Citi Wealth

Investment Strategy *Bulletin*

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Opportunities, Risks for a "Rule-Breaking" Expansion

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- Investors who are struggling to understand the US-led bull market of 2023 and 2024 should get acquainted with the "hidden recession" of 2022-2023 and why economic expansion is likely to persist in 2025-2026 (please see our just-released Wealth Outlook 2025).
- The deep bear market in bonds and 25% inter-year loss for the S&P 500 in 2022 presaged a weakening in cyclical industries through most of 2023 and much of 2024. The post-pandemic recovery in services employment "masked" that weakness and allowed the economy to "break the rules" (for example, the US yield curve was inverted for a record 28 months). Annual global growth hasn't been below 2.5% since the pandemic. US real GDP growth hasn't shown a reading below 1.3% for any 12-month period.
- For sidelined investors looking for another bear market, the 2020 and 2022 periods were the low points. They represented opportunities to earn outsized returns in broad, public markets for the year (or two) that followed.

Potential Portfolio Implications

- The "hidden recession" is largely hindsight now. The S&P 500 has returned 58% over the past two years and 13% annualized over the past decade. A key message of our *Wealth Outlook 2025* is to broaden investment horizons and avoid building a portfolio solely dependent on S&P 500 returns going forward.
- For core portfolios, we see value in small and mid-cap US growth shares which have seen valuations fall slightly over the past decade in contrast to large caps. Some of the same dynamics will help full returns in private markets.
- While non-US equities have seen valuations fall about 40% in USD terms from just eight years ago, we wouldn't take a blanket approach to overweights. Some regional markets are attractively priced or positioned well to potentially benefit from domestic demand growth. Others are beneficiaries of G2 polarization and supply chain diversification.
- For suitable investors, we see potential opportunity in US deregulation beneficiaries. This includes banks and digital assets infrastructure, energy and power infrastructure. Long-term trends should benefit AI infrastructure, software and healthcare.
- We should also be prepared for more volatile markets as US policy shows greater impact across the world in the coming year.

Why Call It A "Rule-Breaking" Expansion?

As we describe in our newly released Wealth Outlook 2025, the global economy has defied expectations. Forecasts of recession in recent years – backed up by usually reliable indicators – came to nothing. Despite the sharpest and most synchronized interest rate hiking campaign by global central banks in decades, growth has endured. Corporate profits in the U.S. recently reached new highs, with profits elsewhere closing in on their former peak.

Just consider, history's most reliable long-term leading indicator of recession, the yield curve, was inverted for a record 28 months from 2022 to mid-2024. But the key measures of US business cycle expansion – output, income, employment – remained positive throughout, and continue to grow now (see **FIGURE 1-2**).

The persistence of growth despite numerous contraction signs is the reason we call it a "rule-breaking expansion." Since 2020's collapse and rebound, annual measures of global growth haven't fallen below 2.5%. US growth over any 12-month period hasn't fallen below 1.3%.

In 2025 and 2026, we expect this rule-breaking expansion to continue. We also expect the growth to be accompanied by further geopolitical and political discord. Amid the inevitable noise, we remain focused on the drivers of global growth, both shorter and longer term, while monitoring the evolving risks.

FIGURE 1: US output, employment, and income kept growing despite recession signals

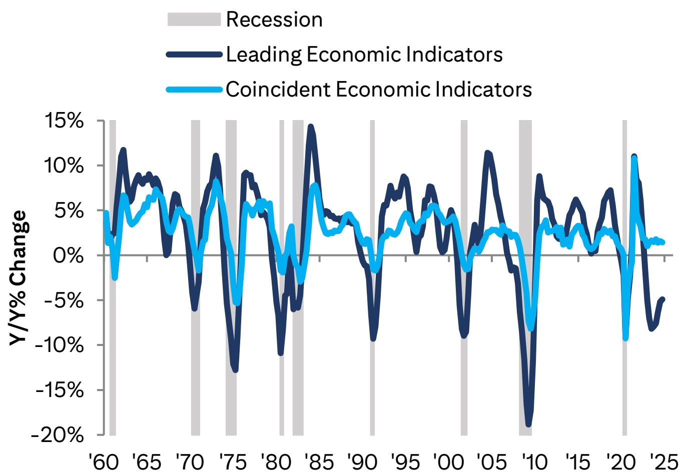
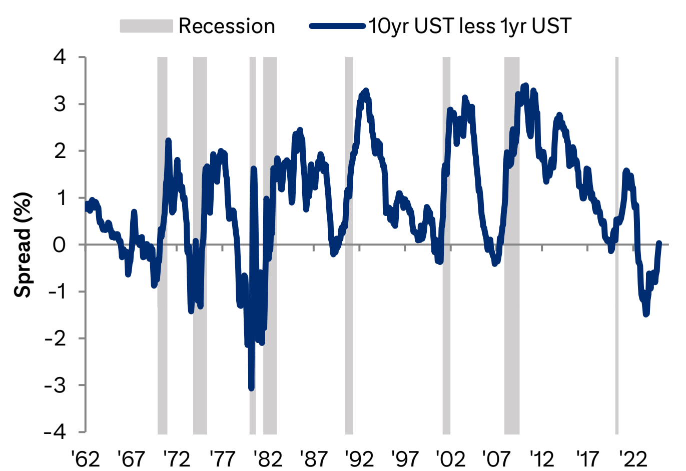


