Citi Global Wealth
Investments

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CIO Strategy Bulletin

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The Investor's Conundrum

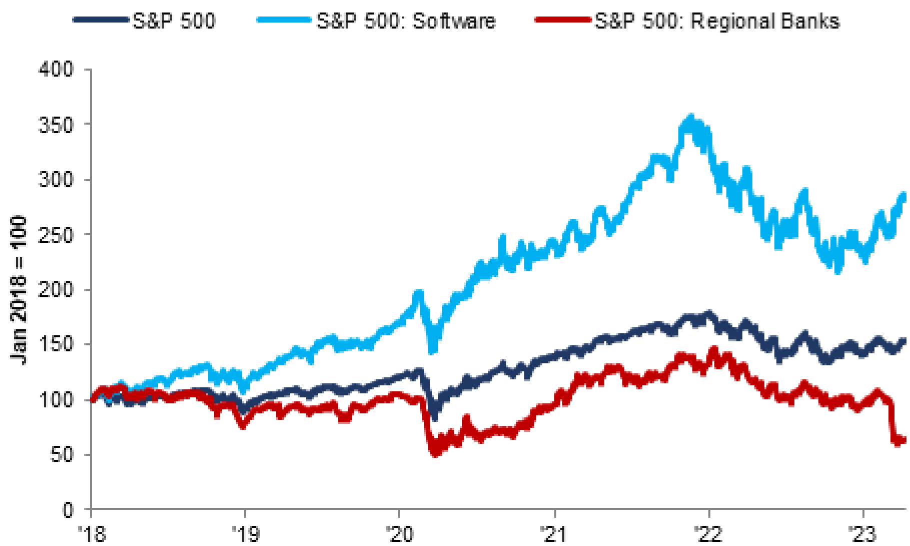
SUMMARY

- It is not easy being an investor these days. For many investors, a volatile mix of news and contradictory economic data has led to investment paralysis. There are large investment balances sitting on the sidelines, even as bearish bets on equities have hit an all-time high. We believe the doomsaying can be easily exaggerated. Facts and data are often ignored when large, disparate trends converge.
- Private employment in March showed the smallest monthly gain since recovery from the Covid shock. We think we will see the end of post-pandemic employment growth in late 2023 and early 2024. Ultimately, we expect two million job losses from late 2023 to 2024 – hardly a catastrophic result given the Fed's huge tightening campaign, but still a material departure from today's economic outlook.
- The Federal Reserve appears more inclined to raise rates than to lower them, with markets expecting a final 25-basis-point rate hike as roughly a 65% chance early next month. This is despite the risk that additional Fed action could exacerbate fears of financial instability once again.
- The bond markets seem to understand that the Fed is likely to err. Recent broad rate decreases across markets presage a deceleration in the economy as well as lower inflation. The equity markets have looked at lower rates beneficially. They are significantly ignoring the effects of a recession on earnings, in our view.
- Over the past 12 months, we have focused our asset allocation strategy to seek to earn as much yield as possible from quality bonds and dividend-paying equities. The Fed-led surge in interest rates and post-2022 pricing in equity markets has offered potential opportunities to improve portfolio quality and generate better returns.
- History shows equity markets rise and fall about six months ahead of corporate profits and we expect equity gains commencing in 2024. With this in mind, the outperformance of defensive investments won't provide a sharp rebound in the coming year. We continue to believe that markets will punish vulnerable borrowers and cyclical investments as the impact of the Fed's tightening cycle fully comes to fruition. Once fully priced, these same "undesirable" sectors may likely be the overweights in portfolios tomorrow.

Balancing Risks and Opportunities Appears Harder

It is not easy being an investor these days. Markets have transitioned from a period of free money to expensive money in just two years. Investors experienced major losses across equities and fixed income in 2022. Inflation and deglobalization emerged as new crosscurrents amid greater stresses between East and West. Then, bank runs raised questions about the safety of deposits. Finally, this past week, the Fed acknowledged that a recession later in the year is more likely than not. In spite of all this news, the S&P 500 Index has remained rangebound overall since September 2022, even as the factors driving particular sectors have diverged sharply (**Figure 1**).

Figure 1: S&P 500 vs Regional Banks and Software



Source: Bloomberg and Haver Analytics as of April 11, 2023. 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. 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 not indicative of future returns. For illustrative purposes only.

During this period, we have focused our asset allocation strategy to seek to earn as much yield as possible from quality bonds and dividend-paying equities. The Fed-led surge in interest rates and post-2022 pricing in equity markets has offered opportunities to improve portfolio quality (**Figures 2-3**).

