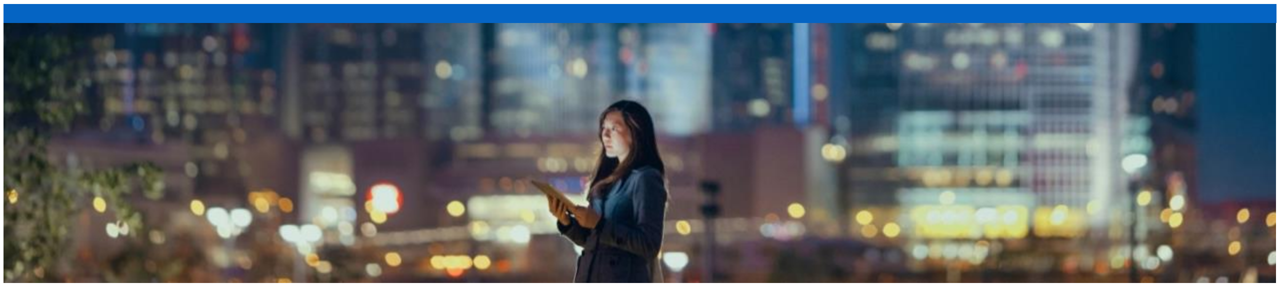
Citi Global Wealth Investments



July 2, 2022

CIO Strategy Bulletin

INSIDE THE MIND OF A CONFUSED MARKET

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SUMMARY

- **It is easy to look backwards at market performance for the first half of 2022 with alarm. Dual fears of inflation and recession are being blamed for these market declines, but it is the Fed's abrupt pivot from being unusually accommodative to severely hawkish that set the market's 2022 steep decline in motion.**
- **There is a high likelihood that we will have seen two consecutive quarters of negative US GDP growth in 2022. Yet, the "rule of thumb" that two quarters of consecutive GDP declines marks a recession is incorrect. Recessions are self-reinforcing, with net job losses measured in millions.**
- **At the moment, the US economy is slowing but a recession has not arrived. US manufacturing data shows new orders slowing, but the overwhelming majority of companies are still hiring. We see a period where evolving conditions are unlikely to provide more conviction about the economic outlook in the US and globally.**
- **So, is another 8-10% drop in US equities warranted? A lot depends on future profitability. What can one now expect from corporate profits in 2023? We think a drop of 3% is likely for 2023 in a "Resilient" (slow growth) scenario, -20% in a "Recession" scenario, and +10% in a Robust scenario. Unless interest rates retreat, markets have not yet fully priced a material earnings decline.**
- **Combining bonds with dividend growth shares and tax efficient strategies for beaten-down equities and bonds offers a lower-risk approach for today's uncertainties. With this strategy, investors need not expect a strongly growing economy to generate moderate returns over the next year or two.**
- **Markets have punished growth shares more than industrials and cyclicals since the beginning of the year. We are likely to become more optimistic regarding the prospects for high-quality growth equities in technology-related sectors once a convincing peak in US interest rates is clear.**

QUESTION OF THE MOMENT: IS THIS THE RECESSION?

Will markets regain strength if inflation falls or will future central bank actions stifle economic growth? At the midpoint of 2022, that is the debate.

And with the likelihood that we will have seen two consecutive quarters of negative US GDP growth in 2022, it is a true tug-of-war. Yet, the "rule of thumb" that two quarters of consecutive GDP declines marks a recession is incorrect. In fact, over the next few weeks it may lead investors to the wrong conclusions and thus take unnecessary risks.

Little of the economic hardship that comes with recessions has transpired. Recessions are marked by a wide **D**ispersion of contracting industries, of significant **D**epth and significant **D**uration (the 3 **DDDs**). At the moment, production and employment continue to grow. If we do see a recession, it will be far worse than present conditions. Recessions are self-reinforcing, with net job losses measured in millions. We are not there yet.

QUESTION OF THE MOMENT: WHAT'S PRICED INTO MARKETS

As an investor, it is better to look forward than backwards in markets. The simplest question to ask (and the hardest to answer) is this: **What is priced into markets at this moment and what is not?** Through this inquiry, we can attempt to determine the risks ahead and the data that we will need to gain clarity on the likely path for the economy and markets.

It is easy to look backwards at market performance for the first half of 2022 with alarm. The business press will be trumpeting the 20.1% fall in the S&P, its worst such start since 1970. The bond market has also suffered a record repricing, with the US Aggregate bond index posting a first half return of -10.3%, its largest drawdown in history.

