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CIO Strategy Bulletin

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There Is No Perfect Time to Invest (You did not miss it.)

- When T-bill rates and deposit rates are high, it is understandably tempting to do nothing or to wait until the stock market "inevitably declines" before entering. But looking out just one year, we believe that those who do not have core portfolio investments may be disadvantaged.
- Markets lead the economy and the introduction of generative AI is a reminder that innovation is itself unstoppable. Innovation and demographics explain why equity markets in the US have returned about 11% annually since the end of World War II.
- Now that markets are up, investors who are on the sidelines wonder if they have missed "it." Of course, there is no perfect time to invest.
- Looking at the Fed's current projections for inflation at the end of 2024, we see that their estimate is 2.6%. If we accept the Fed's inflation projections, would you rather keep money in cash or own intermediate bonds? Money market funds at the end of 2024 are likely to yield closer to 2%. Extending the duration of fixed income portfolios should be seriously considered now that the debt ceiling issue is resolved.
- We suggest clients maintain their plans and investment decisions through market cycles. If you are starting a new Core Portfolio or are concerned about when to add more to your investment account, consider dollar cost averaging. But also understand that picking the "right month" to start is impossible. Once you establish an investment philosophy and asset allocation, get underway. The virtues of portfolio diversification and asset allocation can mitigate the risks of emotional decision making.
- Portfolios evolve. In this week's CIO Bulletin, we list several potential opportunities for portfolios in a slowing economy. We also recommend reading our full Mid-Year Outlook 2023 here.

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There Is No Perfect Time to Invest

When T-bill rates and deposit rates are high, it is understandably tempting to do nothing or to wait until the stock market "inevitably declines" before entering. The temptation to stay out of the market may seem safe, but looking out just one year, we believe that those who do not have core portfolio investments may be disadvantaged.

Strategic Return Estimates (SREs) (**Figure 1-A** at end) reflect what may happen in the decade ahead and our forecasts have risen significantly after the double downturn in bonds and stocks in 2022. Markets lead the economy and the introduction of generative AI is a reminder that innovation is itself unstoppable. Innovation and demographics explain why equity markets in the US have returned about 11% annually since the end of World War II.[1]

The Fallacy of the Ideal Entry Point

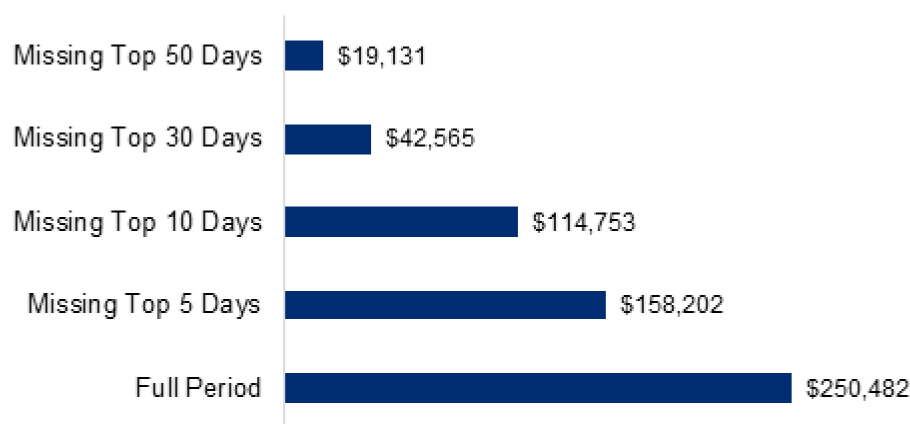
Many investors have waited for an ideal market entry point. That's understandable given that there has been a recession "on the horizon" for almost 18 months. During the interval, they have been hoarding cash and shorting equities. Those who stay in cash will experience poor relative returns when markets recover – and 2023's market action through mid-year demonstrates that a partial recovery is underway.

