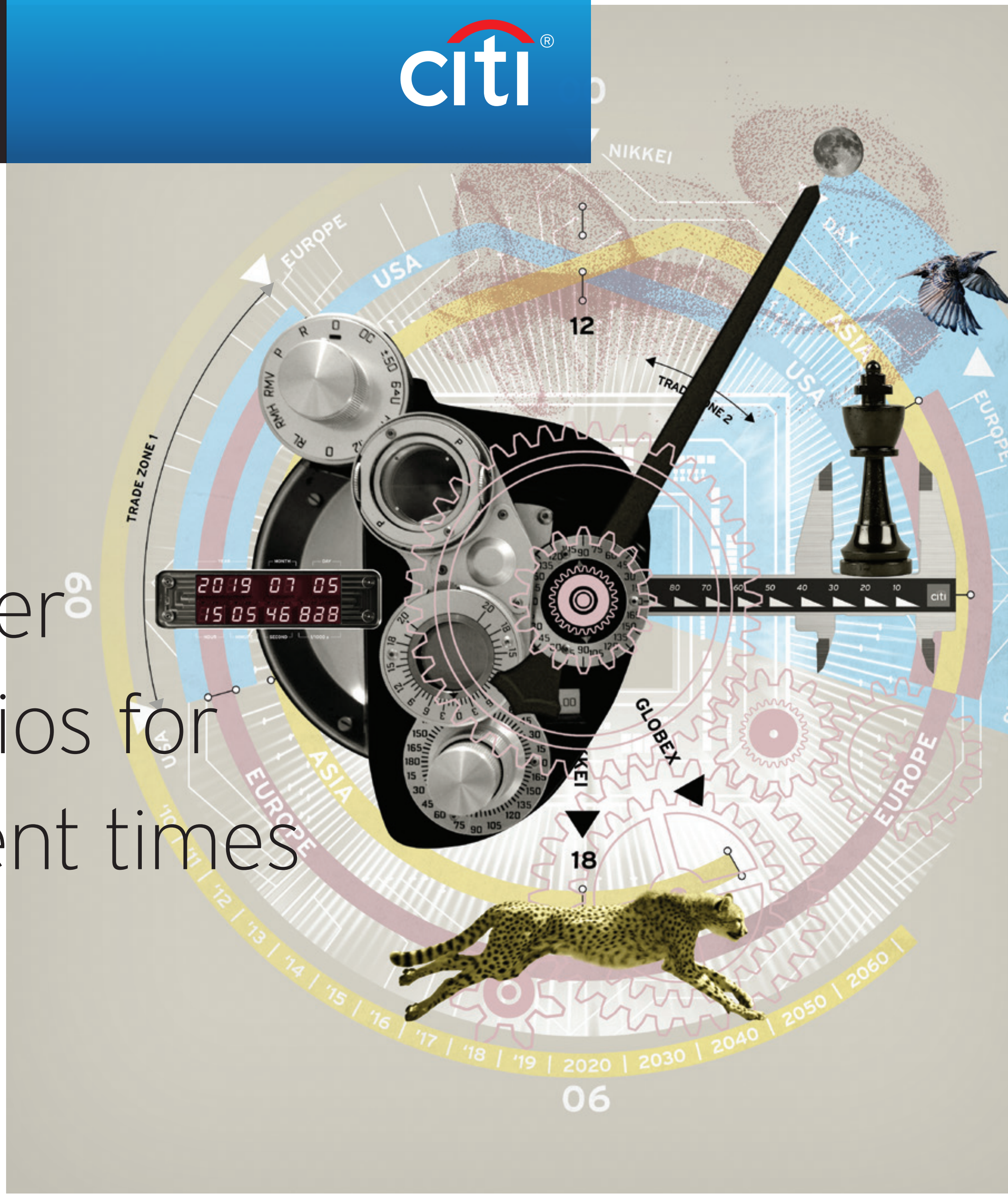
Private Bank

# Stronger portfolios for turbulent times




MID-YEAR OUTLOOK | **2019**

# Watchlist

## How has your portfolio changed since the start of the year?

Without regular reviews and rebalancing, your portfolio may drift away from your recommended allocation over time, potentially sacrificing return opportunities and running unnecessary risks.

To help keep your portfolio aligned to your recommended allocation and to our investment themes, we can provide you with a detailed report showing how your portfolio compares to key benchmarks.

Your relationship team can then recommend ways for you to address any issues identified.

More than 3,482 clients have received their personalized Outlook Watchlist report in 2019.* Why not request yours from your relationship team today?

*As of 15 May 2019. Recommended allocation is the reference allocation that reflects our understanding of your investment objectives and risk tolerance.

Private Banking for Global Citizens

# Stronger portfolios for turbulent times

MID-YEAR OUTLOOK | 2019

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FOREWORD

# Stronger portfolios for turbulent times

**David Bailin** | Chief Investment Officer

Financial markets have had a turbulent six months. They began 2019 by rebounding strongly from the severe late-2018 sell-off. In May 2019, however, the escalating US-China trade war and renewed slowdown fears caused them to surrender some of those gains.

Markets are now reflecting an increasingly unsettled world trade situation, as well as greater political polarization, such as that which we saw in the EU parliamentary elections. Rather than watching the news and taking no steps, we are reiterating a 'call to action' for investors. The central message of **Outlook 2019** – published on 5 December – was to safeguard assets by building strong portfolios for turbulent times. Stronger portfolios should contain higher quality, global fixed income securities, equities with earnings and dividends less likely to be impacted by trade, and alternative investments that diversify portfolios for the long term. Hedging portfolios may have become more expensive, but that doesn't mean hedges are expensive relative to risk. Our other message of making cash work harder means investing in a broad and diversified selection of bonds and cash alternatives, rather than assuming that 'cash' is the best way to manage your portfolio in turbulent times.

**Mid-Year Outlook 2019** is our roadmap for the rest of this year and beyond. 'Stronger portfolios for turbulent times' reflects our belief that the global economy and markets have successfully navigated the acute difficulties they faced in late 2018 and early 2019, particularly because of the US Federal Reserve's retreat from monetary tightening– see **Flying just above the danger zone**.

They now face the renewed threat of trade protectionism once again. However, if policymakers move to contain this risk too, we think that economic growth and market upside can endure into 2020.

Many investors are still apprehensive, but we make the case for keeping portfolios fully invested. Rising earnings and the late-2018 sell-off have combined to lower equity valuations. We also see inflation staying contained and credit risks easing. Nevertheless, we are far from complacent. We acknowledge a variety of important risks, especially that of worsening US-China trade tensions – see **Investing wisely in 2019 and beyond**. Our approach therefore stresses seeking new opportunities and simultaneously moving portfolios towards safer ground.

As well as our roadmap, we offer practical steps for implementing our advice. **Intelligent opportunities for your portfolio** highlights examples of strategies you might consider in today's late-cycle environment. They include seeking ongoing market upside while hedging downside risk as well as diversified equity exposure to our investment themes. We also explore certain vital disciplines that some of the world's most successful investors have consistently followed, showing how we can help apply them to your wealth – see **How we do what we do**.

Citi Private Bank remains your partner and guide throughout turbulent conditions. We look forward to discussing our **Mid-Year Outlook** ideas with you in person and customizing strategies for your portfolio.

It is our privilege to serve as your advisors.

## Nine steps to strengthen portfolios for the rest of 2019 and beyond:

1 **Assess your portfolio now**. Request your Outlook Watchlist and discuss opportunities with your Investment Counselor. Seek our Global Investment Lab's insights.

2 **Understand your risk profile**. Adjust your portfolio if your circumstances or risk tolerance has changed.

3 **Don't try and time the markets** – it's a fool's game.

4 **Preserve your portfolio's value** by diversifying globally and adding higher quality assets.

5 **Have a discretionary manager rebalance your portfolio** as events unfold.

6 **Manage your cash** – all of it – more wisely.

7 **Explore risk management tools as well as strategies** with different risk-return characteristics.

8 **Create an opportunistic element within your portfolio** to allow you to invest during unusual events and short-term market dislocations.

9 **Seek our advice more frequently**, and let us help you understand the data, and interpret the guideposts.

# Invest wisely as uncertainty grows: a call to action

David Bailin | Chief Investment Officer

Navigating global markets in the second half of 2019 and 2020 requires focus upon new geopolitical risks and economic opportunities, while also moving fully invested portfolios toward safer ground.

Uncertainty is rife as the first half of 2019 draws to a close. Escalating tensions over international trade are largely responsible for this uncertainty. Throughout May, the pace of the news flow concerning trade conflicts accelerated rapidly. In the principal battle – between the US and China – China appeared to harden its negotiating stance. The US therefore ratcheted up tariffs and China responded in kind.

The scope of the trade war has also widened. The threat by the US to impose tariffs on all imports from Mexico unless the latter helps to curb illegal immigration into the US is an alarming development. As **Mid-Year Outlook** went to press, President Trump also said the US would no longer designate India a 'developing country,' thereby ending many Indian exporters' exemption from US tariffs. The President may next turn his focus to the unresolved US-European Union trade dispute.

Mounting uncertainty over international trade is likely to feed gradually into economic data. It may register much sooner in company boardrooms around the world, however. As economic risks increase, prudent corporate leaders often take swift actions to shore up their own businesses, delaying capital investment in particular.

They also face difficult decisions on how to adjust their pricing in light of tariff changes. If trade uncertainty persists or worsens, delayed investment and rising prices will pose an increasing threat to growth worldwide.

The potential effects are numerous. Rising costs from tariffs will only be partly passed on to consumers, squeezing profit margins on those goods. Declining sales volumes will then follow. Capital investment could suffer even though companies are forced to spend to reconfigure their supply chains to secure the flow of vital inputs. Global companies accustomed to largely unfettered international trade may find themselves facing barriers they have not encountered for decades. Smaller firms – which cannot build inventories as readily nor have as much financial flexibility – will be even more vulnerable.

We believe that global financial markets have yet to price fully all of the possible outcomes of the trade war. The likelihood of a negative resolution has clearly risen of late. Citi Private Bank's message in this edition of **Mid-Year Outlook** is therefore clear: keep your core portfolio fully invested but raise the quality of its holdings now. On the pages that follow, we explore the rationale for this and ways of doing it.

> We believe that global financial markets have yet to price fully all of the trade war's possible outcomes.

## Looking back just a few months ago...

Prior to the recent escalation of the trade war, the early months of 2019 witnessed a string of memorable comebacks. In golf, we saw one of the all-time greats rediscover the form he displayed in his prime, winning his first major championship in eleven years. In Europe's top club soccer tournament, two teams pulled off seemingly impossible semi-final victories to set up an all-English final.

In the same spirit, global financial markets staged a remarkable resurgence, following a truly abysmal end to 2018. After the worst December for US equities since the Great Depression, the S&P 500 rallied 13.7% in the first quarter of 2019. Global equities – as represented by the MSCI World Index – were up 12.5% over the same period, while US corporate fixed income gained 5%.

Fears that the US might slide into a recession were exacerbated when the US yield curve briefly inverted in March. Such factors helped to distract attention from positive factors such as the Fed's retreat from monetary tightening – see **Flying just above the danger zone**.

The prospects for earnings growth in the face of trade uncertainties are endangered.

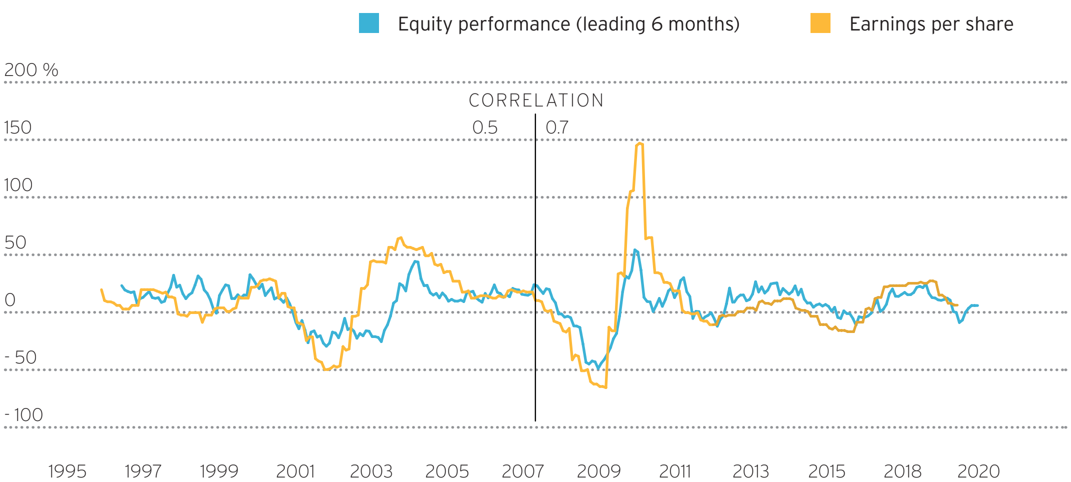
## Equity valuations reset lower

In hindsight, the bigger news was the material decline in equity valuations. In the US, for example, earnings per share rose by 23% in 2018 and a further 2% in the first quarter of 2019. However, US equity prices were flat over the same period, thus producing a substantial contraction in the price/earnings multiple. Currently, that multiple stands around its longer-term average of 16.8. That hardly seems frothy given today's low-interest rate environment. Global equities trade on a multiple of about 15. Emerging equities, meanwhile, trade on 12.2, which is cheap in both relative and absolute terms.

