



Citi Global Wealth Investments

October 3, 2021

CIO Strategy Bulletin

Looking Through the Market Noise to 2022

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CIO Bulletin Alert: A Successful Pill to Attack Covid-19 Arrives

Until now, there has been no simple, oral medication to treat Covid-19. On Friday, Merck and Ridgeback Biotherapeutics announced early results of an oral antiviral that reduced the rate of hospitalizations and deaths among newly diagnosed Covid patients by about 50%. More importantly, the drug appeared effective against all prevalent variants of the virus including Gamma, Delta, and Mu.

Molnupiravir is a new class of antiviral drug that creates multiple errors in the virus's RNA and impairs its ability to replicate (Stat News, Oct 1, 2021)¹. According to Stat News, a 5-day course of the drug achieved the following results among patients who had at least one risk factor associated with poor disease outcomes. In the placebo group, 53 patients, or 14.1%, were hospitalized or died, while among those receiving the drug, 28 or 7.3%, were hospitalized or died. The trial was conducted in several countries including Argentina, Italy, Japan, the United Kingdom, and the United States. The drug is named after Mjölnir, the hammer of the Norse thunder god that was used as both a devastating weapon and a divine instrument to provide blessings.

The² early results among 729 patients were so promising that an independent data monitoring committee, in consultation with the FDA, recommended that the study be stopped so as not to injure those in the placebo group unnecessarily. Merck will now seek emergency use authorization for the drug.

In our view, the arrival of an oral medication to treat Covid-19 is a second major step forward in the fight to end the pandemic and could make the virus “treatable”, like the flu. While final studies need to be conducted, Merck is already in discussions with generic drug manufacturers to produce significant quantities of the medicine globally. If affirmed, this development could have significant, positive impacts on the ability of the global economy to “return to normal”.

¹ [Merck's antiviral pill reduces hospitalization of Covid patients, a possible game-changer for treatment;](#)

² [Merck and Ridgeback's Investigational Oral Antiviral Molnupiravir](#)

SUMMARY

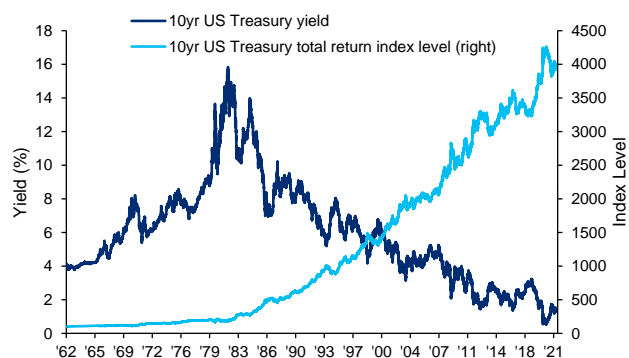
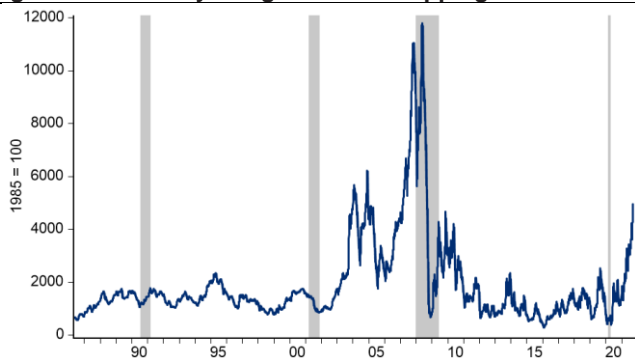
- Right now, global supply chain disruptions are roiling the delivery of goods everywhere, just as the demand for goods relative to services is peaking. Yet, looking ahead, a normalization for most of the economy is likely over the coming year, especially as government stimulus wanes. Near term shipping costs are very high, but we can already see delivery times speeding up. This is a reliable sign of reduced costs to come.
- As the economy rebalances, initial price spikes – including for services – will very likely subside. News of effective new therapeutic COVID treatments makes it more likely that this normalization will fully unfold during 2022. This seems under-appreciated by markets.
- New bond market rate pressures – even if minuscule from a yield level perspective – and the sharp rise in US growth shares has set the equity market up for a rotation similar to the cyclical rally at the start of the year. To the extent that yields rise further, growth stock valuations will be challenged. That's because the US growth index trades at nearly double the valuation of US value shares and international equities in general. But we suggest investors watch the realized EPS growth in certain groups closely. For key growth equity index components such as semiconductors, software and cybersecurity, EPS growth is likely to remain rapid.
- Bond yields below 2% will not inhibit economic growth and are not a major hurdle for equity valuations. Short-term investor repositioning has caused the recent market rotation to cyclicals. We believe that this is likely to reverse as manufacturing and commodity prices peak in the coming year.
- US equities have risen at a 23% annualized rate since COVID struck. We'd expect returns to retreat to the high single digits in the coming year, with short-term corrections along the way. Do not expect another "everything rally" as we saw in the rebound from the 2020 low, leaving "rotation" and inconsistent sector performance to play out.
- **BONUS:** We see an elevated "price of fear" as a potential opportunity for clients to enhance returns by selling market volatility.

