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CIO Strategy Bulletin

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The Great Divergence: Opportunity Amid Uncertainty

SUMMARY

- The early 2023 market rally comes as the world economy is flashing green and red. The outsized January job gains have given some renewed hope that a soft landing is still possible for the US. Yet, the most cyclical areas of the US economy – housing, international trade and manufacturing – are all showing sharp contractions. As we noted last week, the pace of decline in new orders reported by US manufacturing purchasing managers is so severe it would match the Covid collapse or 2008-2009 Great Recession pace if continued for just four months more.
- Investors should not think the labor market is invulnerable; the fastest and biggest interest rate hikes in Fed history, in addition to quantitative tightening, will come with a cost. And Fed Chair Powell said that if we continue to get strong job market reports or higher inflation reports, the central bank may have to raise rates even more.
- We are not convinced that the equity market is adequately pricing in the economic environment – especially a rise in unemployment – that the Fed would likely require before it begins easing monetary policy.
- While we remain fully invested in global, diversified portfolios, we don't own everything equally. A still-challenging economic and profits backdrop speaks to maintaining a high-quality bias with non-cyclical sector tilts. Among the areas we like amid an uncertain market are biotech and life sciences, energy (both old and new), defensive industrials, preferred stocks, and local Chinese equities. And avoid the temptation to time markets.

The Great Divergence

The “joy of missing out” on last year’s market rout has given way to the “fear of missing out” in early 2023. The shares that collapsed most in 2022 have rebounded the most in 2023 so far (**Figure 1**). There are many reasons for this, including massive short-covering, but there is one thing notably missing – a pending economic recovery. This is because the early 2023 rally comes as signals from much of the world economy are contradictory.

Last week we wrote about the gravity-defying 517,000 job gains that the US saw in January (see the Feb. 5 [CIO Bulletin](#)). January and July are notably inaccurate months for estimating employment, with subsequent revisions ranging between -306,000 to +322,000 historically.

The “resilient” job market has given greater hope to the idea that a “soft landing” will be possible. In spite of the known inaccuracies of January data, many believe the economy has changed direction. Reading the New York Times headlines Friday says it all: “[What Recession? Some Economists See Chances of a Growth Rebound.](#)”

At the Economic Club of Washington this past Tuesday, Fed Chairman Powell said that “the reality is if we continue to get strong labor market reports or higher inflation reports, it might be the case that we have to raise rates more” than is now expected. He went on to say that the Fed expects a significant decline in inflation this year though the present data suggests that we are experiencing only “the very early stages of disinflation.”

We believe investors should be careful not to see the US labor market as “invulnerable,” able to withstand the largest and fastest interest rate increases in US history and quantitative tightening without cost. The US bond market still prices Fed rate cuts late this year. This will not happen without economic weakness of some significant magnitude. And if this does not happen, the relief markets have felt from declining long-term interest rates will be erased.

Hardly Hot

As we have said before, there are many signs the economy is cooling apart from the January jobs data. We see this in multiple private and public sources, such as the number of rail cars being filled and the declining imports coming to the US.

- Total real consumer spending fell in both November and December, leaving the end-2022 pace of spending 1.0% below the fourth-quarter average.
- The US manufacturing purchasing managers orders index fell to 42.5 in January (below 50 marks contraction). This is the lowest reading since 2Q 2020 when Covid shuttered the US economy.
- US housing starts dropped 22% over the past year as new home inventories surged 19%.

While areas of strength persist in services, these negative data points suggest that high inventory in wholesale and retail goods are stalling manufacturing demand for domestic and foreign producers. This all makes sense. Industry level micro-data probably help illustrate this best.

Is This a Peak or Is it a Trough? Residential Construction as a Barometer

On the back of sharp increases in US interest rates and other shifts in the economy, the real output of US construction industries (both residential and non-residential) slumped 18% in 2022.

New single-family home sales fell 27% over the past year.

On the supply side, new homes still under construction have only risen despite the large drop in sales contracts. This best explains the high level of labor demand in the construction industry at a cycle peak (**Figure 2**).

Construction employment has shown nothing but gains. Moreover, reported job openings in the construction industry are near all-time highs, consistent with a much stronger level and outlook for housing (**Figure 3**).

Meanwhile, reflecting the slump in home sales of every variety, the industry is simultaneously announcing the largest job reductions (layoffs) aside from the Covid shutdown or the housing collapse of 2007-2009 (**Figure 4**).

