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CIO Strategy Bulletin

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Revisiting China While Yielding to Oncoming Traffic

David Bailin, Chief Investment Officer and Head of Citi Global Wealth Investments
Steven Wieting, Chief Investment Strategist and Chief Economist
Ken Peng, Head, Asia Investment Strategy
With contributions from **Malcolm Spittler, Joseph Kaplan**

Summary

- **Just when inflationary pressures were beginning to abate and supply-demand imbalances were starting to narrow, a series of near-term challenges is muddying the waters.**
- **The latest inflation data showed a 7.5% rise in consumer prices over the last 12 months, with 1.6% of that increase attributed to used-car prices alone. Stubborn supply-chain troubles are not quite done handicapping economic flows, and now a growing list of external factors might delay a return to normal pricing and more balanced levels of supplies for goods.**
- **For one, while now still just a threat, a Russian invasion of Ukraine would impact the world economy, energy and wheat prices in particular. Another is the trucker protest in Canada which has shut a key supply route to the US that has hit auto manufacturing capacity. While the blockade is likely to resolve in the near-term, US car and truck production might weaken in February-March. Another ongoing shift -- the so-called Great Resignation -- has seemed to permanently change people's expectations of work. The premiums many companies are paying to hire and retain employees will continue; but real wage gains will be offset so long as inflation runs higher than expected, compounding wage pressures for longer.**
- **What concerns us is that the near-term environment may provide more fuel for Fed action even as underlying inflationary pressures ease. Recent comments by Fed officials sounded as though some Fed policymakers believe they need to take emergency steps to unwind their own easing steps.**
- **While additional shocks are possible, the real risk is an overreaction to the elongation of inflationary pressures that are beyond the Fed’s control.**
- **And while the Fed embarks on its tightening regime, China is going in the other direction. China has begun to ease its monetary policy after macro-economic and regulatory tightening in 2021 curbed economic growth.**
- **We see several reasons to be positive on China now and believe global portfolios should diversify into markets with lower policy risk like China. And as such we recently added to the overweight of Chinese equities.**

Flashing Yellow Signs for Inflation

Without external shocks and disruptions, 2022 would likely be a year when the economy reaches a new, less inflationary equilibrium. As we have documented (please see our January 23 bulletin), a narrowing in many demand/supply imbalances behind today's high headline inflation is *beginning* to unfold. We see this in several areas as consumer spending on durable goods weakens and supplier delivery times ease.

Not so fast! In the 7.5% jump in consumer prices over the last 12 months, used car prices alone contributed 1.6%, a visceral example of lingering supply chain woes. New car production had been held back by a shortage of semiconductors that was expected to abate in 2022. Core commodity prices were 1% higher (11.7% YoY), food 0.9% higher (7.0% YoY) and energy was 0.9% higher (27% YoY). One would have expected that in an economy normalizing after Covid, these high inflation prints would be exhibiting signs of relief, but so far that has not shown up in the headline data.

The Fed has made it clear that fighting inflation is now its critical mission (see our January 30 bulletin). They have articulated that a "double reverse" strategy -- raise rates and reduce lending at the same time – is on the table, underscoring the seriousness of their intentions. In last week's Bulletin, we wrote that "taking the fight to inflation risks the whole economic recovery" if the Fed moves too harshly and curtails demand more severely than necessary. And we also warned that "the immediate direction of inflation may be decisive for the Fed," meaning that near-term inflation surprises would likely invite a harsher tightening response from the Fed.

Markets last week priced in a more rapid Fed response, particularly *before* geopolitical headlines took the spotlight on Friday. The 10-year US Treasury "blasted" past the 2% threshold for the first time since July 2019. While we think the yield could average 2.5% in a sustained expansion period, it is the speed and intensity of changes in interest rates that influence economic growth. The rise in yields reflects an altered view of US monetary policy as long-term inflation expectations priced into the bond market changed little last week. Even with a sharp decline in equities, as of Friday markets priced a 50-basis point Fed rate hike in March as a 50% probability (25 basis points is priced at 100%). Given the Fed's new rhetoric, we see it difficult for them to tighten any less than markets expect.

