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CIO Strategy Bulletin

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Five Insights Likely to Drive Markets in 2023

SUMMARY

- The Debt Ceiling: If a compromise on the debt ceiling is reached, the negotiations will likely result in more fiscal tightening and may help the Fed achieve its anti-inflationary goals, but at the cost of reversing policies that boosted personal and corporate income over the past few years.
- Citi Global Wealth Investment's updated economic forecast: While the "strong" economy and Fed policy appear to be on a collision course, pent-up demand and the positive inertia of the post-Covid rebound have led to a stronger US economy than we anticipated through early 2023. We've revised our 2023 growth forecasts upward, but caution that this will just defer the economic downturn and recovery.
- A Narrow Rally Led by Mega-Caps: Of the $5.5 trillion in global market appreciation so far this year, 52% can be attributed to just 10 companies. Nonetheless, gains so far this year are just another example of the folly of market timing.
- Smaller Stocks Look More Attractive: As a result of small cap stocks' tepid 2023 performance, valuations have improved, with profitable small and midcap (SMID) names now trading at 14x trailing 12 month earnings, a 26% discount to their larger peers. We see this as one of several opportunities that will likely enter portfolios in the near term.
- An Improving Outlook for Asian Equities: Following a post-Covid reopening in most of Asia in late 2022, an economic recovery led by service industries is well underway. Beyond China, India and parts of Southeast Asia, including Thailand and Indonesia, are leading the world in terms of manufacturing and supply chain expansion. Although China's economic recovery has been uneven, we expect growth in China's onshore equity market.

What to expect if a debt ceiling compromise is reached

US equities fell more than 15% *after* the announcement of the 2011 debt ceiling compromise. The market decline was temporary and fully reversed in four months. In late 2011, the US unemployment rate still exceeded 8.5% and the Fed funds rate remained at zero. The depressed state of the US economy following the deep recession of 2008/2009 left the US economy with years of strong growth and rising profits ahead.

We don't see 2023 as a likely repeat of 2011, however.

Once the 2023 debt ceiling "crisis" passes, US markets will face "late cycle" conditions, as tight monetary policy from the Fed seeks to weaken labor markets. The debt ceiling negotiation is likely to result in further fiscal tightening and may help the Fed achieve its aims, but it comes at the cost of reversing policies that boosted personal and corporate income over the past few years.

US Treasury bills maturing in June yield 175 basis points more than bills maturing this month. A budget deal would close this yield gap and the US Treasury will quickly issue several hundred billion dollars of new securities to fill its depleted coffers. These securities, yielding around 5% for one-year or shorter maturities, will compete for investor dollars from other asset classes. As such, other bond yields are likely to rise after a debt ceiling compromise is reached.

Presently, investors are seeing equity gains as negotiations appear to be progressing. As expected, disagreement and further negotiations between the two parties will continue into the coming week. Given that any compromise is likely to reduce or delay government spending, it is likely to be a net negative for corporate profits and consumer spending. That said, the most important determinant of share prices over the next two months is likely to be corporate profitability and the degree to which unemployment rises. We suspect that the most recent equity gains may reverse in the months following the resolution of the debt ceiling crisis of 2023.

Citi Global Wealth Investment's latest economic forecast

One global shock does not necessitate two recessions. The supply disruptions that came with Covid had historical precedents. No prior period after global supply shocks – whether from wars or embargoes – has left consumer prices stable.

During Covid, policymakers succeeded in limiting long-lasting economic damage from the initial pandemic shock. However, the Fed continued to ease monetary policy all the way through the US growth boom of 2021 – with inflation surging and real GDP up 6% for the year. Their excessive actions provided broad and sustained stimulus during the post-Covid recovery, exacerbating supply/demand mismatches. Subsequently, the Fed has chosen to tighten monetary policy more rapidly than ever before.

