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Citi Global Wealth Investments

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CIO Strategy Bulletin

The Environment for Bonds and Humans

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Summary

The Environment for Bonds

- **The fourth quarter began with the US adding 531,000 new jobs in October, a positive sign for the pace of economic growth, but far stronger than can be sustained in the long run by US demographics.**
- **We see the "COVID bounce-back" and policy distortions significantly boosting growth and inflation temporarily. Meanwhile, bond investors still cannot reconcile 10-year US Treasury notes remaining stuck near 1.5%. A fall in yields Friday came despite the Fed finally beginning to reduce the pace of Quantitative Easing (QE) this month.**
- **The Fed's action seems late and timid for those who see inflation in a lasting acceleration, yet the US dollar index has jumped 1.5% since Fed Chair Powell "pre-announced" of tapering in late September. This is a significant indicator of confidence in US policy and the future stability of US purchasing power relative to other currencies.**
- **Yields are set globally in markets with open capital accounts. The global yield environment is even lower than in the US, and refuses to budge. We also believe the period of central bank "Financial Repression" will not end swiftly even if the Fed and a few others move away from crisis-level stimulus.**

The Environment for Humans

- **Leaders from around the world have gathered in Glasgow for the UNs 26th Conference on Climate change. Determined and detailed pledges to halt deforestation and phase out coal offers a view of the path to the future. At the same time, post-pandemic economic growth and shortages are driving fossil fuel prices higher making alternative energy investments more attractive**
- **On November 5, the House passed a roughly $1 trillion infrastructure bipartisan bill. We examine which industries could stand out as winners and how the bill echoes our unstoppable trends.**

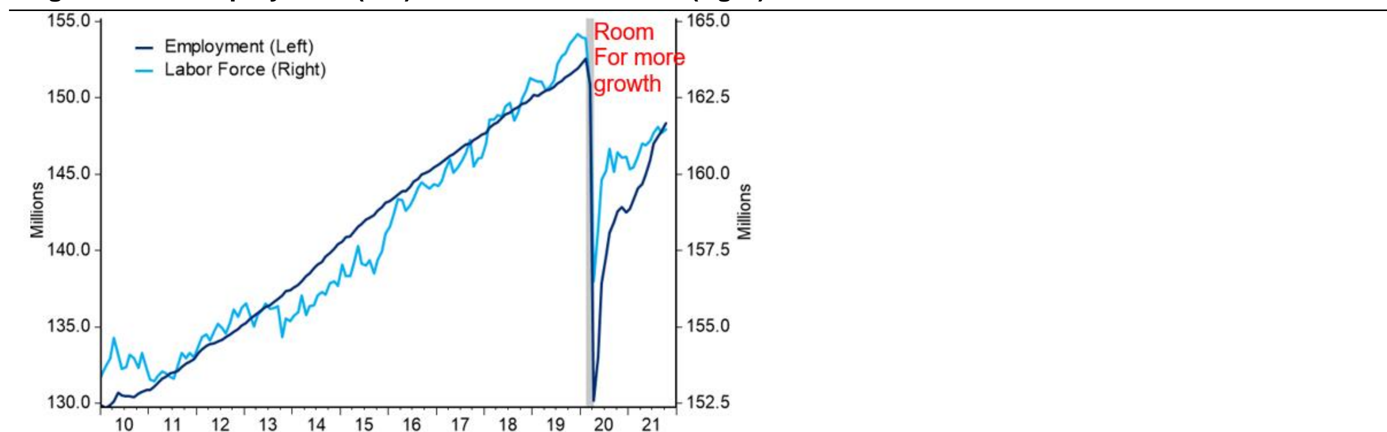
The Environment for Bonds

The No Tantrum, No Problem Bond Market

The COVID "bounce-back" and policy distortions that have boosted both growth and inflation feel far more potent than they are.

The fourth quarter began with the US adding 531,000 new jobs in October. This is a positive sign for near-term economic growth, but unlikely to be sustained for the long run given US demographics. In fact, the available labor force has *fallen* by 3 million since COVID struck. Without more job seekers -- there were only 740,000 over the past 12 months – available labor for particular positions is in short supply (see figure 1). Normally, such a strong employment report would signal higher interest rates.

