Citigold Private Client

PERSPECTIVES

ISSUE 20

Q2 2021

VIEWS

2Q21: Higher Rates vs Global Recovery - Navigating the Volatility

INSIGHT

Bridging the Gap between Green Investment and Investors

Paul Hodes

Head of Wealth Management
Asia Pacific and EMEA
Citibank N.A.

Dear Clients,

2021 has seen economic growth pick up and equity markets trend higher, on the back of effective distribution of vaccinations in developed markets and COVID-19 infection rates falling. This is also supported by governments providing stimulus, as demonstrated by the US$1.9 trillion fiscal stimulus proposal.

Investors are confident on a recovery from the global pandemic however, there are increasing fears that a rapid economic recovery may lead to higher inflation. This uncertainty led to a sharp increase in bond rates in Q1 – the yield on the US 10-year treasuries crossed 1.75% for the first time since January 2020 on 18 March. The rise in bond yields also led to a retreat in global equities, especially the technology sector. While it is likely that housing, certain commodity-exposed products, and in time, services including airline flights may experience a jump in consumer spending, Citi analysts believe that the underlying inflation rate is expected to remain within normal ranges.

As fears receded, global equities gained 5% in Q1, as sectors sensitive to the economic cycle – including energy, financials, and industrials – outperformed. Traditionally defensive sectors, including utilities and consumer staples, lagged. Citi analysts note that the slight pullback in high growth and highly valued companies presents an opportunity within Citi's "Unstoppable Trends" such as healthcare, 5G & hyper-connectivity, Asian consumption-led growth and the transition to renewables.

In this quarter's Insights, Citi analysts discuss how the world looks to have reached a "green tipping point" with global climate policy activity accelerating alongside renewed green commitments from businesses, investors, and consumers. However, there remains a massive investment gap that needs to be closed to meet climate goals, perhaps as much as US$3-$5 trillion per year. Public sector investment is crucial, but so is private investment.

We hope you are staying healthy in these challenging times. Please approach your Citigold Private Client Relationship Manager to understand how these developments can affect your portfolio.

Best regards,
Paul

Views

Higher Rates vs Global Recovery - Navigating the Volatility

Key Takeaways

- With effective vaccinations surging and infection rates falling, Citi analysts expect global GDP growth to rebound to 5.5% in 2021 and 4.0% in 2022. Despite risk of inflation and higher yields, Citi's views are that rising yields are unlikely to signal the end of the equity bull market, as earnings growth in 2021 and 2022 are expected to offset higher and more normal levels of interest rates rising from ultra-low levels.

- Citi's Global Investment Committee (GIC) thus increased its Overweight in Equities, reduced its Underweight in Bonds and reduced Gold from Overweight to Neutral. Real Estate Investment Trusts (REITs) remain Overweight while Cash remains Underweight.

- Citi analysts favor selected cyclical sectors, global ex-US small/mid caps and regions such as Europe/UK and ASEAN while having a thematic preference for Global Healthcare. Over the longer term, Citi maintains a commitment in Unstoppable trends - Rise of Asia, Increasing Longevity, Digital Disruption, and New Energy.

Worldwide vaccine roll out in early days

Since vaccinations began in December 2020 in the US, more than 150 million doses have been administered (as of 30 Mar). About one-third of the total US population has at least a first vaccine dose. At the present pace, 70% of the UK population may be vaccinated with both doses by September 2021 which is expected to be sufficient to achieve herd immunity. In Europe, the slow speed of vaccine delivery has prompted a set of further lockdowns and travel restrictions.

Pace of vaccinations in Asia is relatively slow compared to Western countries. This is because of the large population and lower rates of infection. However, some acceleration in vaccination is likely in coming months.

Keeping an eye on inflation and interest rates

With nearly 10 million US jobs lost during the pandemic, income and output can potentially be much higher during several years of recovery before the economy is overly stretched. US inflation may potentially rise above 3% over the remainder of 2021. The inflation outlook for the longer-term depends on how gradually central banks move away from monetary policies suited for economic collapse and the global health emergency.

