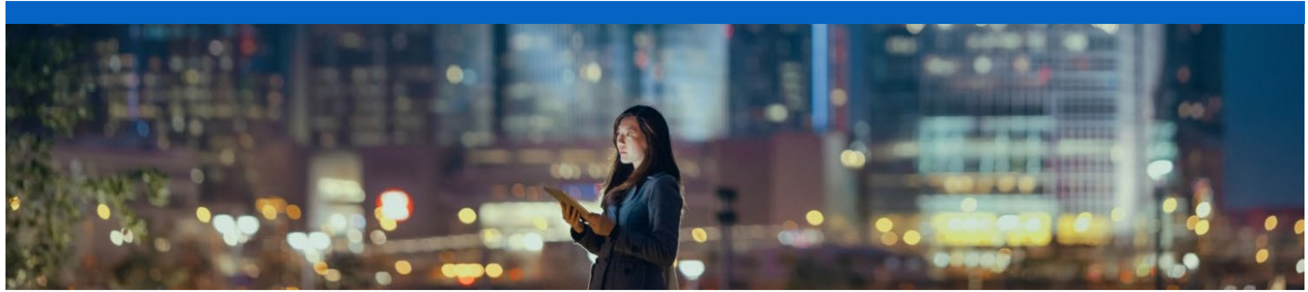
Citi Global Wealth Investments



September 25, 2022

CIO Strategy Bulletin

A Fed Too Far? Positioning Portfolios for What's Ahead

David Bailin, Chief Investment Officer and Head of Citi Global Wealth Investments
Steven Wieting, Chief Investment Strategist and Chief Economist
Bruce Harris, Head, Global Fixed Income Strategy
Joseph Fiorica, Head, Global Equity Strategy
Joseph Kaplan, Global Fixed Income Strategy

SUMMARY

- Fed Chairman Powell's "shock and awe" tightening strategy is a response akin to Volcker's actions in the 1980s. While Powell may crush inflation, the costs will be considerable.
- Digesting the Fed's news, stocks revisited their lowest levels of the year, mortgage rates rose to new highs, home sales fell for the 7th consecutive month and the US dollar soared to new 20-year highs.
- The Fed is undertaking a near-term "pain maximizing" strategy. We see the probability of a US recession next year at 70% and we expect a material fall in employment. The pain inflicted on households and small businesses will have lingering negative impacts into 2024.
- We strongly doubt that the Fed's higher rate views, together with Quantitative Tightening ("QT"), are compatible with its expectation for positive growth in 2023.
- History shows the Fed's policy forecast can change abruptly and is secondary to the Fed achieving its economic goals. We can envision that the Fed will reverse policy later in 2023 after several months of major employment declines.
- Given this outlook, investors should prioritize capital preservation and look to high quality fixed income in portfolios. Short-duration US investment grade fixed income opportunities now yield between 5% and 7% across various market segments. Among the assets we believe investors should consider are US Treasuries, investment grade bonds, municipal bonds and notes, and preferred securities.

To Crush Inflation, the Fed Will Crush the Economy

This past week, the US Federal Reserve chose to shock markets with a third consecutive 75 basis point rate hike in just four months. They also provided forward guidance designed to maximize the impact of its actions. The Fed told us to expect further large rate increases and a longer duration of tightening.

The Fed has never succeeded (or tried in modern times) to arrest a supply-induced inflation shock. The inflation seen to date has had very little connection to domestic labor market conditions. Therefore, in our view, this action represents an economic experiment. So much medicine for this atypical inflation seems severe. We expect many unforeseen outcomes that are likely to be magnified by the broader slowdown in the global economy.

In the early 1980s, Fed Chairman Paul Volcker erased 15 years of accelerating inflation in three years' time by employing "monetary shock therapy." To eliminate entrenched inflation, Volcker manipulated US bank reserves, forcing interest rates to a peak rate of 19% in 1981 and then allowed them to fall to 8.5% in the deep recession of 1982. His strong actions to counter the deleterious impacts of ever-accelerating inflation reversed its course, with only brief inflationary spikes during the first Gulf War of 1990-1991. However, during the two recessions that Volcker induced, the US unemployment rate rose nearly 5 percentage points.

