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Citi Global Wealth Investments

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In Our Future

10% Growth, 5% Inflation, 1.5% Yields
Why Green is Still Unstoppable

David Bailin, Chief Investment Officer and Global Head of Investments
Steven Wieting, Chief Investment Strategist & Chief Economist
Malcolm Spittler, Global Investment Strategy
Joseph Fiorica, Head - Global Equity Strategy
Harlin Singh, Global Head of Sustainable Investing

Market Action Summary

- The US bond market has absorbed a mountain of bearish news with a surge in 1H economic growth, the highest core inflation rate in 30 years and the Fed preparing markets for an end to bond purchases. Year-to-date job growth has averaged 480,000. Record high unfilled job openings support further gains. Even so, 10-year US Treasury yields have been stuck just below 1.5%, lower than even the central bank's long-term inflation target.
- Excessive investor positioning for an inflation surge, technical factors buoying domestic bond purchases, and feeble foreign yields all seem partly responsible for the "stall" in the US bond market.
- An astute trader could easily argue that yields would tend to peak with the strongest growth rate of the economy. Since a US infrastructure bill of nearly any scope will not have an immediate impact, future rate rises could be limited.
- While we expect 10-year yields to rise to 2% by year-end 2021 we consider the implications of being wrong. Just like bonds, one consequence may be growth equities remaining at "unsatisfying" valuations.
- The pace of US consumer goods spending is cooling after the stimulus fades. However, the world's factories are still in overdrive to replenish inventories. With the reopening of travel and leisure services, this combination has accelerated growth driving the second quarter US real GDP to +10%. This is not sustainable.
- We believe secular disinflation has ended. Over the past forty years, multi-year selloffs in long-term US government bonds have been rare. When they've occurred (as recently as 2013/2014) the maximum rise has been 50 basis points or less in the second year.
- As we noted in our Mid-Year Outlook, portfolios should seek to transition from a sole focus on "Mean Reversion" to position for more enduring growth opportunities beyond COVID. The global price of crude oil has climbed back to $75 and the traditional energy sector has returned 47% in the year-to-date. We expect this to refocus policymakers and investors alike on the transition to sustainable energy.

Throwing the Kitchen Sink at US Bond Market

We are deeply impressed with the US (and global) bond market's resilience. As discussed in our latest *Quadrant*, tracking data for US real GDP suggests growth of +10% in the second quarter. This follows a first quarter GDP gain of 6.4% (annualized). Inflation readings have shot up in the past two months with no quick letdown in sight. The US Consumer Price Index was 5% higher in May than a year ago. The Core CPI (ex-food and energy), was up 3.8%, the highest since 1992[1].

Last week, Fed Chairman Powell effectively announced a coming tapering of bond purchases with his comments that an announcement of the timing will be a "meeting by meeting" decision. Yet, here we are with 10-year US Treasury yields hovering just below 1.5%.

Will US Treasury yields ignore the sharpest economic rebound in history? (See figure 1). We share the skepticism of many and still forecast a 2.0% 10-year yield at year end. Present real yield levels are more consistent with an economic contraction than the strong recovery we've seen in economic growth, inflation, employment and job openings (see figures 2-3). We could, however, be wrong, and discuss the likely market consequences below.