Looking Through the Market Noise to 2022

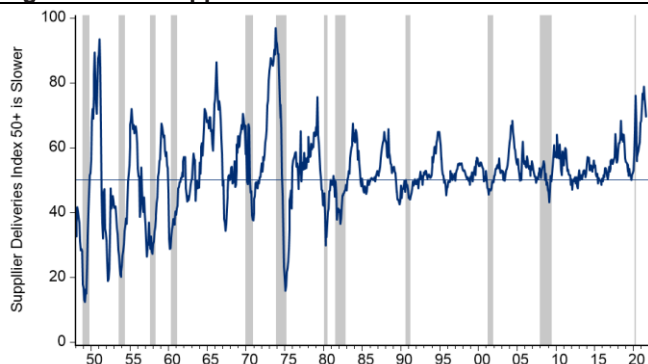
It can be painful for investors to ignore history. At the depths of the Global Financial Crisis, long-term US Treasury yields hovered just above 2%. Then, at the first glimmer of economic growth in the Spring of 2009, rates jumped to 3.9%, "reversing" a portion of the nearly 30-year bull market in bonds (see **figure 1.**) Of course, that reversal was short-lived. Investors assumed that rates "had to continue to go up" as the Fed's QE program was called "hyperinflationary". Not only did interest rates fall over the course of the following decade's long expansion, but inflation abated.

Sound familiar? It should.

In 2009, lingering credit disruptions impaired global supply chains resulting in skyrocketing shipping costs (see **figure 2.**) Commodity inputs for manufactured goods surged in price contemporaneously. The disruptions to the economy due to the pandemic have been far larger and deeper, but the impacts have parallels. Right now, supply chain disruptions are roiling the delivery of goods everywhere, just as the demand for goods relative to services is peaking. Yet, looking ahead, a normalization for most of the economy is likely over the coming year, especially as government stimulus wanes. Near term shipping costs are very high, but we can already see delivery times speeding up. While the surge won't erase immediately, this is a reliable sign of reduced costs to come. (see **figure 3.**)

Figure 1: 10yr US Treasury yield vs total return**Figure 2: Baltic Dry-Freight Global Shipping Cost Index**

Note: Shaded regions are recessions. Source: Haver Analytics and FactSet as of September 29, 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. 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.

