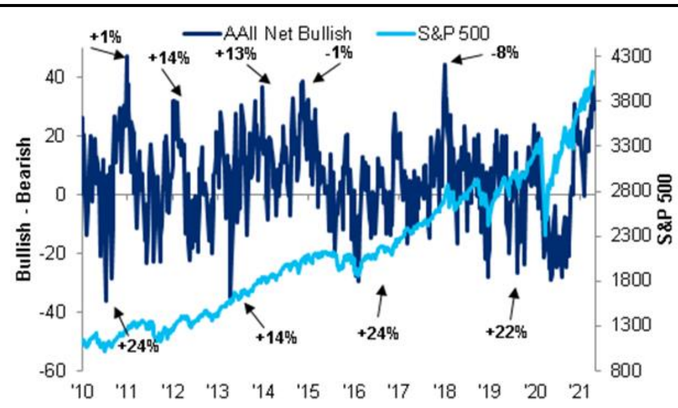
Financial Repression Remains

As we exit the pandemic and enter a new economic cycle, we have made some observations that continue to be important for investor allocations in core portfolios now. The first is that fixed income allocations during a period of financial repression (times when interest rates are being held abnormally low by central banks) do not provide as much diversification as they did from 1980-2008, when real interest rates were positive and falling. Thus, allocations to equities generally have risen. Global diversification has, too. Our medium risk or "Level 3 portfolios" that typically have 61.4% invested in equities are currently 71.4%, when strategic holdings of alternative and illiquid investments are excluded.

The US market is not cheap, but investors assume it is considerably overvalued. How high are US equity valuations overall? For context, the S&P 500 traded at 19.6X trailing EPS at the end of 2019 when the 10-year was 1.9%. This was the last cycle's peak in EPS. Today, US equities trade at 23.6X 2021 EPS estimates, but with considerable scope for further growth and stronger-than-expected results, as 1Q2021 reporting data are beginning to show. Remember, too, that the risk of a new business cycle contraction in the next two years is **much** lower than in 2019, when the market had seen a nearly 11 year uninterrupted expansion.

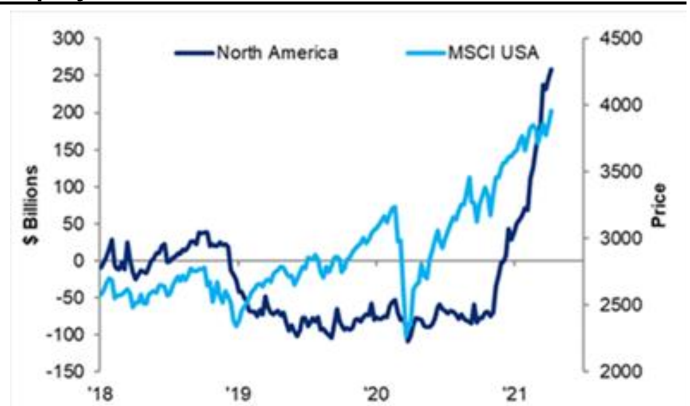
Yet after a world-leading appreciation, our over-weights in the US are limited to the globally cheap Healthcare sector shares and REITS. We removed an overweight to US small caps in late January 2021 after an 80% rally from April 2020 when we had initiated the position. That said, our current allocations reflect a sobering fact. Periods of highly bullish US sentiment have seen subsequent annual returns average a sub-par 4% for the S&P 500 over a the last 12 years of available data (see figure 1). And investors, while saying they are fearful, are behaving bullishly. For example, fund inflows are strongest in US equities (see figure 2). Why might that be?

Figure 1: US Investor Net Bulls/Bears vs S&P 500 Index



Source: Haver Analytics as of April 16, 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 2: US Equity Fund Cumulative Inflows vs US Equity Index



Source: Bloomberg as of April 16, 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.

Stimulus At Work: The Post-Covid Boom Is Here

If anyone ever doubted the efficacy and expediency of fiscal stimulus, US retail spending data for March should put that concern to rest. US retail sales surged nearly 10% (non-annualized) last month as $330 billion in Federal stimulus payments reached nearly 85% of US households (see figure 3). The surge in merchandise sales further drained already low inventories of imported and domestically-produced goods. It leaves US GDP for the first quarter 2021 on track to rise more than 8% on an annualized basis. This will, in turn, drive US industrial production and trade gains to replenish inventories, boosting US growth and employment, while spilling over to foreign producers globally.

Stimulus is going to drive the developed world economies to a faster and more complete recovery than expected. Though we discussed last week that some regions of the world will have to play catch up to the strong US and Chinese economic performance, there is plenty of self-reinforcing economic growth to come, fueled by the bolus of Congressional dollars from the US.