Figure 1: US Employment (left) vs Total Labor Force (right)



Source: Haver Analytics as of November 5, 2021.

The Fed also announced a "tapering" of bond purchases beginning later this month, with a pace that will end Quantitative Easing (QE) by mid-2022. Again, as the Fed stops purchasing bonds issued by the US Treasury and mortgage issuers, one would expect higher rates.

But on Friday, the 10-year Treasury ended the week yielding 1.46%. Even so, the US dollar index has jumped 1.5% since Fed Chair Powell "pre-announced" of tapering six weeks ago. This is a significant indicator of confidence in US policy and the future stability of US purchasing power relative to other currencies.

Many bond investors are, frankly, befuddled that the 10-year US Treasury is stuck at rates that will generate a 10-year real return of -1.05% per annum. How can this be? What does this mean?

Stimulus Exodus

There were "only" two rounds of Federal government income support payments to consumers during the pandemic and there are no plans to repeat them (se figure 2). With emergency support now history, returning to work and consuming wage income should return to their place as the primary drivers of consumption. This means the pace of consumption growth will normalize as consumers finish spending their $4 trillion bonanza. Thus, we rationally expect a corresponding normalization in the types of products consumers demand, with slowing inflation expected for goods in the coming year (see figures 3). This is all indicative of economic equilibrium on the horizon, mitigating future interest rate rises.

Figure 2: US Federal Outlays vs US personal Savings Rate

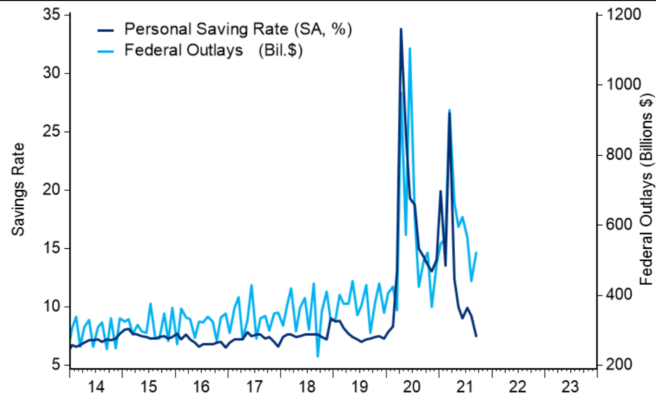
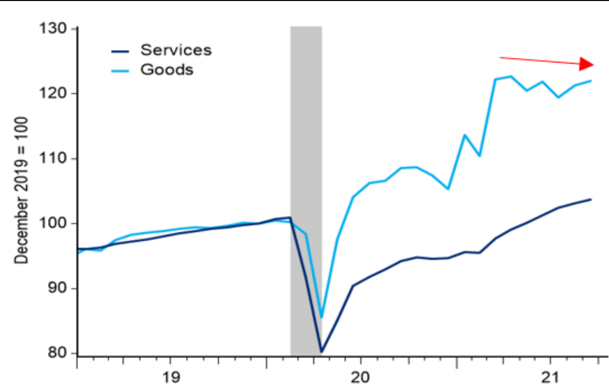


Figure 3: US Consumer Goods vs Services Spending



Source: Haver Analytics as of November 5, 2021. Note: Gray shared areas are US recessions

Rates, Where For Art Thou?

Globally, yields are set by investors shopping worldwide in open capital markets. The global yield environment appears wildly accommodative. For example, Greek bonds yield 45 basis points less than 10-year US Treasuries, Italy yields 60 basis points less, both with obviously greater credit risk (see figure 4).

There are several additional reasons why US long-term yields are not surging to compensate investors for inflation or for likely Fed tightening at the front end of the curve. Investors doubt that the European Central Bank will increase rates in parallel with the Fed when it has spent years fighting “Japanification.” (For more than 25 years, Japan experienced mild deflation on self-imposed austerity). As we see it, the global developed market yield environment is mired in “Financial Repression” (see figure 5 and our Outlook 2021). Financial repression is best expressed as a policy that keeps rates artificially low, deliberately under-compensating bond holders for inflation to make high levels of borrowing affordable for governments.