Dual fears of inflation and recession (see this week's Data Watch) are being blamed for these market declines, but it is the Fed's abrupt pivot from being unusually accommodative to severely hawkish that set the market's 2022 steep decline in motion.

Monetary policy should be connected to the forward-looking performance of inflation. Yet, US monetary policy was disconnected from it. Policy rates through March of 2022 remained at zero and the Fed expanded credit with newly created money even as the economy boomed. The Fed is now reversing course rapidly with rate hikes and reduced lending during an economic slowdown. And now the ECB and other central banks are following on.

The Fed's plan is to bring down aggregate economic demand to address high inflation due to excessive pandemic stimulus and a war that has disrupted the world's supply of energy and food. We remind our readers that the medicines the Fed is using to address inflation, higher rates and QT, are non-specific and have lots of side effects. (See our June 19th CIO Bulletin: THE FED'S EMERGENCY ROOM.)

Further, the aggressiveness of Fed rate hikes (and the absence of tangible milestones and objectives) are likely responsible for some of the market's uncertainty and volatility. For example, if the Fed acknowledged goals for reductions in inflation, with specificity as to the data it deemed most relevant, and if the Fed discussed the economic activity data it deemed most relevant to calibrate its rate and QT actions, markets would have better forward guidance on the path of Fed policy. Monetary policy would provide greater guidance to markets after an historic joint correction in bonds and equities.

Fed Impacts and More…

At the moment, the US economy is slowing but a recession has not arrived.

Last Friday's ISM data showed that U.S. manufacturing activity had a second monthly decrease, with a measure of new orders contracting for the first time in two years. Even so, the "overwhelming majority" of companies indicated they were hiring. "All of the six largest manufacturing industries - computer and electronic products, machinery, transportation equipment, petroleum and coal products, food, and chemical products — registered moderate-to-strong growth…. A gauge of prices paid by manufacturers dropped to a reading of 78.5 from 82.2 in May, supporting views that diminishing demand for goods could help to cool inflation, though that could be offset by higher prices for services." (Reuters, 7/1/2022).

We see a period where evolving conditions are unlikely to provide more conviction about the economic outlook in the US and globally. That reflects the lack of clarity around several issues that may or may not be properly priced into markets. Our goal in this CIO Bulletin is to address some of these. They include:

1. Forward rate expectations.
2. Synchronized central bank tightening.
3. Balance sheet wind-down impacts: Illiquidity in high yield markets.
4. Corporate earnings reductions in 2022 and 2023.

Forward Rate Expectations

Monetary policy has ratcheted up in phases over the past half year in an attempt to manage inflation through a reduction in economic growth. Based on the Fed's actions, we expect sub-2% US economic growth over two years with run-rate inflation falling to 3.5% by the end of 2023. This is all consistent with our "Resilient" scenario and benefits from generally improving supply developments (see Three Scenarios for Markets and the Economy).

Markets assume Fed policy rates will begin to fall again by mid-2023 (see figure 1). This means markets expect the Fed will only be able to sustain peak rates for six months.

What are the economic circumstances that would lead to a Fed policy reversal in 2023 or 2024? A period of weaker than expected growth and/or a period of declining inflation would be a signal for the Fed to pause its current aggressiveness. Similarly, a recessionary collapse would likely drive a dramatic reversal of Fed policy, but not before equity and *risky* credit markets suffer further declines.

The Opportunity in Bonds

For investors, US investment grade corporate bond yields have moved dramatically above Fed policy rates (see figure 2). The increase in Fed rates and the increase in investment grade spreads assume the Fed will follow through with its large tightening cycle. In our view, if inflation recedes from the combination of fiscal and monetary policy tightening while supply shocks are absorbed, bond yields will fall over the coming year. **This is the basis for our "Bonds are Back" theme.**

In the event a recession unfolds because the Fed has been too aggressive with rates and/or QT, the "Bonds are Back" theme has the potential to perform even better as interest rates will undoubtedly peak sooner requiring more accommodative measures to follow.

