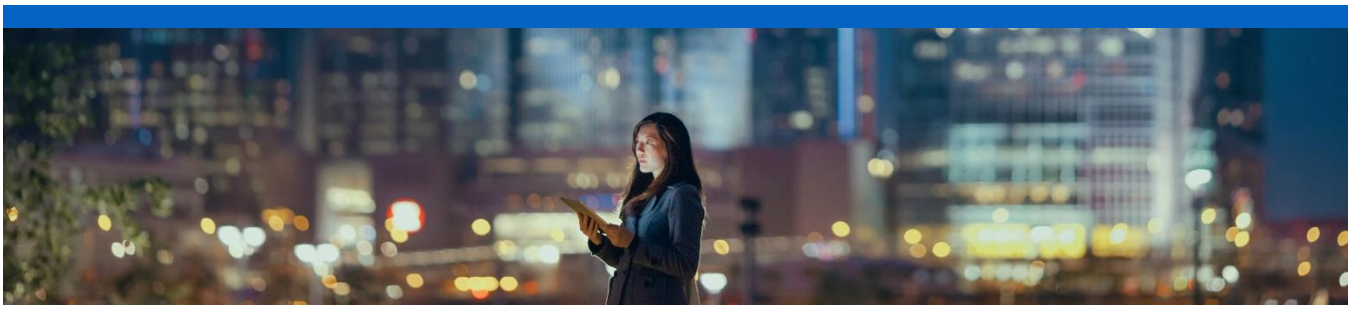
Citi Global Wealth Investments



June 19, 2022

CIO Strategy Bulletin

THE FED'S EMERGENCY ROOM

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SUMMARY

- We have raised the forecast of recession in 2023 to 40% from 35%. This is barely below the 45% we assign to the "resilient" scenario of slow growth and gradual deceleration in inflation over the course of 2022-2023. (Please see more information about the probability scenarios in this Bulletin.)
- The only way for markets to recover quickly is for recession to be definitively avoided. We do not believe that inflation will fall fast enough for the Fed to recognize the cumulative impact of its actions in time to moderate its policies. Thus, the likelihood that the Fed will swerve away from a dangerous course for the economy appears to be falling.
- Pro-cyclical Fed policy warrants higher US fixed income allocations and cautious equity positioning. As such, and despite the sharp correction so far this year, we've chosen to keep our tactical focus on high-quality US fixed income and equities with the strongest dividend yields in industries with robust durable demand.
- We believe US investment grade bond yields offer a more compelling return for the economic environment ahead. Those sitting on the sidelines may be sorely disappointed that their uninvested cash never catches up.

AN INFLATIONARY TRIP TO THE "ER"

During COVID, policy makers faced great pressure to "rescue" the economy. And as the severity of the pandemic worsened, people were impatient for fast results. In 2020-21, new rescue measures were added faster than the impact of the initial stimulus steps could even be felt.

In mid-2022, the “mirror image” reaction to high inflation is quite similar. Just as the Fed made its largest rate increase in nearly 30 years, analysts watching stocks and bonds decline together thought, “perhaps it was not large enough.” So much for patience.

The problem with these mirror images is that it is far easier to reduce rates than to raise them. For most of US history, raising rates has been done gently, because monetary policy actions impact the economy with a significant lag. It is a “shot in the dark.” Knowing what interest rate policy is right for the future is far more difficult than assessing current conditions.

Typically, the Fed watches data carefully and considers this forward-looking impact. With so much of the present mismatch in supply/demand out of the Fed’s control, for it to be the cause of a major recession would be both unusual and undesirable.

PRIMUM NON NOCERE (FIRST, DO NO HARM)

Upon admittance to an emergency room, the first step of the physician is known as triage, a determination of the urgency of the need for treatment and the nature of the treatment required. The “ER” is the place to address the immediate critical conditions, stabilize the situation and set the patient on the right path to health. Of course, the ER is also no place to cause further harm to the patient.