Figure 4: US and Key European 10-Year Government Bond Yields (%)

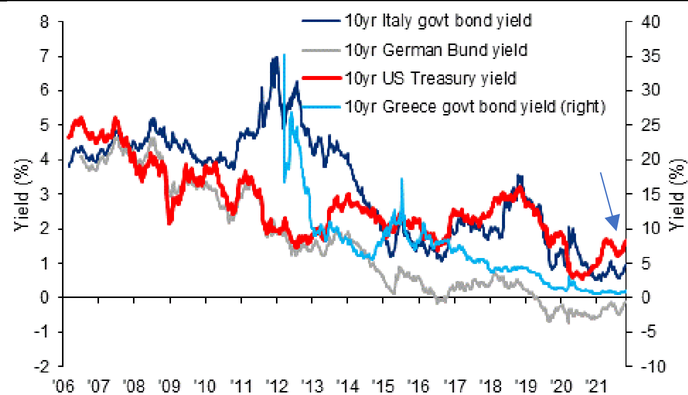
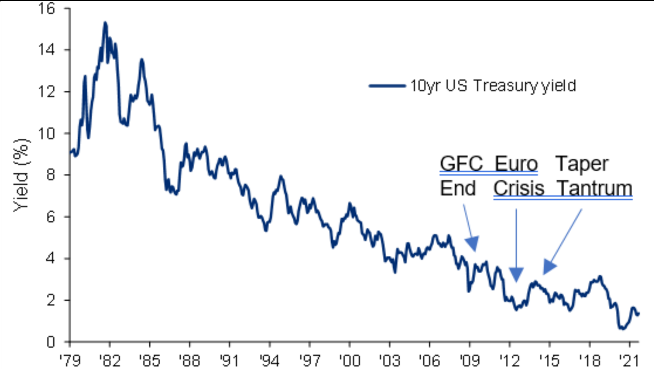


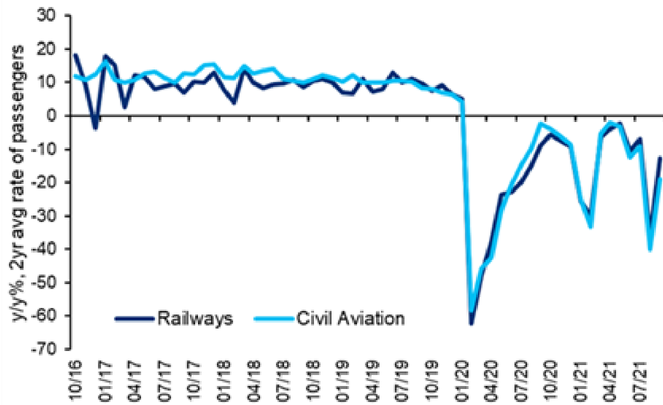
Figure 5: Nominal 10-year US Treasury Yield Since 1980



Source: Bloomberg as of November 5, 2021. Past performance is no guarantee of future results. Real results may vary.

China’s immediate economic outlook is also contributing to lower global rates. The country remains bogged down in its own, self-imposed economic slowdown. New COVID travel restrictions are only the latest example of growth inhibiting actions by the government (see figure 6). Severe measures to constrain property speculation, the unbridled growth of technology firms and policy actions to promote “common prosperity” are other 2021 examples, all of which have negative growth consequences (see our Quadrant).

Figure 6: China's Air and Rail Passengers, 2-Year Average Growth Rate



Source: Bloomberg as of November 5, 2021.

The Inflation Conflation

Friday's employment report is indicative of further employment gains to come. Nonetheless, labor markets simply have not been the inflation story of the past year. Rather, inflation has been driven by a sharp jump in scarce imported goods as COVID-bound consumers shifted the composition of what they purchased more rapidly than in any other time in history (see figure 7). For this reason, the Federal Reserve asked for continued patience, arguing the inflation spike is transitory. We think there is a lot of data to support the Fed's view.