We believe the full economic effects of this tightening cycle have not been fully realized. When the Fed met earlier this month, it raised policy rates to 5.125% and continued Quantitative Tightening (QT). These actions were taken even as the US Index of Leading Economic Indicators was trending down 8% over the past year.

While the "strong" economy and Fed policy appear to be on a collision course, pent-up demand and positive inertia from the post-Covid rebound reflect a stronger US economy than we anticipated through early 2023. China's earlier-than-expected reopening and the fading of a severe war-related energy shock have been marked positives for Europe's economy at the start of the year.

An agreement on the debt ceiling that further restrains growth leads us to view current Wall Street estimates with skepticism. We believe that the Fed's greater-than-expected policy tightening and an abrupt end to US labor hoarding will shift the timing of its impact. Accordingly, our 2023 growth forecasts have been upwardly revised, but a reduction in growth in 2024 is likely to mirror this year's economic resilience (**Figure 1**; see the May Quadrant).

Figure 1: Real GDP Full Year Average % Change with Citi Global Wealth Investments Forecasts

CITI GLOBAL WEALTH INVESTMENTS
REAL GDP FORECASTS AS OF MAY 2023
(PREVIOUS ESTIMATES ARE IN PARENTHESIS)

	2020	2021	2022	2023	2024
China	2.4	7.5	3.0	**5.8 (5.5)** ↑	4.5 (4.2) ↑
US	-3.4	5.7	2.0	**1.0 (0.5)** ↑	1.4 (2.1)
EU	-6.3	5.4	3.6	**0.8 (0.0)** ↑	1.1 ↑
UK	-11.0	7.6	4.1	**0.3 (-0.5)** ↑	1.1 ↑
Global	-3.2	5.7	3.4	**2.5 (2.0)** ↑	2.4 (2.4)

Source: Citi Global Wealth Investments Office of the Chief Investment Strategist as of May 18, 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.

A narrower rally than it appears: Mega-caps drag the market higher

On the surface, the year-to-date equity rally looks healthy at +7%, on pace with a typical year's annual return. But under the hood, the rise has been far from broad-based. Of the $5.5 trillion in global market cap created this year, 52% can be attributed to just 10 companies (there are 2,880 companies in the MSCI AC World Index). Year-to-date winners include US mega-cap technology names seen as key AI leaders, European luxury giants that benefit from China's reopening, and the world's largest oil company. While the cap-weighted S&P 500 is up 7%, the average return across S&P 500 constituents is -0.8%.

Small and mid-caps have performed even worse, dragged lower by the US regional banking crisis. Despite a 75-basis-point decline in 10-year Treasury yields, small cap growth stocks have not rallied alongside their large cap peers. The world's largest tech company is now bigger than the total market cap of the Russell 2000 index.

Regardless of the rally's breadth, gains so far this year should please those who remained fully invested after a challenging 2022. But unfortunately for others who still remain on the sidelines, the question now is whether to buy an even more expensive US market or continue to sit in cash despite looming reinvestment risks.

With huge cash balances on the sidelines, potential "dip-buyers" point to a laundry list of risks from debt ceiling brinksmanship to further potential economic malaise that could catalyze a currently elusive equity market selloff. There's no telling what may catalyze today's equity indices to fall meaningfully. Our new 10-year strategic return estimates reflect the material equity and debt declines of 2022, so investors must remember to consider that we are highly likely to be investing into a "recovery" period in 2024.

Smaller stocks, regional bank shares are looking more attractive

Aggressive monetary and fiscal stimulus lifted all shares in 2020 and 2021, to the outsized benefit of smaller, more beaten-down firms. In the 12 months following the market lows in March 2020, the Russell 2000 index returned 138% vs 80% for the S&P 500. But the ensuing environment of surging inflation and sharply rising borrowing costs turned out to be much more amenable to large firms with scale, balance sheet strength and pricing power. Meanwhile, smaller firms have struggled. Indeed, US small caps have completely given up their outperformance versus large caps in the post-Covid era (**Figure 2**).

