PERSPECTIVAS

“Safety is never a permanent state of affairs.”
- Davos Seaworth

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SPOTTING RISK

INVESTMENT AND INSURANCE PRODUCTS: NOT FDIC INSURED • NOT A BANK DEPOSIT • NOT INSURED BY ANY FEDERAL GOVERNMENT AGENCY • NO BANK GUARANTEE • MAY LOSE VALUE
A NOTE FROM THE EDITOR

We live in times of heightened risk. We say this often but there has rarely been a time that no risk has existed. Think WWI in the early 1900s, WWII thirty years later, the Cold War after that, the collapse of the Soviet Union in the 1990s, and now the Trade “War.” While we can admit that we’ve certainly seen worse problems in the past, that’s not to say that the list of things that keep us up at night today is short. Luckily, we live in the age of information. There is data all around us that supports that the risks we discuss in this edition could materialize.

For this Perspectivas, we took two steps back to look at systemic risks from a global perspective. Different from the risks you hear often, namely slowing global economic growth, trade and other political tensions, etc. The idea is to showcase other (maybe larger) issues that may be just around the corner. From heightened global debt and weaker inflation dynamics to the rise of populism and demographic imbalances, these risks have the potential to materialize into, what could be for some, global crises. For many, their very existence plagues societal expectations and behaviors and threaten the standards of living and consumption patterns around the world.

No one knows what the next crisis will be nor when the next bubble will burst. What we do know is that as wealth managers, prudent investment is key toward safeguarding your assets. We discuss the framework for doing so in this edition and take the opportunity to remind you that while there is risk inherent in almost everything, we are here to help you make informed decisions.
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All forecasts are expressions of opinion and are subject to change without notice and are not intended to be a guarantee of future events. Refer to the Glossary and Important Information at the end of this publication.
In 2019, the U.S. equity bull market will celebrate its tenth birthday. While its demise has not yet been written, we can so far characterize it as a period where:

- The S&P 500 has delivered a total return of 398.50% or 20% a year on average
- The FAANG tech mega caps grew an average of 2230%
- High quality bonds delivered a total return of 43.9%
- The Fed’s balance sheet more than doubled in size, **Figure 1**.

**FIGURE 1.**
S&P 500 INDEX LEVEL VS. FED BALANCE SHEET

The shaded area represents the size of the Fed’s balance sheet. Primarily made of Treasuries and Mortgage Backed Securities (MBS), this number has grown from $2 to $4 trillion over the last 10 years. Many analysts argue this is one of the main reasons why the stock market has appreciated so much during that timeframe. As the Fed unwinds their support of the economy, some analysts believe this would have the opposite effect on the market, translating into negative performance in the following years.

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1Bloomberg, considers annual average return beginning at the bottom reached in March 2019.
2Bloomberg, FAANG refers to Facebook, Amazon, Apple, Netflix, and Google and considers the group’s combined average performance from 2Q 2009 until 3Q 2018. Sources: Citi Research, Bloomberg, St. Louis Fed. Charts and images are for illustrative purposes only. Indices are not managed, have no expenses and cannot be directly invested in. Historical analysis and past performance is not indicative of future results. For additional information, please refer to the Glossary and Disclosure section at the end of this publication.
It should be noted, however, that this rally did not occur without interruptions. Despite the positive total return over the last ten years, a number of macro events have led to bouts of increased worldwide volatility. Some of the most notable moments being as a result of:

**THE 2011 GREEK DEBT CRISIS**
This was the year that Greece’s credit rating was slashed ten times from BBB- to CC over the course of just seven months.

**THE 2011 U.S. CONGRESSIONAL DEADLOCK**
The impasse resulted in a delayed agreement on raising the debt ceiling, which led the country to lose its perfect AAA credit rating from S&P—a rating it has not gotten back since.

**THE COMMODITY CRISIS OF 2014**
Between the summer of 2014 and early 2016, oil prices retraced by 75%. During this period, U.S. energy stocks lost over 40% of their value while corporate defaults spiked to over 25% within the energy sector.

**THE CHINESE HARD LANDING SCARE**
In 2015, global economists were concerned about the deceleration of China’s economy, which had grown accustomed to double-digit growth rates in the previous decade. These concerns collided in the summer of 2015, when Chinese equities lost over 40% of its value. This fed onto U.S. equities which, in turn, retracted over 10% in a matter of days.

**A REDUCTION IN THE FED’S QUANTITATIVE EASING PROGRAM**
At the close of 2017, the Fed began to normalize the size of its balance sheet, while simultaneously increasing the Fed Funds rate. This net tightening effect on monetary policy was not well-received by market participants who deemed the Fed’s action as too aggressive. The result was a large sell-off during Q4 2018 which pulled the S&P 500 Index back nearly 20% from the year’s highs, despite strong corporate earnings and stable economic data.

**THE QUESTION WE OFTEN AS OURSELVES IS:**

Is the world better equipped to handle a crisis than it was a decade ago?

Banks in most countries are more prepared for a downturn. But when a crisis does inevitably break out, despite new layers of safety measures, central bankers and finance ministers will be no readier to battle the flames. In some respects, they’re even less ready—with their hands tied by new laws and opposition from competing parties. “What they did was to write regulations that reduced the chance of a financial crisis but significantly limited the flexibility in dealing with it.” Bloomberg’s Peter Coy says “one reason financial crises keep surprising us is that people aren’t as rational as economic textbooks say we are.”

With these events behind us, we can turn our focus to the state of affairs today and the impact they can have on the current market cycle. As we make our way through 2019, Citi expects corporate earnings to post lower growth. While these forecasts are lower than 2018’s, they are still expected to be positive. We expect the macro backdrop to remain healthy in the short to medium term, with expectations of a recession not materializing until 2020. And while there are risk events on the horizon, the combination of these factors should provide global equities with a stable environment to deliver moderate returns for the year.

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2Bloomberg Businessweek: Fighting the Next Big One (Sep 2018). Sources: Citi Research, Bloomberg. For additional information, please refer to the Glossary and Disclosure section at the end of this publication.
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CORPORATE EARNINGS

REVISING 2019 EARNINGS DOWNWARD, GLOBALLY

2019 is expected to be a challenging year for companies. In light of the projections, U.S. earnings growth forecasts for the year have been downgraded to 7% from 11% expected just a few months ago. Globally, projections did not fare any better. Citi analysts forecast global earnings per share (EPS) growth of only 6.5% with a possibility of even lower prints, potentially at 4%—signifying more cuts may be in store for the future. While downgrades are concerning, they should not be taken as an absolute indicator of conditions. In fact, we have seen this rhetoric for every year of the current bull cycle, with the exception of 2017 and 2018, Figure 2.

Geographically, emerging markets (EM) saw the most severe decline in EPS estimates from Q4 2018 to Q1 2019, Figure 3. EM EPS expectations went from close to 12% to just under 8%, with Korea, Taiwan, and Brazil experiencing the largest cuts. The reductions to EM EPS growth were similar to those of the U.S., with each region experiencing a four percentage point cut. Meanwhile, Europe’s EPS growth forecasts, excluding the U.K., were cut by only two percentage points. Estimates for the region are over 8%, keeping the cohort as a strong contender in the global arena. In the U.K., the negative revision was mostly on the back of weaker growth caused by lower oil prices and not Brexit. With few changes, Japan was assigned the lowest EPS growth forecast of 4% for Q1 2019.

On a per-sector basis, Energy and Real Estate experienced the largest EPS downgrades, Figure 4. Energy received the largest correction by far and is now expected to post negative 17.2% growth in earnings for Q1 2019, from expectations of over 80% for Q4 2018. Nine of the eleven sectors had EPS growth downgrades from the previous quarters. The only two sectors with positive revisions were Communication Services (though Q1 estimates are still expected to post a drop) and Utilities. Health care and Industrials seem to remain resilient, maintaining their positive growth expectations despite moderate downgrades.

Source: Citi Research. Indices are not managed, have no expenses and cannot be directly invested in. Chart and images are for illustrative purposes only. Historical analysis and past performance is not indicative of future results. All forecast are expressions of opinion and are subject to change without notice and are not intended to be a guarantee of future events. For additional information, please refer to the Glossary and Disclosure section at the end of this publication.
A ROUNDPUP OF MAJOR 4Q RESULTS: ANTICIPATION VS. REALITY

TECH: SEARCHING FOR MOMENTUM

Analysts were eagerly looking for answers in tech reports as global economic risks weighed on market sentiment in Q4 2018. Finding the need to support their own optimism, analysts have been unusually forgiving of tech results, which have generally shown mixed earnings and increases in their expense guidance. Citi remains very positive on the Information Technology sector. Investors should focus on companies showing improvements in both revenues and margins. Companies operating in the 5G space, or the latest generation of mobile communications, are particularly expected to improve their consensus estimates.