Figure 3: ISM Supplier Deliver Times

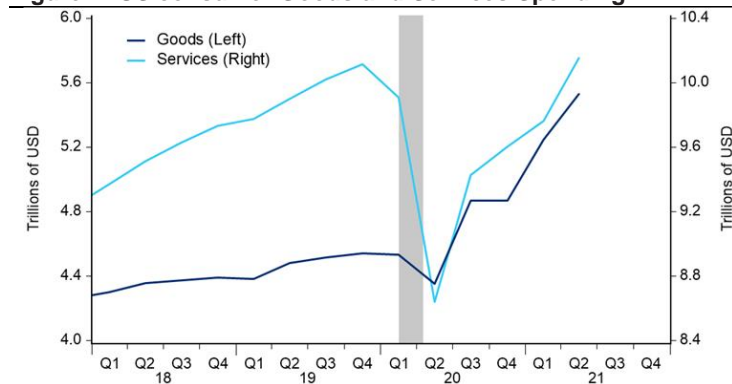
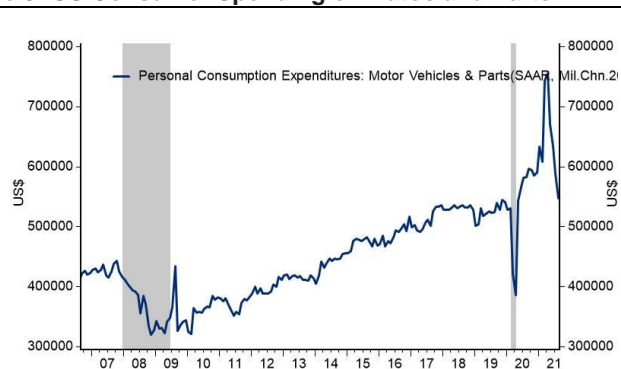
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Hardly Hyper Inflation

Hyperinflation did not appear after the Global Financial Crisis and is unlikely to now despite an even more aggressive monetary policy response to COVID. That said, we have previously written ([Global Fixed Income Strategy Bulletin, September 22 2021](#)) that inflation over the next decade is likely to be greater than the sub-2% per annum rate of the last decade. The pandemic is an exogenous shock that has radically and temporarily shifted demand for goods at the expense of services. This is unique to the COVID economy, augmented by an historically large combined fiscal and monetary stimulus over the past two years. However, like 2008, the defeat of the pandemic will enable an economic normalization.

It is crystal clear (see **figure 4**) that goods demand has hugely outpaced services, with demand exceeding pre-pandemic levels by 30% in nominal US dollars. But socially close services, like travel and restaurants, have not recovered as much and will not do so until the pandemic ends.

What investors do not consider seriously enough is the extent of the shift back from goods to services that will occur in time amid the satisfaction of demand for long-lasting goods (see **figure 5**). People who have already bought new TVs, dishwashers and bicycles will probably wait a few years to buy new ones again. They will, however, travel to see family and friends. And as the economy rebalances, initial price spikes – including for services – will very likely subside. News of effective new therapeutic COVID treatments (see CIO Alert above) makes it more likely that this normalization will fully unfold during 2022. This seems under-appreciated by markets.

Figure 4: US consumer Goods and Services Spending**Figure 5: US Consumer Spending on Autos and Parts**

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Resetting Return Expectations: Be Wary of Bonds

For investors, fear of being caught offside in the bond market is a serious concern. While holders of US Treasuries in 2009 didn't experience a possible default, they did experience a 13% mark-to-market loss on 10-year US notes. And valuation losses on longer-duration fixed income were even larger.

In 2013, investors also got hurt. Then-Fed Chairman Ben Bernanke clarified that the Fed would not finance US borrowing with newly created reserves indefinitely. This unleashed a "taper tantrum." Ten-year US yields leaped from 1.7% to 3.0% in about six months. Holders in 2013 nursed a 7.5% mark-to-market decline in their note values before recovering it all in another cycle of bond price appreciation.

