



January 8, 2023

CIO Strategy Bulletin

David Bailin

Chief Investment Officer
and Global Head of
Investments, Citi Global
Wealth

Steven Wieting

Chief Investment Strategist
and Chief Economist

2023's Higher Hurdles

SUMMARY

- In this period replete with New Year's resolutions, markets have a tendency to focus on what can change for the better. We believe 2022's 19% loss in global equities and 16% loss in global bonds significantly revalued and boosted future return opportunities when measured over a year or more.
- Early positive market performance in a given year does not correlate with full year returns, however. The cost of debt and equity capital is rising, not falling. Our EPS estimates are around -12% relative to market consensus. With December's positive job growth supporting markets, there is likely to be a reckoning. Equity markets have not bottomed before a recession has occurred. The track record of the yield curve (90% of recessions correctly predicted since 1960) is certainly better than the track record of economists.
- Higher minimum required rates of return for equity and debt present a headwind for equity and debt markets.
- Early positive performance in Europe and China provides indicators of future value as uncertainties abate.

The Hurdle

It would be ideal if we could begin 2023 by saying "let's invest **now** for the coming economic recovery." Alas, that is not what the Fed wants to see markets plan for. Just consider the messages the Federal Reserve delivered with the release of its December minutes this past week ([our interpretations in parentheses](#)).

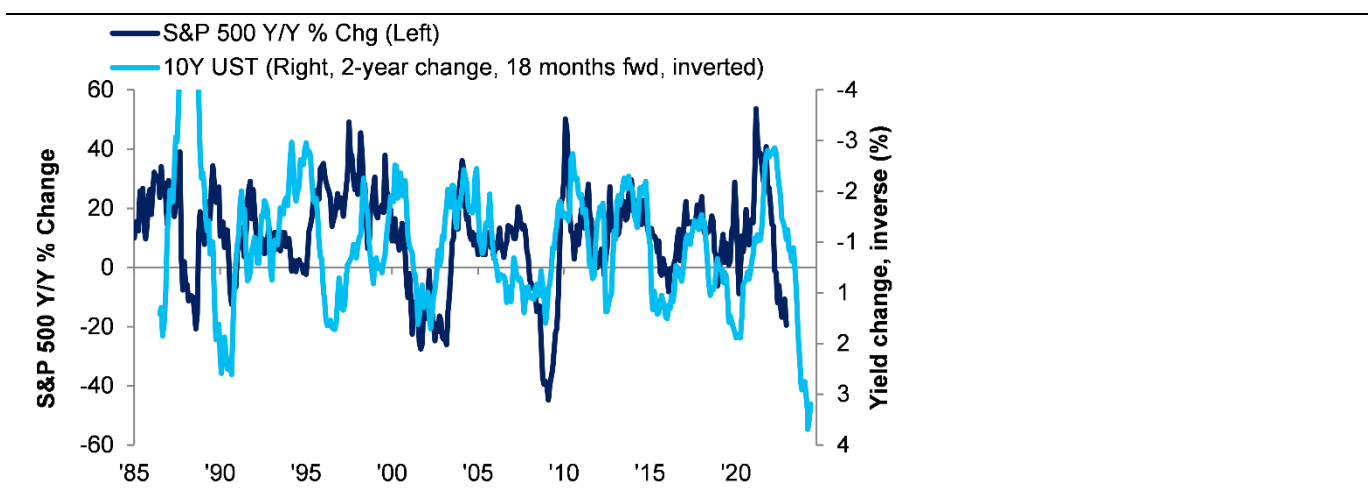
- "Members anticipated that ongoing increases in the (Fed funds) target range would be appropriate." ([We believe short term rates are going higher.](#))
- "No participants anticipated that it would be appropriate to begin reducing the federal funds rate target in 2023." ([We do not expect them to come down soon.](#))
- Expect "ongoing reductions in Fed securities holdings." ([We believe credit liquidity is likely to get worse.](#))

At the same time, the Fed expects the US to weather its strategy to kill inflation without material damage to its economy. We do not think the Fed's economic projections are any more accurate today than they were in 2021 or in 2018. When the Fed does cut rates – an event we expect toward the end of this year – it will be doing so to prevent further damage to job creation and fixed income markets.

