



CIO Strategy Bulletin

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From Engineered Shutdown to Engineered Boom

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In This Issue...

The 2017 Nobel Prize in Economic Sciences went to Richard Thaler who explained the impact on markets of the human tendencies to act irrationally and demonstrate a lack of self-control. It is therefore reasonable to assume that similar biases exist among economic forecasters. Optimists will extrapolate good circumstances into the distant future. Pessimists will find a scenario where the world is to be doomed even amidst a New Economic Recovery. Thus, this week, we set out to be as transparent as we can about our economic and market assumptions and what they lead us to conclude.

We also present two special sections: [Finding Quality Growth Amid the Growth Stock Rout](#) and [The State of China's Policies and Markets](#). Both present important data on opportunities within growth equities and in Chinese shares.

An Economic Tsunami: From Engineered Shutdown to Engineered Boom

The 11-year economic expansion COVID dismembered did not die of “natural causes.” The COVID pandemic was an *exogenous shock*. An “outside disruption” caused the world to substantially shutdown most economic activity for a time as a means of saving human lives. After the initial closures, socially close activity was minimized globally. The resultant recession was hugely different in shape and impact than ones derived from traditional *endogenous* business cycle contractions fueled by demand “overheating” or excessive investment.

The pandemic drove very “abnormal” economic behaviors, including an instant transition to “working from home”, digital versus in-person communications, closures of borders and substitutions in spending patterns to “what one could do” during a forced “stay-at-home” health crisis. Protecting society from COVID caused unprecedented swings in economic output across the world within 2020. In the US, for example, real GDP was -31% and +33% annualized in 2Q and 3Q. It also sharply re-distributed spending between sectors, causing simultaneous booms and busts.

In response, record US stimulus packages and similar, smaller fiscal actions in other parts of the world, were crafted to provide a bridge across an economic chasm. The miraculous, vaccine-driven reopening of services industries will follow. However, vastly different interest rate and fiscal policies across the globe will cause further “abnormalities” in the overall pace of growth going forward and the distribution of activity in particular regions and industries.

The Day Before the Pandemic

Most of the world economy was “healthy” when the COVID shock hit. Just ahead of the shock, these four conditions prevailed:

- No “booms;” no extreme excesses in production – **see figure 1**
- Healthy savings rates; no severe excesses in consumption – **see figures 2**
- Low inflation; supply and demand growth were balanced with neither overheating or deflation – **see figure 3**
- A generally resilient financial system – particularly in the US – **see figure 4**

Figure 1: Past Bubbles in the Economy

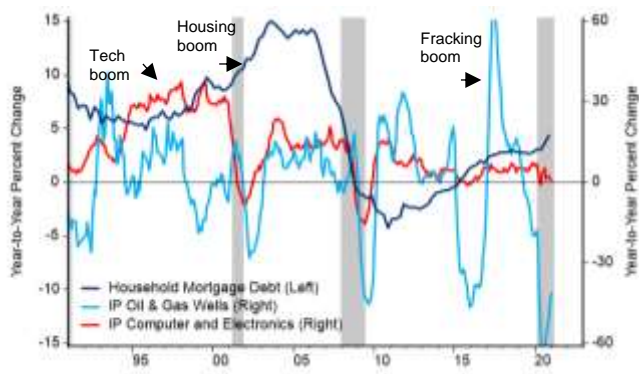
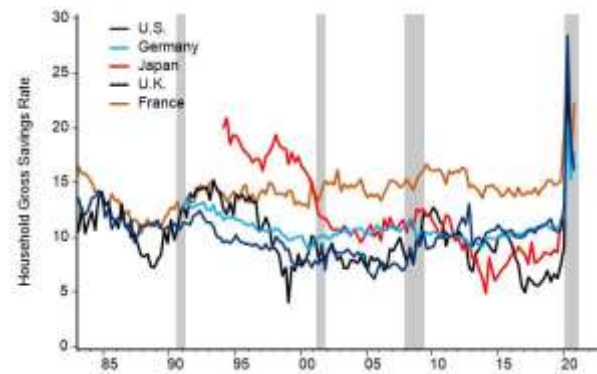


Figure 2: Gross Household Savings Rates



Note: Shaded areas denote recessions. Source: Haver Analytics as of March 5, 2021

Figure 3: Global Consumer Price Inflation

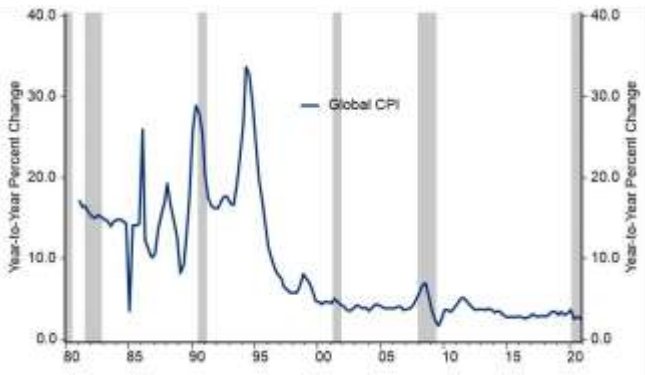
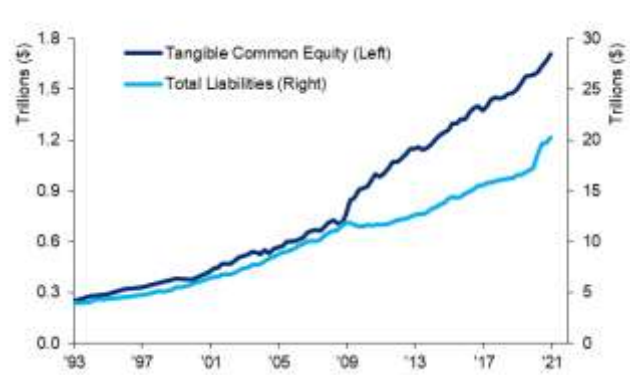


