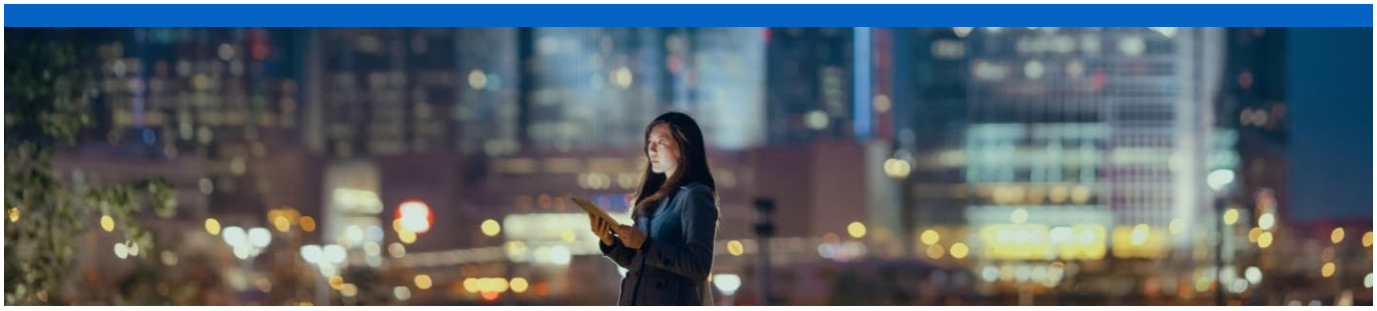
Citi Global Wealth
Investments



November 6, 2022

CIO Strategy Bulletin

David Bailin
Chief Investment Officer and Head of Citi Global Wealth Investments

Steven Wieting
Chief Investment Strategist and Chief Economist

Charlie Reinhard
Head, North America Investment Strategy

Shawn Snyder
Head, North America Consumer Strategy

Lorraine Schmitt
North America Investment Strategy

The Dangers of Driving While Looking in the Rear-View Mirror

SUMMARY

- The Fed's accommodative monetary policy in 2020-21, along with the huge pandemic fiscal stimulus, set the stage for the surge in inflation this past year. Add to the mix the supply chain disruptions, a war in the Ukraine and other geopolitical events, and you get an inflationary cocktail.
- Beating back inflation by raising interest rates has been the Fed's mission this year. The concern, though, is that the Fed's assessment of today's inflation is based on selective data that is short-term focused. Relying on incoming inflation and employment data – as well as looking in the rearview mirror at housing inflation – risks overtightening and a not-so-soft landing.
- The Fed wants to see the effects of its tightening apparent in employment, but October's 261,000 job gain – the slowest since December 2020 – is still too fast for the Fed's liking. Indicators suggest net US employment will drop by about 2 million in 2023, which is enough to push the unemployment rate up to 5.3%. In other words, the full impact of policy tightening has yet to meaningfully hit the labor market.
- When employment does fall, the Fed will need to respond. The first rate cut will likely be in the second half of 2023, in line with the Fed's history. If the Fed dials back from the 75-basis-point pace of the past six months, it might ultimately minimize the severity of the likely 2023 recession.
- Note our special section on the US midterm election on Nov. 8, and how various possible outcomes – including divided vs united government – might impact the stock market.

The Dangers of Driving While Looking in the Rear-View Mirror

Where does inflation come from? The answer is predominantly the Fed itself, which has the power to create money, expand its supply and shrink it. When consumers spend money – rather than hoard it in fear – inflation will follow money growth with a *two-year lag,* on average (Figure 1). The Fed's Quantitative Easing (QE), zero-rate interest policy, along with the huge pandemic fiscal stimulus, set the stage for the surge in inflation this past year. Throw in the 2020-21 supply chain disruptions, a war in the Ukraine and other geopolitical events, and you have an inflationary cocktail.