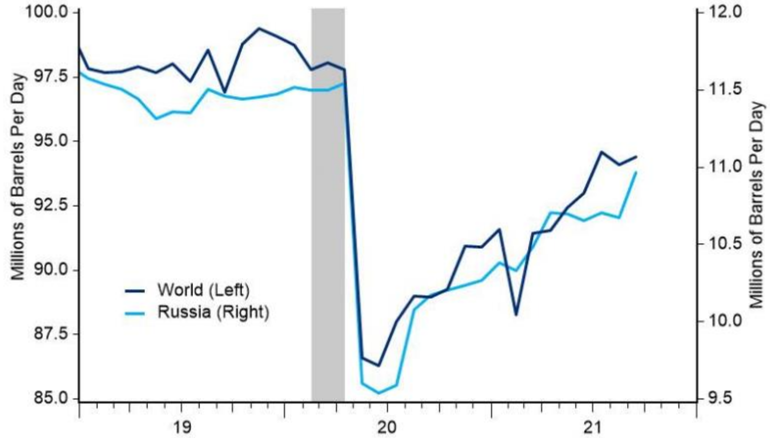
External Vulnerabilities Flashing Red

While the debate rages on about the likely persistence of today's high inflation levels, there is a growing list of exogenous factors that will make a straight-line resolution unlikely. In an ideal circumstance, temporary sources of inflation, such as shortages of car parts or the cost of energy would abate as production rebounds and demand cools. On the immediate horizon are several issues that may delay a return to normal pricing and supplies for autos, energy and commodities, among other product areas.

Russia/Ukraine

On Friday, US Secretary of State Blinken said a Russian invasion of Ukraine "could begin at any time." In the event that Russia chose a full-scale invasion, the impact on the world economy will be material, even if it lasts for only a few months. Europe, which has already spent twice as much on energy in 2022 ($1tr) than last winter, would face gas shortages and much higher replacement pricing. While full trade sanctions have not been threatened, Russia contributes significantly to finely balanced world supplies. Prices would spike materially at a time when inflation is already a significant challenge for the world recovery (figure 1).

Figure 1: World crude oil production vs. Russian production: rebounding, but recovery at risk



Source: Haver Analytics as of Feb. 13, 2022. Shaded regions refer to recession.

Furthermore, Russia is the world's largest exporter of wheat and sanctions would impact the price of non-Russian imports. As a big metals supplier, financial or trade credit curtailments could send prices upward for many manufacturing inputs. Not only would supplies and prices be impacted, but so would supply chains. The movement of goods is dependent on shipping, and conflict can create global disruptions for ships and cargoes that would add time and cost. Most acutely, global energy cost increases have already been severe over the past year, so a further spike now would aggravate a building hurdle for economic growth.

The Trucker Occupation of Ottawa

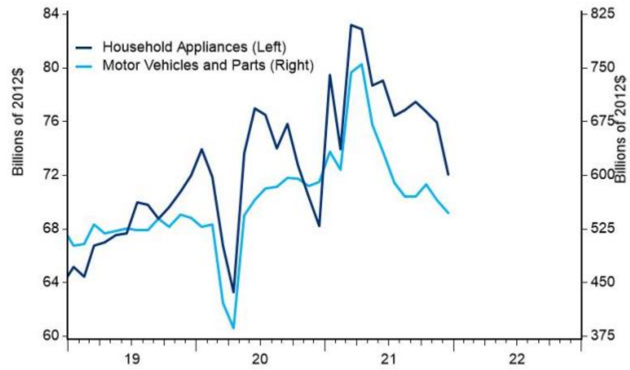
Adding to the existing supply/demand issues facing the auto industry are recent protests by truckers in Canada opposed to vaccine mandates and Covid restrictions. Last week thousands of truckers began blocking major border crossings between Canada and the US, starting with the occupation of Ottawa, the Canadian capital. They then moved to block another bridge this week and shut down two other smaller US/Canada border crossings. The bridge closure is significant because it's North America's busiest international land border crossing and a key supply route for US automakers importing steel, aluminum and auto components.

Without access to critical inputs, major car manufacturers have had to limit production at some factories in Michigan and Ontario and cancel worker shifts, according to press reports. The unexpected Canadian blockade is another headwind for the auto industry. There may be a legal remedy of a judge's order on Friday holds that would end the blockade at the Ambassador Bridge over the U.S.-Canadian border, but disruptions could linger.

In our view, the Canadian truck blockade will likely sink US car/truck production in February and March just when we need it to rebound. It is a short-term phenomenon but will maintain inflationary pressures.

Figure 2: US Car and Truck Production vs CPI for Used Vehicles

Figure 3: Real US Consumer Spending on Motor Vehicles, Parts (new, used) and Household Appliances



Source: Haver Analytics, as of February 13, 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.

