Citi Global Wealth
Investments

June 4, 2023

# CIO Strategy Bulletin


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## Something Has to Give

- Employment gains in May were nearly twice as large as forecasters anticipated. Equities have rallied on the expectation that labor market gains can outlast the Fed's tightening impacts on the broader economy. In a rolling recession scenario, the economy may escape a plunge, but we're skeptical that recessionary industries under profit pressure can maintain their hiring pace. We believe a net slowdown in employment is ahead.
- Now that the debt ceiling dilemma is resolved, there will be a net increase in US Treasury bill issuance of perhaps $400 billion in the near term. The bulk of the new issuance is in shorter-duration bills. These have the highest yields and compete most directly for bank deposits.
- The potential for higher yields to siphon away deposits from weaker US banks is significant. A shift from bank deposits to US Treasuries should not necessarily result in new bank failures, but the systemic risk for banks may rise again despite the 4.8% rally in regional bank shares this week.
- Potential return opportunities in small and midcap (SMID) shares are brightening. SMID's tepid performance over the past two years has left profitable small cap names now trading at a 26% discount to larger peers. While large cap growth shares have rallied in 2023, fast-growing small firms remain in the doldrums.
- Value and defensive sectors were winning investing plays in 2022, with dividend growth shares outperforming the broad market by 12%. As economic and profit growth stalls and bottoms over the next few quarters, the end of 2023 may mark the twilight of the defensive trade.

## Something has to give

Persistent demand for services and labor hoarding is keeping employment growth stronger while recessions are unfolding in manufacturing, trade and residential construction (**Figures 1-2**). In May, employment gains were nearly twice as large as forecasters anticipated. Construction, trade and retailing – industries that are weakening – all saw gains in employment, while manufacturing employment fell only slightly.

Amid negative investor sentiment and bearish positioning in equity markets, equities have rallied on the expectation that labor market gains can "outlast" the Fed's tightening impacts on the broader economy. In a rolling recession scenario, the economy may escape a broad-based plunge. Nonetheless, we are skeptical that recessionary industries under considerable profit pressure will be able to maintain their hiring pace. With falling inventories and reduced demand, we believe a net slowdown in employment remains ahead. Booming industries, such as travel and leisure, will eventually slow, too.

## The silver lining

Equity markets *will* care about future profits. In last week's CIO Bulletin we discussed the "outperformance" of US labor markets in spite of headwinds to GDP and corporate profits. While we still strongly expect US unemployment will rise in the coming two years, it's unlikely corporate profits will underperform. In a "rolling recession" scenario, the resilience of corporate profits may be the silver lining.

**Figure 1**: Total US building permits vs heavy construction and civil engineering employment

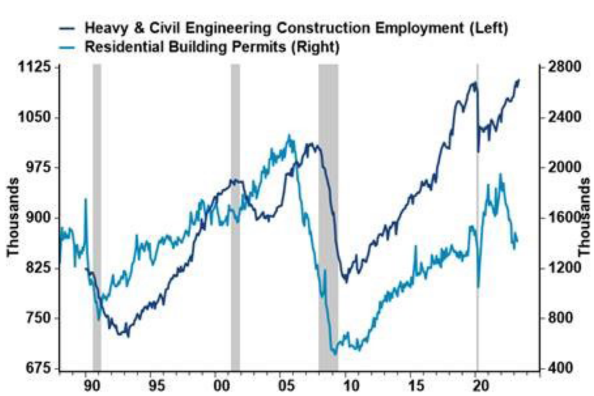



**Figure 2**: US ISM Manufacturing Orders vs Services Orders: 50 = Expansion/Contraction


Source Haver Analytics as of June 2, 2023. Grey areas note recessions. Green circle in **Figure 2** indicates the divergence between the resilience in the services industry and the contraction in the manufacturing industry. 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 will vary.

## Further tightening ahead as the Treasury drains liquidity

In our view, the US Treasury is about to muscle in on investors. Following last week's passage of the US debt ceiling suspension, the Treasury will sharply increase net issuance to rebuild its depleted cash balance. This will mean a *net* increase in US Treasury bill issuance of perhaps $400 billion in the near term, with larger borrowings of longer-dated Treasuries at auction in the months beyond. As of Friday, the Treasury had announced $223 billion in gross new issues of less than three months in maturity.

