



Citi Global Wealth Investments

October 24, 2021

CIO Strategy Bulletin

Be Not Afraid of Growing Slowly...

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Summary:

- As we begin preparing for Outlook 2022, we have updated our economic forecasts. We expect growth to endure. The most likely scenario is that global EPS growth rates will average 7%-8% over the next two years. The period of COVID disruptions and stimulus will give way to a “new normal,” with global GDP gains ongoing, but decelerating. We expect supply shortages to diminish as consumer goods spending moderates. We expect COVID to abate as well, with new social practices, vaccines and treatments making it manageable.
- Ironically, the 28% price rise for global equities over the past 12 months is a source of risk for today’s now wealthier investor. With modest upward pressure in yields, diminished Fed bond purchases, slowing inflation and sustained economic growth, we think investors need to change expectations and portfolios.
- Global equities, with dividends and price appreciation, should generate mid to high single digits returns for coming year. But for bond investors, the yield environment points to another year of negative real returns for global bondholders, but less negative than in 2021.
- Global growth will likely exceed 5.5% in 2021 and fall below 4.0% in 2022. This will “feel much slower” after the unusually large 45% surge in US and global corporate profits in 2021. This deceleration assumes a broadening services expansion and a strong near-term outlook for goods production and trade driven by inventory rebuilding.
- China’s deliberate “multi-policy” tightening should yield its slowest growth rate in modern history aside from the initial COVID shock. However, some temporary elements of the Chinese slowdown – such as energy supply constraints – should see relief.
- China’s slowdown to sub-4% growth near-term will spill over to other world regions. As a result, we have reduced our global equity weighting from 8% to 6% overweight, with cuts to Asia, Europe and some scaling back in the US.
- Though we have reduced our global equity overweights, we have retained our modest equity overweight in China. This may sound odd since China is one of the key sources of potential cyclical weakness in the coming couple of quarters. The reason we’re staying positive on China is that its growth might be rising in 2022, while others slow. And its policy might be easing in 2022, while others tighten. That’s a source of diversification, the only “free lunch” in the business of asset management. See our [Special CIO Bulletin Update on China](#) herein.
- With US bond markets now pricing in 4-5 rate hikes by the end of 2023, intermediate duration US fixed income valuations have improved. We have raised our allocation to intermediate Treasuries, investment grade US corporate debt and municipal bonds for US-taxed investors by 2%, leaving the fixed income and cash allocation at 6% underweight.
- Last year’s energy bust has given way to boom, a common pattern for oil. Slower economic growth, the passing of “crisis pricing” in liquid natural gas and recovering oil production point to moderating prices in 2022. With energy costs now accounting for the largest share of the inflation spike, we see US CPI gains moderating to 3.0% in 2022 after a 4.5% rise in 2021, using yearly average data¹

¹All views/ forecasts are expressions of opinion and are subject to change without notice and are not intended to be a guarantee of future events.

“Be not afraid of growing slowly, be afraid only of standing still.” Chinese Proverb

There have been only three years of world-wide economic contraction since World War II and 2022 will not be the fourth.

Even so, the list of investor worries has grown by the day. (Worried? Please see last month's [Quadrant](#)).

Inflation is high and will remain high.
The federal reserve has been too accommodative.
International travel is not going to return.
Labor shortages will persist indefinitely.
The global supply chain is broken.
The federal reserve will raise rates too quickly.
Technology shares are in a bubble.
China policies make it un-investable.
Higher taxes will kill the recovery.
Energy shortages will slow down renewables.

The preponderance of voices in financial markets are seeing the glass as half-full. That's for sure. From January 1, 2020 to today, the MSCI world index is up 30%, the S&P 500 is up 41% and the Nasdaq is up 68%. How can this “good news” in markets continue in the face of such strong equity performance?

The tug-of-war between the bears and the bulls is evident as the third quarter earnings reporting season begins (see Figure 1). Thus far, the bulls have the upper hand. An historically high positive share of firms are beating their estimates (84% “higher than expected” to 10/22/21.) Of course, skeptical investors could have known that large-firm CEOs were not sweating profusely over their stock prices and compensation. Just look at the high level of confidence they reported to the US Business Roundtable in early October, right before the reporting of results began (see Figure 2)!

