



CIO Strategy Bulletin

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When Zero is Not Enough

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- **With help from Friday's "mere" quarter million job gains, long-term US yields have risen only half as much as they did in the immediate aftermath of the Global Financial Crisis. We believe the largest reason yields have not risen faster is the near-record level of COVID infections globally, in spite of vaccine success in developed markets.**
- **In our view, it is only a matter of time and vaccinations before the global recovery accelerates and we expect bond yields to reflect a substantial change in economic activity.**
- **We find ourselves in general disagreement with both sides of the present "consensus" views regarding rates. Specifically, we believe that bond markets are underestimating the coming strength of the economic recovery and overestimating the intermediate rate of inflation. The net effect, in our view, is a potential yield of 2.0% for the 10-year US Treasury by year end, and 2.5% during the coming couple years of expansion.**
- **A 2.5% nominal US Treasury yield would only equal the inflation rate of the coming 10 years based on trading data from inflation-linked US bonds. This is unusual as the US has not previously sustained long periods with real yields below zero. We also believe that a 2.5% 10-year is unlikely to hamper the expansion, but will continue to challenge valuations of growth equities and speculative investments.**
- **We need to position portfolios that can be damaged by zero or negative real yields in the US. The Fed will almost certainly stay true to its promise of lagging behind inflation while tightening less than in recent decades. Therefore, we remain underweight in fixed income, but increase holdings of less interest rate sensitive securities such as floating rate bank loans. We also reduced global small- and mid-cap shares, which tend to outperform only at the start of economic recoveries, but continue to favor global healthcare and its steady growth in sales and profits.**

World Interest Rates Are "Handcuffed to COVID"

Friday's employment data – which showed a disappointing 266,000 net new US jobs – was a dose of oxygen for bonds. This followed the development of a near-term view that the US administration's prodigious spending plans would be matched by tax hikes thus mitigating future rate hikes. Bondholders who had seen deep mark-to-market losses on their holdings were relieved, though we believe that relief may be short-lived.

Fears of inflation have been on the other side of the rates tug-of-war. As we discussed last week ([Earnings and the End of Euphoria](#)), we don't believe supply-side distortions and surging commodity prices will single-handedly generate lasting, self-reinforcing inflation.

As figure 1 shows, long-term US Treasury yields have moved higher relative to the Fed's policy rate, which is being held zero for an unclear period-of-time. The US has added an average 450,000 jobs per month in 2021 inclusive of the most recent report. This is about twice the average gain in prior recoveries. With COVID losing its grip and vaccinations of school children ahead in the foreseeable future, the conditions for further large gains in employment are falling into place.

In the first quarter, US real GDP grew 6.4%. Current quarter estimates are *above* that pace. Further, the now strong distribution of vaccines in the US and Europe will be followed by improvements globally. Indicators of growth point to gains in economic output lasting well beyond a "growth spurt." And we see above-trend growth and employment gains that could persist for two-to-three years. Thus, there are many reasons to believe that crisis-level interest rates won't persist.

We do not expect a sustained surge in inflation after the coming year's expected jump in prices. Price increases due to supply-side distortions and surging commodity prices will likely be transitory. We expect that the Fed will almost certainly stay true to its promise of lagging behind inflation while tightening less than in recent decades. Therefore, we expect a steeper yield curve that will most certainly benefit equities like financials, and favor certain fixed instruments, such as variable rate loans, over long-duration bonds.

We, therefore, find ourselves in general disagreement with both sides of the present "consensus" views regarding rates. Specifically, we believe that bond markets are underestimating the coming strength of the economic recovery and overestimating the intermediate rate of inflation. The net effect, in our view, is a potential yield of 2.0% for the 10-year US Treasury by year end, and 2.5% during the coming couple years of expansion.

Looking Back at the Last Recovery: What's Different Now?

Long-term yields rose 200 basis points in the early stages of recovery from the Global Financial Crisis of 2008/2009. Why should rates in this recovery rise by only half as much? While there are many good "small" explanations, the likely largest factor appears to be temporary, the dismal state of COVID in the world (see figure 2). With global COVID infection rates only showing hints of peaking from a record high level, most of the world's population cannot foresee an end to crisis in the same tangible way US and UK citizens can. Present markets reflect this view.