An "ideal entry point" would be a moment when all macro-economic risk is in the "rear-view mirror." But our current circumstances are not like 2008 or 2020. We are not experiencing a singular economic shut down or a credit crisis that undermined the nation's financial system. Right now, we are in a rolling recession (see our May 28 CIO Bulletin) where some elements of the economy are contracting, others are expanding, and the Federal Reserve is committed to slowing the economy sharply to reverse stimulus-fueled inflation.

In 2023, investors who accepted the complexity and contradictions of this market and remained invested have earned solid bond market returns and an 11% rise in global equities. Now that markets are up, investors who are on the sidelines wonder if they have missed "it." Such is the lament of the market timer.

Missing the pivot points in markets can be quite costly (**Figure 2**). This is why waiting for the "perfect time" is a fool's game.

Figure 2: Hypothetical growth of $10,000 USD in S&P 500 since January 1990 to June 2023



Source: Bloomberg as of June 15, 2023. Top day refers to top-performing day of the S&P 500 Index. 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. Hypothetical performance results have many inherent limitations. The portfolio performance and return information reflects the benefit of hindsight and does not reflect the impact that material economic and market factors might have had on decision making of the Investment Lab or its affiliates were actually advising an investor in investing in these investments or managing an actual portfolio. Since the trades of the simulated performance results have not actually been executed, the results may have under or over-compensated for the impact of certain economic and market factors, such as lack of liquidity. Also, hypothetical trading cannot fully consider the impact of financial risk, such as ability to withstand losses. An investor's investment in an actual portfolio will be made in different economic and market conditions than those applicable during the period presented. It should not be assumed that an actual investor portfolio will experience returns comparable to the portfolio performance and return information presented herein. Past performance does not guarantee future results. Real results will vary. As a result of market activity following the date of the period presented, current performance may be different from that shown herein.

[1] Source: Proxy used is S&P 500 index since 1946. The indexes 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.

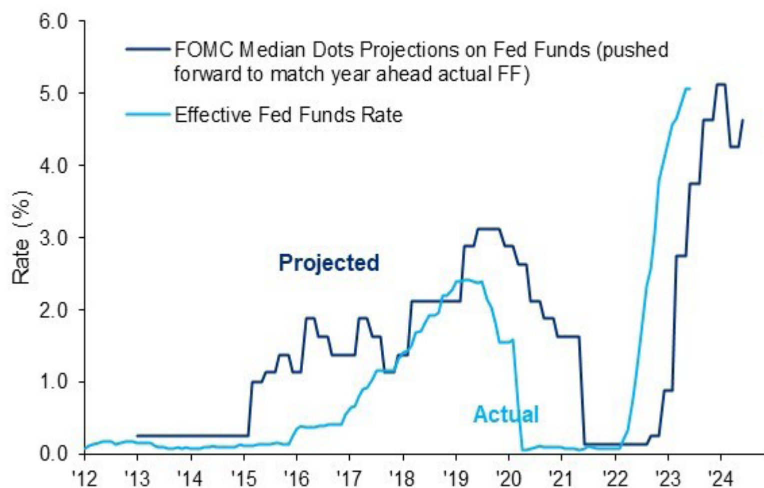
What the Fed Says and Does Is Often Different

This week the Fed paused its rate hikes and also signaled that they are on track to raise rates further if inflation does not cool fast enough. To confuse investors further, Fed Chair Powell spoke about hypothetical future rate cuts, while noting that core inflation measures have fallen much less than headline inflation. Core CPI inflation was 5.3% over the past year, but excluding housing, it was 3.4%.

In the period after the Great Financial Crisis and the COVID shock, central banks were promising "low rates forever" – exaggerating how long the Fed would stay easy. This would tend to boost risk taking and economic activity. Promising a long period of tight policy would have the opposite impact. It would "yield more tightening" from the same interest rate level. But what is clear is this: Inflation is slowing as rapidly as it ever has following a substantial global shock.

