Citi Global Wealth
Investments

July 30, 2023

# CIO Strategy Bulletin


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## Underappreciated Good News

The old adage "bad news sells newspapers" remains true across old and new media. Unfortunately, that comes at a cost for investors. By focusing on what may go wrong, investors may be missing what is going right and what an improving set of circumstances means for investing in the future.

This past week, there were important pieces of good news that collectively indicate improving prospects for the US economy, even in the face of the Fed's most recent rate hike. The balance of this data suggests "normalization" rather than more disruption. It is only natural for markets to rally on this news. With it, we continue to see broader opportunities in staying invested.

The "good news":

- Evidence of US economic resilience is mounting. US real GDP growth accelerated to a 2.4% annualized pace in 2Q2023, led by a bounce-back in business capital spending.
- US inflation continues to fall. For example, the rate of growth in US services prices ex-shelter slowed from a peak of 8% to 3%.
- Fed Chairman Powell indicated that if inflation is falling and the labor market is cooling, there will be no need for monetary policy to force the economy into a full-blown recession. While we believe the progress on underlying inflation measures appears underrated by the Fed, Powell indicated the Fed could back off restrictive monetary policy in the coming year without a collapse in labor markets.
- Markets are looking past this period of "restrictive" monetary policy as the Fed is viewed as unsustainably tight. Yet, high-grade bond yields are near 20-year highs. This presents an unusual opportunity for investors to potentially capture and retain "real yields."
- Several US tech titans reported better-than-expected quarterly profits, reflecting the resilience of their "old economy" businesses. Most of the initial 2Q earnings news supports an improving set of equity market opportunities.
- China's policymakers are coming to grips with the loss of momentum in its economy and moving away from half-hearted measures to stabilize the property sector.
- Japan moved very incrementally again to tighten monetary policy in the last large economy to retain a zero short-term interest rate policy. The Bank of Japan will allow a small rise in long-term bond yields below a maximum of 1%. While the news created fear in global bond markets last week, it's not significant enough to derail global markets or stem a generational change in Japan.
- After the joint stock/bond collapse of 2022, sidelined investors have chased markets higher. However, only now is the world equity market "broadening" its strong performance beyond a few mega-cap shares. Not every risk is behind us, but signs are building that the world economy can transition from a period of slow growth and high inflation to a more sustainable expansion.

## Resilience in World Markets

This past week, the Fed raised short-term policy rates to an upper bound of 5.5%, the highest level since 2001. The move comes at a time of falling inflation. Meanwhile, US real GDP growth accelerated to a 2.4% annualized pace in 2Q, led by a bounce-back in business capital spending. Nominal growth slowed as inflation cooled (**Figure 1**). Outside of the US, it seems likely that future declines in inflation will help sustain the post-Covid expansion.

The central bank has now delivered 525 basis points of rate hikes in less than 18 months. It has also reduced its balance sheet lending by $670 billion, even as it funded a new lending program to support banks holding government securities devalued by the Fed's massive rate hikes.

The European Central Bank raised its own key policy rate 25 basis points and is on its way to raising rates 450 basis points in total (see our July 27 Europe Strategy). Japan also surprised markets with an incremental move to allow its 10-year government bonds to trade in a wider band between 0.5% and 1.0% (raising the rough "cap" from 0.5%). And China's policymakers vowed greater support for a private sector recovery and suggested greater fiscal support for its collapsed property sector.

## Powell Hints at Policy Normalization with Lower Rates

At this press conference last Wednesday, Fed Chairman Powell acknowledged that US monetary policy had moved into "restrictive" territory. Powell noted that it will take a long time for the Fed's preferred measure of core inflation to fall to 2%. To us, this means that the Fed should be done tightening long before that level is reached. If inflation was credibly falling toward the Fed's objective, he suggested policymakers would not seek to keep monetary policy restrictive. We believe this will require an indication from the Fed that labor markets are loosening.

In short, Powell's comments suggest the Fed won't require a "traditional" recession to back off from restrictive monetary policy.