Figure 3: US Retail Goods Sales: Overall and Core Y/Y%

Source: Haver Analytics as of April 16, 2021. Core retail sales defined as a total measure of retail sales, excluding auto and gas sales.

European Markets Remain Cheap with Mean Reversion Likely Still

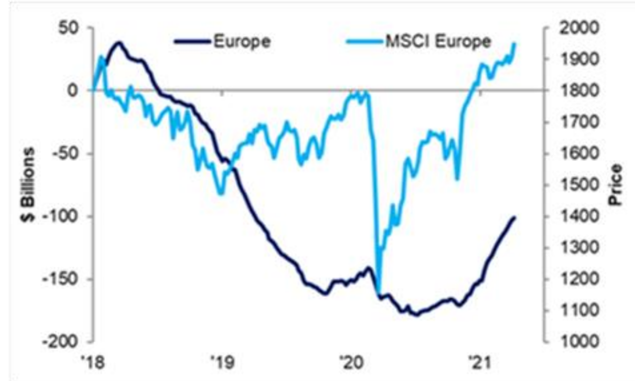
The second observation is that mean reversion does not occur all at once or evenly over time. Take a look at Europe. European and UK shares have lagged less during COVID than emerging market shares, but have a long history of weak performance and low valuations to overcome. Unlike the US which has seen private consumption boom in concert with stimulus checks, the Eurozone is likely to see accelerating private consumption build more slowly. Oxford Economics projects 3.1% growth in 2021 accelerating to 7% growth in 2022, reflecting excess savings rates and a recovery in services with a lag.

And lest you think past trends cannot be reversed (see figure 4). This Europe STOXX 600 data from April 10, 2020 suggests that European equity price performance could be at an inflection point. Remember that Europe has far greater residual angst over COVID's future (see figure 5). Thus, we advise clients to anticipate changes in market dynamics, not to wait until momentum traders enter positions.

Figure 4. European Broad Shares at an Inflection Point

Note: Factset as of April 16, 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.

Figure 5. European Equity Fund Cumulative Inflows vs Europe Equity Index



Source: Bloomberg as of April 16, 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.

Real Laggards Do Recover

Does anyone recall that non-US shares outperformed the US from 2001-2016? (see figures 6-7). It does not seem so. Non-US shares presently trade at a more reasonable 17x 2021 EPS. As we discussed last week, there are many beaten down parts of the world where investor sentiment is quite poor. While we do not see much beside the COVID-crisis adversely affecting Latin American shares in the medium-term, markets are behaving as if there was more bad fundamental news to come. Regardless of its political uncertainties, Brazil is very inexpensive relative to the US. Its currency has fallen about 40% against the US dollar since COVID first hit.

Figure 6: US and Non-US Equities in USD

Source: Bloomberg as of April 16, 2021. US Equities: MSCI US; Non-US Equities: MSCI AC ex-US. 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 7: US and Non-US Price/Earnings on Expected 12-month Ahead EPS

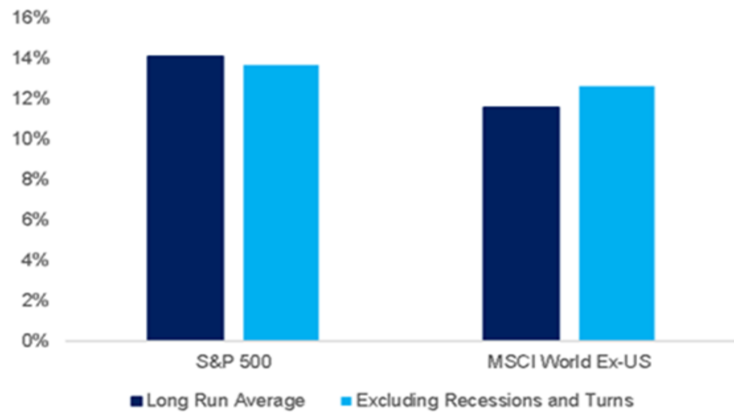
Source: Bloomberg as of April 9, 2021. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Past performance is no guarantee of future results. Real results may vary.

Advice for Those Who Fear Heights: The "Middle Innings" Tend to be Quite Profitable

For those who still fear heights, we have truly good news. The **middle innings** for markets tend to be quite profitable. If one eliminates 1) the final year of economic expansions 2) recession periods and 3) the first year of economic recovery, US and non-US equity returns in "mid cycle" tend to achieve the long-term average. And Non-US equity returns at mid-cycle strengthen slightly as shares "catch up" with the US recovery (see figure 8).

