Citi Global Wealth
Investments

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CIO Strategy Bulletin

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Less Inflation, Better Earnings and a Bit of AI

- The performance of the economy in 2023 remains uneven, but it has exceeded most investors' bearish expectations – even our own. Some of our own concerns haven't materialized, leading us to raise our allocation to global equities.
- The recent inflation news is particularly good for markets. Inflation is slowing even faster than the labor market. Moderating energy costs pulled headline US consumer prices from a peak above 9% to just 3%. We think these developments will ultimately set the stage for the Fed to begin turning away from restrictive monetary policy, most likely in 2024.
- Wall Street research analysts have cut their estimates for Q2 earnings, lowering the bar for success. Annualized Q2 estimates fall 14% compared to Q1. But these same forecasters estimate earnings in Q3 will surge and grow rapidly. In a slowing economy, this makes the possibility of 2H2023 disappointments higher.
- Technology shares have outperformed bank shares considerably this year and broadly for the decade past. The increased regulatory scrutiny faced by banks since the Great Financial Crisis is, in part, responsible as higher capital requirements limit growth and risk. With inflation cooling and reduced economic tail risks, we expect a near-term boost in financials. This is true for banks and publicly traded private equity firms as noted herein.

A Better US Economy Than Expected

This less-than-perfect 2023 economy has exceeded most investors' bearish expectations (**Figure 1**). In fact, it has even exceeded our own. Several of our major concerns have not materialized, leading us to raise our allocation to global equities.

The US Treasury has been able to refill its coffers by more than $500 billion since a debt ceiling agreement passed at the end of May. It did this without draining deposits from banks (**Figure 2**). Short-term lenders reduced their overnight use of a key Fed lending facility, leaving neither the US Treasury nor banks deprived of credit.

The US economy, meanwhile, is seeing a sharp drop in inflation as well as a moderation in hiring (**Figure 3-4**). US employers added 209,000 workers in June, still unsustainable in the Fed's view. Yet, private sector job gains of 149,000 last month were the lowest of the post-Covid expansion period and are decelerating. The healthcare sector accounted for more than 40% of private sector hiring.

Cyclical services like leisure and hospitality added only 58,000 jobs over the entire second quarter and the boom in demand for services is subsiding. Just as the demand for goods surged during Covid and abated in 2022, we think record swings in demand for services will follow the same pattern in 2023-24.

What is particularly good news for markets is that inflation is slowing even faster than the labor market. A moderation in energy costs drove headline US consumer prices from a peak above 9% to just 3%. The CPI for services – excluding shelter – has fallen from an 8.2% yearly pace last autumn to 3.2% in June. And we think a more meaningful drop in core inflation is ahead. The CPI for shelter is barely down from its 8% year/year pace. The collapse of home price appreciation following the Fed's 2022 tightening is only beginning. This lagging inflation contributor is likely to be coming down deep into a future housing recovery. We expect employment weakness in real estate to rise accordingly.

Collectively, we think these developments will bring on a far longer pause from the Fed than the one-month June reprieve. It will set the stage for the Fed to begin turning away from restrictive monetary policy, most likely in 2024. With inflation-adjusted ("real") bond yields surging, we continue to favor quality fixed income while yields are higher than markets may make available in 2024.

The US dollar has dipped on this news – not because of a collapse in the US economy – but because of reduced odds the Fed will press on with "world collapsing" tightening measures. This allows our newly augmented emerging markets fixed income weighting to shine and contribute further to portfolio yield (see **Figure 5** and the latest Quadrant).

Figure 1: Market rally pulls investor sentiment higher (AAII poll of bullish less bearish investors vs S&P 500)