## Resilient Earnings

In the past week, several US tech titans reported quarterly profits that suggest much of their "old economy" businesses are holding up well, easily beating conservative estimates fit for a recession (**Figure 2**). While some disappointments were notable – such as the absence of immediate payoffs for massive capital investment spending in AI services – the bulk of the earnings news bodes well for markets..

Better-than-expected earnings and a more rational Fed supports a range of global equity opportunities, some of which we discuss below (see *Quadrant* for full details).

In fixed income land, markets may look past the period of "restrictive" monetary policy. This makes high-grade bond yields, nearing 20-year highs, quite attractive, especially if there is no credit deterioration (**Figure 3**).

## More Growth, Less Inflation

The Fed's progress on underlying inflation measures seems underrated, in our view. US services prices ex-shelter have slowed from a peak of 8% to 3%. Why would these prices have risen so rapidly and slowed so sharply when wages have only drifted higher? A post-Covid economy hasn't yet reached a stable equilibrium.

When the US services sector finally began to reopen more than a year after the initial global Covid shock, demand skyrocketed at a 24% year/year pace and suppliers of services were overwhelmed. Services spending has subsided to an 8.6% spending pace in nominal terms. While this is still too strong, pent-up demand is being satisfied. We believe restrictive monetary policy will speed the rebalancing of supply and demand in the economy already underway (**Figure 4-5**).

## T-Bill Reinvestment Risk: Duration Looks Good

Holding T-bills carries high "reinvestment risk." Rates may be significantly lower in the future when a given T-bill matures, so that one can only reinvest at lower rates. While rates are not likely to fall in the next six months, there is the opportunity cost of missing out on the potential for capital appreciation of longer-dated securities when rates are expected to fall. For example, assume a 5-year Treasury with a yield currently of 4.05% sees the hypothetical yield drop by the potential 1%, the gain on the Treasury may be almost 4.5%, and one would still have the Treasury yield of 3.05% for the remaining life of the security.

With huge cash balances on the sidelines, potential dip-buyers point to a laundry list of risks, from a commercial real estate crisis to extended economic malaise that could catalyze an equity market selloff. However, with unemployment below 4% and inflation abating, we think waiting for the right entry point isn't an effective strategy.

As inflation continues to drop, the Fed may proactively begin to cut rates in 2024 in an attempt to prevent severe job losses. We expect higher positive total returns if the market increasingly prices in the probability the Fed will begin cutting rates (**Figure 6**).

We suggest fixed income investors consider primarily higher credit-quality corporate bonds (or municipal bonds, for tax advantaged investors), that continue to offer much higher yield now vs expected inflation anytime in the recent past. As of July 27, 2023, IG intermediate-duration credit offers a spread pickup to Treasuries of about 104bps, for an all-in yield of about 5.5%. In addition, for suitable investors aware of the risks might consider adding corporate bonds with rating levels as low as BB, which currently offer spreads of 240bps on average and yields at nearly 7.08%.[1]

For investors who agree that large bank risk has abated and who understand the risk of these instruments, IG preferred securities issued by large banks yield about 7.17%. Finally, emerging market USD-denominated bonds may also offer potentially strong risk diversification, as the index is primarily IG-rated, but within its HY segment it offers idiosyncratic risk that isn't likely highly correlated to US economic outcomes. This index currently yields about 7.48%.2

## Regional Equities Opportunities Ahead

While we noted the fixed income reinvestment risk and opportunity cost for investors sidelined in cash, the same clearly applies to broader asset classes. As we noted in last week's CIO Bulletin, the 17% return in global equities in the year-to-date compares to cash returns of 2.5% over the same period. Even now, after the AI-fueled optimism, the Nasdaq 100 trades 6.5% below its late 2021 record high.[3]

US tech shares trade at nearly double the prospective valuation of broader global equities ex-tech. Investors may be concerned about buying into newly bullish markets as traders cover short positions. However, the potential for a wider set of global equity opportunities (including profitable US small and mid-caps) remains favorably positioned for future returns. Some regional markets have even remained lower than pre-Covid levels in the past three years.