FIGURE 2: US Treasury yield curve was inverted for record 28 months



Source: Haver Analytics as of December 11, 2024. The US Index of Leading Economic Indicators looks at a combination of statistics including manufacturing new orders, money supply and consumer expectations as a guide to potential future activity. The US Index of Coincident Economic Indicators addresses a combination of elements such as labor market activity, personal income, industrial output to capture the state of current activity. All forecasts are expressions of opini on and are subject to change without notice and are not intended to be a guarantee of future events. Past performance is no guarantee of future results. Real results may vary.

Hidden recession allows continued expansion

The idea that some disaster would befall markets has kept many investors sidelined with others "chasing" past returns. We think this is mistake. As discussed in our CIO Bulletins of recent weeks, there are new risks driven by US policy, but there are also signs of a nascent recovery (please see our December 6th and November 29th CIO Bulletins.

When we say "nascent recovery," what investors are often looking for is a "fresh start." That's not exactly how we describe the current expansion and bull market. But despite the appearance of economic growth stability, much went wrong beneath the surface in the past two years allowing growth to persist and, in some elements, strengthen. As

FIGURE 3 shows, typical business cycle drivers such as housing did contract sharply in typical recessionary fashion. In fact, a long list of financial and real economy indicators endured a post-pandemic drop (see **FIGURE 4**).

So why did broad economic output and employment endure in growing? The rebound from the uniquely severe collapse in services during the pandemic allowed related industries to recover (see **FIGURE 5**). This offset the losses in cyclical industries, those most impacted by central bank tightening and fears of a wider downturn. Meanwhile, the bear market of 2022, with another 25% intra-year drop in the S&P 500 was the "double dip" that some investors still fear today (see **FIGURE 6**).

FIGURE 3: US residential investment Y/Y%

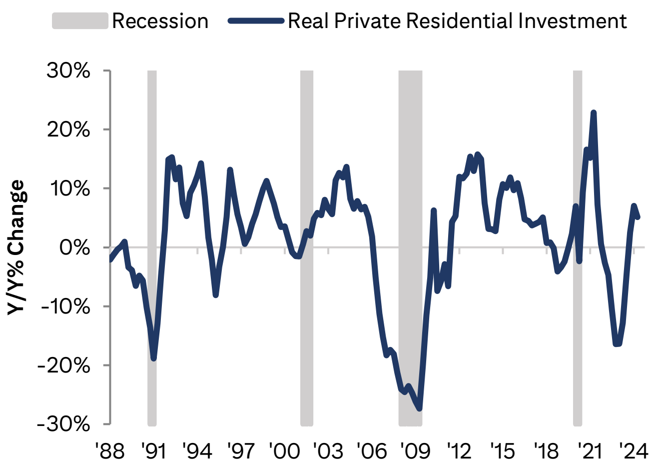


FIGURE 4: Many indicators of recent recession, nascent recovery

- The U.S. stock market fell 25.0% from January through October 2022
- The U.S. Treasury market return was -19.7% from July 2020 through October 2022
- U.S. banks tightened lending standards for nine consecutive quarters through 2Q 2024
- U.S. real residential investment fell 20.5% in the two years ending 1Q 2023
- U.S. home resales fell 28.7% from December 2019 through June 2024 (pre-COVID period to date)
- U.S. manufacturing production fell 2.0% in the year through January 2024
- U.S. goods imports fell 12.7% in the year through March 2023

Source: Haver Analytics as of November 25, 2024. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Index returns do not include any expenses, fees or sales charges, which would lower performance. Past performance is no guarantee of future results. Real results may vary.

