



Citi Global Wealth Investments

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CIO Strategy Bulletin

An Early Call: The Beginning of the End of Easy Money

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Summary

- The Federal Reserve said it wants to give markets a warning “well ahead” of any change in the pace of its bond purchases. It said the timing would depend on the economy returning to a state consistent with the Fed’s “long run goals.”
- The present pace of US job growth is rapid enough to restore the pre-pandemic unemployment rate in just 16 months, even if the 3.5 million sidelined by COVID rejoin the labor force. The drop in US and global COVID infections also suggests the time to give an early warning of “tapering” is now.
- Reacting calmly to another month of surging US consumer prices, investors seem to be strengthening their understanding of the immediate drivers of short term inflation. The COVID-bound economy has seen record swings in demand from sector to sector of a scope that no producer could properly foresee or manage.
- Of course, not all elements of the inflation outlook are transitory. If central banks and fiscal policymakers persist with the same strong stimulus in the post-COVID economy, lasting inflation will result. We think it is highly unlikely that they would do so.
- It is worth noting the lessons from the period following the 2013 “taper tantrum.” The Fed spent five years tightening policy from 2014-2018. The Fed raised short-term interest rates nine times and shrank its outstanding credit by a peak of \$750 billion. In the same period, US equity total returns annualized 11%, inclusive of a near 20% drop at the end of 2018. Owing in part to a surge in the US dollar, non-US equities valuations have remained lower to this day.
- In sum, the period of “free money policy” is coming to an end. The very strongest returns from the crisis period have passed. We still urge investors to allocate for the opportunities of the new post-COVID economy that lies ahead.

The Big Rebound

Armed with medical technology, the world is on its way to defeat the COVID pandemic. Though there is still room for health policy mistakes that can send certain economies into relapse, the rate of new infections is subsiding globally in a way that strongly suggests vaccinations are winning the battle (see figure 1). As a result, depressed services industries are making a recovery. We believe that greater vaccinations globally will eventually reopen the global services economy while helping supply chains recover. It will provide the first opportunity for the smaller, most impacted tourism-driven economies to rebound (see figure 2).

Figure 1: New COVID Infections: US, World Ex-US

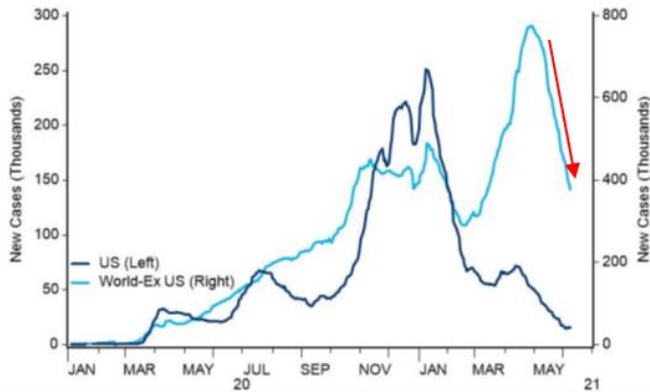
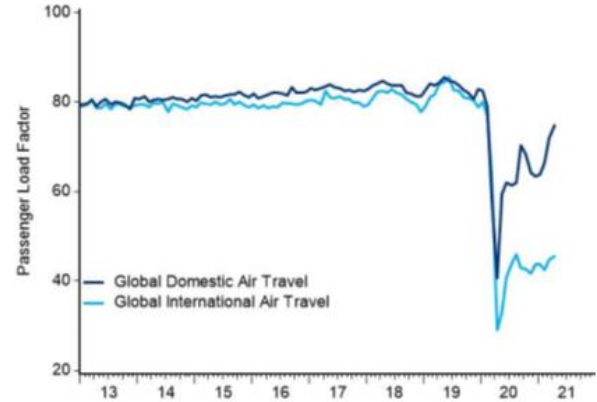


Figure 2: Global Air Passenger Travel: Domestic Locations vs International



Source: Haver as of June 11, 2021.