While equity valuations have become more attractive, we are also very mindful of the need for earnings growth to drive this asset class higher for the rest of 2019 and in 2020. The correlation between future equity performance and corporate earnings has increased over recent years – **figure 1**. And, as we noted, the prospects for earnings growth in the face of trade uncertainties are endangered.



FIGURE 1. MOVING TOGETHER MORE CLOSELY




Source: Haver Analytics, Bloomberg through 17 May 2019. Past performance is not indicative of future returns. Real results may vary. Please see Glossary for definitions.

## Contained inflation, easing credit risks

As equity valuations reset lower in 2018, fixed income rallied globally. Low inflation amid expectations of modest economic growth worldwide were key drivers of this. In May, the rally in fixed income extended, reflecting a flight to quality driven by trade war fears. While wage growth has trended upwards in various major economies, the impact upon consumer prices has been muted. Given that the economic cycle is now ten years old, such contained inflation represents unexpected positive news. As a result, monetary policymakers can focus on protecting the expansion, rather than fighting rising price pressures.

By mid-May 2019, re-financings of high yield bonds hit a record $72bn. This has eased fears of a seize-up in the US debt market, following the complete lack of issuance in December 2018. With banks' balance sheets also having improved greatly in the US and Europe since the financial crisis of 2008-09, a renewed credit crisis striking the global economic system seems less likely.

## China syndrome; Mexico redux and EU-Japan uncertainty

As we discussed earlier, the US-China trade war has taken an unexpected turn for the worse. After the sudden collapse of talks on 5 May, President Trump imposed much higher tariffs on Chinese imports and China retaliated. Emboldened by the US's economic resilience, the president feels that his country can absorb the impact of tariffs without causing itself deep harm. China's leaders seem confident of their uncompromising negotiating position too, after their package of stimulus policies helped boost local lending activity, domestic investment, and equity markets. Both sides appear to have underestimated the determination of the other.

Unless there is now a surprising improvement in the course of negotiations, we believe the trade war is likely to have material economic consequences for both countries. In the US, the tariffs could cost the average family several hundred dollars a year in higher consumer prices. This would potentially erase some of the boost that household incomes received from the tax cuts enacted in 2017. On the Chinese side, the US's 25% tariff on exports to the US are equivalent to about 1% of GDP, but to around 10% to 15% of industrial enterprises' profits. The impact is also likely to spill over to other companies inside China.

We do not think the US would find legislative support for passing another major fiscal stimulus package at this time. By contrast, China is better placed to 'do whatever it takes' to try and maintain economic stability amid the raging trade war. Because they do not face four-yearly electoral pressures, the Chinese authorities are able to take a longer-term view in economic matters, just as President Trump prepares for a grueling re-election campaign in the near future.

## Trade's impact on EPS

The longer the trade war rages – and the more countries are drawn in – the greater the negative impact will be upon global growth and corporate earnings. Our estimates range from a modest negative impact to a cumulative impact that leads to a recession. What we do know with certainty is that the impact of developments so far has been negative.

## What to do: limit losses, not returns

Given the prospect of moderate economic and earnings growth combined with low inflation, we see continued modest, upside potential for markets in 2019 and 2020, even in the face of the trade war. We do not want investors to try to time markets. To pursue the best investment outcomes over the long term, you should remain fully invested at all times. Market timing does not work and most of those who attempted it in 2018 and 2019 ended up foregoing gains or suffering losses – see **How we do what we do**. What really matters is having a carefully constructed, globally diversified core portfolio. If you fear downside in the coming years, consider capital markets strategies that offer intelligent exposure to risk assets, such as upside participation with protection against downside – see **Intelligent opportunities for your portfolio**.



Hedging opportunities to reframe the risk-return characteristics of portfolios remain less expensive than they may become in the near future.

Within your globally diversified core portfolio, we urge raising the quality of the equities you own now and shifting towards industries and styles that may be likelier to prove resistant to shocks. If you feel apprehensive about equities in today's late-cycle environment, remind yourself of the lessons of history. Periods like today have actually been the second most favorable for returns – **figure 2**.

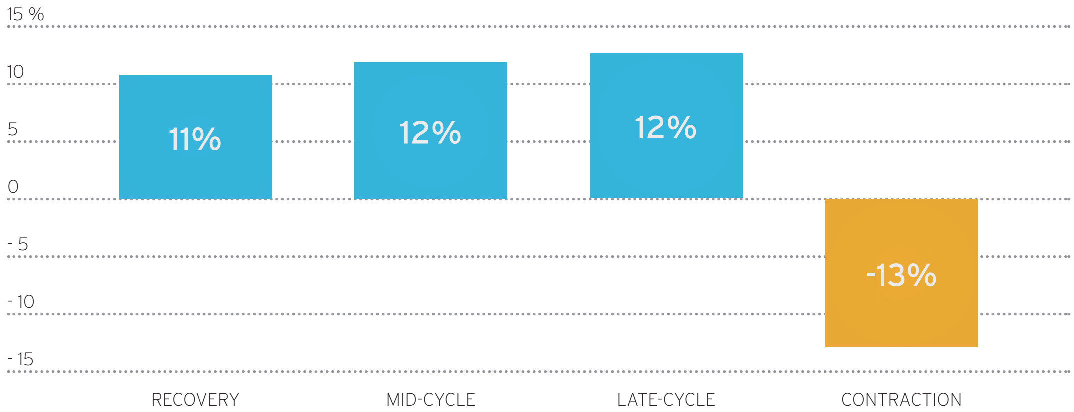
To help dampen portfolio volatility, we recommend selective global fixed income holdings. Our Global Investment Committee recently raised its tactical global fixed income allocation to overweight for the first time since 2012. We urge against taking unnecessary credit risk and emphasize high quality short- and intermediate-term bonds that have benefited from the Fed's rate hikes to date.

Diversifying globally and improving the quality of your holdings are among the wise actions that you can take to prepare for the rest of 2019 and beyond. We also stress other vital investment disciplines that can help you achieve this – see **How we do what we do**. Taken together, we believe these steps can help limit your core portfolio's losses rather than your returns. Let us show you how.

We do not want investors to try to time markets.

FIGURE 2. US EQUITY RETURNS BY BUSINESS-CYCLE PHASE

S&P 500 average annualized return since 1985




Source: Haver Analytics, Bloomberg through May 2019. Past performance is not indicative 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.




# Is your portfolio ready for a 'G2 world'?

David Bailin | Chief Investment Officer

The trade war headlines only represent the beginning of a momentous global economic competition.



A momentous struggle is underway between the world's two economic superpowers. The current trade war between the US and China is merely the most obvious manifestation of this conflict, dominating presidential tweets and the news headlines. However, the underlying tensions extend well beyond the trading relationship between the world's largest and second largest economies. China's ongoing growth is causing clashes with the US on multiple fronts. We believe it is likely to continue doing so, with far-reaching implications for investors.

In the economic sphere, China is seeking to challenge the US in areas where it has been supreme for decades. These include pharmaceutical and biotech research, as well as high tech more generally, where it has a stated ambition of becoming the world's dominant power by 2049. The US is plainly taking this seriously, curtailing its rival's access to inputs in some instances. The implications of China's ambitions often extend well beyond business and the economy.

China's Belt-and-Road Initiative is a case in point. Financing international transport links and other infrastructure overseas clearly aims to reinforce China's trade network. However, it may also strengthen China's diplomatic influence in the countries involved. At the same time, China is courting various longstanding US allies across the Western world, as well as in Africa. Of course, this comes at a time when the US has shifted towards a more isolationist position in global affairs.


From the South China Sea, to North Korea, to the Straits of Taiwan, China will continue to exert increasing influence.



Citi Private Bank believes that the struggle between the US and China will be a focus for politicians, business leaders, and investors for decades to come. From the South China Sea, to North Korea, to the Straits of Taiwan, China will continue to exert increasing influence. Whatever the outcome of today's US-China trade war, substantive future agreements over issues such as intellectual property, digital privacy, access to China's markets, and currency policy will be increasingly difficult to achieve.

What does this escalating rivalry between the 'G2' powers mean for global investors? We believe that as long as no direct military confrontation erupts between the US and China, there may be numerous long-term attractive investment opportunities over the coming years. Rather than a single clear leader within certain industries, several firms may share leadership, requiring portfolios that reflect this. Western firms may face restrictions in China's sphere of influence, while Chinese firms may also face daunting barriers to operating in Western markets. In many other markets, however, US and Chinese business giants may end up competing head-to-head. It is in this third sphere where the 'clash of the G2 titans' may play out most fully, and require careful security selection from investors.

Citi Private Bank stands ready to be your partner and guide as these momentous events unfold. And we think the sooner you start to prepare your portfolio for the new realities of a 'G2 world,' the better.

# Flying just above the danger zone

**Steven Wieting** | Chief Investment Strategist and Chief Economist

The global economy and financial markets have so far flown just above the danger zone, but risks remain. While many investors are apprehensive, we stress ways to seek improved returns while limiting potential losses.

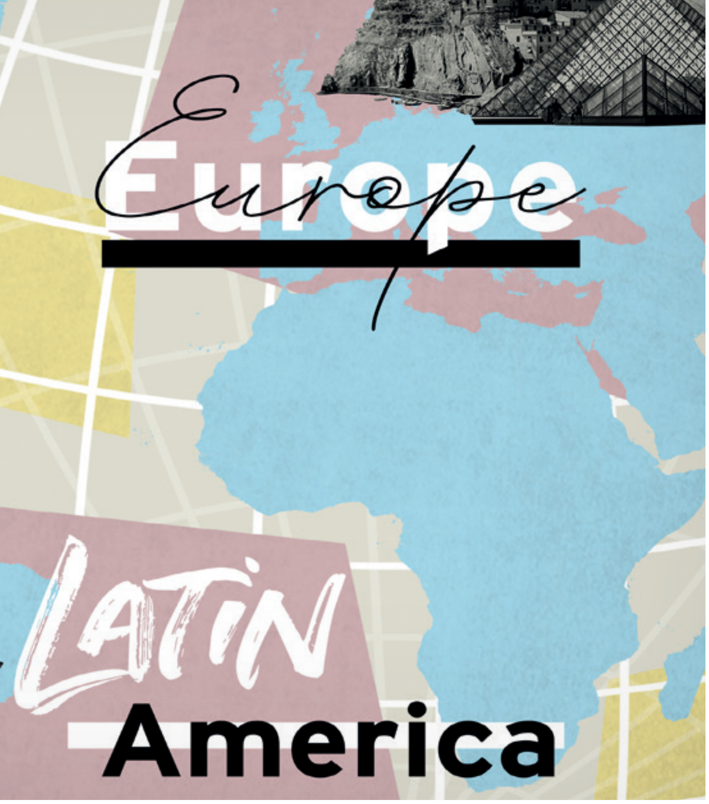


The global economy and financial markets entered the danger zone in late 2018. Nine interest rate hikes from the Federal Reserve since 2015 – with more planned for this year – had helped to put the aging US economic expansion in peril. Monetary tightening was not the only threat, however. Signs of slowing growth in China and Europe were evident, fears related to international trade were rampant, and geopolitical concerns loomed large. Amid the uncertainty, risk assets suffered a serious dislocation. US equities experienced their worst December since the Great Depression.

Citi Private Bank anticipated some of these challenges. In early December, we released our Outlook 2019 publication under the title **Safeguarding assets: Building stronger portfolios for turbulent times**. We suggested that our clients should stay constructively positioned, but also strengthen their portfolios. Following December's dislocation, we recommended shifting tactical cash into beaten-down equities and fixed income assets – **figure 1** – that have since rebounded.

As we write **Mid-Year Outlook**, we are seeing a material increase in trade risk. The breakdown in US-China trade negotiations in May 2019, as well as punitive trade threats against Mexico in response to immigration issues, has darkened economic skies once again. The US Treasury rally underscored the potential negative impact of this news, as corporate profits may be deeply affected if and when tariffs take hold. So, Citi Private Bank's advice to clients is worth repeating. Increasing portfolio quality will make portfolios more resilient and able to withstand the unanticipated effects of trade uncertainty.

