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Investments

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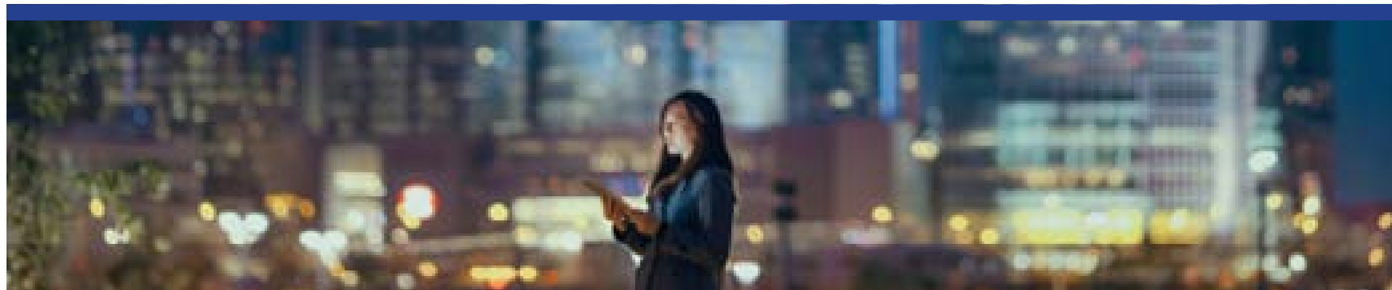

April 10, 2023

CIO Strategy Bulletin

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Don't Let the T-Bill Rate Distract You

SUMMARY

- As investors and risk managers, we need to ask ourselves how to align portfolios for likely near-term headwinds, but also anticipate the potential long-term rewards just over the horizon. Locking in high T-bill yields is not the strategy, especially when you consider we are two-thirds of the way through a bear market. Those lulled into a false sense of security by moving into T-Bills rather than building resilient portfolios are likely to be disappointed by their results just a few years out.
- While the Federal Reserve is committed to fighting inflation and holding rates 'higher for longer', there are increasing signs that the economy is weakening in an accelerating manner. Furthermore, the recent, unexpected banking crisis has also worsened the economic backdrop. We expect that credit availability will decline over the next 12-18 months and the cost of credit will rise meaningfully.
- Private employment gains slowed to below +200,000 in March for the first time since 2020. Construction employment showed the first sizable decline of the cycle. We remain confident that employers in manufacturing and housing will choose to reduce employment and related labor costs in the face of declining demand and rising wages
- Investors are not confident in the profit outlook for corporations. They are 23% net bearish according to the American Association of Individual Investors poll[1]. Yet, in spite of these observations. markets do not reflect the corporate earnings declines we expect. In fact, they have been range bound for more than 4 months.
- For now, our portfolios maintain a "quality income" vigil and seek growth from industries with less than average business cycle risk such as pharmaceuticals (our largest sector overweighting). This comes at the expense of underweights in less well-capitalized and indebted firms.

[1] American Association of Individual Investors poll as of March 29th, 2023. https://www.aaii.com/sentimentsurvey

Getting To a Better Tomorrow

Global share prices and most bond yields have been stuck in a trading range for four months now. This is despite the rapid collapse of three notable banks on both sides of the Atlantic and increasing signs that recessionary forces are building in the US economy.

Shares in US and non-US markets are down 16% respectively from their record highs of 2021/2022. And even after recent rallies in the bond market, US government yields are up 3 to 4% across different points of the yield curve relative to 2020 (see **Figure 1**).

Amidst all this, a violent rotation out of the most speculative investments to the most conservative income-generating assets has taken place.

The realignment of markets reflects the fact that we are “two-thirds” of the way through a bear market and this has improved our long-term return expectations (see **Figure 2 and 3)**.