In the US, where vaccination rates have surged far ahead of the global average, employment in the most severely COVID-impacted services industries has jumped by 1.4 million over the past four months (see figure 3). With domestic hospitality and tourism turning on like a “light switch,” demand for hotel, travel, restaurant and other “leave your home” services is outstripping supply. This is leading to labor shortages (see figure 4), higher wages (see figure 5) and another leg higher in consumer prices. As a result, the widely reported jump in inflation that was first dominated by housing-related durables goods for the “shelter in place” economy is now shifting to “leave your home” services (see figure 6).

Figure 3: US Employment in Leisure and Hospitality Industry

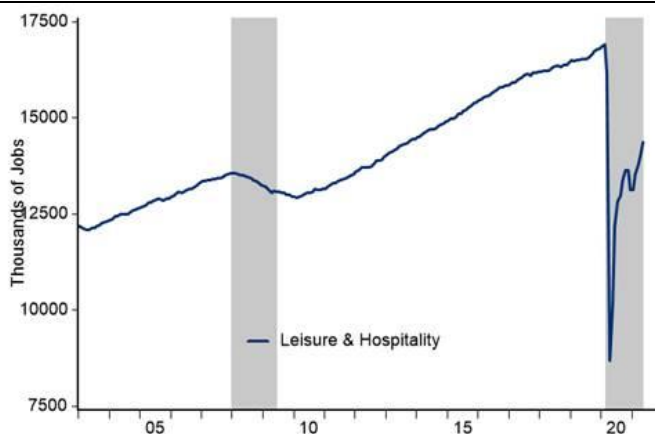
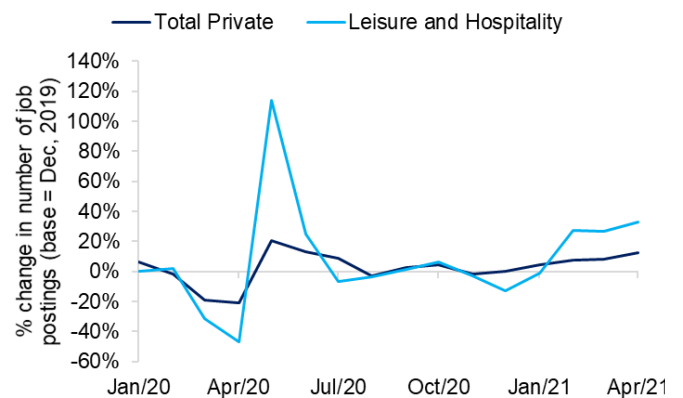
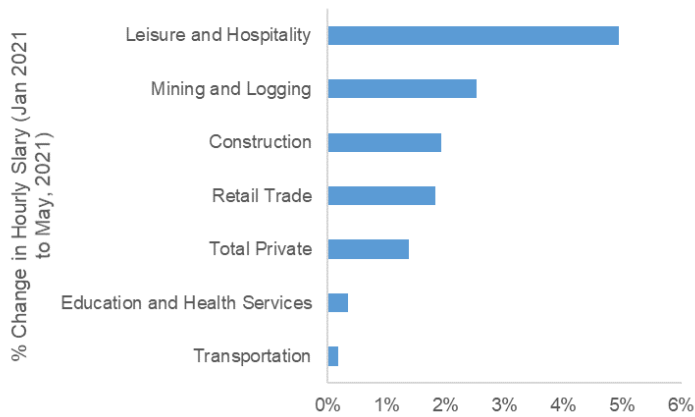


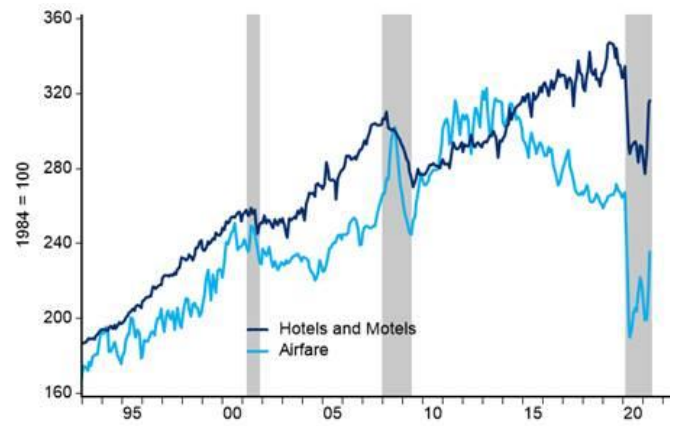
Figure 4: US % Change in Number of Job Openings, Compared to Pre-pandemic



Source: Haver as of June 11, 2021. Grey areas are recessions.