Yet, for many investors, this volatile mix of news and contradictory economic data has led to investment paralysis. There are large investment balances sitting on the sidelines, even as bearish bets on equities have hit an all-time high (**Figure 4**).

Why do we find so many investors choosing to “wait for a better entry point”? Some investors are fearful of another 2008-like financial crisis. TV-watchers are convinced there will be a shutdown of the US financial system when the debt ceiling is pierced. Others are convinced the US dollar is headed for the junk heap as the US runs ever-larger deficits. And some believe fighting inflation will prove to be a forever battle.

We believe the doomsaying can be easily exaggerated. Facts and data are often ignored when large, disparate trends converge.

Figure 2: US corporate investment grade bond yield as % of sub-investment grade

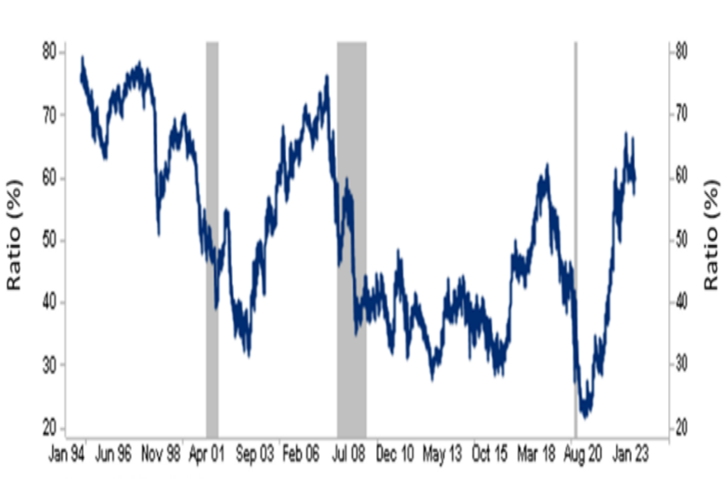
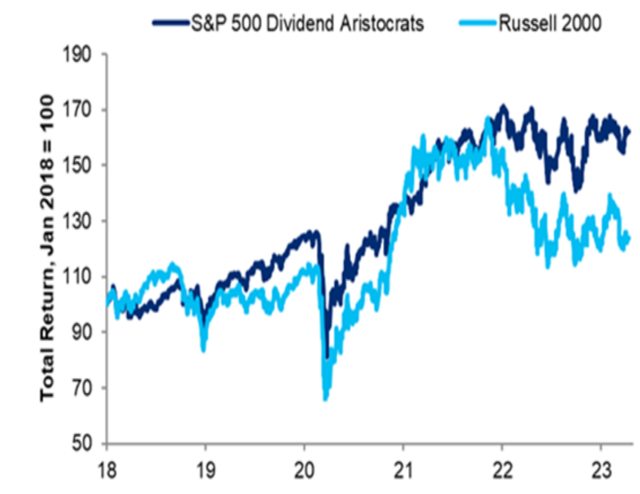


Figure 3: Total return index: S&P 500 Dividend Aristocrats vs Russell 2000



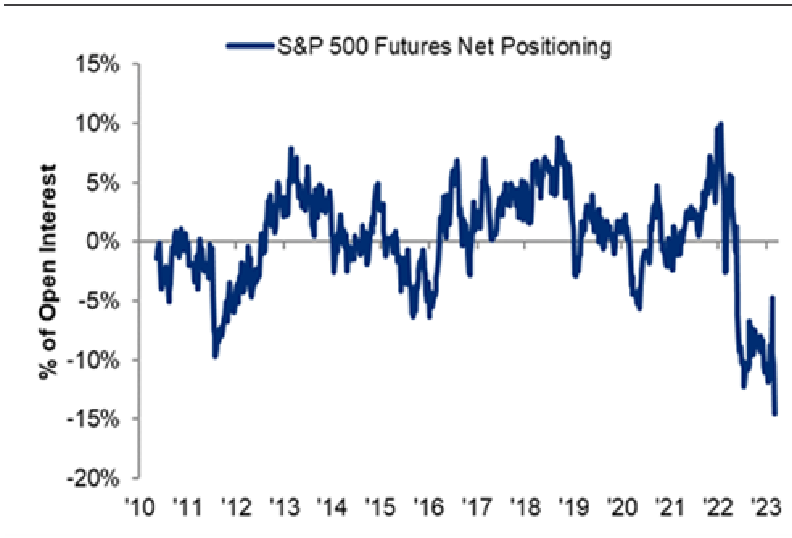
Source: Bloomberg and Haver Analytics as of April 11, 2023. Gray areas are US recessions. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. All forecasts are expressions of opinion and are subject to change without notice and are not intended to be a guarantee of future events. Past performance is not indicative of future returns. For illustrative purposes only.