Figure 1: US 10-Year Treasury Yield Less Fed Funds Rate

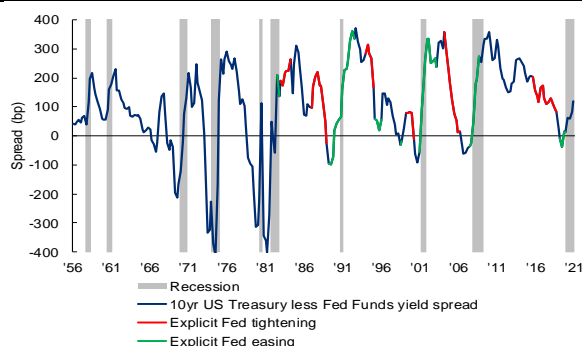
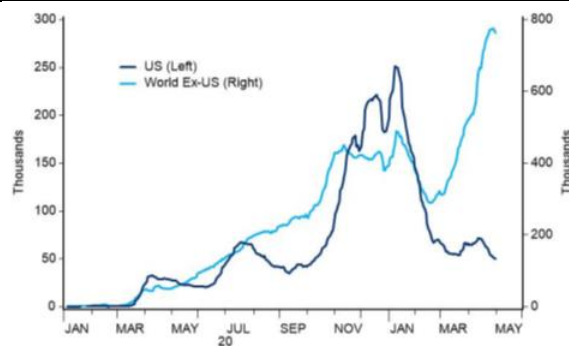


Figure 2: COVID Infection Rates: Global (Ex-US) vs US



Source: Haver Analytics as of May 6, 2021. Past performance is no guarantee of future results. Real results may vary.

The scope of US stimulus and a rapid improvement in the pace of vaccinations has clearly focused investors on the US and its prospects for growth outperformance. We expect the US economy to outpace global growth by a full percentage point in 2021 before the world catches up in 2022. (That is also the time when the peak impact of US stimulus should be fading).

The simplest reason for our global optimism in 2022 is that human biology is not determined by political borders. It is more likely that vaccination rates will rise markedly before a variant that does not respond to the vaccines arises. Until then, the premium value of US bonds hedged into other currencies suggests global inflows into US fixed income. Along with regionalized economic weakness away from the US, this presently *constrains* US yields, moderating the steepening of the yield curve in our view (see figures 3-6).

Figure 3: Japanese Government Bond Yield vs US Treasury Yield Hedged into Yen

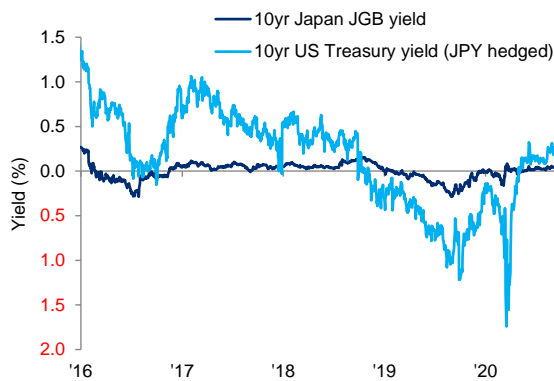
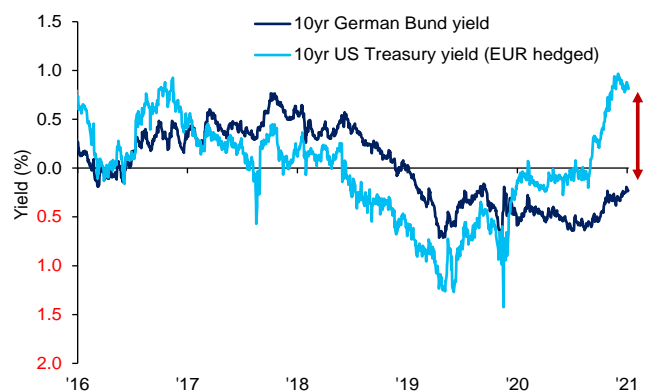


