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CIO Strategy Bulletin

Understanding an Extraordinary Week in World Events

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Summary of Events

This past week, world events that will reshape the global political and economic order were plentiful. And yet, even as investors experienced significant volatility, global equities ended the week trading higher than they were the night before Russia's incursion into Ukraine. (So much for market timing.) Here are key snapshots:

- China's stock market had its most volatile week in decades. Following a Covid lockdown for 40 million people in and around Shenzhen and reports of record Covid deaths in Hong Kong, China's internet index crumpled down 8.1% Tuesday, erasing its gains back to 2013. JP Morgan called Chinese internet stocks un-investable (Bloomberg). A massive reversal began at 1:16pm on Wednesday when the State Council's committee, chaired by Xi Jinping's right-hand adviser Vice Premier Liu He, issued five supportive tech and market policies. In response, the Hang Seng Tech index closed up 22% and the Nasdaq Golden Dragon index jumped 33%, both one-day records.
- European markets closed higher this week, fully recouping losses from Russia's invasion of Ukraine, despite data showing that the EU is likely to suffer energy shortages into 2024. Ukraine undertook effective military counteroffensive measures that portend a more protracted conflict, even as a military stalemate might aid a negotiated peace. A nearly two-hour call between Presidents Biden and Xi capped the week, with the US issuing stern warnings that China would face consequences if it provided "material support" to Russia (The Hill). Xi noted that "some individuals in the United States are sending the wrong signals to pro-independence forces in Taiwan, and that's very dangerous" (Al-Jazeera). Not exactly warm relations.
- In the US, the Federal Reserve raised interest rates by 0.25% for the first time since 2018, the initial salvo of six projected hikes through 2022. After two weeks of losses, US stocks appeared to shrug off the news. The Fed's goal of tightening financial conditions without provoking a recession is worthy, but bond market action suggests this will not be easy. The spread between the 2-year and 10-year Treasury yields, a leading indicator of future recessions, is very close to inverting.

This week's CIO Strategy Bulletin will provide you with our assessment of these events, market responses and possible future reverberations.

Summary Implications

- The likelihood of slower global GDP growth is high. While the US may remain a relative bright spot, China and the EU are under more significant and immediate pressure. China will do more to address its slowdown with future easing steps. However, Covid in China remains a much larger near-term challenge than in most other regions.
- In our view, the Fed cannot directly address the root causes of present inflation. Prior to the conflict in Ukraine – which has severely impacted global trade – supply/demand rebalancing was already beginning to point to a slower path for inflation in 2022. Now, the tightening of both fiscal and monetary policies in the US to “fight” inflation will gradually increase recession risks. Supply increases (and the absence of fiscal stimulus) will do far more to help achieve supply/demand balance over time than the Fed can.
- War risks remain highly elevated. In the event Russia changes tactics or impacts NATO countries directly, scenarios worse than a military stalemate and peace agreement remain distinctly possible.
- The long-term consequences of Russia’s removal from global trade and banking infrastructure are unknown. Energy and agricultural trade disruptions remain highly likely. This is the case even as crude oil fell by more than \$30 per barrel over the past two weeks. While sanctions on Russian entities don’t have large, immediate impacts on energy supplies, they are likely in the coming months. A highly convincing peace agreement would change this, but not completely restore future Russian supplies.
- Relations between the US and China remain under increased strain. The two-hour call between Presidents Biden and Xi Jinping seemed replete with reminders of the sensitivities surrounding Taiwan.
- Markets saw a significant “relief” rally in the past week given the Fed’s policy announcement and moderating commodity prices. However, the Fed’s new economic forecasts – made just after the latest spike in commodity prices - reduced US real GDP growth from 4.0% to 2.8% this year and estimated inflation to rise to 4.3%.
- We believe the rise in inflation, concentrated in commodity producers and support functions, will mean higher profits in related sectors at the expense of consumer discretionary spending and the profits of related firms.
- As [we discussed two weeks ago](#), the full scope of the Russia/Ukraine conflict is as of yet unknown. We believe markets can rally sustainably as clarity improves. We believe the investment environment calls for higher quality, lower cyclical equity and bond portfolios, with the exception of commodities that will replace Russian supplies. Our existing equity overweights remain industry-leading dividend growers. Sector overweights include pharmaceuticals and staples, with thematic holdings in cybersecurity, fintech and payments.
- The Global Investment Committee (GIC) made the following changes to portfolios this month:
 - 1) Added 4% to global natural resources and oil services firms
 - 2) Added 2% to gold as a potential “shock hedge.”
 - 3) Reduced European and Japanese shares while remaining 2% overweight global equities and 3% underweight global bonds and cash.

The Fed

Back in 2010, then-Fed Chairman Ben Bernanke wrote a Washington Post Op-Ed (“What the Fed did and why: Supporting the recovery and sustaining price stability,” Nov. 4, 2010) that explained “quantitative easing” (“QE,” the Fed’s purchase of Treasury securities to stimulate the economy) as a way to reverse the “negative wealth effect” of the Great Financial Crisis. Bernanke wrote:

“Stock prices rose and long-term interest rates fell when investors began to anticipate this additional action. Easier financial conditions will promote economic growth. For example, lower mortgage rates will make housing more affordable and allow more homeowners to refinance. Lower corporate bond rates will encourage investment. And higher stock prices will boost consumer wealth and help increase confidence, which can also spur spending.”