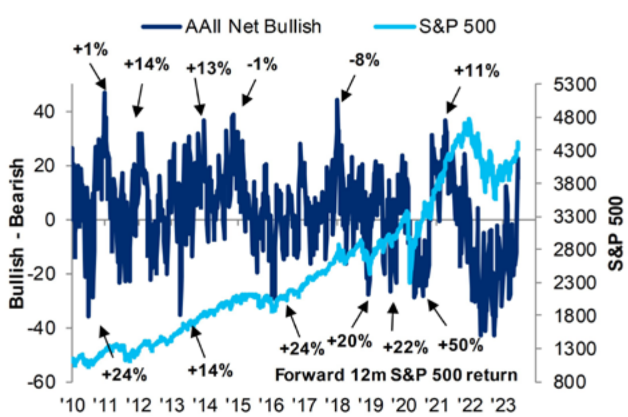
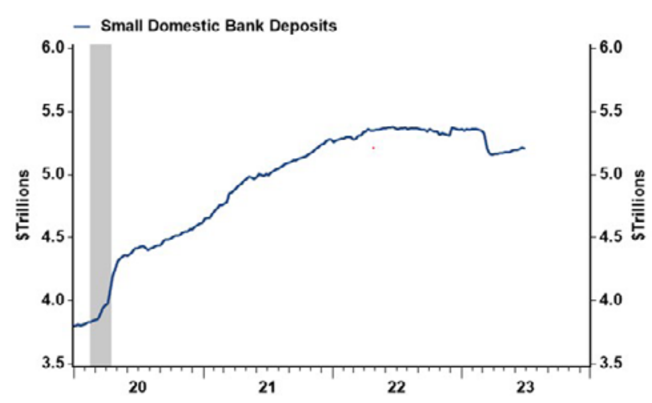
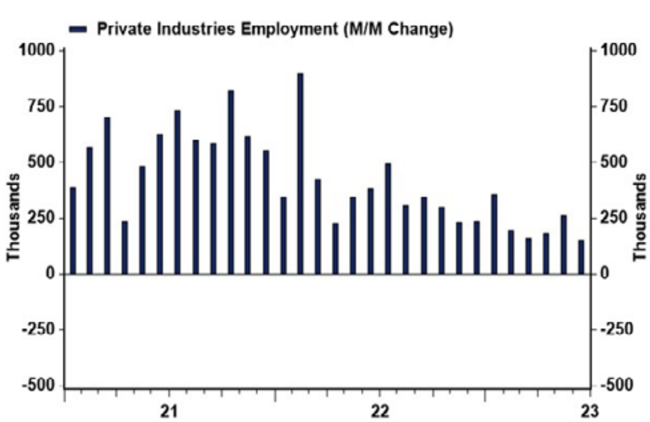


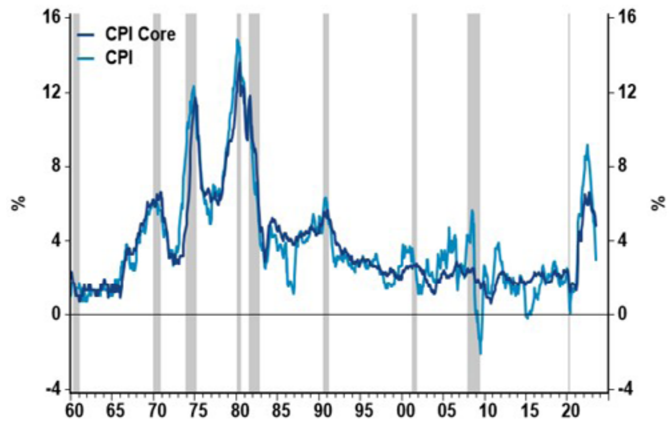
Figure 2: Following Silicon Valley Bank shock, small bank deposits have been steady



Source Haver Analytics as of July 13, 2023. Grey areas note recession. 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.

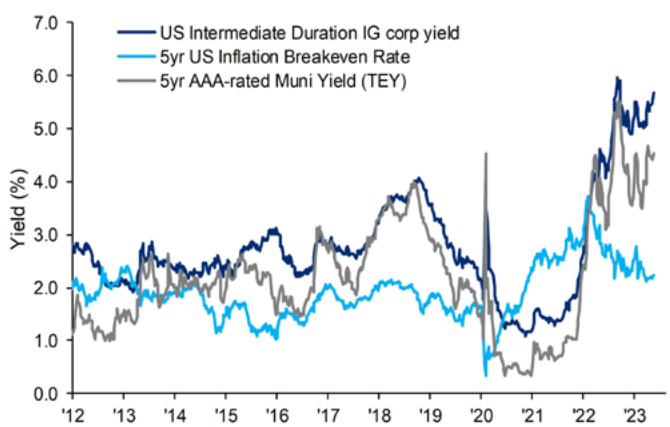
Figure 3: US private sector job gains (thousands/month) **Figure 4**: US CPI slows from 9% to 3% year/year pace





Source: Haver Analytics as of 4 July 13, 2023. Grey areas note recession.

Figure 5: US intemediate corporate yield, muni tax equivalent yield and 5-year expected inflation from TIPS yield



Source: Haver Analytics as of July 13, 2023. All forecasts are expressions of opinion 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.

Earnings Season Olympics See a Lower Bar

Last week, corporate earnings season began with early reports from large banks. In the coming weeks, reports will come from large tech firms, industrials and retailers. Following a long “tradition,” Wall Street research analysts have cut their estimates for upcoming earning reports, lowering the bar for success. An aggregation of the second quarter EPS estimates equates to a 14% annualized EPS *reduction*.

In the first quarter of 2023, managements were effective in limiting expenses and maintaining margins. This cleared the decks for a true earnings surprise. However, both managements and analysts have been cutting near-term estimates for most of the past year. With inflation coming down and the economy slowing, maintaining margins will become somewhat more difficult. Yet, same forecasters estimate earnings in Q3 will surge and keep growing rapidly. In short, as the economy experiences rolling recessions (see our July 2 CIO Bulletin), reaching the projected EPS levels for the remainder of ’23 will be quite difficult.