Shock and Awe

Fed Chairman Powell's "shock and awe" tightening strategy after more than a year's worth of its own excessive economic accommodation is a response akin to Volcker's actions, but under very different circumstances. By acting comparatively early compared to 1970s policymakers, he may prevent the need for further actions to fight inflation, but at considerable economic cost. The pain inflicted on households and small businesses will have lingering negative impacts into 2024.

To magnify the impact of its actions, Powell and the Federal Open Market Committee used a purposefully aggressive communications strategy to cement a larger, more negative market reaction across every asset class. Rather than "risk any optimism" that the Fed might pause its battle to fight inflation, the central bank crushed all hope that the Fed would show rational concern for the economy.

A Blow to Markets

After digesting the Fed's news, stocks revisited their lowest levels of the year. Losses in equities and bonds reduced household net worth by more than $6 trillion in Q2 2022 (a record) with further major losses to come in Q3. Mortgage rates rose to new highs, while home sales fell for the 7th consecutive month, both exceeding their 2007 levels. The US dollar soared to new 20-year highs. This is evidence of a near-term "pain maximizing" approach.

FOMC voters raised their expectation for the end 2023 Fed funds rate from 3.8% to 4.6%. If followed literally, this would mean a 150-basis-point rise in policy rates from current levels through the end of next year. Pursuing its Quantitative Tightening (QT) strategy at the same time, the Fed would presumably reduce its lending to the US bond market by 10%-15%.

Likely Impacts in 2023

Even if the Fed does not follow through with a second year of intense tightening, we believe the Fed's actions will cause the economy to decelerate into recession and drive sizeable job losses. We expect 1-2 million net job losses in 2023, even as the labor force grows. Following through on the Fed's policy communication could worsen outcomes in our view.

Fed Forecasts Are Becoming Unbelievable

The Fed's forecast of its policy rate and the actual rate have often differed greatly (see figure 1). At this time last year, the Fed expected the year-end 2022 Fed funds rate to be 0.3%, not the 4.25% rate we will see if there are 100 basis points of additional tightening by year end.

We strongly doubt that the Fed's higher rate view together with QT are compatible with its own 2023 economic outlook. Given the potency and size of its actions, the Fed's forecast of a 1.2% gain in real GDP next year with just a 0.6% increase in unemployment appears to be wishful thinking.

Importantly for the economy and investors, history shows the Fed's policy forecast can change abruptly and is secondary to the Fed achieving its economic goals.

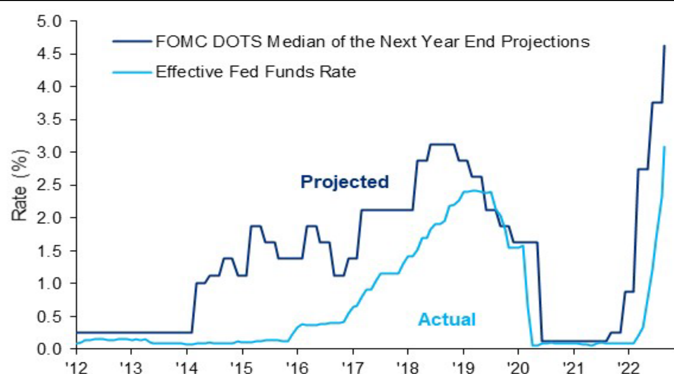
Greater Unemployment Ahead

Even in the time of Paul Volcker, once the Fed's policy rate reached its peak, it did not stay there for very long (see figure 2). While the Fed may be able to continue raising US policy rates over the remainder of this year as US employment continues to grow, we see a different scenario unfolding in the coming year.

Maximizing the impact of the Fed's tightening will extract pain from the economy. We see the probability of a US recession next year at 70% and with that we expect a material fall in employment to begin. Led at first by a loss of housing-related employment (please see last week's CIO Bulletin), we believe the loss of broad private employment is likely to approach 2 million jobs in manufacturing, trade, finance and marketing areas during 2023.