Figure 1: Investor Sentiment vs S&P 500

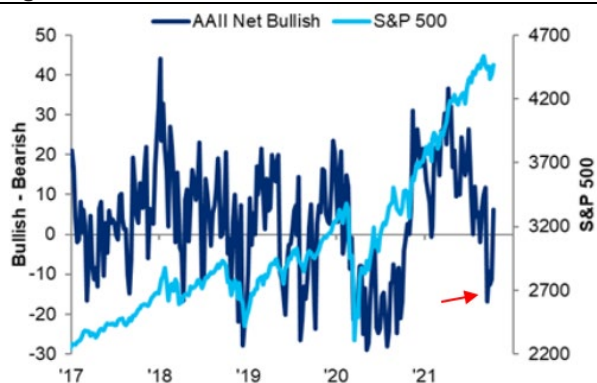


Figure 2: US CEO Confidence Index



Source: Haver Analytics and FactSet as of October 19, 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. Gray shaded areas are periods of US recession.

It turns out that the immediate outlook for the world economy is strong, even with the surprising negative turn in China we discuss below. Why is that? We have noted before that there are several features of this post-pandemic economy that auger for a gentle “return to normal” than one might expect. And by “return to normal”, we mean a return to a global economy that is growing more slowly and yet at a sustainable, potentially profitable pace.

As the public learns to coexist with COVID, services activity is broadening and strengthening in this recovery (see Figure 3). Only international tourism lags severely behind and that is unlikely to last if the pandemic comes to a tame end. The need to replenish global inventories, while meeting unsatisfied demand caused by a stimulus-driven binge on all consumer and business “goods”, has left most global exporters and manufacturing firms on a strong growth path for another year or so (see Figure 4). These sources of economic energy, when combined with increased capital investment in software, digital infrastructure and “onshore” manufacturing capacity, as well as the accelerated adoption of technology broadly, are likely to sustain growth, too.

Of course, economic progress could have been *much* faster had the world managed the vaccine rollout better, if oil and natural gas inventories been plentiful, if labor had returned to their old jobs with gusto, and so on. But we remind our readers that through every year of growth and economic progress, risks and imperfections abound. There are always sources of friction, shortages and surpluses, flawed business models, booms and busts in parts of our financial markets.

What Slower Growth Looks Like

Both stimulus and unsatisfied demand are on the wane. Conditions vary by country, but the world's largest consumer economy has seen annualized personal income drop by \$3.4 trillion from the first quarter 2021 peak as emergency income supports to 85% of the US public were not repeated (see Figure 5). Sales of autos, electronics and housing-related goods are falling back after a stimulus surge equal to a decade's worth of prior spending gains (see Figure 6).

Figure 3: Services Growing Strongly Again
Services PMI: US, EU and UK

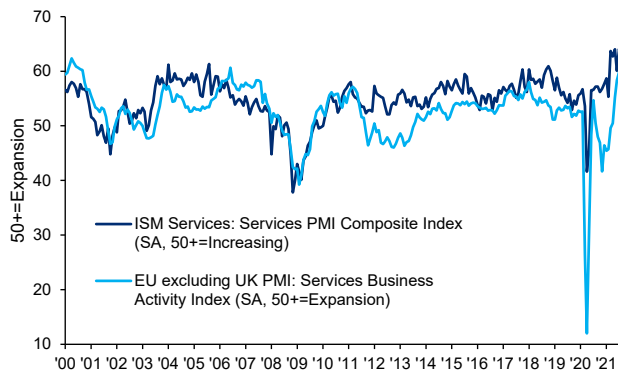


Figure 4: US Goods Imports vs US Business Inventories/Sales Ratio



Source: Haver Analytics and FactSet as of October 19, 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 5: US Wage Payments vs Government Transfer Payments

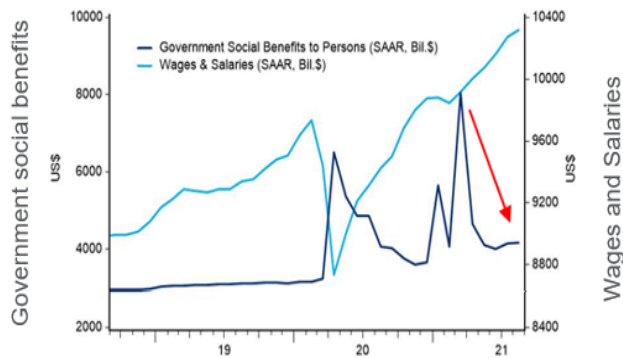
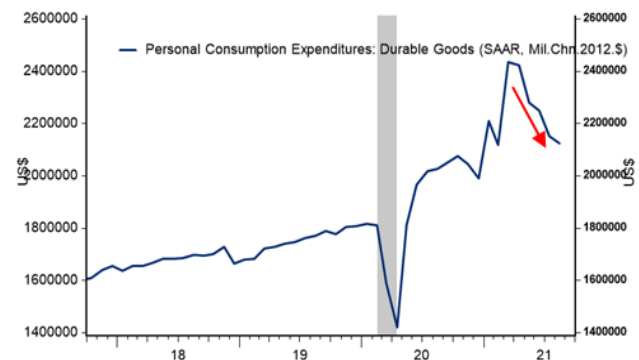


Figure 6: Monthly US Consumer Spending on Durable Goods



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It makes sense that if growth is slowing due to moderating demand, future inflation will be lower than it is at present. To sustain inflation, the demand for goods and services has to exceed supply and people have to believe it is better to “buy now” than to buy later at a higher price.