On the demand side, mortgage purchase applications have fallen 45% over the past two years. This has left new home inventories at their highest level since 2008. Yet, just as long-term mortgage rates have backed off slightly, homebuilders are noting a slight rise in prospective buyer traffic already (**Figure 5**).

So, would one buy homebuilder stocks?

Having a business cycle trough in place should make us bullish on recovery trades and market performance generally (see our [Outlook 2023](#) for discussion). Quite typically, share prices begin to rise when activity measures hit their low point (**Figure 5**). This makes sense, as financial assets always lead recoveries. Yet, in the case of US homebuilder shares, the positive inflection point for buyer traffic has vaulted their shares back up toward 2021 highs. This implies a high level of recovery for residential housing 12-18 months from now.

We think this is a big deal. Home builder shares are priced for a rapid recovery after an incomplete drop.

The most cyclical areas of the US economy – housing, international trade and manufacturing – are all showing sharp contraction. These are the sectors most tied to business cycles (goods industries that manage physical inventories). As we noted last week, the pace of decline in new orders reported by US manufacturing purchasing managers is so severe it would match the Covid collapse or 2008-2009 Great Recession pace if continued for just four months more.

Unemployment in a Small “R” recession

The definition of recession is the period just after a peak in the economy. When a “Recession” begins, employment is at its highest level. The point of “Recovery” is when employment is at its low point for a cycle.

Within a tumultuous three years, US job losses and gains have been the most rapid in history. However, the meager net US job gain since the pre-Covid peak – +2.7 million jobs or just 1.8% over three years – suggests there are not as many jobs for the US economy to lose during its next recession. In other words, the absence of an employment boom shows the economy is not meaningfully vulnerable to a large employment bust. With this said, we don’t believe US employment has already slumped and is poised for a stronger recovery.

What Markets Are Telling Us

We believe markets have taken great comfort in the peaking of inflation, the slowdown from the 9% inflation pace reached at midyear 2022. Long-term US Treasury yields have fallen below short-term rates, our most reliable long-term leading indicator of a business cycle contraction. The Treasury market prices cuts in Fed policy rates late this year.

But has the equity market priced in the economic environment most likely before us – a meaningful rise in unemployment – that the Fed would likely require before it begins monetary policy easing? We have yet to be convinced.

What to Do Amid Uncertainty: Avoid Portfolio Paralysis

We’ve never been fans of market timing. Selling low and buying high is a recipe for wealth destruction. As we’ve [written here before](#) there are many reasons not to be all in or all out. Our investment philosophy holds that “market timing doesn’t work.” Rather, we believe a fully invested portfolio should shift to where we see greater or lesser value (**Figure 6**).

While we remain fully invested in global, diversified portfolios, we don’t own everything. Indeed, a still-challenging economic and profits backdrop speaks to maintaining a high-quality bias with non-cyclical sector tilts. While areas like dividend growers or pharmaceuticals may underperform during “junk rallies” like we’ve experienced in the last month, these areas still provide us with a much more compelling long-term risk/reward.

In the coming few months, the extreme contradictions in the data will most likely resolve. We don’t see an endless period of weakness or contraction in the US and other economies. China, for one, should strengthen soonest. But we also don’t believe the US economy will go unscathed from the lagged effects of “rapid” Fed tightening, as Powell put it at his last press conference.

We would watch high frequency employment indicators such as jobless claims as a key measure to assess the pass-through of layoff announcements to net labor market weakness. When firms cut production to a pace that will reduce inventories in the future, the US economy will be at its slowest point, and very likely before 2022 is over.

