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CIO Strategy Bulletin

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The Finale May Appear Sooner Than Expected

SUMMARY

- January's reported employment gain is inconsistent with many other recent data points reported for the US economy. In fact, the 517,000 gain reported is absurdly large enough to make many market participants skeptical. But that doesn't mean it will be ignored.
- We expect the big jobs number -- and other components of the employment report -- to set back the recent rally in financial assets and strengthen the US dollar. And it likely will provide the Fed support for additional rate hikes, but is unlikely to give policymakers a sustainable rationale for a return to more rapid tightening.
- We believe the impact of last year's rapid monetary tightening hasn't been fully felt through the economy yet, with weaker hiring data on the horizon.
- We know markets lead the economy both up and down. That's why investors shouldn't wait for a weak economy to strengthen before shifting asset allocation to position for growth. What we're looking for are signs pointing to the finale to the weakening of the economy. Our data suggests sidelined investors won't have to wait long before the weakest readings for the economy are in sight around midyear.
- With the reset of global equity and bond valuations in 2022, long-term portfolio return prospects have improved sharply. All of this worry about cyclical conditions -- the ups and downs of the stock market -- can distract investors from focusing on the long-term potential of investing in economic development. That is why we will rotate toward riskier assets as signs of a lasting recovery become more convincing.

An Employment Boom?

The headlines on Friday shouted great news. There were 517,000 new jobs added in January, the strongest employment gain since July of 2022. We had thought the January gain would be large and positive, but nothing of this magnitude (see last week's [CIO Bulletin](#)).

Both January and June see the largest seasonal swings in actual employment in the United States. Therefore, these two months require the largest “seasonal adjustments” to “normalize” the data. The intent of adjustments is to remove large seasonal impacts from temporary employment; think retail hires in December and summer hires at vacation resorts. But what does this mean in simple terms?

The January 2023 employment report anticipated a 3 million drop in unadjusted (i.e., real) employment, but the actual drop in employment was 2.5 million, creating the 517,000 gain in jobs “after adjustments” (**Figure 1**).

In other words, actual employment fell by much less than expected. That’s the “good news.” But read the fine print. Government seasonal adjustments are dramatic and the process of making them is complex and subject to future revisions.

Here’s one industry example: The actual job count in leisure and hospitality fell by 291,000 by the end of January, but because fewer people than expected left the leisure and hospitality workforce the “post-adjustment” number showed a gain of 128,000 jobs.¹

In our view, the reported gain in employment is out of line with many other recent data points reported for the US economy. In fact, the month-over-month gain reported is “absurdly large enough” to make many market participants skeptical. But that doesn’t mean it will be ignored.

We expect this huge “employment gain” – as well as many of the components of the employment report – to set back the recent rally in financial assets and strengthen the USD. For the Fed, it will provide support for additional rate hikes, but is unlikely to provide a sustainable rationale for a return to more rapid tightening.

Contradictory Data Leaves Markets Unsettled

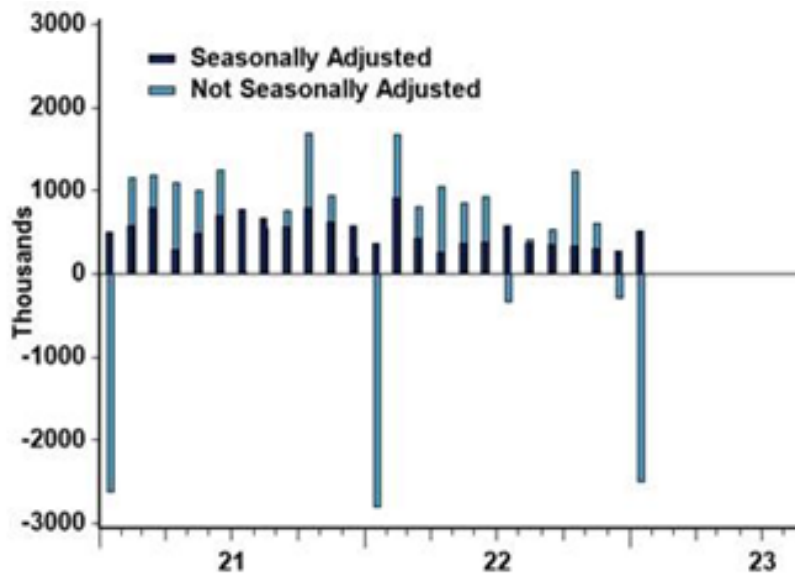
For investors, the huge employment report does cast doubt on other data. Seasonal adjustments and seasonal data should leave us somewhat skeptical about the economy’s true performance until we get more and better information later this spring. That makes our job – to predict the path of the economy and markets – harder.

As we have reported (see the January [Quadrant](#)), there have been many signs of weakness in the US economy. In particular, the cyclical parts of the US economy – manufacturing, trade and residential construction – are all contracting. This is in sharp contrast to January’s employment data.