Figure 5: US Wage Growth by Industry

Source: Haver as of June 11, 2021. Grey areas are recessions.

Figure 6: US CPI Level: Hotels and Airfares

Investor worries over deflation a year ago and inflation this year have been rather extreme and exaggerated. **Yet for the economic and policy outlook we expect, we believe investors should indeed take the risk of higher inflation seriously as a long-term challenge for portfolios** (please see our [Mid Year Outlook](#)).

Some Like It Hot

As we heard from the ECB President Lagarde last week and will likely be reminded by Fed Chairman Powell this coming week, monetary policymakers are determined to see nothing less than a full economic recovery. They remain concerned that the trend inflation might remain stubbornly low, as was the case in the decade past. But this new approach may lead to unintended consequences. By favoring a “run it hot” approach, it is possible that an unhealthy “boom” could build. After all, some sectors of the economy are destined to lag others. However, we don’t expect that monetary policy will not be easing forever.

Distortions? Inflation?

The COVID-bound economy has seen record swings in demand from sector to sector of a scope that no manufacturer could have properly foreseen. These massive distortions are evident in sales data which boomed and in lengthy delays to fill supply chains. In that light, no one would have expected that prices would remain stable, yet investors initially responded with alarm. How could prices be stable through a simultaneous depression, industrial shutdown, and global travel seizure and merchandise boom across 60% of the good economy over little more than a year? (figures 7-8).

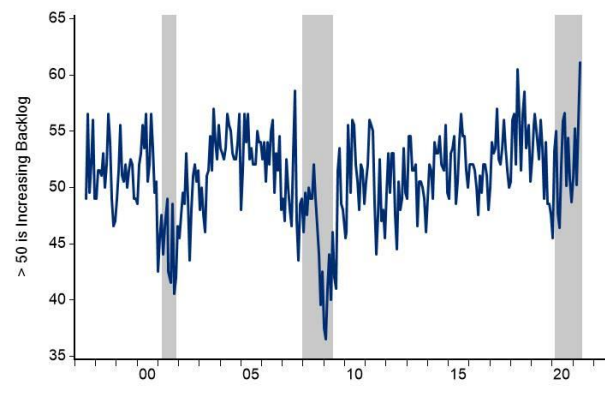
More recently, investors seem to be strengthening their understanding of the immediate drivers of demand-driven, short term inflation. This was evident in the market’s calmer reaction to the large US CPI gain reported last week compared to their reaction to similar news a month earlier.

Figure 7: US Retail Sales Y/Y% vs Manufacturers Supplier Deliver Times



Source: Haver as of June 11, 2021. Grey areas are recessions.

Figure 8: US Services Industries: Backlog of Orders



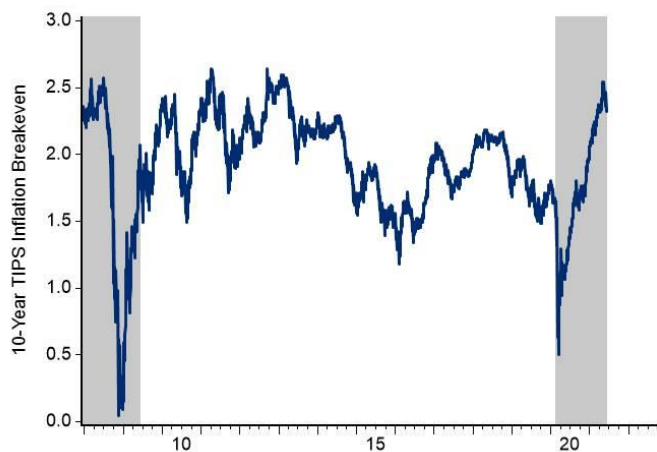
While the scope of the pandemic impact has been unprecedented, supply/demand mismatches caused by disruptions have historically cleared in about a year's time. We'd expect the same over the year ahead. Of course, not all elements of the inflation outlook are transitory. If central banks and fiscal policymakers persist with the same strong stimulus in the post-COVID economy that was used during the crisis, lasting inflation will result. But it is highly unlikely that they would do so.