Such a heavy supply of "risk free" high yielding Treasuries is competition for investor assets of every sort. With six-month bills yielding near 5.5%, the bulk of the early borrowing will be concentrated in the highest yielding, least risky Treasuries. This is more likely than not to effectively tighten financial conditions in the period just ahead.

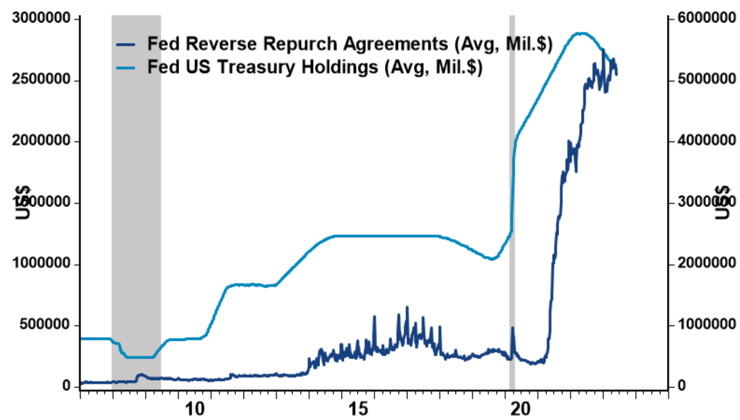
Ironically, after all the hype, the debt ceiling deal itself won't be a major factor in the economy. The very limited agreement didn't include any structural reforms to age-triggered entitlements in an aging nation. Using Congressional Budget Office estimates, federal spending growth will be near zero in fiscal year 2024 instead of growing at a nominal 1%. A slowdown in US government spending in 2024 will neither strengthen nor weaken the broader economy meaningfully.

## Watch the banks

The US Treasury yield curve is inverted, a condition that has occurred in only 15% of all months since 1960. With the possibility of further Fed rate hikes ahead, the pressures of an inverted yield curve are most severe for regional banks. We believe the potential for higher yields to siphon away deposits from weaker US banks is significant. In coming weeks, we'll be watching the Fed's Reverse Repurchase Agreements lending facility and bank reserves to help monitor the impact (**Figures 3-4**). While a shift from bank deposits into US Treasuries need not result in new bank failures, the systemic risk for banks may rise again despite the 4.8% rally in regional bank shares this week.[1]

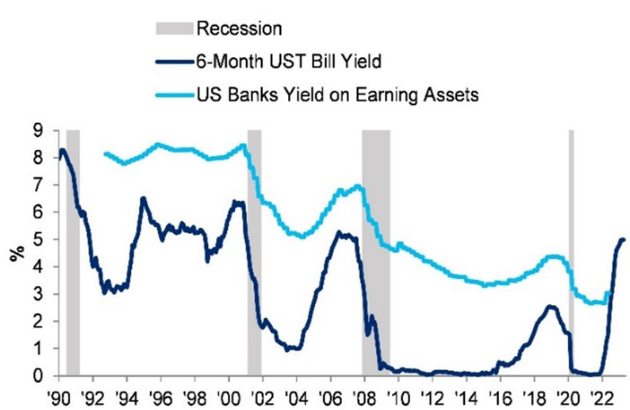
Bank shares are already weak. In 2023, they have lost another 25% in value after weakening in 2022. Though the Fed demonstrated in March that it wouldn't risk a systemic collapse, individual bank equities can still fall to zero. Thus, investors have to be wary of the most vulnerable banks, especially those whose portfolios contain a high percentage of commercial real estate loans. Nonetheless, to the extent that higher US Treasury supply weakens the shares of healthy banks, it may improve the return outlook for investors with a two-year or longer horizon (**Figure 5**).

**Figure 3**: Fed's Give and Take: Fed Holdings of US Treasuries and Lending Facility (Reverse Repurchase Agreements)




Source: Haver Analytics as of June 2, 2023, and Congressional Budget Office. Grey areas note recession.

**Figure 4**: US Treasury 6-Month Bill Yield and Yield on US Bank Loan Assets




Source: Haver Analytics as of June 2, 2023. Grey areas note recession.

1 S&P Regional Banks Index

**Figure 5: US regional bank relative returns to S&P 500 vs US ISM Composite Index**


Source: Bloomberg as of June 1, 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. Real results will vary.