With the US and global economy as its patient, the Fed has determined that its illness – high inflation – is quite severe and the need for immediate and sustained intervention is great. The medicine, a 75-basis-point rate hike (the largest since 1994) and two additional doses (a 50- or 75-basis-point hike next month and September) has been sent into the veins of our economy. It is a “broad spectrum” and in many ways, non-selective medicine, with a systemic blunt effect, raising the cost of capital to restrain the economy to reduce demand that then reduces inflation. It is also a medicine that takes time to work and can have severe side effects.

PATIENT ASSESSMENT

There is no doubt that high inflation is a serious disease, undermining economic health by harming purchasing power. This in turn weakens real consumer spending, production and employment. But more insidious, the uncertainty and volatility it generates can weaken long-term investment and “feed on itself” with greater wage and business costs, slowing *trend* economic growth. At present, the CPI is running at 8.6% with the Fed’s preferred measure, the Personal Consumption Expenditures Deflator, also running high at 6.3%. Unlike the CPI, which changes very slowly in composition, the PCE deflator measures prices of what consumers buy in a flexible basket. (For example, if beef becomes too expensive, consumers might buy chicken if the price isn’t rising as fast.)

But when looking at the source of the patient’s duress, one must assess whether it is internal or environmental. In our view, several major elements of today’s inflation are external. Food and energy supplies disrupted by the war in Ukraine are generating upward price pressures and human suffering for those with the least secure household budgets. Transportation and logistics seem to be the larger part of the shock rather than actual output losses in both Russia and Ukraine. In theory, these issues could resolve more quickly than a permanent loss of productive capacity. But futures markets assume a level of lower prices in any case (see Figure 1).

One new inflationary symptom, a major jump in rents due the impact of higher mortgage rates, is a side-effect of the initial does of the Fed medicine itself. In contrast, the typical internal symptoms of inflation, higher wages and excessive demand (an overheated economic “fever”) are less evident today.

In our view, the Fed has underestimated meaningful evidence of healing already underway. These include:

- Real consumer spending is decelerating overall. Real retail sales fell in both April and May. This will lead to slowing labor demand over time.
- The idea that there is a sustained labor shortage is overstated. Unfilled job openings were near record highs just as the US economy entered recessions in 2008 and 2020. Powell's assertion that there were twice as many unfilled positions as job seekers ignores how easy it has become to post jobs that may never be filled.
- US wages have risen just half as much as prices in the year-to-date, supporting the view that labor is not "the issue."
- Home sales are falling at a double-digit rate as affordability deteriorates. Long-term US mortgage rates have jumped from 3.3% to 6.1% this year alone due to the Fed's rate pre-announcements. (A sad and ironic consequence of the sharp drop in housing affordability, the Consumer Price Index for rent is pushing higher as potential homebuyers are forced to rent instead.)
- Pandemic supply shocks are abating. US production is rebounding and imports are rising, both of which will reverse the consumer goods shortages of 2021 (see Figure 2). In a few weeks, US retailers will be marking down lots of merchandise. They have already issued profit warnings.

All of these suggest that the more flexible elements of inflation will, over time, come down.

Figure 1: Global oil, wheat, German natural gas and steel futures equal weighted indexed to February 2023

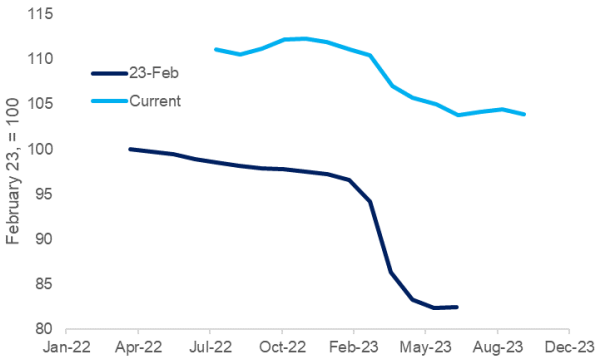
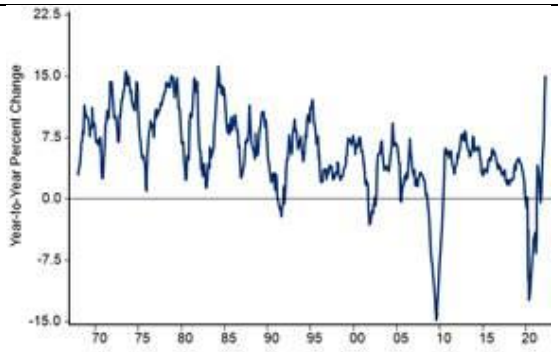