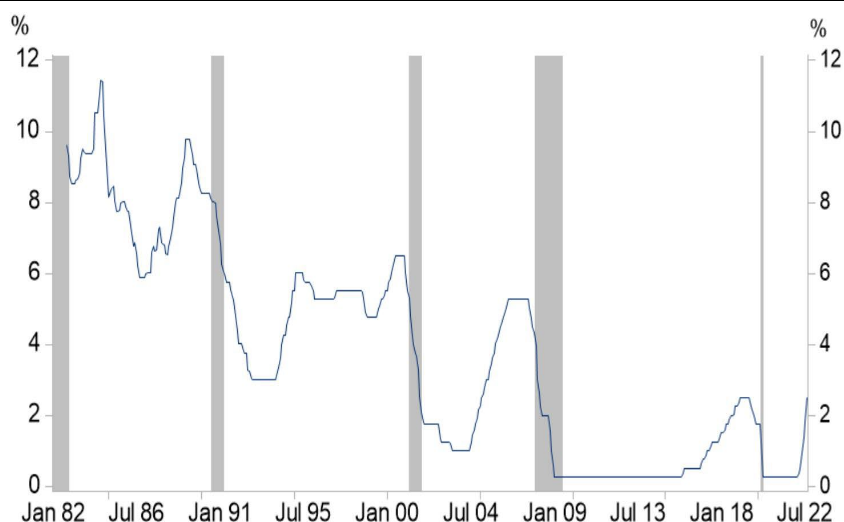
Periods of falling housing-related employment are not isolated to housing. As such, a rise in the unemployment rate of about 2% assuming the labor force grows is, in our view, more likely than the Fed's forecast next year at just one-third of that loss.

Figure 1: Fed's SEP One-Year Ahead Forecast for Its Key Policy Rate and Rate Actually Delivered



Source: Haver through September 13, 2022. 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 2: Fed funds rate target: 7 Month Average Duration at Peak Level, Shorter When Tightening is Rapid



Source: Haver through September 13, 2022. Note: Gray areas are 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.

The Potential Opportunity: Peak Rates Means Attractive Bonds

While we think the Fed is going too far and too fast for the health of the economy, high short-term rate instruments offer investors income, and given their very short duration, low risk of large mark-to-market losses should rates continue rising. Our "up-in-quality" fixed income ideas for investors to consider are US Treasuries, investment grade bonds, municipal bonds and notes, and preferred securities.

Based on the past week's FOMC meeting and projection for future rate hikes, the Fed may continue raising rates by another 100-125bps by early 2023 before a likely reversal in 2H 2023, at which point we expect unemployment to have significantly increased. Fed policy has adjusted cyclically when the US economy has had self-reinforcing declines in total employment. As inflation buckles from the economic slowdown caused by this aggressive Fed, we believe the horizon for easing is sooner than the Fed implied at its press conference.

Unlike equities, even if bonds experience mark-to-market decline, they always repay at par (barring default). With a negative economic backdrop for the year ahead, capital preservation is a critical goal, one that high quality fixed income can provide.

Figure 3: US Unemployment Rate: Rarely Steady for Long

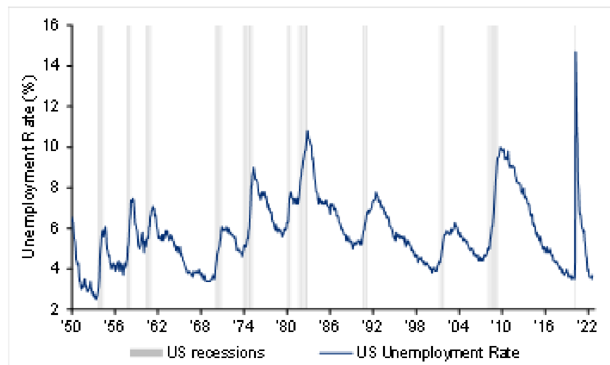
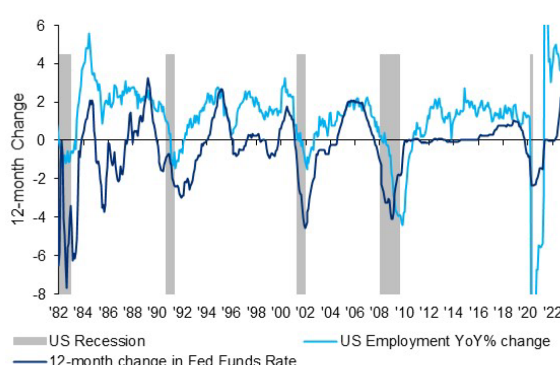