## China: Politburo Delivers Positive Policy Changes

China's economy and markets have struggled for so long that many investors have given up. But as we wrote in Asia Strategy Bulletin, Chinese authorities have sufficient policy tools to stabilize faltering economic growth and restore sentiment.

The breadth and consistency of recent policy announcements is notable. We are more convinced that growth is likely to recover moderately in the second half (**Figure 7**). This will likely lead to a rebound in equities and currency, particularly if the US Fed becomes less hawkish and the USD softens further. Of course, the lack of "bazooka" policy stimulus may continue to frustrate some investors as will the rate of implementation.

The Politburo meeting that concluded on July 24 confirmed some of these actions. Most notably, the Politburo revealed a new stance toward the real estate sector. The slogan from the past seven years—"housing is for living, not for speculation"—was removed. In its place, the central government highlighted three elements to optimize policies for the real estate sector:

- After more than 20 years of rapid construction, "differentiated policies for different cities" is necessary. We believe this signals that property sales had fallen too much and authorities would support ceasing purchase restrictions and mortgage policies.
- Actively support urban renovations and public infrastructure.
- Property debt relief programs would be created to contain risks in local government debt.

Property stocks rallied 8% in the days following the Politburo statement, but it remains to be seen if these policies can stabilize sales that were still falling in June (**Figure 8**).

The Politburo statement also mentioned keeping the renminbi exchange rate "mostly stable at the equilibrium level" for the first time since the second quarter of 2021, potentially signaling the government's unease with its rapid depreciation in recent months. This lifted the CNY exchange rate this week.

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1 Source: Bloomberg as of July 27, 2023. 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.

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3 Source: Bloomberg; global equities return based on MSCI World Index, as of July 27, 2023. Nasdaq 100 Index as of July 27, 2023. 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.

## Japan: Further Equity Upside Potential on Structural Changes

Japanese equities have been on fire this year, with the TOPIX (Tokyo Stock Price Index) up 21% in yen terms, outpacing even the AI-driven S&P 500. Over the past five years, the TOPIX returned 8.3% annually in yen terms and 2.8% in USD, while the S&P 500 returned 12.3%.[4]

The currency impact may have kept many investors away, but we believe that relationship could be changing too. In 1998-99 and again in 2003-05, rebounding inflation lifted both Japanese interest rates and earnings, the yen strengthened along with equities. With current reflation, the BOJ's policy adjustments and the associated yen strength may be consistent with stronger equity performance.

Even as the TOPIX reaches a 33-year high, it's still a modest 14.3x 12-month forward earnings estimates, slightly under the 10-year average valuation of 14.5x, while these earnings estimates continue to be revised upwards.

The Japanese market is benefiting from a rare set of changes that may fundamentally alter the trajectory of corporate behaviors, deriving greater value for shareholders (see Asia Bulletin for more thorough discussion.) These include a focus to improve returns on equity and boost buybacks, especially with the Tokyo Stock Exchange driving reforms to push those companies trading below book value to improve valuations. Still, half of the TOPIX member companies trade below book value even after a recent rally, which would require more fundamental improvements.

And these improvements may have begun, as Japan's deflationary environment seems to have transitioned to "good" inflation. Wages are rising along with corporate profit margins (**Figure 9**), as the labor market becomes more dynamic because of accelerated retirements amid aging demographics. These are lifting both inflation and growth well above historical norms. As a result, the BOJ has begun to gradually unwind its excessively loose monetary policy by first allowing more flexibility in its yield curve control policy.

Further, Japan is now seen as a gateway to Asian markets. Asia represents 30% of world GDP, one-half of global growth, and remains home to swift consumer growth and technological advances, as well as critical global supply chains. Previously, investing in China would have satisfied most of these factors, but Japan is now being reconsidered as a safer bet.

## Conclusion

Investors' herd behavior – storming out of markets in 2022 and racing back in recently – underscores a view we've long espoused: market timing is folly. Investing with an asset allocation suitable to one's risk tolerance and sticking with it helps sustain and grow wealth.