Figure 2: US Retailer Inventories Y/Y%



Source: Haver Analytics, Factset, Bloomberg as of June 16, 2022. Note: Brent, Wheat, German Natural Gas and Steel futures basket is comprised of futures contracts with delivery through 2024, are equal weighted and indexed to Feb 2023; the day before the start of the war was set to 100 for each asset. 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 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 may vary.

TOUGH CHOICES

We grant that exhibiting patience to allow for higher rates to generate a meaningful slowdown in demand and to allow competitive market forces time to bring down inflation gradually is not ideal. Gradual action plans can allow inflation expectations to rise, requiring a more sustained period of tighter monetary policy to bring down inflation.

However, in our view, a recessionary loss of millions of jobs – bringing weaker demand and weaker supply together – seems an even worse approach given the nature of this inflation. In fact, there is some Orwellian "doublethink" happening here. On the one hand, Powell says he wants to protect workers and yet he is well aware that the aggressiveness of the Fed's policies and demand-crushing nature of rapidly higher rates can cause employment to fall mightily, with a lag.

The peak impact of expected Fed tightening will be felt most severely in 12-18 months. Rapid tightening steps will lead to material economic weakness in the year ahead, rather than immediately. Here's what he said in August 2021: "The main influence of monetary policy on inflation can come after a lag of a year or more. If a central bank tightens policy in response to factors that turn out to be temporary, the main policy effects are likely to arrive after the need has passed." ("Monetary Policy in the Time of COVID," Aug. 27, 2021).

We have raised the odds of recession in 2023 to 40% from 35%. This is barely below the 45% we assign to the "resilient" scenario of slow growth and gradual deceleration in inflation over the course of 2022-2023 (see our CIO bulletins of March 27 and May 29).

We do not believe that inflation will fall fast enough for the Fed to recognize the cumulative impact of its actions in time to moderate its policies. Thus, the likelihood that the Fed will swerve away from a dangerous course for the economy seems to be falling.

MARKET REACTION

Investors get to assess the actions of the doctor in the ER. And the market's assessment of the patient's condition and of the treatment applied is unfavorable. Risk assets continued to fall in tandem, rates volatility remained high, while the US dollar stood near its 20-year high. For the week, global stocks fell nearly 6%, 10-year Treasuries rose 30 basis points before almost fully retracing, while high yield credit spreads widened.

We believe the only way markets recover quickly is to avoid a recession in the first place. This would require recognition from the Fed that inflation can only be reduced gradually. And this seems unlikely before September's FOMC meeting.

RESILIENT OR RECESSION?

As we discuss in our Mid-Year Outlook, life isn't as easy after a boom. Market losses "invalidate" a sizeable share of the investment gains achieved in boom times. And the lags between policy and economic activity suggest that recovery from recession is too far off for investors to discount effectively. Yet investors need to endure, not self-destruct.

It is hard for investors or market analysts to know whether the Fed will cause a recession or pause and avoid one. But what is clear is that investor uncertainty would be *reduced* by the actuality of recession, a definite period when fundamentals are depressed and poised to recover, such as 2Q 2020. This is the case even if financial market losses were faster and deeper initially (see our latest *Quadrant* for discussion).

The RESILIENT scenario requires that the Fed and some other central banks pause in September and then decide to swerve from their present course based on the future impact their bolus of medicine will likely cause.