Figure 4: US Bank Equity Capital and Liabilities



Note: Shaded areas denote US recessions. Source: Haver Analytics as of March 5, 2021

A lengthy, uninterrupted period of economic expansion was underway before COVID hit. Starting from a depressed position at the end of 2009, the US and many developed markets had enjoyed 10 consecutive years in which employment growth exceeded labor force growth, causing the unemployment rate to drop. Yet, the minimal wage pressure throughout – with US employment costs rising just 2.7% in 2019 – meant labor market improvements were neither excessive nor unsustainable when COVID ended the expansion. Simply put, what has been labelled a “recession” in 2020 was a much more fierce version of an exogenous shock-driven collapse (1974’s oil embargo provides one much milder example).

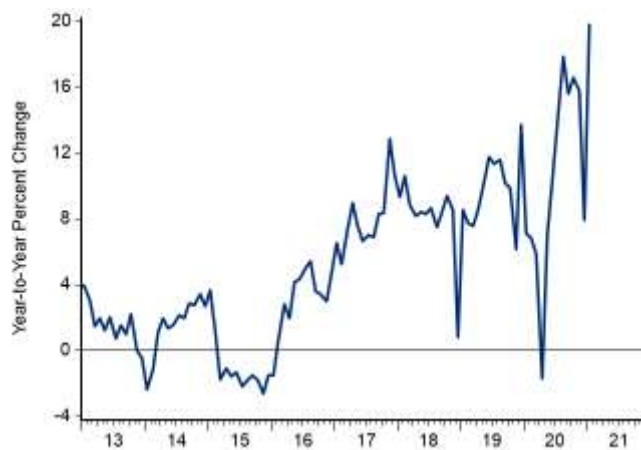
The Re-Opening Rebound

Based on these unusual circumstances and the four pre-conditions noted above, the healthy underlying global economy suggest a greater likelihood that a positive growth dynamic will ensue. The economic policies, rapid vaccine development and technological leap-frogs that enabled the economy to innovate and adapt during COVID will allow for a rapid “resuscitation” from the COVID plunge. We acknowledge that COVID today is still a massive impediment to business activity in many industries such as retail, hospitality, food services and travel (**see figure 5**). Yet, we see the recovery in these sectors as driving substantial incremental acceleration in economic growth, even as “COVID boom” industries such as home electronics fade somewhat in the coming year (see **figure 6**).

Figure 5: US Airline miles traveled



Figure 6: Real US Consumer Spending on Home Electronics



Source: Haver Analytics as of March 3, 2021

The Record US Stimulus Will Travel Globally

The additional \$1.9 trillion in federal spending just signed into law by US President Biden has many necessary elements, as we discussed in our bulletin of January 17 [Fiscal Stimulus, A Shot in Every Arm and Market Volatility](#). These include vaccine distribution spending and continued emergency unemployment insurance subsidies for those still unable to return to work. Similarly, the spending to support schools after a shocking jump in their costs and a corresponding decline in revenues last year makes inherent sense as children at school allow parents to work. And school systems in the US have no independent way of raising revenues to make up for the emergency costs of the pandemic.

The plan also aids US state and local government balance sheets harmed by the pandemic. Here, the new administration and Congress have made a political decision to refill their coffers. Since state and local government spending has typically contracted deep into typical recoveries, such immediate federal support should offer fuel for a more rapid recovery.

What is very unusual is the degree to which the US is “priming the pump”. The overall fiscal stimulus in the US is at least twice as large relative to GDP as any other major economy in 2021. The 2021 bills are larger than the 2020 bridge across the shutdown. This seems like the right policy for a depression, not for the *recovery phase* from a year-long pandemic (see **figures 7-8**). Thus, we expect “overflow”, the likelihood that there will be excesses in demand in the US that will “leak out” and stimulate the world economy.

Figure 7: US New Covid Cases Per Million Persons

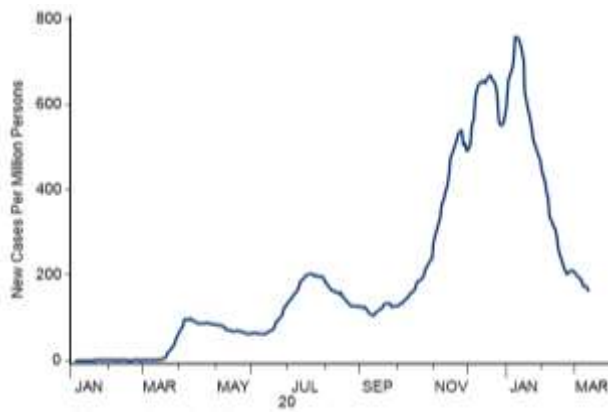
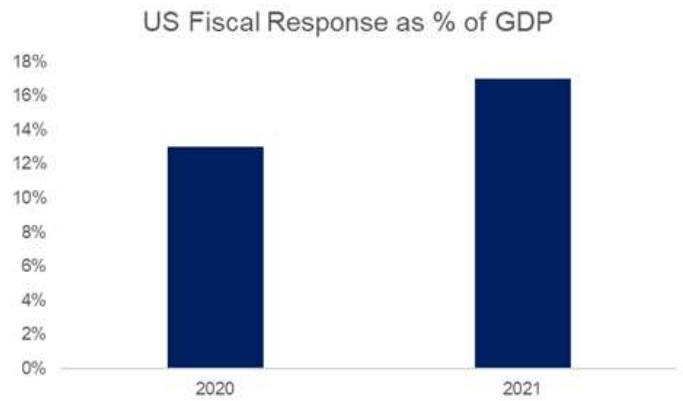