Figure 4: Changes in Fed Policy Rate and Year/Year Change in US Employment (%)



Source: Haver through September 13, 2022. Note: Gray areas are recession. 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.

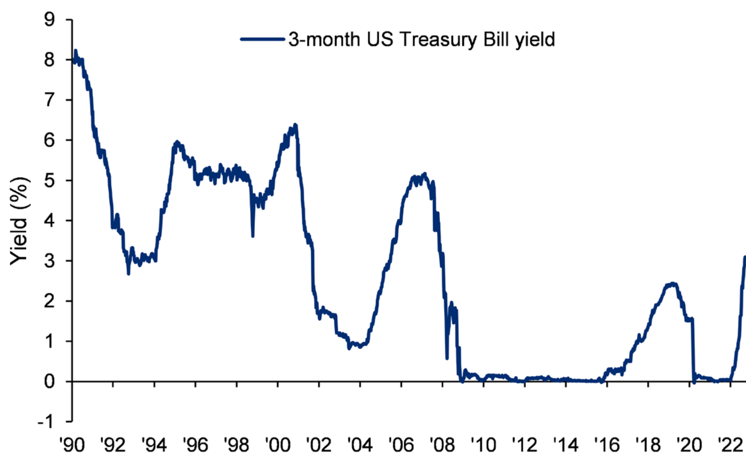
Treasuries and TIPS, Not Cash

Almost all Treasury rates now offer historically high yields. How high are these rates? The generic 3-month US T-Bill currently pays almost 3.17%, the highest rate since 2007 (Figure 5). In fact, it's close to the highest rate this century, barring a few years in the mid-aughts.

Not only are these risk-free US government rates comparatively high in nominal terms, but they're also high compared to expected headline inflation as measured by Treasury Inflation-Protected Securities (TIPS). In 2021, the yield on TIPS was sharply negative, as investors expect to be compensated with much higher inflation. Now, with headline inflation expectations across the TIPS curve at 2.5% or lower, TIPS yields have turned positive, meaning that an investor can earn both a positive yield and obtain inflation protection, as well.

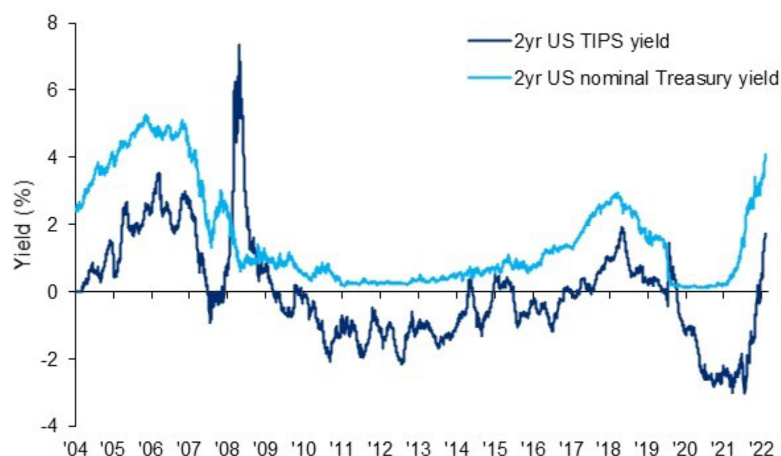
For example, the 2y Treasury currently pays about 4.19%. The 2y TIPS pays 2.02%. For an investor in TIPS to earn the same as if they had bought a regular Treasury, headline CPI needs to average about 2.17% each year over the two-year period (see figure 6).