The "End of Covid" and the Great Resignation

Researchers suggest this spring will mark the "End of Covid" from an economic standpoint, if not from a medical one. Expectations are that more people will return to work, but not exactly in the way they did before. Since April 2021, more than 19 million US workers have quit their jobs. According to McKinsey research (February 2022), 40% of surveyed employees said they are at least somewhat likely to quit in the next three to six months, a pace set to disrupt business across industries. Meanwhile, 36% of "leavers" did not have other positions when they resigned.

It would appear that the pandemic has irrevocably changed what people expect from work. In addition to traditional issues like compensation fairness, employees want to feel a sense of belonging, better work-life balance, and more work-from-wherever flexibility. For companies to address these issues, retain existing employees and attract new ones, there are numerous frictional costs. According to the Harvard Business Review (January 13, 2022), employees changing priorities "will lead to sustained, higher turnover rates compared to any historical norms." And HBR noted that "in today's labor market, companies are paying 20% compensation premiums to hire new employees".

In our view, the need to pay higher wages to attract and retain employees will continue in 2022-23. To the extent that inflation runs higher than projected, real wage gains will remain scarce (average wages are up 5.7% in the past 12 months while inflation has been 7.5% over that same period) and wage pressures, fueled by a loss in real income, may continue for somewhat longer than expected.

In the Near Term

The "afterglow" of the spending boom and the literal physical limitations on producing, importing and transporting products in higher quantities resulted in the 7.5% surge in US inflation over the past year. The boom has spread to services to some extent. Yet the surge in goods prices has been nearly three times that of services (12.3% vs 4.6%). Still, we saw a major gain for US business inventories in the fourth quarter of 2021 and we expect more to come. Continuing to import at this pace after the end of all fiscal stimulus will eventually help stabilize prices. We believe this will occur whether or not the Fed moves swiftly to tackle inflation.

So, what we worry about is that the near-term environment may provide more fuel for Fed action even as underlying inflationary pressures ease. Last week, Federal Reserve Bank of St. Louis President Jim Bullard seemed to argue for "emergency tightening" steps – or at least extoll the potential value of an intermeeting move to raise interest rates with the Fed's next meeting more than a month away. While some Fed officials quickly moved to soften the rhetoric, the comments sounded as though some Fed policymakers believe they need to take emergency steps to unwind their own easing steps.

Ironically, if the Fed engineers a US downturn with abrupt and severe monetary tightening, safe-haven inflows would likely sink bond yields again. This would be the case even if the Fed were an outright seller of bond holdings. Thus, we need to be mindful of the flashing yellow signs ahead of us. While additional shocks are possible, the real risk is an overreaction to the elongation of inflationary pressures that are beyond the Fed's control.

China Is a Counterpoint to US Fed Policy

Just as the US is tightening via higher rates to combat inflation, China's policy approach is to ease after heavy-handed macro-economic and regulatory tightening steps in 2021. Just as we worry that the US Fed may overshoot, China's own policies in 2021 stunted its economic growth to rates well below its official targets. With China's cycle ahead of the US – whether by coincidence or otherwise – it would be ironic if US policymakers don't take a lesson from what has just transpired in the second-largest economy.

The Value of Adding China to a Portfolio Now

During times like these, the value of diversification in portfolios cannot be understated. We have suggested numerous steps to strengthen portfolios by adding to "corporate leaders," focusing on businesses that can sustain growth even as the global economy cools and seeking dividends as a means to get paid now. Interestingly, China presents another way to diversify portfolios. There are several reasons to be positive on China now:

First, Chinese equities are far more correlated to their domestic credit conditions than to US monetary policy. From 2015-2018 the path of Chinese markets matched credit flows, deeply negative in 2015, positive in 2016-17, and negative again in 2018. As we enter 2022, we expect credit impulse to remain positive, following a trend taking shape since October (see figure 4).