Figure 8: US fiscal Stimulus 2020 vs 2021



Source: Haver Analytics as of March 13, 2021

If Only Herbert Hoover Had Janet Yellen

It is not possible to determine with precision what of the \$1.9 trillion can be spend, but it is possible to make an intelligent guess. Here are our assumptions and observations:

- Direct transfer payments to households are just above 1% of annualized GDP.
- Significant portions of the stimulus can result in at least a temporary rise in savings at the expense of larger Federal deficits (**figure 2.**) This results in a “wash” for the economy.
- Elements of the 2020 CARES Act went unspent. The current bill will likely see similar results.

Based on these assumptions and observations, an economy that previously would have grown 4% in 2021 may achieve a 6% rate of growth. We say “may” because such real growth requires real production, not just movement of money around the economy. The speed at which labor can be redeployed has limits.

We think that the manufacturing sector seems poised for a very robust, conventional cyclical boom (see **figures 9-10**). The services sector (**figure 5**) is most poised to jump forward due to pent-up demand. Yet, we are not being even more aggressive since there are limits and frictions that temper maximum economic growth. Businesses will not likely overinvest in their capacity due to the one time nature of the stimulus.

Figure 9: US Auto Inventory-to-Sales Ratio

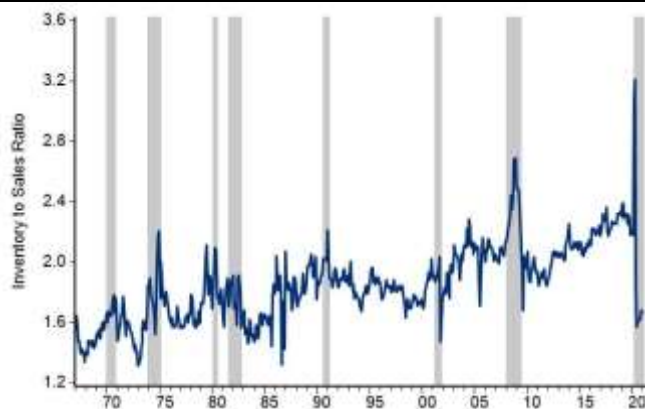
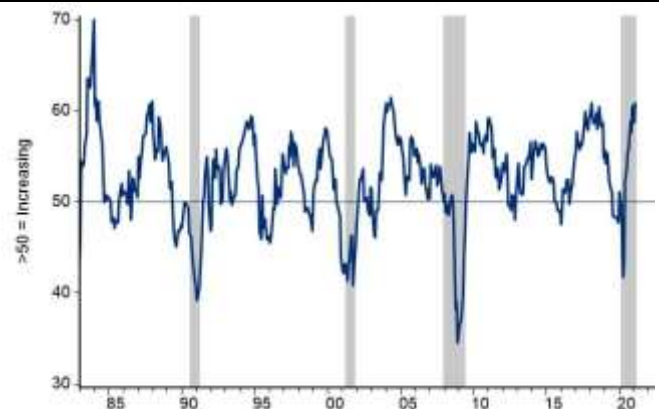


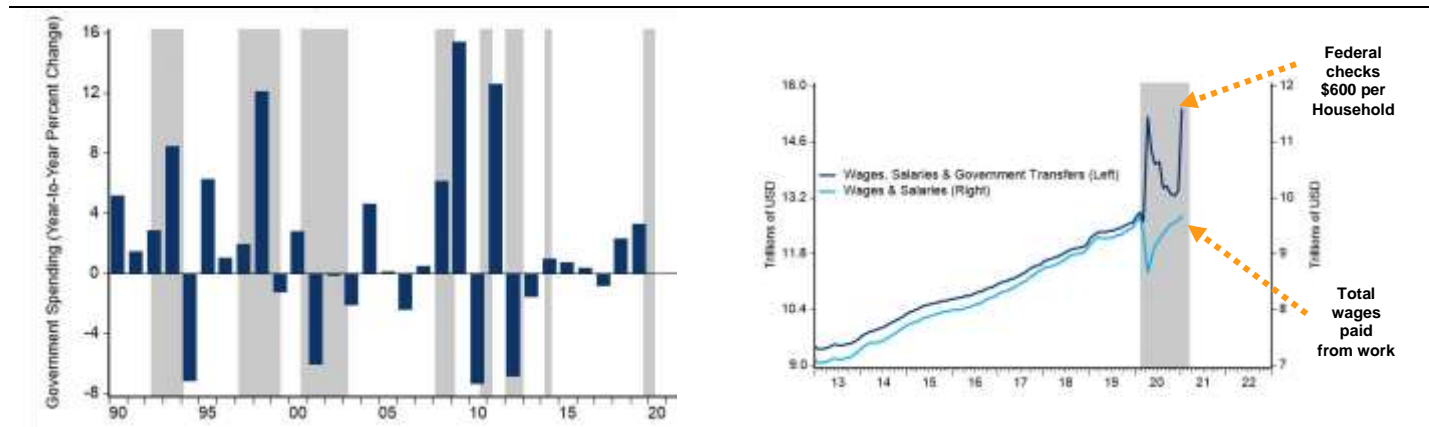
Figure 10: ISM Manufacturing Shows Rebound



Note: Shaded areas denote US recessions. Source: Haver Analytics as of March 13, 2021

Beyond 2021-to-2022, a normalization of growth will follow. We do not expect 2023 and beyond to be a slow growth environment, but it may “only” achieve a growth rate that is half the pace of the late 2021/2022 period. Lasting economic growth is not achieved through boluses of stimulus, as the Japanese fiscal experience dated back to the 1990s teaches us (see **figures 11-12**).