Figure 5: 3-month US Treasury Bill Yield



Source: Bloomberg as of Sept. 22, 2022. Past performance is not indicative of future results.

Figure 6: 2yr real yield vs 2yr nominal US Treasury yield



Source: Bloomberg as of Sept. 22, 2022. Past performance is not indicative of future results.

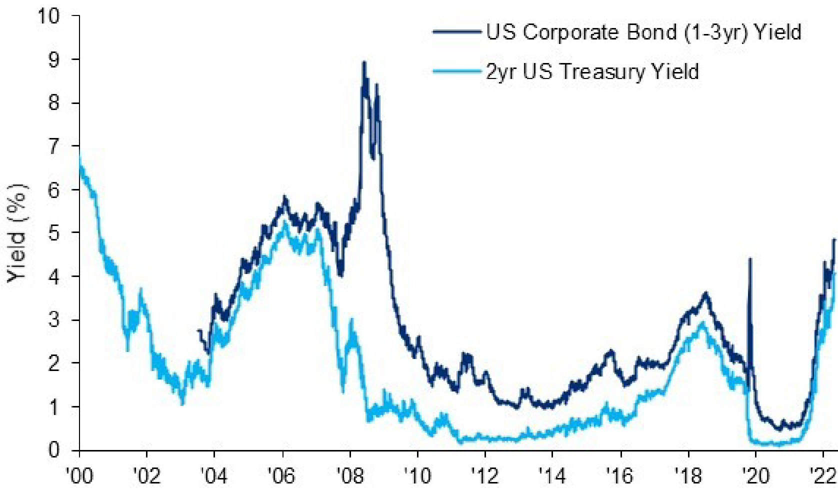
Investment Grade Credit

Of course, Treasury rates make up the "base rate" for all credit instruments, so any credit instrument will have higher rates than Treasuries, along with varying degrees of credit risk. Probably the least risky of these would be short-term investment grade. The index comprises debt of 1-3 year maturities, with an average duration of about 1.9 years.

The index currently yields nearly 5%, which is almost 75bps higher than comparable-maturity Treasury bonds (basically the 2y Treasury). One of the interesting features about short-term investment grade bonds is that these bonds are definitionally near the "front of the line" to be paid by the issuers, which gives them priority in payment order over longer-dated issues.

In addition to index levels, individual issuers may offer more opportunistic yield levels for investors who understand the credit risk of the issuer. There are also funds that offer this type of product and service. An index is an "average" of yields, so today there are numerous examples of high-quality credits that pay above index yields. For example, many U.S. money-center banks currently have shorter than 3yr maturity bonds that yield near or above 5.25%.

Figure 7: US short term IG corporate yield vs 2yr UST yield

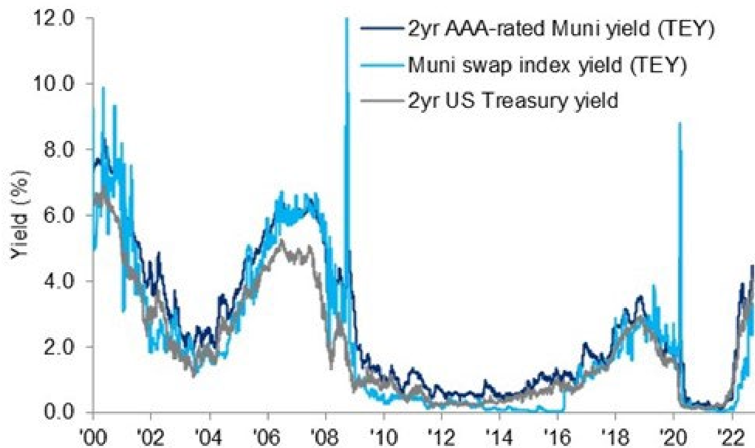


Source: Bloomberg as of Sept. 22, 2022. Past performance is not indicative of future results.