This “boom and bust” pattern in the economy appears more closely aligned with the extremes of monetary policy easing and tightening over the past few years. This seems to be the pattern we are in just now, especially if there is a rate reversal in our near future (Figure 1). This underscores our question: Are we really at the stock market bottom when the economy has further to weaken? Does the market properly value lower earnings and higher short-term rates than the yield curve anticipates?

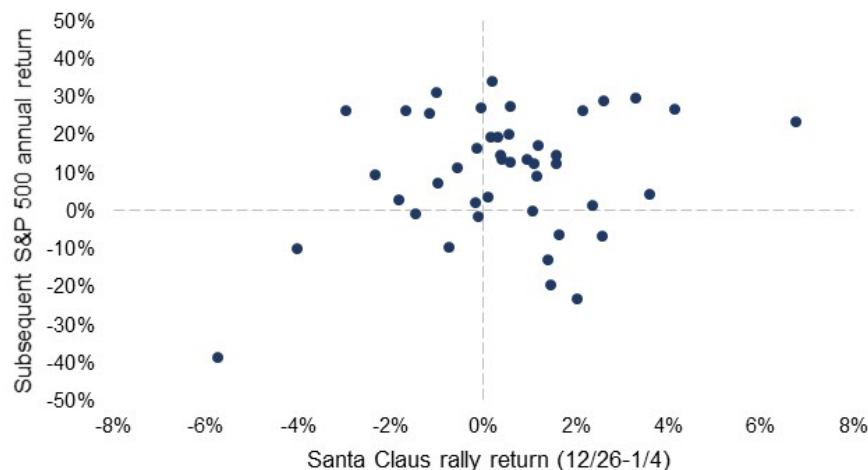
In this period rife with New Year's resolutions, markets have a tendency to focus on what can change for the better. In equity markets, the start of the year tends to be a seasonally strong period for returns. However, early performance does not support future outcomes. In fact, the initial movements in share prices around the turn of the year tend to be poorly correlated with full-year returns (Figure 2).

Figure 1: Change in US 10-year Treasury yield (18 months) vs S&P 500 Y/Y%



Source: Haver Analytics as of Jan. 4, 2023. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Past performance is no guarantee of future results. Real results may vary.

Figure 2: Weak correlation between returns at the end or start of the year and full-year market returns for the S&P 500 since 1978



Source: Factset as of Jan. 4, 2023. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Past performance is no guarantee of future results. Real results may vary.

The Future Is Indeed Brighter, but It Is Not Now

We believe 2022's 19% loss in global equities and 16% loss in global bonds significantly revalued and boosted future return opportunities when measured over a year or more.¹ However, we are skeptical that the scope of the Fed's actions to slow the economy have been fully discounted in equities markets. The cost of capital for investment grade US borrowers doubled from 3% to 6% last year (Figure 3). Of course, equities didn't fall 19% in 2022 amid rising profits without these fears in mind.

The combined impact of sharply higher rates, reduced lending by the Fed in credit markets and a future economic slowdown suggest there is a wide range of possible outcomes ahead of us. The most recent December employment data suggests resilience in labor with 223,000 new jobs added. Meanwhile, our EPS estimates for 2023 are around 12% below the consensus of industry analysts, suggesting there is a downward skew to future market action.²

Message to Investors

The combined impact of sharply higher rates, reduced lending by the Fed in credit markets, and a future economic slowdown suggest we should seek to focus on earning high-quality income from our investments, rather than pivot to high risk/return opportunities too soon. Elevated current yields reflect the opportunity cost to bet on speculative investments. Due to both sharply reduced liquidity and higher cost, riskier credit especially may soon see both wider credit spreads as well as higher overall default rates, suggesting we wait before adding to portfolios.

Message to the Fed

Central planners at the Fed ought to take note of the collective wisdom of investors willing to lock in yields on long-term bonds well below short-term yields. The market is forecasting business cycle risks and expectations for the economy and inflation that differs from the Fed's. The track record of the yield curve (90% of recessions correctly predicted since 1960) is certainly better than the track record of economists (Figure 4). While we do not

¹ Proxy for global equities is MSCI AC World Index; proxy used for global bonds is Bloomberg Barclays Global Aggregate Bond Index.