FIGURE 5: Services employment before and after recessions (2020 vs average since 1960)

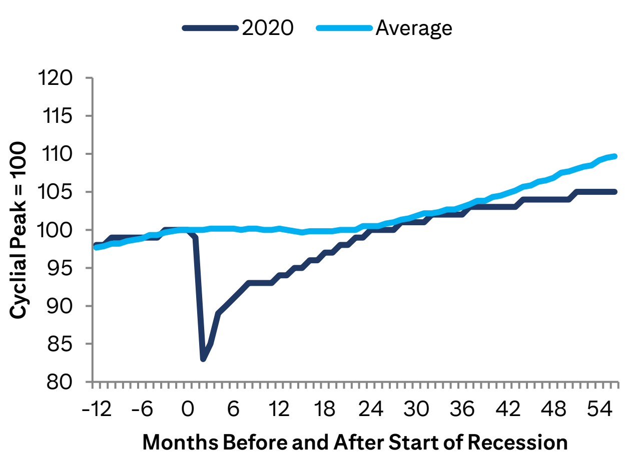
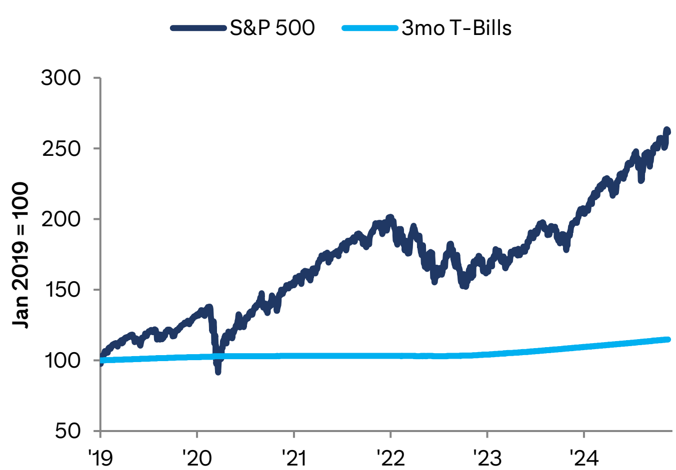


FIGURE 6: Market timers missed the "hidden recession" of 2023. It was felt in 2022 returns



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As we discussed in these pages in recent weeks, the change in US administration brings new opportunities and risks to global markets that will garner great attention. We also want to highlight that much of what is driving markets is not particularly linked to business cycles, bull and bear market excesses. It's technological development and the widening impact of technologies, most obviously AI, beyond the mere creation of its infrastructure (please see Wealth Outlook 2025 and more to come in these pages in coming weeks).

History suggests the US, what worked best over the past decade, won't drive the next decade's returns

Much of what we've just explained about the economy should be considered hindsight for investors. The S&P 500's 58% total return over the past two years came from a depressed point in 2022. But EPS for US large cap shares rose just 10% over the same period, with much more of the gains in profits expected to be delivered ahead. We must consider too that the S&P 500's strong performance for the past decade, 13.3% annualized, and stark outperformance versus most other assets alters the long-term return outlook. A key message of our *Wealth Outlook 2025* is to broaden investment horizons and avoid building a portfolio solely dependent on S&P 500 returns going forward. We were overweight US large caps through November and continue to be overweight to some degree in US equities overall. But for the coming year, we've chosen a tactical mix that diversifies and broadens to many of the less expensive US and global assets that have been left behind (see **FIGURE 7**).