Fast forward to October 2021. From March 2020 to March 2021, 10-year yields rose again from 0.6% to 1.7%. This caused an 8% reduction in price. At the time, bond markets were vulnerable, and yields could have risen further. However, the COVID delta variant interrupted global progress toward a "post-COVID" economy. The most social-close services industries slowed in recovery. Ten-year US yields fell back to 1.2% from May through August 2021, a 50-basis point drop. **In 2021-to-date, overall global fixed income returns are -1%, trailing world equities by 15 percentage points.**

Gyrating Interest Rate Impact

The collapse and rebound in bond yields both boosted and challenged long-duration, low-yield assets (see **Figure 6**.) Gold prices – sans yield – have moved in parallel with long-term real interest rates. US growth shares did better, recovering losses and then some as rate pressures calmed in recent months. This set growth shares up for their recent price volatility as rates rebounded in the past two weeks.

This all makes sense. In 2020, US growth stocks surged when technological solutions such as e-commerce and teleconferencing served as "survival" tools for the COVID shutdowns and economic collapse. Investors didn't require immediate dividend payments from these "firms of the future." With valuations elevated, the subsequent 100 basis point rise in long-term yields through March 2021 pressured these growth shares lower.

Growth Stocks vs. Interest Rates

Powell and the Fed are clearly poised to begin the tapering process, despite an imperfect COVID health situation. Adjusting to this view, the bond market is now discounting one 25 basis point rate hike in 2022 and three further rate hikes in 2023. With the Fed yet to do any of this, the Treasury yield curve has steepened in anticipation, with 10-year US yields up nearly 25 basis points in the past two weeks.

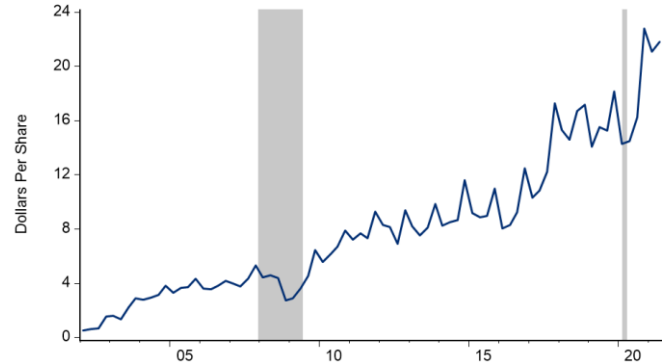
New bond market rate pressure – even if minuscule from a yield level perspective – and the sharp rise in US growth shares has set the equity market up for a rotation similar to the cyclical rally at the start of the year. To the extent that

yields rise further, growth stock valuation will be challenged. That's because the US growth index trades at nearly double the valuation of US value shares and international equities in general. But we suggest investors watch the realized EPS growth in certain groups closely. For key growth equity index components such as semiconductors, software and cybersecurity, EPS growth is likely to remain rapid. For example, look at the overall expected EPS growth rate for the S&P 500 IT sector at +28% for third quarter. Even though the rate of growth is slowing, a growth rate of 14% would do much to diminish future valuation pressure (see Figure 7).

Figure 6: US 10-Year Treasury Yield, US Growth Stocks and Gold Price



Figure 7: S&P 500 Information Tech EPS



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Fears, Tears and the Next Two Years

This brings us back to what is going on in markets now, reflecting a wide range of fears we discussed the last CIO bulletin ([Excessive Worrying May Be Costly For Investors, September 26, 2021](#)).

To avoid the jarring reactions of the past decade, Fed Chairman Powell has been remarkably disciplined and consistent in his messaging over the US central bank's policy course. On inflation, he has asked analysts to look past the remarkable shifts and distortions of the COVID economy. Yet, like Bernanke, the Powell Fed won't support a permanent monetization of all new US debt. The Fed will slowly stop buying bonds so that the financing of US Treasuries and Mortgage-related bonds will have to shift to private savers. If government spending grows significantly, this will mean rationing credit to other borrowers to limit the rise in inflation.

As this all of this unfolds, equity returns will likely moderate and credit market returns will remain poor as we discussed last week ([Excessive Worrying May Be Costly For Investors, September 26, 2021](#)). Inflation, however, should abate. Looking at Citi Research commodity price forecasts, one can see that 2022 should see outright price declines or at the very least a moderation of price increases (see figure 8).