Figure 1: 10-Year US Treasury Yield and US Nominal GDP Growth

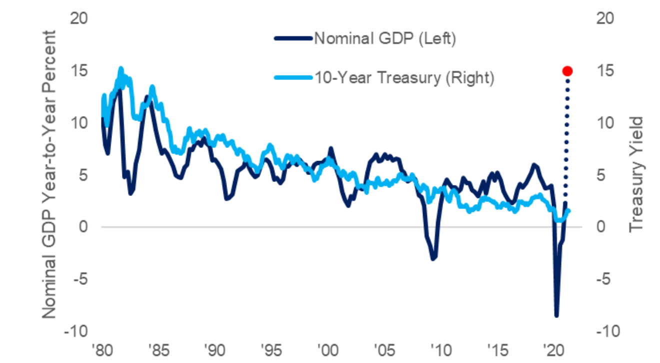
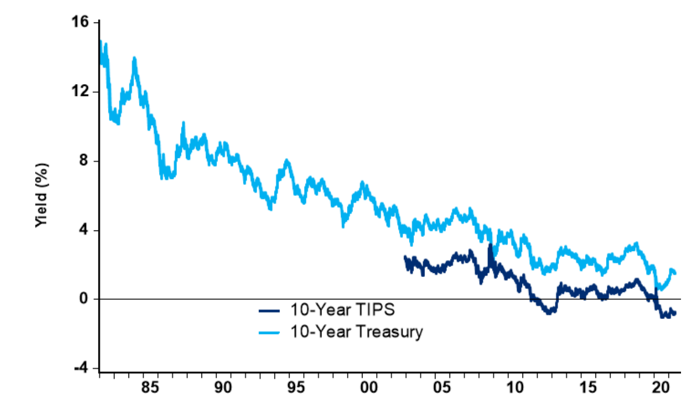
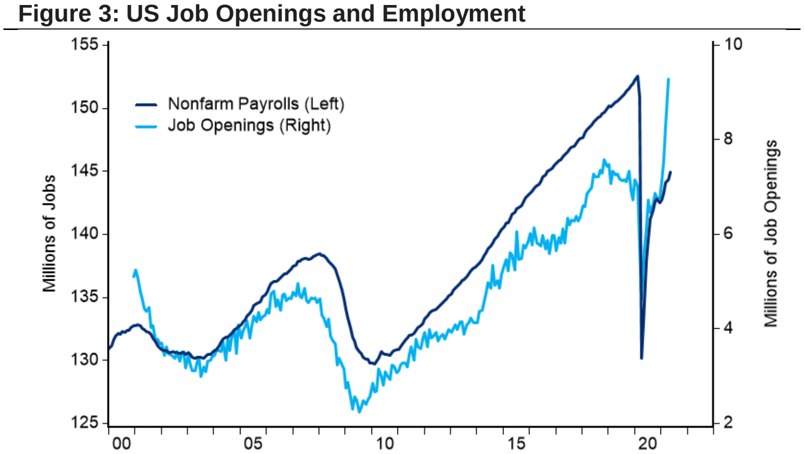


Figure 2: 10-Year US Treasury Yield and 10-Year US Treasury Inflation Protected Security Yield



Note: Red dot and dotted line depict estimated 2Q GDP. Source: Haver Analytics as of June 24, 2021. Indices are unmanaged. An investor cannot invest directly in an index. Grey areas represent recessions. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Past performance is no guarantee of future results. Real results may vary.

Figure 3: US Job Openings and Employment



Source: Haver Analytics as of June 24, 2021.

In last week's CIO bulletin, we discussed the strong investor positioning in so-called "inflation trades." This preceded the flattening out of long-term bond yields last week. Successful vaccines and the economic rebound sent investors flooding

[1] Source Bureau of labor statistics as of June 25, 2021..

into cyclical recovery sectors in equities and into commodities such as copper. They've recently slowed fund inflows into "COVID defensive" sectors such as Information Technology. As is often the case, one-sided investor positioning often sets the stages for "counter-trend" movements. The latest, still small drop in long-term US yields may be symptomatic of that. The wall of money the Fed has created without comparable demand to borrow is another (please see this Fixed Income bulletin for discussion).

The Logic of Yields Ignoring the Boom

With that said, there's some logic to markets "discarding" the performance of an economy wildly distorted by the pandemic's effects (shutdowns and reopening) and one-off stimulus measures. If not for the remarkably low level of interest rates – albeit higher than last year - an astute trader could easily argue that yields would tend to *peak* with the strongest growth rate of the economy.

The pace of consumer goods spending is cooling from a stimulus rush. However, the world's factories are still in overdrive to replenish inventories. With the reopening of travel and leisure services, this combination has sent admittedly volatile tracking estimates for second quarter US real GDP to +10%.

The combination of strong growth in manufacturing and new growth in services has sent the Institute for Supply Management's composite to a record high (see figure 4). Globally, Leading Indicators and purchasing managers surveys can't maintain such a strong growth momentum (see figure 5).

This suggests less rapid growth. While the political parties jockey in Washington for rhetorical advantage as they announce a "bi-partisan" deal, we would note that a US infrastructure bill of nearly any scope wouldn't be larger than the amplitude of the COVID distortions on the US growth pace.