Figure 4: German Government Bond Yield vs US Treasury Yield Hedged into Euros

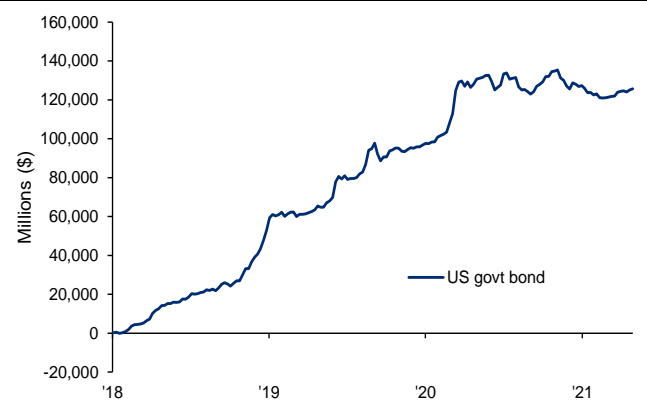


Source: Bloomberg as of May 6, 2021. Past performance is no guarantee of future results. Real results may vary.

Figure 5: Total Foreign & Official Holdings of US Treasuries



Figure 6: Cumulative Fund Flows into US Government Bonds



Source: Haver Analytics, Emerging Portfolio Fund Research (EPFR) as of May 6, 2021.

US Treasury Secretary Yellen said something we believed obvious last week: “It may be that interest rates will have to rise somewhat to make sure our economy doesn’t overheat.” Yellen’s comments came in a discussion of the impact of the Biden administration’s spending and tax plans, which amount to roughly 2% of GDP annually over the remainder of the decade. Yellen was (ironically) criticized for “crossing the line” with views that could be twisted to challenge the Fed’s independence.

The administration’s fiscal plans – which bear significant legislative uncertainty – are meaningful tools of redistribution in the economy, but not the largest of the reasons we expect a strong recovery. Among them are an easing of financial conditions beyond financial markets, to lending activity (see figure 7). And as such, we don’t believe that crisis-level interest rates will persist, as long as, they did in the last economic cycle.

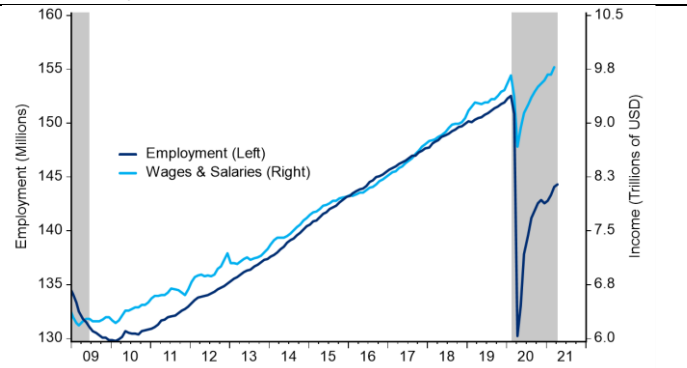
Economic bears can highlight a “fiscal cliff” ahead as direct income supports such as the \$1400 checks to households in the first quarter 2021 won’t be repeated. They also cite the administration’s plan for higher taxes as a headwind. We think these arguments are thin. The US economy held up well in 2020, a period that contained 10 white-knuckle months during which US households did not receive direct income support beyond unemployment. And the administration’s plan for higher taxes is highly concentrated among few payers, those whose spending will be least impacted by tax rates.

Let’s look at the cold data. Millions are now poised to be re-employed as the economy reopens (see figure 8). Even more striking is the fact that the bulk of the government transfers (stimulus payments) have yet to be spent (see figures 9-10). This suggests both a broadening of consumer spending in a reopening economy and *reduced downside risks* to spending.