Investors are Learning to be Discerning

With this understanding, the 10-year average expected US inflation rate priced in the US bond market has fallen 20 basis points over the past month (see figure 9). Is it pre-mature to conclude that inflation expectations have peaked for the long-term? We think so. We expect higher interest rates as the expansion broadens. Investors who are focused on inflation as their sole concern would be wise to reconsider. In our [CIO Bulletin of May 30](#), we note that there are wise asset allocation adjustments of moderate scope that can combat inflation *and* benefit from healthy real economic growth.

There are other reasons for portfolios to be allocated dynamically in an economy that is rapidly changing. COVID has driven a massive dispersion of investment returns that has only partly normalized (see figure 10). There are also emerging growth opportunities that can be anticipated in the post-pandemic economy whose future valuations will be higher than in the past. (See figure 11 and our [Mid Year Outlook](#) for full discussion).

Figure 9: US Treasury 10-Year Inflation Expectation



Source: Haver Analytics as of June 11, 2021. For illustrative purposes only. Past performance is no guarantee of future results. Real results may vary. Grey areas are recessions.

Figure 10: S&P 500 vs. Airlines, Hotels, Resorts and Cruise Lines

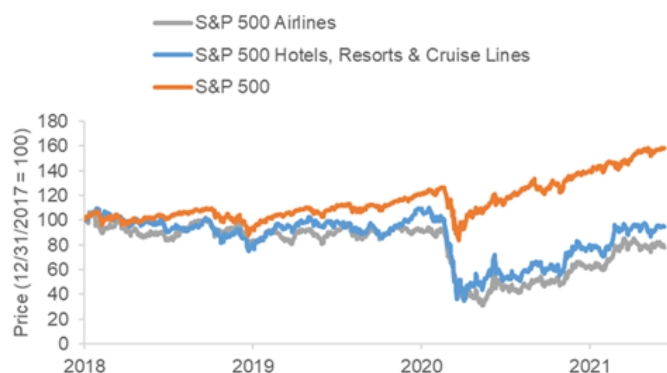
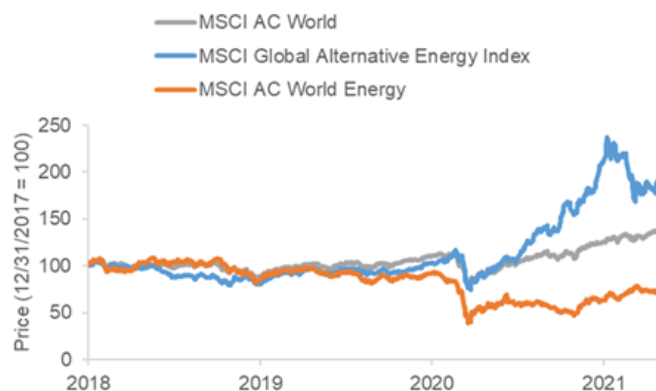


Figure 11: Global Equities vs Energy and Alternative Energy



Source: Factset as of June 11, 2021. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Past performance is no guarantee of future results. Real results may vary.

Whispers of Tapering

Reading the Fed's comments recently reminds one of a badly written fortune cookie.

At its meeting in late April – before the release of the strongest US inflation readings of 13 years – the US Federal Reserve noted “the economy was still far from the Committee’s longer-run goals.” The US central bank also highlighted the importance of communicating its assessment of progress “well in advance” of the time when it “could warrant a change in the pace of its asset purchases.”

Let's restate all that.

The Fed said it wants to give markets a warning well ahead of any change in the pace of bond purchases. This is important because the Fed is presently buying \$120 billion of US Treasuries and Mortgage Backed Securities per month with newly minted money. In normal times, the Fed's overall balance sheet growth is roughly zero. With their desire NOT to surprise markets, the Fed said “a number of participants suggested that if the economy continued to make *rapid progress* toward the Committee’s goals, it might be appropriate at some point in upcoming meetings to begin discussing a plan for adjusting the pace of asset purchases.”