Figure 11: Japan Real Government spending % Change since 1985 **Figure 12: US wages and wages + government transfers**



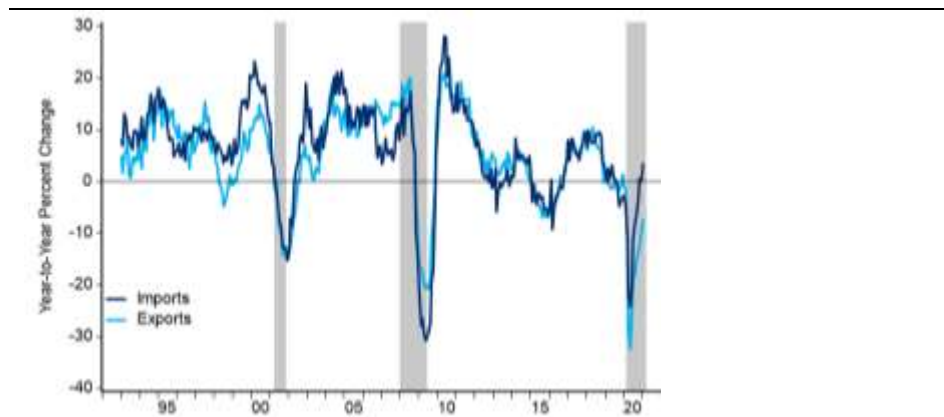
Note: Shaded areas denote Japanese recessions on Left and US recession on the right. Source: Haver Analytics as of March 12, 2021. All forecasts are expressions of opinion and are subject to change without notice and are not intended to be a guarantee of future events. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only

And What of Inflation and International Markets?

A period of lasting higher inflation would be likely if US policymakers choose to sustain the stimulus even in a fully-recovered economy (see February 21 [Beware the Cash Thief](#)). While there may be some advocates for persistent inflationary policies, there is little evidence that current US policymakers would deliberately over-stimulate an economy at full employment.

US federal borrowing will benefit individuals directly and will also have large, indirect positive “spillovers” impacts for non-US trading partners. When a government spends borrowed money, it creates demand without explicitly creating supply. Some portion of the demand (“the marginal propensity to import”) is satisfied by foreign trading partners. This, in turn, will be a source of growth in international economies whose COVID recoveries will take place after the US, and who will benefit from the excess demand.

Figure 13: US Import and Exports



Note: Shaded regions denote recessions. Source: Haver Analytics as of March 13, 2021.

Interestingly, the earlier stimulus packages have already had this effect as US imports have surged on the shift from services (a US strength) to goods (China's strength) *prior* to the end of the pandemic (see **figure 13**). Despite a likely shift back, the huge third round of US stimulus will certainly extend and sustain import growth. We therefore remain bullish on overseas markets and maintain overweights to certain international equity allocations (See [Quadrant: Too Much Satisfaction.](#))

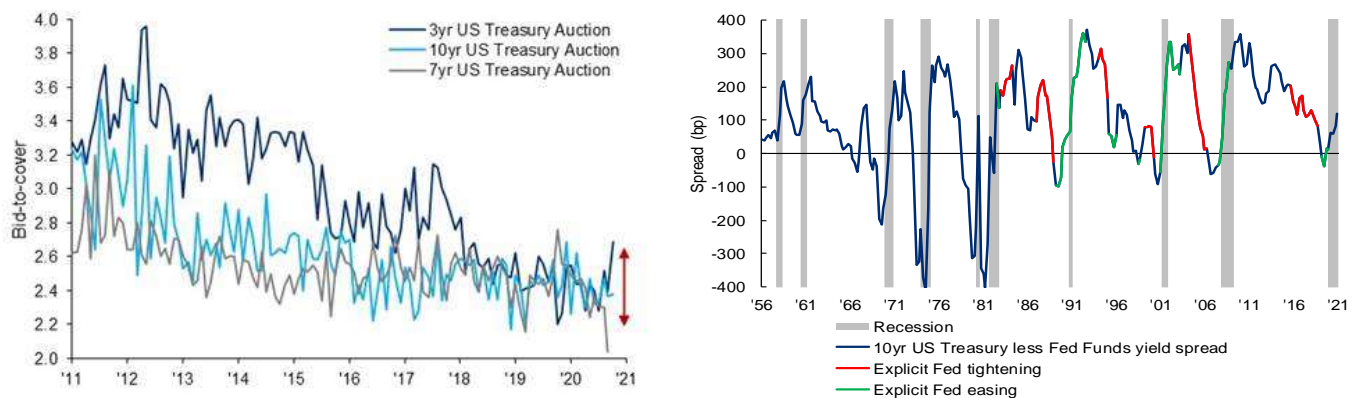
Funding the US Deficit

It is common for rates to rise at the beginning of new economic cycles (see **figure 14**). As we discussed last week, the fact that the US Treasury is planning to borrow roughly four times the amount the Fed is lending means that external capital flows will be diverted from other markets in large amounts. This is likely to require higher interest rates. That fact is fueling uncertainty and volatility in bond markets and other asset classes.