Figure 7: Share of US Banks Easing Lending Standards for Commercial and Industrial Loans vs S&P 500 EPS



Figure 8: Total US Wage Payments from Employment vs Total Employment (Jobs)



Source: Haver Analytics as of May 7, 2021. 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. Grey shaded areas represent recessions.

Figure 9: US Personal Savings Rate

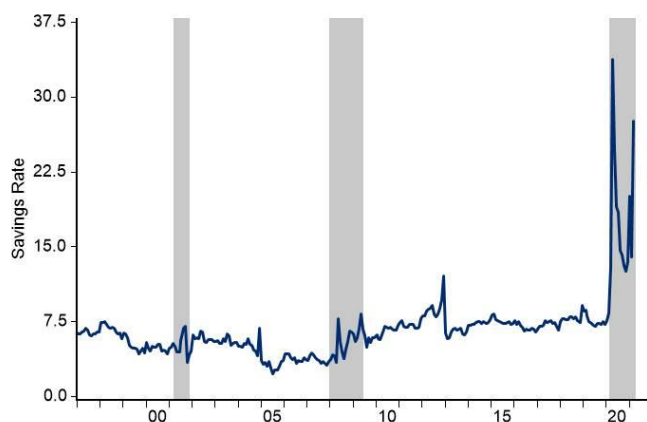
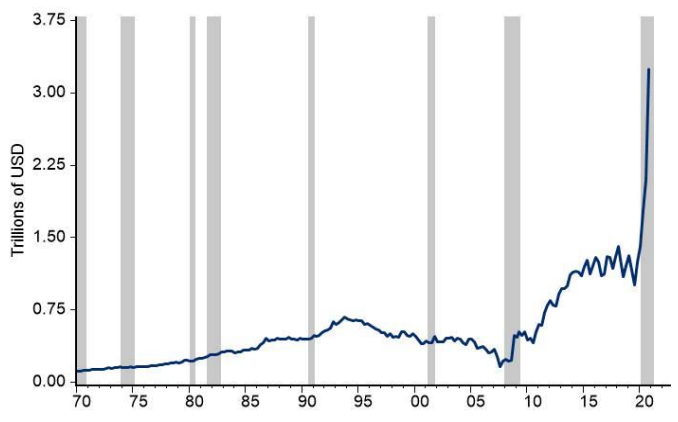


Figure 10: Cash and Cash Equivalent Liquid Assets: US Households



Source: Haver Analytics as of May 6, 2021. Grey shaded areas represent recessions.

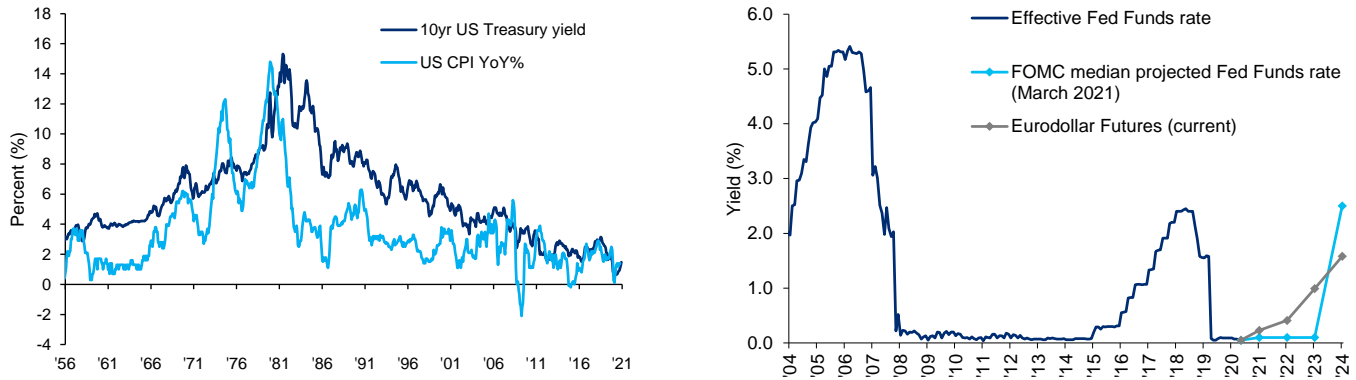
Rates and Inflation at a Turning Point

Decades of falling inflation and declining real bond yields cannot be repeated (see figure 11). At the same time, as we noted on March 7 ([Rates, Recovery and Resolve](#)), history is full of short-lived rate spikes since the “Great Inflation” of the 1970s was shut down as a result of severe Fed tightening in the early 1980s. With that said, a secular *end to disinflation* seems likely.