Within that asset allocation, there is opportunity to shift to stronger yields or undervalued growth. For example, our own view – which may or may not be correct – is that non-US equity opportunities are underrated by global investors. In fixed income, US yields still look among the most attractive.

The tangled set of data and policy actions of the past week alone shows the complexity of the world economy. Investors have had much to fear from overzealous policymakers in the past few years – overstimulating and overtightening – as they sought to micromanage the economy through unprecedented shocks.

Real economic growth, however, is normal and far more common than contraction. The balance of data we've seen in the past few weeks suggests "normalization" rather than more disruption. We expect markets to rally on this news. With it, we continue to see broader opportunities in staying invested.

4 Source: Bloomberg as of July 26, 2023. 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 1**: US nominal vs real GDP growth (shrinking gap means falling inflation)

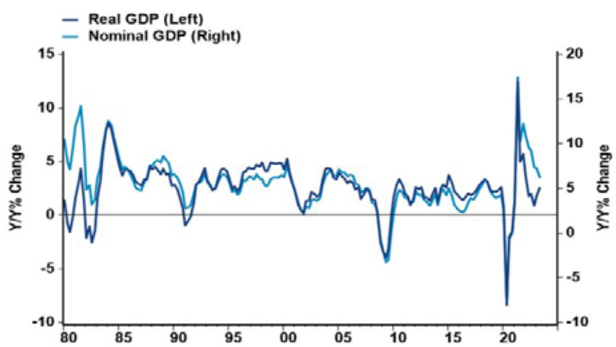
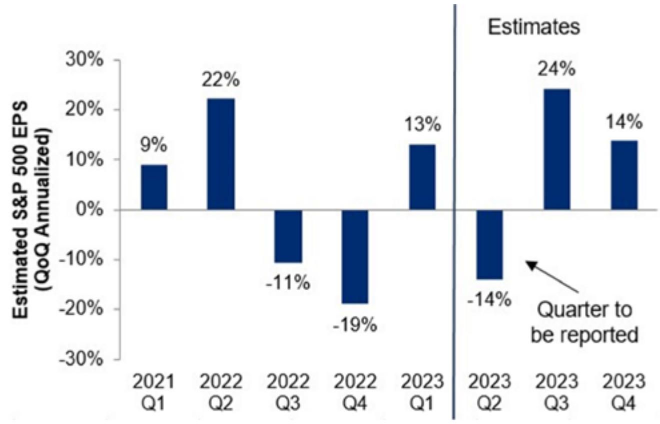



**Figure 2**: EPS beating analysts' estimates for contraction in 2Q




Source: Haver Analytics as of July 28, 2023; **Figure 2**: Refinitive and S&P as of June 30, 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. 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. Real results may vary.

**Figure 3**: Fed funds target, 5-year US Treasury yield and 3-5 year average US investment grade corp. yield (%)


Source: Haver Analytics as of July 24, 2023. Grey areas note recession. 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. Real results may vary.

**Figure 4**: US nominal spending on goods vs services Y/Y%

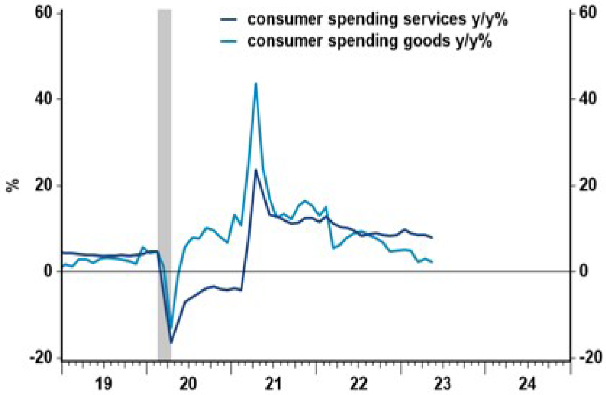
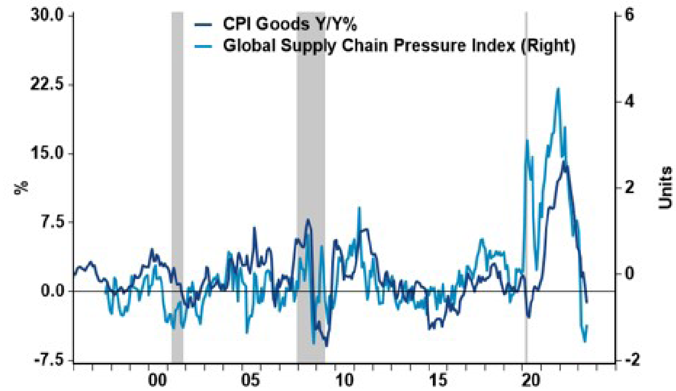