FINANCIALS: HIGH EXPECTATIONS, MIXED RESULTS

Banks’ results have been somewhat mixed. While the challenging market environment in Q4 contributed to a slightly lower fixed income trading revenue, loan demand rose, boosting interest income revenue. Analysts will be closely watching credit losses this year in anticipation of a potential slowdown as credit quality tends to decrease prior to recessionary periods and can negatively affect banks’ balance sheets.

OIL: DELIVERED RESULTS EVEN UNDER PRESSURE

Big oil companies reported results not seen in years. With a clear focus on profitability, instead of production, many companies were able to move past the sector’s geopolitical price swings and reported record-breaking profit. Oil companies are expected to continue a disciplined approach to managing their operating cash flows and returning capital to shareholders, even during periods of price pressure. Reductions in capital spending are expected to be lower by about 7%, while production is still forecast to increase by about 7%, versus last year.

INDUSTRIALS: OPPORTUNITIES EXIST BUT NEED TO BE SELECTIVE

Industrials have remained in tech’s shadow for the last few years, however, the most recent bout of earnings results showed that growth could be seen in that space as well. Investors need to be selective, nonetheless. While aero defense and railroads appear to be on solid ground, manufacturers (which are affected by tariffs) could face lower sales and other side effects from protectionist measures.

Does This Mean That Equities Are Doomed This Year?

Expected returns for the MSCI All Country World Index remain at 14% for 2019—A healthy level compared to its 11.88% annualized return over the last 10 years. Additionally, we have seen multiple historical precedents of earnings forecasts experiencing downward revisions and equities still trending up. This has happened 15 times since 1989. The selloff in Q4 2018 also helped price in some of the potential slowdown, making valuations more attractive.

FIGURE 4.
RUSSELL 1000 EPS GROWTH EXPECTATIONS BY SECTOR

<table>
<thead>
<tr>
<th>Sector</th>
<th>Q1 2019</th>
<th>Q4 2018</th>
</tr>
</thead>
<tbody>
<tr>
<td>Consumer Discretionary</td>
<td>-5.3%</td>
<td>16.1%</td>
</tr>
<tr>
<td>Consumer Staples</td>
<td>-3.1%</td>
<td>5.0%</td>
</tr>
<tr>
<td>Energy</td>
<td>-17.2%</td>
<td>85.2%</td>
</tr>
<tr>
<td>Financials</td>
<td>-0.6%</td>
<td>8.2%</td>
</tr>
<tr>
<td>Health Care</td>
<td>2.7%</td>
<td>14.9%</td>
</tr>
<tr>
<td>Industrials</td>
<td>2.0%</td>
<td>19.7%</td>
</tr>
<tr>
<td>Information Technology</td>
<td>-9.8%</td>
<td>7.5%</td>
</tr>
<tr>
<td>Materials</td>
<td>-13.0%</td>
<td>18.2%</td>
</tr>
<tr>
<td>Real Estate</td>
<td>-18.4%</td>
<td>37.1%</td>
</tr>
<tr>
<td>Communication Services</td>
<td>-3.3%</td>
<td>-10.5%</td>
</tr>
<tr>
<td>Utilities</td>
<td>8.7%</td>
<td>4.3%</td>
</tr>
</tbody>
</table>

Source: Citi Research, Fact Set, Russell Investments
MARKET DYNAMISM

Financial headlines have been fixated on estimating when the longest bull market on record will end. That focus, however, has obscured some other long-running trends. For example, the number of publicly traded companies in the U.S. has declined steadily since the late 1990s, a trend reinforced by a declining number of initial public offerings (IPOs). Should this trend continue, it could signify fewer firms available on stock exchanges, fewer opportunities for investors, and points to, perhaps, a less dynamic market.

De-listings (the removal of companies from stock exchanges) is a normal occurrence as businesses decline, companies go private, or mergers and acquisitions (M&A) take place. This attrition is typically counteracted by new listings, the traditional source being the IPO. However, the number of IPOs has been shrinking at a dramatic pace, Figure 5. The number of companies trading on U.S. exchanges has more than halved since peaking in 1996, see Figure 6.

A confluence of factors is believed to be responsible. While going public has always required companies to report results and undergo increased scrutiny, the decline in IPOs is also attributed to the increase in the regulatory burden companies face—an issue that has steadily grown since the accounting scandals of the early 2000s and in the aftermath of the financial crisis of 2008. Another explanation is often that the reasons for going public have changed. Historically, companies sold shares as a means of raising capital. Today, companies have an increasing number of alternatives to raise capital as venture capitalists and alternative sources of capital have become more pervasive. Companies like Uber and Airbnb have been able to raise billions without ever going to the public market because of these non-traditional sources of capital.

Sources: Jay R. Ritter, Warrington College of Business Administration, University of Florida; University of Chicago Center for Research in Security Prices

Sources: Jay R. Ritter, Warrington College of Business Administration, University of Florida; Bloomberg: Where Have All the Public Companies Gone?, various; ValueWalk: Number of US Public Companies Falls By Almost 50%; SEC. Chart and images in this publication are for illustrative purposes only. Historical analysis and past performance is not indicative of future results. For additional information, please refer to the Glossary and Disclosure section at the end of this publication.
Regardless of the cause, the reduction in the number of U.S.-listed public companies is a serious issue for our markets and the country more generally. To the extent companies are eschewing our public markets, the vast majority of Main Street investors will be unable to participate in their growth. The potential lasting effects of such an outcome to the economy and society are, in two words, not good.

- Jay Clayton, chairman of the Securities and Exchange Commission, summarizing the consequences of this trend succinctly

This trend could cause investors to potentially miss out on the early growth phase of startups as some go public not to raise capital, but as a means of providing liquidity to their early supporters and employees. Alternatively, companies may be compelled to go public as a result of tapping-out private investment funds. Data shows that the percentage of IPOs with negative earnings has risen almost consistently since the tech bubble in 2000, Figure 7.

At the same time that the number of public companies has declined, the market value of the remaining firms has grown, Figure 8. In other words, there are fewer, but larger companies trading on the stock market and their total market value, as a percentage of GDP, is close to the peak reached in 1999. This again points to perhaps the scarcity in public investments but, at the same time, highlights a less dynamic market, with greater consolidation and less competition.

FIGURE 7.
PERCENTAGE OF IPOS WITH NEGATIVE EPS, 1980-2018

Source: Jay R. Ritter, Warrington College of Business Administration, University of Florida

FIGURE 8.
MARKET VALUE OF COMPANIES LISTED ON U.S. STOCK EXCHANGES, AS A PERCENTAGE OF GDP

Sources: World Bank

*Bloomberg: Where Have All the Public Companies Gone? Sources: Jay R. Ritter, Warrington College of Business Administration, University of Florida; Bloomberg; ValueWalk; SEC. Chart and images in this publication are for illustrative purposes only. Historical analysis and past performance is not indicative of future results. For additional information, please refer to the Glossary and Disclosure section at the end of this publication.
INFLATION

For some time now, the U.S. Federal Reserve, the European Central Bank, and the Bank of Japan (just to mention a few) have been using the “magic” 2% inflation target as a means to set monetary policy. Although the validity of the 2% target has been questioned by policymakers in recent years, this figure is used by most central banks as a guideline for “mild inflation”—which is believed to lead to the most desirable economic climate.

WHY WE NEED SOME INFLATION

There are those who insist that advanced economies should aim to have 0% inflation, or in other words, stable prices. The general consensus, however, is that a little inflation is actually a good thing.¹ When inflation is on the rise, people will consume more today on expectations that things will get pricier in the future—an event that fuels economic growth. When there is inflation, central bankers can also raise interest rates, which gives them ammunition to lower them in the event of an economic downturn in order to stimulate growth. And, there are yet others who believe that the primary function of inflation is to prevent deflation.² Figure 9.

WHEN MORE THAN SOME INFLATION BECOMES A DETERACTOR INSTEAD OF A CONTRIBUTOR

When the demand for goods and services rises faster than supply, prices rise. Higher prices combined with steady wages result in falling real incomes, denting consumer demand. Savings too fall in real value and retirees on fixed incomes are particularly hurt by the loss in purchasing power. Pressure builds for governments alike as they try to keep up with the increasing cost of living and the value of its pensions and welfare programs. For firms, wage unrest rises as workers demand higher pay. As costs rise, companies become less competitive versus lower-cost international peers. Additionally, because high inflation usually leads to higher interest rates, businesses (and people) become less inclined to invest or borrow at higher costs of funding—lessening both business and consumer investments and loans.

WHAT’S KEEPING INFLATION DEPRESSED

Inflation typically rises as a result of increases in the demand for G&S or increases in production costs (e.g. raw materials or wages). However, inflationary forces in any economy are much more complex than that. Take the U.S. for example. Strong consumer spending has been the main contributor to the country’s healthy 2-3% economic growth seen since the financial crisis.³ And wage growth, while below its 60-year average of 6.2%, has fairly recovered and hovered just above 3% since 2017.⁴ However, under the hood of these seemingly inflationary forces, lie potential problems with the transmission.