Figure 4: Institute for Supply Management Composite Activity Measure (Services + Manufacturing)

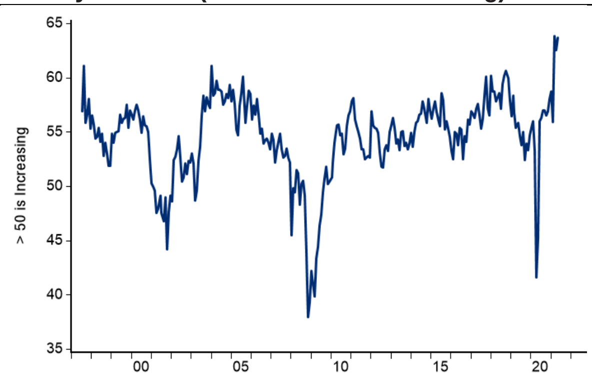
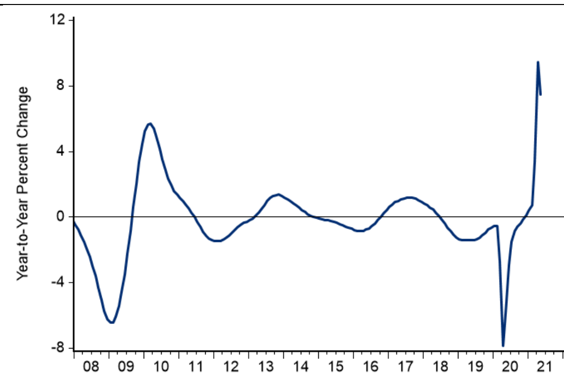


Figure 5: OECD Composite Leading Indicator Y/Y%

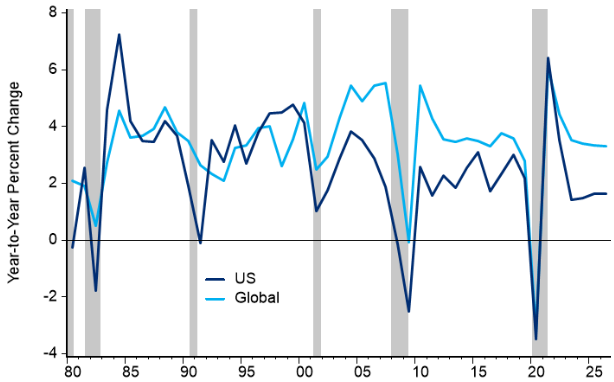


Source: OECD and Haver Analytics as of June 24, 2021.

Still Bullish on '21 and '22 Growth

We are still bullish on growth prospects in 2021 and 2022. Growth and economic progress is the norm. US economic expansion periods have exceeded contraction periods by more than 5-fold since World War II. Fully global economic contractions are even rarer as regional recessions are far more common than global recessions. Global shocks, including COVID, have sunk the world economy only three times since World War II (see figure 6).

Figure 6: US and Global Real GDP (IMF Projections through 2025)

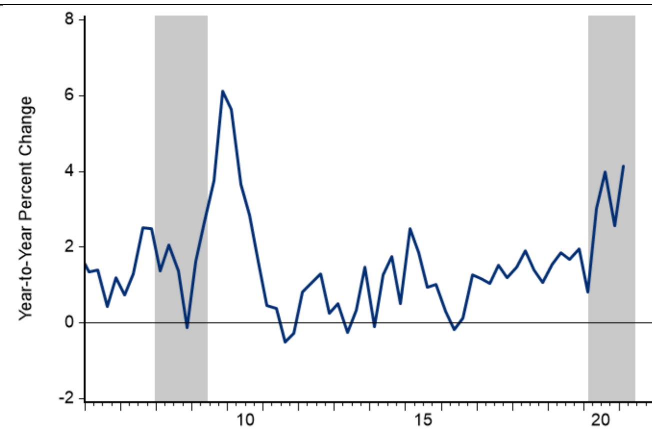


Note: Shaded regions are recessions. Source: Haver Analytics as of June 24, 2021. All forecasts are expressions of opinion and are subject to change without notice and are not intended to be a guarantee of future events.