Figure 1: Fed funds rate and expected Fed funds rate implied by markets

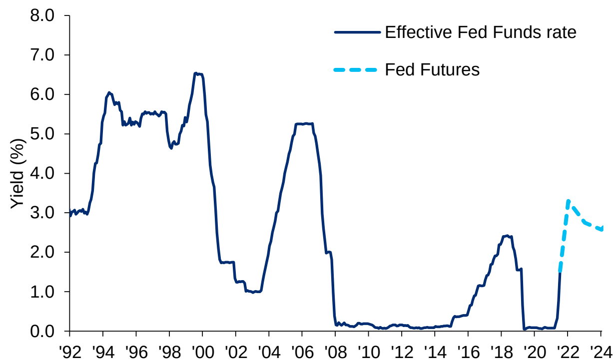
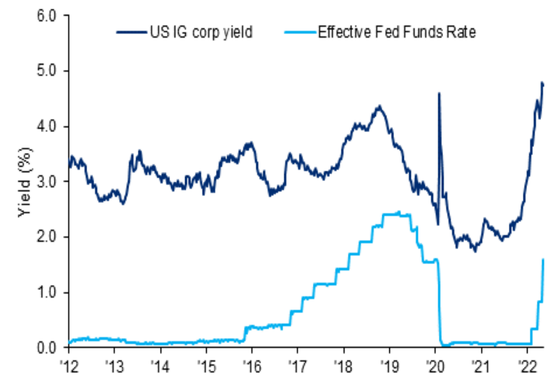


Figure 2: IG corporate bond yield (all durations) vs Fed policy rate



Source: Bloomberg as of July 1, 2022. 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.

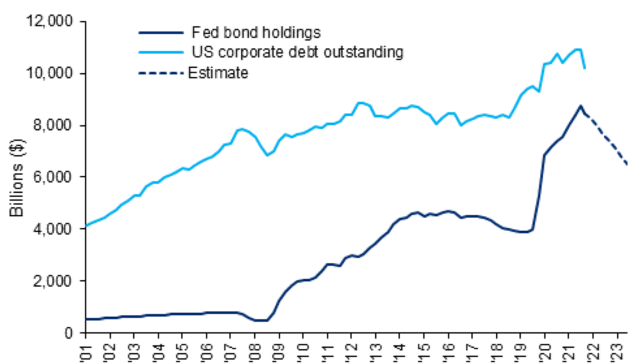
Synchronized Central Bank Tightening

The US isn't alone in its inflation battle as other developed economies face similar price pressures affecting households, and their central banks are responding by tightening monetary policy.

- The flash estimate of euro area headline HICP rose from 8.1% YY in May to a new record high of 8.6% YY in June, exceeding consensus expectations. In June the European Central Bank confirmed its intention to hike interest rates at its July policy meeting and downgraded its growth forecasts. The ECB expects a further hike at the September meeting, but noted that the scale of that increment would depend on the evolving trajectory of the medium-term inflation outlook.
- UK inflation is yet to peak and the outlook for UK consumers appears dreary. At its June 16 Monetary Policy Committee meeting, the Bank of England announced a 25-basis point rise in its policy rate to 1.25% and warned it expected inflation to rise above 11% before the end of 2022.

The cumulative impact of higher rates in developed markets is unclear, but the general impact on global growth is negative. The economies most impacted by the war are the least able to address the inflation stemming from it through traditional means.

Figure 3: Fed holdings of securities vs Total US corporate debt outstanding



Source: Bloomberg as of June 27, 2022.

Balance Sheet Wind Down Impacts: Illiquidity in High Yield Markets.

The Fed's bond purchases during the pandemic drove high quantities of riskier lending. The reverse applies as the Fed begins to shrink its balance sheet (see figure 3). As the Fed now allows $95 billion-a-month of US Treasury and mortgage-backed securities to roll off its balance sheet, this is likely to shrink the supply of credit to less worthy borrowers. In turn, this will likely limit the Fed's peak policy rate and upper bound of where Treasury yields may peak.

We are already seeing material underperformance of lessor credits in the high yield and CMBS markets. Risky bond prices are falling as market liquidity abates. US HY bond spreads are breaching levels reached during the 2016 commodity crisis and the 2018 Q4 sell off. While spreads at +570bps are still below prior recessionary periods, a further widening would be warranted if a full-blown recession ensued and default rates, now just 1.4%, rose sharply (see figure 4).

Fed Policy and Lower Oil Prices

Oil is a vulnerable commodity in a recessionary scenario, even in the face of ongoing Russian disruptions. A fall in oil prices would lower inflation, but also weaken a key component of risky credit (see figure 5). Thus, we expect a decline in cyclically sensitive commodities such as oil, lumber and construction materials (from cement to iron and copper) may unfold in the year ahead. This could be pivotal in reaching a peak in both interest rates and inflation.