What constitutes rapid progress?

With 3.5 million fewer labor market participants than when the pandemic hit, a normalization of the labor force would suggest the true US unemployment rate is closer to 8.5% than the 5.8% officially reported. At the same time, the US has added nearly 480,000 jobs per month on average in 2021. This is more than twice the number one would expect in a typical expansion. **If sustained, the present pace of job growth is rapid enough to restore the pre-pandemic unemployment rate in just 16 months, even if those sidelined by COVID rejoin the labor force.**

Higher US Taxation Will Not Impeded Growth

As Charlie Reinhard and Shawn Snyder, CPB North America Strategists detail in the [update of US fiscal negotiations](#), the Biden administration seems poised to compromise on the level of US corporate tax rates. Still, the likelihood of some tax increases seems quite high. The blueprints for Biden's “American Jobs Plan” and “American Families Plan” collectively target higher personal income taxes, corporate taxes, and capital gains taxes. In all probability, the administration and Congressional democrats will use the reconciliation process to achieve as much as they can of Biden's tax and spending recommendations this year.

Since 1950, there have been 15 (in some cases overlapping) instances of personal, corporate or capital gains tax increases. In only one year (1969), did US equities fall overall (see figure 12). Bearing this in mind, a US minimum corporate tax rate of 15% for large multinationals (much less a *global* minimum) would still have impact individual firms

(see figures 13-14). As a risk, some of these shares are the same beneficiaries of low or falling interest rates which we don't believe will be sustained.

Figure 12: Summary of U.S. Stock Market Reaction During Tax Increases Since 1950

US personal income tax	US corporate income tax	US capital gains tax
Only 1 of 5 cases coincided with a yearly decline in US share prices	0 of 5 cases coincided with a yearly decline in US share prices	0 of 4 cases coincided with a yearly decline in US share prices
Average annual gain in US shares when	Tax increases %	Tax cuts %
Personal income tax rates change	15.1	6.3
Corporate tax rates change	18.9	10.4
Capital gains tax rates change	16.3	18.9

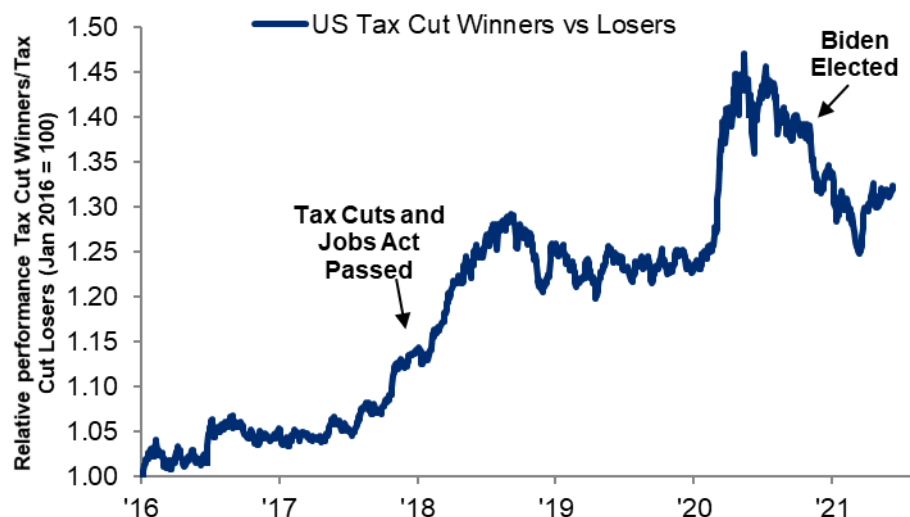
Source: Citi Private Bank Office of Chief Investment Strategist, and Bloomberg as of June 2021.