With that said, fundamentals suggest a slower phase of growth beyond a 2021-2022 snap back (see figures 7-8). As figure 2 showed, 10-year US Treasury yields rose 125 basis points from 2020's low point. There have been back-to-back annual periods in which US bond yields rose. Note that since 1981, all of these periods have seen yields rise no more than 50 basis points in the second year of recovery.

Figure 7: Global and US Population Growth (With UN Forecasts)

Figure 8: US Productivity Growth and Periods of Recession



Note: Shaded regions are recessions. Source: Haver Analytics as of June 24, 2021. All forecasts are expressions of opinion and are subject to change without notice and are not intended to be a guarantee of future events.

What if Bond and Growth Stock Valuations Remain Unsatisfyingly High?

As discussed in detail in our Mid-Year Outlook, the "digital economy's" lasting, higher share of economic activity is real and persistent. The recent rebound in the relative performance of cyclical "value" equities compared to US growth shares is indicative. What's most interesting to is the fact that US growth stock valuations haven't fallen sharply during this rotation (see figure 9). To date, long-term interest rate pressure hasn't been sufficient to drive a larger correction (see figure 10). We can't be sure it ever will.

Figure 9: US Value/Growth Relative Returns and Relative and Valuation

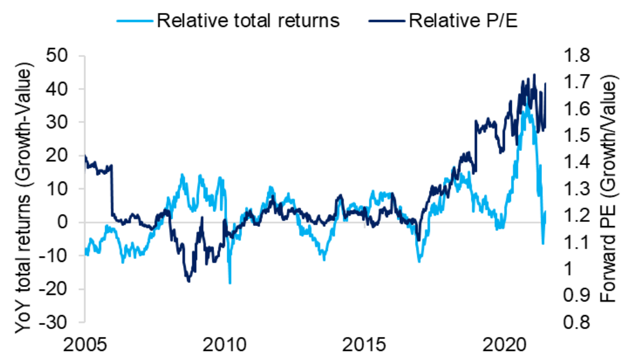
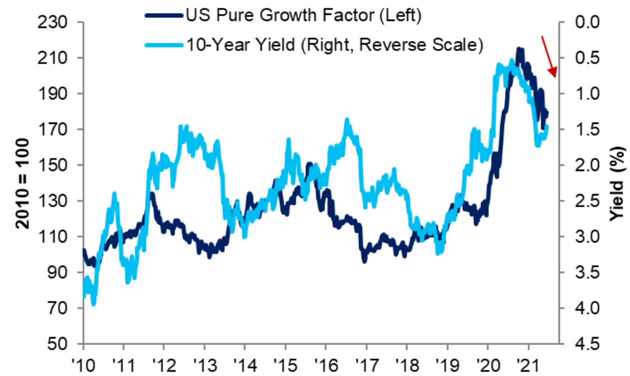


Figure 10: US Treasury 10-Year Note Yield vs US Growth Stock Index

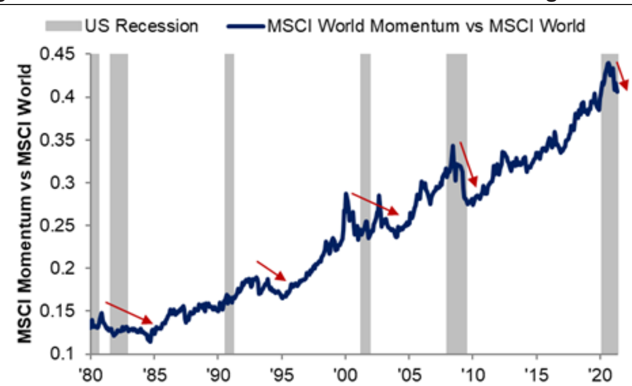


Source: Haver Analytics and Bloomberg as of June 24, 2021. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Past performance is no guarantee of future results. Real results may vary.

As discussed in our Outlook for 2021, business cycle turning points – recessions and recoveries – are rare moments when “mean reversion” strategies outperform. The remainder of the time, areas of enduring growth leaves “trend followers” to outperform (see figures 11-12). Certain growth opportunities, such as cyber-security software, look like highly secure, “staples” of the digital future (please see last week’s CIO bulletin). As the lows in the world economy and markets were seen a year ago now, we need to be careful not to ignore the *value* of enduring growth.