In responding to critics that QE might lead to higher inflation, Bernanke said the Treasury purchases would be temporary. Though the Fed did not reduce its balance sheet after the GFC (**Figure 1**), global inflation remained quiescent for the ensuing decade.

QE Redux²

When Covid struck, fiscal and monetary authorities felt emboldened to increase deficit spending and conduct even larger rounds of QE, expecting no major inflationary pressures.

The wealth effect that Bernanke expected in 2010 exploded in 2020-21 (**Figure 2**). Over the course of the pandemic, US household wealth grew by \$33.5 trillion. It had taken the prior six years -- from 2014 to 2020 -- for net worth to grow by that amount. So fast was this wealth created that for the first time ever, according to Zillow, the median American house value grew more in one year (\$52,667) than the median wage (about \$50,000) in the US.

Stimulus checks and rapid increases in household wealth allowed Americans to spend hand over fist to buy goods, even as productive capacity was capped by Covid labor shortages and supply chain issues. The ensuing inflation (see "[Fear and Loathing of Inflation](#)" from November 14) shocked markets and caused consumer sentiment to turn negative. And now this inflation has been exacerbated by the invasion and a major, likely permanent shift in trade away from Russia (see the March *Quadrant*, "[A Global Scramble for Resources](#).")

Better Late Than Never?

As noted in our [Global Fixed Income Strategy Bulletin](#) this week, the Fed announced several measures aimed at one goal: tightening financial conditions without provoking a recession. The Fed raised the federal funds rate 25bps, with a strong indication of at least six more such hikes in 2022, bringing the target rate up to 1.875%. In addition, "quantitative tightening," the reduction of the Fed's balance sheet (QT), is expected to start imminently, perhaps as soon as May, and may eventually total \$2-3 trillion over the next few years.

We believe that the Fed's aggressive posture to quell inflation is unlikely to do so. Many aspects of this inflation surge, from energy prices to chip shortages, cannot be addressed with monetary policy. Supply increases can mitigate these components of inflation. But so would a recession.

In order to raise rates quickly while engaging in QT, the Fed has to believe that the US and global economic recoveries are durable. Clearly, Powell does. His opening statement was replete with references to "a *very strong economy*." He noted repeatedly that the labor market was "extremely tight," at one point even stating, "*if you...take a look at today's labor market, what you have is 1.7-plus job openings for every unemployed person.*" Unlike Bernanke's experience when the 2008 economic downturn created spare capacity for years, Fed stimulus, 2020 technology and consumer adaptability quickly overcame the economic disaster that the pandemic wrought.

Looking Beyond Today's Data

In our view, the Fed's intended actions (higher rates and QT) have added risk to our economic outlook. Here is why:

- Government spending is going down (data for January and February [showed federal spending down 22%](#) from 2021, with further declines to come. **Figure 3**).
- Rates have already risen and consumers are buying fewer durable goods and homes. Mortgage rates have moved up over 100bps since January.
- Equity indexes have dropped 10% and bond and credit funds have experienced one of their worst YTD starts as rates moved higher.
- Inflation is likely to be more persistent due to world events, but this time without income supports to help consumers.

Another major limit to higher rates is the total amount of debt outstanding. Global debt growth has ballooned over the past few years and is not confined to the US. [Per the IMF](#), as of 2020, global debt had reached \$226 trillion, or 256% of global GDP – a 28% increase over 2019. When one considers the enormity of global debt – with a few additional percentage points of interest expense providing a meaningful drag on GDP – policymakers will have to calibrate just how restrictive they can become before it is inconsistent with a continued expansion.

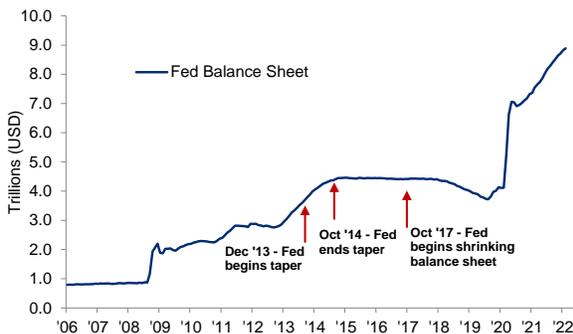
Listening to the Bond Market's Heartbeat

A widely followed market indicator is the spread between the 2-year Treasury yield and the 10-year Treasury yield. When this spread “inverts,” and the 2y yield is higher than the 10y, recessions often follow within 1-2 years. While current Fed policy rates aren’t close to two year-yields, the two-year note is a predictor of *where the Fed is headed*. This indicator is very close now to inversion (**Figure 4**).