This past week, the US Treasury auctions for 3-year and 10-year notes fared far better than the poor US 7-year auction two weeks ago. What was the difference? Higher rates worked, but we also believe that the divergent policy approach in Europe and Japan provides an interesting source of cheaper capital for the US. The European Central bank said this past week that it would act to keep European rates from rising across all maturities. Thus, the interest rate differential between US and European bonds allows buyers in Europe to hedge their Treasury purchased into the Euro at little cost. The same is also now true for Japanese investors who can earn a higher return in US bond markets hedged back into Yen (see **figures 16-17**).

While we still expect upward long-term rate pressures in the US to cause yields to rise 50 bps higher over the next 12 months, for now, the US will help the world by importing goods and the world will help the US by importing American bonds. This is the silent help that could make 2021 US deficit more tolerable rate-wise than many expect.

Figure 14: US Treasury 3-, 7-, 10-Year Auction Bid-to-Cover **Figure 15: US 10-Year Treasury 11Yield Less Fed Funds Rate**



Source: Haver Analytics as of March 12, 2021

Figure 16: Japanese 10-Year Yield and US Treasury 10-Year Yield Hedged into JPY

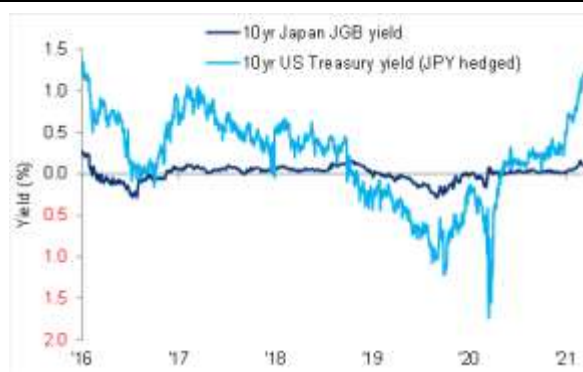
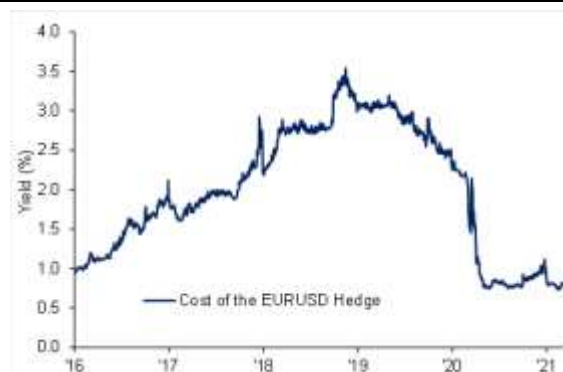


Figure 17: Cost of Hedging USD into Euros



Source: Haver Analytics as of March 12, 2021

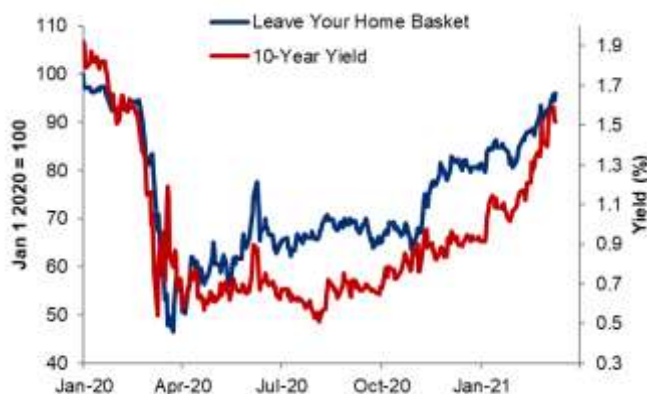
Special Section: Finding Quality Growth amid the Growth Stock Rout

Long duration growth investments across asset classes have sold off as interest rates rose. A re-valuation of many popular long positions has led to a reckoning in technology and other growth shares. In particular, Citi Private Bank's "[Unstoppable Trends](#)", which are very much geared towards long-term growth opportunities, have also been repriced, presenting an opportunity for clients to gain exposure in secular themes at prices much less than just a few weeks ago.

Figure 18: Long duration assets paring gains as COVID retreats



Figure 19: COVID-impacted firms have rallied alongside the rise in interest rates



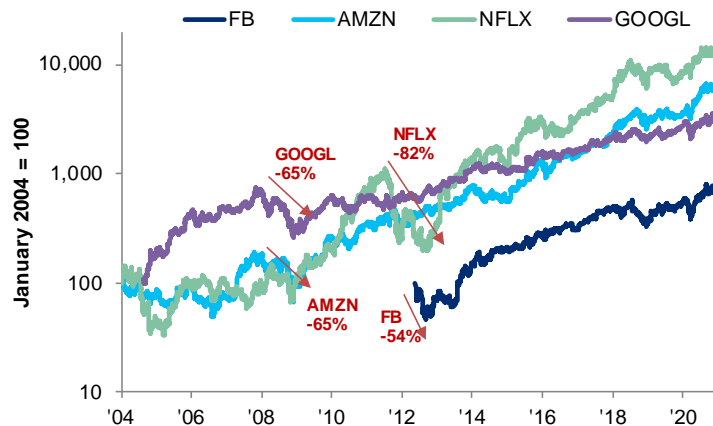
Source: Bloomberg as of March 12, 2021. US Pure Growth Factor proxied using Bloomberg US Pure Growth Index. "Leave Your Home" basket includes Buy and Neutral Rated US names in the following sub-industries: Banks, Industrial Conglomerate, Machinery, Oil Gas & Consumable Fuel, Textiles Apparel & Luxury Goods, Energy Equipment & Services, Hotels Restaurants & Leisure, Building Products, Retail REITs, Construction & Engineering, Leisure Products, Airlines, Multiline Retail. 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.