Looking at the Fed's current projections for inflation at the end of 2024, we see that their estimate is 2.6%. But even if inflation is low, the Fed will respond to rising unemployment with lower rates. Ironically, at the time unemployment is rising and the Fed is easing, we may be at the end of a rolling recession, presaging growth in markets in 2024. Remember, there is a history of inconsistency between Fed statements and actions as illustrated in **Figure 3**.

Figure 3: Fed funds rate and Fed's 1-year ahead estimate from Summary of Economic Projections



Source: Bloomberg as of June 14, 2023.

An Immediate Opportunity

If we accept the Fed's inflation projections, would you rather keep money in cash or own intermediate bonds? We think high overnight money fund rates and 5.25% short-term T-Bills will not be available a year from now. Extending the duration of fixed income portfolios should be seriously considered now that the debt ceiling issue is resolved.

Money market funds at the end of 2024 are likely to be closer to 2%, whereas many bonds may appreciate in value while retaining their yield. This is an example of why we are suggesting suitable investors act to keep what's necessary in cash and move toward quality bonds.

Your "Investment Philosophy"

We have previously published our views about having an investment philosophy. This is a set of principles that will inform investment decisions. We believe a thoughtful asset allocation that takes all of a client's wealth into account has the potential to deliver investment results over time. And we also believe in the idea of a "Core Portfolio" complemented by opportunistic investments.

The Core Portfolio is intended to be the majority of one's investments and should be fully invested for the long term, diversified across asset classes and geographies, and regularly rebalanced to a set strategic asset allocation. Opportunistic investments can be added, whether short or long term, based on ideas or themes that can broaden the return profile of the Core Portfolio as well as an investor's risk tolerance and objectives.

Once you have a Core Portfolio that is suitable for you, the behavior one exhibits as the economy and markets zig and zag becomes highly relevant. When the world is abuzz with recession talk, for example, investment decisions can get postponed. When cash yields appear “too high to ignore,” a disproportionate amount of cash can be set aside.

Therefore, we strongly suggest clients maintain their plans and investment decisions through market cycles. For example, if you are starting a new Core Portfolio or are concerned about when to add more to your investment account, consider dollar cost averaging by adding money regularly over a few months. But also understand that picking the “right month” to start is impossible. Once you establish an investment philosophy and asset allocation, get underway. The virtues of diversification and asset allocation can mitigate the risks of emotional decision making.

Portfolios Address Market Conditions

The best investors do not decide when to sell everything and when to buy again. They are constantly reviewing where areas of potential opportunity exist and when certain markets are overbought. They are conscious of macroeconomic conditions and exogenous risks. Thus, portfolios evolve. For example, in 2022 our MACs multi-asset class discretionary portfolios became defensive. Instead of selling out of equities, we moved into defensive shares and a higher portfolio share of bonds. Investments in the most consistent dividend growers in the US, for example, outperformed the S&P 500 1300 basis points. (Note: This is the return of S&P Dividend Aristocrats vs S&P 500 Total Return.)

Now, as we look ahead, we anticipate rotating Core Portfolios into the following areas of potential opportunity.

Areas of Value

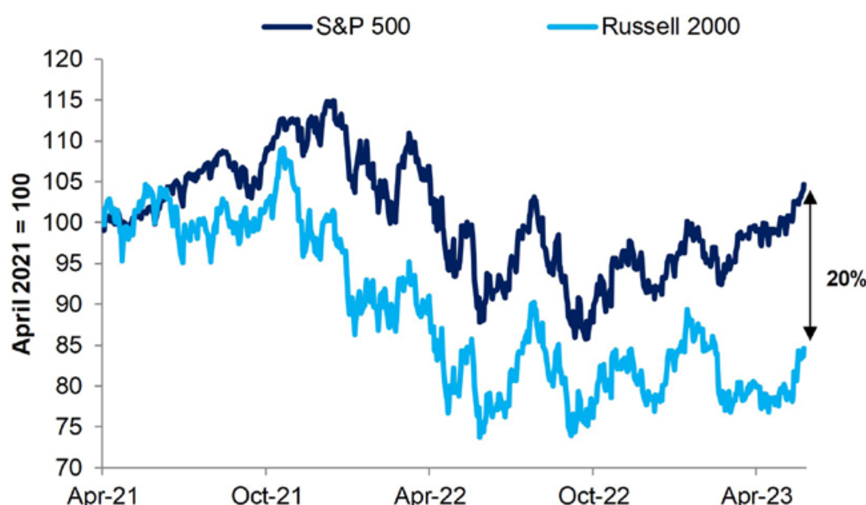
Given our view of returns across asset classes for the coming 10 years, we make the following observations:

- **Non-US equities have fallen to near record low valuations vs US large caps.** The US dollar’s 10-year rally and sharp spike up in 2022 will unwind in coming years, potentially boosting returns for non-USD investments.
- **US small caps have fallen to near record low valuations vs US large caps.** A very narrow rally in US large cap tech masks sharp downward adjustment in other US shares, creating an equity opportunity away from “defensive” equities.
- **Long-term growth opportunities are beginning to recover.** Only AI infrastructure builders have seen their shares increase in value from what is likely to be a broad, positive productivity shock that will unfold in coming years. The unstoppable trends of digitization and diversifying energy sources have been re-invigorated in 2023.

There are risks embedded in these areas of value as well:

- Because some indices are trading at low values, there may be no catalyst to have them perform better.
- The timing of when one enters will have an effect on the return earned subsequently.

Figure 4: Large and small cap performance since we moved underweight SMID



Source: : Bloomberg and Factset as of June 7, 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. Index returns do not include any expenses, fees or sales charges, which would lower performance. For illustrative purposes only. Past performance is no guarantee of future results. Real results may vary.

Figure 1-A: Strategic Return Estimates (SRE) Return Expectations Are Higher for 2023 from 2022

ASSET CLASS	2023 SRE	2022 SRE
Developed Market Equities	7.0%	3.8%
Emerging Market Equities	12.9%	8.1%
Investment Grade Fixed Income	4.6%	1.8%
High Yield Fixed Income	7.4%	2.6%
Emerging Market Fixed Income	7.8%	3.6%
Cash	3.4%	0.9%
Hedge Funds	9.1%	4.1%
Private Equity	17.6%	11.6%
Real Estate	10.6%	8.8%
Commodities	2.4%	1.5%

Chart shows Citi Global Wealth investments 10-year annualized nominal asset class return expectations, in US dollars. Source: Global Asset Allocation Team data as of October 31, 2022. Strategic Return Estimates (SRE) based on indices are Citi Global Wealth's forecast of returns over a 10-year time horizon for specific asset classes (to which the index belongs). Indices are used to proxy for each asset class. Cash refers to the US Cash SRE. The forecast for each specific asset class is made using a proprietary methodology that is appropriate for that asset class. Equity asset classes use a proprietary forecasting methodology based on the assumption that equity valuations revert to their long-term trend over time. The methodology is built around specific valuation measures that require several stages of calculation. Assumptions on the projected growth of earnings and dividends are additionally applied to calculate the SRE of the equity asset class. Hedge Fund and Private Equity SREs are linked to equity SREs. Fixed Income asset class forecasts use a proprietary forecasting methodology that is based on current yield levels. Other asset classes use other specific forecasting methodologies. SREs are in US dollars. SREs are generally updated on an annual basis, however they may be updated off cycle based on market conditions or methodology adjustments. Strategic Return Estimates are no guarantee of future performance. SREs do not reflect the deduction of client fees and expenses. Future rates of return cannot be predicted with certainty. Investments that pay higher rates of return are often subject to higher risk and greater potential loss in an extreme scenario. The actual rate of return on investments can vary widely. This includes the potential loss of principal on your investment. It is not possible to invest directly in an index. All SRE information shown above is hypothetical not the actual performance of any client account. Hypothetical information reflects the application of a model methodology and selection of securities in hindsight. No hypothetical record can completely account for the impact of financial risk in actual trading.

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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

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