There are three data points that suggest inflation will moderate. The first is core CPI, where monthly changes have moderated down from a high of 0.9% from earlier this year, to an average of 0.2% over the last three months (see Figure 7). The second is the likely path for the cost of inputs to goods (Figure 8 & 9). Citi Research's commodity price forecasts suggest that in 2022, there will be a return to more typical input prices. And finally we see oil prices abating now and a futures curve pointing downwards (see Figures 10 & 11). This is despite the long-term aims of monetary policymakers, who seek a higher underlying inflation trend.

Figure 7: US Core CPI Month/Month % Change

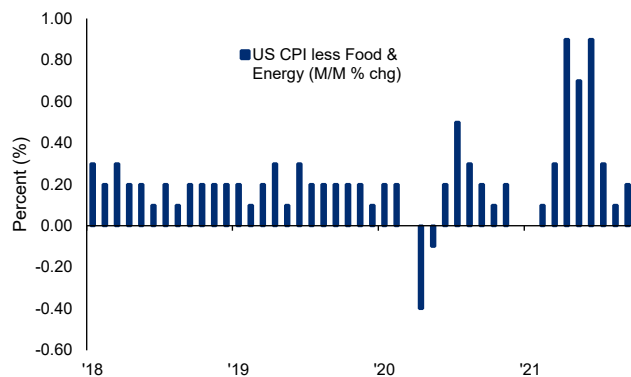
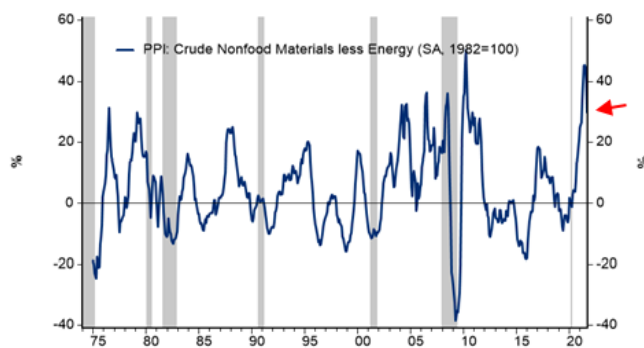


Figure 8: US Producer Price Index for Core Crude Materials Y/Y%



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Figure 9: World Crude Oil Price Y/Y%

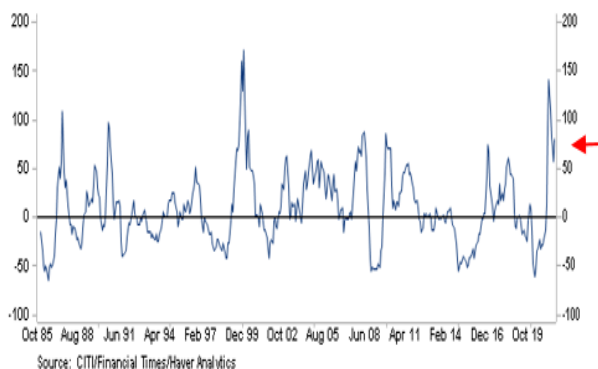
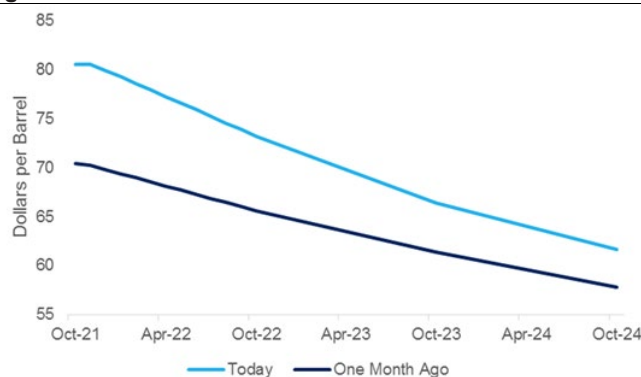


Figure 10: Crude oil futures term structure



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Figure 11: Citi Research Commodity Price Forecasts End 2021, 2022

Commodity Prices		Current	End-2021 Forecast	% Chg vs Current	End-2022 Forecast	% Chg vs Current
WTI Oil	USD/bbl	82	80	-2.1%	62	-24.1%
Brent Oil	USD/bbl	84	85	0.9%	65	-22.9%
Henry Hub Natural Gas	USD/MMBtu	5.01	6.0	19.8%	5.2	3.8%
Copper	USD/MT	10555	8600	-18.5%	9000	-14.7%
Aluminum	USD/MT	3163	2800	-11.5%	3100	-2.0%
Iron	USD/MT	120	160	33.7%	110	-8.1%

Source: Citi Research as of October 19, 2021. All views/ forecasts are expressions of opinion and are subject to change without notice and are not intended to be a guarantee of future events.