US policy rates are zero and will most likely stay at zero for all of 2021. Yet, as we discussed in the [March Quadrant From Rescue to Rescue](#), Fed Chair Powell and other officials have begun to downplay the significance of Fed forecasts for policy rates to stay at zero through all of 2023. They forecast a strong US economic recovery. They have not, however, forecast a path for short-term interest rates that is *consistent with that view*. In other words, the Fed is not likely to change policy until a strong, full recovery is well underway.

After such large policy steps in 2020, even a small adjustment to US monetary policy may shock financial markets. Fortunately enough, the bond market has wisely stopped taking the Fed’s rate guidance literally. You can see this in figure 12 that the market has prices in a small first tightening step late in 2022, two years earlier than the Fed’s infamous “dot plots”. (Also, appropriately in our view, the bond market prices a lower rate than the Fed does looking several years out.)

Figure 11: US 10-Year Treasury Yield vs Annual CPI Inflation **Figure 12: Market Expected Fed Funds Rate vs Actual**



Source: Haver Analytics, FactSet, Federal Reserve as of May 6, 2021. All forecasts are expressions of opinion and are subject to change without notice and are not intended to be a guarantee of future events. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only. Past performance is no guarantee of future returns. Real results may vary.

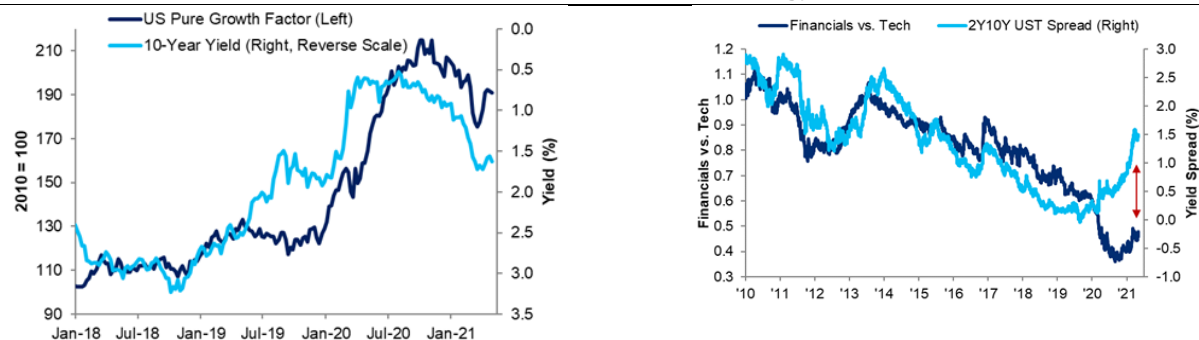
A plausible scenario is that in a year's time, the Fed will be at the earliest stages of planning its exit from a zero interest-rate policy. This will begin first with reductions in the pace of US bond purchases made with newly minted money. If that happens, a sharp slowing in reserve creation will generate turbulence beyond US fixed income. This was last seen during the "taper tantrum" of 2013. The Fed would strongly prefer avoiding a repeat of that episode and possibly slowing the economy more than desired. However, because of the strong influence of the Fed on the appreciation of financial assets, we expect the markets will respond negatively to the change in policy direction, nonetheless.

What Happens as Rates Normalize?

Higher long-term interest rates and early, modest Fed tightening have never ended a US expansion. However, there are certain assets that will be impacted more severely. As figure 13 shows, US growth stocks have clearly benefited from falling interest rates. As discussed in last week's bulletin ([Earnings and the End of Euphoria](#)), their earnings growth and resilience has been extraordinary. In order to overcome higher yields, they will need to demonstrate their ability to grow revenues highly and consistently to sustain valuations.