Now, after lighting this inflationary candle, the Fed intends to put it out and fast. According to Powell, the Fed will snuff out US inflation at whatever the cost. In its formal statement on Nov. 2, the Fed acknowledged "the lags with which monetary policy affects economic activity and inflation," and the "cumulative effect" of 375 basis points of rate hikes in just nine months. Said simply, nothing the Fed can do will have immediate impacts on the supply/demand balance. The full effects of a monetary policy-induced recession in 2023 we expect will slow inflation most acutely in 2024.

The problem now lies with Powell's assessment of today's inflation. It is based on selective data that is short-term focused. The Fed said it would focus on incoming inflation and employment data – which reflect the **recent** past – to set monetary policy for the future. The CPI for services is one such measure. Highlighted by Powell as the new front of inflation, services inflation has just posted its largest gains for the cycle thus far.

Services prices are a member of the Index of **Lagging** Economic Indicators and are usually rising most strongly as the economy contracts or if it is shortly approaching a bust. This is actually typical of recessionary periods. The US Index of Leading Economic Indicators has slipped into contractionary territory already (Figure 2). By focusing on services inflation, Powell may miss the degree to which the economy is about to slow while directing the public to focus on the past consequences of the 2021 growth boom.

A Rear-View Look at Housing Inflation, Too

At his press conference, Powell did not answer a direct question about housing. He was asked whether the Fed was negatively impacting housing supply as well as housing demand. This is highly pertinent as surging mortgage rates drive down housing affordability, while plunging home sales will reduce future home construction.

Poor affordability and poor housing supply drive up the CPI for shelter, the largest component of core inflation. And, again, these are inflation measures the Fed is weighing most heavily in setting policy. Higher interest rates force potential homebuyers to compete for a limited stock of rental units.

While Powell noted that incipient measures of home prices and rental costs are falling, he said it was still appropriate to use the CPI for rent of shelter as the primary indicator of housing inflation. By doing so, the Fed overweights a second "lagging" inflation indicator to set future policy (see figures 3-4).

Another Fallacy: Employment Tells Us Where the Economy Will Be in the Future

Strong employment growth in 2022 – the byproduct of severe job losses in 2020 during a period of strong demand – has made policy tightening seem almost "cost-free" for the economy (see figure 5). While October saw the slowest job gains since December 2020, the 261,000 job gain last month is still faster than adult population growth. This is too fast for the Fed.

This week we read two contradictory surveys of employment. The establishment survey still showed solid gains in headcount and wages. The other – the survey of households – showed a recessionary 328,000 contraction in employment and a rise in unemployment from 3.5% to 3.7%. This is the third instance this year of unusually sharp divergence between the surveys.

The Fed will rely significantly on gains in the establishment survey headcount to determine policy. And that's despite Powell noting that wages (reported in the establishment survey) were **not** the primary driver of inflation in a period marred by supply shocks and government stimulus.

We also note that employment freezes and layoffs in the most creative US industries and well-known companies is in the news lately. This underscores the fact that robust employment gains are behind us. As figure 6 shows, real business inventories are rising at the fastest pace in 24 years. These data imply US production, imports and related employment are growing much faster than demand, portending industrial layoffs to come. In short, the full impact of policy tightening has yet to hit employment (see our Oct. 29 CIO Bulletin). The Fed wants to see faster impact than measured thus far.

Data Bias and the Future Impact of Quantitative Tightening

After downplaying "QT" in September, Powell acknowledged the "important role" Quantitative Tightening will play in driving US monetary policy into "restrictive" territory. The Fed's projected $95 billion per month in reduced lending will shrink money and credit in the US economy and reduce the flow of US dollars across the globe in 2023. In early 2021, the annualized growth of broad US money supply was as high as 28%. In 2022, it has slowed to below 2% and has been falling outright since March.