FIGURE 7: Our positioning: strategic and tactical allocations

ASSET CLASSES | GLOBAL USD LEVEL 3 ASSET ALLOCATION

	STRATEGIC (%) (long term)	TACTICAL (%)
FIXED INCOME	37	-2.5
DEVELOPED SOVEREIGN	18.8	-5.6
U.S.	8.8	1.6
NON-U.S.	10	-7.3
U.S. SECURITIZED	6.1	2
DEVELOPED IG CORPORATES	6.9	-0.3
HIGH YIELD	2	-1.5
EMERGING MARKET SOVEREIGN	3.1	-1
THEMATIC: PREFERREDS	0	2
THEMATIC: U.S. BANK LOANS	0	2
EQUITIES	60.9	3.5
DEVELOPED EQUITIES	52.2	2.9
LARGE CAP	46.3	1
U.S.	33.1	0
S&P 500	33.1	-1.5
THEMATIC: EQUAL WGT S&P 500	0	1.5
CANADA	1.5	0
U.K.	1.9	0
EUROPE EX-U.K.	5.4	0
ASIA EX JAPAN	1.4	0.5
JAPAN	3	0.5
SMALL- AND MID CAP (SMID)	5.9	1.9
CORE GLOBAL SMID	5.9	-1.1
THEMATIC: U.S. SMID GROWTH	0	3
EMERGING MARKET EQUITY	8.7	0.6
ASIA	7.4	0.5
LATIN AMERICA	0.8	0.5
EUROPE, MIDDLE EAST AND AFRICA	0.5	-0.4
THEMATIC: HEALTHCARE	0	0
CASH	2	-1
COMMODITIES	0	0
GLOBAL USD LEVEL 3 ASSET ALLOCATION	100	

STRATEGIC ASSET ALLOCATION — ACTIVE

Source: Citi Wealth Investments Global Investment Committee and Citi Wealth Strategic Asset Allocation and Quantitative Research Team, as of Nov 9, 2024. The above table is an example for educational and illustration purposes only and does not constitute a portfolio recommendation. It was generated without taking into account any individual's specific circumstances or requirements. Investors looking to develop their portfolio should contact their Citi representative for further guidance. Risk level 3 is designed for investors with a blended objective who require a mix of assets and seek a balance between investments that offer income and those positioned for a potentially higher return on investment. Risk level 3 may be appropriate for investors willing to subject their portfolio to additional risk for potential growth in addition to a level of income reflective of his/her stated risk tolerance. The asset classes used to populate the allocation model may underperform their respective indices and lead to lower performance than the model anticipates.

Ten off-benchmark opportunities, new and old

We believe that building a core portfolio is key when seeking to preserve and grow wealth over time. In our view, such a portfolio should be fully invested for the long term and diversified across asset classes from around the world.

With a long history of benchmark returns, we can estimate risk and return with relative rigor for investors over the decade ahead. However, we also recognize that many clients also wish to invest in ways that do not necessarily fit within a core portfolio. This is where opportunistic investing may help.

An opportunistic portfolio is an additional, much smaller portfolio for pursuing investments that may fall outside the scope of a suitable investor's long term plan. The investments held may be shorter-term and have little or no track record of risks and returns. An opportunistic portfolio is often concentrated. It may also be held in cash until a potential opportunity arises, enabling a quick response in what may be a brief window.

Despite its flexibility, opportunistic investing calls for a disciplined approach. We believe the aim should be to complement a core portfolio, potentially enhancing returns or risk-adjusted returns. **FIGURE 9** lists our new and ongoing opportunistic ideas as well as some where we have moved to the sidelines since we published them last December[1]. We provide a benchmark index in each case. Before considering an idea, investors should ascertain its suitability in light of investment objectives and then discuss the appropriate allocation with their financial professional.

Of those that we no longer see as offering opportunistic potential, some are still relevant to core portfolios. Copper mining and cyber security, for example, are key ingredients to the unstoppable trends of the energy transition and digitization respectively. Our suggested opportunistic timeframe is up to two years or so.

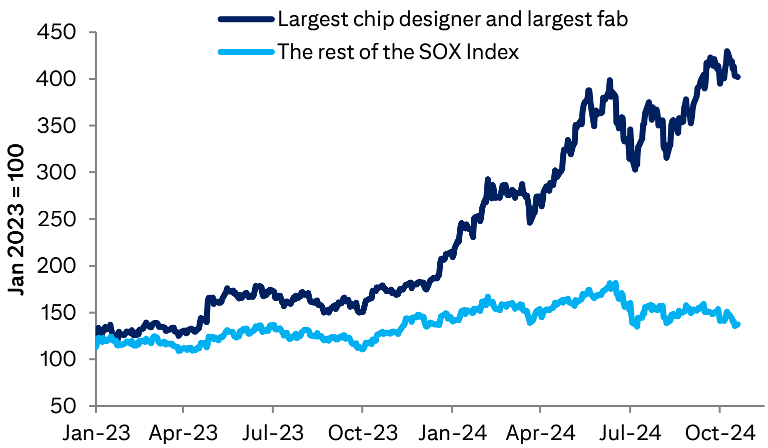
1. Semiconductor Equipment Makers

The AI buildout has created massive demand for semiconductors, even while demand for chips from cyclical industries such as autos has disappointed. Against this backdrop, U.S.-led restrictions on exports of advanced chips and equipment to China have hit some semiconductor equipment maker equities. This is despite the U.S. government and others offering subsidies to producers to reshore the Taiwan-centered semiconductor supply chain.