While many argue that the economic growth experienced in the last few years is due to growth in consumption, there is evidence that consumption growth in aggregate has not been accelerating

FIGURE 9.
THE DAMAGING EFFECTS OF DEFLATION

Lower Prices for G&S

Oversupply of G&S

Lower profits and higher bankruptcies

Lower income and less spending on G&S

Reductions in production

Layoffs and higher unemployment

Source: Investing Answers, Investopedia

LEARNING BOX

Deflation refers to a broad decline in the price of goods and services (G&S), signifying a negative inflation rate. Deflation can result from declines in aggregate demand for G&S, decreases in the money supply, government spending, and business investment.

¹Investopedia: The importance of inflation and GDP. ²Investopedia: How can inflation be good for the economy? Sources: The Balance, Investopedia, tutor2u, Reuters, Bloomberg. Historical analysis and past performance is not indicative of future results. For additional information, please refer to the Glossary and Disclosure section at the end of this publication.
LEARNING BOX

Secular stagnation refers to a period of long-term negligible or no economic growth in a market-based economy due to a chronic lack of demand. Historically, a booming economy with low unemployment and high GDP growth (i.e., an economy at or above capacity) would generate inflation in wages and products. However, an economy facing secular stagnation behaves as if it is operating below capacity, even when the economy appears to be booming; inflation does not appear.7

DID YOU KNOW?

Inflation is considered to be a product of economic growth and money supply. Where there is inflation, the cost of servicing debt is slowly eroded over time, making debt payments more affordable.

Consider a homebuyer in the 1980s. According to the U.S. Census Bureau, the median home price was $62,900 in January 1980. A person who took out a mortgage then would typically enter a fixed monthly payment for the next 30 years. As the economy expanded over the course of the loan, and the price of G&S increased, wages also improved. This resulted in a mortgage payment that, over time, represented a smaller portion of the debtor’s annual salary. In other words, the debtor would be repaying 1980s debt with in 1990s and 2000s dollars (and its respective inflation), essentially helping bring down the value of their debt.

The same concept applies to companies and nations. When used responsibly, debt is a magnifier of economic output and wealth generation, and a healthy level of inflation has historically served as a means to help make debt more manageable—setting in motion the gears to fuel further economic growth.

due to a fall in real income.5 A closer look at the parts that make up consumption indicates that while services (the largest component) have remained relatively stable, discretionary consumption (the most indicative component of leading economic trends) showed renewed optimism in 2017 and has since trended lower. In fact, the only reason the broader category of total consumer spending is not trending lower is due to a rise in nondurable goods [such as food and clothes] consumption throughout most of 2017.5

Economists point to a slew of other factors that might also explain the conundrum. Labor market forces is one of them. Some question the Fed’s affirmation that we are, in fact, in “a tight labor market.” Certainly 3.8% unemployment* versus Fed projections of a normal rate being between 4% and 4.6%, throws into question the “slack” still present in the labor market. “It may be, for example, that the level at which unemployment provokes higher inflation is lower than estimated.”6 This could be because these figures only include people actively looking for work and ignore, domestically, those hired off the sidelines and, more broadly, the increasing supply of global labor. Aging populations, that save more and spend less, could be another explanation. Technology, or the rise of the digital economy, is yet another suspect, as discussed in the fifth volume of this publication.

In light of these findings, how then is growth accelerating if consumer demand is seemingly stagnant? This is again another topic of complexity. Since the financial crisis, government spending (to the detriment of the federal deficit) has been a growing contributor to economic growth. In the short term, inventories and the biggest corporate tax cut in U.S. history (which is now fading) have also been penciled in as contributors to growth. However, it is difficult to say with certainty that these suppliers will hold past the “short-term.”

WHAT HAPPENS IF INFLATION DOESN’T RISE

Recall that high inflation typically leads to higher interest rates. Thus, tepid inflation keeps central bankers at bay and interest rates low. This lessens the Fed’s power should a recession strike, but just as importantly, it puts at risk the credibility of the central bank in setting economic targets and meeting them. Certainly, the Fed prefers inflation overshoots over misses as the latter poses a real question for the path forward. Persistently low (or below-target) inflation further develops the threat of secular stagnation, which can’t be overcome even with near-zero interest rates.7 Stagflation can depress GDP growth for a long time, heighten the need for increasingly larger injections of monetary and fiscal stimulus—all risks that could catapult the U.S. into unchartered territory, bringing into question many of the traditional market theories and policies in place today.
DEBT

Since 1999, global debt has more than doubled, going from nearly $80 trillion to an all-time high of $244 trillion as of 2018. Figure 10. While over half of that debt rests on the shoulders of just three borrowers—the United States, China, and Japan—higher levels of debt is a global phenomenon. In a March 2018 Policy Paper, the International Monetary Fund noted that “while the majority of low-income developing countries remain at low or moderate risk of debt distress, the number of countries at high risk or in debt distress has increased from 13 in 2013 to 24 in January 2018.”

**FIGURE 10.**
THE GROWTH OF DEBT OVER THE LAST 20 YEARS (ON A NOMINAL BASIS)

This massive spike in debt is largely attributed to the low-interest-rate era that followed the Great Financial Crisis. In hopes of promoting economic growth and aid consumers and corporations alike, the U.S. Federal Reserve decreased the reference rate to near zero percent and held it at that level for nearly seven years. With such low funding costs, global entities, sovereign states, and consumers piled-on large amounts of debt at perhaps the lowest interest expense in history.

The magnitude of the risk associated with such elevated levels of debt can be explained by looking towards the west. The U.S. leads the world in total government and corporate debt on a nominal basis—and the projections for the next decade don’t fare any better. Because of this, we thought it sensible to highlight how this catalyst could affect investors in the (hopefully distant, but maybe not so distant) future.
CASE STUDY: U.S. GOVERNMENT DEBT

U.S. government debt is over $22 trillion and is expected to reach $28.7 trillion by 2029, according to the Congressional Budget Office.

As long as the fiscal deficit persists, government debt should continue to grow. While minor at first glance, small fiscal deficits have the potential to become large loads of debt over time. Take Figure 11, for example. This figure graphs the U.S. Federal surpluses and deficits over time. When receipts exceed outlays, as they did last in the early 2000s, a fiscal surplus occurs. When outlays are larger than receipts, however, the difference results in a deficit. As illustrated in the figure, deficits became the largest during the Great Financial Crisis—creating a gap in funding that was covered by issuing debt, or essentially borrowing funds from the bond market. The recurrent issuance of debt caused U.S. debt-to-GDP to increase from 62% at the close of 2007 to over 104% at the close of 2018.

HOW DOES THIS IMPACT US?

Despite the ballooning amount of outstanding debt, the real risk lies in the willingness and capacity of the debtor to pay. In order to prevent debt from broadly expanding, Congress imposes limits on the amount of liability that can be incurred. In the instances where the amount of debt runs up against the stated limit, Congress would have to approve a new level of debt or cap. Failure to do so implies the government is incapable of paying its debt obligations. Should the capacity of the U.S. government to repay its debt come under question, the repercussions could be apocalyptic for investors. Around the globe, Treasuries exemplify the benchmark for risk-free assets and represent the most widely used instrument to store wealth. Global financial institutions, governments, and pensions hold large amounts of Treasuries as vehicles for holding dollar reserves. A default by the U.S. government would throw into question the adequacy of bank capitalizations and potentially lead to worldwide bailouts by local authorities. At the same time, many governments would find themselves in a weakened position and not in a capacity to bail-out the banking sector. Similarly, pensions would experience capital losses and find themselves unable to meet pension payments to retirees—an event which would become a crisis in itself. The geopolitical repercussions could also be substantial. A default could cause the U.S. to lose its global hegemony and notionally drag the rest of the world into what could be a severe, secular recession. For investors, this could signify the end of modern financial markets as we know them.

FIGURE 11.
U.S. TOTAL SURPLUSES AND DEFICITS

![Image of Figure 11: U.S. Total Surpluses and Deficits]

Source: U.S. Congressional Budget Office, January 2019

The U.S. government budget is divided into discretionary and mandatory spending. Discretionary includes defense spending as well as other government activities (from public services to national parks’ upkeep). Mandatory spending is made up of: Medicare, health care benefits for the elderly and disabled; Medicaid, health care benefits for very low income families; and Social Security, most widely known as benefits for the retired, however, includes several other social welfare and insurance programs.

While the crisis certainly contributed in large part to the swelling of the federal debt, a closer look at the U.S. budget reveals that mandatory expenses are, in fact, one of the largest outlays for the U.S.—accounting for approximately two-thirds of the U.S. budget. Social Security alone represents nearly a trillion dollars, or nearly 25% of the U.S. 2019 budget.