Figure 1: Global Equities vs US Treasury Yield, Weighted Average %

Figure 2: S&P 500 Information Technology Index vs Unprofitable Tech Index

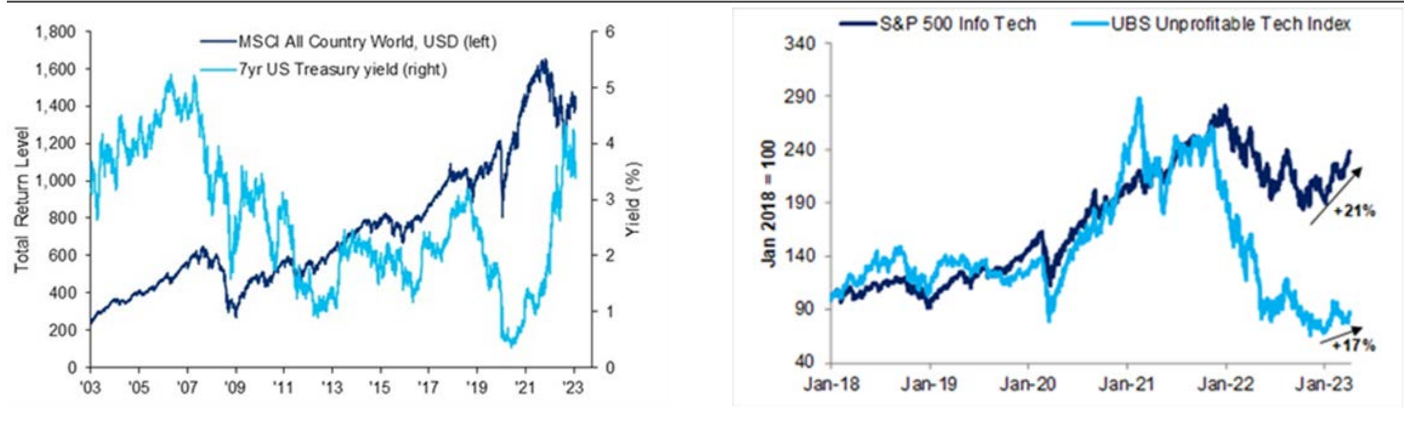

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Figure 3: Citi Global Wealth Investments 10-Year Annualized Nominal Asset Class Return Expectations in USD

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%

Source: Bloomberg as of April 4, 2023 (left) and CGWI Global Asset Allocation Team as of October 31, 2022 (right). 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. 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.

We Have a Recession to Get Through

There is a huge divergence between analyst estimates for corporate earnings and our view of them. As we discussed in our latest Quadrant: One Shock, Two Recessions, analyst EPS estimates for the first quarter of 2023 are expected to reflect a 7.5% drop in profits for the S&P 500 relative to a year ago. This seems reasonable.

Yet, looking at the same industry analysts' second quarter estimates (April-June 2023), an immediate earnings rebound is likely. Analysts expect a 7% improvement in Q2/2023 profits. This would be the equivalent of a +31% annualized earnings growth rate using the same method that GDP estimates are based upon. The gains in profits they estimate are across the entire spectrum of market caps, though varying across industries.

Our views of corporate earnings are very different than these analyst estimates. In our expected case, a low in corporate profits may occur by the third quarter of this year.

Bearishness is Abundant

Investors are not confident in the profit outlook for corporations. They are 23% net bearish according to the American Association of Individual Investors poll[1]. This bearishness is appropriate as markets are not priced for record high profits later this year (see **Figure 5**). On the other hand, this high level of bearishness is typically a bullish sign 12+ months out. Current levels of pessimism are typically consistent with rebounding equity markets in the year to come (see **Figure 4**). And if interest rates are lower one year hence, as we expect, their attractiveness relative to equities will have been reduced.

1 American Association of Individual Investors poll as of March 29th, 2023.

Figure 4: Net AAII Bears/Bulls vs S&P 500 and 12-Month Return from Bearish Extreme Readings

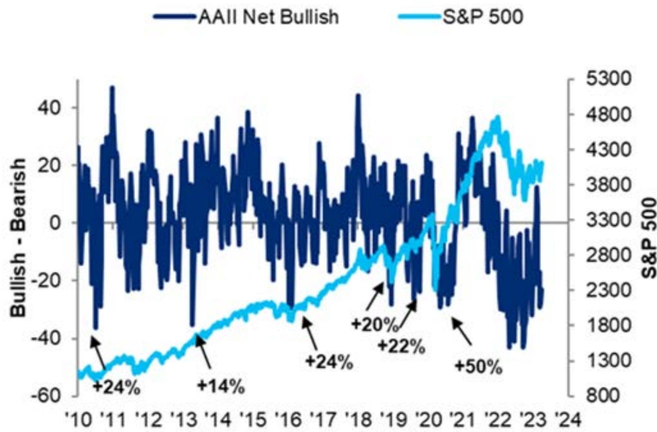


Figure 5: S&P 500 vs EPS Level with Consensus Estimates and CGWI Estimates

Source: Haver Analytics as of April 4, 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.

Cracks in the Economy are Growing

While the Federal Reserve is committed to fighting inflation and holding rates "higher for longer", there are increasing signs that the economy is weakening in a meaningful way (**Figure 6**). Private employment gains slowed to below +200,000 in March for the first time since 2020. Construction employment showed the first sizeable decline of the cycle. We remain confident that employers in manufacturing and housing will choose to reduce employment and related labor costs in the face of declining demand and rising wages (**Figure 7**).

The recent, unexpected banking crisis has also worsened the economic backdrop. As we wrote in our March 26 Bulletin: As Go the Banks, So Goes the Economy, we expect that credit availability will decline over the next 12-18 months and the cost of credit will rise meaningfully. Until there is stability in deposit levels and costs, as well as a reduction in Fed short term rates, companies will take a more conservative posture in their plans for capital expenditures.