Unfortunately, we believe the impact of the “rapid” monetary tightening of 2022 (Fed Chairman Powell’s words) has not yet been fully felt throughout the economy. We continue to believe the anticipated January job surge is out of line with forward-looking fundamentals and we believe weaker hiring data is likely in the coming months. But it’s also possible that the resilience of the economy has been underappreciated.

¹ Bureau of Labor Statistics

Figure 1: US employment: Less than meets the eye



Source: Haver Analytics as of Feb. 3, 2023.

Reasons for Optimism? Putting Events in Context

A year of surging inflation and rapid, historically unprecedented rate hikes from central banks left nearly all asset markets reeling in 2022. As we discussed in our [Outlook](#) for this year, the combined performance of equities and bonds was the worst since 1931.

January's bear market rally is based, in part, on the earlier bearishness of investors. For example, trader short positions in 2023 are unusually large (**Figure 2**). This provides fuel for rallies as short sellers scramble to buy back stock to mitigate their losses. You can see this activity by looking at the sharp pivot in market leadership as some of 2022's biggest decliners – the most shorted shares – have rallied strongly (**Figure 3**). In particular, electric vehicle companies, semiconductors, social media, and consumer discretionary have led the race to “buy the dip” (**Figure 4**).

That's not the whole story.

Rightly or wrongly, the market is pricing increasing odds of a soft landing based on falling inflation *and* Fed rate cuts at the same time. Across rates, equities and FX, 2023 to date has looked like the inverse of last year's portfolio carnage. After the [Fed meeting this week](#) where it acknowledged some signs of falling inflation, investors feared missing out, with traders chasing the rally higher and covering shorts. This is the opposite of 2022's pessimism rooted in concerns about ever-rising inflation and an aggressive Fed that sank stocks and bonds in tandem.

Figure 2: S&P 500 futures net short positions

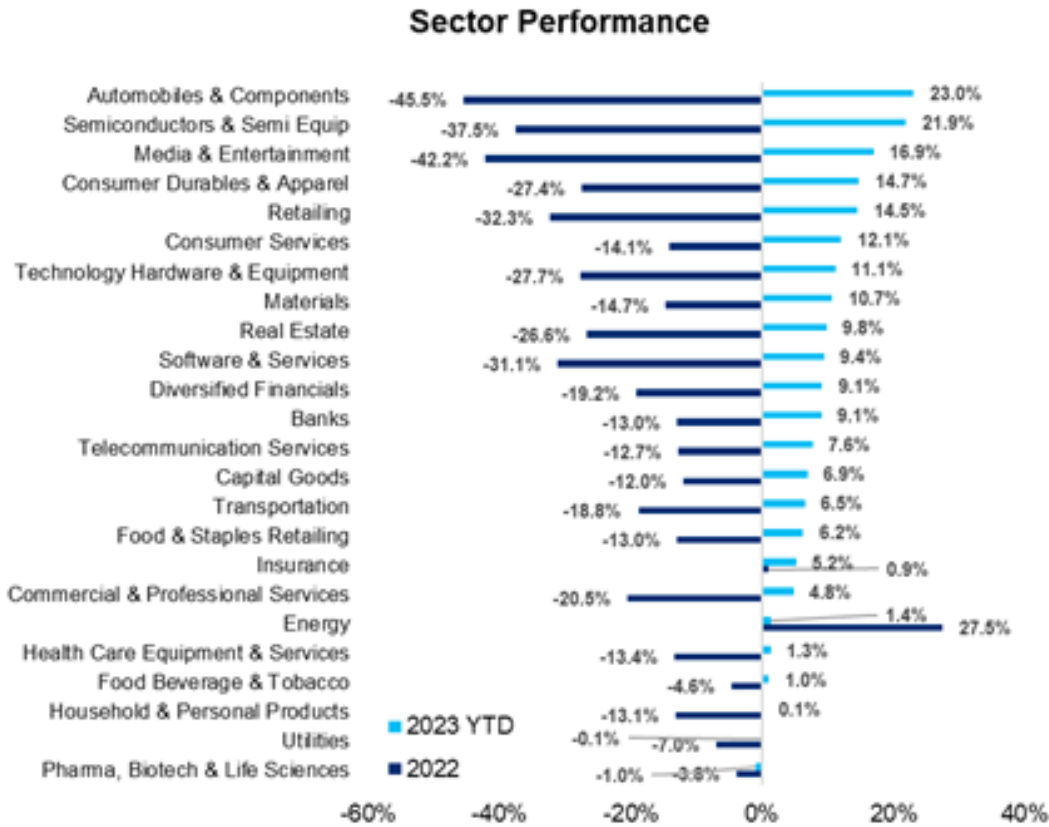


Figure 3: Performance of least shorted US equities vs most shorted



Source: Haver Analytics as of Feb. 3, 2023. 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 4: S&P 500 Industry Group performance in 2022 and 2023 YTD



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Known Knowns

Earnings

As we anticipated in our [4Q earnings preview](#), firms have by and large beaten consensus estimates for the quarter after they had been reduced over the past few months. That said, relative “positive performance” has been more muted than in a typical quarter, with earnings exceeding consensus by “only” 1.3% vs. an average of 6% since 2010.