Our Revised “Citi Global Wealth” Growth Forecast

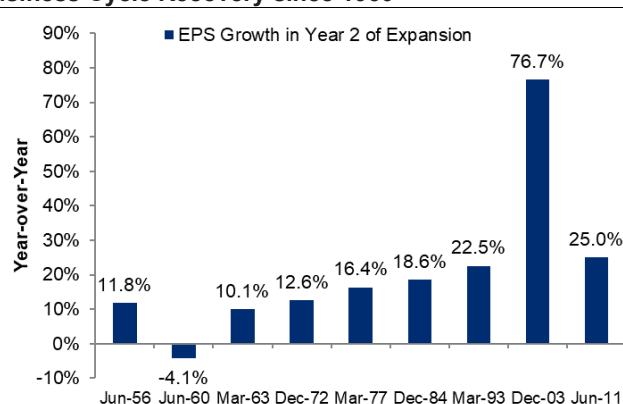
As we begin preparing for Outlook 2022, we have updated our economic forecasts. They suggest neither a continued boom nor a coming bust. The most likely scenario is that EPS growth rates will average 7%-8% over the next two years. This will “**feel much slower**” after the unusually large 45% surge in US and global corporate profits in 2021. Our estimates suggest slower than the average growth when compared with the previous second full years of prior recoveries experienced during the past six decades, but robust growth nonetheless (see Figure 12).

Figure 12: Citi Global Wealth GDP Assumptions for 2021-2023

	2020	2021	2022	2023
China	2.4	8.0	4.5	5.0
US	-3.4	5.5	3.5	2.6
EU	-5.9	4.8	3.9	2.4
UK	-9.7	6.0	4.2	2.5
Global	-3.2	5.6	3.8	3.5

Source: Citi Global Wealth Office of the Chief Investment Strategist and National sources, Haver Analytics and FactSet as of October 19, 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. All views/ forecasts are expressions of opinion and are subject to change without notice and are not intended to be a guarantee of future events.

Figure 13: S&P 500 EPS growth in the Second Full Year of a Business Cycle Recovery since 1960



And in bond land, we are faced with some startling realities. US bond yield curves have always steepened on the earliest signs of economic recovery, largely before the Fed's rate-setting committee could possibly act. **Yet, in every year post-1985, longer-term US Treasury yields have never risen more than 50 basis points further after an initial lurch higher at the start of the recovery (see figures 14-15).** Even with sub-2% yield levels, the 100-basis point rise in the year through March 2021 qualifies as the "initial lurch."

Despite historically poor yields, we would not estimate more than another 50 basis point rise in 10-year US Treasury yields through year-end 2022. We suspect further inflows into US bond markets as US yield premia to other developed bond markets will attract foreign investors and will benefit the USD as well.

Figure 14: US Yield Curve (10-Year UST less Fed funds rate)

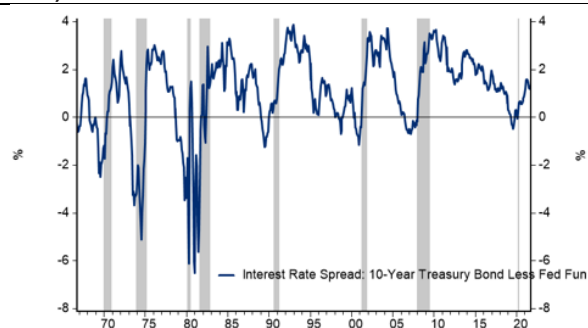


Figure 15: US 10-Year Yield Level: No Sustained Long-Term Rate Increases of More than 150 Basis Points Since Early 1980s



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Growing Wealth in the Markets to Come

Ironically, the 28% price rise for global equities over the past 12 months is a source of risk for today's now wealthier investor. Asset allocation balances scenarios with both more optimistic and less optimistic assumptions to grow wealth. With modest upward pressure in yields, diminished Fed bond purchases, slowing inflation and sustained economic growth, we think investors should look to change expectations and portfolios. We expect mild valuation pressure across equities as markets aggregate and understand the events leading to a more normal, post-COVID economy.

