Private Bank

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CIO Strategy Bulletin

September 20, 2020

There Are More Potential Profit Opportunities Than Investors Think

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Summary

- ***Digitization* – a Private Bank "Unstoppable Trend" - made it possible for vast parts of the world economy to adapt to social distancing needs and saved many lives as the pandemic progressed. Nonetheless, with "TMT"[1] sectors rising to more than 40% of the US equity market, we have been concerned about markets pricing all tech shares as winners and all other industries as losers.**
- **Within the past three weeks, the Nasdaq 100 has corrected 12%. In contrast, the Russell 2000 has dropped a mere 3% while non-US shares overall are about flat. In fixed income, falling US interest rates have pushed the global bond aggregate yield – including Emerging Markets and Sub-Investment Grade debt - to below 1.0% for the first time.**
- **Now that "growth stock" momentum investors don't feel so invincible, we would refocus on diversified asset allocation, with dividends and certain fixed income substitutes of rising importance to portfolios in the present economic setting.**

Neither Bread nor Digital Services Alone

Resilience and adaptability have been remarkable economic features of the pandemic. The Northern Hemisphere is still basking in the warm late summer glow. This has allowed restauranteurs to serve meals on the sidewalks in the US as they do in Europe while hiring back 4.2 million hospitality workers over the past four months. When schoolchildren sit in classrooms, fresh air flows through open windows.

World markets also exhibit underlying strength and look ahead to a future not locked down by Covid, one that enjoys much more than basic necessities and digital services. **Even as the richly valued Nasdaq 100 experienced a correction over the past three weeks, we see a much broader range of potential investment opportunities that excite us for the future.**

The average US stock has not seen nearly the extremes of the tech-sector rally or subsequent selloff (see figure 1). Rather, many non-tech sectors saw their gains slow down. "Covid Cyclical" sectors such as *Materials, Industrials, Real Estate* and its components have avoided a severe "sympathy" selloff despite the fact that equity correlations are typically high (**see figures 2-3**). So, what accounts for the endurance of the global equity asset class away from the rise and fall in tech?

[1] TMT is Technology, Media and Telecom.

The fact that many information technology companies exhibit both defensive and growth characteristics explains their considerable outperformance in 2020. *Digitization* – a Private Bank Unstoppable Trend - made it possible for vast parts of world economy to adapt to social distancing needs and saved many lives as the pandemic progressed. Yet, with Technology, Media and Telecom shares surging to more than 40% of US market capitalization this year, we have been warning that gravity exists even for technology stocks. Does it make sense that the value of Apple Inc. exceeded that of the entire UK equity market or the Russell 2000 index? (See our July 12 CIO Bulletin and our August Quadrant for discussion).

While we always want to invest in technological breakthroughs, we want to be mindful of over-exuberance. Many of the biggest stock market winners have seen accelerated growth through Covid and some will benefit as their solutions are made permanent. Telehealth, video conferencing, e-commerce across every sector are unlikely to see a reversal of fortune. That said, we also believe that competing technologies *do not* all deserve premium valuations at the same time. "Moats" may exist for first movers, but barriers to competition are few and harder to maintain in the technology sector than in less innovative sectors of the economy. Therefore, while we *do not* expect a fundamental drop in revenues for the "tech economy," we do expect more muted equity returns over the medium-term given their present valuations. We would expect those companies without the most dominant products and solutions to see a decline in stock market performance, particularly after the pandemic abates.

Figure 1: Is the US Stock Market Rising or Correcting?