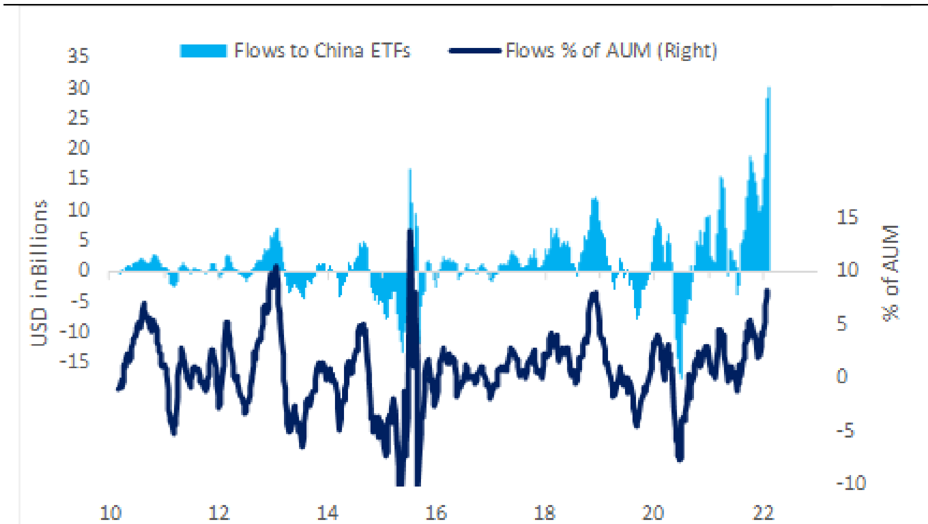
Second, China has a more favorable inflation picture. Weaker but improving domestic demand has not spawned material inflation. Its own supply chain worries are likely overdone because Chinese authorities have prioritized manufacturing production continuity, while placing limits on real estate and e-commerce activity dampens economic activity.

Third, foreign investors have noted the improvement in Chinese credit, attracting material funds flows. Since China's Central Economic Work Conference in December, inflows to Chinese equity ETFs have risen by $30bn over the last eight weeks, the largest on record (figure 5). These inflows amounted to 6% of the ETFs' AUM, a level at which stock rallies have often followed. These inflows contributed to the comparative resilience of Chinese equities in the year-to-date, even as US stocks corrected. That said, the MSCI China remains 38% cheaper than the S&P 500 in terms of a forward price/earnings basis. These ETF flows were independent of mutual funds where flows have been neutral, suggesting there is some catch-up from them to come.

Figure 4: China aggregate credit as % of GDP

Source: Bloomberg and Haver Analytics as of January 2022. 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. 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 5: Record inflows to Chinese equity ETFs



Source: EPFR, Haver Analytics, Bloomberg as of February 8, 2022.

China's State asset managers take part in mitigating real estate risks

In their effort to shore up the beleaguered property sector, Chinese regulators have enlisted the help of state-owned asset management companies (AMCs) to participate in the restructuring of weak real estate developers, purchase stalled property projects and buy soured loans (reported by Bloomberg). The latest developments involving AMCs are likely the next step in this process to curb default and contagion risk of the real estate sector.

China easing again in earnest

Apart from the official steps to stabilize and contain property risks, broader easing is beginning to take place more aggressively and is beginning to bear fruit. January's money and credit data showed significant credit easing following a signal from policymakers of the need to support growth. New aggregate financing amounted to a record 6.17 trillion yuan ($972bn). The bulk of the gain came from 4.2 trillion yuan ($661bn) in domestic loans. The People's Bank Of China lowered its key interest rate in January – acting earlier and stronger than many observers expected – and has urged financial institutions to expand lending.

This is in sharp contrast to the US Fed's imminent tightening regime. China has now become a market of lower policy risk, at least until the inflation fight is concluded. For this reason, we recently added to the overweight of Chinese equities and believe global portfolios should diversify into markets with lower policy risk.

Conclusion

Fiscal and monetary easing was so dramatic and overly broad in 2020-2021 that the world faces the "afterglow of the boom" in the form of inflation. The end of fiscal stimulus in early 2021 is already evident in slowing demand data. Trade has been a very bright spot in the world economy as imports have accelerated, speeding products to consumers. In time, this alone would slow inflation. However, the speed of the normalization has been insufficient to stem disruptive, atypical price increases. These price increases have affected consumer sentiment negatively and caused many to believe they were likely to continue. Unfortunately, new external shocks and frictions may aggravate and elongate the road to normalization. The US Fed, in particular, appears to have run out of patience.

We see greater portfolio diversification as critical in the current setting and our asset allocation has adapted by spreading equity investments more widely across global regions. We have done this while diminishing investments in the most risky and cyclical areas (please see Quadrant for discussion). While not immune from its own particular risks, China appears to be setting out on a different path from reactive monetary tightening in the US, having suffered its own self-induced slowdown over the year past. Its present economic weakness – coupled with new fiscal and monetary easing and depressed asset prices – offers a brighter outlook for its markets in the year ahead.

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