In fact, when we look across equities on price-to-sales basis, we find that the most expensive equities have sold off the most since February (**figure 20**). Significant corrections among fast-growing stocks are routine. This time, they are presenting opportunities to add exposure to market leaders within our favorite themes where we expect enduring growth in the economy (**figure 21**). While indexes tracking broad themes indicate that areas like renewable energy, fintech, and cyber security are correcting, we seek to identify the strongest firms within each theme, while avoiding weaker "imitators" with less proven business models or track records.

Figure 20: Poor Get Richer and Rich Get Poorer: US Price/Sales Ratio vs 2021 Returns



Figure 21: Legging into secular winners after dips has typically been a profitable strategy



Source: Bloomberg as of March 13, 2021 Note: Using S&P 500 constituents. For illustrative purposes only. This should not be construed as an offer of, or recommendation of companies discussed. 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. 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.

Here is our analysis: We start with global companies outgrowing the world economy on a secular basis, but entering 2021 trading at large valuation premiums to their expected revenue growth. We then break up this group into different categories of profitability and growth. This analysis yields a surprising result: fast-growing firms that have already achieved profitability *have underperformed unprofitable or slower growing firms since interest rates spiked (figure 22)*.

As interest rates have risen, investors sold off growth stocks that had risen in valuation on falling interest rates last year. Yet they punished companies *more* whose profits and cash flow were already apparent. **We believe this presents an opportunity for clients to gain exposure to secular growers at a discount today.**

Note that this exercise is highly concentrated in the US and China markets where innovation is highly valued. Indeed, among the hardest-hit growth stocks, we identify a number of household names in sectors like technology, communications services, and health care that are likely to deliver above-market growth for many years to come (**figures 23-24**).

Figure 22: Decomposing the selloff by underlying growth and profitability



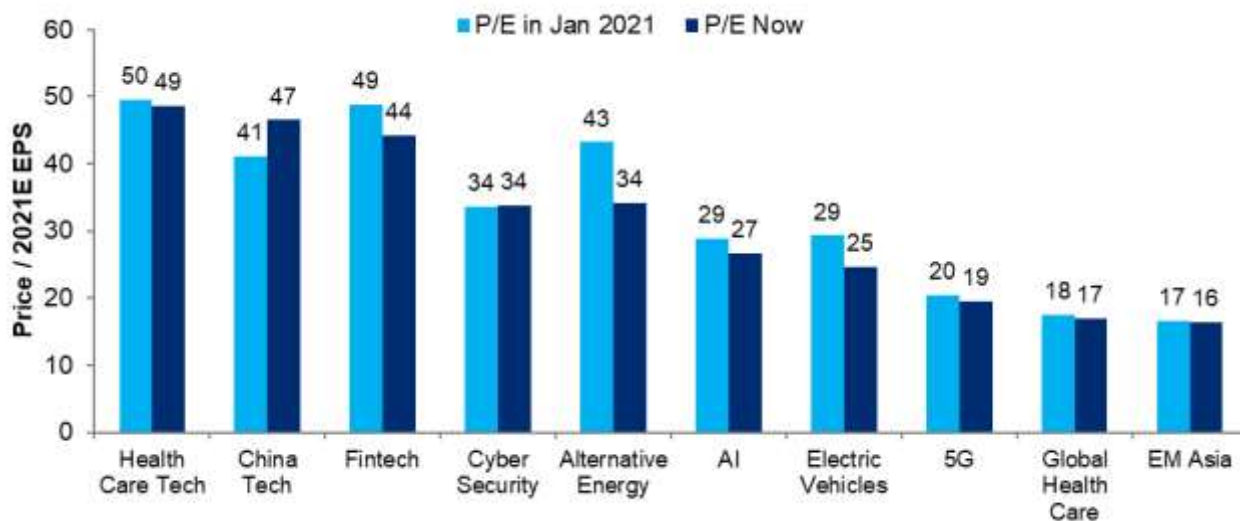
Figure 23: Richly valued, fast growing: it's a G2 World

Country	Share
UNITED STATES	58%
CHINA	29%
NETHERLANDS	3%
JAPAN	2%
SOUTH KOREA	2%
OTHER	6%
Total	100%

Sector	Share
Consumer Services	38.7%
Information Technology	25.0%
Consumer Discretionary	12.0%
Health Care	8.6%
Other	15.7%
Total	100%

Source: Bloomberg as of March 5, 2021 Note: Using MSCI AC World and Russell 2000 constituents. This analysis is shown illustrative purposes only and does not represent the performance of any specific investment. Past performance is no guarantee of future results. Real results may vary. Indices are unmanaged. An investor cannot invest directly in an index.

Figure 24: Falling valuations among CPB Unstoppable Trends



Source: Bloomberg as of March 5, 2021 Note: Thematic proxies are: MSCI AC World Health Care Index, BlueStar 5G Communications Index, Indxx Artificial Intelligence and Big Data Index, MSCI Emerging Asia Index, Indxx Global FinTech Thematic Index, ROBO Global Health Care Technology and Innovation Index, Prime Cyber Defense Index, CSI Overseas China Internet Index. Electric Vehicles proxied using equal-weighted average of Citi Research Theme Machine constituents with high exposure to "electric vehicles" theme. 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.