Figure 13: Companies Paying Less than a 15% Effective Tax Rate in the Last Three Years (Top 20 By Market Cap)

Name	Symbol	Market Cap	Sector Name	Effective Tax Rates			
				2020	2019	2018	'18-'20 Avg
Apple Inc.	AAPL-US	2,100,805.8	Information Technology	14%	16%	18%	17%
Microsoft Corporation	MSFT-US	1,888,843.6	Information Technology	17%	10%	55%	32%
Amazon.com, Inc.	AMZN-US	1,616,972.9	Consumer Discretionary	12%	17%	11%	14%
Alphabet Inc. Class A	GOOGL-US	1,513,199.1	Communication Services	16%	13%	12%	13%
Facebook, Inc. Class A	FB-US	791,534.2	Communication Services	12%	25%	13%	19%
Berkshire Hathaway Inc. Class B	BRK.B-US	668,136.7	Financials	22%	20%	-8%	6%
NVIDIA Corporation	NVDA-US	438,050.0	Information Technology	2%	6%	-6%	0%
Johnson & Johnson	JNJ-US	437,064.7	Health Care	11%	13%	15%	14%
Bank of America Corp	BAC-US	370,794.4	Financials	6%	16%	19%	17%
Walt Disney Company	DIS-US	321,924.0	Communication Services	-40%	22%	11%	17%
PayPal Holdings Inc	PYPL-US	309,000.5	Information Technology	17%	18%	13%	16%
Adobe Inc.	ADBE-US	241,151.0	Information Technology	-26%	8%	7%	8%
Oracle Corporation	ORCL-US	239,016.2	Information Technology	#N/A	16%	10%	13%
Verizon Communications Inc.	VZ-US	237,225.9	Communication Services	23%	13%	18%	16%
Intel Corporation	INTC-US	231,660.1	Information Technology	17%	13%	10%	11%
salesforce.com, inc.	CRM-US	219,906.5	Information Technology	-59%	82%	-13%	35%
Netflix, Inc.	NFLX-US	219,369.1	Communication Services	14%	9%	1%	5%
Pfizer Inc.	PFE-US	219,149.7	Health Care	6%	8%	6%	7%
PepsiCo, Inc.	PEP-US	204,260.4	Consumer Staples	21%	21%	-37%	-8%
AbbVie, Inc.	ABBV-US	198,452.8	Health Care	-36%	6%	-9%	-1%

Source: Bloomberg as of Jun 7 2021. For illustrative purposes only. Past performance is no guarantee of future results. Real results may vary. This does not constitute an offer to sell or a solicitation to buy any securities to any person in any jurisdiction

Figure 14: Relative Performance of US Equities That Saw Largest Tax Cut Benefit from 2017 Legislation



Source: Bloomberg as of Jun 7 2021. For illustrative purposes only. Past performance is no guarantee of future results. Real results may vary. Tax cut winners (losers) identify the 5 companies in each S&P 500 sector which saw the largest (smallest) decline in their effective tax rates following the passage of the Tax Cuts and Jobs Act of 2017. The baskets are equal-weighted and sector neutral.

Income Redistribution Consistent With Economic Growth

While mildly supportive for US growth potential, the administration's infrastructure, education and investment spending plans would significantly redistribute income in the economy. Many investors cringe in fear at this thought. We would focus instead on the miracle of COVID vaccines and the technologies that allowed much of the economy to adapt rather than collapse in the pandemic. The Fed did the same by creating a bolus of new reserves to finance debt. Monetary policymakers acted wisely to address emergency liquidity needs and to counter self-reinforcing fears in the crisis. Yet only technological progress (including organizational efficiencies) drives improvements in real per-person living standards. This has been the basis of real wealth creation since the stone age.

The Beginning of the End of Easy Money

We don't believe that changes in taxation will derail the economic recovery and that Biden's policies for income redistribution won't either. Yet neither offers a free lunch to all.

It appears to us that the time for the Fed to make its early warning about likely reductions in bond purchases is now. While the Fed does not need to raise interest rates this year, the likely end of COVID (see figure 1 again) is the primary reason to do so. In its meeting minutes, the Fed highlighted progress in addressing the COVID pandemic as most critical to such a move. Though the Fed might take months just to begin slowing the pace of its bond purchases, we think that it can no longer avoid having a conversation about how and when to swerve from its crisis-period easing course. The Fed's minutes suggest this is time is closing in. The Fed's recent decision to allow corporate bond holdings (with only \$14 billion of holdings) to mature without replacement should also stand as a signal that the Fed is beginning to contemplate an exit strategy.