DID YOU KNOW?

In 2011, in the midst of a severe recession, with declining tax revenues and expenditures from a maturing population on the rise, S&P downgraded the U.S. government’s debt by one notch (to AA+). It was the first time ever that the U.S. was given a credit rating below the highest rating (AAA). The occurrence threw into question the creditworthiness of the most liquid and risk-free assets worldwide, placing the cornerstones of global financial markets on shaky ground.
DEBT

CASE STUDY:
U.S. CORPORATE DEBT

U.S. corporate debt has also seen a substantial increase in recent years. According to the St. Louis Fed, the amount of corporate debt is at an all-time high, reaching nearly $6.2 trillion at the close of Q1 2018, and it is continuing to grow, Figure 12. The amount of debt taken on by corporations now represents nearly 30% of U.S. GDP. Similarly, the aggregate credit rating of all outstanding corporate debt is at multi-year lows. The median credit rating is now BBB-, one notch away from high yield, as seen in Figure 13. This means that there is more debt today than at any other point in history and less than a third of that debt is of high quality.

The circumstances are certainly troubling. Adding to the mountain of worry: global central banks are slowly but steadily removing the economic stimulus support, while an aging bull market may be a headwind for the valuation of these outstanding debt instruments.

FIGURE 12.
OUTSTANDING NON-FINANCIAL CORPORATE DEBT

FIGURE 13.
S&P GLOBAL MEDIAN CORPORATE CREDIT RATING

Sources: Wikipedia, Citi Research, Bloomberg, St. Louis Fed. Charts and images are for illustrative purposes only. Historical analysis and past performance is not indicative of future results. For additional information, please refer to the Glossary and Disclosure section at the end of this publication.
AS INVESTORS, WE MUST ASK OURSELVES A FUNDAMENTAL QUESTION:

Does the yield received by a debt instrument compensate me for the level of risk associated with it?

Emerging market (EM) debt issuers are particularly exposed to higher risks. According to the Institute of International Finance, EM economies have over $8 trillion in debt issued in foreign currencies such as the dollar and the euro. Under normal conditions, this debt should be relatively manageable for EM companies to repay. However, during periods of stress EM currencies typically devalue, weakening companies’ capacity to repay debt issued in other currencies.

A recent example of this is Turkey. After battling double-digit inflation figures and a widening current account deficit, increased U.S. sanctions sent the Turkish Lira into a nearly 50% decline during the summer of 2018. This devaluation led to a halt in economic activity and large defaults in the local corporate sector—something which continues to pressure the banking sector today. The events in Turkey reverberated throughout capital markets, also affecting the loan portfolios of financial institutions in Spain, France, and Italy. This prompt example suggests that even if an investor owns no direct exposure to a specific risk, they could still be affected by contagion from other events.

Sources: Wikipedia, Citi Research, Bloomberg, St. Louis Fed. Charts and images are for illustrative purposes only. Historical analysis and past performance is not indicative of future results. For additional information, please refer to the Glossary and Disclosure section at the end of this publication.
PENSIONS

Due to improvements in health care and better standards of living in most countries around the world, life expectancy has been on the rise. While increased longevity is a positive step toward productivity and social health, it also has profound economic impacts on the social protection systems designed to support the elderly. As retirees live longer, they become more expensive. In order to sustain the increase in costs, pension systems need a larger, working-age, contributor base. This problem has been met with generally decreasing fertility rates across developed countries—a phenomenon which has caused the ratio of retired people to those of working age to rise, adding significant pressure on the pension system.

Pension promises for retirees are usually the norm in developed economies and are in increasing demand in less-developed parts of the world. Increasing expectations around pensions indicate sensible social issues that governments around the world have been slow to address. With the exception of Denmark, Netherlands, and Australia, among a few others, governments and corporations have largely failed to put aside enough funds to meet the commitments made to their pension recipients. This implies that the assets held in pension plans are not enough to cover the obligations to its citizens and employees and, instead, constitute a liability. Over time, this gap between assets and liabilities could grow in their respective countries, thereby imposing economic pressure and a diminished standard of living for everyone.

According to Citi estimates, as of the end of 2015, “the total value of unfunded (or underfunded) government pension liabilities for twenty countries belonging to the Organization for Economic Co-operation and Development (OECD) is a staggering $78 trillion, or almost double the $44 trillion national debt number”, Figure 14. In addition to governments, corporations have also consistently underfunded their pension obligations. Data for end of 2018 shows that the aggregate of U.S. corporate pension plans remain underfunded by close to 16%, Figure 15.

Sources: Citi Global Perspectives & Solutions, OECD, Word Economic Forum, Aon Hewitt. Charts and images are for illustrative purposes only. Historical analysis and past performance is not indicative of future results. For additional information, please refer to the Glossary and Disclosure section at the end of this publication.
It’s worth mentioning that the magnitude of the pension crisis shows itself in many different ways across the world: Social security systems, national pension plans, private sector pensions, and individual retirement accounts (to name a few). In the U.S., in addition to national pension plans, corporate benefit programs are severely underfunded. This poses a real problem for companies as they will need to steer cash flow from capital expenditures and shareholders pockets to fund their pension obligations, potentially hurting their profitability down the line. This issue is particularly serious in Europe where generous social benefits do not reflect the region’s tepid economic growth. Italy, France, Spain, and Greece, among others, have pension expenditures of more than 12% of their GDP, with this number only expected to get worse. In Asia (excluding Japan), the problem is not as severe from the point of view of underfunded obligations as there are little retirement provisions.

Given these points, we can conclude that nations, employers, and local governments alike have not kept up to speed with changes in demographics. Taking into account the rise of the old-age dependency ratio and the wide gap of underfunding, it’s becoming more difficult for social security programs and private pension funds to honor retirement commitments to future generations. These issues are considered by many analysts to be the foundation for a not-so-distant global crisis.

**BRAZIL IN FOCUS**

Brazil sits atop a list of countries with a dire need to update a costly state pension system.

According to studies from the OECD, Brazil has one of the most free-handed pension policies in the world. To put it into perspective, the average OECD-country-worker retires at age 65 1/2 with a pension worth 53% of their pre-retirement income. In Brazil, a man can retire at 55 with a pension worth 70% of their previous earnings.

The resulting effect is a country that is facing the burden of committing a large part of their GDP to pension expenditures for a relatively small percentage of their population, **Figure 16**.

Over time, the problem could get worse as more people enter retirement age and annual pension costs increase. This would have dire consequences for a country which already operates with a large budget deficit.

If this scenario persists, it can bring significantly negative consequences to the country’s credit profile and long term growth. Because of this, the approval of a meaningful pension reform in Brazil is crucial. Pension reform holds the key toward fixing the country’s public finances and unlocking the investment needed to boost a much-anticipated economic recovery.

Citi Private Bank’s base case is that a watered down version of the pension reform presented by the Bolsonaro administration will be approved some time during the second half of 2019. Analysts believe there is a 50% chance of this happening. However, should there be no reform at all, Brazilian assets could be negatively impacted.

**FIGURE 16.**

**PENSION EXPENDITURE VS. DEPENDENCY RATIOS**

Source: Deutsche Bank, 4 September 2018

Relative to Greece, which has a relatively older population, Brazil has nearly the same pension expenditures despite having a younger population.

Sources: Citi Private Bank, OECD, Deutsche Bank. Charts and images are for illustrative purposes only. Historical analysis and past performance is not indicative of future results. All forecast are expressions of opinion and are subject to change without notice and are not intended to be a guarantee of future events. For additional information, please refer to the Glossary and Disclosure section at the end of this publication.
We began 2019 with a positive outlook for global equity and fixed income markets on the back of continued solid economic growth, both in the U.S. and in emerging markets. While we maintain our positive global outlook, investors should take note that the likelihood of lower real economic growth could bring a scenario of more moderate equity market returns over the coming years.
EQUITIES

Despite a substantial bounce off 2018 lows, we remain optimistic on U.S. equities. Particularly within large-caps, we expect positive momentum from the trade negotiations with China and a less restraining monetary policy by the Federal Reserve. While we believe recessionary risks are limited in 2019, there are warning signs that indicate we may be entering a period of lower economic growth. For example, the lack of additional tax cuts, slowing retail sales, and a decrease in small businesses hiring intentions, if persistent, could point to a less robust growth dynamic within the U.S. economy.

In Europe, we continue with a neutral view. While some exposure to the region is advised as part of a total asset allocation strategy, the amount depends on your risk profile and objectives. That said, our view is that a number of idiosyncratic factors, such as the slowdown in motor vehicle output from Germany, political issues in France and Italy, Brexit in the U.K., and tightening financial conditions, have reduced growth expectations across the region.

There is no change in our view for emerging market (EM) equities. We maintain our positive outlook, particularly from the tailwinds generated from monetary and fiscal stimulus in China, which should be supportive not just for EM but for the global economy.