So, to what extent are the global economy and markets now out of the danger zone? What went wrong and what has since gone right? And, how should you position your portfolio for the rest of 2019 and beyond?




Increasing portfolio quality will make portfolios more resilient and able to withstand the unanticipated effects of trade uncertainty.



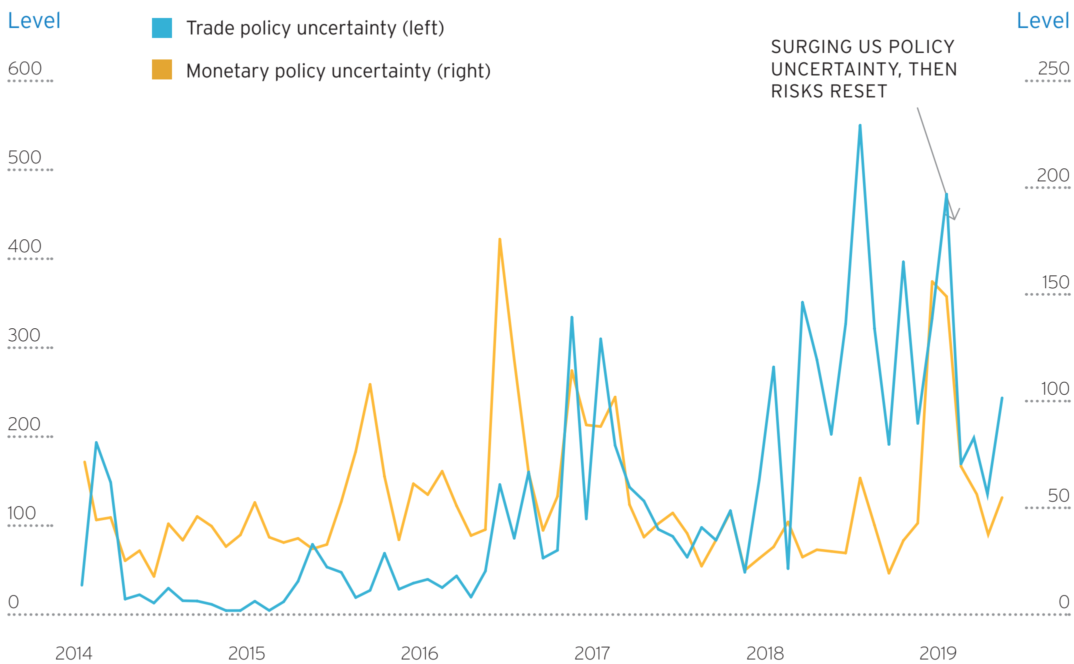
FIGURE 1. OUR ASSET ALLOCATION AND RETURN ESTIMATES

| | Current Allocation (%) | Current Active Weight - Tactical vs. Strategic (%) | Previous Active Weight - Tactical vs. Strategic (%) | Year-to-Date Local Total Return (%) | 1-Year Ahead Tactical Return Estimate (%) | 10-Year Ahead Annualized Strategic Return Estimate (%) |
|---|---|---|---|---|---|---|
| Global Equities | 35.8 | -2.0 | 2.0 | 12.6 | 7.0 | 6.2 |
| Global Fixed Income | 39.8 | -2.0 | 0.0 | 3.6 | 2.0 | 3.6 |
| Alternatives* | 21.8 | n/a | n/a | n/a | n/a | 10.1 |
| Commodities | 0.0 | 0.0 | 0.0 | 6.5 | 1.0 | 2.2 |
| Cash | 2.5 | 0.5 | -2.0 | 0.9 | 2.0 | 3.2 |

*Private Equity, Real Estate, Hedge Funds
Note: Global Equities' Strategic Return Estimate is weighted composite of developed markets indexes at +5.3% and emerging markets at 11.4%.

Source: Citi Private Bank Quant Research & Global Asset Allocation (QRGAA) and Global Investment Committee (GIC). The Quant Research & Global Asset Allocation (QRGAA) team creates strategic asset allocations using Citi Private Bank's Adaptive Valuation Strategy (AVS) methodology on an annual basis. The GIC provides underweight and overweight decisions to AVS's Global USD without Hedge Funds Risk Level 3 portfolio. The above strategic/tactical allocations are reflective of the 3 June 2019 GIC meeting. Overweight/underweight = the difference between tactical and strategic allocations. Minor differences may result due to rounding. All allocations are subject to change at discretion of the GIC of the Citi Private Bank. Past performance is no guarantee of future results. Real results may vary.

FIGURE 2. TRADE AND MONETARY POLICY UNCERTAINTY INDICES




Source: Haver Analytics as of 19 May 2019.



## What went wrong

In 2018, policymakers in the US and elsewhere took excessive risks. The Federal Reserve seemed to treat the US economy's faster 3% growth rate as if it were permanent, rather than boosted specifically by tax cuts. Having raised interest rates four times in 2018, the Fed was predicting three more hikes for 2019. On top of this, it was also tightening monetary policy via a $50bn-per-month reduction in its bond holdings for an indefinite period ahead. The European Central Bank, meanwhile, ended its own €30bn-a-month bond-buying scheme during the market turmoil of December. Put simply, these activities were collectively 'too much' for markets that were more fragile than current data at that time suggested.

Overly aggressive monetary tightening was not the only danger. Entering last year, we saw a possible trade war as the biggest macroeconomic risk, even though it was not our base case. The US, China, and others did indeed hike tariffs, altering the terms of doing business for many producers worldwide. Trade policy uncertainty surged – **figure 2** – while business confidence correspondingly sank in many regions of the world, including the US.

Against this backdrop of rising rates, trade-war fears, and faltering business confidence, we believe the probability of a US recession rose to its highest level since the Great Recession of 2008 – **figure 3** - even though the severity and scope of US vulnerabilities are quite different from a decade ago.

## What has gone right since then...

The market dislocation of late 2018 was a dire warning to policymakers worldwide. In December 2018, US credit markets financed the fewest borrowers in history. US equities fell nearly 20% in the year's fourth quarter. Fortunately, policymakers heeded these warnings just before they may have caused irreversible harm. The Fed took additional rate hikes out of its base-case forecasts for 2019. It also announced the end of its balance sheet reduction efforts, albeit not until September 2019. In March, the European Central Bank announced a fresh round of stimulus and said it now envisaged keeping interest rates on hold at least through 2019, rather than only through the summer of this year.

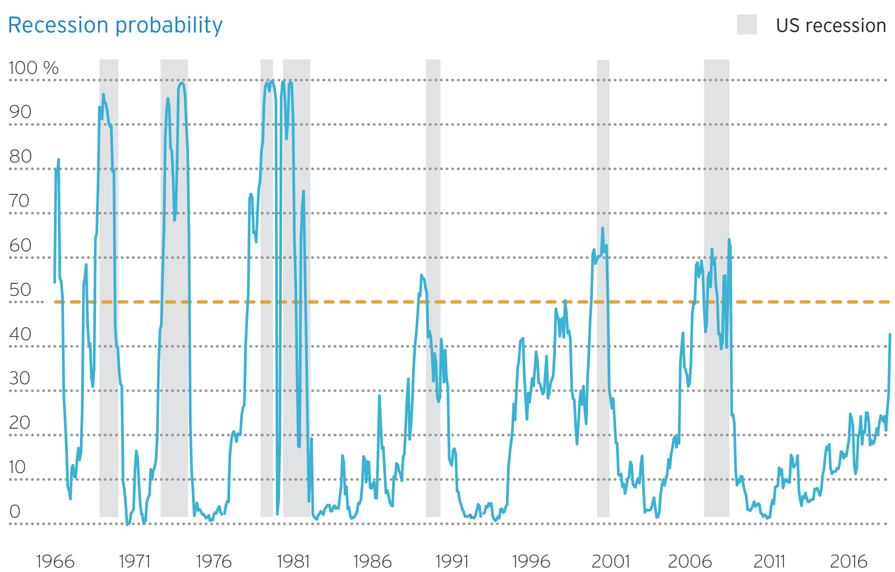
The US yield curve – the best long-term predictor of US recessions – inverted at the end of March. But we believe that the monetary authorities acted just in time. From the perspective of the key risk driver of 2018, we believe the Fed's change of course has reduced the risk of recession.

Unfortunately, the second key policy risk that sank markets in 2018 has been revived. As David Bailin discussed, the early year strength of the US and Chinese economies may have emboldened both sides to press their conflict further. Whether the US-China and other trade issues are resolved is critical. If all tariff threats from the US against China and Mexico were maximized, the US tariff collections from importers would equal 17% of large capitalization firms' US profits.

Yet if deals are reached, we could imagine a rebound much like we saw in the first quarter 2019. In the absence of a severe trade shock, we think the US economy can grow at slightly above 2% even without a repeat of 2018's tax cuts.

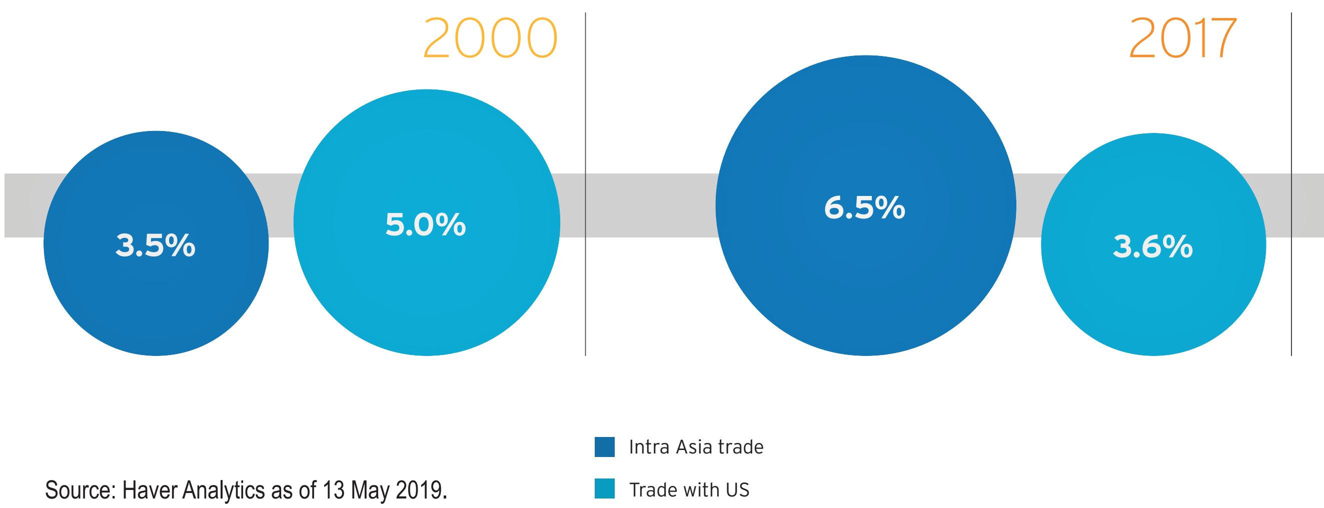


FIGURE 3. ESTIMATED US RECESSION PROBABILITY SIX MONTHS AHEAD




Source: Haver Analytics as of 13 May 2019.

FIGURE 4. ASIAN INTRA REGION TRADE GROWTH VS TRADE WITH US




Source: Haver Analytics as of 13 May 2019.



Meanwhile, China faced similar threats to its growth about nine months before the US. The Chinese authorities had previously tightened credit policies in an effort to reduce risks within its financial system, albeit at a cost of some growth. Confronted with the US trade war, however, they began to reverse their tightening measures last year. Results have materialized, with China showing stronger than expected growth in the first quarter of 2019.

While we believe first quarter growth rates in the world's two largest economies - the US and China - were misleadingly strong and thus potentially confusing, policy actions and leading indicators suggest that both economies should keep growing well into 2020.

We see reasons for cautious optimism elsewhere. In Asia, growth outside China is also proving resilient, with growing domestic demand and intra-regional trade decreasing Asia's reliance on the US. Gains in the share of trade for countries in Asia may limit the regional spillover from the US-China conflict – **figure 4**. And, while Latin America's recovery remains sub-par, it is nevertheless experiencing some growth. Again, barring a severe trade escalation, for the global economy as a whole, we would see growth surprising investors positively, rising near 3%.