As a result of their tepid performance, valuations have improved, with profitable SMID names now trading at 14x trailing 12 month earnings, a 26% discount to their larger brethren (**Figure 3**). While large cap growth in particular has rallied in 2023, fast-growing small firms remain in the doldrums (**Figure 4**). Market expectations for a Fed pivot should change this paradigm, enabling a catch-up in small cap growth shares, led by non-cyclical health care and technology names.

Meanwhile, our view on small cap value remains closely tied to our outlook for regional banks. While it's hard to say for sure that further large bank failures are behind us, it seems more likely than not that further consolidation in the regional banking sector is likely. Given their systemic importance to the US economy as a whole, we find it hard to believe that broad regional bank shares collectively won't recover once economic conditions stabilize. Regional banks now trade at 1.1x tangible book value, versus a Covid low of 1x. While we may not have hit bottom, quality small cap value shares look compelling at current levels with a multiyear time horizon. So do regional banks.

Figure 2: SMID underperformance is the worst since the depths of Covid

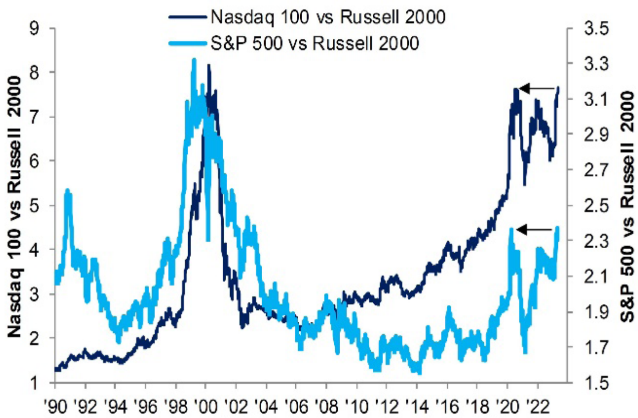

Figure 3: Large, mid and small cap valuations

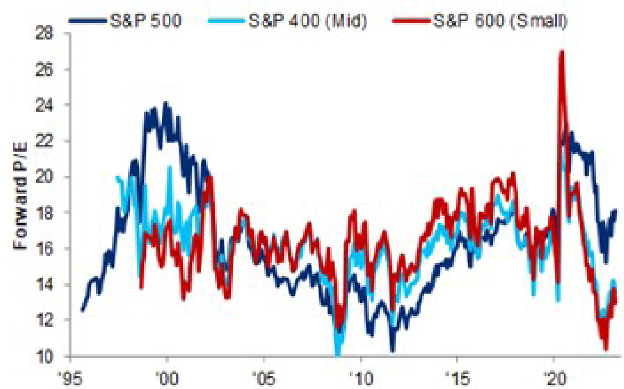

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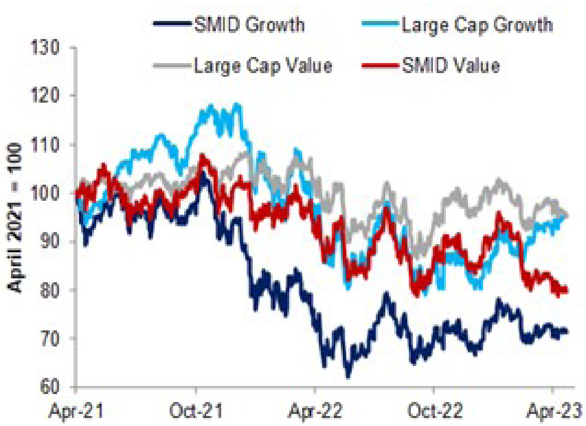
Figure 4: Small and large cap growth and value



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Why the outlook for Asian equities is improving (even as its equities lag)

Most of Asia, especially North Asia, reopened from Covid controls in late 2022. The recovery in activity is very clear in services, while manufacturing growth has been uneven and muted. Still, India and parts of Southeast Asia like Thailand and Indonesia are leading the world in terms of manufacturing expansion, as measured by Purchasing Managers Indices (PMI). Among those with services PMI surveys, India also ranked at the top with a whopping 62 reading in April. Meanwhile, inflation in the region has been tame. (See our Asia Strategy note for more.)