S&P 500 Equal Weight, Nasdaq 100 and Russell 2000 2H 2020-to-date

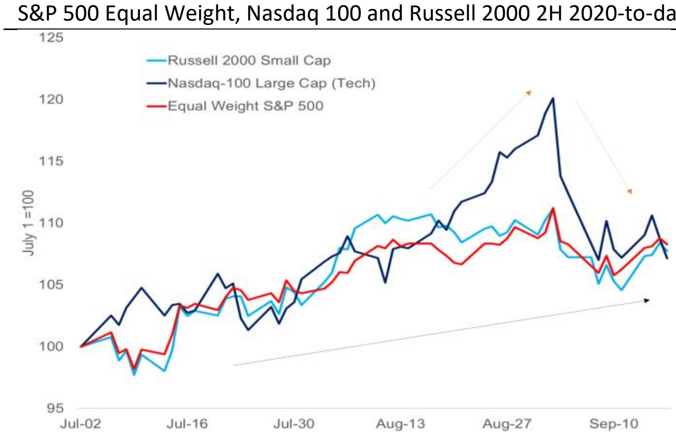

Figure 2: US Covid Cyclicals vs Covid Defensives

Source: Bloomberg, Factset and OCIS as of September 17, 2020

COVID cyclicals: Financials, industrials, energy, materials, real estate, consumer discretionary ex-Amazon | COVID defensives: IT, healthcare, communication services, consumer staples, utilities, Amazon. FAAMNG is a basket of Facebook, Apple, Amazon, Microsoft, Netflix and Google.

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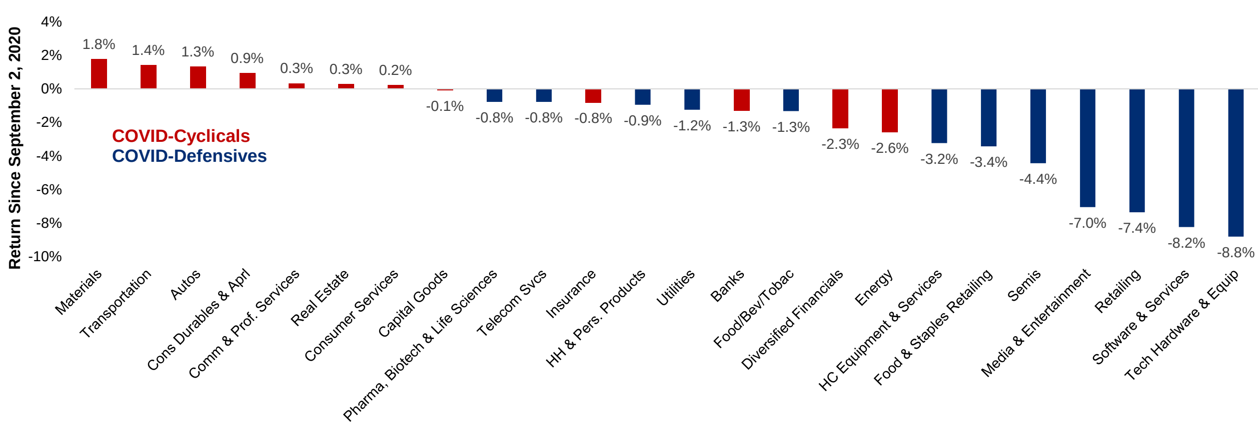
Figure 3: Global Industry Group Performance Since Sep 2 Nasdaq Peak: Covid Cyclicals and Covid Defensives



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Neither recessions nor pandemics last forever. Businesses directly and indirectly punished by the pandemic are appealing to us as they have fallen this year on the *temporary* Covid shock. We see many undervalued opportunities within "Covid cyclicals". More broadly, one of our favorite sets of companies are firms that are able to sustain dividend payments under today's challenging circumstances (**see figure 4**). Reinvested dividends have driven roughly half the total return of equity markets over time, this even includes long-term bull markets such as the record run led by tech shares in the US from 1982-1999. (In that boom period, reinvested dividends contributed 41% of US equity returns).

In fact, we need to put the value of dividends in broader context now. Global interest rates – including the US, Emerging Markets and sub-investment grade bonds – have now together fallen to below a 1% yield for the first time (**see figure 5**). If investors can select equities with sustainable dividends and the likelihood of future dividend growth, a case can be made that such a portfolio would help reduce portfolio risk more than a bond-only portfolio at current yield levels.