Moreover, the absolute yield level indicated by the 10y is only 2.15% currently. If the Fed was truly able to raise rates by 2023 to the 2.75% level it has indicated, then either the 10y yield must move higher to avoid inversion, or the yield curve will invert.

Based on the yields and curves today, the bond market doesn’t believe the Fed can, in fact, raise rates much above 2% - and simultaneously shrink its lending - without causing the economy’s growth to slow precipitously. The market doesn’t immediately anticipate recession. To avoid this, the Fed needs to be more “data dependent” than “autopilot.” We believe that as the Fed raises rates and initiates QT, it will need to “watch the speedometer” of the real economy carefully or ignite a market collapse as it did in Q4 2018. With the Fed having little ability to alter the course of a supply shock, Fed policy needs to acknowledge that it can’t trample down inflation in the near-term. Only heightened supplies of goods and services can preserve growth and slow inflation (**Figure 5**).

Figure 1: Fed balance sheet



Source: Bloomberg as March 16, 2022. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Past performance is no guarantee of future results. Real results may vary. All forecasts are expressions of opinion, are subject to change without notice, and are not intended to be a guarantee of future events.

Figure 2: US Household Net Worth

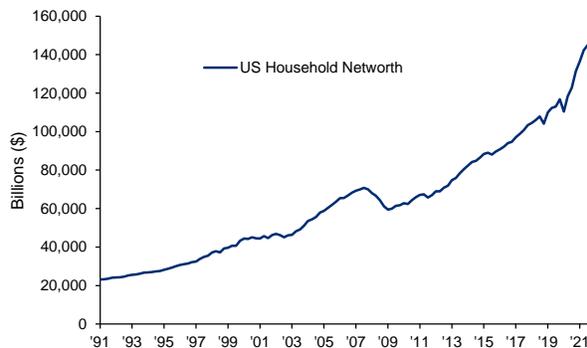
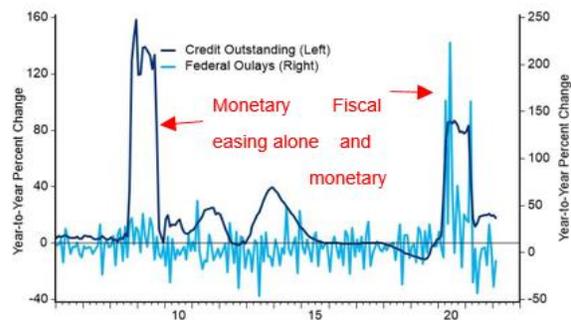


Figure 3: US income support for consumers has fallen by \$1.8 trillion in year through Jan-2022



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Figure 4: US Treasury yield curve, 10 year less 2 year

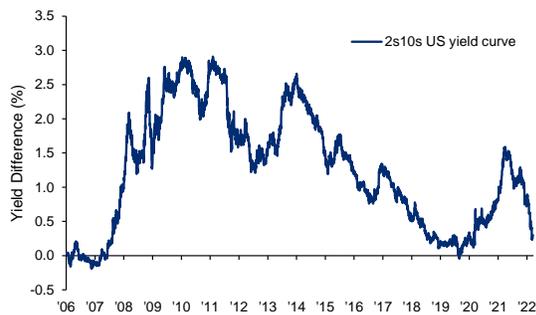
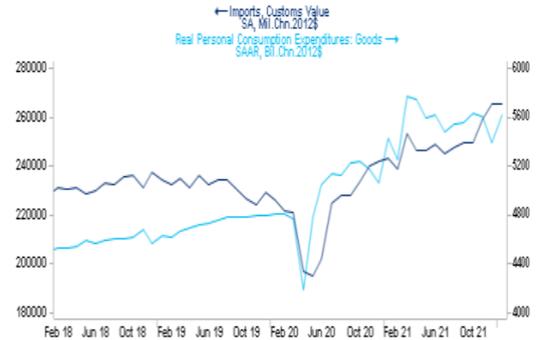


Figure 5: Real consumer goods spending has fallen 2.5% since peaking in March 2021. Real imports +4.8% over the same period



Source: Haver Analytics through March 18, 2022

The Direction for Global Markets

As we outlined in the March 6 CIO Strategy Bulletin, “[Pivot Point for the World](#),” financial markets could rally once the full scope of the supply disruptions are known. Until then, markets may overshoot to the downside, but once a bottom is reached, markets assess new realities. For example, when there is a severe supply shortage, desperate bidders will typically overpay, generating a “crisis spike” in prices. We then expect producers to rapidly adjust outputs to take advantage of the higher profit opportunity.

A Turning Point for China Policy

Since mid-February, Chinese equities have faced mounting headwinds. Escalating geopolitical risks, a disappointing stimulus package from the National People’s Congress, ADR delisting concerns, Covid lockdowns, and renewed regulatory worries have deeply depressed market sentiment. As a result, the market tumbled. And the unwinding of leveraged and derivative positions exacerbated the market falls until a sharp reversal on March 16.