Lots to Like: Areas to Add in Uncertain Times

- **Biotech and life sciences:** After a challenging 2022 for growth investors, we see the coming pause in Fed hikes as already providing some relief for long-duration assets. With economic slowing likely to persist, we see potential opportunity in non-cyclical growth shares like biotech and life sciences. As we wrote in our [Wealth Outlook 2023](#), innovation in the health care space is only likely to accelerate as global populations age. Meanwhile, valuations have improved among innovators focused on cutting-edge biologics research, life sciences tools, and gene editing (Figure 7).
- **Old energy:** Turning to another Citi Global Wealth “Unstoppable Trend,” we see investments in Energy Security as likely to persist in 2023 regardless of the economic environment. In the near term Europe’s energy security will likely involve increased imports of oil and especially natural gas from Western allies. After a devastating decade for oil and gas profitability, the sector has largely refocused its business model toward more disciplined investment and diligent return of capital to shareholders. As China reopens, OPEC is already trimming production targets in anticipation of a slowdown across much of the rest of the world. We therefore expect that oil prices will decline less this year than we typically see during US recessions, sustaining near double-digit free cash flow yields for US energy giants (Figure 8).
- **New energy (more green):** Government subsidies and improving relative economics should be supportive for “greening” technologies alongside their dirtier peers. Public investments in clean energy, electric vehicles, and energy efficiency are already ramping up across Europe, the US and China, including the \$369 billion allocated to climate change prevention in the US Inflation Reduction Act. Subsidies are likely to incentivize automakers to shift their mix of EV offerings, while wind turbine manufacturers should see full order books out several years. A shortage of mining capacity for key metals like lithium and copper should benefit miners and battery producers as EV production picks up globally. The shock from Europe’s high gas prices last winter should support demand for more energy efficient heat pumps in the years to come as an alternative to gas-fired boilers.
- **Defensive industrials:** Areas like defense and infrastructure should experience less volatility than their other capital goods peers as government investments provide relative stability for revenues. While new infrastructure spending is unlikely in a divided government, funds from the \$1.2 trillion Bipartisan Infrastructure Law passed in the last Congress will begin to get spent in 2023, benefitting large construction and engineering contractors. Meanwhile, a need to refill stockpiles of equipment and ammunition that have been provided to Ukraine should also keep defense contractors producing at capacity in the coming years (Figure 9).
- **Preferred stocks:** Preferred equities, which sit between debt and common stock in the corporate capital structure, provide a compelling mix of high yield and low beta in the current environment. Typically issued by large, highly capitalized global banks with investment grade issuer ratings, we prefer to take subordinate risk in these issuers rather than owning more senior bonds issued by lower-quality junk firms. We see preferreds – which have a beta of 0.6 to the S&P 500 and current yields north of 6% -- as likely to offer lower downside capture in portfolios while still providing reliable income, even if broad equity markets do correct lower again.
- **Local Chinese equities and China-exposed global shares:** While the rest of the world is likely to experience an economic slowdown in 2023, we believe China will be sharply accelerating. As we wrote in the [Jan. 15 CIO Bulletin](#), China’s abrupt change in Covid policy and shift toward fiscal and monetary easing are likely to be supportive for risk assets linked to the Chinese economy. With valuations still relatively depressed and earnings likely to grow another 15% this year, we see more room for upside in Chinese shares despite the sizable rally already since October (Figure 10).

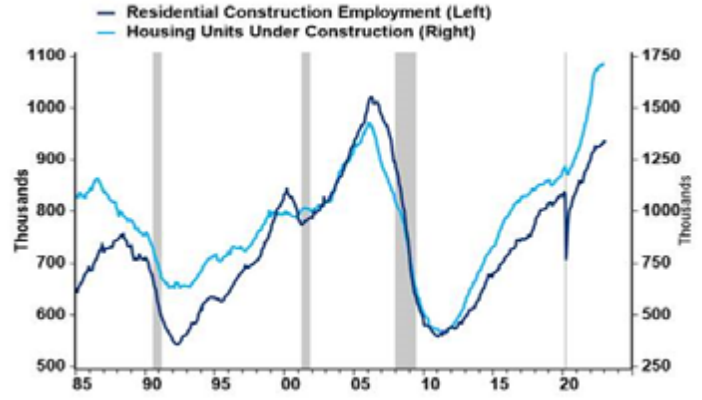
Cyclicals to Avoid Amid Economic Uncertainty

- **Transportation and trade:** Elevated retail inventories coupled with a weak environment for goods demand spells trouble for US imports. Fewer new orders have already materialized in falling freight demand, while a slow de-clogging of supply chains has reduced pricing power for transportation shares. While they were big winners in the post-pandemic goods bonanza, we expect a more challenging backdrop for shipping and transportation equities in the coming months.
- **Machinery:** A worsening near-term outlook for US manufacturing activity seems apparent. Meanwhile, machinery shares are still trading near all-time highs. Certain segments like infrastructure and oil & gas drilling may hold up this year, but more discretionary projects are likely to get scrapped or delayed as the economy slows, in our view. This will affect manufacturers and operators of heavy machinery in the near term (Figure 11).