Many semiconductor companies have delivered only modest performance since the start of 2023, even as the equities in the leading firms have climbed sharply (see **FIGURE 8**). Ultimately, the penetration of semiconductors in everyday products, innovation and obsolescence drive industry growth. Global semiconductor market revenue could grow from $607.4 billion in 2024 to $980.8 billion by 2029[2]. Despite semiconductors returning 34.4%[3] since we identified its opportunistic potential last year, we see more scope for upside in 2025. Disruptions to supplies of essential materials, market access restrictions and an economic downturn are among the risks.

[1] Wealth Outlook 2024
[2] Statista, as of Aug 2024
[3] Bloomberg, as of Nov 15, 2024

FIGURE 8: Semiconductor leadership has been concentrated



Source: Factset, as of November 14, 2024. SOX is the Philadelphia Semiconductor Index. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Index returns do not include any expenses, fees or sales charges, which would lower performance. Past performance is no guarantee of future results. Real results may vary.

2. Medical Equipment: Improving Vital Signs

In a rapidly aging world and with wealth levels rising, we see healthcare as a long-term focus for core portfolios. We also see ongoing opportunistic potential among one of its subsectors: the companies that conceive and create innovative diagnostics and instruments, such as laboratory testing equipment, imaging systems, surgical tools, and wearable or implanted devices for those with chronic conditions. AI may increasingly augment some of the sector's products and services.

Having rallied in 2024 – albeit by less than U.S. equities overall – medical equipment may have further to go, in our view. Forecast earnings per share may increase 9.5% in 2025, giving a forward price/earnings multiple of 20.4. While the subsector is less exposed to political risks than some other areas within healthcare, it may still encounter supply chain issues and shortages, technological reversals, and patient privacy issues arising from AI deployment.

3. Defense Contractors in an Unsettled World

In recent decades, business was often seen to drive geopolitics. Governments prioritized commercial interests in their external policies on trade and energy, for example. But in today's often polarized world, geopolitics is driving business. As nations focus on bolstering their strategic and defensive needs, we see potential opportunities for some sectors. Among them are the providers of weaponry, aircraft, advanced defense technologies and the like.

In 2024, some 23 NATO members are likely to meet their commitment to spend 2% or more on GDP on defense, up from just six members in 2021.[4] Even if the Ukraine and Middle East conflicts are resolved swiftly, we would expect continued spending in Europe and elsewhere, especially given reduced certainty over U.S. intervention in future conflicts. High government indebtedness, competing spending priorities, supply chain issues and technological disruption are among the challenges facing defense firms.

[4] Citi Research - Money and Might: Financing the Future of Defense, Oct 2024

FIGURE 9: Potential opportunistic positions

ONGOING	Return since Dec 7, 2023 (Publication of Wealth Outlook 2024)
1. Philadelphia Stock Exchange Semiconductor Index	34.4%
2. Dow Jones U.S. Medical Equipment Index	19.6%
3. S&P Aerospace & Defense Index	33.3%
WEALTH OUTLOOK 2025 ADDITIONS	
4. S&P Biotechnology Select Industry Index	
5. S&P 500 Banks Index	
6. Alerian Midstream Energy Index	
7. MVIS Global Uranium and Nuclear Energy Index	
8. CBOE VIX (1-month implied volatility) Index	
9. Bitwise Crypto Innovators 30 Index	
10. MSCI Brazil USD Index	
WHERE WE MOVED TO THE SIDELINES	
RETURN FROM OL24 (DEC 7) TO MAY GIC (MAY 22)	
1. Solactive Global Copper Miners Index	41.6%
2. Red Rocks Global Listed Private Equity Index	17.6%
3. Nasdaq CTA Cybersecurity Index	10.5%
RETURN FROM OL24 (DEC 7) TO JULY GIC (JULY 17)	
4. S&P 500 Energy Sector Index	17.8%
RETURN FROM OL24 (DEC 7) TO AUG GIC (AUG 7)	
5. Yen Rebound	-1.7%
RETURN FROM OL24 (DEC 7) TO NOV GIC (NOV 19)	
6. MSCI Japan USD Index	9.1%
7. Shift of the 10s1s UST yield spread	+100.7bps
8. ICE BofA US ABC & CMBS Index	6.7%

Source: Citi Wealth Investments, Bloomberg, as of November 14, 2024. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Index returns do not include any expenses, fees or sales charges, which would lower performance. Past performance is no guarantee of future results. Real results may vary.