The Fed's holdings of fixed income securities have fallen only $15.5 billion in 2022 so far. Thus, the future path for QT points to an outright, possibly severe drop in US money supply in the year ahead.[1] With the Fed's power to sway markets without seeking a profit, its reduced financing of securities may be amplified by others who step back from taking credit risk. The heightened cost of debt capital across the economy is one of the primary ways the Fed will achieve the slowdown it demands.

Why the US Central Bank Is No Longer Looking Ahead

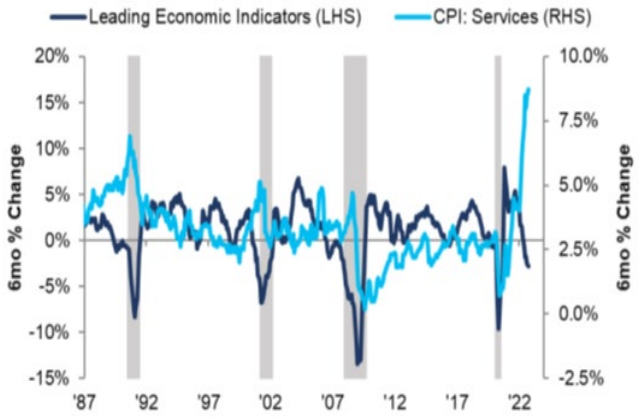
In the decade following the Great Financial Crisis, the Fed shifted its strategy from one of forecasting the economy and setting policy with the future in mind to reacting to inflation. The strategy was adopted because forecasts of that period did not accurately show that labor markets could expand further without stoking inflation. It was a strategy based on the "hidden supply" that allowed the economy to expand more and brought prosperity to a wider swath of society. But sticking to this approach fails during a period of supply shocks and demand instability.

This has put the Fed in an untenable position, reacting to lagging developments when the US and the world needs prescient policy. The Fed's present focus on largely backward-looking inflation and employment data tells us that officials could raise interest rates until employment begins to drop outright. In our view, this is set to begin no later than the end of 1Q 2023. Several indicators suggest net employment will decline by about 2 million in the US in 2023, which is enough to push the unemployment rate up toward 5.3% from its recent low of 3.5%. With policy restrictive at that time, we expect the Fed will be forced to ease yet again.

[1] Private lenders can increase the supply of money by leveraging their balance sheets, but are unlikely to do so while the Fed contracts its own. For the Fed, the actual path of QT has been complicated by several factors, including the unusually large drop in mortgage refinancing activity as interest rates have surged and housing mobility has plunged. See our last CIO Bulletin.

Figure 1: **US money supply growth (leading two years) vs US CPI**

Figure 2: US Index of Leading Economic Indicators vs CPI for Services (component of Index of Lagging Economic Indicators)



Source: Haver Analytics through Nov. 3, 2022. Note: Grey areas are recessions. Components of the LEI are average the spread between 10-year US Treasuries and Fed funds, S&P500, inflation adjusted M2 money supply, University of Michigan consumer expectations, weekly manufacturing hours, supplier delivery times, new orders for non-defense capital goods, building permits. Components of the coincident Index are non-farm employment, real personal income less transfer payments, industrial production, inflation adjusted manufacturing and trade sales. Components of the lagging index are the CPI for services, the duration of unemployment, the real ratio of manufacturing and trade inventories to sales, the prime rate, real commercial and industrial loans, the ratio of consumer credit to personal income.

Figure 3: **US CPI for Rent Y/Y% vs Housing Affordability Index**

Figure 4: **US Home Prices (leading 18 months) vs US CPI for rent**

Source: Haver Analytics through Nov. 3, 2022. Note: the housing affordability index combines mortgage rates, home prices and disposable income data. An index value of 100 means that a family with the median income has exactly enough income to qualify for a mortgage on a median-priced home. The affordability measure has plunged 28% over the past year as 30-year fixed mortgages have jumped from 3.2% to 7.4%. 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. For illustrative purposes only.