Figure 11: Relative Performance of Mean Reversion Strategy

Figure 12: Relative Performance of Trend Following Strategy



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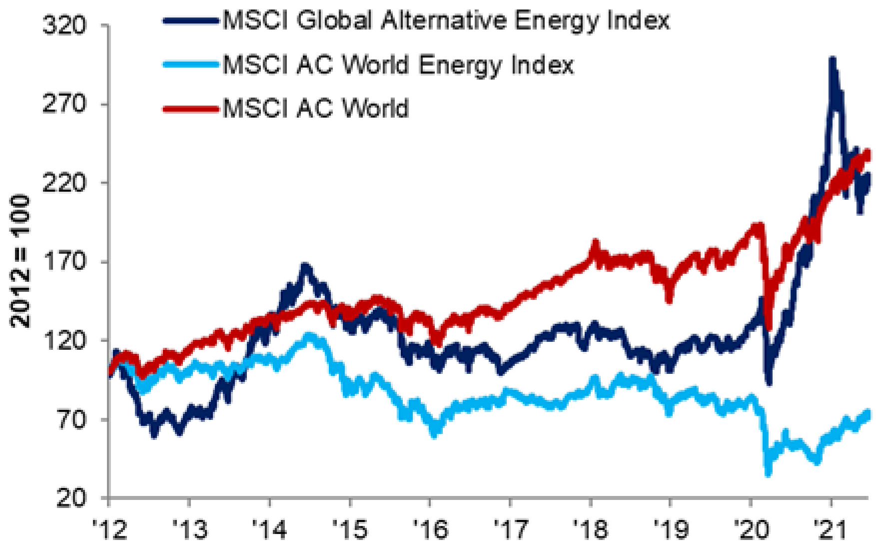
All That Grows is Still Green

Last week, we discussed the security needs of the digital economy. Below, we discuss an entirely different growth opportunity, one that also has compelling technologies behind it, but entirely unrelated as an economic trend.

In 2020, equities aligned with “greening the world” posted a 106% total return[2], but are down 25% from the January peak after that unsustainable gain (see figure 13). The global price of crude oil has climbed back to $75 and the traditional energy sector has returned 47% in the year-to-date. We expect this to refocus policymakers and investors alike on transition to sustainable energy.

[2] MSCI Global Alternative Energy Index is used for this calculation.

Figure 13: Global Equities, Energy Sector, Alternative Energy



Source: Bloomberg as of June 24, 2021. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Past performance is no guarantee of future results. Real results may vary.