Be Wary, Bond Investors

Overall, global bonds are poorly valued for the recovery and expansion of the next few years, regardless of when or if the Fed changes course. Though global bond investors may not be as shocked by "tapering" after their experience in 2013, as figure 15 shows, bond investors should not take comfort in subsiding inflation. The present level of 10-year real yields, -0.9%, will cost investors 9% of their wealth at maturity. We expect that real yields might only climb gradually in the coming expansion. Yet, we see it difficult to imagine a permanently negative, real cost of capital even for the US Treasury.

So How Could Long-Term Yields Fall As They Did Last Week?

For the bond market, the latest drop in yields is perplexing. “Short covering” has been widely cited, even as dealer positioning data in cash securities and speculative futures positioning seems only mildly indicative of a short squeeze. It might be that moderating upward momentum in commodities prices is a factor, even in those commodities with solid fundamental support (see figure 16).

But the notion that milder inflation -- the 5% annualized gain in US consumer prices over the year-through May was likely the peak -- will keep rates down is inconsistent with the economic growth ahead. In our view it is more likely that growth will be robust, the Fed will begin a slow and thoughtful process of reducing its support and rates will head higher.

Figure 15: Real US Yield – 10 Year US TIPS

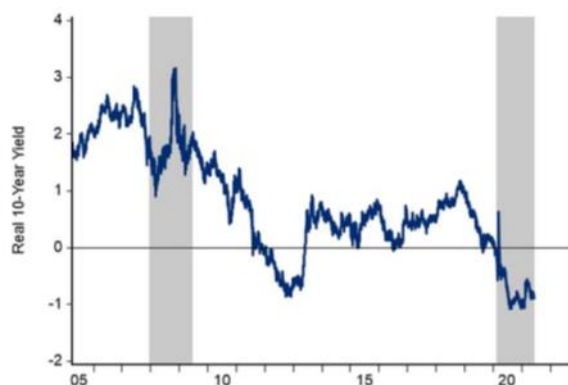
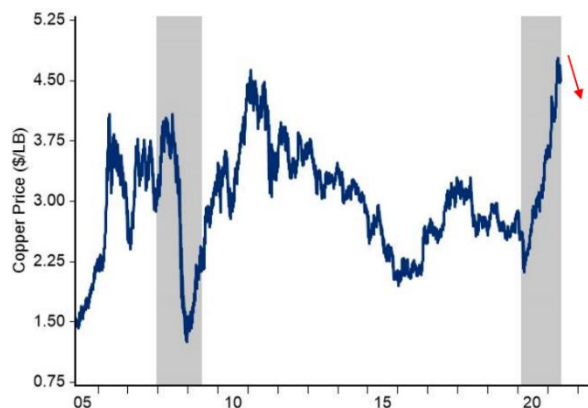


Figure 16: Copper Spot Price

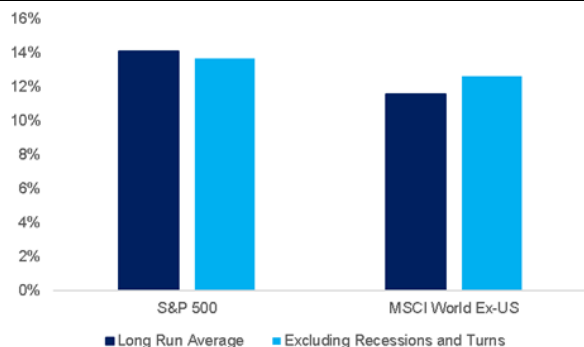


Source: Haver as of June 11, 2021. For illustrative purposes only. Past performance is no guarantee of future results. Real results may vary. Grey areas are recessions.

For Portfolios and Investors: Stay the Course

In our [Mid-Year Outlook](#), we showed that taking looking across both collapses and rebounds, mid-cycle equity returns have differed little from overall long-term returns (see figure 17). After a 43% gain from a depressed period one year-ago, we would argue that multi-year returns will be lower looking ahead, but still rewarding.