US Municipal Bonds

For investors who can take advantage of the tax benefits, highly rated US municipals can be a very interesting short-term fixed income option. Municipals generally pay a "tax-equivalent yield" that is near the equivalent Treasury yield (Figure 8), but sometimes that yield can be higher than Treasuries as it was earlier this year. When that happens, the tax equivalent yield, especially for US taxpayers in high tax states, can offer similar yields to investment grade, for government credit risk.

Figure 8: Short-Term Muni Tax Equivalent Yields (TEY)



Source: Bloomberg as of September 22, 2022. Note: Tax equivalent yields (TEY) adjust for top Federal and Affordable Care Act tax rate (40.8%). The SIFMA Municipal Swap index is a 7-day high-grade market index comprised of tax-exempt VRDOs reset rates that are calculated weekly. Past performance is not indicative of future results.

Variable Rate Demand Notes

Another alternative in the municipal market is called a "Variable Rate Demand Note" (VRDN), which is usually a bond issued for a longer date that resets its interest rate in very short periods. VRDNs come in

two varieties: those that reset on a daily basis and those that reset on weekly basis. Yields differ with daily resets generally pricing at lower yield levels than weekly resets due to the daily liquidity afforded by the structure. For the highest tax bracket US taxpayer, current yields on VRDN's can be an attractive short duration asset that should perform well in a rising rate environment.

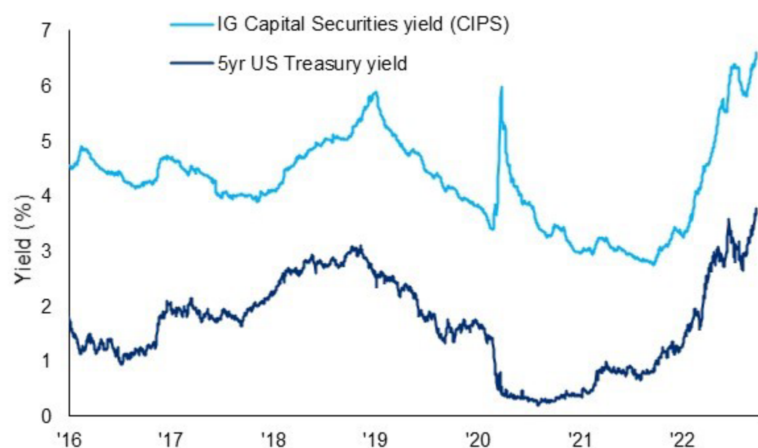
Despite their very short interest-rate reset periods, VRDNs carry the same credit risk as longer-dated bonds issued by a given municipal entity.

Floating/Short-callable Preferred Securities

Preferred securities are an interesting idea to seek additional yield to suitable portfolios. These securities are typically issued by banks, utilities and insurance companies. They usually are subordinated in payment rank to the debt of the issuer, and rank just above equity. By design, a large majority of the global preferred security market does not have a maturity date. However, certain variable-rate preferred securities tend to display relatively lower durations versus long-dated bonds due to embedded issuer call options. In simpler terms, an issuer has the right to return principal to a preferred investor on a future pre-determined call date. If the issuer chooses not to return principal at that time, future coupon payments would then either become floating, or would be reset at prevailing Treasury yields (depending on the particular preferred). The large rise in Treasury yield has created a yield opportunity in short-callable variable-rate preferreds, or even preferreds that are already floating.

The current investment grade index yield for this asset class is almost 6.70%, with a duration of less than 4 years (Figure 9). Preferreds can be accessed both individually and through funds.

Figure 9: US IG-rated preferreds yield



Source: Bloomberg as of September 22, 2022. Past performance is not indicative of future results.