Figure 4: S&P 500 and MSCI World High Dividend Yield Index Trailing Price/Earnings Ratio

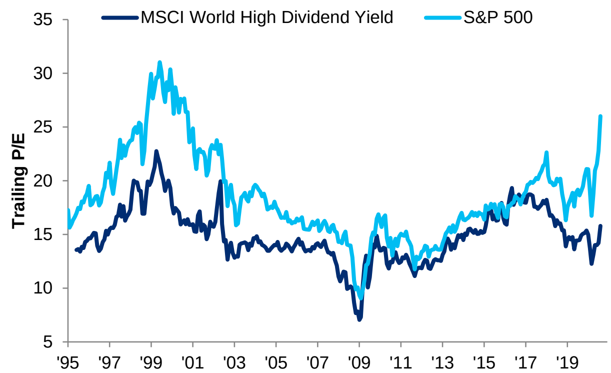
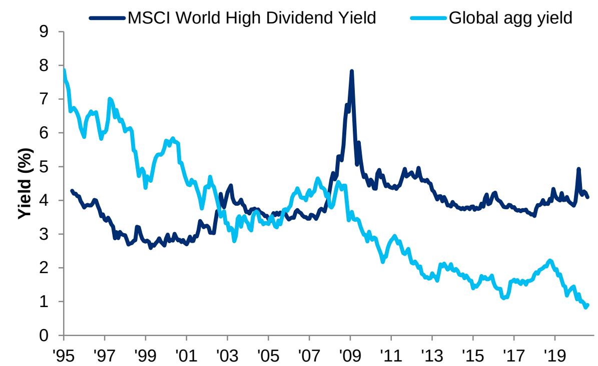


Figure 5: World Bond Yield Aggregate vs MSCI World High Dividends Yield Index Yield (%)



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Where Value Can Thrive When Growth Drives Yields Higher

US growth stocks have enjoyed a boom from falling bond yields (**see figure 6**). When rates fall, the present value of future cash flows rises relative to stores of value such as zero-coupon bonds or gold. The same is true for growth stocks: firms with *expected* large profits *far off* in the future.

In contrast, the relatively low level of correlation between global interest rates and dividend yields has appeal for investors once long-term interest rates have bottomed. Current income streams are *not* particularly price sensitive to movements in interest rates partly because recovery in the economy drives both interest rates and immediate profits/dividends higher.

The Federal Reserve, rightly or wrongly, has stated its intent to maintain a zero-interest rate policy through 2023, despite an expectation of a 9.5% cumulative gain in real GDP and a drop to 4% in US unemployment over that time. But this should not prevent some modest rise in long-term yields which have routinely risen in economic recoveries since World War II (**see figure 7**). As a result, fixed income investors will struggle to find reasonably-valued opportunities at present.

One such opportunity is higher dividend yielding equities in cyclical industries. The Global High Yield Equity Index now yields more than 3 percentage points more than the world bond index, a differential that is near the highest level ever sustained for all but short periods.

For equities, a portfolio manager's challenge will be to identify sustainable dividend growth. This is to provide investors with both scarce income and low sensitivity to movements in interest rates. Such shares are not likely to be Covid defensives or traditional "bond proxy" equities, like utilities. We believe the hunt for both appreciation potential and income will be satisfied by looking beyond just the US.

Why focus on dividend income now? Because both fixed income investors and growth stock investors face valuation risks together.