So, do not be a market timer. Market timing is extremely difficult and has demonstrably harmed investor returns (Please revisit our Outlook 2021for that discussion). Aside from short-term pullbacks that are common to most every year, we expect that this mid-cycle (post-Covid) will likely behave similarly.

Figure 8: What Happens at Mid-Cycle: Annualized US and Non-US Equity Returns Overall, and Excluding Periods 12-months prior-to, through-12-months after US Recessions (Jan 1950 – Mar 2021)



Note: Averages since 1950. Source: Factset as of April 16, 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.

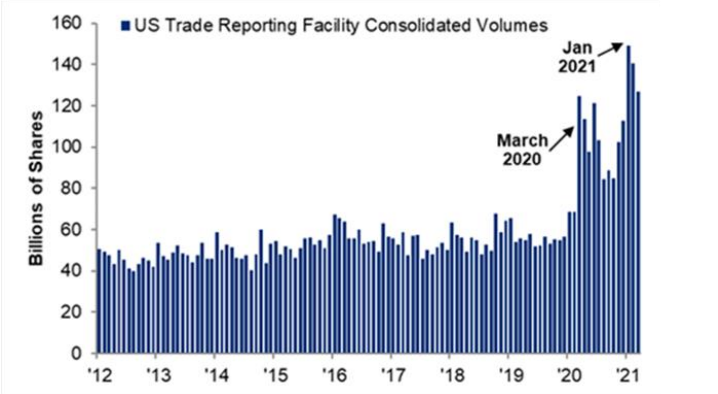
Worries Ahead?: Caffeinated Retail Investors, Rancorous Relations

Recipients of checks from Uncle Sam almost certainly didn't just splurge on goods. Web traffic data suggests record numbers opened new brokerage accounts. These new investors, predominantly Millennial and Gen Z'ers, sent US trading volumes to record highs (see figure 9). And they have been using call options as a way of achieving leveraged returns. This goes well beyond the "Game Stop fever" episode when social-media "activists" effectively banded together to drive a severe squeeze in a small number of highly concentrated short positions of hedge funds (please see our bulletin of January 31 for discussion).

Apex Clearing, which maintains the leading data set for these new, retail investors, notes that they maintain core positions in leading tech companies (i.e. Apple, Microsoft), were early players in the "recovery from the Pandemic", favor e-commerce, electric vehicles, and personal tech broadly and also like "Reddit" or meme trades as well as penny stocks. Looking through the data, we see a lot of momentum trading going on in this new cohort of investors and, while that does not generally earn the greatest returns, it does speak to youthful optimism in future industries and sectors.

Overall, we observe that equity call volume data far outnumber puts (see figure 10). In other words, at least some markets are getting "caffeinated", by new and existing investors. This can leave markets susceptible to a short-term correction on even a whiff of trouble. And there are two short-term possibilities for such news. We would watch for headlines from China in the coming days in particular amid struggles from a state-owned debt consolidator. A second source would be US Congressional action to further confront China.

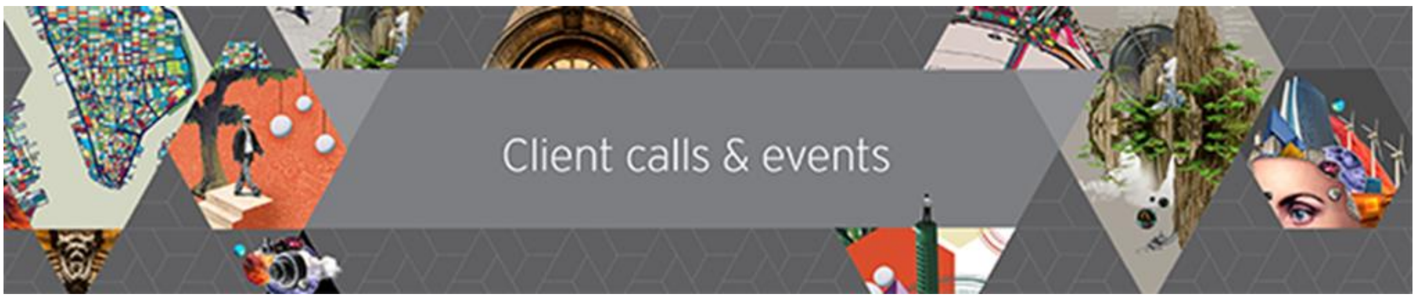
Figure 9: US Consolidated Equity Trading Volumes (On and Off Exchange)



Source: Haver Analytics as of April 16, 2021

Figure 10: US Equity Call and Put Volumes

Source: Haver Analytics as of April 16, 2021



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