Global equities, with dividends and price appreciation, should potentially generate mid to high single digits returns for the coming year. But for bond investors, the yield environment points to another year of negative real returns for global bondholders, but less negative than in 2021.

We assess potential vulnerabilities that have not resulted in a turning point for the world economy in the past, but may do so in the future. Events in China, for example, create “tail risks” that can be reflected in portfolio construction now. For us, we will accept some lower returns with a portion of portfolio assets to reflect these outlier scenarios.

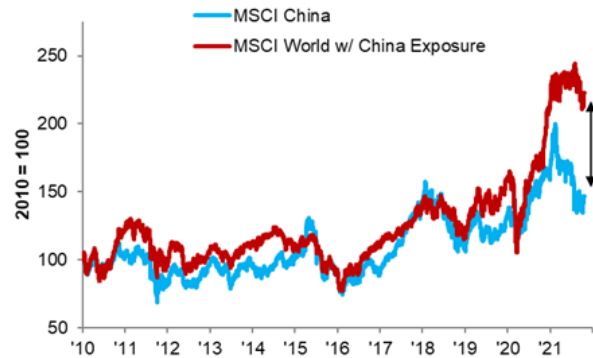
China’s surprising policy turn has pushed our view of near-term economic growth much lower. Only a return to more positive macroeconomic policies would restore China’s growth to even a 5% pace, less half that of China’s growth rate over two pre-2010 decades.

This slowing will have direct negative implications on exporters to China across the world (see figure 16). With a largely closed capital account, and low levels of cross-border liabilities, it will not spark a crisis (please see our [last Quadrant](#)). China’s growth hit is why we reduced our weightings in Asian and European markets that have more sensitivity to China. As figure 17 shows, markets have priced in far less distress for foreign firms operating in China than for the country’s own shares.

Figure 16: China Manufacturing PMI vs 12-Month Change in German IFO Business Confidence Index



Figure 17: Developed Market Equities with High China Business Exposure vs China Equities



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Reducing our equity exposure to firms in developed markets with high exposure to China’s beleaguered industries does not eliminate all risks. Exports are one of China’s limited bright spots in its growth outlook. However, there is only a window of time for this sector to be truly robust.

Slower Growth in China Creates Future Risks

If China accepts a lowered growth target of 5%, it will not wish to cede significant market share in global exports to others. It may use foreign exchange rates to do this. China’s currency is presently among the most stable within EM, so even small moves lower have weakened other currencies by a greater amount across the world. Markets may react more calmly than they have in the past, but we cannot rule out an over-reaction akin to 2015. Then, global equities temporarily dropped nearly 12% on a 3% depreciation of the CNY (see figure 18).

Other risks in Asia remain high, too. Contentious trade negotiations between the US and China have continued into a second administration. The global supply chain has been shown unable to adjust to large and unpredictable swings in demand merely from COVID (see figure 19).

Figure 18: Global Equities Temporarily Dropped 3x the Decline in CNY vs USD in 2015

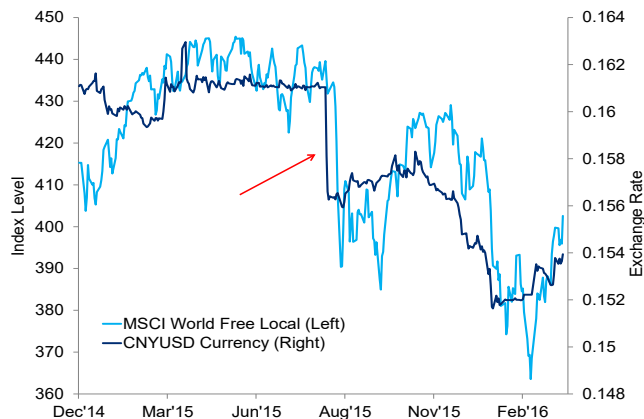
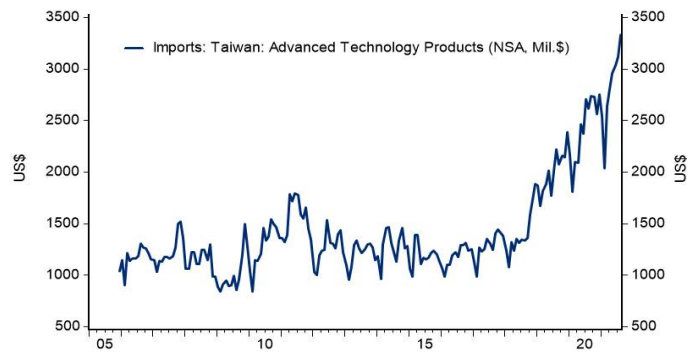


Figure 19: US Imports of Advanced Tech Products from Taiwan (semiconductors, etc.)