Figure 6: US 10-Year Yield (Inverted Scale) vs US Growth Equities and Gold Price

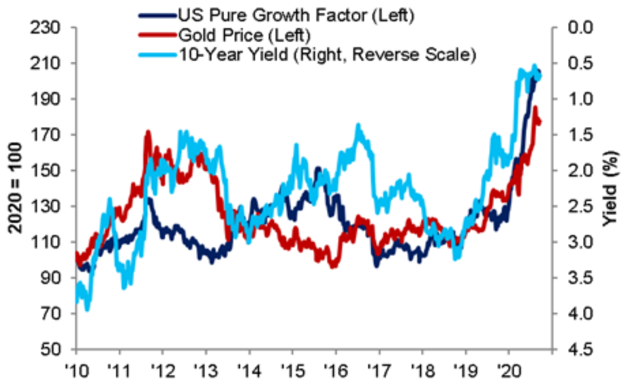
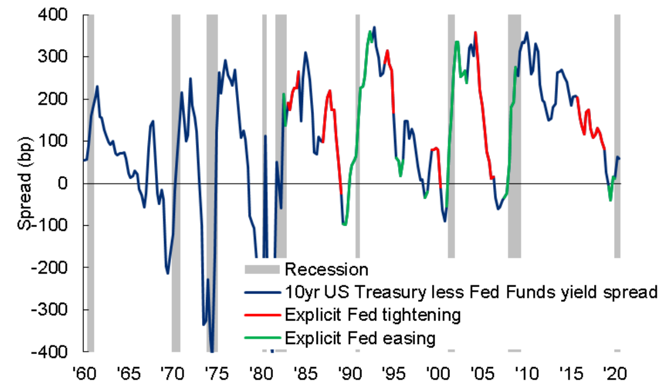


Figure 7: US 10-Year Yield Less Federal Funds Rate: Arrow Shows Early Cycle Yield Curve Steepening



Source: Haver and Bloomberg as of September 17, 2020. 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.

The Portfolio Manager Challenge: Looking for Profits in all The Right Places

Big Pharma

Looking at portfolio opportunities within equities, we see the pharmaceutical sector as particularly appealing. These shares offer compelling and perhaps growing dividends, but have underperformed year-to-date (**see figure 8**). The underperformance has largely been driven by fears of US drug price regulation from Republicans and Democrats alike during a Presidential election year. While markets are fixated on the potential for drug price reform, we see far more regulatory fear priced into pharma shares than most other sectors. In recent weeks, President Trump has announced a few Executive Orders that would imply price caps on some pharmaceuticals, but we believe that these changes are unlikely to be implemented. The expectations that Democrats, if elected, will broadly restrict prices does not have much historical precedent.

In contrast, industry fundamentals are as robust as we've seen in many years. Near-term earnings growth is underpinned by recent innovative product launches. Even with Covid as a backdrop, early stage clinical assets in many Pharma pipelines are underappreciated by investors. Valuations on a relative basis are below their historical average and are accompanied with robust free cash flow yields as well as dividend support.

Figure 8: US Healthcare Group 2020 return, yields, valuation and Geographic Diversification

HC Industry	YTD Return (%)	Div Yld (%)	P / 21E	Non-US Rev Exposure (%)
Pharma	4.96	2.74	14.57	58.00
Biotech	10.54	1.80	15.72	34.90
Providers	-3.13	1.37	12.53	9.90
Equipment	11.80	0.87	27.93	53.10
Life Sciences	27.73	0.23	29.82	57.20

Note: 2021 earnings figures are Bloomberg consensus. Source: Bloomberg as of September 17, 2020. Indices are unmanaged. 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 guarantees of future events.

Value in Technology? How Can That Be?

Despite unrelenting rallies across a number of tech industries before this month's corrections, there are still pockets of value in this year's most loved sector. We can still identify select tech stocks trading on attractive valuations, some of which also pay attractive and sustainable dividends. While some company's strong balance sheets and high dividend yields relative to the broader market have not been rewarded so far this year, it would be unwise to assume that those qualities will remain out of fashion for long.

Industrials for the Industrious

The Industrial sectors have been much less loved by investors this year (underperforming technology by a whopping 25% in the US year-to-date). Looking more deeply, we see further bifurcation in performance between individual names. While airlines (for obvious reasons) and industrial conglomerates have lagged significantly, automation has finally seen relatively strong performance. As we look ahead, therefore, the potential upside in industrial conglomerates is rising relative to the automation space over the next 12 to 18 months.

Commodities Provide a Clue.

Typically, commodity producers have lower growth rates, weaker balance sheets, and are dependent on volatile movements in commodity prices for revenues. Yet this year, they have outperformed relatively more innovative industrial firms contrary to long-term trends (see figure 9). This is particularly true of capital goods producers including Industrial Conglomerates, Aerospace and Defense firms. Aerospace and Defense has firm-specific issues, but we see short-term performance and political concerns driving sentiment toward undue pessimism, much like the pharma sector.