In March, the Federal Reserve (Fed) maintained its dovish stance, keeping rates unchanged at 0% and the bond-buying program at its current size. Citi analysts do not expect any rate hike in 2021.

Wealth Themes

Renew your Portfolio in the New Economic Cycle

2021-22 is likely to be a period of recovery and strong economic growth driven by vaccines, a rebound in trade and industrial production, pent up demand for services and global stimulus.

Short-term recovery plays

As markets recover, Citi analysts favor

- Global ex US small/mid caps (US SMID)
- Cyclicals (Industrials, Financials)
- Southeast Asia and sectors (Consumer Discretionary, Financials and Industrials)
- Global Healthcare, given its relative valuation near historic record lows. The sector underperformed global equities by nearly 8% last year, despite having the most stable growth fundamentals.

Long-term Unstoppable trends

Citi maintains a commitment in Unstoppable trends which are likely to last for two decades or more:

- Rise of Asia – Companies exposed to Emerging Market (EM) consumerism;
- Increasing Longevity – Focusing on healthcare technology;
- Digital Disruption – 5G, Cyber Security, Fintech, Artificial Intelligence, Data Storage (Big Data), Internet of Things;
- New Energy – Smart Grids, Solar, Wind, Hydro, Energy Storage and Energy Efficiency.

Avoiding the Inflation Drag

Citi analysts continue to look for opportunities to pick up yield, while staying diversified in portfolio risks.

Bonds

- US HY – Citi analysts prefer higher yielding variable-rate bank loans. Moving up in the capital structure, not only provides lower volatility, but its floating rate component provides protection if short-term rates rise.
- EMD – Citi analysts prefer Asian HY credit, where spreads are double their US counterparts.

REITs

- REITs may benefit from recovery in property fundamentals, low interest rates and credit easing.

Dividend plays

- As the global economy recovers, Citi analysts expect "dividend grower" equities to resume their long-term, lower-volatility outperformance.
- Citi analysts advocate global dividend exposure, as well as a mix of cyclical and defensive sector exposure.

Recycle: The Power of Investing with Purpose

A recent 2020 study estimates that investment in ESG funds is now over US$40 trillion, increasing by approximately US$10 trillion every two years with a growth trajectory that shows no sign of abating.

The European Union's €750 billion recovery fund will have a green emphasis, both in terms of focus as well as fundraising. The EU has promised to raise 30% of the required debt by issuing green bonds. In addition, it has pledged that all of the spending must contribute to its emission-cutting goals. In addition, a number of EU-wide green taxes are under consideration to support the eventual repayment of the fund.

As part of its COVID-19 recovery plan, China announced an extension of electric car subsidies and tax breaks through 2022. Previously, these were set to expire in 2020. Furthermore, China has started spending $1.5 billion to grow its electric car-charging network by 50% in 2020. President Xi also announced China's goal of reaching carbon neutrality by 2060, planning investments of more than $5 trillion in renewable power generation, while shuttering coal-fired plants or retrofitting them with carbon capture technology.

Position for a bottoming USD, financial repression in EUR & JPY and a commodities (ex Gold) reflation narrative

Position for a bottoming in USD amidst expectations for higher real yields in US versus financial repression in Europe and Japan.

- Position for a bottoming in USD versus financial repression in EUR and JPY. Prefer USD over EUR, JPY, CHF and Gold.

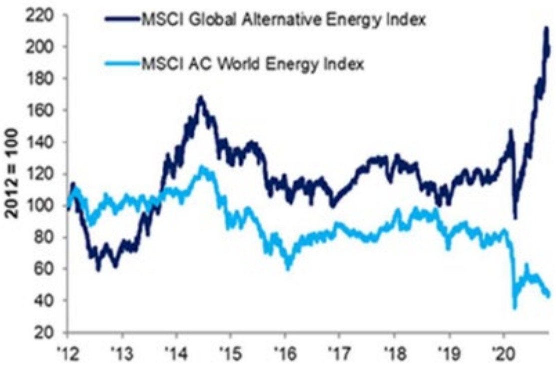
Position for commodities reflation narrative

- Position for a risk asset and commodities reflation narrative that favors inflows into oil, copper, iron ore to support commodity FX.