Even with supply distortions abating, there are good reasons why we should expect an end of the four-decade long period of disinflation in the US and other Developed Markets. To us it appears that central banks have waived the victory flag. They are no longer trying to force down the trend pace of inflation. With some complex fine print, they have adopted slightly higher long-term inflation targets. Nonetheless, as the history of Financial Repression suggests, bond holders are not likely to be compensated for their wealth losses to inflation (see figure 8).

Figure 7: US Core Goods vs Services CPI

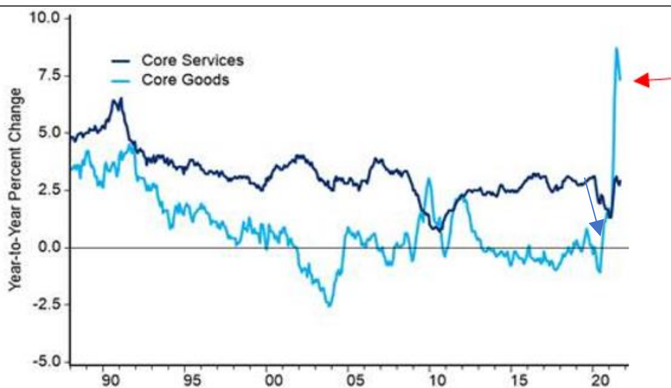
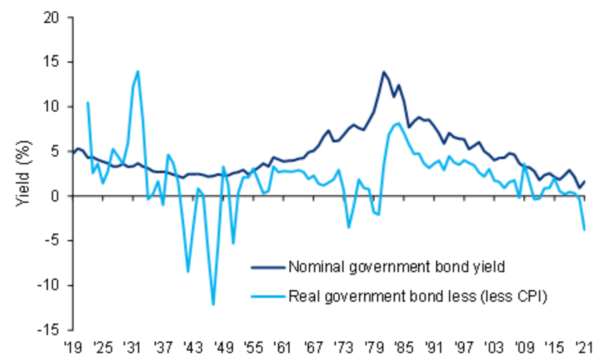


Figure 8: US 10-Year Government Bond Yield and Yield Less 12-Month Inflation



Source: Bloomberg as of November 5, 2021. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only. Past performance is no guarantee of future returns. Real results may vary. Grey shaded areas are recessions.

The Environment for Humans

Why Glasgow Matters

Speaking in front of global leaders at the opening ceremony of the UN's 26th Conference on Climate Change (CoP26) on Nov 1st, Sir David Attenborough said that all of modern human history (the last 10,000 years) "The global temperature has not wavered by more than plus or minus one degree Celsius – until now". The rise in our planet's temperature has increased the intensity and frequency of heatwaves, hurricanes and droughts. More CO2, methane, nitrous oxide and industrial gasses have reduced the cooling capacity of the Earth. As the Economist noted, global warming "has made the permafrost impermanent".

The CoP26 in Glasgow has gathered world leaders to discuss solutions to the large-scale impacts of climate change and to slow their seemingly relentless progression. Yet, at the same time, the worldwide recovery from COVID and shortages of are fossil fuels are driving energy prices higher (see figure 9), In fact, the surge in natural gas prices in Europe and China are two of the most vivid examples of how dependent the world remains on greenhouse gas emitting fuels. In short, investment in fossil fuels is diminishing more quickly than replacements have come online.

Over the past 60 years (see figure 10), geopolitical turmoil, geological challenges and triumphs have swung fossil fuel prices enough to trigger recessions and booms, as well as change consumer attitudes and buying behaviors. And all of this has occurred without broad agreements on worldwide carbon emissions and the resources needed to foster a transition to a carbon neutral world.