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Finally, a Bond with Better Risk/Return Characteristics

Fortunately, financial markets have presented improved valuations for intermediate bonds. As figure 20 shows, the US rate markets have priced in nearly five Federal Reserve rate hikes of 25 basis points by end 2023. This is a plausible forecast under a positive economic scenario. With the rise in short-term rate expectations for late 2022, 2023 and beyond, US Treasuries and Investment Grade corporate debt of 5-7 years in duration have seen a “worthy” rise in yield (see figure 21).

“Worthy” is not historically attractive. Rates remain below our expectation for inflation. We would not choose these low risk assets to grow wealth. However, for multi-asset class portfolios, high quality bonds may dampen volatility, with a near -0.5 correlation to global equities (see Figure 22).

Figure 20: US Implied Policy Rate end 2023 and 2025

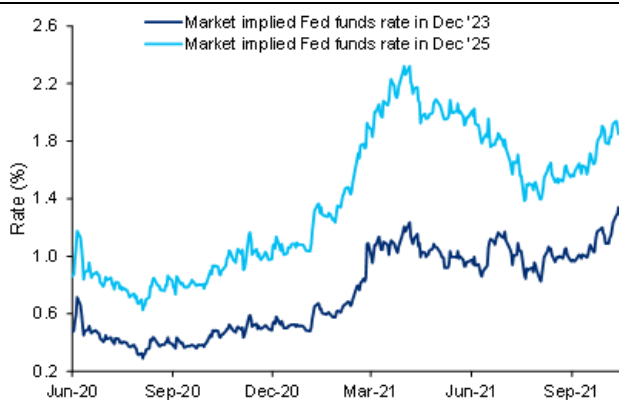
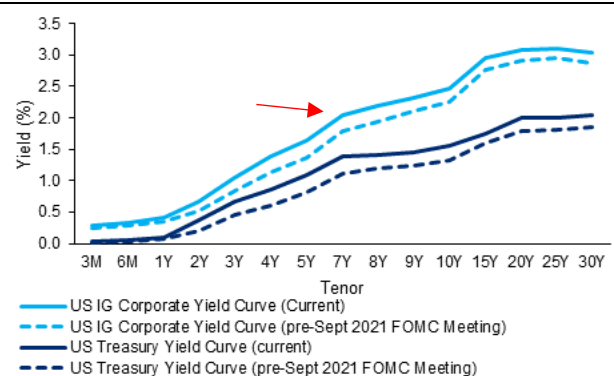
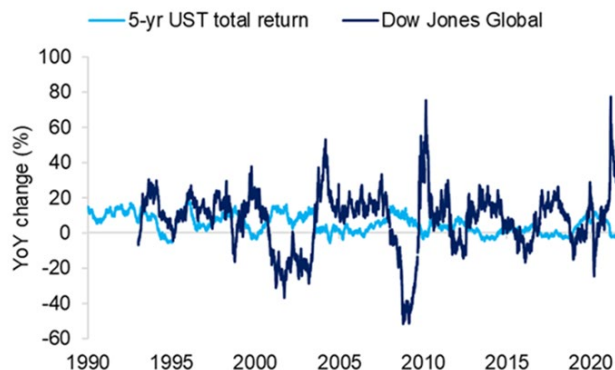


Figure 21: US Treasury and Investment Grade Corporate Bond Yield Curves



Source: Haver Analytics and FactSet as of October 19, 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. All views/ forecasts are expressions of opinion and are subject to change without notice and are not intended to be a guarantee of future events.

Figure 22: Global Equities vs US 5-Year Treasury Total Return
Y/Y%: 1/4th the volatility, negative return correlation (-44%)



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Special CIO Bulletin China Update

China - Cyclically Worse, Technically Better

With our latest move to shift towards a more mid-cycle asset allocation, we reduced global equity overweights, but kept our modest equity overweight in China. This may sound odd since China is one of the key sources of potential cyclical weakness in the coming couple of quarters. The reason we're staying positive on China is that its growth might be rising in 2022, while others slow. And its policy might be easing in 2022, while others tighten.

First, the downward cyclical pressures are intense so far in 4Q.