Figure 5: **US consumer spending vs employment**

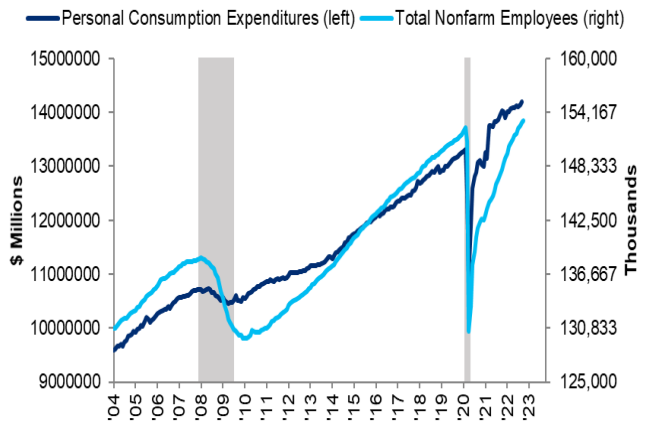
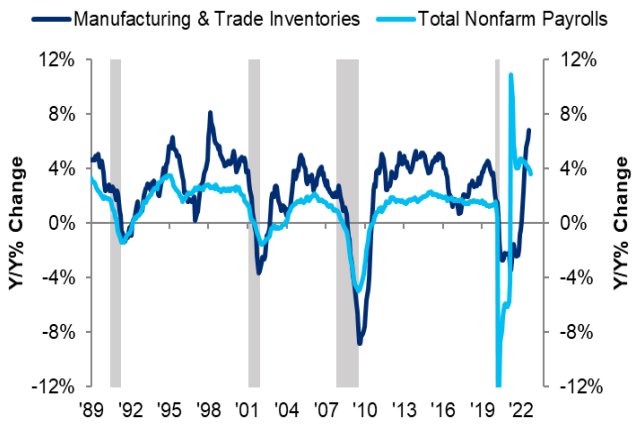


Figure 6: **Real US business inventories and employment Y/Y % changes. (Note: Latest jobs data for October; inventory data is for August)**



Source: Haver Analytics as of Nov. 4, 2022. Note: Grey areas are recessions.

The Fed Will React Only When Employment Falls (and That Is Too Late)

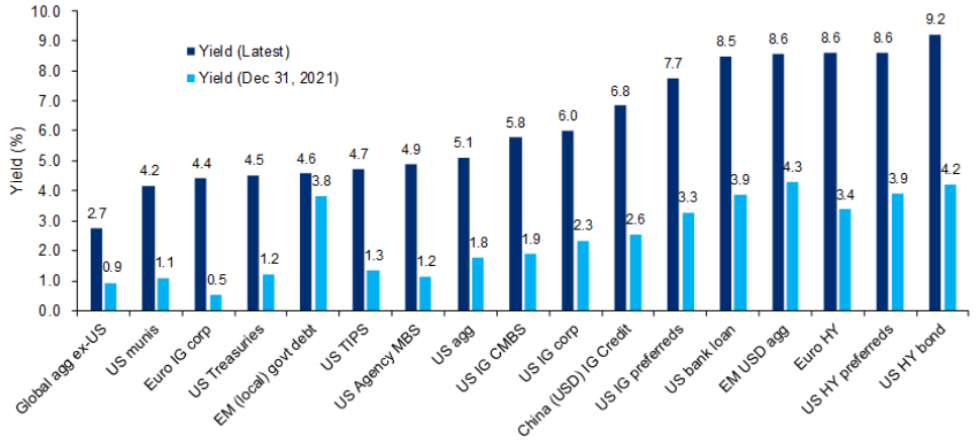
When employment falls – most likely in the first half 2022 – Fed officials won't be able to ignore it. As job losses accelerate and become self-reinforcing, their "need to react" will be akin to how they've treated inflation, in our view. This has been their reaction function for decades, including the high inflation period in the early 1980s (see our Sept. 25 CIO Bulletin).