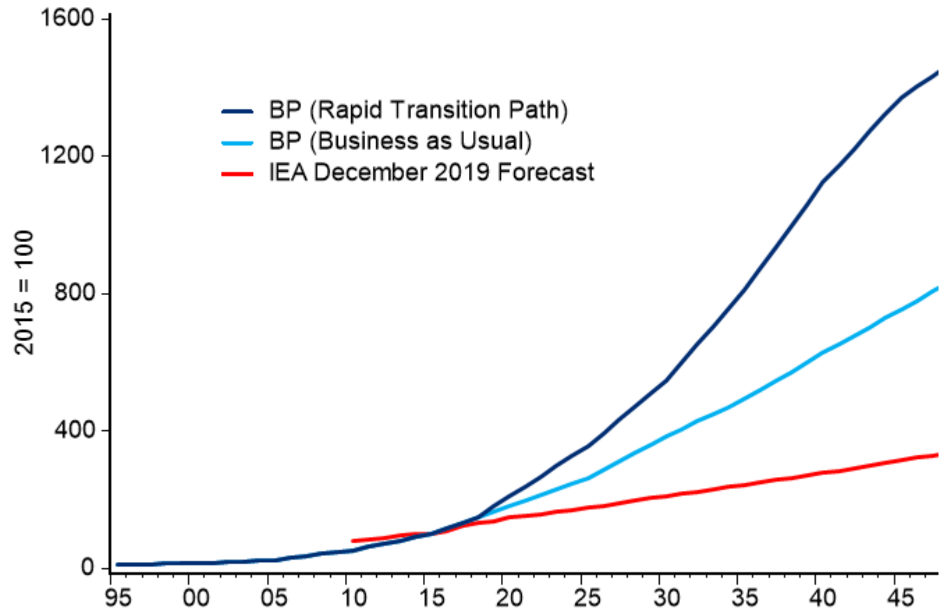
A Greener Future Remains Unstoppable

While 2020 and 2021 have been years of profound human suffering, and dramatic challenges, they have also reaffirmed the capacity of humans, governments, firms and markets to direct shocking amounts of resources to solve a global scale problem. We have faith in the ingenuity of humans and the power of free markets to meet the challenge of climate change head on and not merely survive but thrive.

The difference between an unstoppable trend and a trading opportunity is clearest when the market moves against your view. For an unstoppable trend, this creates a little discomfort for existing positions, and an attractive entry point for those who have sat on the sidelines through the last few years or who want to top up. In fact given the faster than expected run-up in green energy in 2020, the give back in 2021 is not a terrible surprise (Figure 13 above). Global warming is front and center making green energy and sustainability a key focus for investors.

While greening is an unstoppable trend, it is not a mature market. Thus, many potential opportunities for investment lie in private markets. Ambitious forecasts are being set and look conservative within a few years (Figure 14), with the International Energy Agency's December 2019 forecast for renewable energy consumption looking starkly unambitious when compared to British Petroleum (BP's) forecasts for business as usual and rapid transition that were published in May of this year. We view the analogy of tech firms in and around the turn of the millennium as apt. Any forecasts for the amount of data produced, or the number of connected devices that were made in 1999 would have looked hopelessly outdated even a few years later. To us, the large differences in forecasts suggest that when a "tipping point" for green is reached, it will be seen in a rear view mirror.

Figure 14: Renewable Energy Consumption Forecasts Keep Increasing



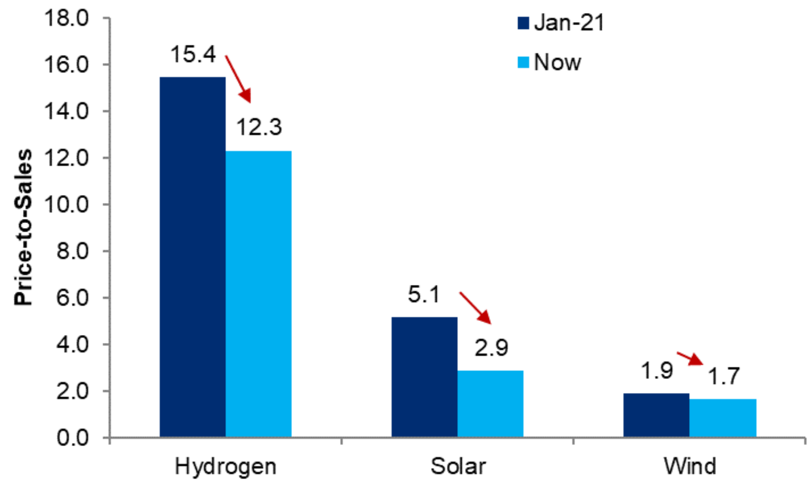
Note: BP forecasts are based on either a business as usual path without major government intervention or a rapid transition path. Source: Haver Analytics as of June 25, 2021. All forecasts are expressions of opinion and are subject to change without notice and are not intended to be a guarantee of future events

Then, as now, there is a genuine world changing collection of technologies and market needs but it is not yet clear who will be the largest winners and the household names in the decades to come. As such greening doesn't fit tidily within the Global Investment Committee (GIC) framework, but instead takes more selectivity than just buying an index and hoping for the best. Many large firms are setting ambitious net zero targets and are taking both physical and transition risk seriously. Even for traditional companies using a selective manager may be useful as they can identify firms that will be well positioned in the scenario of an expansion of either cap-and-trade or other greenhouse gas emission reduction programs. We look to work with experienced managers who can select firms and technologies with proven track records and solid earnings and being aware that there may be some as of yet speculative technologies that could create potential winners.