Figure 8: Citi Research Commodity Price Forecast for End 2021, End 2022

Commodity Prices		Current	End-2021 Forecast	% Chg vs Current	End-2022 Forecast	% Chg vs Current
WTI Oil	USD/bbl	74	71	-3.9%	59	-20.1%
Brent Oil	USD/bbl	77	74	-4.2%	62	-19.7%
Henry Hub Natural Gas	USD/MMBtu	5.66	3.9	-31.1%	3.0	-47.0%
Copper	USD/MT	9227	8600	-6.8%	9000	-2.5%
Aluminum	USD/MT	2913	2800	-3.9%	3100	6.4%
Iron	USD/MT	114	160	40.4%	110	-3.5%

Source: Citi Research as of September 22, 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.

Remember Normal Economic Growth? Here it Comes!

Real economic growth is not a function of money printing. US employment and real economic output have soared for ages due to innovation and technological advances, generating rising incomes (see Figure 9). With this in mind, investors should make note that cumulative US equity returns have averaged 36% after the first rate hike in each expansionary cycle since 1960. Only one of 9 expansions saw a negative US equity return during a tightening cycle. And cyclical bull market peaks are reached two years after the first rate hike on average, though with much variability (see Figure 10).

Figure 9: US Employment and Federal Reserve Credit

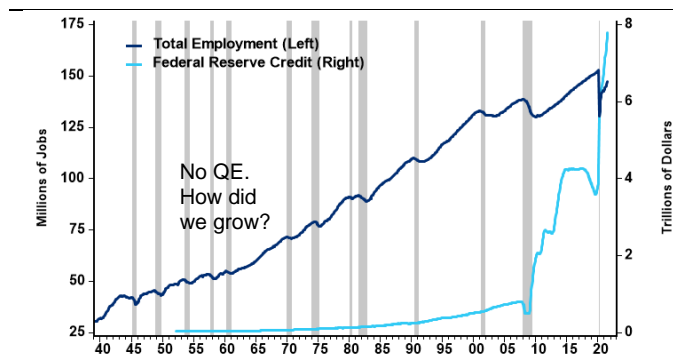


Figure 10: S&P 500 returns to bull market peak following a first Fed Rate Hike

First Rate Hike	S&P 500 Index	S&P 500 Peak Date	S&P 500 Index	S&P 500 % Move From Hike to High	Number of Months from Hike to High
7/17/1963	68.9	2/9/1966	94.1	36.5	31
01/15/1973	118.4	11/7/1974	75.2	-36.5	22
08/31/1977	96.8	9/12/1978	107.0	10.6	13
08/07/1980	123.3	11/28/1980	140.5	14.0	4
5/25/1983	166.2	10/10/1983	172.7	3.9	5
12/31/1986	242.2	8/25/1987	336.8	39.1	8
2/4/1994	469.8	7/17/1998	1186.8	152.6	54
6/30/2004	1140.8	10/9/2007	1565.2	37.2	40
12/16/2015	2073.1	2/19/2020	3386.2	63.3	51
Average				35.6	25
Median				36.5	22

Note: bull market peaks marked as periods preceding 20% or larger declines. (bear markets).

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When the Fed withdraws support, all assets will cease to rally together at this more-advanced stage of a bull market. As Figure 11 shows, the industry groups that are most sensitive to global economic growth and inflationary pressures will rise and will perform inversely to industry groups that benefit from subsiding rate pressures. Clean energy technologies and Fintech are beneficiaries of the coming environment if their growth meets or exceeds expectations. In the event that rates rise in a healthy economy, companies that return current profits to shareholders will do best. These include traditional energy shares and financials.