The key cause for the reversal was a Financial Stability and Development Committee (FSDC) meeting chaired by Vice Premier Liu He, who demanded immediate measures to support growth and to stabilize financial markets. Policymakers then announced coordinated measures to address property, monetary and credit policy, platform company regulations and foreign listings.

The key policy initiatives from the FSDC policy meeting are:

1. **Addressing property sector risk:** Stepping up effective policy to deal with default risks; increasing loan issuance and encouraging M&A financing for quality developers; no expansion of property tax pilot program this year.
2. **More effective macro policy stimulus:** People’s Bank of China policy to be more proactive and to “maintain appropriate growth of new loans”; expecting both RRR and interest rate cuts soon.
3. **Predictable regulation on tech and platform companies:** Regulations to be transparent and predictable, while restructuring and antitrust measures may continue; communications with the markets to step up to avoid surprises.
4. **Negotiating in good faith with the US to avoid ADR delisting:** No change of support for overseas listing of Chinese companies; to have “achieved progress” with US regulators to avoid delisting of ADRs.

Figure 6: Even after the sharp rebound of past few days, most Chinese equity indices remain well below pre-pandemic levels

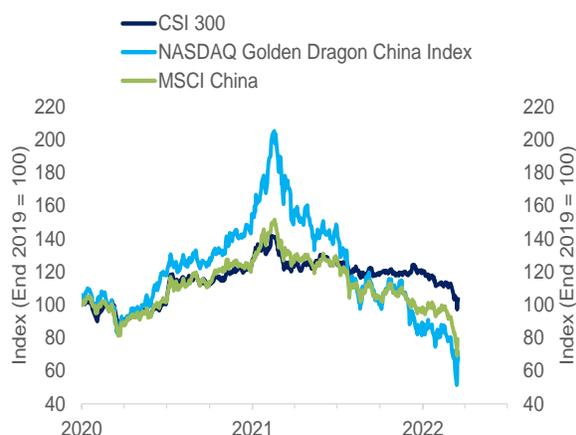
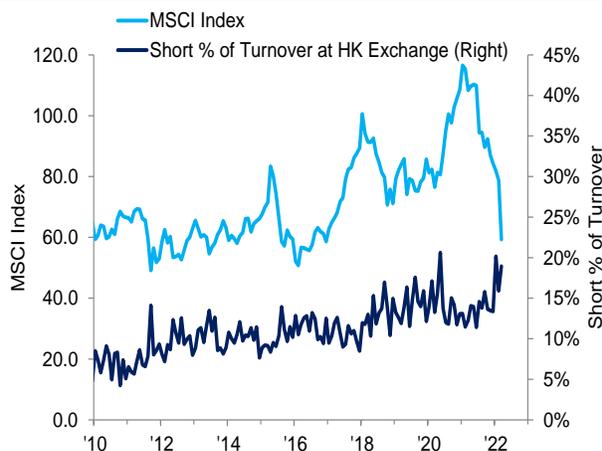


Figure 7: Sharply higher short volumes have preceded bull markets in the past



Source: Bloomberg, as of 17 March 2022. 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 results. Real results may vary.

Rebound, Then What?

These policy announcements saw both Mainland China and Hong Kong markets rebound sharply with gains of 7.1% and 16%, respectively, over the last three trading sessions. The natural question is whether the market rallies can be sustained. It is, therefore, critical to see whether the policies are effectively implemented in coming weeks. As the markets have been disappointed before, anything short of meeting the renewed, positive market expectations will likely lead to renewed concerns and volatility in China's markets.

China's Pandemic Is Underway

It is fair to say that China's pandemic is beginning in earnest now. Yet, given the 20th Communist Party Congress will open in either October or November this year, stability leading up to the event will remain top priority. Hong Kong's present experience with surging cases and record high death rates are precisely what the Chinese authorities would like to avoid (see [Asia Bulletin - Hong Kong's Fifth Wave: A Thorny Path to Reopening](#)). These two realities are crashing against each other right now.

On March 17, President Xi chaired a Standing Committee Meeting of the Politburo, the highest decision-making body in China, to discuss the recent Covid outbreaks and strategies to contain the latest wave. China has previously allowed imports of Covid treatment drugs, and some may have thought China was in the position to relax the Covid Zero Strategy somewhat. The March 17 Politburo meeting has dispelled such speculation. Governments at all levels were asked to maximize the effectiveness of Covid containment with the least costs, while minimizing the impact on economic activities and people's daily lives.

China saw a renewed outbreak of Covid cases after the Winter Olympics. The total daily cases are now close to those reached in early days of the Covid-19 eruption in Wuhan (**Figure 8**). The current wave of Omicron variant outbreaks has spread to 27 provinces; four cities have been fully locked down (Shenzhen, Dongguan, Jilin and Changchun). Shanghai is under a semi-lockdown, as movement to and from the city is mostly blocked.

There are 13 and 254 locales being labelled as high- and medium-risk areas, respectively. Those high-risk cities amount to 6.9% of GDP, 6.7% of manufacturing output, and 7.7% of tertiary sector production. The combined high- and medium-risk areas could be much larger, amounting to 16.7%, 15.5%, and 18.6% of GDP, manufacturing output, tertiary sector production, respectively (**Figure 9**). Indeed, the impact this round could be large and potentially serious.