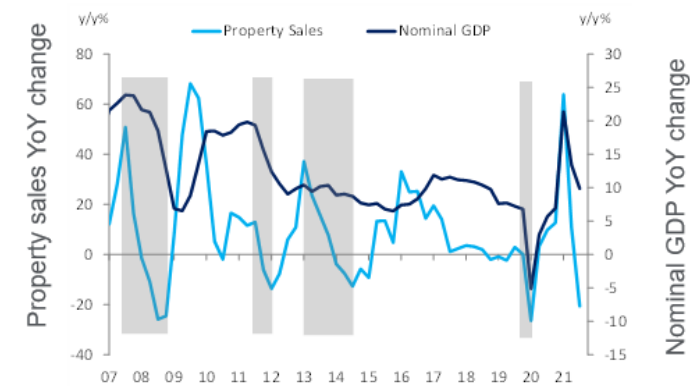
Property sales have collapsed by 36% year over year in September and could lead to decline in investment in 4Q, as only unfinished projects are getting funding, while housing starts and land sales fall. The level of real estate investment would only stabilize at a lower level, whereas the sector was still growing at 9% in the first three quarters of 2021, implying further downside to GDP growth (see figure 23).

Power shortages seemed to ease a bit in October after Premier Li Keqiang spoke against abrupt rationing implemented in September. But coal supplies have further tightened due to floods in Shanxi province, while there are new policies to discourage speculation. The power shortage may still deepen in the winter heating season and drag industrial production in 4Q (see figure 24). We expect supplies to recover next spring, as more coal mines are resuming production.

Given the above challenges, we expect China's real GDP growth to fall below 4%/y/y and possibly to around 2%/y/y in 4Q. Policy so far has not reacted to the slowdown in a meaningful way, partly because the power shortage would limit the impact on immediate activity, and partly because the annual growth rate would still be 8%/y/y even if 4Q registers zero sequential growth. Some relaxation in mortgage policy is taking place, but the PBOC has said that the supply and demand for liquidity is roughly balanced, implying no major easing in 4Q.

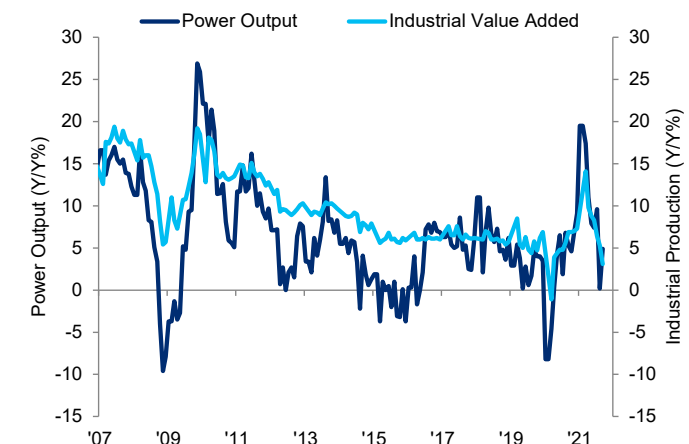
Against this backdrop, global investors should be prepared for a setback to growth expectations this quarter and next. Along with lower growth, worries about inflation and excessive tightening are likely to subside as well. But beyond the winter, we do expect the supply chain issues to ease. The business cycle may be moving into a slower phase, but it is far from over.

Figure 23: Sharp Decline in Property Sales, with No Major Stimulus Elsewhere, Imply Further Downside to GDP



Source: Haver Analytics, as of Sep 2021. Gray shaded areas are periods of US recession.

Figure 24: Power Shortage Is Severe, But Power Output Have Yet to Fall below Past Cycles, Suggesting More Pressure in the Months Ahead



2022 May Surprise Investors in China

Going into 2022, however, things might look more positive for China.

COVID policies may be poised to ease. China has recently instructed local governments to increase capacity for quarantine for foreign visitors. Currently, few foreigners are visiting due to suspension of most visas. The preparations are likely meant for the Winter Olympics in February 2022. But beyond that, there may be broader re-opening to international travel. After all, there is no need to require zero cases for what is effectively a potent flu once vaccines and medical solutions are readily available.

There may also be some political incentives to promote growth. 2022 is the last year of the 19th Party Congress and President Xi's second term. The work report in October is unlikely to say that a key performance indicator was missed. To the extent that 2021 policies changes are meant to solidify control of the web and of the economy, a new term is likely to begin with more attention on economic development.

We expect Chinese GDP growth to fall well below 4% in 4Q, but would rebound to 4.5% in 2022 and then to 5% in 2023. Meanwhile, global growth is likely to fall from 5.6% in 2021 to 3.8% and 3.5% in 2022-23 (see figure 12). Moreover, tech underperformance from regulatory tightening likely have reached a nadir and policy stance may be turning.

On October 18, President Xi professed his desire to "fully capitalize on China's advantage in generating and applying rich data," and called internet based digital technologies good for China's economic rebalancing, industrial modernization and international competitiveness. Similar to the 14th Five Year Plan, he wanted to invest into digital infrastructure, cloud, AI, de-carbonization, cyber security, scale up industrial applications, software and core technologies.

Of course, all of these would take place at a higher level of regulation. Platform companies are told to pay attention to their social responsibilities, and not to harm society.