Position for risk asset recovery reflected in higher real yields

- Position for Gold cycle likely peaking due to risk of Fed tapering asset purchases by end-2021 and more aggressive US rates pricing for lift-off.

Chart 1: New energy has outperformed traditional energy



Source: Citi Private Bank. As of November 2020.

Asset Class	Weight
Fixed Income	UNDERWEIGHT
Global Investment Grade	UNDERWEIGHT
• Global Sovereign	UNDERWEIGHT
• Corporate Investment Grade	NEUTRAL
Global High-Yield	OVERWEIGHT
APAC ex Japan / EM	OVERWEIGHT
REITs	OVERWEIGHT
Cash	UNDERWEIGHT
Equities	OVERWEIGHT
US	OVERWEIGHT
Europe	OVERWEIGHT
Japan	OVERWEIGHT
Asia ex Japan	OVERWEIGHT
Emerging ex Asia	OVERWEIGHT
• Emerging EMEA	NEUTRAL
• Emerging Latin America	OVERWEIGHT
Commodities	NEUTRAL

Source: Citi Private Bank GIC Asset Allocation. As of March 2021.

Increased Overweight in Equities, reduced Underweight in Bonds and reduced Gold to Neutral. REITs remain Overweight while Cash remains Underweight.

Equities

- US SMID reduced from Overweight to Neutral. Since adding an overweight to US SMID in April 20, this asset class has gained nearly 80%. In place of this, the GIC added to global healthcare, given its relative valuation near historic lows. The sector underperformed global equities by nearly 8% last year, despite having the most stable growth fundamentals.
- Within Asia, the GIC reduced overweights in China, Taiwan and Korea to neutral, while adding to ASEAN. This takes into account Chinese monetary policy becoming more hawkish, which could limit gains. ASEAN may have more exposure to the recovery.
- The GIC added weights to UK equities. At 4.0% average dividend yield, UK equities trade at 14.2 x 2021 EPS, a 40% discount to US equities, with a EPS rebound likely.

Fixed Income

- The GIC switched out of US High Yield and added into US Bank Loans after rallies in credit assets. Within Sovereigns, the GIC reduced weights in US Short-term treasuries. Citi's base case anticipates continued upward long-term interest rate pressures, as the economies recover from COVID-19. The GIC added weights to Treasury Inflation-Protected Security (TIPS), which may benefit from the Fed's higher inflation target.

Commodities

- Gold is a performance risk when market interest rates rise. Since 1985, gold has risen more than 20% during six periods, and fell more than 20% in four cases. The gains for gold through 2020 reflected a peak pace of US monetary easing. This leaves gold vulnerable.

Insights

Bridging the Gap between Green Investment & Investors

Key Takeaways

- Investor interest around Environmental, Social and Governance (ESG) investment started taking off in 2018 and momentum continues to be strong, possibly enhanced by the COVID-19 pandemic.
- Citi analysts believe the world has reached the “green tipping point” where global climate policy activity is accelerating alongside renewed green commitments from businesses, investors, and consumers.
- However, there remains a substantial gap between the US$3-$5 trillion level of annual green investment likely needed to meet the 1.5°C limit on global warming by 2050 and the nearly US$600 billion of total climate finance invested in 2017/2018.

Climate change is a defining challenge of our time

Record temperatures and increasingly extreme and frequent droughts, floods, wildfires, and storms bear clear testimony to global warning. Climate change requires extensive climate mitigation and also climate adaptation.