We believe the government will attempt to keep the Covid Zero policy in place until after the party Congress meets. As a result, we also believe the costs of keeping Covid Zero will rise significantly. It is estimated the current wave of Omicron outbreak across 27 provinces could take off GDP growth by up to 0.8ppt, short of additional policy stimulus. Thus, the around 5.5% GDP target set by the NPC for 2022 will become nearly impossible to achieve.

While China's markets could be boosted by more effective policy implementations as required by the March 16 FSDC meeting, the uneven and unwieldy spread of Omicron is another risk that will add to China's market volatility, regardless of the Financial Stability and Development Committee's new initiatives.

Figure 8: China's Covid cases surge again, almost matching the cases in Wuhan in Jan-Feb 2020

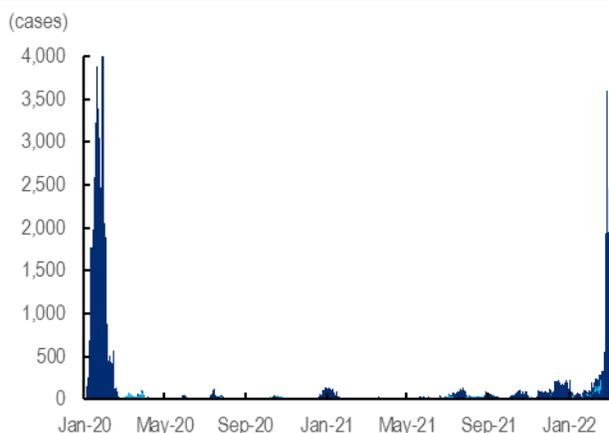
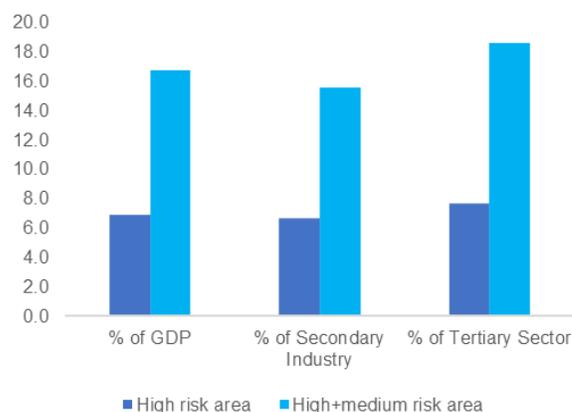


Figure 9: Outbreak regions and their economic share in terms of GDP and industrial sectors



Source: Bloomberg, CEIC, Citi Research as of 17 March 2022. 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 results. Real results may vary.

European Markets Reflect Strife and Hope

This week equity markets in Europe bounced back to levels seen just before the Russia-Ukraine conflict (**Figure 10**). Year-to-date returns for both the Stoxx 50 and UK equities are -9.0% and 0.0%, respectively. Across all tenors, German bund yields are higher (**Figure 11**) than when the conflict began, largely reflecting the more hawkish tone by the ECB in its March 10 meeting.

Figure 10: European equity market recovers

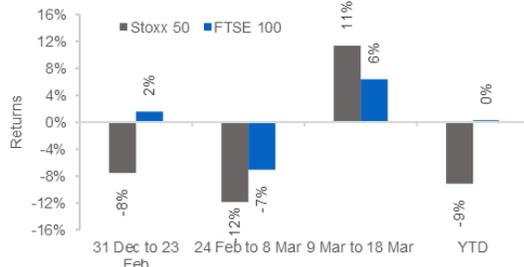
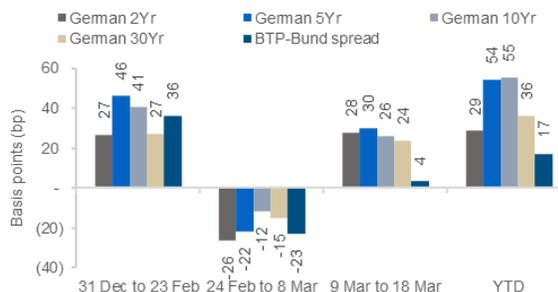