## The trade beast returns

Despite the monetary authorities' so-far successful response to the dangers presented in late 2018 and early 2019, we remain vigilant for threats to the aged economic expansion. President Trump has raised tariffs a further 15 percentage points on $200bn of Chinese exports to the US. And the administration has announced potential plans to raise tariffs to 25% on all Chinese imports, perhaps just before a meeting between Trump and Chinese President Xi in Japan in late June. Previous attempts to reach agreement have all fallen short.

The vulnerability is not China's alone. US consumers and businesses must bear the price of tariffs.

US IT firms earn a sizeable 15% share of their revenues in China itself, nearly three times the level of other US sectors. Likewise, harming China's economy inevitably harms others, including German capital goods exporters and US farmers.

We don't believe rising tariffs will single-handedly arrest the world economic expansion. We do acknowledge that a severe and lasting escalation of tariffs and counter-tariffs across regions could raise the threat level considerably. A wide range of security-related risks have also risen. These include disputes over the enforcement of US sanctions against Iranian oil exports, and technology security issues that further complicate US-China relations. Apart from temporary bouts of weakness, financial markets have been relatively sanguine about where these issues will settle.

## Bubble risk in good times

Besides the unresolved set of international disputes, what else might ultimately end the present expansion and the bull market in risk assets that has accompanied it?

One possibility is that the Fed's retreat from monetary tightening leads to over-exuberance in credit markets. US corporates have already accumulated so much debt that their average credit rating has deteriorated rather than improved, despite ten years of economic expansion. In a low-interest rate environment – and barring any economic shocks – marginal borrowers are likely to keep increasing leverage. High borrowing in certain industries often creates greater financial risks when downturns strike, although lower rates mitigate these risks. In the meantime, though, history emphasizes that this behavior is consistent with strong equity market gains - **figure 5**.



FIGURE 5. BUBBLE RETURN TABLE

US DEBT BOOMS

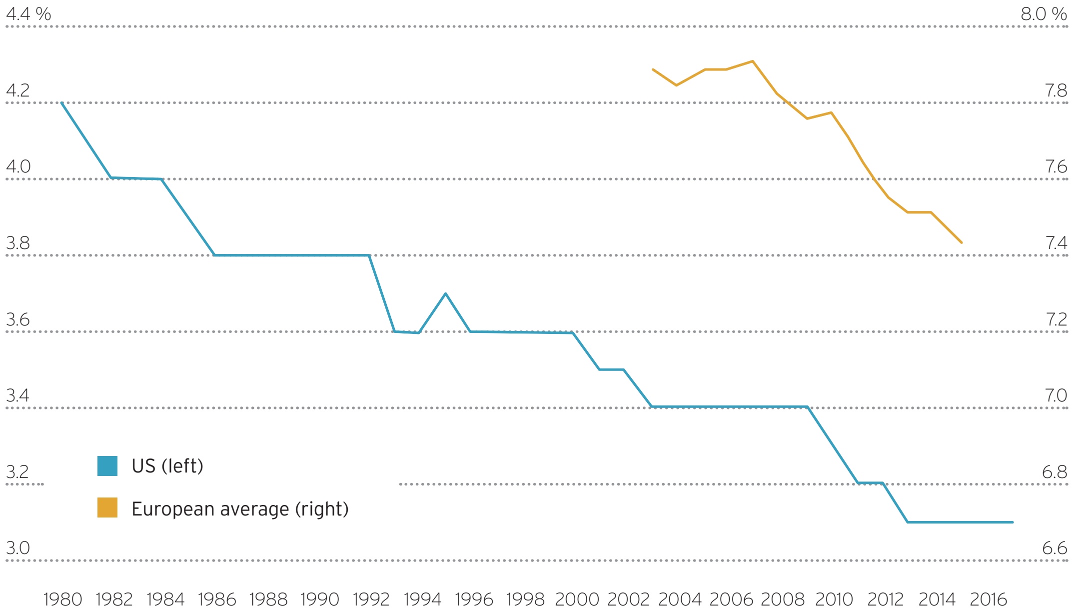
| | Period | Debt growth | S&P 500 return during period |
|---|---|---|---|
| US telecom boom (HY) | 1997 - 2000 | 187% | 110% |
| US LBO transaction volume | 2004 - 2007 | 362% | 50% |
| US household mortgage debt | 2002 - 2007 | 95% | 51% |
| US energy boom (IG+HY) | 2012 - 2015 | 88% | 61% |

INTERNATIONAL DEBT BOOMS

| | Period | Debt growth | Local equity performance |
|---|---|---|---|
| Japan real estate bubble | 1984 - 1989 | 86% | 293% |
| Greek debt boom | 2002 - 2007 | 55% | 96% |

Source: The YieldBook and Haver Analytics as of 13 May 2019.
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.

FIGURE 6. BOTTOM QUINTILE INCOME SHARE IN US AND EUROPE




Source: Haver Analytics as of 13 May 2019.



Emerging market (EM) assets could also be at risk of irrational exuberance at some point. Unlike central banks in developed markets, no EM central bank pursued quantitative easing policies over the last decade. Partly as a result, EM asset prices rose by much less than developed market assets. Their relatively low valuations could set the stage for a future bout of investor exuberance, particularly once the Fed is in the advanced stages of its next monetary easing cycle – see **When might emerging markets outperform again?** However, we think this is unlikely to occur in 2019.

## Two faces of populism

We also keep a watchful eye on politics, notably the 2020 presidential race in the US. A further upsurge in populism in the US and Europe in particular presents a clear economic risk. The US economy has of course experienced robust growth in recent years, while Europe has enjoyed a recovery that many doubted would even be possible. Top-line growth figures do not tell the full story, however. The experience of the typical swing voter – particularly those whose income is in the bottom fifth of national distributions – is far more influential in elections. Such voters have not shared meaningfully in the recovery of the last decade – **figure 6**.

European parliamentary elections in May returned the highest ever number of deputies from non-mainstream parties. The timing of the UK's departure from the EU and its future trading relationships with the EU remain highly uncertain and potentially disruptive. Meanwhile, the US and China are seeking tools with which to apply leverage over each other in coming talks.

Much wider-ranging trade policy considerations between the two will arise before long. An escalation of the trade conflict between the US and Europe could particularly damage the latter's more fragile economy.

Looking ahead to 2020, the US presidential election will again have far-reaching implications domestically and beyond. President Trump's victory in 2016 led to the large corporate tax cuts that drove local equity outperformance, as well as to elevated uncertainty over global trade. While perhaps improbable, there is some risk that the election leads to the reversal of tax cuts and perhaps even to major upheaval of the US healthcare system. In either case, exaggerated economic effects are possible.

While perhaps improbable, there is some risk that the election leads to the reversal of tax cuts and perhaps even to major upheaval of the US healthcare system.

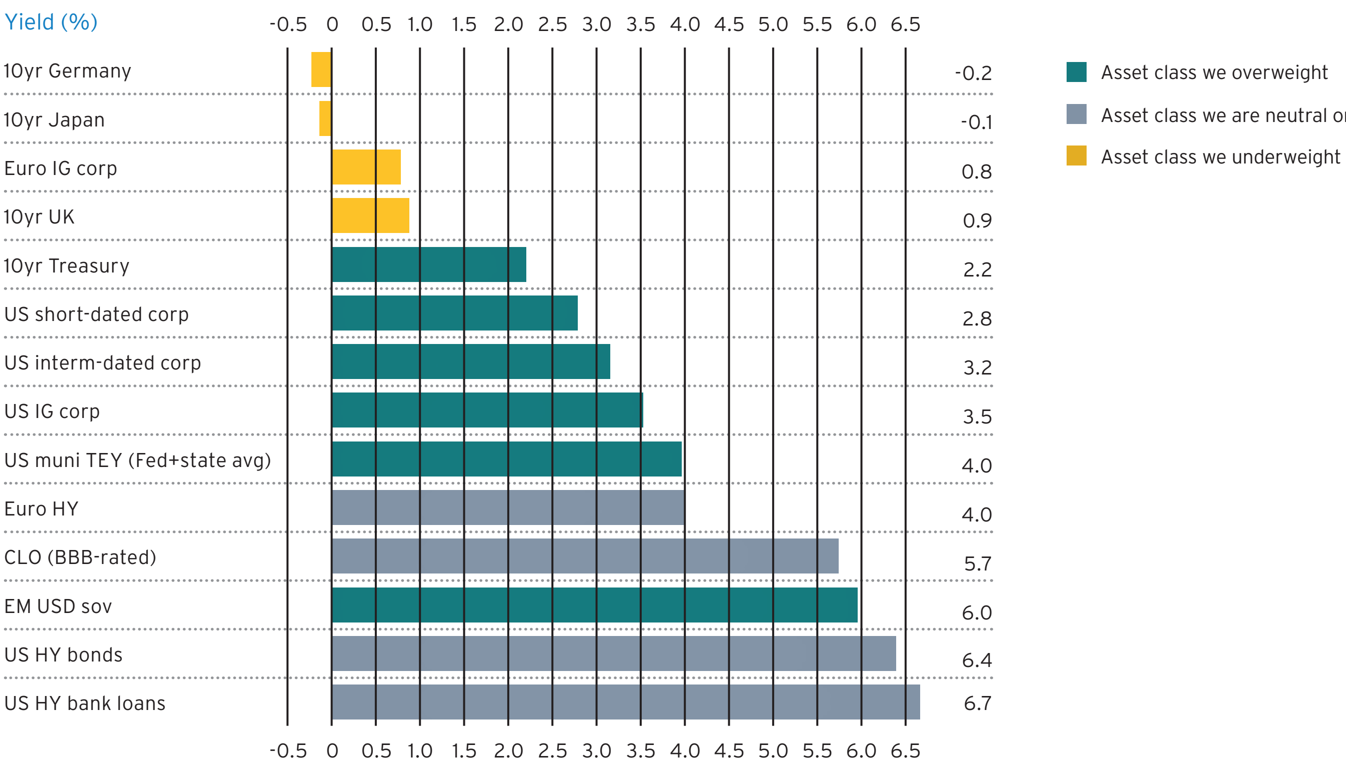
## How to position portfolios: Improving returns and limiting losses

With reduced risks of a new economic downturn, global markets have recovered strongly in the first half of 2019. Equities have posted double-digit returns, while there have been sharp improvements in credit markets. Notably, this came after a valuation decline of some 25% in 2018 that has only been half-reversed. Yet having captured much of these unusual gains, we have now unwound our tactical asset allocation shift.

Despite a new all-time high in US equities in April, neither positioning nor sentiment reached levels that accompanied last year's peak. Many investors are clearly still apprehensive, which could provide a supportive environment for further gains, following a traditional summer correction.

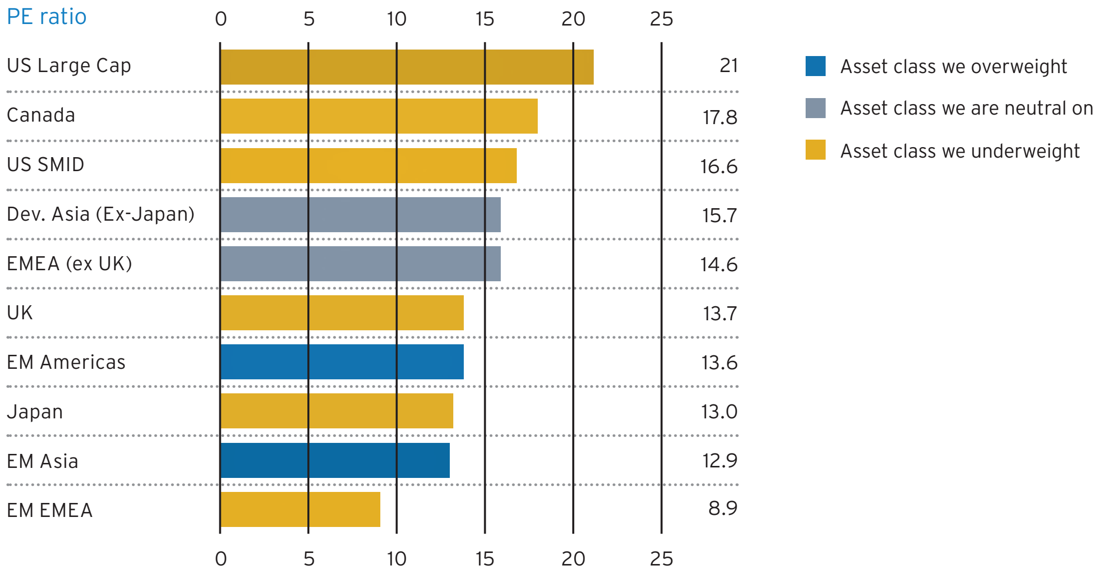
As we noted, trade developments – one of the two issues that dogged markets in 2018 – are key. As markets fall, they create capacity for higher future returns. From current levels, however, we can only expect more normal total returns than those seen in the first four months of 2019. In global equities, for example, we look for mid- to high- single-digit returns. Wide trading ranges, significant variability by country and sector, and often-sharp reactions to political headlines all seem likely. Although we have lately reduced our tactical equity overweight, we could still envisage increasing it again even before the end of the present cycle, if the conditions appeared right.