FIXED INCOME

There have been no significant changes to our global fixed income view since the beginning of 2019. We continue to like credit relative to equity and prefer investment grade corporates, especially within short- and medium-term maturities. We hold a neutral stance on high yield securities due to less compelling valuations.

In emerging markets, we continue with our favorable outlook for both hard- and local-currency debt, specifically as less hawkish monetary policy in the U.S. should prove beneficial for emerging economies.

As for interest rates, we expect no more rate hikes in the U.S. during 2019 based on expectations of lower inflation and increased recessionary risks. Additionally, the Federal Reserve has indicated the halt of its balance sheet run-off program in September (with reductions beginning in May) in order to avoid altering short-term markets and place upside pressure on yields. Our expectation is for the 10-year U.S. treasury yield to trade range-bound between 2.5-3.0% throughout the year.

“Growth is turning over and inflation is low or possibly still falling...this can still be a reasonable environment for equities, with 5-10% returns historically the norm. It is also usually a good environment for fixed income markets with outsized returns to government bonds and high quality credit historically.”

- Citi Research's Global Asset Allocation, Feb 2019

Sources: CPB Quadrant, Mar. 2019; Global Asset Allocation, Feb. 2019. The views and opinions expressed herein, which are subject to change without notice, are those of Citi at the time of publication. Historical analysis and past performance is not indicative of future results. All forecast are expressions of opinion and are subject to change without notice and are not intended to be a guarantee of future events. For additional information, please refer to the Glossary and Disclosure section at the end of this publication.
SAFEGUARDING ASSETS

Maintaining a balanced investment strategy is not always easy, especially when you see your portfolio take a hit. When that happens, take a breath and remember that as long-term investors, there will be periods of stress. Studies have shown that losses are really the one constant across all cycles1, Figure 17.

The immediate reaction most investors have when their portfolio stalls or falls is to sell to avoid further losses. It is precisely in these moments of panic, that it is most important to hold onto unrealized losses. Even through ups and downs, markets have historically always recovered.2

As investors, our next thought is often “What if I could avoid such drawdowns?” There are many investors that attempt to time the market. Unfortunately, this is not a sustainable tactic. In fact, no market timing method has consistently been able to avoid losses. The idea is to remain invested and stay the course. History has shown that the worst performing days in the markets are generally followed by the best performing days. Therefore, if you sold out of panic there is a high probability of missing the rebound.

No one knows exactly when the next recession will arrive. It can be triggered by an event or it can be a slow process of deteriorating market conditions. What we do know is that the next downturn is inevitable. With that in mind, investors should prepare their portfolios for moments of uncertainty.

1. Re-assess your risk profile. Market volatility is a characteristic of near-end cycles. As such, choose an appropriate level of risk commensurate with how much volatility you can bear. Talk to your financial professional about our asset allocation guidelines. These estimates will give you an indication of potential drawdown for each level of risk.

2. Set your short and long-term goals. A clear view of your needs is essential to making fundamental portfolio decisions. Remember that you can rebalance your investment portfolio as your needs and goals change.

3. De-risk your portfolios. Choose more defensive strategies to safeguard your assets. You may also consider adding uncorrelated assets to your portfolio. These strategies can improve diversification and may help mitigate market volatility.

4. Invest globally. Global portfolios could help lower the overall risk of a portfolio and potentially increase return opportunities.

FIGURE 17.
MARKET DRAWDOWNS (1835-2015) S&P 500 TOTAL RETURN INDEX

Source: Global Financial Data, A Wealth of Common Sense

LEARNING BOX

A balanced investment strategy is a method of portfolio asset allocation aimed at balancing risk and return. Such portfolios are generally balanced between equities and fixed-income securities and is typically suitable for those investors with a long-term time horizon (of five years or longer), and a higher degree of risk tolerance versus a capital preservation strategy.3

A capital preservation strategy follows a conservative approach to investing whereby the primary goal is to minimize losses and preserve capital. This strategy would typically invest in the safest short-term instruments, such as Treasury bills and certificates of deposit.

Generally speaking, defensive strategies are those that have relatively higher payoffs during broad market downturns and lower payoffs, relative to the broader market, in a rising market environment.4

Despite the allure of market timing, staying invested is necessary to earn the majority of the total long-run returns.

- Citi Global Strategy Quadrant, 1 Feb 2019

1 A Wealth of Common Sense: 180 Years of Market Drawdowns. 2 Citi Perspectivas Vol. 12: Don’t Listen To Your Heart... At Least Not For Investing.

3 Investopedia: Balanced Investment Strategy. 4 Seeking Alpha: FTSE Russell Research. Sources: Citi Research, Citi Private Bank, Investopedia. Historical analysis and past performance is not indicative of future results. Asset Allocation and Diversification does not assure profit nor does it guarantee against losses. For additional information, please refer to the Glossary and Disclosure section at the end of this publication.
THE STRATEGIC ALLOCATION ILLUSTRATED BELOW REPRESENTS THAT OF A MODERATE LEVEL 3 PORTFOLIO.

53% EQUITIES
- 25% North America Large Cap
- 4% North America Small/Mid Cap
- 11% Europe
- 5% Japan
- 2% Asia ex Japan
- 5% Emerging Asia
- 1% Emerging EMEA
- 1% Emerging LatAm

33% FIXED INCOME
- 21% Developed Sovereign
- 7% Developed Investment Grade
- 2% Developed High Yield
- 2% Emerging Market

12% ALTERNATIVES*
- 12% Alternative Investments*

2% CASH
- 2% Cash

Most Conservative
For investors who seek capital preservation and relative safety over the potential for a return on investment.

Conservative-Moderate
For investors seeking income generations and capital preservation.

Moderate
For investors with a blended objective who seek balance between investments that offer income and a potentially higher return.

Moderate-Aggressive
For investors who seek long-term growth of capital with moderate risk and market value fluctuations.

Most Aggressive
For investors who seek maximum long-term growth of capital with greater risk and market value fluctuations.

<table>
<thead>
<tr>
<th></th>
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<th>Level 3</th>
<th>Level 4</th>
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<tr>
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<td>33%</td>
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<td>53%</td>
<td>70%</td>
<td>86%</td>
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<tr>
<td>Alternatives*</td>
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<td>8%</td>
<td>12%</td>
<td>14%</td>
<td>14%</td>
</tr>
</tbody>
</table>

This model portfolio allocation follows Citi Private Bank’s Adaptive Valuations Strategy (AVS) methodology. Source: Global Strategy Quadrant (Sept 2018).

*Alternative investments include hedge funds, private equity, and real estate among others. Asset Allocation does not assure profit nor does it guarantee against losses. Chart and images are for illustrative purposes only. For additional information, please refer to the Glossary and Disclosure section at the end of this publication.
EUROPE

Social media welcomed 2019 with a viral tag referred to as “The Ten Year Challenge.” The tag, popularly known as “#10YearChallenge”, involved people comparing pictures of themselves in 2009 versus pictures of them in 2019. In the spirit of the challenge, we take the opportunity to compare economies that were under substantial instability ten years ago and discuss where they are today.

In the wake of the collapse of the U.S. real estate market that began in 2007, and the Great Financial Crisis that ensued the following year, by 2009, a global contagion had erupted. In Europe, particularly, the collapse of Iceland’s banking system had spread to Portugal, Italy, Ireland, Greece, and Spain (PIIGS) by the end of 2009. The inability to neither repay nor refinance their government debt, and incapacity to bail out their over-indebted banks, gave rise to the European Sovereign Debt Crisis. At the time, the external debt of these five countries were large and their economies considered the European Union’s (EU) weakest. Tension peaked around 2011 when the probability of Greece defaulting on its $345 billion debt obligation was nearly 100%, Figure 18. As a result, the countries received bailout funds from the EU and International Monetary Fund and were forced to implement stringent austerity programs to combat the crisis.

Flash forward ten years, many of the PIIGS are now on more solid economic footing, as evidenced by their economic growth rates and budget balances, Figures 19 & 20. All five countries are experiencing stronger economic growth in 2019 versus 2009 and have budget balances that have recovered from larger deficits ten years ago (with the exception of Italy).

DID YOU KNOW?

The term PIIGS is an acronym made popular during the European debt crisis. It stood for the five countries that had high debt and deficits and poor prospects of repaying their loans. Because of the acronym’s association with the farm animal, the respective leaders of the involved countries voiced their disagreement with the term. However unflattering, the nomenclature has prevailed, and it is still used today by reporters and columnists when referring to these events.