As figure 10 shows, US manufacturing orders have rebounded sharply from the Covid collapse, but key Industrial sector shares – even apart from the most negatively impacted, such as airlines – have not risen in step. We see the rise in commodity shares as an indicator of economic recovery, future orders for capital goods – including government-funded infrastructure - and the shares of these companies.

Figure 9: US ISM Orders Index vs S&P Capital Goods Group Y/Y% Change

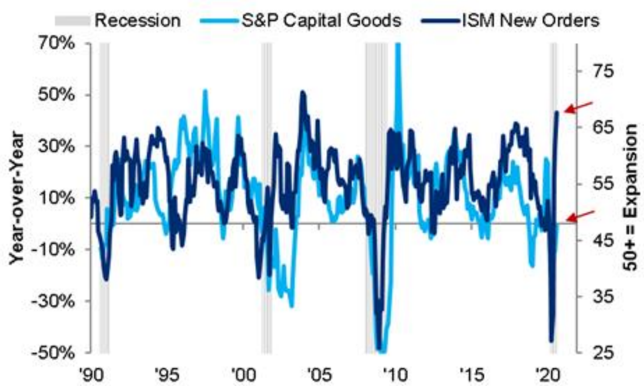


Figure 10: Year-to-Date Performance for S&P Materials Sector vs Capital Goods

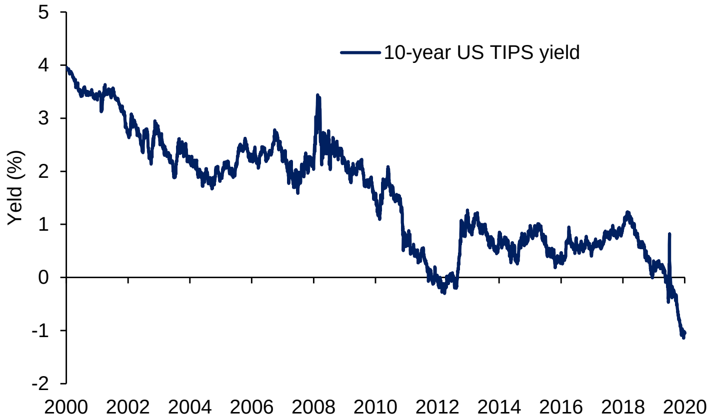
Source: Bloomberg as of September 17, 2020. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Index returns do not include any expenses, fees or sales charges, which would lower performance. For illustrative purposes only. Past performance is no guarantee of future results. Real results may vary.

Fixed Income: Yield to Reality

Despite the rise and fall in global equity and credit markets this year, there has been one constant: interest rates remained low. For US Treasury (UST) debt, what was once the most attractive sovereign bond market has now joined the rest of the low yield world. With 10-year UST yields sitting around 0.65%,

More notable has been the impact Fed policy has had on real US yields, or yields adjusted for the current rate of inflation. With nominal UST yields reacting to a severe economic recession and the Fed’s aggressive pick-up in asset purchases, real yields have dropped sharply into negative territory **(see Figure 11)**. Using the TIPS (Treasury Inflation Protected Securities) market has an indicator, the entire US real yield curve is deeply in negative territory. This creates big problems for investors looking to generate returns on their fixed income above the current rate of inflation.

Figure 11: 10-year real yields at an historical low of -1.0%



Source: Haver as of September 17, 2020.
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In our view, today's unprecedented interest rate environment requires us to think differently about how we build income-oriented portfolios. While core fixed-income assets remain essential, utilizing other parts of the global credit, securitized and derivatives markets are key to enhancing real returns. Certain dividend generating equity strategies could fit well within a globally diversified fixed income portfolio. As noted, these select assets can even defend portfolio returns if (or when) interest rates rise.

Little Value in the Safest Munis

Investment-grade (IG) corporate bonds have been a part of the European Central Bank's (ECB) quantitative easing program for many years. Over the last several months, the US Fed has joined the corporate bond buying party, accumulating $12 billion in ETFs (exchange-traded funds) and individual bonds. Though primarily beneficial to US investors, tax-exempt municipal bonds have also been offered "protection" by the Fed through various facilities. As a result, these high quality markets have normalized, spreads have narrowed, and yields have fallen to historical lows.