Figure 9: Oil, Natural Gas Prices vs Alt Energy Equities

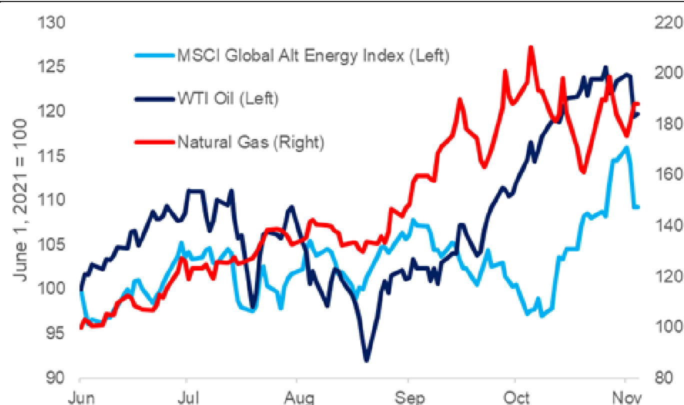
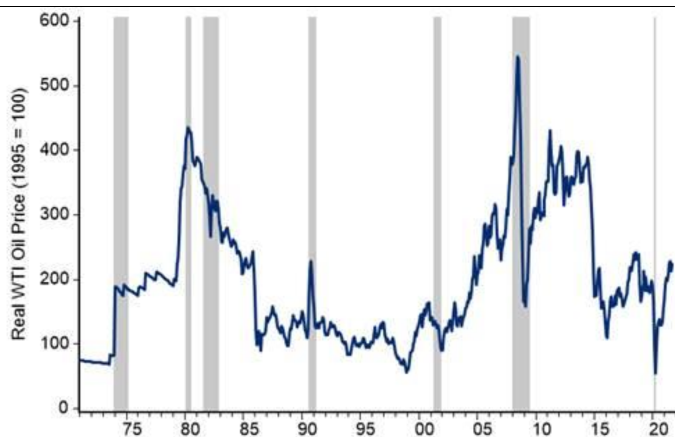


Figure 10: Real Crude Oil Price and US Recessions



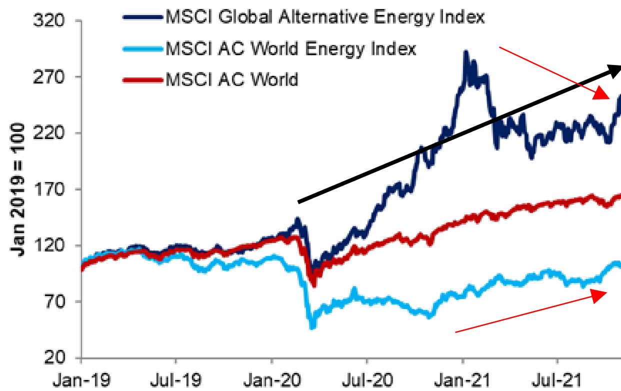
Source: Bloomberg as of November 4, 2021. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only. Past performance is no guarantee of future returns. Real results may vary. Grey shaded areas are recessions.

Inequality vs. Ingenuity

The need to address global warming is coming at a time of global political upheaval, with cooperation among leading carbon emitters falling across a range of social, trade and political issues. In the face of this instability, the gathered leaders are considering potentially important pledges – ranging from halting and reversing deforestation to phasing out coal. To do this, developed and developing nations will need to deal with the "inequality implications" of the costs associated with addressing climate change. This is making Article 6 of the Paris Agreement a key discussion point. Just how will the funds raised by charging carbon emitters be used? And how they will impact consumers in both rich and developing nations equitably?

The complexity of the world's climate issues is in contrast to the ingenuity that humans have shown in developing the technologies to combat this self-induced crisis. There are now valid alternatives to these fossil fuels. Each time we see a price spike in fossil fuels, the relative value of green energy solution become more attractive. As we can see in the last few months, the rise in fossil fuel prices have helped to end the doldrums for alternative energy equities after the early 2021 pull back from high valuations (see figure 11).

Figure 11: Alternative Energy, Traditional Energy and Global Equities



Source: Bloomberg as of November 4, 2021. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only. Past performance is no guarantee of future returns. Real results may vary.

Markets to the Rescue?

The intermittent production of green energy supplies has long been a stumbling block on the road to a low carbon future, as traditional fuels have been required for times of still winds, low tides or night. However, the cost of solar with storage or wind with storage is now well below the price of new coal plants (see figure 12). Also, once a solar, wind or tide power source is installed there are no risks from surging input costs.