WISE ASSET ALLOCATION

We reiterate our current asset allocation, 2% overweight global equities including a 4% overweight to commodity producers and oil services shares (thus -2% for other shares). Fixed Income and cash are 4% underweight. However, US fixed income is about 6.5% overweight as our FI underweight remains focused on very low-yielding Japanese and European government bonds (-10%). Belatedly, European bond markets are dropping sharply as the ECB and others prepare to exit negative interest rate policy.

We are maintaining our allocation to natural resources. Looking forward, we will need to carefully assess commodity price risks on the potential for weakening global demand. However, very broad supply

disruptions remain from the conflict in Eastern Europe and alternatives to Russian output remain in high demand.

WHAT DOES ONE DO? START WITH "BONDS ARE BACK"

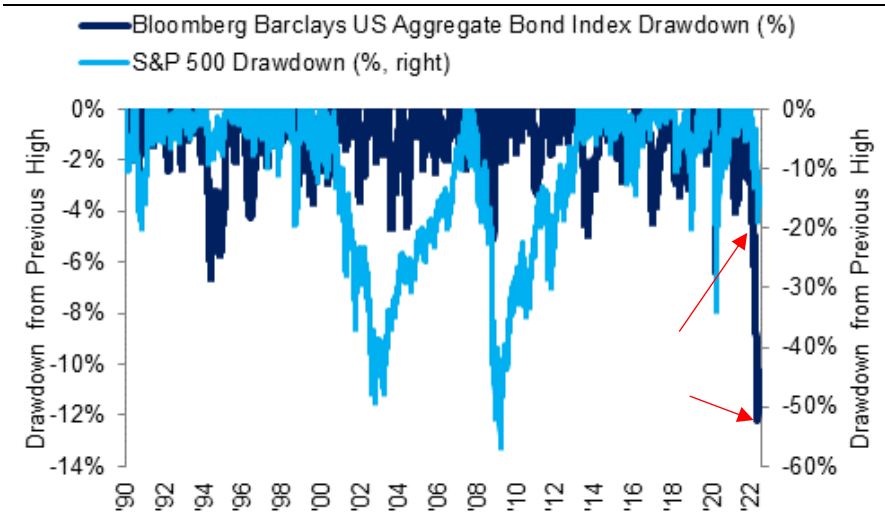
As our Global Investment Committee met last week, we saw rather severe and rapid declines in world financial markets, but found no advantage in changing our very diversified allocations that focus on income generation from higher quality equities and bonds.

"Pro-cyclical" Fed tightening argues for higher US fixed income allocations and cautious equity positioning. We continue to believe broader financial markets cannot find stability until interest rate markets define a range.

With this in mind, despite the steep correction to date, we have chosen to keep our tactical focus on high-quality US fixed income and equities with strong dividend delivery in industries with the most durable demand.

As of mid-2021, US Treasury yields had already doubled from the crisis-period lows. After another doubling in yields, the losses suffered in the bond market suggest that this is a time to invest (see Figure 3).

Figure 3: US stock and bond drawdowns from previous peak



Source: FactSet, Bloomberg as of June 16, 2022. Red arrows illustrate amount of drawdown for S&P 500 index and Bloomberg Barclays US Aggregate Bond Index since their previous highs – around 18% and 12%, respectively. Past performance is no guarantee of future returns. Real results may vary. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only.

We value the newly competitive investment yields offered in US fixed income markets (see Figures 4-5). The 200-basis-point rise in US investment grade bond yields offers a more compelling return for the economic environment ahead. Those sitting on the sidelines may be sorely disappointed that their cash on the sidelines never catches up (see Figure 6). In the past two decades, cash deposit rates peaked about 150 basis points below the Fed's policy rate on average.