Official comments from the Fed this past week suggest it is done raising rates by 75 basis points every 6 weeks. However, as there are three Fed meetings between now and the end of 1Q 2023 – when we think employment will decline meaningfully – we could see the Fed raising the higher end of the Fed funds target range to as much as 5.0% before the same data they now emphasize suggests a new policy course. This means the timing of the first Fed rate cut is likely 2H 2023, in line with the Fed's history.

By slowing from the 75-basis-point pace of the past six months, even coincident economic indicators should begin to suggest a change in course may be needed in 2023. This might minimize the extent of the Fed's tightening and, in turn, the severity of the likely 2023 recession.

The only silver lining in this dark picture of rising real interest rates is the sharp increase in prospective fixed income returns for long-suffering bond holders (see figure 7).

Figure 7: **Global fixed income yields: Now vs end of 2021**



Source: Bloomberg as of Nov. 4, 2022. 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. All forecasts are expressions of opinion, are subject to change without notice, and are not intended to be a guarantee of future events.

US Midterms – Nov. 8

Election Day is now upon us, and the latest signs favor the Republicans (GOP) flipping the House and perhaps the Senate. While voters care about a range of issues, polls indicate that inflation and the economy top the list of concerns. FiveThirtyEight sees an 85% chance of the GOP taking control of the House and a 53% chance of taking the Senate too. Meanwhile, RealClearPolitics projects the GOP picking up four net seats to gain control of the Senate by a 54-46 margin.

Historically, the party not in the White House has gained seats in 37 of the last 39 midterms and the Democratic party was starting with a slim 222-213 majority. But the Senate calculus has shifted more than once this year. According to betting site PredictIt, the odds of the GOP taking control of the Senate dropped in July and August for reasons we laid out in Road to the Midterms: Part 2 before mounting a comeback. Turnout will matter and some of the tighter Senate contests to watch include those in GA, WI, NV, NH, PA, NV, WA, and AZ. Gubernatorial elections are also taking place in 36 states and three territories.

The US stock market has performed poorly in the first nine months of midterm election years and far better afterwards based on history (Figure 8). In 2022, the S&P 500 has returned -24.8% through Sept. 30 and 4.9% since that date. If this bounce continues, we'd view it as a countertrend move. The Fed raising rates into a slowing economy poses a significant challenge for the market in the months ahead, in our view. We see 70% odds of a recession, and stocks typically bottom in the middle of a recession – not before one even starts. As a result, we remain invested but in a defensive, late-cycle manner.

In terms of sectors, the Inflation Reduction Act allows Medicare to negotiate lower some drug prices while also encouraging the transition toward clean energy. It was passed along party lines in 2022. Not surprisingly, pharma stocks have followed the GOP's prospects relative to the S&P 500 in recent months, as have traditional energy stocks relative to clean energy stocks (Figure 9).

Looking out further, the stock market has performed better when the White House and both chambers of Congress were split between the two parties rather than united under one (Figure 10). Investors seem to be at ease with gridlock in Washington that results from both parties acting as a check against each other. Stocks also tend to perform quite well in the year following midterm elections, but we don't expect this dynamic to be the fundamental driver of returns in 2023.