At the same time, the surge in prices in natural last month then has seen the shuttering of 10 natural gas suppliers in the UK alone, as regulated consumer markets interact with unregulated energy markets.

With falling prices as well as strong consumer and government support the stage is set for even more acceleration in green energy construction. In fact, BNEF forecasts suggest twice as much green energy supply will be brought on in the next ten years as in the prior twenty (see figure 13). Moreover, these estimates have a long history of being understated as new technologies and efficiencies of scale have been driving down prices at an accelerating pace, one not accurate embedded in forecasts. Thus, it is technologically and economically plausible that within the next ten years, between carbon taxes and market forces, green energy with battery storage will be less expensive than keeping old fossil fuel plants running.

Figure 12: Cost of Electricity by Source Globally (indexed to compare)

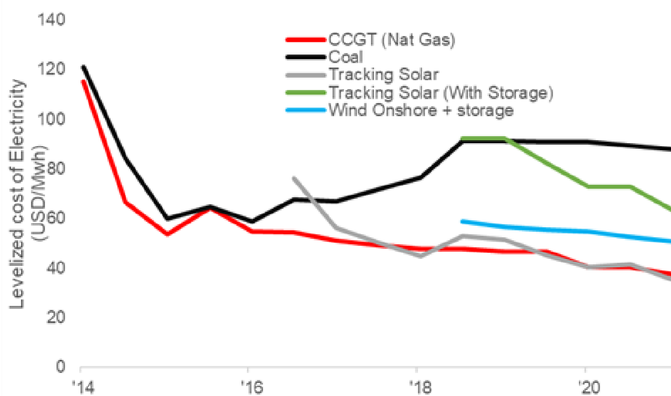
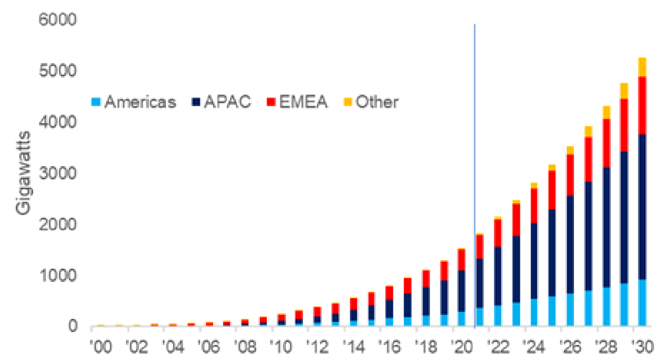


Figure 13: New Clean Energy Production Forecasts



Source: Bloomberg New Energy Finance as of November 4, 2021. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only. Past performance is no guarantee of future returns. 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.

Negativity Shall Lead to Positive Action

We expect a great deal of pessimistic “news” to come from the COP26 meetings. Phrases like “too little, too late” and “non-binding agreements” will likely be common.

That said, investors and the companies they invest in will see change forced upon them. We expect that corporate emissions are going to be a factor in how capital is allocated. Already, a large fraction of major developed market equity indexes voluntarily report Greenhouse gas emissions (see figure 14). With prices of Carbon Allowances in Europe increasingly impactful for companies, we expect that there will be a divergence in the performance of the 20% of the Stoxx index with the highest carbon intensity (most euros of sales per ton of carbon emitted) versus the 20% with the lowest carbon intensity (least sales per ton of carbon. see figure 15).

Figure 14: Market Cap Weighted Share of Sectors Reporting Greenhouse Gas Emissions