4. Biotechnology: Healthcare's Cutting Edge

When it comes to healthcare innovation, the biotechnology sector is at the cutting edge. Firms in this space have made important progress in recent years in the likes of therapies that seek to disrupt the environment that tumors need to grow, personalized treatments based on genetics, weaponizing the body's immune system to fight disease, and advanced vaccines that address cancer and rare conditions. We believe the AI revolution could accelerate biotech innovation on various levels, from drug discovery and development to advanced diagnostics to enhanced manufacturing.

Having rallied for much of 2024, we believe that biotech equities may offer outperformance potential. Decent valuations and lower interest rates could encourage renewed mergers & acquisitions activity, involving both private equity and large pharmaceutical firms seeking to replenish their product pipelines. Political risks, regulatory obstacles and rising interest rates are among the pitfalls facing the sector.

5. Deregulation Potential: U.S. Banks

Could deregulation boost U.S. banks during Trump's second administration? An overall tightening of rules since the financial crisis of 2007–09 has made for tougher operating conditions for the sector. But having eased some rules during his first term, Trump may go further this time, especially following his campaign commitment to overseeing the "largest regulatory reduction in the history of this country." Since the election, U.S. financials have rallied from near-record relative lows against the wider stock market.

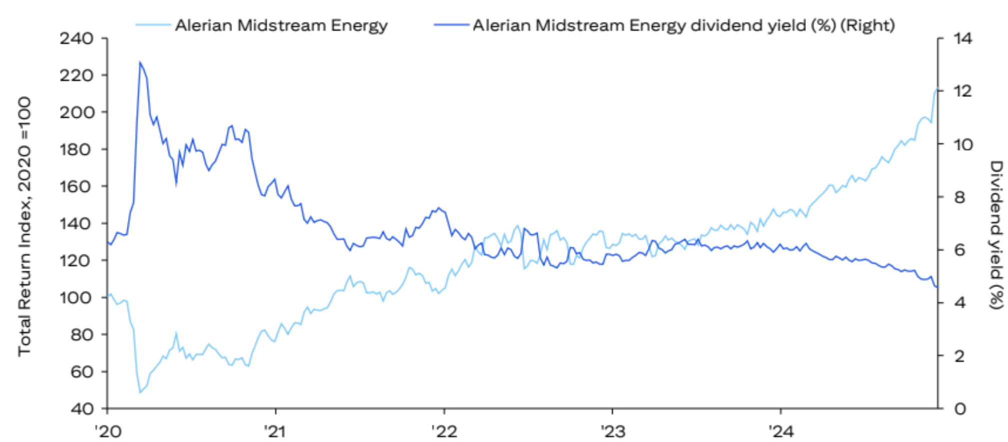
Possible deregulation measures include looser rules on how much capital banks must hold and a more permissive mergers & acquisitions regime. This could see consolidation among smaller and midsized banks, as well as more dealmaking activity among companies in general, feeding through into more fees for bigger banks. If Trump's pro-growth agenda succeeds, this could also generate a better business environment for the sector. Of course, such changes may not come to pass, while deregulation can ultimately increase the sector's riskiness. An overheated economy followed by a bust is another risk. For now, though, we see the recent rally continuing in 2025.

6. Going with the Flow: Midstream Energy Transportation

The incoming U.S. administration is a friend of traditional energy sources. Even as U.S. oil output reaches record levels, potentially sinking prices and profits for the industry worldwide, Trump has vowed to boost production further. With easing regulations, rising demand and more gas export, we are attracted to master limited partnerships (MLPs) and corporations owning the pipelines, storage facilities and processing plants that make up the "midstream" between production and consumption.

Master limited partnerships seek to pay out more of their cash flows to investors. The Alerian Midstream Energy Index recently had a dividend yield of 4.5%.[5] Its total return since 2020 has exceeded that of the S&P 500 Index and we believe its momentum may persist for now (see **FIGURE 10**). Risks include falls in energy demand and prices as well as the substantial debts that many MLPs have.