² CGWI estimates relative to IBES consensus.

assume a particularly severe recession will occur or that declines in EPS will be as significant as they were in recent recessions, the likelihood for a major slowdown remains high.

The Higher Cost of Capital

For example, a large private real estate investment trust (REIT) received a multibillion-dollar investment by a major institutional investor. The transaction provides a capital injection at a time when new equity capital is scarce. The value for this equity was high, and while just one data point, this unusually high cost of long-term equity capital is happening amid broad declines in the price of publicly traded REITs.

Liquidity constraints in the fixed income markets are having meaningful knock-on effects on domestic equity return requirements for those investors willing and able to take longer-term risks. We also expect that over-leveraged businesses that require significant new capital, or that operate dated business models, may face real financing challenges. One major retailer has already announced a risk of default this week.

Financings via CLOs (“collateralized loan obligations”) that buy and own as much as two-thirds of the leveraged loan market may not be able to absorb as many new loans as they did last year. Private credit lenders, which generally have much more flexibility, are also reportedly becoming increasingly picky by reducing their loan amounts versus borrower asset values, avoiding certain sectors altogether and charging much higher yields when they do lend.

All of this data suggests that the rate investors will demand for taking risk is rising, not falling, presenting a headwind for markets in the US.

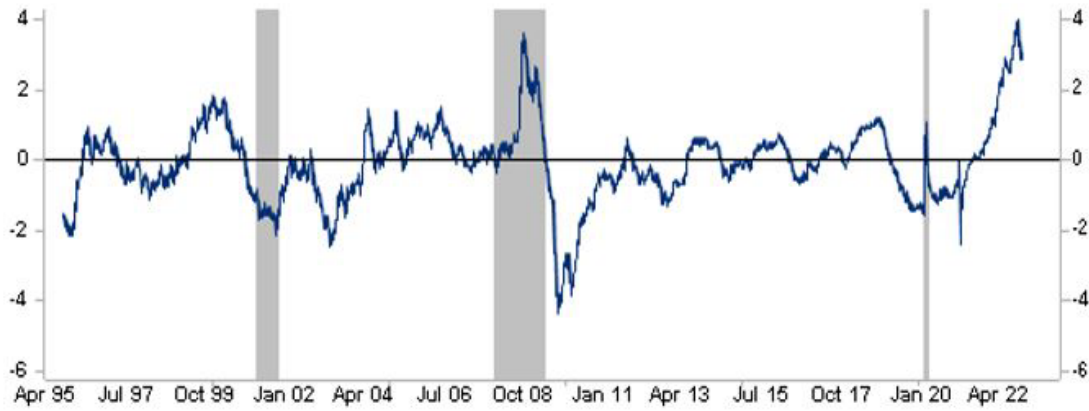
Early Outperformers

The earliest data for returns in 2023 suggest the outperformance of quality income that characterized 2022 is continuing this year (Figure 5).

China shares have led performance early in 2023 after a hard landing in 2022. This is due to Covid policy changes that, while risky, indicate the extent to which policy makers want to see the world’s second-largest economy reopen. Further, China’s much looser monetary policy will also accelerate growth as the year progresses. Ironically, we believe US markets will follow China higher in time given the mirrored – if time-lagged – similarities in the policies both are likely to follow.