Special Section: The State of China's Policies and Markets

In January, we recognized the risks associated with hawkish policy talk and lofty valuations in Chinese equities, particularly the high growth sectors (see [Asia Strategy](#), 13 Jan 2021). We brought our allocations to Chinese (plus Korean and Taiwanese) equities from overweight to neutral, while adding to Southeast Asia (see [Quadrant](#), 29 Jan 2021). Since mid-February, Chinese equities have erased most of the impressive gains from the first six weeks, similar to the action on the NASDAQ. Meanwhile, the “low tech” or cyclical markets in the rest of Asia held up comparatively, similar to the Dow Jones Industrial Average (**Figure 25**).

At this juncture, we believe a majority of the correction in Chinese growth shares is complete, but there remain some uncertainties about policy and the USD, which implies elevated near-term volatility.

After Chinese officials from the central bank and banking regulators warned of asset bubble risk, the National People's Congress sent more messages about prioritizing quality and sustainability over immediate growth.

- **Normalization of credit growth:** Real GDP growth target is set at “over 6%”, with credit growth set at a similar level to nominal GDP growth. The growth target is easy to reach given low base in 2020, our forecast is just above 8% real GDP growth in 2021. Inflation would be hard pressed to reach the 3% target, but likely closer to 1.5%. Together, this imply credit growth of around 11%, which is materially lower than 13.4% in 2020, but basically back to 2018-19 levels. The resulting decline in the credit impulse still points to moderate downside to Chinese equities, but the majority of the rationalization appears to be done (see [Asia Strategy Bulletin](#), 8 March 2021).
- **Property policy as a part of structural deleveraging:** The National People's Congress (NPC) reiterated that “housing is for living not for speculating”, and emphasized on stabilizing prices and avoiding major ups and downs. The key development goal is to encourage the rental market and deploy differentiated policies based on local needs. The banking regulator sees the property sector as a major part of structural deleveraging, pointing out that household leverage also needs to be contained along with developer leverage. As such, the “three red lines” for curbing developer financing implemented since August 2021 are likely to remain in place, while household mortgage lending may also be contained.
- **Decarbonization priority:** The goal of peak carbon emissions by 2025 and carbon neutrality by 2060 would involve mainly two types of efforts: Cutting existing emissions and investing in greener technologies. The investment part is going to benefit areas like renewable energy and electric vehicles. But the cutting part may actually prolong the commodities bull cycle. Aluminum, for example, is a heavy source of pollution in that it consumes huge amount of electricity that is produced from coal, often by smaller less efficient power plants attached to smelters. China accounts for 60% of the world's capacity for aluminum. Enforcing reductions in capacity in highly polluting and energy consuming manufacturing industries could curb short term growth, but could also benefit the surviving producers both inside and outside of China.

US Actions Impacting China

Beyond Chinese domestic policies, the direction of the USD could also raise some hurdles in the near term. US growth is likely to accelerate, with falling unemployment. Real interest rates are likely to climb as a result. The US also happens to be leading major economies, along with the UK, in approaching herd immunity, and more complete re-opening. This is likely to lift the USD initially, putting pressure on the CNY and Chinese equities (**Figure 26**), which benefited from superior Chinese growth in 2020. A short-term bout of USD strength is still possible and can be disruptive to the capital inflows that China had enjoyed over the past year. Policy normalization and USD risks could weigh on Chinese equities in the near term, but earnings growth and longer term prospects remain attractive.

Figure 25: China's performance since the start of 2020 had been similar to that of NASDAQ, while more cyclical Asian markets were closer to the Dow, a pattern that is likely to continue

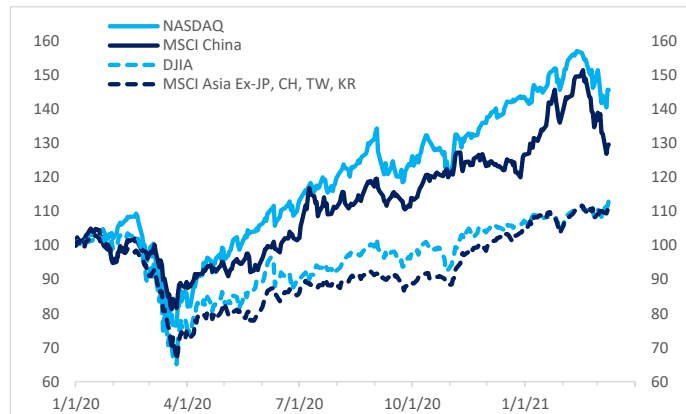
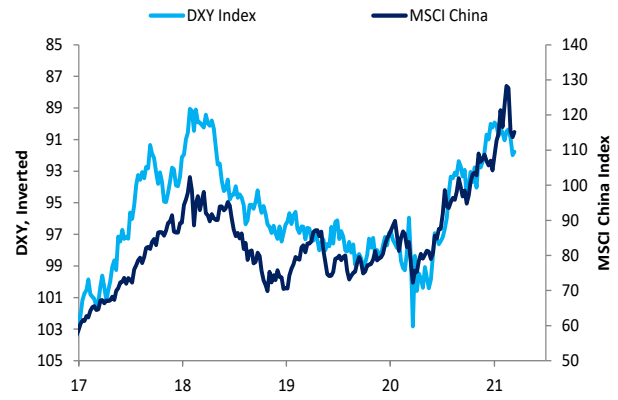


Figure 26: Potential USD rebound could weight on near term returns of Chinese equities



Source: Haver Analytics and FactSet as of Jan 15, 2021. Gold is the – London Bullion Market Association (LBMA) Gold Price index; US Pure Growth Factor is the Bloomberg Pure Growth Index. 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.