Considering our constructive economic outlook and under the current monetary policy framework, we are comfortable moving down in quality for additional yield. In some instances it's out of necessity, as taxable-equivalent yields for particular high quality tax-exempt municipal bonds don't exceed taxable IG corporates. At the same time, short-duration or high quality IG corporate bonds do not generate positive real yields.

In corporates, we favor select opportunities in BBB-rated debt, which yields 2.3% and where spreads have scope for additional tightening **(see figure 12)**. We are also comfortable extending duration for additional value, depending on the issuer or sector. We remind that the Fed's corporate bond buying has been focused on bonds maturing within five years. Better value can be found by extending beyond their scope. Taxable municipals are also an attractive substitute to corporates, or can contribute to portfolio diversification **(see figure 13)**.

Figure 12: Value in munis is *down in quality*

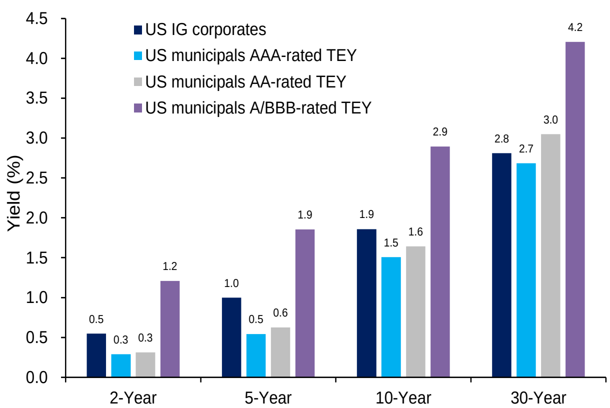
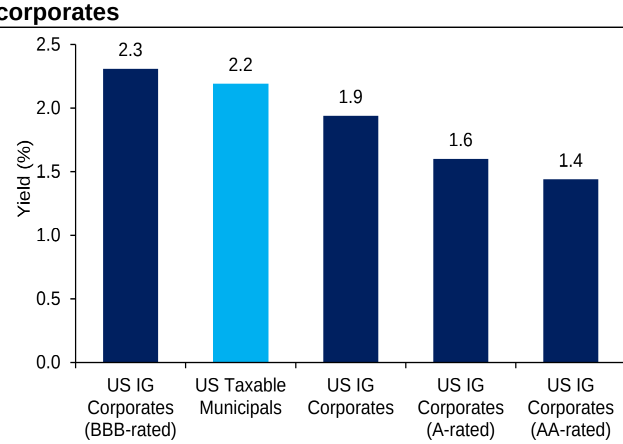


Figure 13: Taxable munis are a good substitute for corporates



Source: YieldBook and Factset as of September 17, 2020. 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.

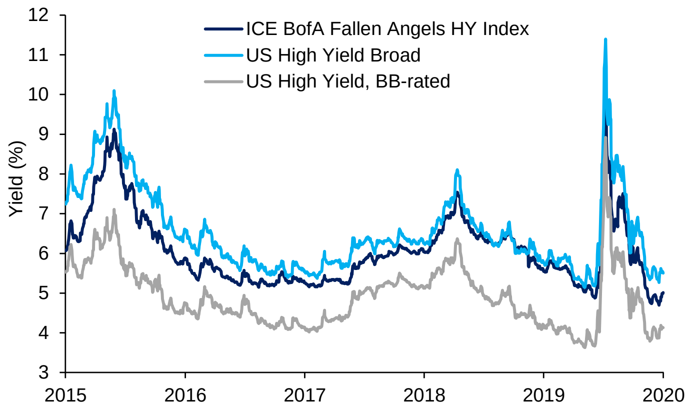
High Yield "Fallen Angels"

Unlike the ECB's bond buying, the Fed has become a buyer of certain high yield (HY) bonds. This has helped HY markets fully recover from the March sell-off. Despite the impressive turnaround, spreads are still relatively attractive, with average yields near 5.5%. Of course, these valuations imply you would need to own some of the riskiest parts of the HY market. This leads us to our high conviction in the Fallen Angel (FA) market.