Earnings appear to have declined slightly in 2022’s fourth quarter, in line with the negative retail sales and industrial production data for November and December. This is actually weaker than we expected. Forward-looking indicators suggest this weakness was not the end point, but the beginning of a retrenchment in profits that should continue for at least the first half of 2023.

Profits are on track to decline by 2.7% year-over-year and -4.5% quarter-over-quarter. Meanwhile, while revenues rose by almost 5% last quarter, profit margins contracted as firms struggled to transfer sales growth to the bottom line amid still-rising costs.

The Fed

In his first FOMC meeting of the year, expectations were high that Fed Chairman Powell would vow more rate hikes to come even with the economy and inflation slowing. Powell didn’t veer from this script. Markets viewed his expected comments as a positive sign, having feared even more hawkishness. This provided another source of “relief” for markets.

For equities investors, the point of watching the Fed boils down mostly to its impact on the future performance of the economy. Equities tend to predict where future earnings will be. In our view, the immediate news on the economy doesn’t support a view of rising EPS, but rather falling EPS over the coming few quarters (**Figure 5**).

In real time, it is difficult to distinguish between a new bull market and a shiny, tempting bear market rally. Unlike previous new bull markets, economic conditions do not signal “all clear.” The Fed has not completed its hiking cycle and several Fed leaders have stated unequivocally they have no plans to cut rates until inflation falls sharply.

Big Tech

Big tech bellwethers reported earnings this week, with disappointing results from all but the most beaten-down segments like social media. Holiday smartphone and e-commerce sales missed estimates, cloud growth continues to decelerate, and slowing digital advertising revenues are a clear concern. Across technology industries, cost cutting remains a consistent reprise for management teams seeking to preserve cash flow as sales slow for the first time since the pandemic.

Tech-related layoffs have jumped to their highest levels since the dot-com bust (**Figure 6**). While firms with sufficient organic free cash flow should be able to sustain growth even as they cut costs, we remain especially cautious on unprofitable technology firms that no longer benefit from “growth at any cost” valuation premiums in an era of tighter money.

The Finale May Appear Sooner Than Expected

Historical precedent is clear: Don’t wait for a weak economy to strengthen before changing your asset allocation to position for growth. This is because markets lead the economy in both directions. What we are looking for are signs pointing to the finale for the weakening of the economy. While the January employment report suggested otherwise, in our view, the preponderance of data still suggests sidelined investors won’t have to wait long before the weakest readings for the US economy are in sight around midyear 2023.

If the pace of the decline in US manufacturing orders over the last 12 months continues, it would rival the Covid collapse and 2008/2009 bust. We see this as unlikely. Unlike those periods, neither a forced shutdown of economies nor a systemic banking sector collapse is on the horizon.

We continue to veer overall portfolios toward quality income characteristics for now. The 19% drop in US shares in 2022 suggests the equity market has moved sufficiently to price in the economic weakness we have seen to date. What shares don't appear poised for today is further economic weakening that is likely after the Fed's powerful and unprecedented monetary tightening.

If the economy stalls and profits retrench as we expect, the routine patterns of decline and recovery will play out with markets leading the way. After all the apprehension of 2022, market behavior suggests investors are eager to participate.

With Our Strategic Return Estimates Up, Portfolios May Lean In

Investors who sold out of equity portfolios after a large drop in 2022 expecting to suffer worse in 2023 are likely worried about missing out now. Spooked bond investors who thought yields could only climb after last year's rout may have experienced 14% total return in long-term Treasuries during the past quarter if they had held instead of sold². (Read about market timing in our Oct. 2, 2022 [CIO Bulletin](#) and "[Beat the Cash Thief](#)" in Outlook 2023.)

The 10% drop in US shares over the last 12 months suggests the equity market has moved sufficiently to price in the economic weakness we've seen to date. What shares don't appear poised for is further economic weakening that is likely after such substantial monetary tightening (**Figure 7**). That's a short-term issue, however.

With the reset of global equity and bond valuations in 2022, long-term portfolio return prospects have improved sharply. All of this worry about cyclical conditions – the ups and downs of the stock market – can really derail investors from focusing on the long-term potential of investing in economic development. And that is why we seek to rotate toward riskier assets as signs of a lasting recovery become more convincing (**Figure 8**).