But greening is much more than renewable energy. With a growing portion of the world's population exposed to the ravages of drought, clean water access, agricultural efficiency and desalination are going to take on an increasingly important role in the years to come. And while often these areas are treated as humanitarian in nature and not likely to be solved by markets, this is clearly not the case now, with many highly affluent and influential areas of the US West facing historic droughts as well as rapidly growing regions of China. California has already built 11 desalination plants with the first opening in 1992, but currently has 10 in planning or construction phases. We believe that desalination like green energy is fundamentally a technology challenge, and that as social and market demands create pressure, human ingenuity and market leaders will create solutions. The pipeline of novel technologies for desalination is growing every year, and while any given technology is not necessarily going to be the panacea of the world's water woes it is clear that the incentives are moving in the right direction for rapid development.

Given the early stage for much of the greening theme, whether in new energy, desalination, EVs or electrification there are likely to be many firms with big ideas that raise money, and yet never actually succeed at bringing a product to market. While not as extreme as the coat hanger effect in the crypto currency space with its thousands of entrants, we see the dozens of new EV makers hoping to be the next Tesla, and are skeptical about how many of them will ever produce a car that can be purchased much less earn a profit. While EVs have received the most attention, especially in the SPAC market, technology around carbon capture, utilization, and storage (CCUS), green hydrogen, and sustainable agriculture have been on the rise and have cheapened along with broader growth equities this year (Figure 15).

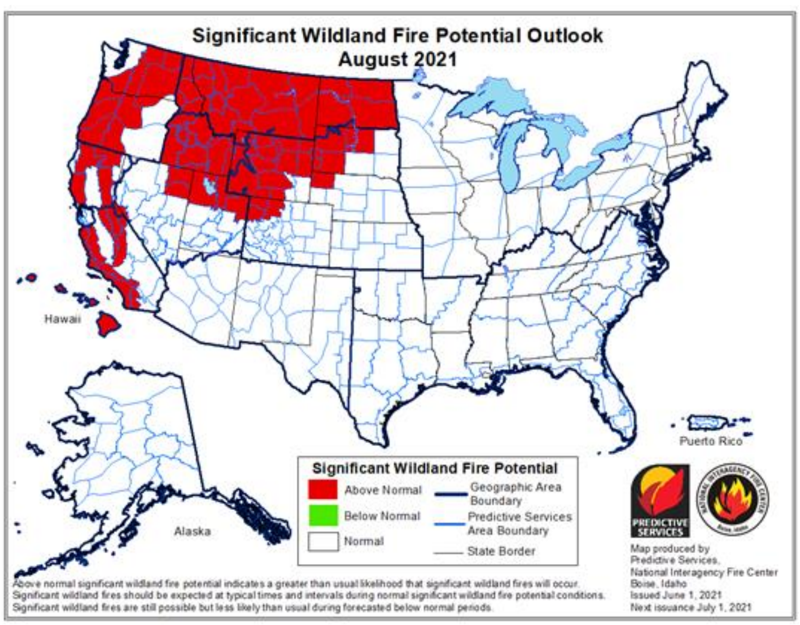
Figure 15: New Energy Valuations in January 2021 and Today



Source: Factset as of June 25, 2021.

This is not a short term-trading idea, but there are reasons to suspect that market sentiment could soon be shifted back to climate change in the months to come. For instance with most of the US West is currently in a state of extreme drought with government forecasts for fire risk showing most of the population centers of the West at above normal fire risk as dry conditions combine with record heat to parch the landscape and set the stage for perhaps another summer of horrific wildfires and increased market focus on climate and greening themes. Already the agriculture of the Western states have been impacted by below normal water levels with cattle ranchers culling herds they won't have sufficient pasture for. August 2021 cattle futures have risen by nearly 20% since the start of Water Year 2021 in October of last year.

Figure 16: Federal Wildfire Prediction Maps Show large Swaths of Above Normal Risk, and Startlingly No Areas of Below Normal Risk for August 2021



Source: National Interagency Fire Center as of June 25, 2021. All forecasts are expressions of opinion and are subject to change without notice and are not intended to be a guarantee of future events

If the drought is as bad as forecast and the fires that are anticipated ignite, it will bring back to the forefront of investor and politician's minds the dramatic need for action to fight not just climate change but the more immediate shortage of water in heavily populated and high income locations. Given the news that President Biden is on board for the new bipartisan infrastructure deal which notably avoids large scale spending on climate related infrastructure, we anticipate this taking on a larger standalone roll in the months ahead.