As we highlighted in the August Quadrant, HY issuers that were once IG offers a unique opportunity. What makes FA's unique are the somewhat mechanical nature of how bond prices are discounted *prior* to a rating downgrade. In anticipation, active IG managers become sellers to help protect portfolio returns. Index-based managers then become forced sellers upon the actual downgrade to junk status. This tends to leave prices of FA's depressed or sometimes oversold, as they are introduced to a new buyer base.

Considering these issuers were once IG, the average rating of FA's is BB. However, because of the discounting that takes place, the yields of FA's are much more attractive. Today, the yield (to worst) for FA's are closer to 5.0%, while the average BB-rated HY bond yields closer to 4.0% **(see figure 14)**. This pick-up in value is what helps FA's consistently outperform the broader HY market. Something FA's have done 17 of the last 23 years, including 2020.

Figure 14: Fallen Angels offer yields above similarly rated HY



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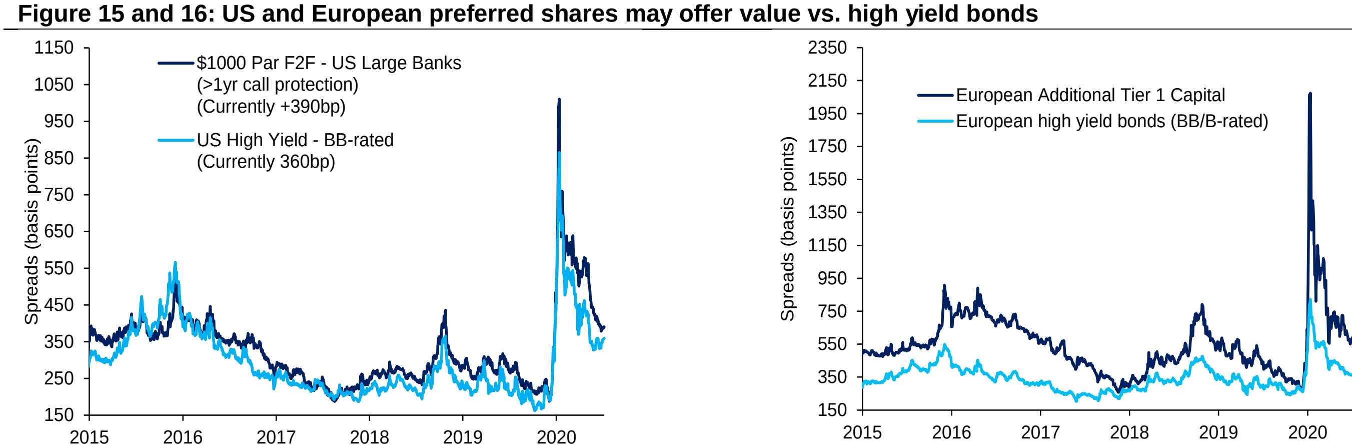
Preferred Securities

Ranked above equity (without voting rights) and mainly issued by financials, preferred stocks have been a good source of high current yield. Due to the lack of new issuance and the demand for higher yields, preferred stock valuations have risen over the years. However, with US preferred yields averaging 4.0% and European yields 5.0%, we believe value still exists. In many instances, valuations of preferred shares are comparable with similarly rated HY bonds **(see figures 15 and 16)**.

Figure 15 and 16: US and European preferred shares may offer value vs. high yield bonds



Note: F2F are fixed to float bonds. Source: YieldBook and Factset as of September 17, 2020. 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.

We continue to feel comfortable moving down in capital structure for higher yields in preferreds. In our view, large banks have entered the current economic slowdown from a position of fundamental strength. Indeed, Dodd-Frank and Basel III regulations have required banks to increase their capital base substantially. While common dividend cuts remain an area of concern for a few select banks, we do not believe preferred dividends are at risk. If anything, preferred stock weakness derived from potential common dividend cuts should be views as an opportunity to add exposures.