Figure 6: US Job Openings and Layoff Announcements Year-over-Year Difference

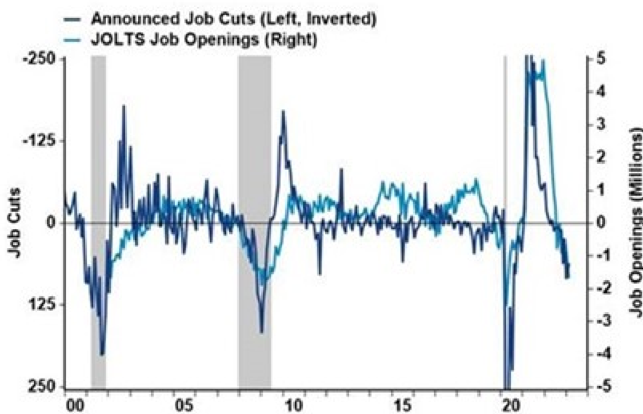


Figure 7: US Manufacturing Purchasing Managers and Homebuilders Indices (Note: 50+=Expansion)

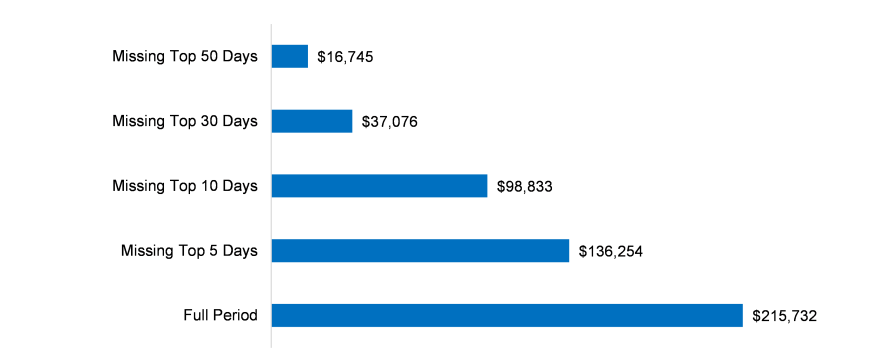
Source: Haver Analytics as of April 5, 2023. Note: gray areas are US recessions.

Portfolio Awareness and Adaptation

As investors and risk managers, we need to ask ourselves how to align portfolios for the near-term headwinds that we believe are upon us and anticipate the potential long-term rewards just over the horizon. For example, earning a six month T-Bill return of 4.7% is attractive. But a high six month T-bill yield does not provide medium and long-term benefits.

We suspect that locking in a T-bill yield at the expense of maintaining a broader portfolio return will inhibit portfolio results. In fact, the maturity date for bills may weigh down decision-making. To the extent that high rates defer investment in broader, diversified portfolios, it will be the equivalent of market timing. And the cost of that can be severe (**Figure 8**). In fact, given that we are nearing a "pivot point" in markets over the next 3-6 months, some of the best (and worst) days may be before us. Missing these days is very costly to portfolio returns. Despite macro-economic risks, bull market psychology is surely absent now. Yet, markets will begin to anticipate an economic recovery well before one is underway.

Figure 8: Hypothetical growth of $10,000 USD in S&P 500 since January 1990



Source: Haver Analytics as of December 31, 2022. Top days represent highest daily gains in the S&P 500. 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. The performance 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. For example, there are numerous factors related to the equities, fixed income, or commodities markets in general which cannot be, and have not been accounted for in the preparation of hypothetical performance information, all of which can affect actual performance. The returns shown above are for indexes and do not represent the result of actual trading of investable assets/securities. The asset classes used to populate the allocation model may underperform their respective indexes and lead to lower performance than the model anticipates.

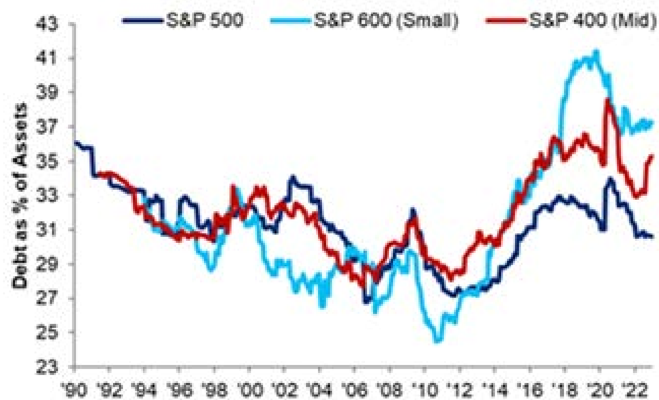
Portfolio Patience for Now

For now, our portfolios maintain a "quality income" vigil and seek growth from industries with much less than average business cycle risk such as pharmaceuticals (our largest sector overweighting). This comes at the expense of underweights in less well capitalized and indebted firms (see **Figures 9-10**).

There will never be a time when we can say all portfolio risks are absent and returns will only be positive. Yet, as greater bearishness over the outlook for growth gets priced in – with bond yields falling and small cap/cyclical shares underperforming – we would look to realign portfolios for greater risk and expected higher returns.

Figure 9: S&P 500 Pharmaceuticals vs Russell 2000

Figure 10: Debt as % of Assets: Large Caps, Mid Caps, and Small Caps



Source: Bloomberg as of April 3, 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.

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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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