Figure 4: US HY credit spreads

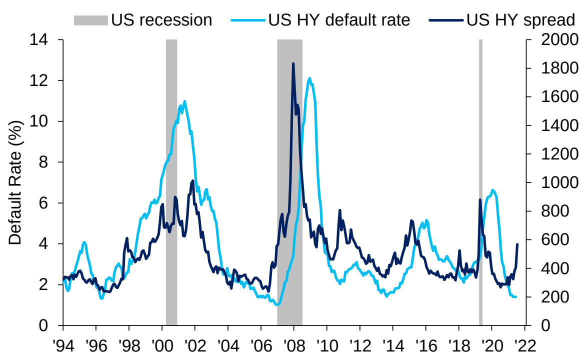
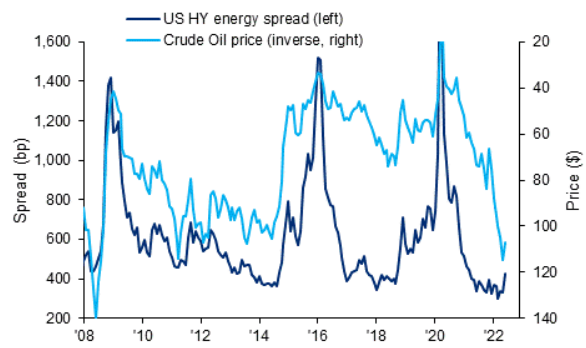


Figure 5: US HY energy bond spreads track movements in crude oil prices



Source: Bloomberg as of July 1, 2022. Grey areas note recession. 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.

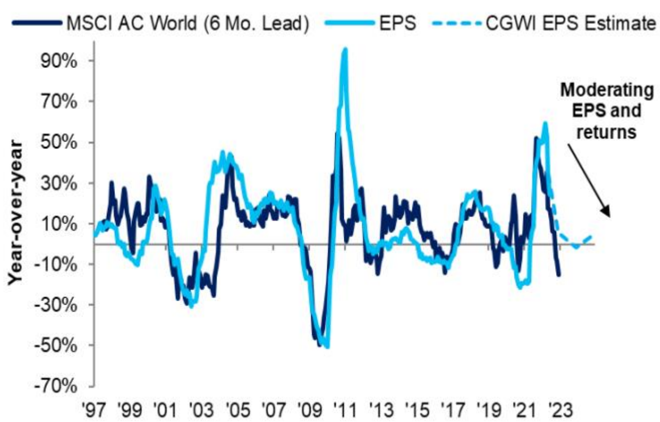
Corporate Earnings in 2022 and 2023

The capacity of the economy to generate profits rises with time. Even this year, we expect a 5% rise in US corporate profits and a comparably larger gain in dividends. So, is another 8-10% drop in US equities warranted? A lot depends on future profitability. A market that has fallen to reflect higher interest rates does not mitigate earnings risks.

What can one now expect from corporate profits in 2023? After a massive surge in 2021 and a rise of 5% in 2022, we think a drop of 3% is likely for 2023 in a "Resilient" (slow growth) scenario, -20% in a "Recession" scenario, and +10% in a Robust scenario. This is -8% for EPS next year on a probability weighted basis. Unless interest rates retreat, markets have not fully priced a material earnings decline.

Global equities markets have led corporate profits by about 6 months throughout our available data history. This includes both periods of monetary tightening and easing (see figure 6).

Figure 6: Global equities and EPS Y/Y%



Source: Bloomberg as of June 27, 2022. 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.

The Most Reliable Sources of Return Now

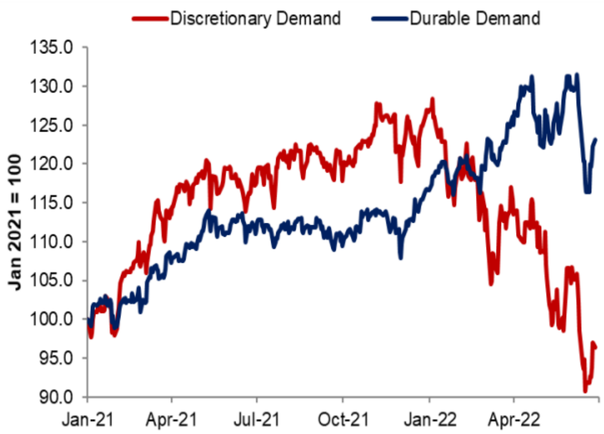
After a massive surge higher in US and global corporate profits in 2021, it will be hard for profits to make net gains of any magnitude in 2022-2023. This leads us to invest in the most durable demand industries, and particularly in the shares of firms with the most consistent track record of dividend growth (see figures 7-8). Such firms need to over-earn their dividend to sustain higher payouts. This points us to so-called "dividend aristocrats", firms with the strongest track record of growing dividends. These shares have solidly outperformed this year already.

The outperformance of high-quality dividend growers in 2022 might be a concern for returns in 2023. This may be particularly true in an economic recovery when more speculative shares rebound. However, the weak performance of dividend growth shares in 2020 and 2021 – years dominated by tech and cyclicals respectively – suggests "defensive income-oriented shares" is still the right core strategy for equities.