Figure 11: German bund yields higher than pre-conflict levels



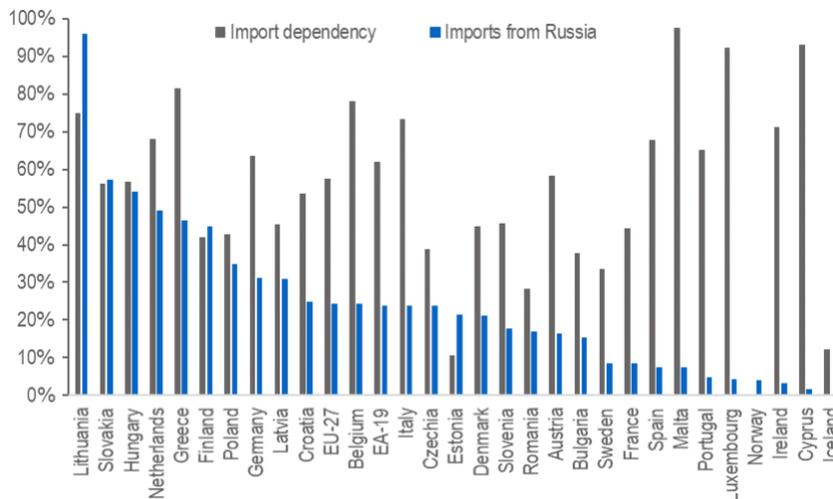
Source: Bloomberg, data as of 18th February 2022. Past performance is no guarantee of future returns. Real results may vary. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Past performance no guarantee of future results. Real results may vary.

European Dependencies

The conflict in Ukraine demonstrates how deeply Europe depends on energy imports (just under 58% for the EU-27) and has underscored the need for the EU to secure energy supplies from safe, reliable sources. Russia today accounts for almost a quarter of European energy imports. Germany imports 60% of its natural gas from Russia, while Italy imports 40% and France imports 20%. The numbers by source are 19.3% for coal, 36.5% for oil and 41.1% for natural gas across all economies. European gas storage levels are low and demand for natural gas for winter heating remains high, creating immediate risks for Europe broadly (see **figures 12 and 13**).

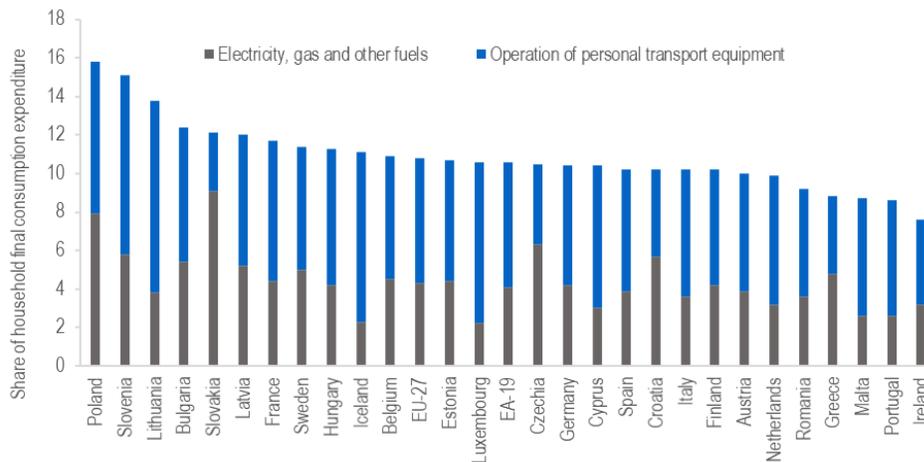
Various estimates suggest that Europe could just about stop importing natural gas from Russia until the summer when different strategies would be required. But this would likely be at a significant cost to economic activity, as it will likely require rationing, impacting some sectors with high energy intensity in countries that are very reliant on Russian natural gas. And there are some differences in national priorities and concerns that will make unanimous decisions hard to reach, unless there is public clamor to do so.

Figure 12: High energy import dependency (57.5% for EU-27), particularly from Russia (24.4%)



Source: Eurostat through March 16, 2022. Import dependency is defined as the share of net imports (imports – exports) in the gross available energy (including solid fossil fuels, natural gas, oil and petroleum products (excluding biofuel portion) and renewables and biofuels).

Figure 13: Mapping countries' vulnerability to higher energy prices



Source: Eurostat through March 16, 2022.

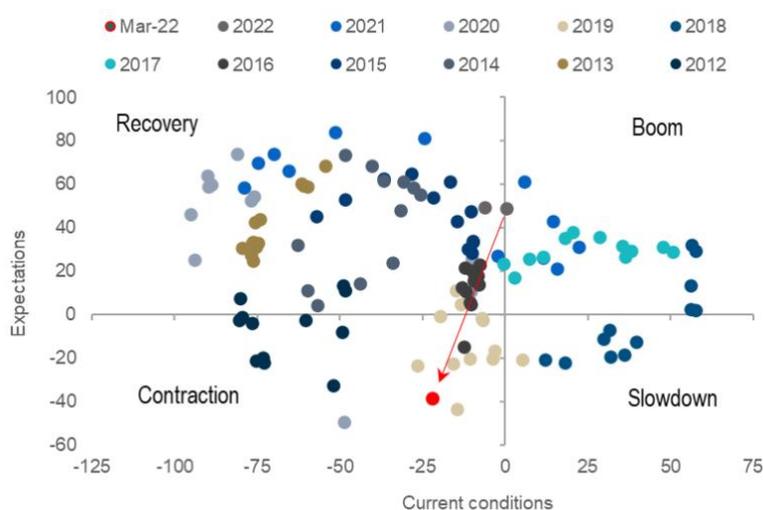
Economic Sentiment and the Conflict Are Integrally Tied

The ZEW survey provides a window on the major hit to sentiment created by the military conflict in Ukraine and the repercussions it could have on economic activity in Europe.