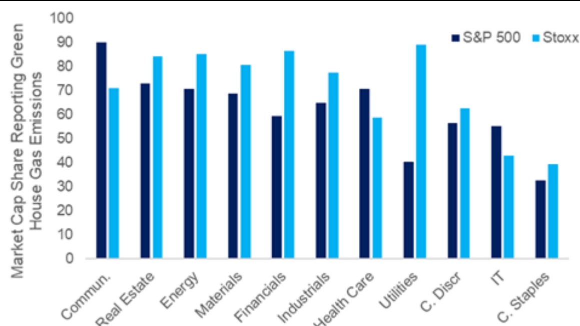
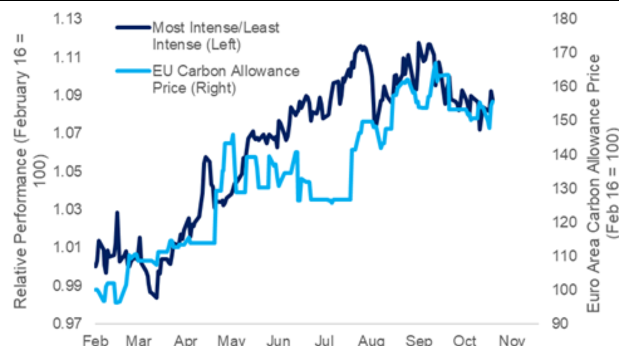


Figure 15: Relative Performance of Stoxx Companies with High Carbon Intensity vs. Low Carbon Intensity



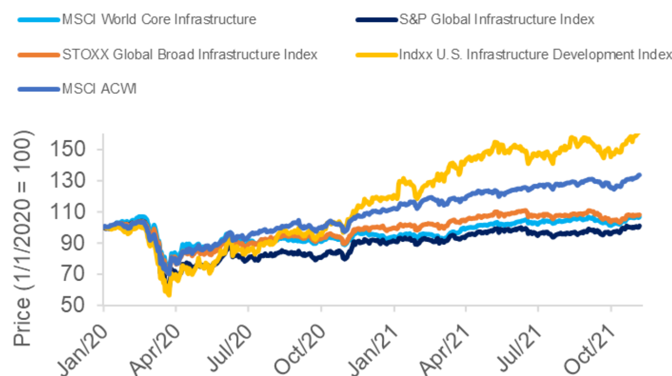
Source: Bloomberg New Energy Finance as of November 4, 2021. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only. Past performance is no guarantee of future returns. Real results may vary.

Unstoppable Trend: Green in the $1 Trillion US Infrastructure Bill

Government support for greening isn’t limited to Europe. The just-passed US Infrastructure Investment and Jobs Act calls for $550 billion in new spending, of which $73 billion is targeted on improving the electrical grid, $55 billion for clean drinking water, $39 billion on improving public transit including the use of zero emission electric buses and $7.5 billion for electric vehicle charging stations.

The Infrastructure Investment and Jobs Act supports our Unstoppable Trends including Greening the World, Longevity and Hyper-Connectivity. In addition, the effort to improve the nation’s infrastructure is, in part, motivated by an urgency to modernize to better compete with China in a G2 World, another unstoppable trend. We believe the leading firms tied to these trends will out-grow the market at large (see figure 16).

Figure 16: US Infrastructure Stocks Have Outperformed



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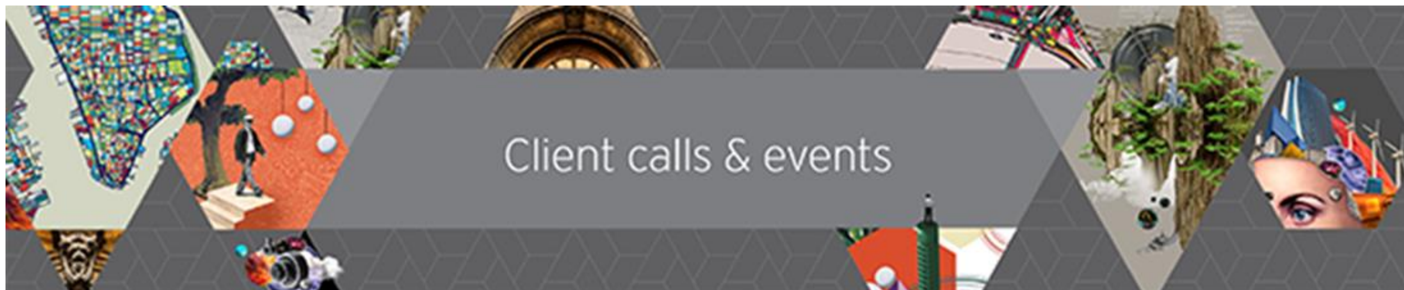

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