Meanwhile, high-quality US investment grade bonds now lead the world in yield and are a key overweight in our portfolios. This is even while we continue to underweight bonds (and equities) in Europe and Japan.

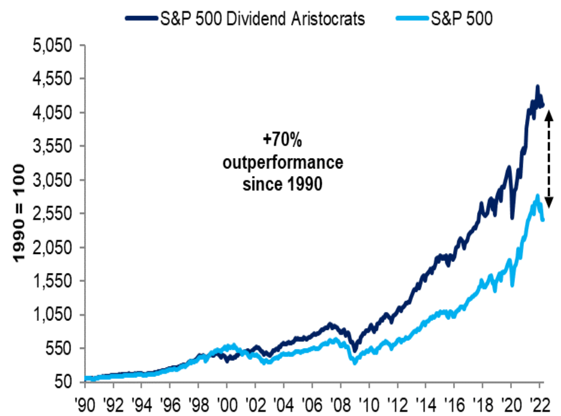
Investment grade bond portfolios with a range of diversified risks can be created with near-5% yields and moderate duration. Combining bonds with dividend growth shares and tax efficient strategies for beaten-down equities and bonds offers a lower-risk approach for today's uncertainties. With this strategy, investors need not expect a strongly growing economy to potentially generate moderate returns over the next year or two.

Figure 7: Durable vs discretionary demand shares



Source: Bloomberg as of June 27, 2022. Note: Discretionary demand industries are household durables, specialty retail, textiles, apparel & luxury goods, residential RETs, Hotels, Restaurants & Leisure, Financials and Airlines. Durable demand industries are Food, Beverage & Tobacco, Energy, Utilities, Health Care, Telecommunication services.

Figure 8: Dividend Aristocrats vs S&P 500



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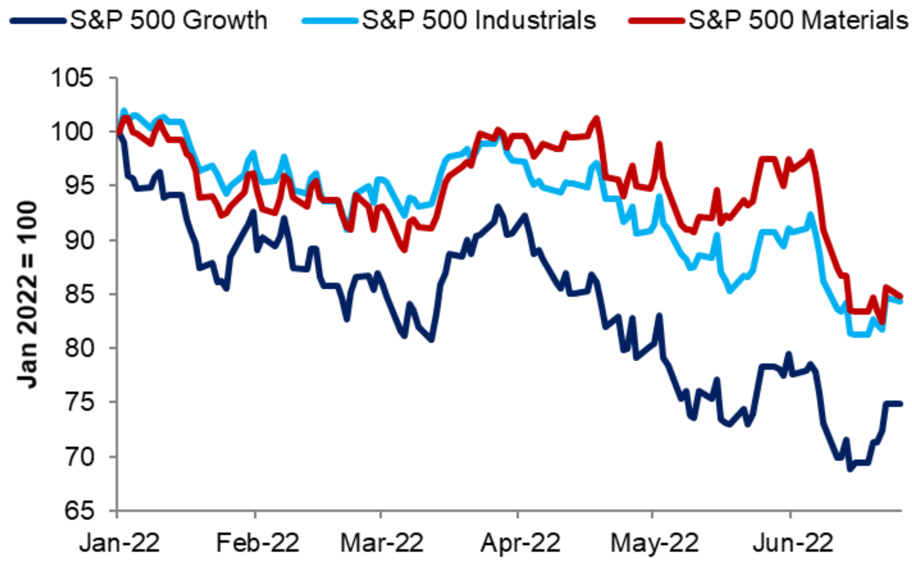
On the Horizon, Growth Shares and Interest Rates

We are likely to become more optimistic regarding the prospects for high-quality growth equities in technology-related sectors once a convincing peak in US interest rates is clear.

Markets have punished growth shares more than industrials and cyclicals since the beginning of the year. Yet, we see a potential reversal in fortunes on the horizon (see figure 9). In the event that the economy slows or enters a recession, cyclical industries such as homebuilding, retailing and industrial materials producers that would likely suffer larger negative swings in profits. In contrast, less cyclical technology investments, such as software and telecom services, would see continued revenue growth and higher cash flows.

Twenty years ago, investors who did not have the patience to wait or the courage to re-engage with the investments responsible for true growth and innovation missed out on the strongest returns of the two decades past. Today, we don't advocate a wild swing towards such investments or away from them. We consider accumulating shares in beaten down secular growth industries such as cyber-security software, which has fallen 20% in 2022 even with no loss of business activity.

Figure 9: Growth vs Cyclicals



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