Figure 1: Most consistent US dividend growers vs profitless tech firms



Figure 2: Housing still under construction requires labor



Source: Bloomberg and Haver Analytics as of Feb. 9, 2023. Grey areas note recessions. 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 3: Real US residential and non-residential investment vs job openings in construction

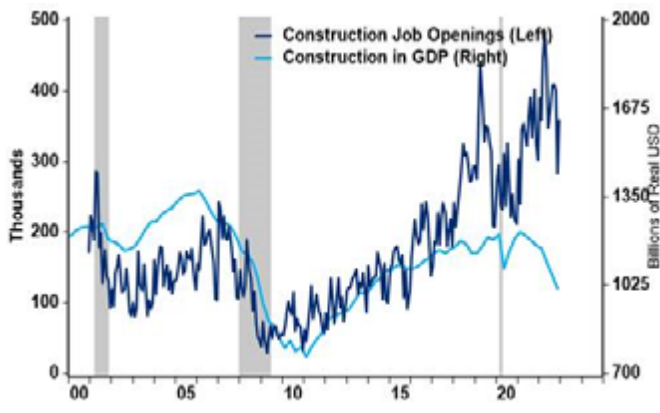
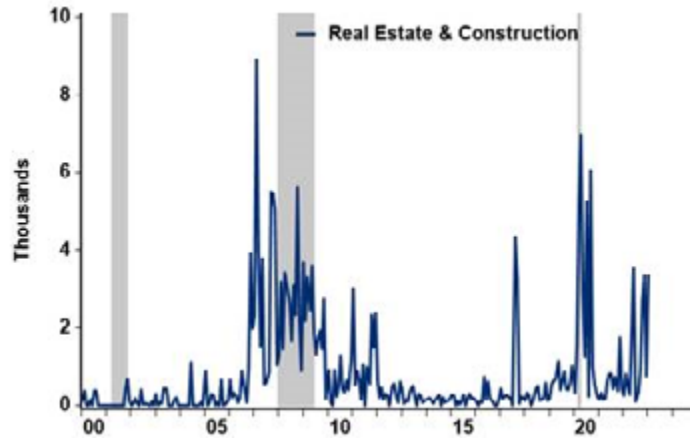


Figure 4: US layoff announcements in construction and real estate



Source: Haver Analytics as of Feb. 9, 2023. Grey areas note recession.

Figure 5: Homebuilding can rebound, but construction still has to fall. Equities imply “fast, strong” rebound

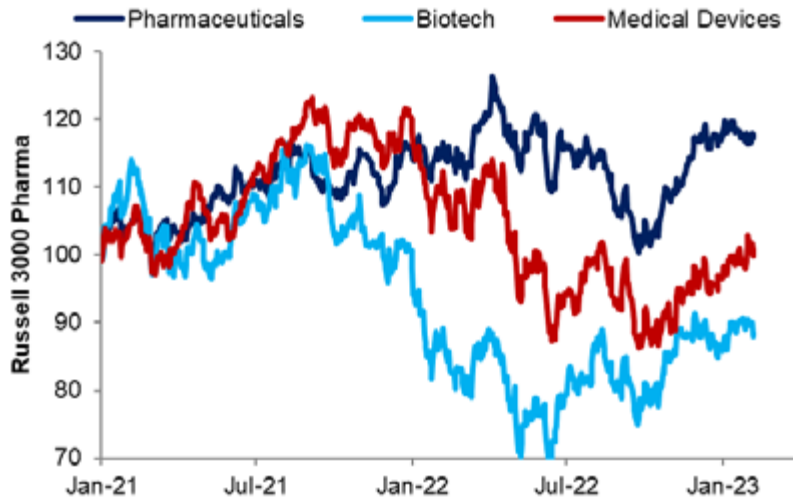


Figure 6: US 2-Year Treasury yield vs global bond aggregate yield (includes all currencies, ratings, durations)