Figure 11: Groups and Styles Share Price Performance, Correlation to Movements in the US Yield Curve

Index	Q1 '21 Performance	Implied YC Sensitivity (% of EPS after 2023)	Correlation to 3m10y	Rank	
Banks	15%	70%	0.39	1	↑ Outperform when yield curve steepens
Energy	18%	71%	0.00	2	
Diversified Financials	9%	81%	0.37	3	
Autos	5%	78%	0.16	4	
Capital Goods	9%	84%	0.15	5	
Insurance	7%	73%	0.23	6	
Materials	6%	75%	0.08	7	
Real Estate	6%	82%	-0.33	8	
Russell Value	11%	81%	0.21	9	
Global High Dividend	6%	71%	-0.10	10	
Semis	11%	86%	0.09	11	↓ Outperform when yield curve flattens
Telecommunication Services	4%	75%	-0.07	12	
Consumer Durables & Apparel	2%	86%	0.02	13	
Div. Growers	9%	83%	0.04	14	
Media & Entertainment	7%	88%	0.02	15	
Transportation	7%	84%	0.09	16	
Consumer Services	5%	91%	-0.10	17	
Food Beverage & Tobacco	0%	83%	-0.29	18	
Health Care Equip & Svcs	2%	87%	-0.07	19	
Com & Prof Services	2%	89%	-0.28	20	
Food & Staples Retailing	0%	86%	-0.01	21	
Pharma Biotech & Life Sc	0%	83%	-0.12	22	
Utilities	1%	82%	-0.36	23	
HH & Personal Prod	-2%	88%	-0.20	24	
Tech Hardware & Equipment	-2%	85%	0.04	25	
Retailing	1%	89%	-0.03	26	
Fintech	3%	89%	-0.15	27	
Software & Services	0%	91%	-0.17	28	
Russell Growth	1%	90%	-0.09	29	
Clean energy	-14%	88%	-0.07	30	

Source: FactSet as of September 29, 2021. Note: Semis are Semiconductors. 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.

Earnings Matter and Will Grow

With the quarterly earnings reporting season three weeks away, firms with strong recent rallies are highly scrutinized by short-term traders. Any sign that future profits won't *beat* expectations will cause share pullbacks, some in reaction to earnings releases, others in advance of those releases.

Looking beyond this quarter to the full year ahead we believe that the picture is clear and constructive. The year 2021 has seen severe supply bottlenecks from highly unusual demand shifts as well as one-time big boosts from Covid stimulus. With production rebounding as rapidly as possible, we are likely at the peak growth rate for cyclical activity (see Figure 12).

As we noted last week, manufacturing orders measured by US purchasing managers have only been more rapid in 6% of all months since World War II. This has boosted the shares of traditional cyclicals. Their outperformance might last for another quarter. However, as we discussed last week, full-year growth will be best and most sustainable for higher quality, larger cap firms with *less* cyclical economic exposure (see Figure 13).

Figure 12: Industrial Sector Revenues vs Healthcare Y/Y%

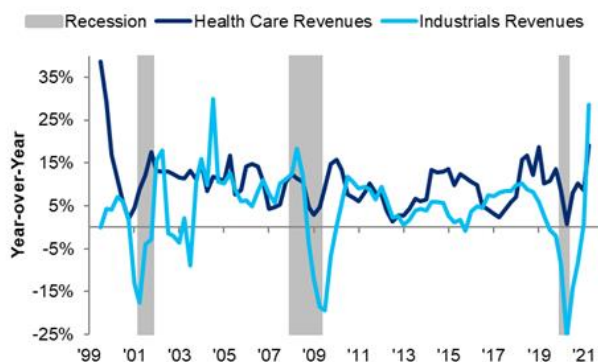
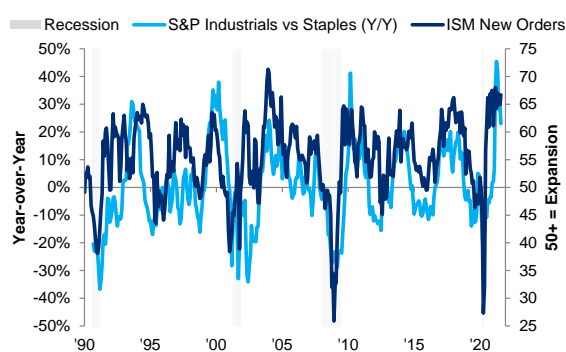