Identifying Market Stress

There are elements of financial stress in pockets of the economy. Markets judge that it's more probable than not the Fed will deliver a final rate hike in early May despite the impact this may have on bank deposit flows. The US dollar is likely to decline in value over time after the Fed's extreme tightening campaign in 2022. Corporate profits are poised to decline even as analysts expect them to rise above 2022's all-time highs within the year. Manufacturing and construction sectors are now seeing output and employment declines in the face of falling margins. While travel and leisure spending remains strong, the industry accounts for just 10% of US employment and cannot overcome broader employment losses.

But these are of stress are collectively insufficient to suggest that investors time markets, in our view.

Figure 4: S&P 500 Futures Net Short Positions as % of Open Interest



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True Near-Term Risks

We expect that current earnings season will see wide disparities in “hits and misses,” particularly for future EPS guidance. Financial shares appear to be benefiting from better-than-expected earnings. Early big-bank results benefited from transaction-oriented revenues. Yet, markets feared more widespread problems after the Silicon Valley Bank episode. Discretionary services such as travel and leisure are booming and will likely see upside earnings surprises despite rising costs.

Yet, problems are building for goods producing sectors, discretionary consumer merchandise and services. And smaller banks face growing risks. Future credit weakness has been priced for regional banks (see **Figure 1** above), but commercial real estate defaults will take time to materialize. These idiosyncratic risks make the broader projected gains in profits highly unlikely over the coming two quarters (**Figure 5**).

The Recession Begins…?

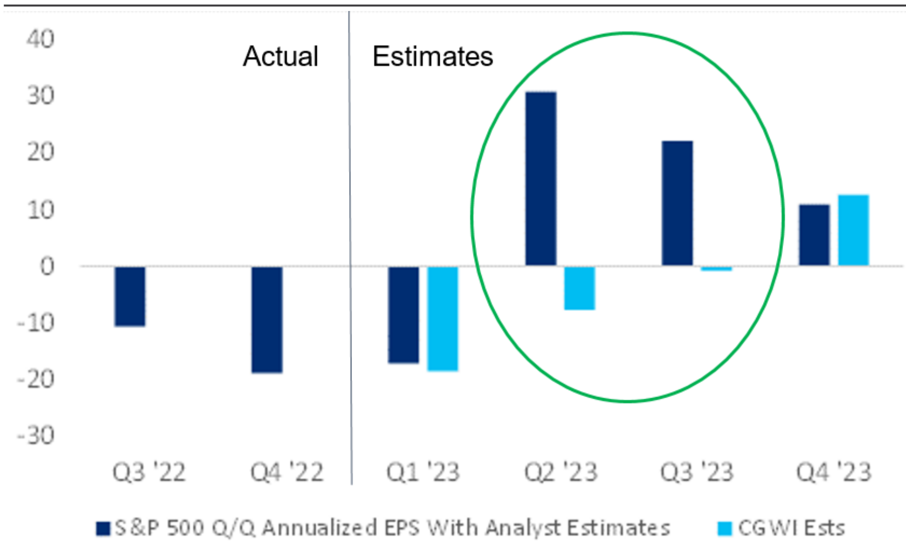
In March, private employment in the US showed the smallest monthly gain – a below-200,000 print – since recovery from the Covid shock. We think this is the beginning of a meaningful slowing and, ultimately, the end of a period of employment growth in late 2023 and early 2024. We expect two million job losses from late 2023 to 2024 – hardly a catastrophic result given the Fed’s huge tightening campaign, but still a material departure from today’s economic outlook.

The US central bank views today’s 3.5% unemployment rate as “unnaturally” low. And they view inflation as more persistent than it actually is (see the April 14 Data Watch). In our view, economic growth is still being exaggerated by the post-Covid recovery in the services sector and distorted measures of seasonal economic strength. For example, a strong gain for hiring and US consumer spending in January will make the quarter just past appear quite strong even as subsequent months showed consecutive declines.

All this means that the Fed is still more inclined to raise rates than to lower them, with markets expecting a final 25-basis-point rate hike as roughly a 65% chance early next month. This is despite the risk that additional Fed action could exacerbate fears of financial instability once again.

The bond markets seem to understand that the Fed is likely to err. Rates on the Treasury two-year note yield dropped by nearly 100 basis points over the past five weeks. The 10-year has similarly fallen from a cycle high of 4.25% to 3.50%. Such broad rate movements presage a deceleration in the economy as well as lower inflation. The equity markets have looked at lower rates beneficially. They are significantly ignoring the effects of a recession on earnings, in our view.