Aside from this meeting, the market also welcomed a few other developments, including, lower than expected penalties for Meituan, resumption of online game approvals, and the reported reappearance of Jack Ma.

In sum, we believe that the worst of the technology regulatory actions are over. This may provide an inflection point for Chinese equities, even as cyclical conditions are likely to remain challenging through the winter. Chinese equities already reflect weak expectations, especially in beaten down tech shares, while the highly cyclical materials sector have gained 50% since the end of 2019 (see figure 25). Our collection of valuation metrics show that MSCI China has fallen to 1.5 standard deviations below mean, which has previously been an indication of strong performance for the forward 12-24 months (see figure 26).

Figure 25: Policy Tightening Caused China Internet Shares to Vastly Underperform US Tech Shares or Even China Cyclical

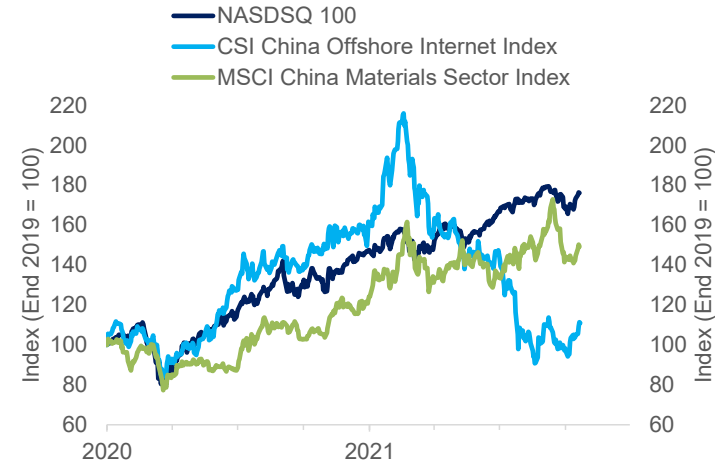
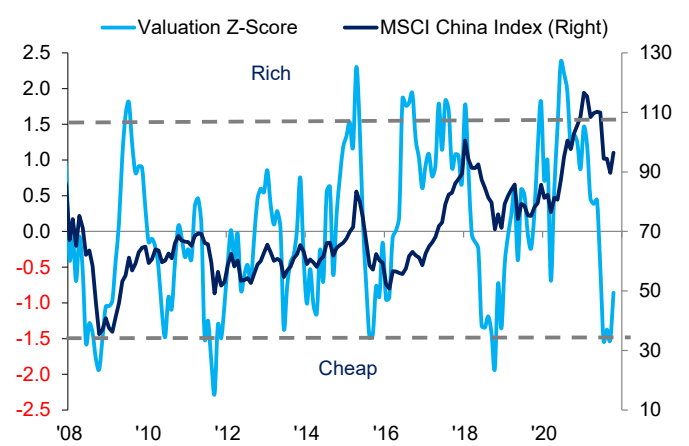
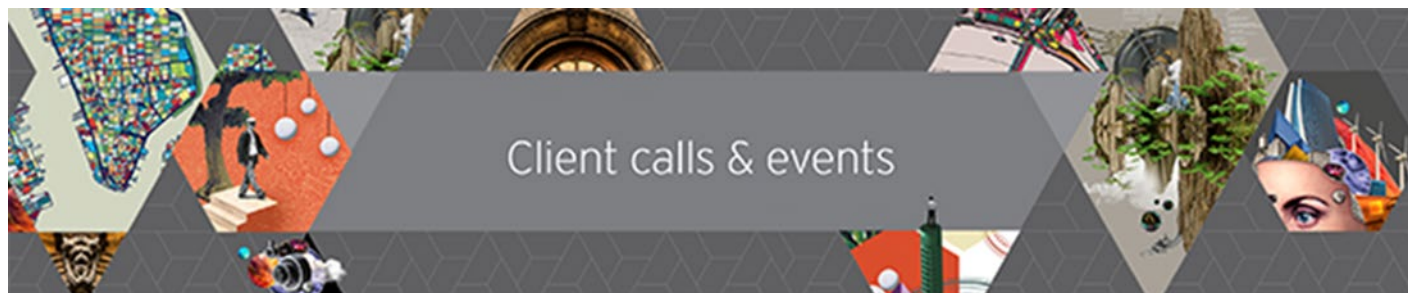


Figure 26: A Collection of Valuation Measures Indicate that Future Returns Are Likely to Be Robust



Source: Bloomberg, as of 20 Oct 2021. Note: Valuation z-score is an average of rolling 12-month standard deviations from mean for price / cash flow, trailing PE, EV / EBITDA, price / book and inverted dividend yield. 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.



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