Figure 5: S&P 500 vs EPS estimate revisions for the coming year



Source: Haver Analytics as of Feb. 3, 2023. 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.

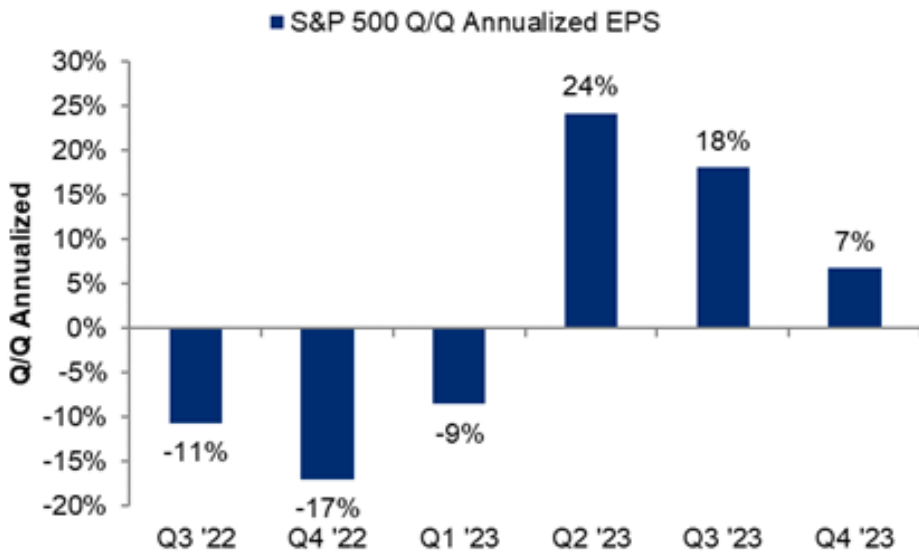
² This was the return of a long term Treasury index over the last quarter.

Figure 6: Tech-related layoff announcements



Source: Haver Analytics as of Jan. 27, 2023. 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 not indicative of future returns. Real results may vary.

Figure 7: Consensus EPS growth (quarter-over-quarter)



Source: Factset through Feb. 2, 2023. 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 not indicative of future returns. Real results may vary. All forecasts are expressions of opinion and are subject to change without notice and are not intended to be a guarantee of future events. Past performance is not indicative of future returns. For illustrative purposes only.

Figure 8: 10-year strategic return estimates after the 2022 stock/bond correction


	Strategic Return Estimates in USD for 2023
Global Equity	7.6%
Global Fixed Income	5.1%
Developed Market Equities	7.0%
Emerging Market Equities	12.9%
Investment Grade Fixed Income	4.6%
High Yield Fixed Income	7.4%
Emerging Market Fixed Income	7.8%
Cash	3.4%
Hedge Funds	9.1%
Private Equity	17.6%
Real Estate	10.6%
Commodities	2.4%

Source: Global Asset Allocation Team, data as of 31 October 2022. Strategic Return Estimates (SRE) based on indices are Citi Global Wealth's forecast of returns over a 10-year time horizon for specific asset classes (to which the index belongs). Indices are used to proxy for each asset class. Cash refers to the US Cash SRE. The forecast for each specific asset class is made using a proprietary methodology that is appropriate for that asset class. Equity asset classes use a proprietary forecasting methodology based on the assumption that equity valuations revert to their long-term trend over time. The methodology is built around specific valuation measures that require several stages of calculation. Assumptions on the projected growth of earnings and dividends are additionally applied to calculate the SRE of the equity asset class. Hedge Fund and Private Equity SREs are linked to equity SREs. Fixed Income asset class forecasts use a proprietary forecasting methodology that is based on current yield levels. Other asset classes use other specific forecasting methodologies. SREs are in US dollars. SREs are generally updated on an annual basis, however they may be updated off cycle based on market conditions or methodology adjustments. Strategic Return Estimates are no guarantee of future performance. SREs do not reflect the deduction of client fees and expenses. Future rates of return cannot be predicted with certainty. Investments that pay higher rates of return are often subject to higher risk and greater potential loss in an extreme scenario. The actual rate of return on investments can vary widely. This includes the potential loss of principal on your investment. It is not possible to invest directly in an index. All SRE information shown above is hypothetical not the actual performance of any client account. Hypothetical information reflects the application of a model methodology and selection of securities in hindsight. No hypothetical record can completely account for the impact of financial risk in actual trading.

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High quality (very strong)	Aa	AA	AA
Upper medium grade (Strong)	A	A	A
Medium grade	Baa	BBB	BBB
Not Investment Grade			
Lower medium grade (somewhat speculative)	Ba	BB	BB
Low grade (speculative)	B	B	B
Poor quality (may default)	Caa	CCC	CCC
Most speculative	Ca	CC	CC
No interest being paid or bankruptcy petition filed	C	D	C
In default	C	D	D

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