Figure 5: S&P 500 EPS: Analyst EPS Estimates vs Citi Global Wealth Investments Estimates



Source: S&P, IBES, and Citi Global Wealth Office of the Chief Investment Strategist as of April 11, 2023. Note: circled area shows large contrast between CGWI estimates and consensus forecasts. 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. All forecasts and estimates 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 not indicative of future returns. For illustrative purposes only.

The Banking Crisis Will Slow the Economy Even if the Fed Pauses Rate Hikes

Signs of weakening bank lending are beginning to appear more rapidly following the loss of more than $300 billion in US bank deposits in March. In just the last two weeks, overall US bank loans fell by $105 billion. This was led by a $74 billion drop in lending by small US banks, including a $34 billion reduction in commercial real estate loans, the second largest drop in history (**Figure 6**). A material slowdown in commercial and industrial loans is well underway and will be extended by the recent loss of deposits in the banking system. (Note: Real C&I loans are a component of the Index of Lagging Economic Indicators.)

The initial impact on bank credit appears small, but the latest report included a notable pickup in the share of small enterprises reporting restraints on the availability of credit. These smaller firms account for the majority of net US hiring and have no access to public bond markets (**Figure 7**). A reduction in available credit – even at current interest rates – can have substantially more impact on affected firms than rate hikes. Small business optimism remained in recessionary territory in March.

Figure 6: US banks commercial real estate loans weekly % change

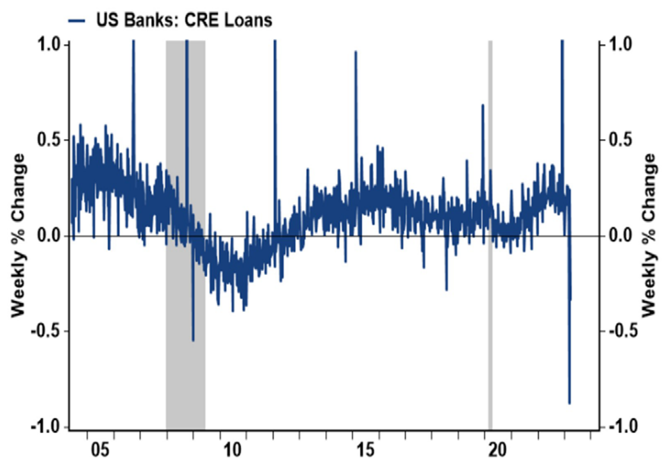


Figure 7: Share of small businesses reporting credit harder to get

Source: Haver Analytics as of April 11, 2023. Gray areas are US recessions.

Why the Recession Will Be Mild

Optimistically, we continue to believe the economy did not build up a dangerous overcapacity in the period following the Great Financial Crisis or the brief post-Covid recovery. US employment gains have been a mere 2.1% since the pandemic hit when a normal cyclical recovery might have generated gains nearly twice as large. While home sales have collapsed, unlike the late 2000s, tremendous unmet demand for housing remains. The Fed simply needs an offramp from the tightening cycle to avoid turning a coming stall in the economy into an unnecessarily severe contraction.

Another Reason for Optimism: The Inflation Fight Is Being Won

Last week's CPI report for March showed a continued slowing in headline price measures and hopeful signs that the last significant driver of inflation – housing services – will decelerate as has happened in prior cycles. The drop in inflation is gradually reducing a drag on consumer income and is already helping to stabilize consumer sentiment. The Fed's tightening of monetary policy – now shrinking broad US money for the first time since 1947-1948 – is a leading indicator of future **disinflation.** If maintained without a change of course from the Fed, the drop in money supply would prove deflationary in time.