*The probabilities are calculated based on the current cost of buying protection, via Credit Default Swaps, over a period of years, typically five, versus the expected recovery rate. Sources: ResearchGate.net, Country Acronyms in Comparative Political Economy, by Samuel Brazys and Niamh Hardiman. The views and opinions expressed herein, which are subject to change without notice, are those of Citi at the time of publication. Chart and images in this publication are for illustrative purposes only. All forecast are expressions of opinion and are subject to change without notice and are not intended to be a guarantee of future events. For additional information, please refer to the Glossary and Disclosure section at the end of this publication.
FIGURE 19.
REAL GDP GROWTH

Portugal Italy Ireland Greece Spain

0.0% 1.7% 2.5% 1.4% 2.2%

2009 2019 Citi Forecast 10-Year Low

Source: Bloomberg, Citi Research

FIGURE 20.
BUDGET BALANCE-TO-GDP

Portugal Italy Ireland Greece Spain

5% -5% -10% -15% -20% -25% -30% -35%

Budget Surplus Budget Deficit

2009 2019 10-Year Low

Source: Bloomberg

FIGURE 21.
DEBT-TO-GDP

Portugal Italy Ireland Greece Spain

200% 200% 160% 120% 80%

2009 2019 10-Year High

Source: Bloomberg, Citi Research

THE CAVEAT

Some of the structural issues that led to the crisis remain today. For example, Greece’s debt-to-GDP ratio is still about 182%, and uncomfortably close to the risk of default. Portugal’s debt-to-GDP ratio also remains elevated (126%) despite considerable progress made by the government in rebalancing the country’s finances. In fact, today all the PIIGS (except Ireland) stand near their all-time high in their debt-to-GDP ratio, Figure 21.

In light of the circumstances, in March of this year, European Central Bank (ECB) officials signaled the extension of its stimulus package a day after the Organization for Economic Cooperation and Development downgraded the growth outlook for most of the advanced economies in the world. Just three months after the ECB halted its crisis-era bond-buying program and signaled it may raise borrowing costs later in the year, ECB President Mario Draghi surprised investors with a support package for the Euro-area. In order to combat weakening growth, the central bank will now offer cheaper loans to banks, more targeted long-term refinancing operations, and keep rates at record-lows for longer.

Sources: Bloomberg, Citi Research Foreign Exchange Forecasts by Jeremy Hale. ResearchGate.net, Country Acronyms in Comparative Political Economy, by Samuel Brazys and Niamh Hardiman. Chart and images in this publication are for illustrative purposes only. All forecast are expressions of opinion and are subject to change without notice and are not intended to be a guarantee of future events. For additional information, please refer to the Glossary and Disclosure section at the end of this publication.
PORTUGAL

"After a decade of crisis and recovery, Portugal made great strides: Its real GDP is now back above the level it was before the crisis, and its unemployment rate is at a fifteen-year low, with the program-era labor reform facilitating strong job creation. Its business climate is more attractive to investors, and its economy has rebalanced to become more export-oriented, including a reinvigorated tourist sector."

- Christine Lagarde, Managing Director of the International Monetary Fund (IMF) (March 2019)

ITALY

Italy has technically enter into a recession after two consecutive quarters of GDP contraction. The country’s economy shrank 0.1% in the 4Q 2018, less than the 0.2% drop in initial readings, however, still marking a second consecutive quarterly drop. The Italian recession reflects its close integration within the European supply chain, especially with Germany. If German industrial activity recovers, Italy could also see itself in a position to return to modest growth. Nevertheless, some of the slowdown has domestic roots amid higher policy uncertainty and tighter financial conditions. Lower growth is also a negative contributor to public debt dynamics and credit ratings. Italy’s rating is still below the levels reached during the Euro debt crisis, Figure 22. No further downgrades are imminent, but risks are skewed to the downside.

FIGURE 22.
ITALY SOVEREIGN RATINGS, 2002-2019

IRELAND

As soon as 2008, Ireland’s minister of finance began to implement corrective action to combat the crisis, including fiscal measures and spending restraints. By 2009, the government laid out a multi-year program of fiscal adjustment, which encouraged the markets. All the same, during 2009-10, the markets’ lost confidence in the efficacy of these measures as these were met with no real pickup in employment or economic activity until 2012.

The country has since recovered, welcoming 2019 with a year-over-year GDP growth close to 5%. In terms of GDP-per-capita, Ireland is the third richest country in Europe, after Luxembourg and Norway. Today, a possible point of tension for Ireland stems from the geopolitical tension regarding Brexit and the question of the Irish backstop.

Sources: Bloomberg, Citi Research Europeans Economic Weekly Germany, Italy, France: Recession Watch. International Monetary Forum. Chart and images in this publication are for illustrative purposes only. For additional information, please refer to the Glossary and Disclosure section at the end of this publication.
GREECE

Post-bailout, GDP growth has been on the rise, improving relations between Athens and its creditors. This, together with the end of the bailout saga of August 2018 and better-than-expected fiscal performance, has contributed to the restoration of trust in the Greek economy, once again making it attractive for foreign investors. Figure 23.

In light of the economic improvements, Moody's has raised Greece's sovereign credit rating by two notches, to B1, with a stable outlook. Despite debt-to-GDP having been steady in recent years, the IMF warns that if Greece continues at its current pace, debt-to-GDP will hit a whopping 275% by 2060. Both the IMF and Greece's euro-area creditors have demanded that the country implement a law that automatically introduces austerity measures if a budget surplus of 3.5% of GDP isn't met.

SPAIN

Spain's recovery remains intact, with real GDP growth well above potential and generally above the rest of the euro area. GDP growth in 2018 remained remarkably resilient to the slowdown in the rest of the EU. The unemployment rate is still elevated (~15% versus 18.8% in 2009), though we expect the labor force participation rate to continue rising (Figure 24) as the structural reforms implemented during the crisis make their way into the economy. Slowly rising wages may, however, diminish the pace of job creation.

Politics remain very volatile, with Prime Minister Pedro Sanchez calling a snap election for April 28. "Polls suggest that the center-right parties, the People's Party and Citizens, together with new right-wing Vox, could have better chances than the Socialists currently in power to form a coalition government. A center-right administration is likely to be seen as a more market-friendly and more stable government than the current one, but tensions with Catalonia are more likely to re-escalate."1 Though the structural budget deficit has considerably improved in the last ten years (from 11% in 2009 to close to 3% of GDP today), we see little scope for any meaningful consolidation effort in the coming 12-24 months.

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1Citi Research’s Global Economic Outlook and Strategy (Feb 2019). Sources: Bloomberg. Citi Research European Economic Weekly Spain’s Election, Euro Area Labor Market: Trouble Brewing?. Citi Research European Economic Forecast Monthly, February 2019. Chart and images in this publication are for illustrative purposes only. All forecast are expressions of opinion and are subject to change without notice and are not intended to be a guarantee of future events. For additional information, please refer to the Glossary and Disclosure section at the end of this publication.
India’s Prime Minister Narendra Modi has accomplished much during his five years in office: a strengthened economy, improved international relations, more transparent governance, and a focus on rural development, all of which has led to a boost in foreign direct investment and employment. In fact, India’s 2019 GDP growth forecast exceeds most of its emerging market peers. **Figure 25.**

**FIGURE 25.**
**INDIA VS. EM: 2019 GDP GROWTH FORECASTS**

<table>
<thead>
<tr>
<th>Country</th>
<th>Forecast</th>
</tr>
</thead>
<tbody>
<tr>
<td>India</td>
<td>7.5%</td>
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<tr>
<td>China</td>
<td>6.2%</td>
</tr>
<tr>
<td>Indonesia</td>
<td>5.0%</td>
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<tr>
<td>Taiwan</td>
<td>2.2%</td>
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<tr>
<td>Mexico</td>
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<tr>
<td>Russia</td>
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<tr>
<td>Brazil</td>
<td>2.2%</td>
</tr>
<tr>
<td>South Africa</td>
<td>1.4%</td>
</tr>
</tbody>
</table>

Source: Bloomberg, Citi Research

MACROECONOMIC LANDSCAPE

Because India is increasingly reliant on oil imports to fuel its GDP growth, rising oil prices and a depreciating rupee have challenged the country’s macroeconomic strength.

To stoke growth, the government has invested in vast subsidies to its constituents, namely power, irrigation, health, education, and energy. These subsidies have added pressure to the country’s current account and fiscal deficits. To bridge the gap, the government may look to state-owned oil and natural gas companies to share the burden. This move could impact the financial condition of those companies, at a time when fuel price deregulation has reduced their flexibility. Although a drop in oil prices last year lowered input costs, prices that are now market-linked, rather than controlled, could add volatility and increase hedging costs.

In a surprise move, which potentially indicates its concern regarding softening demand, the Reserve Bank of India (RBI) recently backtracked on its calibrated tightening path by lowering its key (repo) rate by 25 basis points to 6.25%. While the move came as a relief to India’s government, the shift in policy risks sending headline inflation above the 4% tolerance level. This risk is especially exacerbated by a currency which is underperforming its broader emerging market counterparts.