**FIGURE 7. GLOBAL FIXED INCOME YIELDS**




Source: The Yield Book, as of 28 May 2019. Past performance is no guarantee of future returns. Real results may vary.

FIGURE 8. GLOBAL EQUITY VALUATIONS




Source: Citi Research, Worldscope, MSCI, Factset, as of 28 May 2019. 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. All forecasts are expressions of opinion and are subject to change without notice and are not intended to be a guarantee of future events.



With a sharp 'flight to quality' rally, global fixed income returns should slow. We expect a total return of 2% across all regions and different types of credits – see **figure 1** in **When might EMs outperform again**. Besides outperformance, we expect our fixed income overweights to do the more important job of dampening overall portfolio risk and volatility.

In January 2019, we raised global fixed income from an underweight to a neutral or 'full' weighting, for the first time since 2012, and then went overweight in early June. The largest portion of our fixed income overweight remains in bonds we see as cash alternatives. These include short-to-intermediate US Treasuries, investment grade US corporates, and US municipals, all of whose yields have risen thanks to the Fed's nine rate hikes that are unlikely to be reversed this year.

Having eliminated our tactical cash weighting entirely to buy equities and fixed income in January, we have raised our allocation from maximum underweight to 0.5% overweight.

We believe that our diversification and particular overweights can help improve portfolio returns and limit losses for the rest of 2019. We continue to urge creating globally diversified core portfolios while warning against attempts to time the markets – see **How we do what we do**. In the focus piece that follows, we examine the performance of our thematic recommendations and reiterate their ongoing relevance, especially our message of safeguarding assets - see **Reviewing and reiterating our themes**.

*Joe Fiorica and Malcolm Spittler contributed to this article.*

# When might emerging markets outperform again?

The US and other developed market (DM) economies have used extraordinary 'quantitative easing' (QE) policies to provide stimulus over the past decade, with varying degrees of success. The US has experienced the strongest economic and market recovery, with the Eurozone, UK, and Japan economies lagging behind materially. By contrast, no emerging market (EM) central banks pursued QE. EM asset prices and valuations have not risen nearly as much as those in developed markets – **figure 1**. So, what might happen around an eventual recession where developed market central banks cut rates and perhaps pursue QE once more?

We believe that relatively modest EM asset valuations set the stage for their long-term outperformance. Our valuation-based strategic asset allocation methodology points to EM equities producing an annualized return of 11.4% over the coming decade, compared to 5.3% for DM equities.

And, we think that renewed DM monetary easing could provide the trigger for that outperformance to begin. Combined with large US budget deficits, a future Fed rate-cutting cycle that continued well after a US recession could subsequently drive EM equities, fixed income, and currencies higher.

However, we envisage the most significant EM outperformance occurring after a future period of US economic weakness. At that time, we expect the Fed still to be easing monetary policy despite an early-stage recovery being underway, given the US central bank's tendency to lag behind the economic cycle. It will be around then, therefore, that we will probably have our largest tactical overweights to EMs over DMs in our allocations. Until then, we see EM performance as being subject to setbacks. Therefore, we maintain only a modest tactical overweight to EM assets at this time. However, we emphasize that the coming decade is likely to be much more generous to EMs than the last one was.

FIGURE 1. GLOBAL EQUITY AND FIXED INCOME RETURNS

| | EQUITY | | | | FIXED INCOME | | | |
|---|---|---|---|---|---|---|---|---|
| Cumulative returns | S&P 500 | MSCI EM | MSCI DM Ex US | Stoxx 600 | Global aggregate | US aggregate | EM USD sovereign | US High Yield |
| 1-Year | 2.7% | -14.0% | -7.7% | 1.1% | -1.1% | 3.5% | 2.6% | 4.8% |
| 3-Year | 40.0% | 30.5% | 13.9% | 11.8% | 5.6% | 6.0% | 16.0% | 27.6% |
| 5-Year | 53.3% | 11.8% | -0.1% | 18.3% | 3.8% | 12.7% | 28.3% | 25.6% |
| 10-Year | 273.1% | 98.5% | 90.1% | 126.1% | 36.0% | 44.4% | 128.8% | 202.0% |

Global aggregate: Bloomberg Barclays Global Aggregate Index; US aggregate: Bloomberg Barclays US Aggregate Bond Index; EM USD sovereign: Citi Emerging Market Sovereign Bond Index (ESBI); See Glossary for definitions.

Source: Haver and Citi Private Bank, as of 17 May 2019. Past performance is no guarantee of future results. 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.

# Reviewing and reiterating our 2019 themes

As we prepared **Outlook 2019** last autumn, we were concerned about various risks, particularly the advanced stage of US monetary tightening. We therefore stressed both tactical portfolio positioning and longer-term investment themes that addressed these concerns. We had no idea quite how timely our advice would be. As we published **Outlook 2019** on 5 December, US equities were entering their worst final month of the year since 1931, during the Great Depression.

In our **Safeguarding assets** theme, we argued that although global growth was likely to endure throughout 2019, it was also time to safeguard assets. Among other actions, we recommended building globally diversified portfolios and strategies for creating intelligent exposure to a late-stage bull market. As we pointed out, the cost of equity hedges had plunged during the decade-long recovery to date. Within a month of our publishing **Outlook 2019**, the cost and value of hedging against a 10% or larger equity decline rose by more than 200%. With volatility since having declined, we re-emphasize the case for exploring equity hedges again, as well as global diversification and prudent use of leverage in core portfolios.

**Make your cash work much harder** recommended putting more portfolio cash to work in income-seeking investments. Doing so can potentially enhance returns, preserve wealth, meet periodic liquidity requirements, and improve portfolio diversification. Given the Fed's then forecast of further interest rate hikes, we liked floating rate loans. We continue to find them attractive, given the relatively high level of US policy rates. That said, returns may now be somewhat less robust than if the Fed had been able to raise rates as it had planned. US floating rate notes seem excessively discounted at the moment. Rates range from 6.7% on lower quality short-to-medium duration US dollar denominated instruments to 3.3% for the highest quality. And this is just one of the ongoing opportunities we see to earn potentially better returns on excess portfolio liquidity than are available in cash.

**Unstoppable trends** focused on various powerful forces that are transforming the world around us. We believe that the rise of Asia, increasing longevity, and digital disruption have implications for your wealth. Investments related to digital disruptors have since performed strongly, while those associated with longevity – principally in healthcare – have done less so. Although our themes are concerned with longer-term performance, we think the relative performance of digital disruptors and healthcare could change in the second half of 2019. We believe the long-term case for emerging Asia remains intact, even if we have recently reduced the scope of our short-term tactical overweight following the strong first-half performance – see **When might emerging markets outperform again?**

### 1 MAKE YOUR CASH WORK MUCH HARDER

**Fixed income allocation return over cash YTD: +2.7%**

### 2 SAFEGUARDING ASSETS

EQUITY HEDGE

**S&P VIX: +74% 5 Dec to 24 Dec**

RAISE PORTFOLIO QUALITY

**US large cap/small cap to date since 5 Dec: +3%**

### 3 UNSTOPPABLE TRENDS

THE RISE OF ASIA

**EM Asia return: +7.6%**
**China: +12.9%** YTD in USD

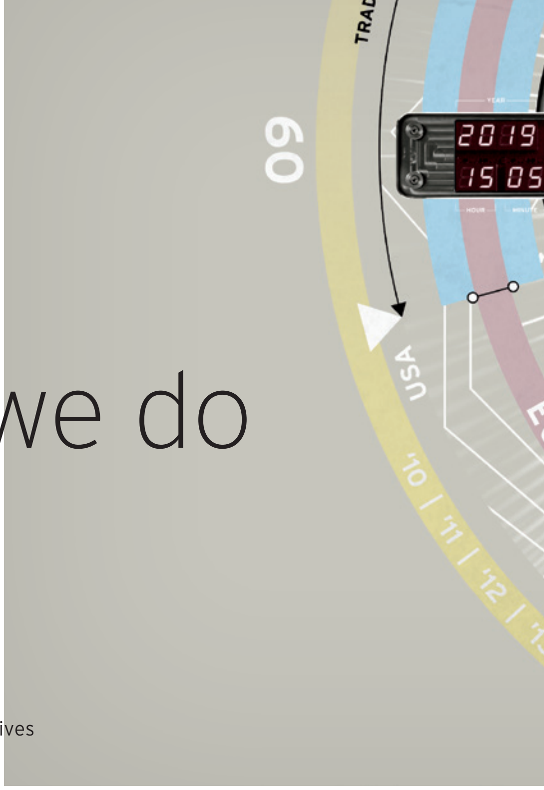
INCREASING LONGEVITY

**Global healthcare YTD return: +4.7%**

DIGITAL DISRUPTION

**Software return YTD: +21.5%**
**Semiconductors: +16.3%**
**FANG+ Index return YTD: +20.3%**

Source: Haver Analytics as of 13 May 2019. The FANG+ Index consists of Facebook, Apple, Amazon, Netflix, Alphabet, Alibaba, Baidu, Nvidia, Tesla, Twitter. 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.




# How we do what we do

**Steven Wieting** Chief Investment Strategist and Chief Economist
**Gregory van Inwegen** Global Head of Quantitative Research and Asset Allocation, Citi Investment Management
**Rob Jasminski** Co-Head of Citi Investment Management
**Ray Joseph** Co-Head of Citi Investment Management
**Dan O'Donnell** Global Head of Citi Investment Management Alternatives

Our investment process helps you implement the same vital disciplines that the world's most successful investors follow in their core portfolios.



What separates the most successful investors from those who consistently suffer sub-par returns and take unnecessary risks? Based on our long experience of serving the world's wealthiest families, Citi Private Bank believes that the answer lies in discipline. Specifically, we find that the most successful investors are those who follow the discipline of building a globally diversified multi-asset class core portfolio, which they hold for the long term and rebalance regularly – see **Invest wisely as uncertainty grows: A call to action** Our investment process therefore embeds this vital discipline throughout. Here, we explain how we do what we do – and why it is just as essential for you.

## Creating a robust plan for you

Building a disciplined core investment portfolio begins with a robust long-term investment plan. Based on your return goals, risk tolerance, and other criteria, we determine the appropriate mix of asset classes from around the world specifically for you. **Figure 1** shows a recent example of such a globally diversified multi-asset class allocation. As well as equities and fixed income, it contains hedge funds, private equity, and real estate, with the potential to add cash and commodities. Besides exposure to particular asset classes, countries, and industries, we also advocate emphasizing certain investment themes – see our **Reviewing and reiterating our 2019 themes**.