FIGURE 10: Midstream's recent performance



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[5] Bloomberg, as of 15 Nov 2024

7. Nuclear Energy's Ongoing Role

Power demand is on the rise worldwide, with artificial intelligence and cryptocurrency mining among the drivers. Electricity generation may increase from 28,000 terawatt hours in 2023 to 36,000 terawatt hours by 2030.[6] We expect this to come from a variety of sources, both traditional and alternative. Nuclear seems likely to play an ongoing role here, given that supply is not intermittent and does not emit carbon directly. Over the past year, equities relating to such areas as uranium mining, nuclear power facilities and generation, nuclear-sourced electricity, and providers of hardware and services have rallied. We believe there may be more to come. Risks to the sector come from shifting political agendas – such as nuclear phaseouts and subsidy withdrawal in certain countries – safety incidents and concerns and legal challenges.

8. Positioning for Renewed Volatility

Market volatility seems likelier in 2025. The risk of escalating trade tensions, in particular, is likely to keep uncertainty at more elevated levels. However, as of mid-November 2024, implied U.S. equity market volatility – as measured by the VIX Index – was around record lows. In our view, this creates potential to enter into hedging strategies at a reasonable cost. But once the index surges again, as we expect it to do, another possibility would be to enter positions that seek to convert demand for hedging strategies into an income. Adverse volatility developments, illiquidity of positions during times of market stress, and counterparties defaulting all pose risks here.

9. Enablers of Cryptocurrencies' Growth

The global market for digital assets continues to expand. In November 2024, the combined capitalization of cryptocurrencies alone reached an estimated $3.2 trillion.[7] The new U.S. administration is crypto-friendly, with Trump having spoken of establishing a national strategic bitcoin reserve, wanting to see more crypto mining domestically and perhaps creating a more accommodative regulatory environment.

To maintain its growth, the crypto market will need greater infrastructure. Among the providers of this are crypto mining companies, mining equipment makers, brokerages and trading firms. Equities across this space – as represented by the Bitwise Crypto Innovators 30 Index – have recovered strongly from their late-2022 lows. We believe they may remain on this path in the coming year. We also consider crypto industry equities as having the highest risk of the opportunistic positions discussed here, particularly given their rapid recent appreciation. Price volatility, technological failures, cyberbreaches and unfavorable regulatory developments could challenge our positive case.

10. Brazilian Equities' Snapback Potential

Brazilian equities have fallen hard in 2024, as has the nation's currency. This may partly reflect concern over government finances, where reform progress has disappointed. Latin America's largest market trades at just 7.8 times forecast earnings for 2025 – near historic lows – but with consensus estimates pointing to a 17% EPS rebound in the coming year.[8] As such, we believe the pessimism to be overdone and see scope for a potential bounce back in this market.

Of course, emerging markets tend to be more volatile and come with other risks, including sensitivity to slowing global growth. Further setbacks to the government's efforts to get the public finances on a more sustainable footing as well, deteriorating inflation and more currency weakness could dent Brazil's performance, on the other hand.

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[6] Statista, as of Aug 2024
[7] Bloomberg, as of Nov 2024
[8] Haver, as of Nov 24

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Bond rating equivalence

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Bond credit quality ratings	Rating agencies		
Credit risk	**Moody's[1]**	**Standard and Poor's[2]**	**Fitch Rating[2]**
Investment Grade			
Highest quality	Aaa	AAA	AAA
High quality (very strong)	Aa	AA	AA
Upper medium grade (Strong)	A	A	A
Medium grade	Baa	BBB	BBB
Not Investment Grade			
Lower medium grade (somewhat speculative)	Ba	BB	BB
Low grade (speculative)	B	B	B
Poor quality (may default)	Caa	CCC	CCC
Most speculative	Ca	CC	CC
No interest being paid or bankruptcy petition filed	C	D	C
In default	C	D	D

1 The ratings from Aa to Ca by Moody's may be modified by the addition of a 1, 2, or 3, to show relative standing within the category.
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- volatility of returns;
- restrictions on transferring interests in the Fund;
- potential lack of diversification and resulting higher risk due to concentration of trading authority when a single advisor is utilized;
- absence of information regarding valuations and pricing;
- complex tax structures and delays in tax reporting;
- less regulation and higher fees than mutual funds; and
- manager risk.

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