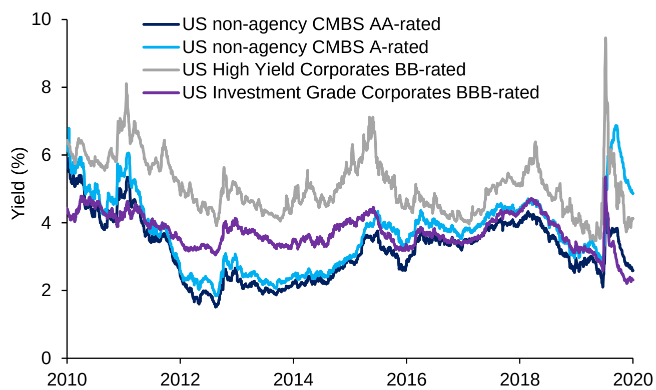
Mortgage Credit

In today's environment, we find several opportunities in mortgage credit. First, the COVID-19 global shutdown has had little impact on residential home prices. If anything, home prices in certain suburban areas have risen as families in urban cities look to relocate. With home prices supported, non-agency residential mortgage-backed securities (RMBS) are likely to benefit. Again, credit quality can vary by security, but the non-agency RMBS market can offer yields near 4.0%.

Second, most commercial mortgage-backed securities (CMBS) backed by hotels or office buildings have deteriorated significantly. However, prices on high quality A/AA-rated securities still offer yields up to 5.0% **(see figure 17)**. This far exceeds the yields found on some low quality IG and high quality HY bonds. Despite the potential losses that could be incurred from certain areas of the commercial real estate market, we do not think high quality securities (A-rated or above) will be impacted.

As suitable, a potentially even higher-yielding derivative play on commercial and residential mortgage credit are mortgage equity REITS. While volatile and leveraged, with forward-looking yields above 8% and still off nearly 40% in price year-to-date, we see this small sector as a valuable supplemental holding in our tactical asset allocation (**see figure 18**).

Figure 17: Some high quality CMBS tranches still yields like junk



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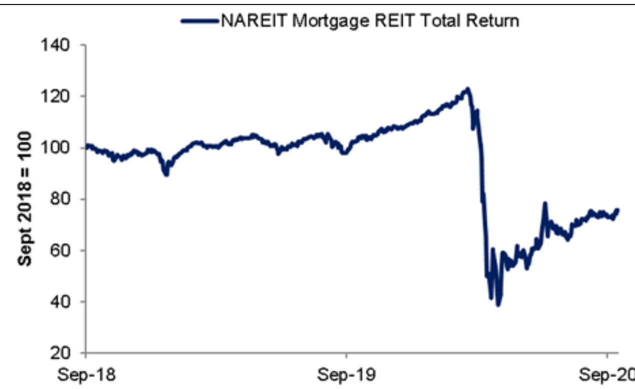

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Combine and Thrive

Though the aforementioned opportunities can stand on their own merits, we believe these strategies work best when combined together in a diversified portfolio. Other income generating assets such as emerging market equities and debt offer investors much needed diversification after a year of sharp appreciation in tech shares and low-risk, negligible yield bonds. Combining these opportunities in core portfolios can lower correlation, which can lower overall portfolio volatility and better help investors navigate the current low yield world.

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MBS are also sensitive to interest rate changes which can negatively impact the market value of the security. During times of heightened volatility, MBS can experience greater levels of illiquidity and larger price movements

Bonds are affected by a number of risks, including fluctuations in interest rates, credit risk and prepayment risk. In general, as prevailing interest rates rise, fixed income securities prices will fall. Bonds face credit risk if a decline in an issuer's credit rating, or creditworthiness, causes a bond's price to decline. High yield bonds are subject to additional risks such as increased risk of default and greater volatility because of the lower credit quality of the issues. Finally, bonds can be subject to prepayment risk. Please click on above link 'Read additional important information' to see Bond Rating Equivalence table.

Important information, including information relating to risk considerations can be found in the link above..

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