**Figure 5**: NY Fed Supply Chain Pressure Index vs CPI Goods Y/Y%




Source: Haver Analytics as of July 24, 2023. Grey areas note recession. 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. Real results may vary.

**Figure 6**: Fed funds futures curve

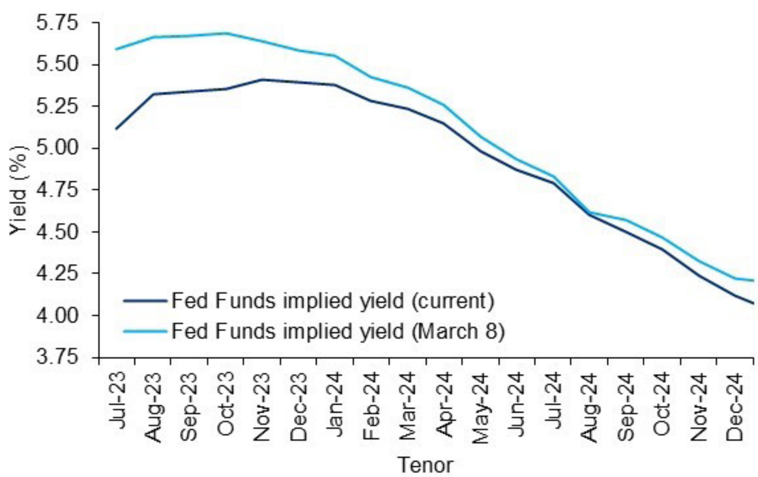



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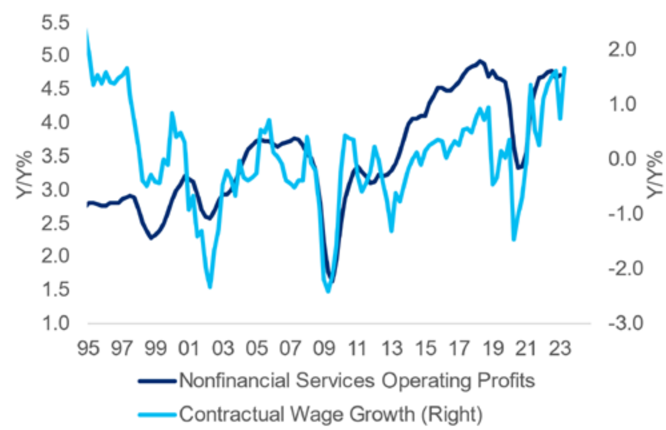
**Figure 7**: Restoring growth in the second half, even if just moderately, could help lift China's equities and currency


Source: Bloomberg, as of May 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 8**: The new stance on property policy may stabilize the beleaguered sector if well implemented


**Figure 9**: Japan: Higher wages are consistent with higher corporate profit margins

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**Bond rating equivalence**
Alpha and/or numeric symbols used to give indications of relative credit quality. In the municipal market, these designations are published by the rating services. Internal ratings are also used by other market participants to indicate credit quality.

| Bond credit quality ratings | Rating agencies | | |
|---|---|---|---|
| **Credit risk** | **Moody's[1]** | **Standard and Poor's[2]** | **Fitch Ratings[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.
2 The ratings from AA to CC by Standard and Poor's and Fitch Ratings may be modified by the addition of a plus or a minus to show relative standing within the category.

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