Likewise, when we look back at the dramatic images and heart breaking narratives of natural, human and financial loss stemming from the 2020 wildfires it seems likely that the shift from President Trump who had a well-publicized feud with California Governor Newsom to President Biden who has publicly supported Newsom during his recall election. As such, we may see significant Federal aid both on fire prevention and climate change, but also potentially on the most immediate issue of water scarcity.

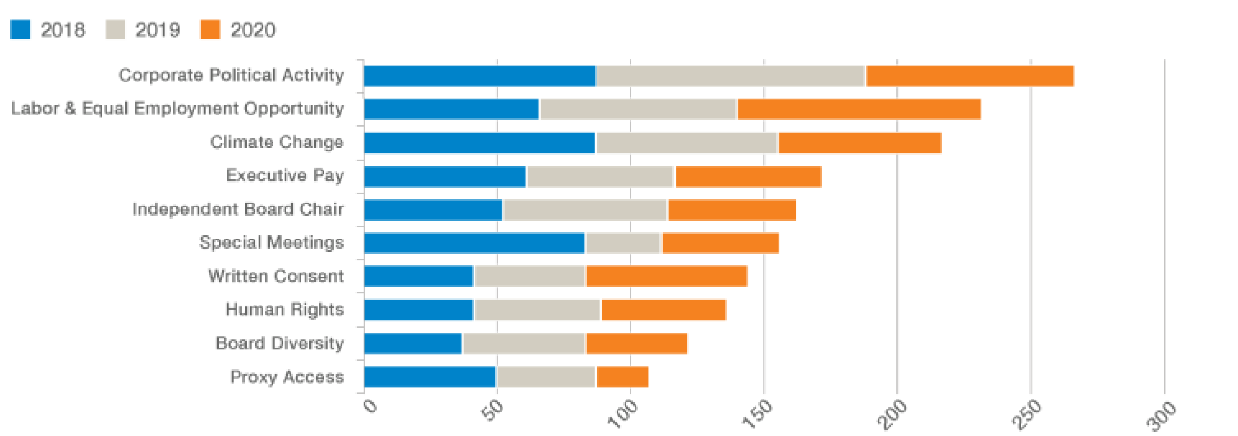
Policy makers and businesses are looking to November, when the UK will host the 29th United Nations Climate Change Conference of the Parties (COP26) in Glasgow. The summit brings together world leaders to address climate change. After the events in 2020, many hope that governments will commit to further measures to cut emissions in order to meet the objectives of the Paris Agreement and limit global warming to 1.5 degrees Celsius. COP26[3] aims to deliver a "green industrial revolution" by investing in renewable energy, electric transport, innovative technologies and protecting nature – creating impactful economic opportunities in the process. Furthermore the Convention on Biological Diversity COP 15, focusing on preventing further biodiversity loss and restoring nature will be held in Kunming, China is scheduled for October. With the private sector mobilized to address climate and bio-diversity issues, businesses will be paying heed as ESG matters, such as energy transition and protecting nature, are increasingly prioritized by shareholders.

ESG and Investors

With novel solutions not just fixing problems but improving lives and generating entirely new industries with their attendant winners. As we rebuild our world, we can take the opportunity to look beyond the next month, quarter or year and assess ESG risks and opportunities of new technologies, processes and companies, to invest for a more sustainable future over the long run.

Investors this year were mobilized by ESG issues, taking issues to proxy season. Notable this year, was shareholder votes to replace 3 board members on Exxon's board, led by climate activist fund, Engine No. 1. These moves by investors have indicated that greening is not just a satellite position, but is a fundamental risk to entire portfolios and are forcing companies to be better aligned with fundamental risks posed by changes in climate and regulations that favor a transition to a low carbon economy.

Figure 17: Leading ESG Issues 2018-2020, by Number of Shareholder Proposals Filed



Source: The forum for Stainable and Responsible Investment, 2020 Trends report.

Global issuance of sustainable debt soared in 2020 and seems to be an increasingly useful tool for companies looking to raise capital to finance the transition or development of new technologies to facilitate one.

[3] See COP26 Explained for more information.

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