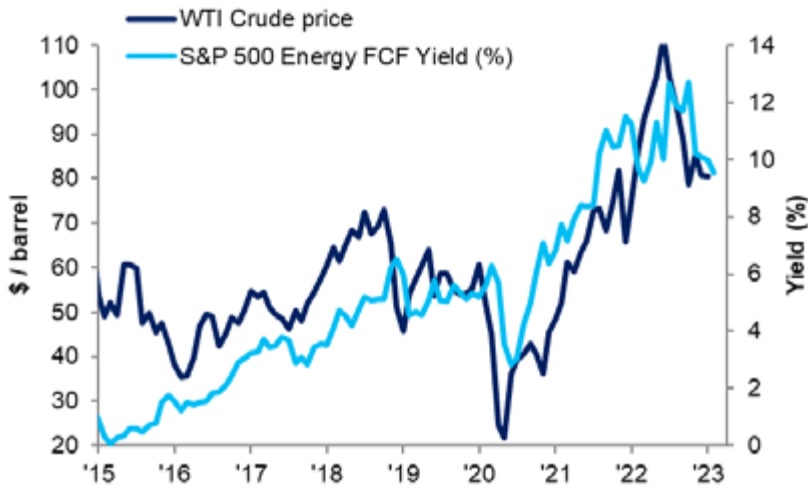
Source: Haver Analytics as of Feb. 9, 2023. Grey areas note recession. Right had side shows prospective buyers; left-hand side shows S&P500 Homebuilding index. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Past performance is not indicative of future returns. Real results may vary.

Figure 7: Pharma, biotech and medical devices since 2021



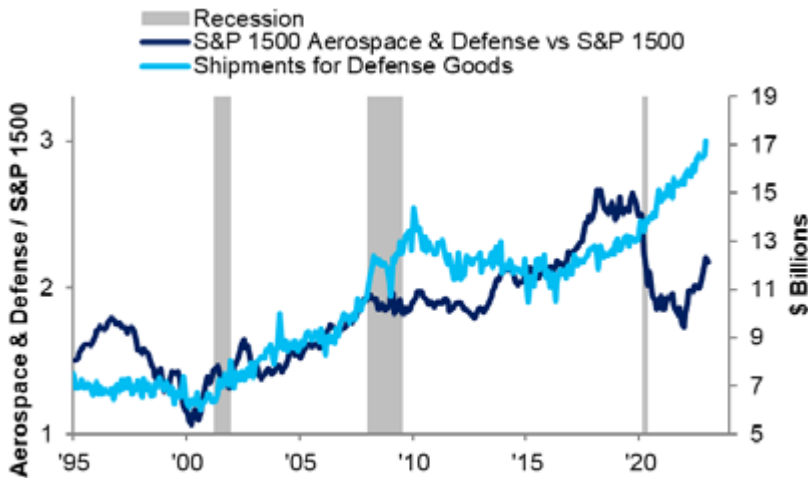
Source: Bloomberg as of Feb. 9, 2023. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Past performance is not indicative of future returns. Real results may vary.

Figure 8: S&P 500 energy free cash flow yields vs WTI crude



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Figure 9: Aerospace & defense vs US defense shipments



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Figure 10: MSCI China EPS and forward P/E valuation



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Figure 11: S&P 500 Machinery vs S&P 500 index



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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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Mortgage-backed securities ("MBS"), which include collateralized mortgage obligations ("CMOs"), also referred to as real estate mortgage investment conduits ("REMICs"), may not be suitable for all investors. There is the possibility of early return of principal due to mortgage prepayments, which can reduce expected yield and result in reinvestment risk. Conversely, return of principal may be slower than initial prepayment speed assumptions, extending the average life of the security up to its listed maturity date (also referred to as extension risk).

Additionally, the underlying collateral supporting non-Agency MBS may default on principal and interest payments. In certain cases, this could cause the income stream of the security to decline and result in loss of principal. Further, an insufficient level of credit support may result in a downgrade of a mortgage bond's credit rating and lead to a higher probability of principal loss and increased price volatility. Investments in subordinated MBS involve greater credit risk of default than the senior classes of the same issue. Default risk may be pronounced in cases where the MBS security is secured by, or evidencing an interest in, a relatively small or less diverse pool of underlying mortgage loans.

MBS are also sensitive to interest rate changes which can negatively impact the market value of the security. During times of heightened volatility, MBS can experience greater levels of illiquidity and larger price movements. Price volatility may also occur from other factors including, but not limited to, prepayments, future prepayment expectations, credit concerns, underlying collateral performance and technical changes in the market.

Alternative investments referenced in this report are speculative and entail significant risks that can include losses due to leveraging or other speculative investment practices, lack of liquidity, volatility of returns, restrictions on transferring interests in the fund, potential lack of diversification, absence of information regarding valuations and pricing, complex tax structures and delays in tax reporting, less regulation and higher fees than mutual funds and advisor risk.

Asset allocation does not assure a profit or protect against a loss in declining financial markets.

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