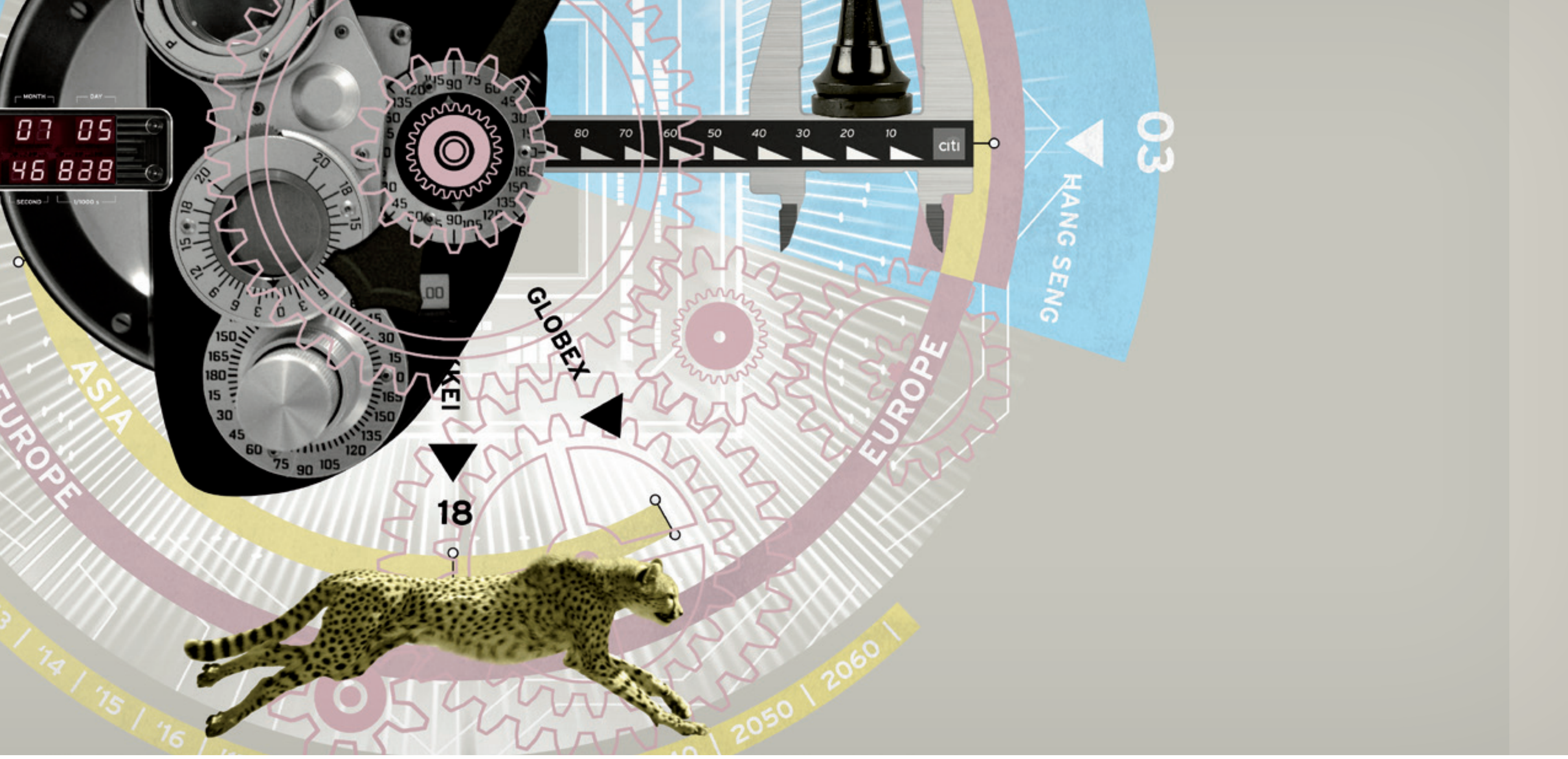
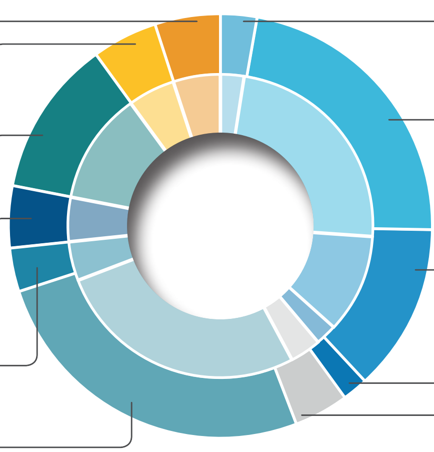



FIGURE 1. GLOBAL MULTI-ASSET CLASS DIVERSIFICATION IN ACTION

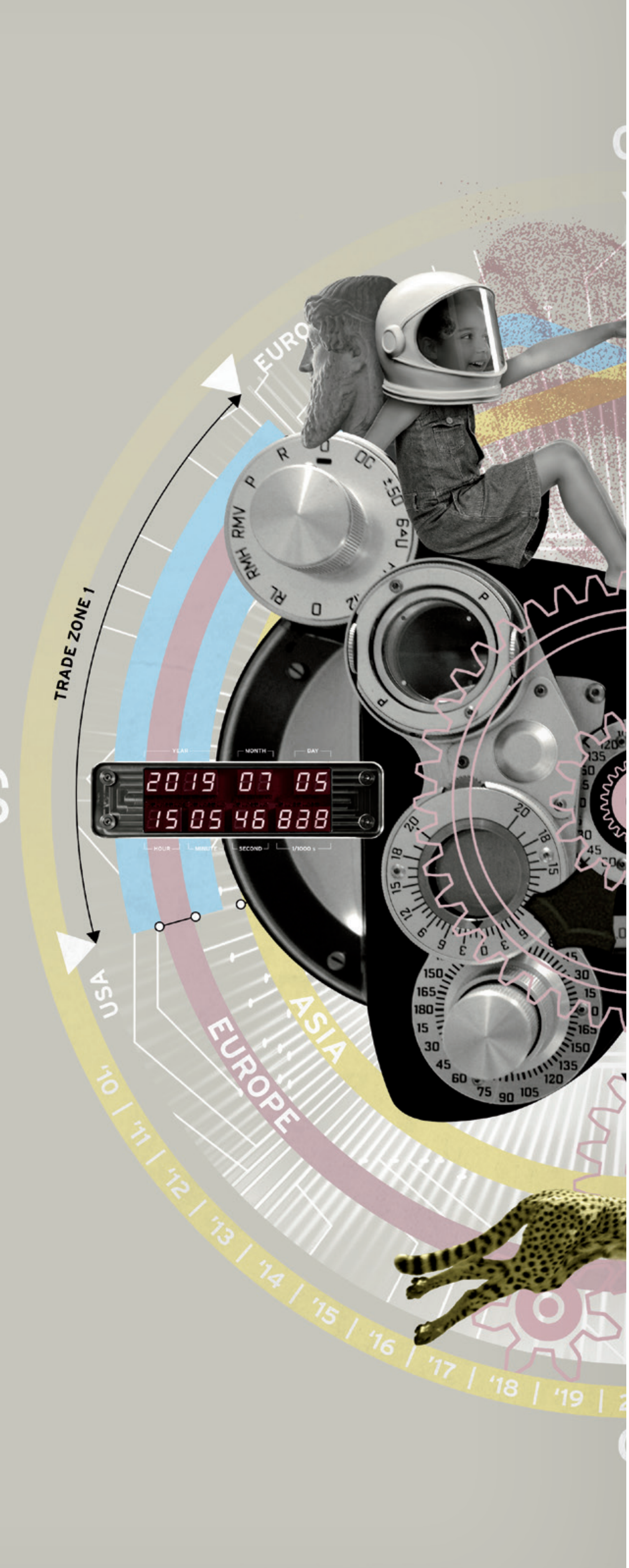
Strategic Asset Allocation (inner wheel)
Tactical Asset Allocation (outer wheel)



| | Tactical allocation | Active weight |
|---|---|---|
| REAL ESTATE | 5.0% | +0.0% |
| PRIVATE EQUITY | 5.0% | +0.0% |
| HEDGE FUNDS | 11.8% | +0.0% |
| EMERGING ALL CAP EQUITIES | 4.7% | +0.1% |
| DEVELOPED SMALL/ MID CAP EQUITIES | 4.1% | -0.7% |
| DEVELOPED LARGE CAP EQUITIES | 27.0% | -1.4% |
| COMMODITIES | 0.0% | +0.0% |
| CASH | 2.5% | +0.5% |
| DEVELOPED NATIONAL, SUPRANATIONAL, AND REGIONAL | 23.7% | -1.4% |
| DEVELOPED CORPORATE INVESTMENT GRADE | 10.7% | +2.1% |
| DEVELOPED HIGH YIELD | 2.0% | +0.0% |
| EMERGING MARKET DEBT | 3.4% | +0.9% |

NOTE: **Active weight** is the difference between tactical (outer wheel) and strategic (inner wheel) allocations.

Global USD allocation with Hedge Funds and 10% illiquids (PE & RE): Risk Level 3 - Tactical Allocations. Source: Global Asset Allocation team, Citi Private Bank. Figures in brackets are GIC active allocations as of 3 Jun 2019. All allocations are subject to change at discretion of the GIC of Citi Private Bank.




## Allocating more to cheaper asset classes

We determine an appropriate allocation for your core portfolio in a distinctive way. Our proprietary methodology – Adaptive Valuation Strategies (AVS) – estimates future asset class returns based on current valuations.[1] Our analysis going back many decades shows that higher returns typically follow lower valuations and lower returns tend to follow higher valuations. **Figure 2** highlights this relationship for the S&P 500 Index, where valuations are currently high by past standards. By contrast, emerging market equities' modest valuations today suggest more robust returns over the coming decade.

Having estimated future returns based on current valuations, AVS then typically recommends larger allocations to asset classes with higher return estimates and smaller allocations to those with lower return estimates. By contrast, many other institutions naively extrapolate future returns from past averages when they create allocations. However, this assumption all too easily comes unstuck when asset classes are over- or under-valued. This can result in making inappropriately large and small allocations to over- and under-valued asset classes respectively. Subsequent portfolio performance may therefore suffer.

[1] Adaptive Valuation Strategies: A New Approach to Strategic Asset Allocation 2019 Annual Update, https://www.privatebank.citigroup.net/investments/AVS_Annual_full.pdf

Our analysis going back many decades shows that higher returns typically follow lower valuations and lower returns typically follow higher valuations.

FIGURE 2. VALUATIONS FORECAST LONG-TERM RETURNS

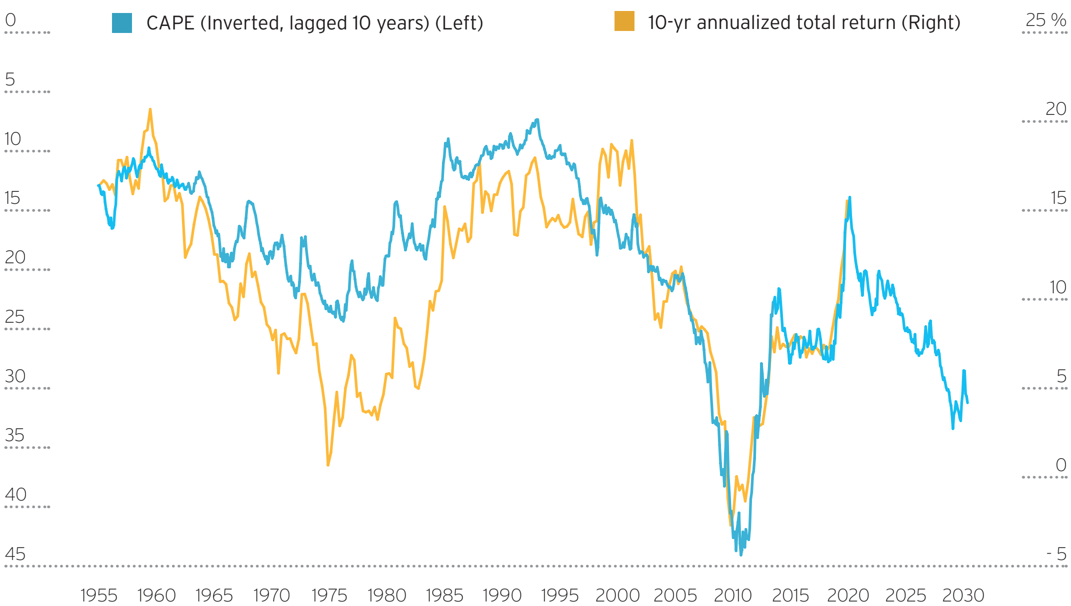



Chart shows cyclically-adjusted price to earnings valuation for the S&P 500 Index today shifted ten years forwards as well as subsequent total annualized returns. The return is a rolling 10-year average. Source: Haver Analytics through 6 May 2019. Past performance is no guarantee of future returns. All forecasts are expressions of opinion and are subject to change without notice and are not intended to be a guarantee of future events. See glossary for definitions.

## Enhancing your long-term returns

We believe that the case for disciplined global multi-asset class core portfolios could not be clearer. Over the last seven decades, such an allocation would have produced an annualized return before fees of 10.5% at an asset class level – **figure 3**. By contrast, an allocation consisting only of equities and fixed income from the best-performing market – the US – would have returned 9.2%. A US-only allocation of equities and fixed income allocation with a 30% cash weighting would have returned just 7.9% a year. A global allocation has also performed more consistently than any individual asset class over time, ranking in the top half of the returns table in every decade – **figure 4**.

Despite such compelling evidence, we frequently encounter clients who shun global multi-asset class diversification in their core portfolios. Instead, they insist upon skewing their holdings to one or two asset classes and/or countries, often including a large weighting in cash. Rejecting the discipline of a globally diversified approach can have profound effects upon a family's level of wealth over time. A $1m investment in a cash-heavy allocation would have become $163.2m between 1952 and 2018, compared to $782.0m for a global asset allocation.