Traditional bank lending is cyclical, as figure 7 showed. We expect that powerful secular competition from FinTech competitors will hurt smaller lenders who are unable to maintain investment in infrastructure to counter the tech-threat. Nonetheless, the business cycle recovery favors further broad gains for the financial sector in the year ahead (see figure 14).

Figure 13: US 10-Year Treasury Yield vs US Growth Factor Equities Basket **Figure 14: US Yield Curve vs US Financial Sector Relative to Technology**



Source: Haver Analytics as of March 5, 2021. 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. US Pure Growth Factor: Bloomberg US Pure Growth Index. Financials: S&P 500 Financials. Tech: S&P 500 Tech.

Many millions of homeowners are refinancing mortgages to save on payments, but also out of fear of higher rates (see figures 15-16). As discussed in [Outlook 2021](#), the Fed will maintain an easier policy *than seen over the past four decades* in part to assure that debt burdens don't stand in the way of achieving a full recovery. Yet aside from periods of war, there is little precedent for holding nominal long-term US interest rates below the inflation rate.

Figure 15: US Mortgage Refinancing Volume

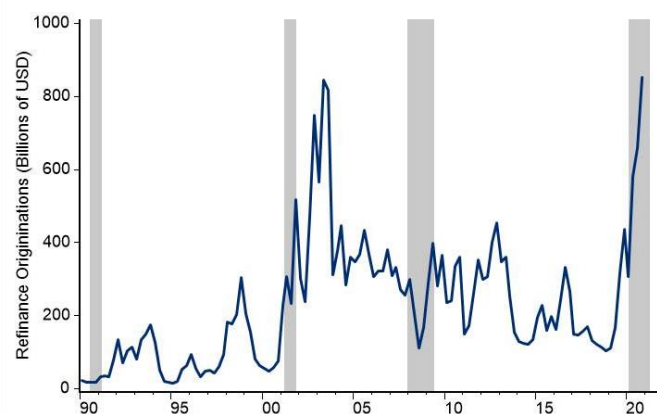
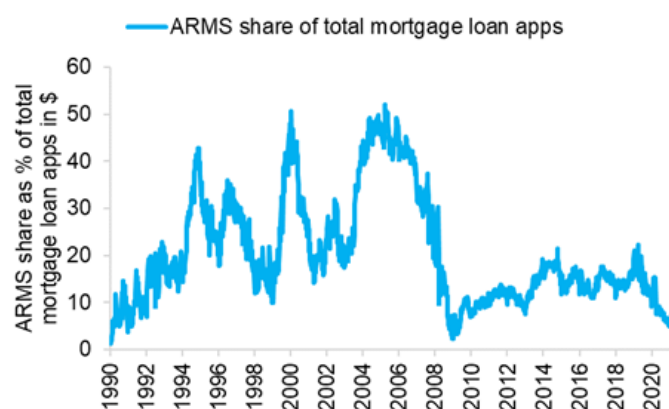


Figure 16: Adjustable Rate Share of US Mortgage Applications



Source: Haver Analytics as of May 6, 2021

Borrow! Borrow!

Borrowing while base policy rates are zero makes ample sense. We still believe the preponderance of evidence supports locking in funding costs and earning higher variable yields when interest rates are this low.

As we discussed in the [April Quadrant Hope, Fear, Opportunity in Divided World Markets](#), we've doubled our exposure to floating rate loans in our medium-risk global portfolios now that yields, spreads, and bond prices in the high yield market have recovered fully (see figure 17). The near-zero duration variable rate loan market will earn the very same yields with far less price variability and risk of depreciation (see figure 18).