Figure 8: **S&P 500 Returns During Midterm Election Years (since 1953)**

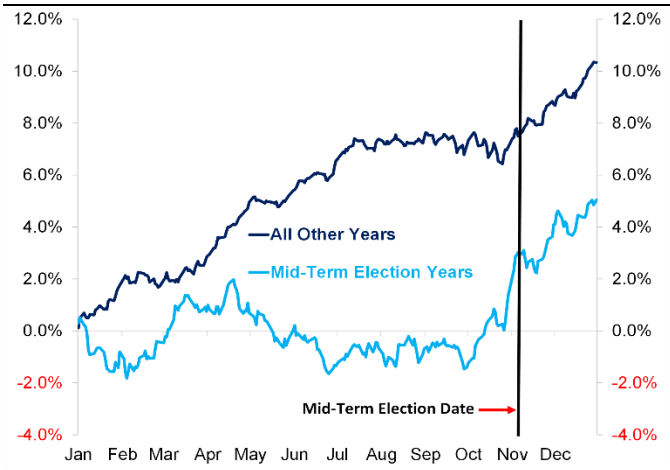
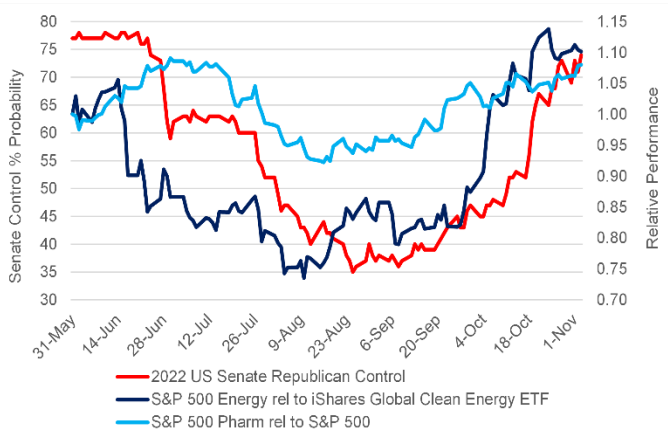
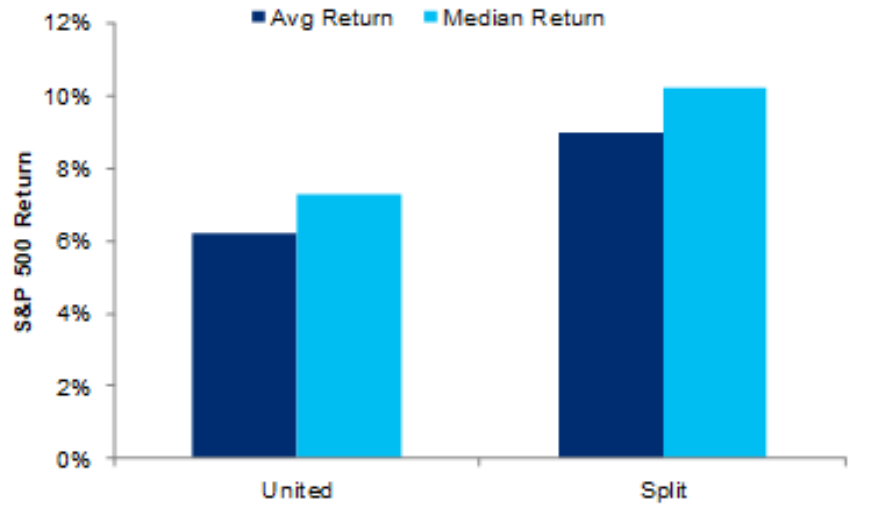


Figure 9: **Pharma and Traditional Energy Stock Relative Performance vs. PredictIt GOP Senate Control Odds**



Source : Haver Analytics as of Nov. 3, 2022, and Bloomberg as of Nov. 3, 2022. Implied probabilities are calculated using data offered by PredictIt, the contracts are independent, and their values may not add up to 100 percent 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. For illustrative purposes only. Past performance is no guarantee of future results. Real results may vary.

Figure 10: **Average S&P 500 performance during united and split government (since 1928)**



Source: Haver Analytics as of Nov 3, 2022. 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. For illustrative purposes only. Past performance is no guarantee of future results. Real results may vary.

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

Register now

DISCLOSURES

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

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

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

Read additional Important Information

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

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

MBS are also sensitive to interest rate changes which can negatively impact the market value of the security. During times of heightened volatility, MBS can experience greater levels of illiquidity and larger price movements.

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

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

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