If the conflict were to deteriorate dramatically, it could prompt a re-think in the strategy of countries in Europe about more direct involvement or, more likely, a further escalation in sanctions, including the ban of all energy imports. The current situation is illustrated by the red dot in the contraction/recession quadrant in the bottom left-hand side of **Figure 14**. The extent of the deterioration from one month to the next has been substantial.

There is now a clear bias toward a deterioration in economic activity, but also a sharp swing in expectations to their third-lowest level on record, only exceeded on two occasions around the start of the Covid pandemic. Without a material deterioration in the economic outlook, investors are probably too cautious given likely ECB rate trajectory and other likely policy initiatives.

Figure 14: Euro area: ZEW survey swings from boom to recession in one month?

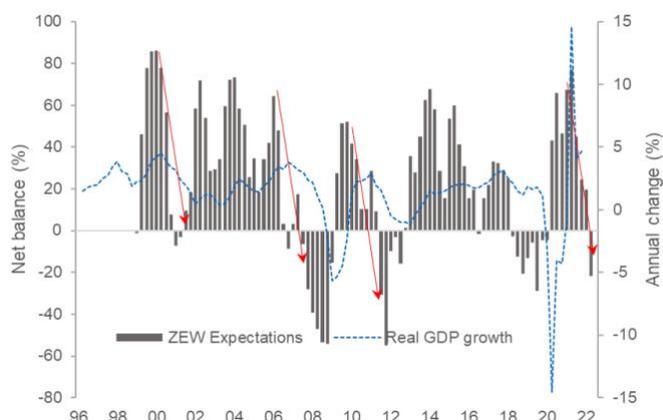


Sources: Haver Analytics through March 16, 2022.

A Decline in the European Economy: No Recession Yet

The ZEW survey is a good indicator of turning points in economic trajectory (see **figure 15**). But it is not as useful as a gauge of subsequent swings in GDP growth. At these levels of expectations, recessions have occurred in 2008-09 or 2020, but are not always indicated. What seems clear however, is that the next few quarters will likely see a material slowdown in the pace of economic activity, but it might be hard to reconcile with a recession yet. Sentiment would probably need to deteriorate again or at least stay very negative for a couple of quarters.

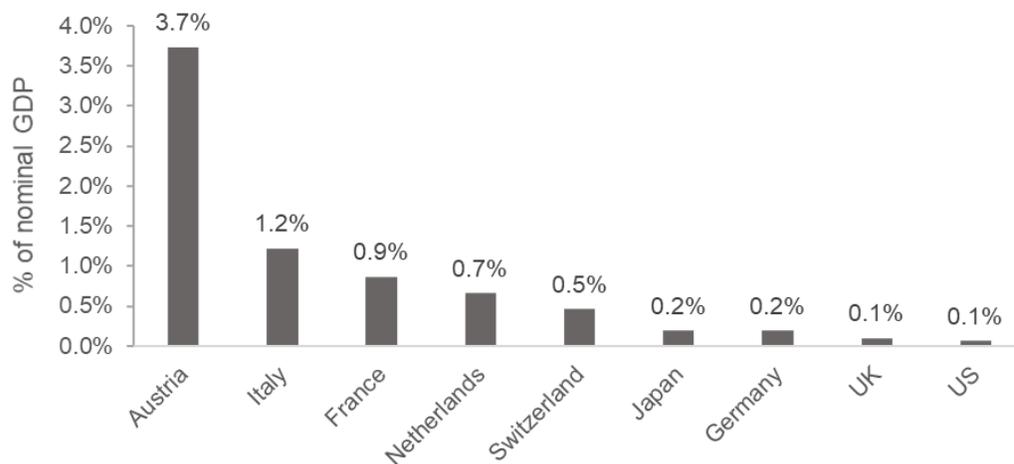
Figure 15: Euro area: ZEW expectations and turning points in economic activity



Sources: Haver Analytics through March 16, 2022.

Figure 16 shows which banking systems have the largest amount of claims on their Russian counterparts as a percentage of the respective banks' country GDP. There is very limited exposure in the US, UK or even Germany and Japan. Exposure is rising in countries like France and Italy, around the 1% of GDP mark. Exposure is much more elevated in Austria, accounting for almost 4% of GDP. Yet, if anything, exposure has been reduced since 2014 and the annexation of Crimea by Russia.

Figure 16: Claims on an immediate counterparty basis, Russia



Source: Bank of International Settlements (BIS) and Bloomberg through March 16, 2022.