Figure 4: Municipal bond yields

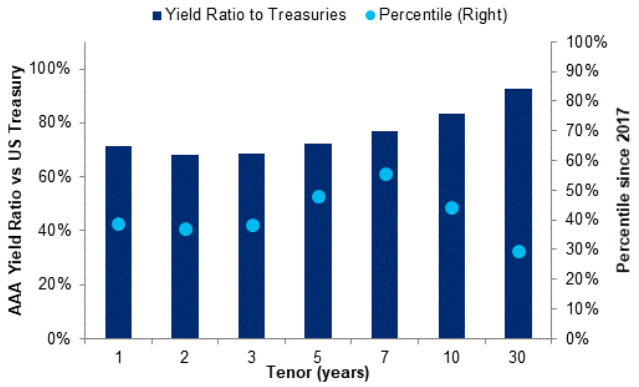
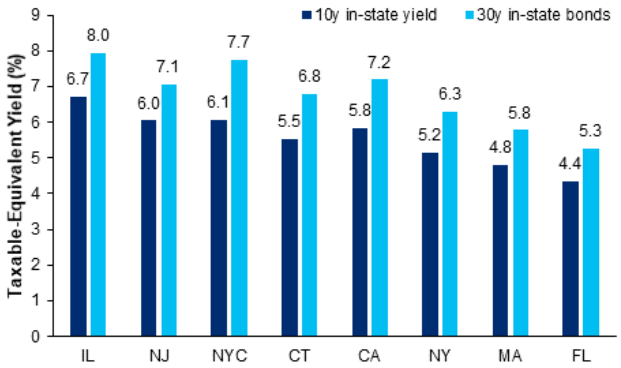
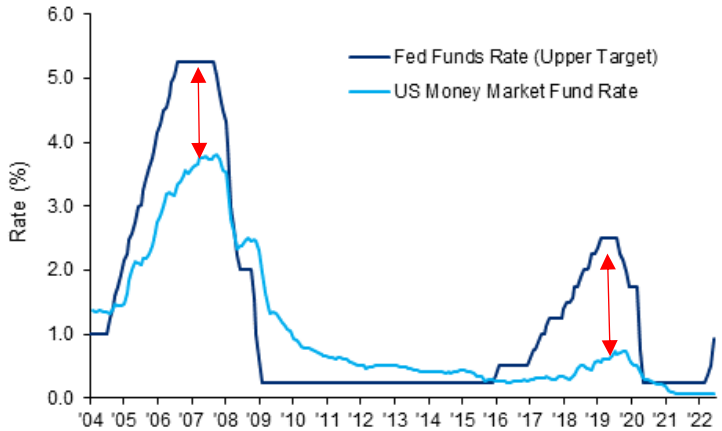


Figure 5: Muni bonds tax equivalent yields



Source: FactSet, Bloomberg as of June 16, 2022. Past performance is no guarantee of future returns. Real results may vary. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only.

Figure 6: Fed Funds Target vs Money Funds Yield



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WHAT DOES ONE AVOID

Staying deeply underweight European bonds (and underweight European equities) may deliver outperformance within our tactical asset allocation. Global small and mid-caps, where we are significantly underweight, have fallen more than global dividend growers – our largest overweight. But avoiding larger losses is not the same thing as delivering gains.

WHEN ONE WOULD BUY MORE EQUITIES

Historically, future equity returns are strongly enhanced after a 20% decline, and particularly a 30% decline (see figures 7-8 and the updated long-term return estimates in Mid-Year Outlook).

Note that in a recession scenario, the timing of an economic recovery is still in the distance. Equities typically rise six months before gains in profits. But today, corporate profits have yet to fall. Thus, patience will be required from equity investors to capture future rebounds.