**Figure 17: “Mid Cycle Returns – US and Non-US
Overall Returns vs Returns Excluding Period 12-months
Prior to 12-months after US Recession**



Source: Bloomberg as of Jun 7 2021. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Past performance is no guarantee of future results. Real results may vary.

In particular, it is worth noting the lessons from the period following the 2013 “taper tantrum.” The Federal Reserve spent five years tightening monetary policy from 2014-2018. During that five year period, the Fed raised short-term interest rates nine times (225 basis points) and shrank its outstanding credit by a peak of \$750 billion. In the same period, US equity total returns annualized 11%, inclusive of a near 20% drop at the end of 2018. Owing in part to a surge in the US dollar, non-US equities posted a much smaller gain that persists to this day (see figures 18-21).

With this lesson in hand, we urge investors to allocate for the progress that lies ahead.

Figure 18: S&P 500 vs Federal Reserve Credit (2014-2018)

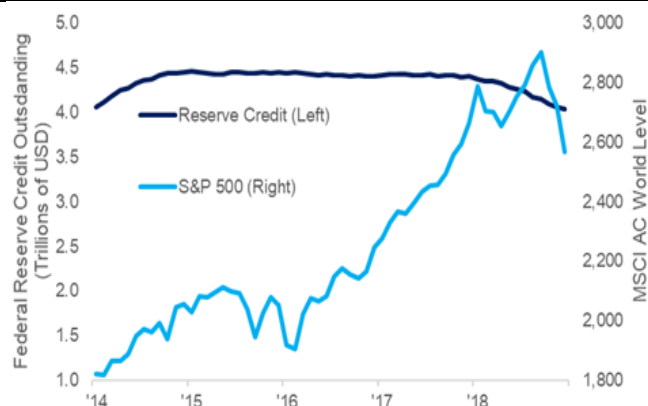
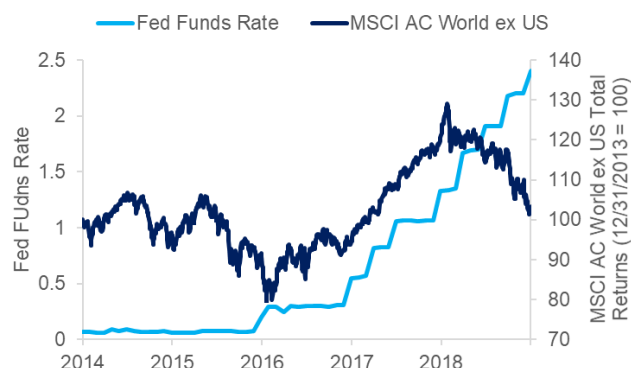


Figure 19: Non-US Global Equities vs US Fed Funds Rate (2014-2018)



Source: Haver and Factset as of June 11, 2021. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Past performance is no guarantee of future results. Real results may vary.

Figure 20: Forward P/E ratio: US vs. Non-US



Figure 21: Citi Global Wealth Asset Allocation Highlights For Risk Level 3 Global Portfolios

Largest overweights

- +2.5% Developed Equities (non-US)
- +1.5% Emerging Markets
- +4.0% Global Healthcare (Majority US)
- +1.0% Global REITS (Majority US)
- +1.0% US Mortgage REITS
- +8.0% Total Equities and REITS
- +2.0% US Treasury Inflation Protected Securities
- +3.0% High Yield Debt (loans) and EM Debt

Largest underweights

- -6.5% European Government Bonds
- -3.2% Japan Government Bonds
- -2.9% Cash, Short-Term US Treasuries
- -1.0% Global SMID
- -8.0% Total Fixed Income and Cash (vs -10% in March 2021)

Source: Haver Analytics, as of June 7, 2021. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Past performance is no guarantee of future results. Real results may vary.

Source: Citi Global Wealth Global Investment Committee (GIC) as of June 11, 2021

Citi Global Wealth Investments

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Traveling to the post-COVID world
New portfolios for a new economy

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