## Potential investment opportunities on the other side

Given the level of Treasury issuance in front of us, other markets will likely perform relatively poorly for a time. As we discussed last week, this could create opportunities in non-US debt, particularly higher yielding investment grade Emerging Markets. We also see that the valuation of small and mid-cap shares has fallen to record lows by some measures (**Figure 6**). While this is partly because of the burst of optimism in AI-driven large cap US tech shares, we've been cautious to add exposures largely because of cyclical risks to the economy. Now that this is becoming priced in, return opportunities in small and midcap (SMID) shares are brightening.

## Capturing improving value outside of mega-caps

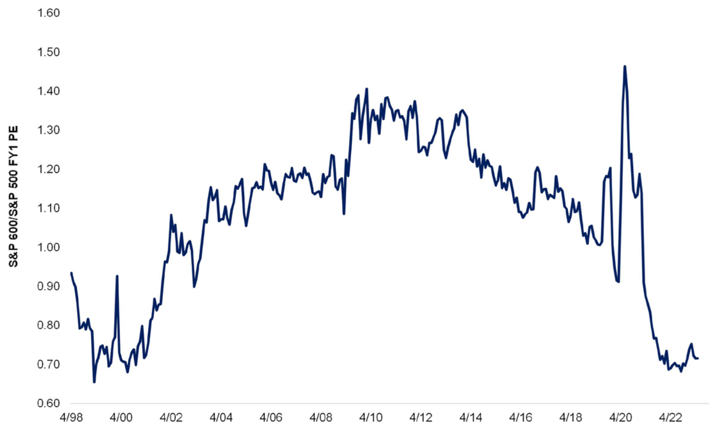
The side effects of post-pandemic stimulus – surging inflation and sharply rising borrowing costs – have predominantly benefited large firms with scale and pricing power. Meanwhile, smaller firms have lagged, giving up all of their post-Covid era gains.

SMID's tepid performance over the past two years has left profitable small cap names now trading at a 26% discount to larger peers. While large cap growth in particular has rallied in 2023, fast-growing small firms remain in the doldrums (**Figure 7**).

Small cap value benchmarks are closely tied to performance of regional banks. Though we still expect some further banking consolidation ahead, broad regional bank shares should recover once economic conditions stabilize. Regional banks play a key role in the US economy, facilitating and underwriting loans to small businesses in local markets where large banks are not players. From a valuation perspective, regional banks have only been cheaper on a price-to-tangible-book basis during the depths of Covid and during the Great Financial Crisis.

While it may be a bit premature to add SMID shares during the Treasuries borrowing boom, quality small cap value shares look compelling at current levels with a multiyear time horizon. In 2024, when the Fed pivots, we also expect a catch-up in small cap growth shares, led by non-cyclical health care and technology firms. Remember that "bearish investors" have a record amount of sidelined money to put to work (**Figure 8**). These are the riskier equities we have underweighted over the past 16 months.

**Figure 6**: Small Cap/Large Cap US Relative Valuation

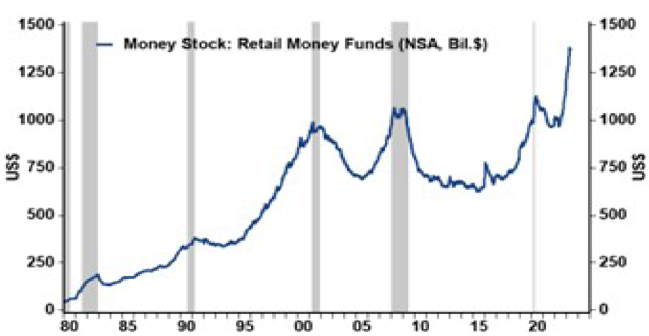



Source: Bloomberg as of June 1, 2023. The indexes are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Index returns do not include any expenses, fees or sales charges, which would lower performance. Past performance is no guarantee of future results. Real results will vary.

**Figure 7**: Large cap (Nasdaq) vs mid cap growth valuations


Source: Bloomberg as of June 1, 2023. Midcap growth proxied using S&P 400 Growth Index. 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 will vary.

**Figure 8**: Retail money market funds




Source: Haver Analytics, as of June 2, 2023. Shaded areas are recessions. 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 will vary.

## Why we prefer profitable small caps

While the value proposition in small shares is apparent, moving down in capitalization doesn't come without taking on some additional risk. When the Global Investment Committee (GIC) moved small and midcap to overweight in April 2020, economic and pandemic-related conditions were still highly uncertain, but policy was unambiguously supportive. We don't enjoy those same tailwinds today. The longer interest rates stay high, the greater refinancing risk will be for small, more highly levered companies.