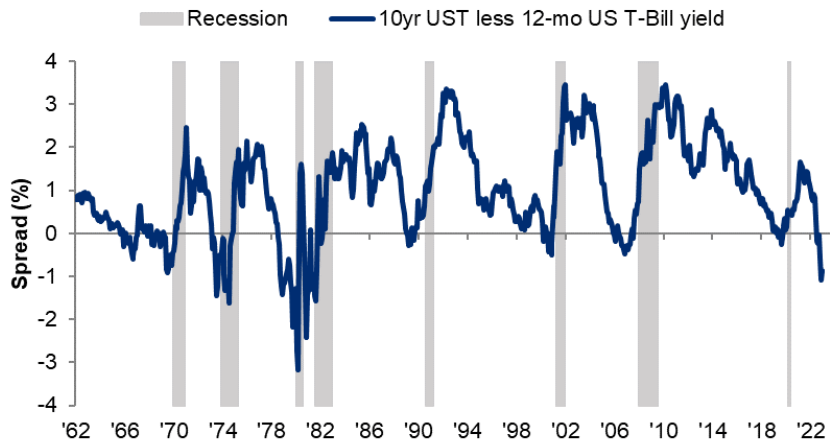
Europe, meanwhile, is providing an upside surprise in 2023. Investor outflows in 2022, lower valuations and a clearer onset of recession last year put Europe’s markets in a better place for recovery this year. Warm weather and full inventories of natural gas have undermined the story of a Russian-led shock (see our Nov. 4, 2022, [Europe Strategy Monthly](#)). And even after a 10% rally, the euro remains structurally cheap and is indicative of weak investor positioning in these regional assets.

Figure 3: Debt cost of capital for US IG corporate borrowers (12-month difference)



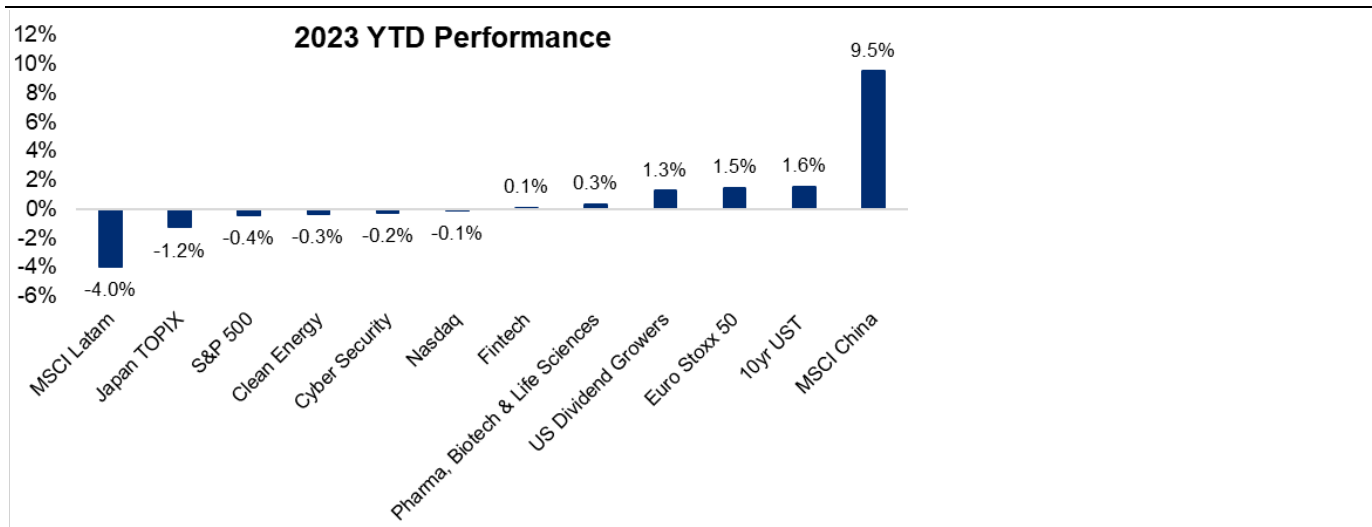
Source: Haver Analytics as of Jan. 4, 2023. Grey areas note recessions. Past performance is no guarantee of future results. Real results may vary.

Figure 4: Believe the Fed or the yield curve?



Source: Factset as of Dec. 31, 2022. Grey lines note recessions. Past performance is no guarantee of future results. Real results may vary.

Figure 5: Early 2023 trading suggests continuation of late 2022 trends




Source: Bloomberg as of Jan. 5, 2023. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Past performance is no guarantee of future results. Real results may vary. All forecasts are expressions of opinion, are subject to change without notice, and are not intended to be a guarantee of future events.

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