FIGURE 3. GLOBAL ALLOCATIONS VS NARROW ALLOCATIONS

| ALLOCATION | ANNUALIZED RETURN (%) | ANNUALIZED VOLATILITY (%) | RISK-ADJUSTED RETURN |
|---|---|---|---|
| GLOBAL MULTI-ASSET CLASS | 10.5 | 7.7 | 1.363 |
| US-ONLY EQUITIES AND FIXED INCOME | 9.2 | 9.4 | 0.978 |
| US-ONLY EQUITY & FIXED INCOME, WITH 30% CASH | 7.9 | 6.6 | 1.197 |

Source: Global Asset Allocation team, Citi Private Bank, as of 31 Dec 2018. The Global US Dollar allocation represents a AVS Risk Level 3, including allocations to equities, fixed income, commodities, cash and hedge funds. Risk levels are an indication of clients' appetite for risk. Risk Level 3 – Seeks modest capital appreciation and, secondly capital preservation. These returns were calculated at an asset class level using indices and do not reflect fees, which would have reduced the performance shown. Past performance is no guarantee of future returns. Real results may vary.

FIGURE 4. GLOBAL ALLOCATIONS VS INDIVIDUAL ASSET CLASS RETURNS

| 1950s (%) | 1960s (%) | 1970s (%) | 1980s (%) | 1990s (%) | 2000s (%) | 2010s (%) | Avg 10-Year Return (%) | Risk-adjusted return* |
|---|---|---|---|---|---|---|---|---|
| World ex-US Equities 20.8 | US Small Caps 15.5 | "EM Govt USD Bond 14.4 | World ex-US Equities 22.8 | US Equities 18.2 | EM Govt USD Bond 12.9 | US Equities 12.5 | US Small Caps 11.9 | Asset Allocation 0.52 |
| US Equities 19.3 | US Equities 7.8 | US Small Caps 11.5 | US Equities 17.5 | US Small Caps 11.6 | G7 Govt Bond 6.4 | US Small Caps 9.5 | US Equities 11.4 | US Equities 0.48 |
| US Small Caps 16.9 | Asset Allocation 5.4 | World ex-US Equities 10.1 | Asset Allocation 17.4 | Asset Allocation 11.0 | US Investment Grade 6.4 | Asset Allocation 6.9 | World ex-US Equities 10.3 | EM Govt USD Bond 0.42 |
| Asset Allocation 12.1 | World ex -US Equities 5.1 | Asset Allocation 8.0 | US Small Caps 15.8 | G7 Govt Bond 8.0 | Asset Allocation 3.4 | EM Govt USD Bond 5.9 | Asset Allocation 9.2 | US Small Caps 0.37 |
| EM Govt USD Bond 5.3 | Cash 4.1 | Cash 6.5 | US Investment Grade 12.8 | US Investment Grade 8.0 | Cash 2.7 | World ex-US Equities 4.6 | EM Govt USD Bond 8.0 | World ex-US Equities 0.36 |
| Cash 2.0 | EM Govt USD Bond 3.5 | US Investment Grade 6.1 | G7 Govt Bond 12.8 | EM Govt USD Bond 7.7 | US Small Caps 2.2 | G7 Govt Bond 3.6 | G7 Govt Bond 5.7 | G7 Govt Bond 0.17 |
| G7 Govt Bond 0.4 | US Investment Grade 2.4 | G7 Govt Bond 6.1 | Cash 9.1 | World ex-US Equities 7.3 | World ex-US Equities 1.6 | US Investment Grade 3.4 | US Investment Grade 5.6 | US Investment Grade 0.17 |
| US Investment Grade 0.4 | G7 Govt Bond 2.4 | US Equities 5.8 | EM Govt USD Bond 6.4 | Cash 5.0 | US Equities -0.9 | Cash 0.4 | Cash 4.3 | |



Source: Factset and Citi Private Bank, Global Asset Allocation team as of 6 May 2019. Adaptive Valuation Strategies (AVS) is the Private Bank's proprietary strategic asset allocation methodology. 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. "Asset allocation" in this diagram represents an AVS Risk Level 3 allocation, which includes allocations to equities, fixed income, commodities, cash and hedge funds. Risk levels are an indication of clients' appetite for risk. Risk Level 3 – Seeks modest capital appreciation and, secondly capital preservation. The returns shown were calculated at an asset class level using indices and do not reflect fees, which would have reduced the performance shown. Risk-adjusted return is defined here as the Sharpe ratio. See glossary for definition of terms.

FIGURE 5. GLOBAL HAS DONE BETTER IN REGIONAL CRISES

| REGIONAL CRISIS | RETURN DURING FIRST YEAR OF CRISIS (%) | |
|---|---|---|
| ASIAN CRISIS, 1997 | ASIA<br>-28.3 | GLOBAL<br>15.0 |
| LATAM CRISIS, 1998 | LATAM<br>-35.1 | GLOBAL<br>22.0 |
| EU CRISIS, 2011-2013 | EUROPE<br>-10.5 | GLOBAL<br>-6.9 |
| COMMODITY COLLAPSE, 2015 | LATAM<br>-30.8 | GLOBAL<br>-1.8 |
| US-CHINA TRADE WAR | CHINA<br>-18.7 | GLOBAL<br>-8.9 |

Average Difference 28.6 percentage points. Source: Haver Analytics through 6 May 2019. Past performance is no guarantee of future returns. When determining an allocation for your core portfolio, we focus upon the risk of simultaneous heavy losses across asset classes that could occur in a crisis. To do so, we look back at asset class performance over many decades, including many crises. Our methodology then sets a maximum allocation to each asset class based on its worst losses throughout history, as well as reflecting your own risk tolerance. This contrasts again with methodologies that only look back at recent decades and therefore exclude many of history's worst crises.



## Mitigating your risks

As well as enhancing returns, global diversification has been the single most effective means of mitigating core portfolio risk over time. In our study, a global allocation was less volatile and produced a higher risk-adjusted return than a US-only allocation – **figure 3**. We also stress the value of global allocations for preserving your wealth during the crises that periodically strike individual regions of the world. For example, global equities have outperformed those of the affected region in each of the last five regional crises that we examined – **figure 5**.

## Implementing our advice for you

Having created a long-term plan for you, we work with you to implement it in your core portfolio. We present you with opportunities from around the world, consisting of managed investments, individual securities, and capital markets strategies. (See focus - **Systematically selecting alternative asset investments**.)

We encourage full investment at the earliest opportunity and then staying fully invested for the long-term. Sitting in cash and awaiting a more favorable entry-point typically results in foregoing compound returns over time. Likewise, we advise strongly against trying to switch between risk assets and cash in an attempt to catch market uptrends and avoid downtrends. Such market timing risks missing out on the market's best days over time. Missing the stock market's twenty best days each decade would have had a devastating impact on long-term returns – **figure 6**.

If you are concerned about the risk of market declines, we advocate using certain capital market strategies that offer exposure to market upside while seeking to protect against downside.

Despite our best efforts, not all clients follow our advice in a disciplined way. In the aftermath of the Global Financial Crisis of 2008-09, equity valuations worldwide signaled robust subsequent returns. However, some clients continued to shun equity exposure for some years after the crisis passed, even as markets rallied strongly. More recently, we have seen numerous cases of clients retaining excessive cash balances. Such clients most often tell us that they have hopes of buying risk assets at cheaper prices at some unknown point in the future.

## We bought equities and credit in January. Did you?

Citi Private Bank's discretionary managers play a vital role in implementing discipline in many clients' core portfolios. Having put each client's long-term plan into action, they subsequently rebalance and rotate portfolios systematically over time. By late 2018, for example, US and global equities had suffered peak-to-trough declines of roughly 20%, causing equity allocations to drift below target levels.

Our discretionary managers thus rebalanced holdings by adding more equities. In early 2019, they also implemented the tactical recommendation of our Global Investment Committee (GIC) to use our entire tactical cash holdings to add to equity and credit holdings. The GIC based its decision partly on its six-decade analysis of buying US equities after 20% declines, with subsequent median one- and two-year year returns of 23% and 33% respectively. In keeping with the historical tendency, global equities indeed went on to register double-digit returns in the first four months of 2019 – see **Flying just above the danger zone** – and the GIC has since reversed its equity overweight.

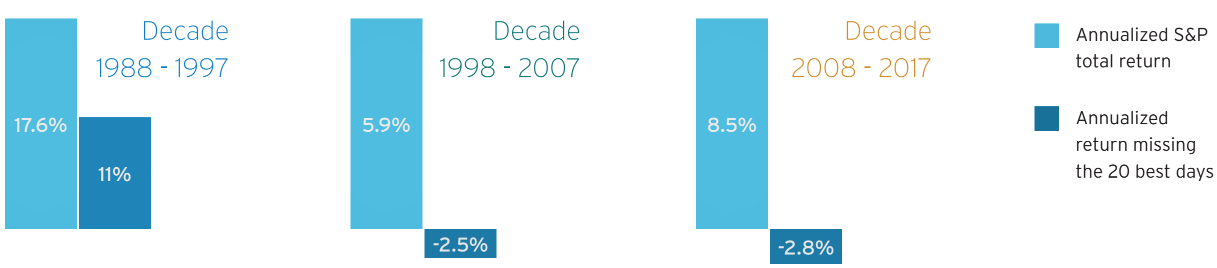
## Add more discipline to your core portfolio now

Does your core portfolio reflect all of the vital disciplines practiced by successful investors? To find out, we urge you to request your very own Outlook Watchlist report at regular intervals from now on. This report will set out how closely your holdings reflect the long-term allocation we created for you, as well as the tactical adjustments of the GIC. Your Investment Counselor will then suggest ways to align your portfolio with the plan. If you haven't done so already, we also recommend you consider creating an opportunistic portfolio to complement your core portfolio. Following these disciplines could offer long-lasting benefits to your wealth.

*Joe Fiorica contributed to this article.*



FIGURE 6. MISSING THE US EQUITY MARKET'S TWENTY BEST DAYS EACH DECADE




Source: Bloomberg, Citi Private Bank Global Investment Lab as of 31 Oct 2018. The historical performance on an asset class level based on historical index performance and is gross of any commissions, expense ratios, margin costs, or fees that would reduce the return illustrated. 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.

FOCUS | 3

# Systematically selecting alternative asset investments

Alternative asset classes – private equity, real estate, and hedge funds – can potentially provide various benefits to core portfolios. These include potentially enhancing returns and adding further diversification. The Citi Investment Management Alternatives (CIM Alternatives) team seeks to originate relevant and timely investment opportunities across these asset classes. Its approach is based on research and driven by investment themes.

To identify investment themes, the CIM Alternatives team draws upon the work of the Private Bank's Global Investment Committee. The team examines influential long-term forces across the economy, markets, politics, regulation, and more. Specifically, it looks for investable secular trends, market aberrations that might be exploited, and potential pitfalls to be avoided. Based on its findings, the team quantitatively and qualitatively researches strategies from experienced managers. It then works with those managers who pass the rigorous selection criteria to offer bespoke investment vehicles to clients. As well as holdings for core portfolios, the team highlights timely possibilities for opportunistic portfolios.

# Intelligent opportunities for your portfolio

**Iain Armitage** Global Head of Capital Markets
**Rob Jasminski** Co-Head of Citi Investment Management

In today's late-cycle environment, we see opportunities for potentially enhancing your portfolio's risk-return characteristics.

Build a globally diversified core portfolio and then keep it fully invested for the long term. This simple but critical piece of advice has been valuable for decades. That said, buy-and-hold strategies can be enhanced prudently. Portfolio quality should increase with uncertainty and the age of market cycles. And, just as one owns insurance for unforeseen events, there are opportunities to change the risk-return dynamics of portfolios. The right mix of strategies may well vary according to the stage of the cycle. Given today's late-cycle environment, here are three strategies that we believe may help limit your core portfolio's losses rather than its returns.

## Seek upside, hedge downside risk

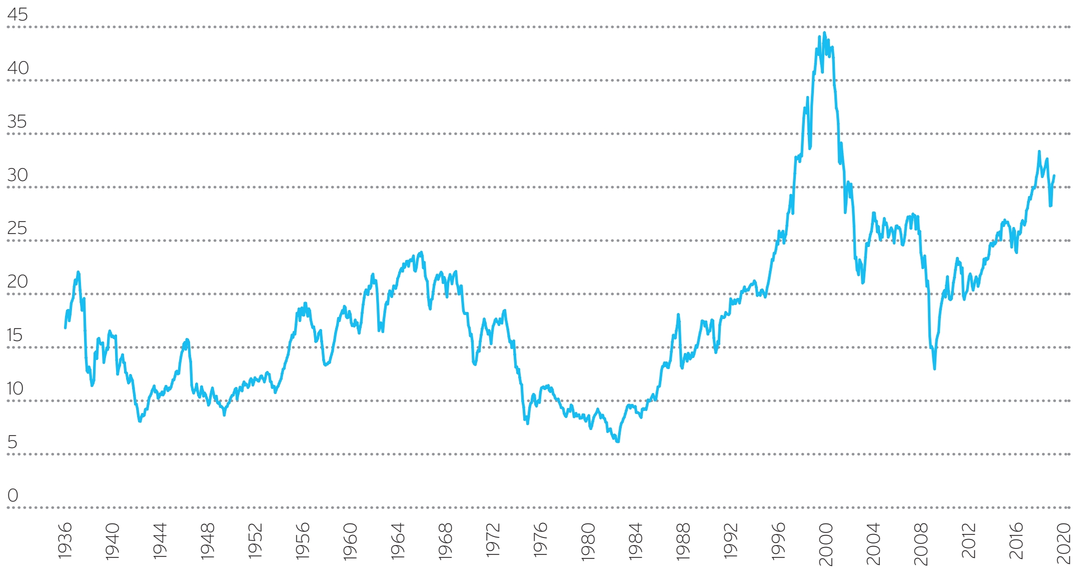
We remain fully invested in global equities – see **Flying just above the danger zone**. While we believe that the upside can continue through 2019 and into 2020 if trade risks are contained, we also accept that the next downturn could arrive sooner than we expect. For investors who are concerned about the risk of another equity sell-off such as we saw in the last quarter of 2018 – or worse – we would suggest capital markets strategies that provide upside exposure while simultaneously protecting against downside.