China's recovery has been uneven and its data for April showed a surprising contraction in manufacturing PMI. However, data from the Labor Day holiday in early May showed tourism and consumption surged to above-2019 levels. The divergence between China's consumer and industrial activity is keeping investors on the sidelines. The MSCI China, together with other various equity indexes, has been lagging year to date, trailing many other country indexes.

Looking backwards, Chinese equities do not reflect its actual growth in Q12023. Even with the April miss, the level of economic expansion is well above the equity valuations of today's market (**Figure 5**). This reflects investor skepticism in government policy and a reluctance of foreign institutional investors to reenter the markets in the face of geopolitical instability.

That said, we do see signs of life in China's onshore equity market. A-share investors are aware that margin leverage is an important indicator for market potential. The number of newly opened margin accounts amounted to nearly 100K in March, the highest since September 2021, while margin balances also rose (**Figure 6**).

Figure 5: Even with April setback, Chinese equity valuations still fall well short of recovery pace

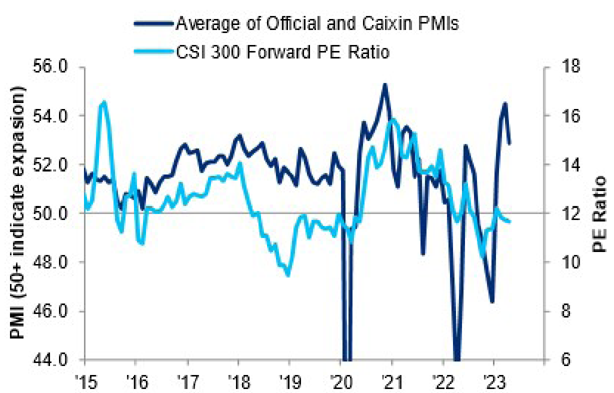

Figure 6: Margin account activities are beginning to pick up in the A-share market

Source Fig 5: Haver Analytics, Bloomberg, as of 4 May 2023; Fig 6: Bloomberg, as of 28 Apr 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.

ASEAN equities may benefit from sustained USD weakness

Historically, the periods of a weaker US dollar have supported equity performance in Asian emerging markets (EM), particularly ASEAN (the Association of Southeast Asian Nations) and India. This is because the most externally vulnerable emerging Asian markets like India, with double deficits in current account and in fiscal budget, would feel less pressure from capital outflows. Second, relative growth advantage would attract capital inflows, while local central banks would be better able to bring rates lower without having to worry about destabilizing exchange rates.

Further, China's reopening is most positive for export-oriented economies, such as Singapore, Malaysia and Vietnam, and tourism-oriented countries such as Thailand. More domestically oriented economies, such as Indonesia and the Philippines, will see less of a direct benefit.

The opposite side of rising US-China tensions are changes in worldwide business models to address supply chain management concerns. Potential capital inflows to China may come from businesses that need to build and support supply chain redundancy there. Major Chinese investments are likely to be made in infrastructure to bring down logistical costs and improve efficiency.

India's resilience may indicate ASEAN's coming rise

Across ASEAN, earnings revisions have picked up in 2023. The reopening of tourism sectors and a rise in commodity prices underpin this recovery. On the other hand, valuations have fallen to a historically low 14x, as stock prices have not seen a rise due to buyer skepticism. By contrast, equities in India have been relatively resilient, with the MSCI India index just 7% below its all-time peak. Earnings growth had been strong in 2021-22 and revisions are steady in 2023. This has brought its PE to about 20x from much loftier levels. We see a future parallel in Chinese and ASEAN shares.

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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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