Figure 7: S&P 500 Returns Measures from -20% Threshold: 64% of 12-Month Returns are Above Zero

Date First Hit -20%	Forward 12 month return	Forward 2 Year Return	Forward 3 Year Return	Forward 5 Year Return
9/9/1946	-1%	7%	3%	57%
10/21/1957	31%	44%	38%	40%
5/28/1962	26%	45%	58%	63%
8/29/1966	25%	33%	27%	34%
1/29/1970	12%	21%	35%	-11%
11/27/1973	-27%	-5%	8%	-1%
2/22/1982	30%	38%	61%	153%
10/19/1987	24%	52%	36%	85%
3/12/2001	-1%	-32%	-6%	9%
7/9/2008	-29%	-13%	6%	33%
3/12/2020	59%	68%		
Average	**14%**	**23%**	**27%**	**46%**
Median	**24%**	**33%**	**31%**	**37%**
Max	**59%**	**68%**	**61%**	**153%**
Min	**-29%**	**-32%**	**-6%**	**-11%**
% Positive	*63.6%*	*72.7%*	*90.0%*	*80.0%*

Figure 8: S&P 500 Returns Measures from -30% Threshold: 86% of 12-Month Returns Above Zero

Date	Forward 12 month return	Forward 2 Year Return	Forward 3 Year Return	Forward 5 Year Return
5/14/1970	35%	42%	41%	21%
7/5/1974	12%	24%	19%	24%
10/19/1987	24%	52%	36%	85%
9/17/2001	-16%	-1%	8%	27%
10/6/2008	0%	10%	10%	59%
3/20/2020	71%	96%		
Average	**21%**	**37%**	**23%**	**43%**
Median	**18%**	**33%**	**19%**	**27%**
Max	**71%**	**96%**	**41%**	**85%**
Min	**-16%**	**-1%**	**8%**	**21%**
% Positive	*66.7%*	*83.3%*	*100.0%*	*100.0%*

Source: FactSet, Bloomberg as of June 16, 2022. Past performance is no guarantee of future returns. Real results may vary. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only. 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.

WHEN TECHNOLOGY? WHEN GROWTH?

Ultimately, we expect the powerful interest rate shock of this year to be self-limiting. Both home sales and construction are now falling even as the full impact of the latest sharp rise in mortgage rates has not been fully felt. With the Fed tightening through both reduced lending and higher interest rates, we expect peak rates to be achieved in 2022.

Unlike the period in 2000-2002, even if the US economy contracts, we do not expect a “tech led” recession. It will take some time for investors to regain visibility on EPS trends unless the Fed changes course quickly. However, we would expect the EPS trough for many technology firms to be a “high trough” compared to many cyclical industries. In a recession scenario, there will be some “overshooting” in all shares, but the time to add quality growth shares is likely to come before 2023.

As we discuss in Mid-Year Outlook, investors 20 years ago 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 (see figure 9). Today, we don’t advocate a wild swing toward such investments or away from them.

We will also accumulate 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 (see figure 10)

Figure 9: NASDAQ and Patents Granted

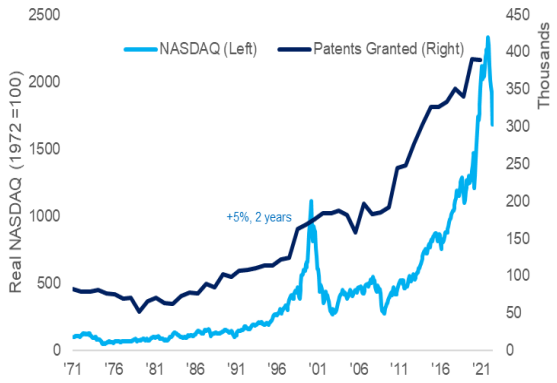
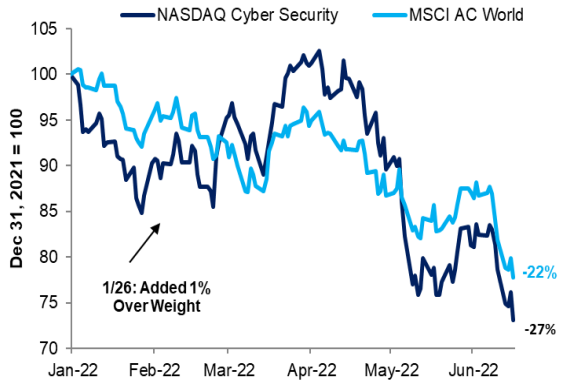


Figure 10: Cyber Security vs MSCI AC World



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