Let's say you share our view that the S&P 500 Index's ten-year bull market is likely to extend into 2020. However, you also believe that high valuations – see **figure 1** on the next page – leave your S&P 500 equities vulnerable to shocks. You could therefore pay to enter into a hedging strategy that would provide you with a return if the index has fallen below a certain level in six months' time.

If your concerns prove correct and the index drops through the stated level, the return you receive at maturity from the strategy helps offset the decline in your equity holdings. If the market has instead risen by the end of the strategy's lifetime, however, your equities will have gained in value, although you forfeit the cost paid to enter the strategy.

You can even adjust the terms of such a hedging strategy after you enter it. Say the S&P 500 has risen by 10% three months into your six-month strategy. You are keen

FIGURE 1. S&P 500 CAPE




*CAPE stands for Cyclically Adjusted Price to Earnings, and is defined as: Current price/10-year average EPS. Indices all from S&P 500. 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.



to remain exposed to further potential gains but also protect the gains just made by raising the level set for your hedge. For a relatively small additional cost paid at the outset, you can retain the right to change the terms of the hedging strategy by raising the level that the S&P 500 has to fall below in order for you to receive a return.

Not only might this strategy make sense in the present environment, you can enter it relatively cheaply today. However, this would likely change if markets began to decline. Hedging against future downside risk is most effective in calmer times.

Note: Options involve risk and are not suitable for all investors. If your portfolio is not strongly aligned to the S&P 500 Index you will have correlation risk. Fees and expenses will have an impact on the strategy and should be considered. Please see page 44 for the link to the Options Risk Disclosure document for additional risks.

## Defensive exposure to range-bound markets

Rather than trending strongly higher or entering a bear market, equities might also remain in a broad range for some time. Capital markets strategies exist that can seek returns from the market either moving modestly upwards or downwards while protecting against deeper downside.

One such strategy would gain in value if your chosen equity benchmark rose or fell up to certain levels over the next two years. For example, if developed equities either rose as much as 12% or fell by as much as 18%, the strategy would pay a positive return of the same amount at maturity. In other words, you could profit from either mild upside or downside in equities over a two-year horizon.

There are various alternative approaches to implementing this strategy. A number of risks could apply depending upon the implementation approach chosen.

## Diversified exposure to secular growth

We believe that your core portfolio should have exposure to the multi-year investment themes that we identify each year. Our themes focus upon long-term forces that we think will transform society, the economy, industries, and businesses. These forces include increasing human longevity, environmental change, technological disruption, and shifts in global economic power – see **Reviewing and reiterating our themes** in **Flying just above the danger zone**. We believe that these forces are likely to persist throughout economic and market cycles, providing your portfolio with a potential source of secular growth.

Our themes can be implemented in various ways, such as buying individual equities and thematic baskets – see **Harness the power of Global Thematic Equity Recommendations**. However, we believe that actively managed, globally diversified strategies targeting equities across several of our themes offer efficient exposure for today's late-cycle conditions and beyond.

Careful equity selection may contribute to higher risk-adjusted returns across an entire economic cycle. Some active managers may have the ability to mitigate risk during difficult conditions, perhaps by improving the quality of the strategy's holdings. Diversification across themes, sectors, and geographies should also help to mitigate overall risk. However, such diversification will not eliminate the risks from falling equity markets, individual companies suffering financial distress, and weakening foreign currencies.

## Customizing strategies to your portfolio

Citi Private Bank believes that the strategies discussed here can provide intelligent exposure to risk assets in today's late-cycle conditions and beyond. You can use them even more intelligently, however, by customizing them to your own core portfolio. For example, you can adjust the terms of a capital markets strategy to reflect your specific needs, including the markets involved, the strategy's lifetime, and the degree of upside participation and protection. Likewise, it may be possible to construct active multi-thematic strategies that reflect areas of particular importance to you, such as income or ethical concerns. If you would like to explore opportunities to create intelligent exposure in your portfolio, your Investment Counselor stands ready to assist.

*Ben Garrity contributed to this article.*

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## Harness the power of Global Thematic Equity Recommendations

What are some of the key forces that could shape your wealth over the coming years and decades? To help you answer this question, Citi Private Bank every year produces a set of investment themes, which appear in our Outlook publication. These themes represent our latest thinking about some important long-term drivers of change in the world around us.

In 2019, for example, we have focused on the shift of economic power towards Asia, the aging of the global population, and how digital technologies are transforming business. In a new monthly publication, Global Thematic Equity Recommendations, we aim to identify sub-themes and individual opportunities that offer exposure to our themes.

In this publication Citi Private Bank's strategists screen for individual equities that offer exposure to each of our themes, drawing upon the insights of Citi Research's award-winning institutional equity analysts combined with rigorous quantitative screening. As well as having substantial exposure to our themes, companies appearing in the screens all have a market capitalization over $1bn, upon which Citi Research has issued 'buy' ratings.

By bringing together Citi Private Bank strategists' preferred themes with Citi Research's coverage of over 3,500 stocks, you can get unique access to actionable thematic equity ideas through a variety of investment structures.

To receive Global Thematic Equity Recommendations and discuss implementation possibilities, please speak to your Investment Counselor.

*Wietse Nijenhuis contributed to this essay.*

# Glossary

## ASSET CLASS DEFINITIONS

**Cash** is represented by US 3-month Government Bond TR, measuring the US dollar-denominated active 3-Month, fixed-rate, nominal debt issues by the US Treasury.

**Commodities** asset class contains the index composites — GSCI Precious Metals Index, GSCI Energy Index, GSCI Industrial Metals Index, and GSCI Agricultural Index — measuring investment performance in different markets, namely precious metals (e.g., gold, silver), energy commodity (e.g., oil, coal), industrial metals (e.g., copper, iron ore), and agricultural commodity (i.e., soy, coffee) respectively. Reuters/Jeffries CRB Spot Price Index, the TR/CC CRB Excess Return Index, an arithmetic average of commodity futures prices with monthly rebalancing, is used for supplemental historical data.

**Global Developed Market Equity** is composed of MSCI indices capturing large-, mid- and small-cap representation across 23 individual developed-market countries, as weighted by the market capitalization of these countries. The composite covers approximately 95% of the free float-adjusted market capitalization in each country.

**Global Developed Investment Grade Fixed Income** is composed of Barclays indices capturing investment-grade debt from twenty different local currency markets. The composite includes fixed-rate treasury, government-related, and investment grade rated corporate and securitized bonds from the developed-market issuers. Local market indices for US, UK and Japan are used for supplemental historical data.

**Global Emerging Market Equity** is composed of MSCI indices capturing large- and mid cap representation across 24 individual emerging market countries. The composite covers approximately 85% of the free float-adjusted market capitalization in each country.

**Global Emerging Market Fixed Income** is composed of Barclays indices measuring performance of fixed-rate local currency emerging markets government debt for 19 different markets across Latin America, EMEA and Asia regions. iBoxx ABF China Govt. Bond, the Markit iBoxx ABF Index comprising local currency debt from China, is used for supplemental historical data.

**Hedge Funds** is composed of investment managers employing different investment styles as characterized by different sub categories – HFRI Equity Long/Short: Positions both long and short in primarily equity and equity derivative securities; HFRI Credit: Positions incorporate fixed income securities; HFRI Event Driven: Positions in companies currently or prospectively involved in wide variety of corporate transactions; HFRI Relative Value: Positions based on a valuation discrepancy between multiple securities; HFRI Multi Strategy: Positions based on realization of a spread between related yield instruments; HFRI Macro: Positions based on movements in underlying economic variables and their impact on different markets; Barclays Trader CTA Index: The composite performance of established programs (Commodity Trading Advisors) with more than four years of performance history.

**Private Equity** characteristics are driven by those for Developed Market Small Cap Equities, adjusted for illiquidity, sector concentration, and greater leverage.

**Real Estate** contains index contains all Equity REITs (US REITs and publicly-traded real estate companies) not designated as Timber REITs or Infrastructure REITs: NAREIT US REIT Index, NAREIT Canada REIT Index, NAREIT UK REIT Index, NAREIT Switzerland REIT Index, NAREIT Euro-zone REIT Index, NAREIT Japan REIT Index, NAREIT Hong Kong REIT Index, NAREIT Singapore REIT Index, NAREIT Australia REIT Index.

## INDEX DEFINITIONS

The **Bloomberg Barclays Global Aggregate Index** is a flagship measure of global investment grade debt from twenty-four local currency markets. This multi-currency benchmark includes treasury, government-related, corporate and securitized fixed-rate bonds from both developed and emerging markets issuers.

The **Bloomberg Barclays US Aggregate Bond Index** is a broad-based flagship benchmark that measures the investment grade, US dollar-denominated, fixed-rate taxable bond market. The index includes Treasuries, government-related and corporate securities, MBS (agency fixed-rate and hybrid ARM pass-throughs), ABS and CMBS (agency and non-agency).

The **Citi Emerging Market Sovereign Bond Index** includes Brady bonds and US dollar -denominated emerging market sovereign debt issued in the global, Yankee and Eurodollar markets, excluding loans. It is composed of debt in Africa, Asia, Europe and Latin America. We classify an emerging market as a sovereign with a maximum foreign debt rating of BBB+/Baa1 by S&P or Moody's. Defaulted issues are excluded.

The **Euro Stoxx 600** represents large, mid and small cap companies across 17 countries across Europe including: Austria, Belgium, Czech Republic, Denmark, Finland, Germany, Ireland, Italy, Luxembourg, the Netherlands, Norway, Portugal, Spain, Sweden, Switzerland and the United Kingdom.

The **MSCI All Country World Index** represents 48 developed and emerging equity markets. Index components are weighted by market capitalization.

The **MSCI AC Asia Index** captures large and mid cap representation across Developed Markets countries and Emerging Markets countries in Asia. With 967 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country.

The **MSCI Emerging Markets Index** captures large and mid cap representation across 24 Emerging Markets (EM) countries. With 845 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country.

The **MSCI World Index** represents the performance of more than 1,600 large- and mid-cap stocks across 23 developed markets countries. The index covers approximately 85% of the free float-adjusted market capitalization in each country

European equities are represented by the **MSCI Europe index**, which captures large- and mid-cap representation across 15 Developed Markets (DM) countries in Europe. It covers approximately 85% of the free float-adjusted market capitalization across the European Developed Markets equity universe.

The **S&P 500 Index** is a capitalization-weighted index that includes a representative sample of 500 leading companies in leading industries of the US economy. Although the S&P 500 focuses on the large cap segment of the market, with over 80% coverage of US equities, it is also an ideal proxy for the total market.

**Uncertainty indices** are derived using terms from over 2,000 US newspapers by scanning for language stressing uncertainty around various policy event types. "Non-trade" is a simple average of the following separate indices: Monetary Policy, Fiscal Policy, Taxes, Government Spending, Healthcare, National Security, Entitlements, Regulation, Financial Regulation, Debt and Currency issues.

## OTHER TERMINOLOGY

**Correlation** is a statistical measure of how two assets or asset classes move in relation to one another. Correlation is measured on a scale of 1 to -1. A correlation of 1 implies perfect positive correlation, meaning that two assets or asset classes move in the same direction all of the time. A correlation of -1 implies perfect negative correlation, such that two assets or asset classes move in the opposite direction to each other all the time. A correlation of 0 implies zero correlation, such that there is no relationship between the movements in the two over time.

**Sharpe ratio** is a measure of risk-adjusted return, expressed as excess return per unit of deviation, typically referred to as risk.

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MID-YEAR

# OUTLOOK 2019

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