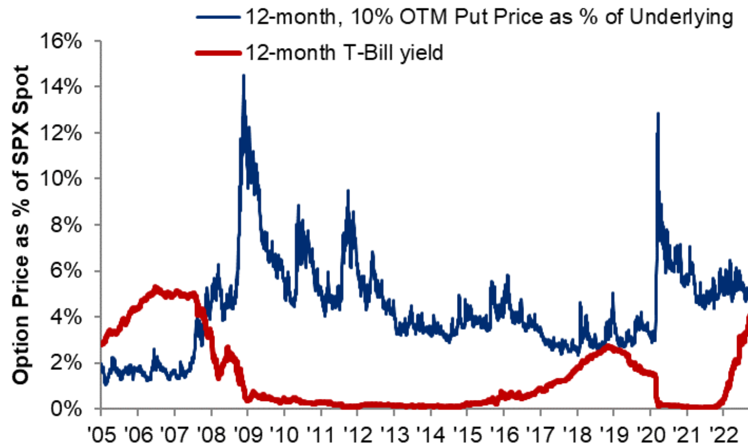
Using Volatility as a Strategy to Seek to Enhance Income

For suitable clients, expectations for persistent volatility in the months ahead can be used to seek income beyond what is available in traditional fixed income. For example, this can be achieved by selling a hedge to another investor against a predefined market action such as falling share prices or higher interest rates in exchange for an "insurance" premium. In the current environment, 15-year highs in short-term interest rates can be combined with this elevated implied volatility to create potential payouts with limited downside risk and a pre-defined upside or income stream.

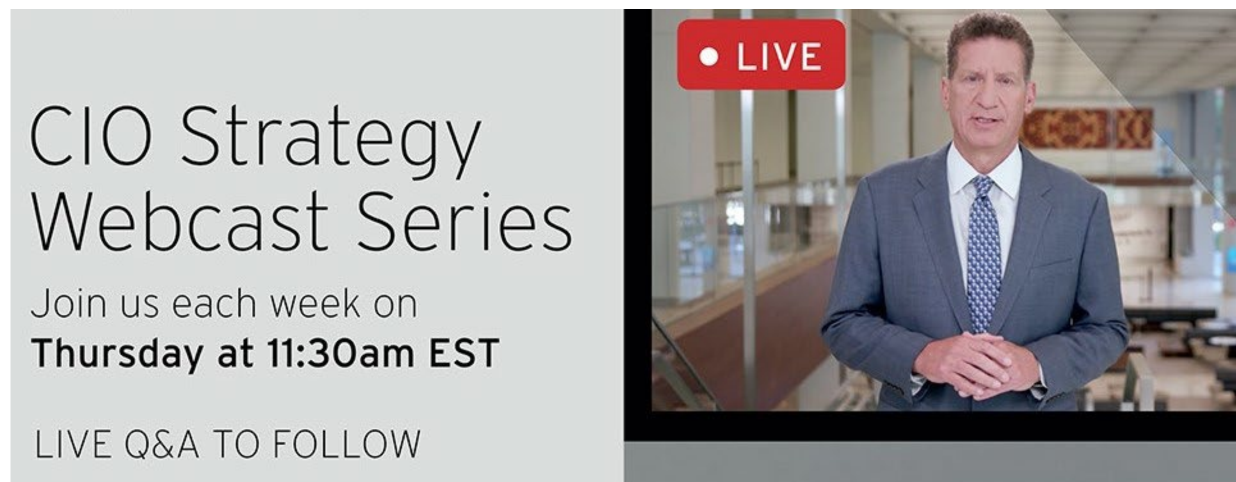
On the equity side, our macro-outlook suggests that the next 6 months of equity returns remain highly uncertain, though we do not expect a severe collapse in markets akin to the 2007-08 period. For the time being, we believe there can be better risk/reward in strategies that can shield principal loss while generating income (see figure 10). With the market pricing an elevated cost for buying protection out over

the next year or two, this creates potential opportunities for suitable investors to earn a fixed coupon or use those funds to strategically accumulate positions in equities if dips occur. Of course, there are downside risks including loss of principal or changes to issuer credit quality, which should be understood before considering any strategy.

Figure 10: Implied Yield on Selling S&P 500 Downside Protection vs US Treasury Bill Yield



Source: Bloomberg as of September 22, 2022. Past performance is not indicative of future results. 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.



Join us each week on Thursday at 11:30am EST for a conversation with senior investment professionals and external thought leaders on timely market events and ask your most pressing questions.