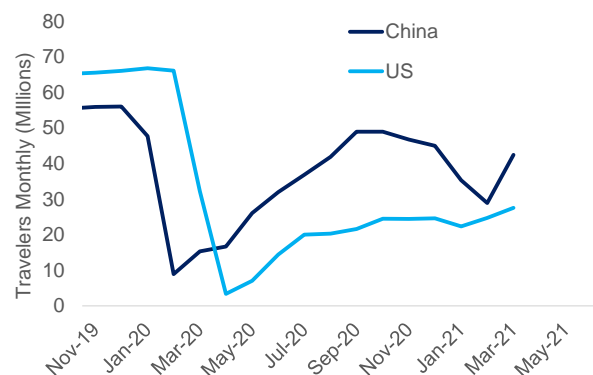
Growth in China to Remain Strong in 2021

In 2021, consensus earnings per share (EPS) for the MSCI China index are projected to grow by 18%, which may be conservative given how exports growth has and will surge further (**Figure 27**). Moreover, the service sector recovery also continues to make progress, with domestic travel, domestic airlines, retail, restaurants and catering, accommodation, and gaming all seeing substantial growth during this year's Lunar New Year holiday (**Figure 28**). For example, catering sales during the week of Feb 11-17 grew 28.7% y/y and related revenue at digital payment platforms jumped 130% y/y. Hotel occupancy surged to 90% of pre-pandemic levels in the outskirts of Shanghai and Beijing. And the national box office hit a record high. The key industries that are likely to benefit the most from pent-up demand are tourism, hospitality, airlines, retail and gaming. So far, Asia tourism related equities outside of China still lag significantly (**Figure 29** and **Figure 30**).

Figure 27: Exports in Jan-Feb is not only 60% higher than 2020, they were 33% higher than same period 2019, implying strong rebound in earnings

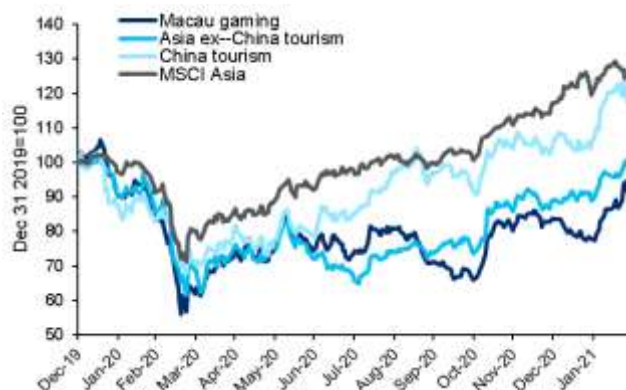


Figure 28: As a reflection of service sector recovery, air passenger volume in China has rebounded sharply after the winter wave to 75% of pre-pandemic levels, compared to about 40% in the US



Source: Haver Analytics and FactSet as of Jan 15, 2021. Gold is the – London Bullion Market Association (LBMA) Gold Price index; US Pure Growth Factor is the Bloomberg Pure Growth Index. 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 29: Outside China, the catch-up in Asia tourism equities is just getting started



Source: Bloomberg, as of Feb 26, 2021. Tourism includes stocks in restaurants, airlines, hotels, department stores and online tourism agents

Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only. Past performance is no guarantee of future returns. Real results may vary.

Figure 30: China led the way in Airline revenue recovery, while rest of Asia remains in deep depression



Source: Bloomberg, as of Feb 2021

Looking out further, the NPC had provided more details on China's 14th Five Year Plan (FYP), in which greening the future and technology self-sufficiency feature prominently.

In pursuing a greener future, China is expediting its decarbonization process. On top of China's ambition of peak the carbon emissions by 2030 and realizing carbon neutrality by 2060, more granular goals have been clarified at this year's NPC:

- Energy consumption per unit of GDP and carbon dioxide emissions per unit of GDP will be reduced by 13.5% and 18% respectively by 2025. This would require carbon emission growth to be cut to 4% annually from 6% over the past two decades
- Non-fossil fuels consumption to increase to 25% of primary energy consumption by 2030, vs 17% currently.
- Wind and solar installations to reach at least 1200 GW by 2030, much higher than that of the entire world in 2019 (~800GW), indicating a CAGR of 16%.

One key application of China's decarbonization is electric vehicles (EV), which has seen annual sales surging from less than 500 units in 2009 to more than 1.2mn units in 2019. China is leading the way for EV market globally, and is expected to reach 5mn units by 2025, or nearly two thirds of the global total. China's EV policy is transitioning from direct subsidies to facilitating development of the entire supply chain and related infrastructures like the electric grid and charging stations. Subsidies to EVs have been extended to end of 2022, from end of 2020 in response to the pandemic, while new initiatives from the NPC are focused on battery charging, swapping and recycling systems.

On the decarbonization front, we see numerous equity opportunities in wind, solar, nuclear and hydro energy among the renewables space, as well as EV producers, battery, and chip makers on the EV supply chain.

In core technologies, China is providing large amounts of funding and policy support to make up for shortfalls in technology. During 14th FYP (2021-25), nationwide R&D spending to grow at least 7% annually. The NPC identified a few areas of focus: basic research to overcome bottlenecks, strategic technologies like 5G and satellite communication, reducing the "publishing burden" to improve talent development, and incentivize private sector enterprises to be the center of innovation. The industries of focus are semiconductors, artificial intelligence, quantum computing, healthcare, neuro science, genetics, aerospace, geological and oceanic exploration, where major national level projects may be planned.

We believe that these efforts would greatly benefit the growth trajectory of industries like semiconductors, software, cloud computing, aerospace, defense, and other research heavy areas of technology.



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