Our preferred way to leg back into the SMID space is through an up-in-quality approach. Profitable small and midsized stocks are more likely to survive a period where capital costs remain elevated than those that rely on access to debt or equity markets to sustain growth. This is a segment of the equity market where active management seeks to add real value by hunting for under-the-radar opportunities while avoiding value traps at risk of stagnation or bankruptcy.

## Why dividend growers and health care remain part of core portfolios

Hiding out in value and defensive sectors was a winning playbook in 2022. Dividend growth shares outperformed the broad market by 12%, while sectors like energy, pharmaceuticals, staples and utilities delivered positive performance as growth shares plunged. This ongoing macro uncertainty has led many investors – including us – to maximize stability in portfolios.

As economic and profit growth stalls and bottoms over the next few quarters, the end of 2023 may mark the twilight of the defensive trade. We already trimmed our overweight to global pharmaceuticals after 23% outperformance vs global equities since mid-2021. US large cap value shares are now trading at valuations 21% above their average since 1995 (**Figure 9**).

Not all defensive shares were spared last year. Faster-growing health care segments like biotech and life sciences were hit by rising capital costs, but their underlying business models should be relatively uncorrelated to the business cycle. The earnings of cyber security specialists remain resilient and will likely be a key secondary beneficiary from the buildout of AI.

Global dividend growth is another Global Investment Committee (GIC) tactical overweight that's seen smaller drawdowns since the bear market began in 2022 (**Figure 10**). While dividend growers tend to lag in early cycle recoveries, we still believe this strategy has a permanent place in core portfolios given their track record of long-term outperformance.

## The near-term narrative

Higher short-term Treasury interest rates may cause further distortions in yields elsewhere and in the relative value of certain equity markets. Given our rolling recession scenario, we expect a slow reduction in labor demand, but are highly confident the Fed will maintain an aggressive higher rate posture until it succeeds in bringing down inflation. Ultimately, higher rates for longer will cause a rise in unemployment and, finally, a Fed pivot in support of the labor markets.

Markets will anticipate all this, of course, but not without volatile and potentially valuable moments for investors. Those investors with fully invested portfolios should consider rotating exposures to positions more likely to profit in the years to come, as we complete a large adjustment in the US and global economies.

**Figure 9**: US growth and value vs non-US equity valuations

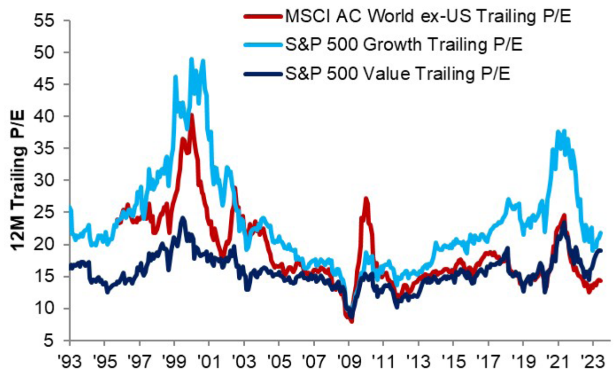



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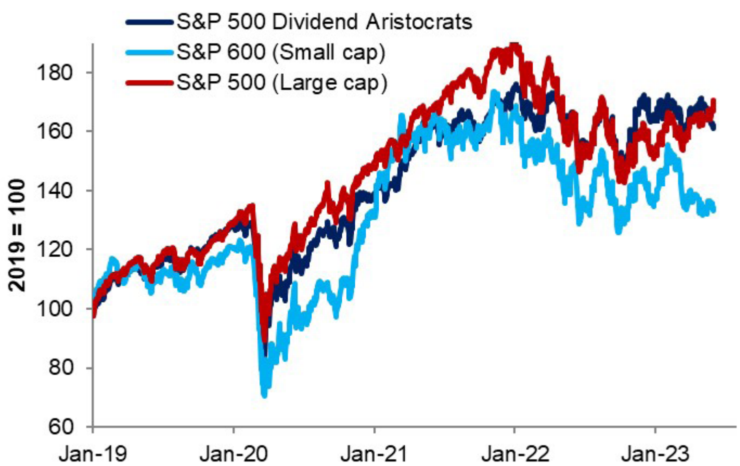
**Figure 10**: Dividend growers vs large caps and profitable small caps

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| 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 |

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