Register now

DISCLOSURES

This email contains promotional materials. If you do not wish to receive any further promotional emails from Citi Global Wealth Investments, please email **donotspam@citi.com** with "UNSUBSCRIBE" in the subject line. Email is not a secure environment; therefore, do not use email to communicate any information that is confidential such as your account number or social security number.

This Communication is prepared by Citi Global Wealth Investments ("CGWI") which is comprised of the Investments and Capital Markets capabilities of Citi Private Bank, Citi Personal Wealth Management and International Personal Bank U.S.

Citi Private Bank and Citi Personal Wealth Management are businesses of Citigroup Inc. ("Citigroup"), which provide clients access to a broad array of products and services available through bank and non-bank affiliates of Citigroup. Not all products and services are provided by all affiliates or are available at all locations. In the U.S., investment products and services are provided by Citigroup Global Markets Inc. ("CGMI"), member FINRA and SIPC, and Citi Private Advisory, LLC ("Citi Advisory"), member FINRA and SIPC. CGMI accounts are carried by Pershing LLC, member FINRA, NYSE, SIPC. Citi Advisory acts as distributor of certain alternative investment products to clients of Citi Private Bank. Insurance is offered by Citi Personal Wealth Management through Citigroup Life Agency LLC ("CLA"). In California, CLA does business as Citigroup Life Insurance Agency, LLC (license number 0G56746). CGMI, Citi Advisory, CLA and Citibank, N.A. are affiliated companies under the common control of Citigroup. Outside the U.S., investment products and services are provided by other Citigroup affiliates. Investment Management services (including portfolio management) are available through CGMI, Citi Advisory, Citibank, N.A. and other affiliated advisory businesses. These Citigroup affiliates, including Citi Advisory, will be compensated for the respective investment management, advisory, administrative, distribution and placement services they may provide.

International Personal Bank U.S. ("IPB U.S."), is a business of Citigroup which provides its clients access to a broad array of products and services available through Citigroup, its bank and non-bank affiliates worldwide (collectively, "Citi"). Through IPB U.S. prospects and clients have access to the Citigold® Private Client International, Citigold® International, International Personal, Citi Global Executive Preferred, and Citi Global Executive Account Packages. Investment products and services are made available through Citi Personal Investments International ("CPII"), a business of Citigroup which offers securities through CGMI, member FINRA and SIPC, an investment advisor and broker–dealer registered with the Securities and Exchange Commission. CGMI investment accounts are carried by Pershing LLC, member FINRA, NYSE, and SIPC. Insurance is offered by CPII through CLA. In California, CLA does business as Citigroup Life Insurance Agency, LLC (license number 0G56746). Citibank N.A., CGMI, and CLA are affiliated companies under common control of Citigroup Inc.

Read additional Important Information

Past performance is not indicative of future results. Real results may vary.

Citi and its employees are not in the business of providing, and do not provide, tax or legal advice to any taxpayer outside Citi. Any statement in this Communication regarding tax matters is not intended or written to be used, and cannot be used or relied upon, by any taxpayer for the purpose of avoiding tax penalties. Any such taxpayer should seek advice based on the taxpayer's particular circumstances from an independent tax advisor.

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.

Important information, including information relating to risk considerations can be found in the link above.

Views, opinions and estimates expressed herein may differ from the opinions expressed by other Citi businesses or affiliates, and are not intended to be a forecast of future events, a guarantee of future results, or investment advice, and are subject to change without notice based on market and other conditions. Citi is under no duty to update this presentation and accepts no liability for any loss (whether direct, indirect or consequential) that may arise from any use of the information contained in or derived from this presentation.

© 2022 Citigroup Inc., All Rights Reserved. Citi, Citi and Arc Design and other marks used herein are service marks of Citigroup Inc. or its affiliates, used and registered throughout the world.

INVESTMENT PRODUCTS: NOT FDIC INSURED · NOT CDIC INSURED ·
NOT GOVERNMENT INSURED · NO BANK GUARANTEE · MAY LOSE VALUE