Taken alongside broader economic challenges, financial integration, urbanization, and industrialization of the most impoverished households should spur natural internal demand for basic materials and support strong domestic consumption (60% of India’s GDP). Exports such as iron, steel, precious metals, mineral fuels and machinery, however, are at risk from the global trade war and slowing external demand as global economic growth matures.

Sources: Citi Research, ET Energy World, From The Economic Times, World’s Top Exports, Coface For Trade. Chart and images in this publication are for illustrative purposes only. All forecast are expressions of opinion and are subject to change without notice and are not intended to be a guarantee of future events. For additional information, please refer to the Glossary and Disclosure section at the end of this publication.
2019: AN ELECTION YEAR

In cutting rates, the RBI may be pre-empting political instability ahead of this year’s upcoming general election, which could, in turn, translate into lower consumer confidence. That said, Modi’s Bharatiya Janata Party (BJP), which has mostly held a stronghold since his momentous election in 2014, enters 2019 under threat. The Congress Party, responsible for India’s independence 70 years ago, is showing signs of re-emergence, based on the results of three recent state elections, and is expected to be a challenge to adored frontrunner Modi. The BJP’s neglect of the agriculture sector, upon which over 60% of Indian livelihood depends, is also contributing to growing disillusionment, and giving the once moribund Congress party new hope. A victory for the incumbent implies policy continuity while defeat certainly presents uncertainty.

Citi’s base case is for a “BJP-led government with a reduced majority. However, we note that the risk of a market-unfriendly outcome, like a hung parliament, has risen.” Markets might be wary about the risks of populism if schemes that involve government overspending are enacted to guarantee an election victory.” A BJP-led coalition, which has a majority in both houses of Parliament, could be deterred by the recent three-state setback. Meanwhile, a Congress-led alliance that lacks the Upper House majority could struggle to quickly enact legislation and “major political risk could arise if none of the parties are in a position to offer a stable government.”

MARKETS

While India holds an equivalent weighting in the MSCI Emerging Markets Index, similar to China, the country is not adequately represented in many global benchmarks. For example, the MSCI All Country World Index has about a 1% allocation to India and just over 3% to China, despite their shares of global GDP being approximately 7% and 15%, respectively. The broad underrepresentation of both countries often leads global investors to be underexposed to the two most populous countries on the planet, leaving them with little participation to one third of the world’s population, and one quarter of global GDP.

Year to date, Indian markets have underperformed emerging market peers, likely due to lofty relative valuations (Figure 26) and as investors have allocated resources away from more richly priced markets in favor of more punished ones. Caution prevails as absolute valuations remain near 17x—above the historical average of 14.9x earnings, given the multitude of aforementioned uncertainties.

Within Asia, our analysts favor Thailand, Taiwan, and Korea—fundamentals for the latter being typically a leading indicator for both China and Euro-area data, Figure 27.

**FIGURE 26.**

MSCI INDIA PREMIUM TO MSCI EM

**FIGURE 27.**

KOREA-CHINA RELATIVE FUNDAMENTALS

[Investopedia: Citi Research's India Economics View: 2019 Outlook – Macro Worries to Ease, Politics Takes Over. Sources: Citi Research, Citi Private Bank. Indices are not managed, have no expenses and cannot be directly invested in. Chart and images are for illustrative purposes only. Historical analysis and past performance is not indicative of future results. All forecast are expressions of opinion and are subject to change without notice and are not intended to be a guarantee of future events. For additional information, please refer to the Glossary and Disclosure section at the end of this publication.]
MEXICO

Upon his presidential election victory, Andrés Manuel López Obrador (AMLO) promised to bring forth Mexico’s fourth transformation, Figure 28. Unluckily, however, the welcoming package for his new administration has so far been riddled by:

- “Huachicoleo,” which has resulted in fuel shortages around Mexico and crisis in major cities.
- A credit downgrade to the country’s state-owned oil company Petróleos Mexicanos (Pemex). Fitch Ratings downgraded Pemex’s debt by two notches, from BBB+ to BBB-, with a negative outlook, citing insufficient investment to restore declining production.¹
- The cancellation of a $13 billion airport project backed by some of the nation’s wealthiest businessmen—A move which damaged investors’ confidence in the market-friendly leader and sparked a rout in the country’s stocks, bonds, and currency.²
- Inaction on the Venezuelan crisis and other issues that affect immigration to Mexico. This has led to public uncertainty as to the political allegiances of the new administration.

Despite the setbacks, AMLO’s marketing campaign promised to spur economic growth beyond the 2% average achieved over the last six years. He has also promised to keep fiscal constraints in place by keeping inflation low and maintaining Mexico’s investment grade credit rating.

FIGURE 28.
MEXICO’S GREAT TRANSFORMATIONS

LEARNING BOX
In Mexico, huachicoleo is a term used to refer to the theft of gasoline from pipelines. The problem of huachicoleo dominates the political and social debate in Mexico since AMLO’s government launched a strategy against the theft of gasoline. During the last few years, the “huachicoleros”—who participate in the extraction and sale of stolen fuels—have generated millions in losses to the state-owned company Pemex.¹

¹The Wall Street Journal. ²Bloomberg. Sources: Citi Research, The Washington Post, Wikipedia. Chart and images in this publication are for illustrative purposes only. Historical analysis and past performance is not indicative of future results. For additional information, please refer to the Glossary and Disclosure section at the end of this publication.
MORENA, AMLO’s new leftist party, has taken control of the Mexican congress with a majority representation in the House and Senate. The new cabinet will have to turn to their neighbor to the north, as U.S. direct investment and demand for products is one of the main drivers for growth in the Mexican economy. The new trade agreement called USMCA (or T-MEC as it is known in Mexico) has reduced trade concerns between the neighboring countries. However, the agreement still needs to be ratified and implemented by political representatives in each of the participating countries.

Doubts about AMLO’s policies linger and the new government has a lot to prove. It is also important to note that exogenous factors like a U.S. economic downturn or turmoil in global financial markets could have an adverse impact on the efficacy of AMLO’s policies. Therefore, we feel it is prudent to remain cautious on Mexico.

We have revised our macroeconomic outlook for Mexico in 2019. We anticipate 2019 GDP growth to decelerate to 1.4% from 1.7%, and below AMLO’s promise of 2% growth. We also slightly lower inflation to 3.9% from 4.0% previously. This should lead Banxico to initiate its cutting cycle in June 2019, with the overnight rate closing the year at 7.75% from the current 8.25%. As for the Citibanamex expectation survey, the USD/MXN forecasts point to a stronger peso by year-end 2019 at 20.17 from 20.33.

LEARNING BOX

USMCA refers to the United States-Mexico-Canada Agreement signed in November 2018. The agreement is sometimes referred to as "New NAFTA" in reference to the previous North American Free Trade Agreement (NAFTA) it is meant to supersede. Compared to NAFTA, the USMCA increases environmental and labor regulations, incentivizes more domestic automotive production, and provides updated intellectual property protections.

Though signed, the agreement still needs to be ratified by all three governments—a feat that likely has a long road ahead. In Mexico and Canada, the USMCA is expected to pass. However, “the U.S. Congress hasn’t taken up the USMCA yet, and it’s unclear what lawmakers will do, especially now that Democrats control the House.”

Wikipedia: USMCA 2Vox: USMCA, Trump’s new NAFTA deal. Sources: Citi Research, Citi Private Bank. All forecast are expressions of opinion and are subject to change without notice and are not intended to be a guarantee of future events. For additional information, please refer to the Glossary and Disclosure section at the end of this publication.
GLOSSARY

COMMODITIES

WTI Crude: West Texas Intermediate (WTI), also known as Texas Light Sweet, the majority of which is located in the Permian oil Field. It is a type of crude oil used as a benchmark in oil pricing and the underlying commodity of New York Mercantile Exchange's oil futures contracts.

Brent Crude: Is used to price two thirds of the world's internationally traded crude oil supplies. Brent Blend is a combination of crude oil from 15 different oil fields in the North Sea. It is less “light” and “sweet” than WTI, but still excellent for making gasoline. It is primarily refined in Northwest Europe, and is the major benchmark for other crude oils in Europe or Africa.

LME: London Metal Exchange

CURRENCIES

Currency Abbreviations: AUD: Australian Dollar; GBP: British Pound; EUR: Euro; CHF: Swiss Franc; JPY: Japanese Yen; BRL: Brazilian Real; MXN: Mexican Peso; CNY: Chinese Renminbi; INR: Indian Rupee; USD: U.S. Dollar

INDICES

MSCI AC World: The MSCI All Country World index is a market capitalization weighted index designed to provide a broad measure of equity-market performance throughout the world.

S&P 500: Index of 500 widely held common stocks that measures the general performance of the market.

Euro Stoxx 600: Dow Jones STOXX 600 Index represents large, mid and small capitalization companies across 18 countries of the European region. Free float market capitalization subject to 20% weighting cap.