A Bit About 2023 Equity Winners and Losers

Tech's Resurgence

2023 has seen a huge tech-driven rally. Hype around Artificial Intelligence propelled mega-cap equities through the nearly forgotten collapse of three US regional banks. Embedded in tech valuations is a lot of hope around long-term earnings growth. Indeed, expected earnings beyond 2025 explain 90% of the price an investor pays for the S&P 500 Tech index (**Figure 6**).

We don't view tech's long-term outperformance as unjustified. In fact, tech earnings have mostly kept pace with their rising share of overall market cap as the sector sells products that are indispensable to daily life. Companies that hold the keys to cutting-edge processing power and troves of data will continue to benefit from AI buildout. But as we approach tech earnings in the coming weeks, clients over-exposed to expensive technology and under-allocated to more beaten-down sectors run the risk of some portfolio disappointment if the AI hype does not generate further positive news.

Banks to Rebound

This year's relative poor performance of banks versus technology shares is not new. Tech outperformance is reflective of the increase in regulatory scrutiny faced by banks since the Great Financial Crisis (**Figure 7**).

With inflation cooling and reduced economic tail risks, select financials look poised for a catch-up. Collectively, banks are barely more valuable than the book value of their assets, with the Russell 3000 banks index trading at 1.0 price to tangible book (**Figure 8**). Valuations of issues higher in the bank capital structure, like preferreds, have also improved. If a firm employment backdrop keeps the Fed holding rates higher for longer, value sectors – including financials – could make up ground versus growthy tech.

While all the global systemically important banks passed their annual stress tests, regulators are still worried about capital ratios in the banking system after the banking jitters earlier this year. Amid an uncertain regulatory backdrop, large banks, in the aggregate, have been hesitant to meaningfully boost buybacks and dividends, leading to a more muted positive reaction following last month's solid stress test results. But peering beyond the near-term inertia, high quality financials – including leading banks and asset managers – look compelling over a one- to two-year horizon.

Alternative Managers Are Looking Good Here, Too

As we discussed last week in our CIO Bulletin focused on alternative investing, while private equity deal activity has slowed this year, the composition of that deal flow has been concentrated in the highest quality managers. That additional dry powder will enable private equity leaders – many of whom are listed in public markets – to take advantage of dislocations and opportunities as they arise in the coming quarters (**Figure 9**). The possibility that the public private equity sector will outperform the bank rebound remains strong, too.

Figure 6: Tech valuations are mostly driven by long-term optimism and large-cap growth and value

Source: Bloomberg as of July 12, 2023. All forecasts are expressions of opinion and are subject to change without notice and are not intended to be a guarantee of future events. 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 7: Financials vs information tech long-term performance

Source: Haver, as of July 12, 2023. Grey areas note recessions. 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.

Figure 8: Price-to-book ratio of Russell 3000 banks

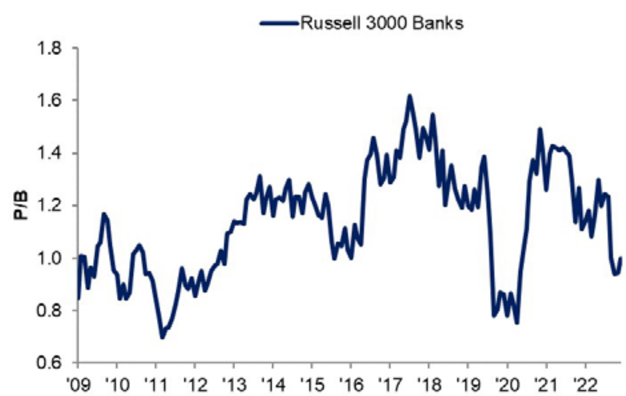


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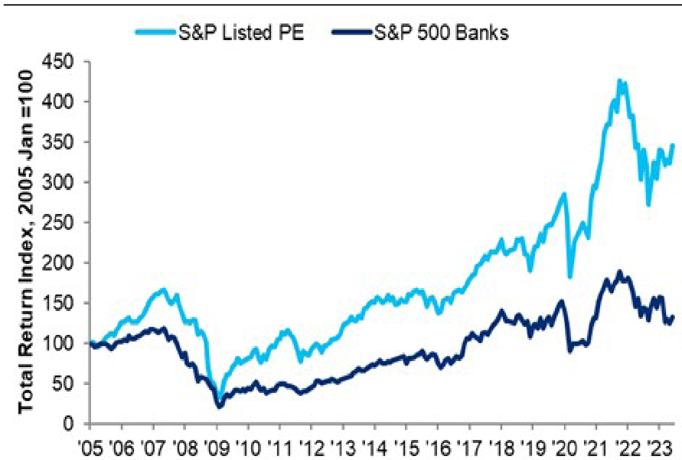
Figure 9: S&P-listed private equity vs S&P 500 banks



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Most speculative	Ca	CC	CC
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