Climate mitigation to achieve the Paris Agreement goals – remaining within 1.5 degrees Celsius (1.5°C) from pre-industrial levels – requires staying within a carbon budget of ~420-580 $GtCO_2e$. This means present greenhouse gas (GHG) emissions of ~53 $GtCO_2e$ need to be cut in half by the 2030s, and reach net zero by midcentury. Net negative emissions could further help as part of ongoing climate restoration.

Momentum for climate change was already underway before COVID-19, but is now accelerating and reaching a tipping point. Governments are putting net zero emissions targets and stronger climate policies in place for mid-century, notably the European Union (EU) and China. The US has rejoined the Paris Agreement in 2021. Corporations and investors are joining the “net zero club”, while individuals are embracing climate considerations in lifestyles and consumption. Meanwhile, the oil and gas sector is also adapting to the wider energy transition.

“Investors now recognize the embedded risk that climate change represents in portfolios.”

Many investors now recognize the embedded risk that climate change represents in their portfolios and are looking to deploy capital to align with their values or participate in the energy transition. Renewable energy funds, particularly solar, had incredibly strong growth in 2020, with several providing returns of more than 100%.

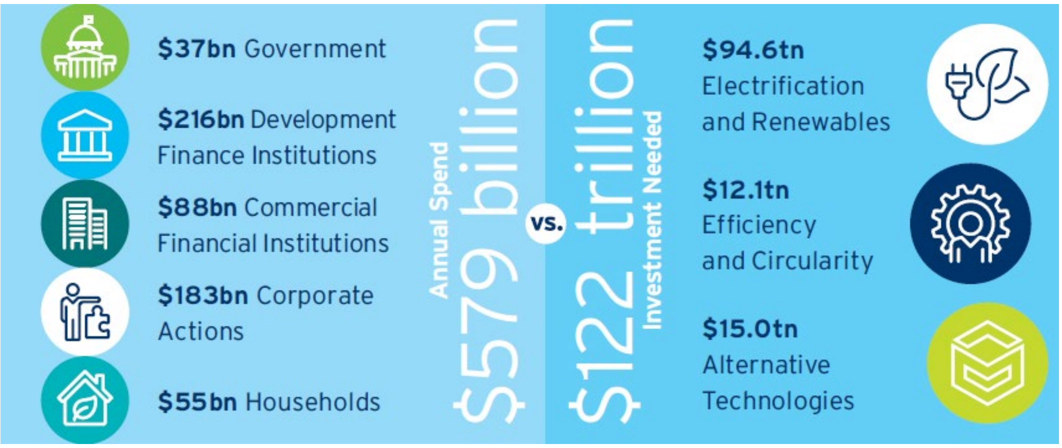
Strong investor interest is critical as demand for private funding to finance the transformation to a 2°C or ideally 1.5°C world is likely to remain after the COVID-19 crisis subsides. More governments around the world are making policy and legislative commitments to net zero targets and will need to fund them.

The 2025 UN Intergovernmental Panel on Climate Change (IPCC) calculated that to reach a 1.5°C world, the average annual investment in transitioning the global energy system to reduce greenhouse emissions needs to be approximately US$2.4 trillion per year between 2016 and 2035.

This represents an increase in the level of annual investment in low-carbon energy technologies and energy efficiency of roughly a factor of six by 2050 compared to 2015, overtaking investment in fossil fuels globally by around 2025.

On a regional level, as the largest jurisdiction with planned legislation to reach net zero, the EU estimates €260 billion of additional investments per year are needed to achieve the 2030 targets it agreed in Paris, including a 40% cut in GHG emissions. This amount is equivalent to about 1.5% of 2018 EU GDP. The EU has since submitted an increased target of a 55% cut by 2030, which could inevitably require enhanced investment ambition.

Chart 2: Annual Climate Finance Spend (2017-18) vs. Green Investment Needed to Meet Climate Goals



Source: Citi Research. As of February 2021.

Investor Attitudes have Shifted

ESG funds under management continue to grow, demonstrating continuing interest on the part of both investors and corporates to participate in the green asset revolution.