Figure 17: US HY vs US Treasury Yield of Similar Duration

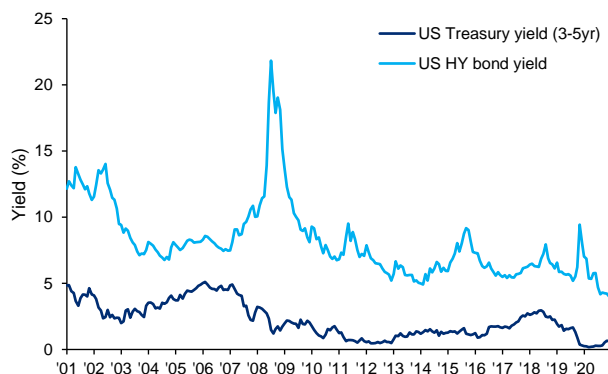
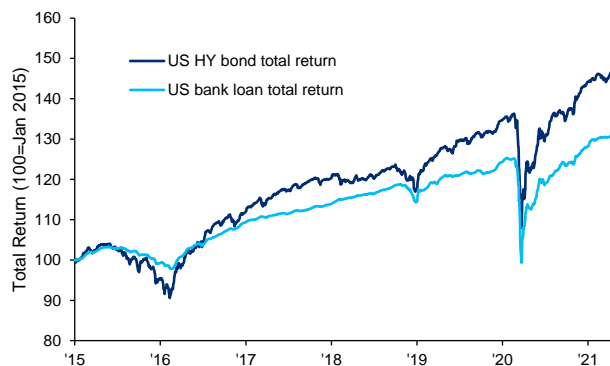


Figure 18: US HY vs US Bank Loan, Total Return



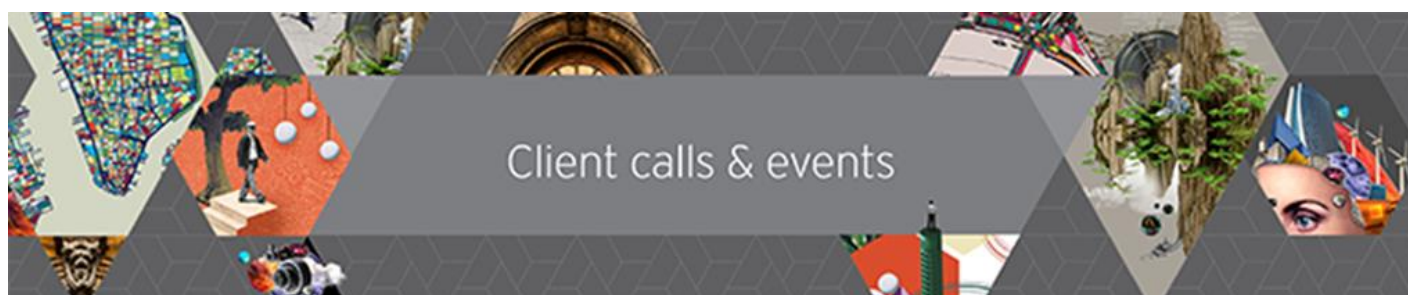
Source: Bloomberg Barclays Indices, S&P as of May 6, 2021. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Past performance is no guarantee of future results. Real results may vary.

Investor Considerations

With a strong global recovery and a rising rate environment in mind, we would like to re-iterate some prior conclusions.

1. Given our views on rates, we are staying underweight in bonds. We are adding to less interest rate sensitive securities such as floating rate bank loans.
2. We believe borrowers should lock in financing consistent with the Fed's zero policy rate. The US central bank will not follow Europe to negative deposit rates.

3. We expect market volatility as the economic recovery accelerates. Just as employment data surprised to the downside this week – and markets rallied – it is as likely that employment and economic data will surprise to the upside – and markets may fall. That said, the trajectory of equities should tilt higher. We've upgraded equity portfolio quality already by reducing cyclicals with poor balance sheets in the SMID sector.
4. Mean reversion is likely to persist. Thus, we advise investors continue to favor COVID-cyclicals¹, non-US equities and dividend growth shares even in the face of volatility and rising rates. We would add to US growth equities once their valuations reflect further normalization in US long-term yields.



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¹ COVID-cyclicals: Financials, industrials, energy, materials, real estate, consumer discretionary ex-Amazon