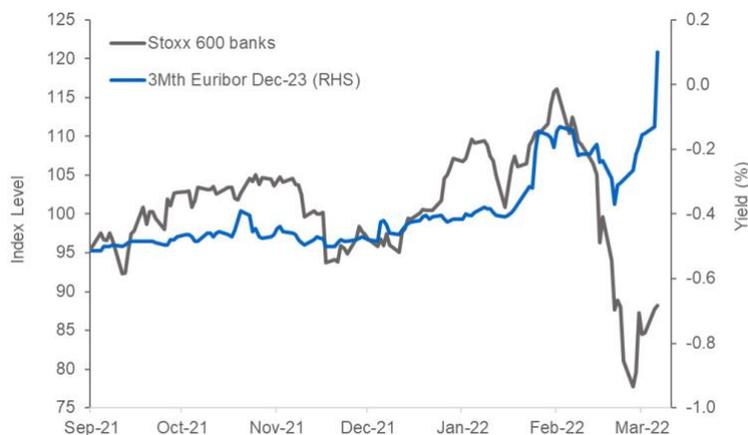
Strong Banks, Negative Investors

European banks are in a strong prudential position regarding their capital, liquidity and asset quality, having improved their ratios during the pandemic (see **figure 17**).

Despite a more negative attitude by investors about European banks, Andrea Enria, chairman of the ECB Single Supervisory Mechanism (SSM), argued this week that direct exposure to Russia is manageable overall, and while there were channels of indirect impact, none were disruptive so far. He concluded that banks' catch-up pay-outs via dividends and buybacks were "broadly acceptable" in light of previous restrictions. Reading between the lines, unless

there was a more material deterioration in the outlook of euro area GDP growth and/or much broader financial market volatility that could trigger counterparty credit risk (margin calls) losses or cybersecurity risks, the SSM would be unlikely to impose any new restrictions on banks' ability to pay dividends in 2022, excepting provisions for doubtful loans.

Figure 17: Bank valuations and ECB pricing expectations



Source: Bloomberg through March 16, 2022.

Two Scenarios for European GDP Growth and a Likely Fiscal Policy Response

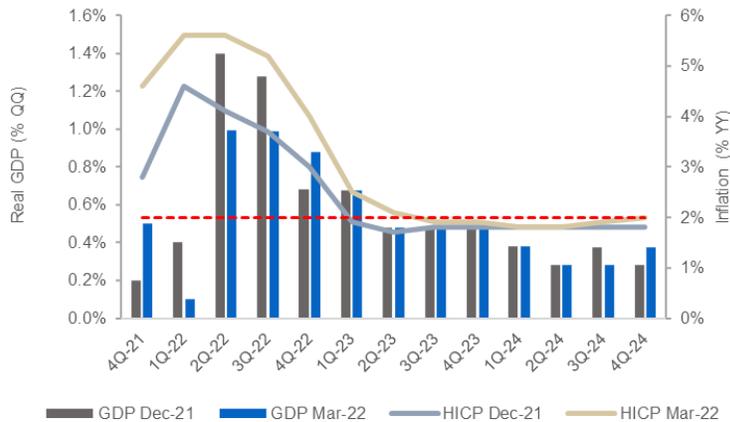
In our previous EMEA bulletin (see “[Ukraine/Russia: How much of a downside risk for Europe in 2022?](#)” in [Quadrant](#)), we presented two scenarios for GDP growth in Europe. In the first, GDP is ratcheted down by 1pp (our baseline) to 3%; and in the second by 2pp to 2% in case of significant restrictions to energy supply.

While Europe might decide to go down this route in the late spring (when demand for gas from Russia falls and the European Commission has presented its RePowerEU strategy), we think that fiscal policy coordination worth around €150bn/200bn will be agreed upon, alongside another year of suspension of the fiscal rules, protecting downside risks to the GDP baseline (see [figure 18](#)).

Inflation was already running hot (this week's print was revised up 5.9% Y/Y in February, a new all-time high). Excluding energy, food, alcohol and tobacco, core inflation was confirmed at 2.7% Y/Y, its highest level since October 1995.

But inflation could easily be higher for longer – meaning the wind will continue to blow in favor of monetary policy tightening, albeit from an exceptionally loose level of monetary conditions.

Figure 18: ECB Staff Projections (Quarterly path to 4Q-24)



Source: European Central Bank through March 16, 2022

Risks to economic activity looks skewed to the downside. We doubt that the ECB's new baseline forecasting only a very small reduction in the GDP trajectory in 1Q-3Q necessarily encompasses the full range of likely distortions to GDP growth. Nevertheless, this crisis has a silver lining for Europe. It is forcing European governments to envision new systems of burden-sharing and the sudden realization that funding for European public goods in sectors such as defense, energy networks, and renewables should be pooled if the aim is to avoid creating additional pressure on the debt sustainability of some member states.

Overall...

Only a strong, positive supply-side response can curb inflation while allowing economic growth to continue. In the past two weeks, the Fed has pounded its hawkish message home and oil has retreated from 14-year highs. While we would warmly welcome it, we are not prepared to speculate on a peace agreement between Russia and Ukraine that restores the old economic order.

The Fed will remain a constraint on growth until inflation subsides sharply and/or economic slack allows for a re-acceleration in growth. We believe the investment environment calls for higher quality, lower cyclicity in equity and bond portfolios with the exception of commodities that will replace Russian supplies. We are against market timing and for reallocating to these trends in the aftermath of a lingering, war-related supply shock.

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