FTSE 100: This is a share index of the 100 most highly capitalized UK companies listed on the London Stock Exchange.

Topix: Tokyo Stock Price Index is an important stock market index for the Tokyo Stock Exchange (TSE) in Japan, tracking all domestic companies of the exchange’s First Section. It is calculated and published by the TSE.

MSCI EM: The MSCI Emerging Markets Index is a free float-adjusted market capitalization index that is designed to measure equity market performance in the global emerging markets. The MSCI Emerging Markets Index consists of the following 25 emerging market country indices: Argentina, Brazil, Chile, China, Colombia, Czech Republic, Egypt, Hungary, India, Indonesia, Israel, Jordan, Korea, Malaysia, Mexico, Morocco, Pakistan, Peru, Philippines, Poland, Russia, South Africa, Taiwan, Thailand, and Turkey.

MXCN: The MSCI China Index captures large and mid cap representation across China H shares, B shares, Red chips, P chips and foreign listings (e.g. ADRs). With 150 constituents, the index covers about 85% of this China equity universe.

Sensex: Is a value-weighted index composed of the 30 largest and most actively traded stocks in India, representative of various sectors, on the Bombay Stock Exchange.

Bovespa: The Bovespa Index is an index of about 50 stocks that are traded on the São Paulo Stock, Mercantile & Futures Exchange in Brazil.

Bolsa: The IPC index is Mexico’s balanced weighted selection of shares that are representative of all the shares listed on the exchange from various sectors across the economy. Weight is determined by market capitalization.

FIXED INCOME

Investment Grade Bonds: A bond is considered investment grade, or IG, if its credit rating is BBB- or higher by Standard & Poor’s or Baa3 or higher by Moody’s. By Fitch, the rating must be BBB- or higher to be considered IG. Generally these are bonds that are judged by the rating agencies as likely enough to meet their payment obligations.

High Yield Bonds: A high-yield bond is a high paying bond with a lower credit rating than investment-grade bonds. Because of the higher risk of default, these bonds pay a higher yield than investment grade bonds. Based on the two main credit rating agencies, high-yield bonds carry a rating below “BBB” from S&P, and below “Baa” from Moody’s. Credit ratings can be as low as “D” (currently in default), and most bonds with “C” ratings or lower carry a high risk of default; to compensate for this risk, yields will typically be very high.

Yield: The yield is the income return on an investment, such as the interest or dividends received from holding a particular security. The yield is usually expressed as an annual percentage rate based on the investment’s cost, current market value or face value.

Yield Curve: A graph illustrating the term structure of interest rates by plotting the yields of all bonds of the same quality, with maturities ranging from the shortest to the longest available.
**GLOSSARY**

**Emerging Market Bonds:** Emerging market bonds are debt issues by countries with developing economies as well as by corporations within those nations. Bonds are issued from developing nations and corporations based in countries, such as Asia, Latin America, Eastern Europe, Africa and the Middle East. Typically offering higher returns, emerging market issues tend to carry higher risks than those associated with Treasuries and domestic corporate bonds. The risks of investing in emerging market bonds include the standard risks that accompany all debt issues, such as the variables of the issuer’s economic or financial performance and the ability of the issuer to meet payment obligations. These risks are heightened due to the potential political and economic volatility of developing nations. Although emerging countries, overall, have taken great strides in limiting country risks, it is undeniable that the chance of socioeconomic instability is more considerable in these nations than in developed countries, particularly the U.S. When assessing the risks associated with each emerging nation, investment analysts often refer to that country’s sovereign risk. Emerging markets also pose other cross-border risks, including exchange rate fluctuations and currency devaluations. If a bond is issued in local currency, the rate of the dollar versus that currency can positively or negatively affect your yield. If you do not want to participate in currency risk, it is possible to invest in bonds that are dollar-denominated, or issued only in U.S. dollars.

**Risk Premia:** Is the return that you receive above the return of a risk-free investment. In other words, it is the excess return the investor receives for taking on a higher level of risk.

**Spread:** A spread measures the difference between the yield earned on a Treasury bond and the yield of a corporate bond of similar maturity but lesser credit quality.

**Maturity:** The date on which a security may be presented to the issuer for payment of face value.

**Basis Points (bps):** One basis point is equal to one hundredth of 1% i.e. 130 basis points equals 1.30%. It is generally used to denote a percentage change.

**CREDIT QUALITY AND RATINGS DEFINITIONS**

**Standard & Poor’s:**

**Investment Grade:** AAA obligator has extremely strong capacity to meet its financial commitments; AA obligator has very strong capacity to meet its financial commitments. It defers from the highest rated obligators only in small degree; A obligator has strong capacity to meet its financial commitments but is somewhat more susceptible to the adverse effects of changes in circumstances and economic conditions that obligators in higher-rated categories; BBB obligator has adequate capacity to meet its financial commitments but adverse economic conditions or changing circumstances are more likely to lead to a weakened capacity to meet its financial commitments.

**Non-Investment-Grade:** BB obligator is less vulnerable in the near term than other lower-rated obligators. However, it faces major ongoing uncertainties and exposure to adverse business, financial, or economic conditions which could lead to the obligator’s inadequate capacity to meet its financial commitments; B obligator is more vulnerable than the obligator rated BB but it currently has the capacity to meet its financial commitments. Adverse business, financial, or economic conditions will likely impair its capacity or willingness to meet its financial commitments; CCC obligator is currently vulnerable, and is dependent upon favorable business, financial, and economic conditions to meet its financial commitments; CC obligator is currently highly vulnerable; R obligator is under regulatory supervision owing to its financial condition. During the pendency of the regulatory supervision the regulators may have the power to favor one class of obligations over others or pay some obligations and not others; SD and D obligators has failed to pay one or more of its financial obligations when it came due. D is assigned when S&P believes that the default will be general and that the obligator will fail to pay all or substantially all of its obligations as they come due. SD rating is assigned when S&P believes that the obligator has selectively defaulted on a specific issue or class of obligations but it will continue to meet its payment obligations on other issues or classes of obligations in timely manner. Plus (+) or minus (-): ratings from AA to CCC may be modified by the addition of a plus or minus sign to show relative standing within the major rating categories.

**Moody’s:**

**Investment Grade:** Aaa obligations are judged to be of the highest quality, with minimal risk; Aa obligations are judged to be of high quality and are subject to very low default risk; A obligations are considered upper-medium grade and are subject to low credit risk; Baa obligations are subject to moderate credit risk, they are considered medium-grade and as such may possess certain speculative characteristics.
Non-Investment-Grade: Ba obligations are judged to have speculative elements and are subject to substantial credit risk; B obligations are considered speculative and are subject to high credit risk; Caa obligations are judged to be of poor standing and are subject to very high credit risk; Ca obligations are highly speculative and are likely in, or very near, default, with some prospect of recovery of principal and interest; C obligations are the lowest rated class of bonds and are typically in default, with little prospect for recovery of principal or interest; WR Withdrawn. Moody’s appended numerical modifiers 1, 2, and 3 to each generic rating classification from Aa through Caa. The modifier 1 indicates that the obligation ranks in the higher end of its generic rating category; the modifier 2 indicates a mid-range ranking; and the modifier 3 indicates a ranking in the lower end of that generic rating category. When Moody’s places a rating on watch, Bloomberg uses *+ for possible upgrade, *- for downgrade, and* for developing.

Fitch:

Investment Grade: AAA-ratings denote the lowest expectation of credit risk. They are assigned only in case of exceptionally strong capacity for timely payment of financial commitments. AA-denotes very high credit quality, as well as very low expectation of credit risk. Indicate very strong capacity for timely payment of financial commitments. This capacity is not significantly vulnerable to foreseeable events. A-denotes high credit quality and low expectation of credit risk. The capacity for timely payment of financial commitments is considered strong. However, this capacity may be more vulnerable to changes in circumstances or in economic conditions than is the case for higher ratings. BBB denotes good credit quality. BBB ratings indicate that there is currently a low expectation of credit risk. The capacity for timely payment of financial commitments is considered adequate, but adverse changes in circumstances and in economic conditions are more likely to impair this capacity.

Non-Investment Grade: BB denotes speculative quality. BB ratings indicate that there is a possibility of credit risk developing, particularly as the result of adverse economic change over time. However, business or financial alternatives may be available to allow financial commitments to be met. B denotes highly speculative quality. B ratings indicate that significant credit risk is present, but a limited margin of safety remains. Financial commitments are currently being met; however, capacity for continued payment is contingent upon a sustained, favorable business and economic environment. CCC, CC, C denote high default risk. Capacity for meeting financial commitments is solely reliant upon sustained, favorable business or economic developments. CC rating indicated that default of some kind appears probable. C ratings signal imminent default. D ratings indicate an issuer that in Fitch Ratings opinion has entered into bankruptcy filings, administration, receivership, liquidation or other formal winding-up procedure, or which has otherwise ceased business.
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