Green bond issuance has increased substantially each year. The Climate Bonds Initiative's analysis of annual green bond and loan issuance for 2019 showed US$266.1.9 billion that met internationally accepted definitions of green were issued, up 52% from 2018. Despite the impact of COVID-19, US$222.8 billion of green bond/loan issuance was reported for 2020, crossing US$1 trillion in cumulative issuance.

The seemingly insatiable appetite among investors for green bonds is an illustration of the shift in investor attitudes. More asset owners want to see corporates aligning their business models with Paris targets. Increasingly, asset managements are also responding by re-shaping investment strategies to enhance exposure to greener assets and sending strong signals to corporate issuers that they need to address the climate risk on their balance sheets.

Sustainable factors have emerged as a new nexus for risk and increasingly, a driver for alpha. Investors are realizing that ignoring societal or environmental impacts of the companies they invest in, could result in additional risk (see chart 3).

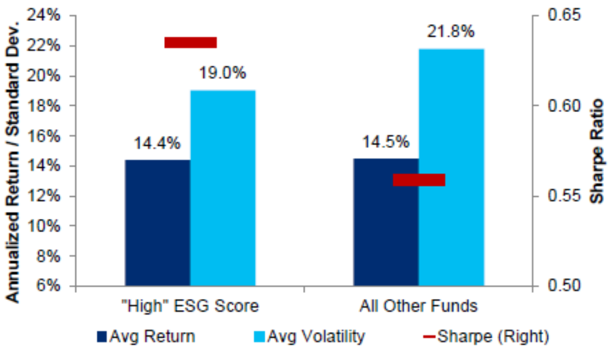
Hurdles Remain

Nevertheless, the hurdles to investing in green projects are significant for corporates, banks, and investors. For corporates, the return on capital typically produced by green assets is over a longer time period and may have a lower internal rate of return than more traditional energy and infrastructure investments have historically.

The need for longer-term financing may also deter banks from providing the requisite capital for these projects. Banks also may have industry, country and credit quality concentrations that create upper limits on exposures.

Realistically, investment in green assets, while achieving a societal goal and potentially yielding strong returns, can also be more risky. Project approvals are subject to environmental and historical impact assessments and public consultation periods can be lengthy and not always end with approvals.

Chart 3: Relative Performance of "High" ESG Funds



Source: Citi Private Bank. As of 21 March 2021.

While some technology is well-proven and has been commoditized (e.g. photovoltaic systems and wind turbines), other technology like batteries and plastic recycling, are still being commercialized.

A lack of agreement on what is “green” can also create uncertainty for investors. While policymakers are slowly developing classification systems for what a “sustainable investment” looks like, there is not yet a globally consistent interpretation.

The EU Taxonomy for Sustainable Activities is an important step in the right direction, but even the passage of such a comprehensive classification system into law could create uncertainty. Nonetheless, it appears likely that the EU Taxonomy could be one that becomes the most widely adopted by investors.

Citi analysts think this decade could see three major transformations related to ESG data: 1) standardization of corporate reporting, 2) introduction of global regulations to govern how capital markets facilitate sustainable finance flows and risk transfers; and 3) reengineering of buy-side and sell-side data architectures to incorporate ESG data. These need to happen quickly to achieve the climate change targets.

Conclusion

Decarbonizing the world requires nothing short of a great transformation of the global economy, with no single silver bullet but a whole portfolio of mitigation.

There remains a massive investment gap that needs to be closed to meet climate goals, perhaps as much as US$3-$5 trillion per year. Public sector investment is crucial, but so is private investment.

New ESG investing approaches have begun to transform the investment management industry and investors are increasingly engaging with the companies they own to drive positive change, in some cases demanding incremental targets to achieving large-scale emissions and waste reductions.

Ignoring ESG factors can also be an expensive mistake, with sustainable factors such as environmental impact or social responsibility emerging as a driver for returns. Investors could potentially be assuming additional risk simply by ignoring these factors.