Strategic Return Estimates Signal Coming Opportunities

Getting From Here to There

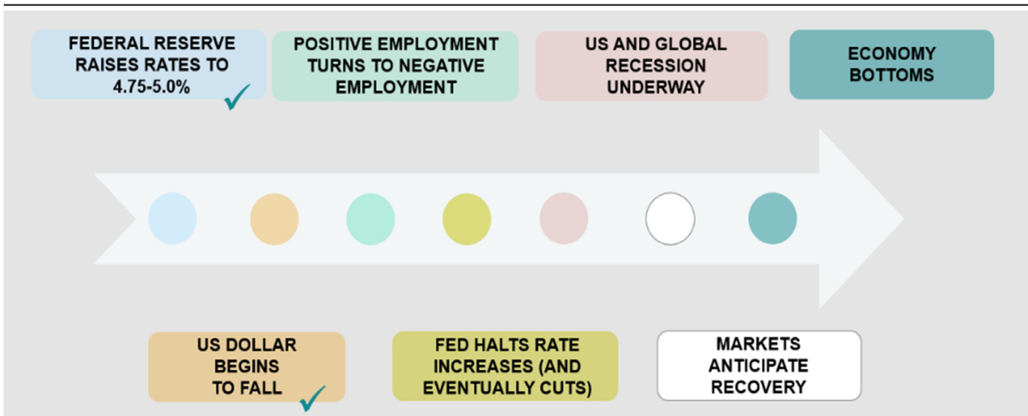
In our view, employment gains will fade and producers will exercise excessive output caution in the period just ahead. This will result in inventory declines that will set the stage for a cyclical recovery (**Figure 8**). For markets, greater pessimism about growth prospects is likely still ahead. Yet the preconditions for an economic recovery in 2024 should become evident later this year, leading to renewed opportunities for investors.

As [we discussed last week](), it's unusual for investors to be able to plan for economic weakness – placing record cash hordes on the sidelines – while being forced to wait for the actual economic slowdown to occur. Yet the double-digit declines in global equities and bonds last year were a major signal. And the fact that two-thirds of the bear market is over has already improved long-term returns (**Figure 9**).

Investors will need patience for the economy to follow markets and for industry analysts to generate rational EPS estimates. History shows equity markets rise and fall about six months ahead of corporate profits and we see equity gains commencing in 2024. Until then, firms with less severe profit vulnerability – including defensive sectors like pharmaceuticals – should get stronger asset allocations. Investments to avoid are leveraged and cyclical firms most dependent on increasingly dear bank credit.

With this in mind, the outperformance of defensive investments won't provide a sharp rebound in the coming year as they never dropped in value. We continue to believe that markets will punish vulnerable borrowers and cyclical investments as the impact of the Fed's tightening cycle fully comes to fruition. Once fully priced, these same "undesirable" sectors are likely to be the overweights in portfolios tomorrow.

Figure 8: How CGWI believes the recovery may unfold across 2023



Source: Citi Global Wealth Investments' Office of the Chief Investment Strategist as of April 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.

Figure 9: 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: Haver Analytics as of Jan. 18, 2023. 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. Strategic Return Estimate (SRE) Citi Global Wealth Investments' forecast of returns for specific asset classes over a 10-year time horizon. The forecast for each specific asset class is made using a proprietary methodology that we believe is appropriate for that asset class. Equity asset classes are forecast using a proprietary methodology based on the calculation of valuation levels with the assumption these valuation levels revert to their long-term trends 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. Fixed Income asset classes are forecast using a proprietary methodology based on current yield levels. Other asset classes have other specific forecasting methodologies. Please note that hedge funds, private equity, real estate, structured products and managed futures are generally illiquid investments and are subject to restrictions on transferability and resale. Asset class SREs are made up from each individual country's SREs in each asset class. AVS weights each country's SRE by that country's market capitalization to calculate an overall asset class SRE. But for home-bias allocations, the home-bias country is given much larger weightings than its market capitalization would suggest, while other countries get a proportionately lower weighting. All SRE information shown 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. Adaptive Valuation Strategies (AVS) [provides SREs and asset allocations profiles for multiple currency and geographic preferences. Each SRE is gross of actual client fees and expenses. Components of the methodology used to create the SREs include the rate of return for various asset classes based on indices. Termination and replacement of investments may subject investors to new or different charges. Past performance is not indicative of future results. 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 over time, especially for long-term investments. This includes the potential loss of principal on your investment. It is not possible to invest directly in an index.

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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

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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.

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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Factors affecting commodities generally, index components composed of futures contracts on nickel or copper, which are industrial metals, may be subject to a number of additional factors specific to industrial metals that might cause price volatility. These include changes in the level of industrial activity using industrial metals (including the availability of substitutes such as manmade or synthetic substitutes); disruptions in the supply chain, from mining to storage to smelting or refining; adjustments to inventory; variations in production costs, including storage, labor and energy costs; costs associated with regulatory compliance, including environmental regulations; and changes in industrial, government and consumer demand, both in individual consuming nations and internationally. Index components concentrated in futures contracts on agricultural products, including grains, may be subject to a number of additional factors specific to agricultural products that might cause price volatility. These include weather conditions, including floods, drought and freezing conditions; changes in government policies; planting decisions; and changes in demand for agricultural products, both with end users and as inputs into various industries.

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