Figure 13: ISM New Orders vs Industrials/Staples Relative Share Prices



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Conclusion: 2022 is Positive for Equities, Not So Much for Bonds

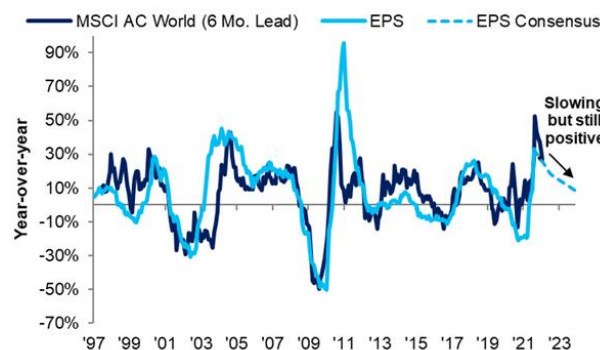
Talk of Fed rate hikes is unlikely to derail the recovery, while supply chain related inflation indicators should start to abate next year (see **figure 14**). Indeed, we expect companies will invest in expanding capacity to mitigate some of these bottlenecks, with these capital expenditures providing a tailwind for earnings and economic growth. While fiscal spending globally is unlikely to match this year's massive stimulus, we do believe a moderate amount of infrastructure and other social spending will be passed by the Biden administration, which would benefit select industries, while offsetting tax hikes should only shave 2-3 percentage points off of EPS growth next year. Taking all these factors together, we expect a 7-8% annualized EPS growth over the next 2 years to sustain positive equity returns (see **figure 15**).

Figure 14: US Producer Price Index for Crude Materials Ex-Food and Energy



Source: CITI/Bureau of Labor Statistics/Haver Analytics

Figure 15: Global Share Prices vs EPS

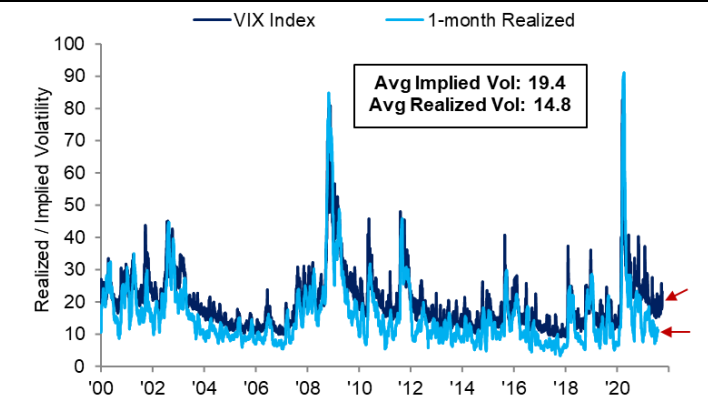


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Bulletin Bonus: One Way to Profit from the Noise -- Monetize Volatility

Due to the near-term "Wall of Worry", markets may encounter some bumps along the way. Modestly higher interest rates could place some valuation pressure on longer duration, growth-oriented shares, which could lead to some valuation contraction. With that said, current levels of implied volatility trade at a premium to realized volatility, suggesting that investors are "paying up" for downside protection (see **figure 16**). We believe this may present an opportunity for suitable clients seeking to potentially enhance returns or limit some downside exposure in exchange for some upside by selling volatility.

Figure 16: Implied vs Realized Volatility



Source: FactSet as of September 29, 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. 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. Please refer to the Appendix for additional information and risks regarding options.

For those seeking to buy equities following a correction, some strategies may allow suitable investors to generate a premium while establishing the discipline of buying dips if they do occur. The income available from these strategies can often out-yield much of the fixed income complex, as investors receive a premium in exchange for the obligation to buy if equity markets fall (see **figure 17**).