All in, Citi analysts are of the view that investors and businesses can improve their image, bottom line and environmental and social impacts with a focus on the major unstoppable trends that are now remaking our global economy.

World Market at a Glance

	Last price	52-Week	52-Week	Historical Returns (%)			
	14-Apr-21	High	Low	1 week	1 month	1 year	Year-to-date
US / Global							
Dow Jones Industrial Average	33730.89	33911.25	22789.62	0.85%	2.91%	40.84%	10.21%
S&P 500	4124.66	4151.69	2727.10	1.10%	4.60%	44.93%	9.81%
NASDAQ	13857.84	14175.12	8215.69	1.23%	4.04%	62.73%	7.52%
Europe							
MSCI Europe	531.37	532.15	359.00	1.12%	3.06%	40.33%	6.84%
Stoxx Europe 600	436.57	437.65	322.37	0.52%	3.19%	30.75%	9.41%
FTSE100	6939.58	6949.56	5525.52	0.79%	2.63%	19.83%	7.42%
CAC40	6208.58	6217.74	4194.58	1.27%	2.68%	37.24%	11.84%
DAX	15209.15	15311.86	10160.89	0.22%	4.87%	42.19%	10.86%
Japan							
NIKKEI225	29620.99	30714.52	18858.25	-0.37%	-0.33%	50.83%	7.93%
Topix	1952.18	2013.71	1392.58	-0.78%	0.06%	36.18%	8.17%
Emerging Markets							
MSCI Emerging Market	1336.59	1449.38	871.71	-0.16%	-0.86%	49.12%	3.51%
MSCI Latin America	2370.27	2568.33	1460.19	0.52%	2.78%	40.18%	-3.32%
MSCI Emerging Europe	169.37	175.55	119.51	3.22%	-1.91%	23.65%	4.02%
MSCI EM Middle East & Africa	262.67	262.67	176.80	0.99%	0.86%	35.87%	8.87%
Brazil Bovespa	120294.70	125323.50	72040.80	2.27%	5.37%	50.52%	1.07%
Russia RTS	1490.00	1555.74	991.49	4.23%	-1.94%	31.48%	7.39%
Asia							
MSCI Asia ex-Japan	876.44	959.95	577.26	-0.18%	-1.06%	48.95%	3.98%
Australia S&P/ASX 200	7023.10	7071.50	5100.70	1.37%	3.79%	27.97%	6.62%
China HSCEI (H-shares)	10999.30	12271.60	9269.87	-0.64%	-1.55%	11.70%	2.43%
China Shanghai Composite	3416.72	3731.69	2758.25	-1.81%	-1.05%	20.85%	-1.62%
Hong Kong Hang Seng	28900.83	31183.36	22519.73	0.79%	0.56%	18.27%	6.13%
India Sensex30	48544.06	52516.76	29968.45	-2.25%	-4.43%	58.18%	1.66%
Indonesia JCI	6050.28	6504.99	4441.09	0.23%	-4.84%	28.55%	1.19%
Malaysia KLCI	1598.28	1695.96	1359.54	-0.14%	-1.08%	16.52%	-1.78%
Korea KOSPI	3182.38	3266.23	1828.13	1.43%	4.19%	71.36%	10.75%
Philippines PSE	6523.21	7432.40	5390.97	-1.93%	-3.05%	12.84%	-8.63%
Singapore STI	3179.39	3221.85	2420.84	-0.51%	2.72%	20.68%	11.80%
Taiwan TAIEX	16865.97	17076.73	10140.09	0.30%	3.76%	63.23%	14.48%
Thailand SET	1541.12	1606.41	1187.49	-0.99%	-1.73%	22.67%	6.33%
Commodity							
Oil	63.15	67.98	-40.32	5.66%	-3.75%	214.02%	30.15%
Gold spot	1736.43	2075.47	1659.55	-0.07%	0.54%	0.55%	-8.53%

Source: Bloomberg, as of 14 April 2021.

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