For clients under-invested in our Citi Global Wealth Unstoppable Trends, we also see a potential opportunity to use elevated implied volatility across digital services, renewables, health care, and Chinese equities to accumulate long-term positions while potentially limiting downside exposure (see **figure 18**).

Figure 17: Yield on T-Bills and 1-year out of the money S&P 500 volatility

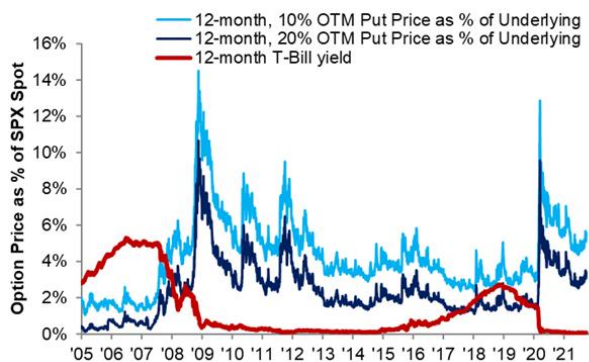
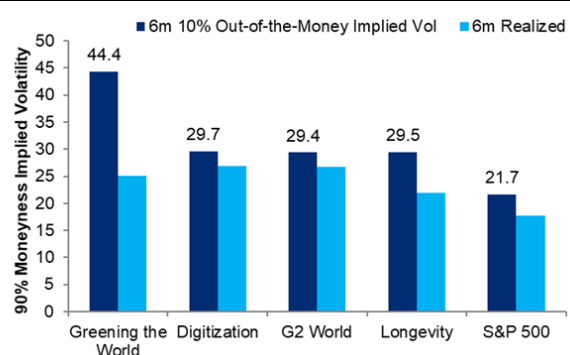
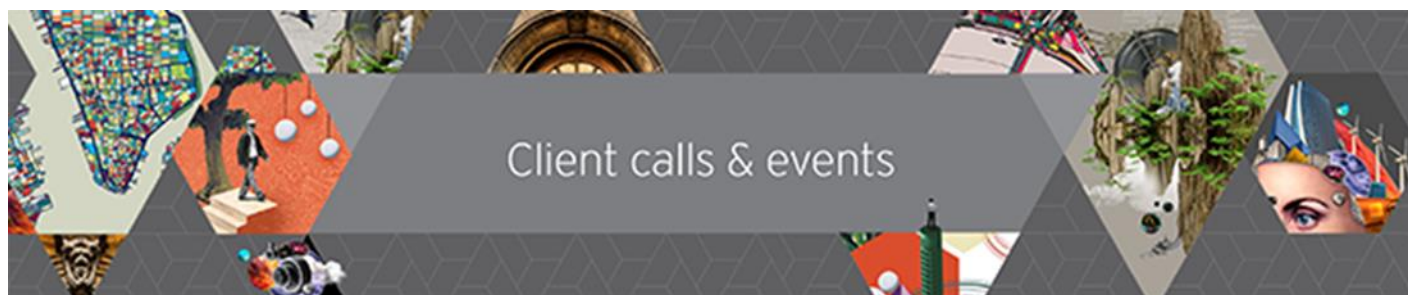


Figure 18: Implied vs Realized Volatility in Citi Global Wealth Unstoppable Trends



Source: Bloomberg as of September 29, 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. 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. Please refer to the Appendix for additional information and risks regarding options



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<http://www.theocc.com/components/docs/riskstoc.pdf>

http://www.theocc.com/components/docs/about/publications/november_2012_supplement.pdf

https://www.theocc.com/components/docs/about/publications/october_2018_supplement.pdf

If you would like an additional copy of this document please contact Citigroup Global Markets Inc., Options Department, 390 Greenwich Street, New York, NY 10013 or from your Financial Professional.

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