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CIO Strategy Bulletin

There is Nothing to Fear but the Fed Itself

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SUMMARY

- As the S&P 500 approaches bear market territory, investors are looking to the Fed to see if it can engineer a “soft landing.” But the very use of that phrase ignores its definition. To achieve a soft landing, the Fed would typically need to raise interest rates just enough to slow inflation in an overheated economy without causing a severe economic downturn. Therein lies the stock market’s anxiety. The economy is slowing and the Fed is still taking its fastest and most aggressive rate stance in decades.
- We modified our ratios for our ROBUST, RESILIENT and RECESSION scenarios to 20%, 45% and 35% respectively this past week. The [increase in the RECESSION scenario](#) percentage is linked to market action as markets typically lead the economy, particularly when a strong direction is sustained. The loss of confidence and the actual loss of buying power can be self-reinforcing.
- In our view, a recession is not the only way for the Fed to stabilize inflation. A policy of gradual rate increases and patience may achieve the same goal. We see evidence that demand will be satisfied through an ongoing supply recovery. US industrial production is finally catching up to the rapid growth of imports. Both are now rising faster than consumer demand, measured in real units.
- We believe there is a 70% probability that we are at or near peak rates for 2022. Last month, the GIC raised long-duration US Treasuries to an overweight for the first time since yields bottomed in 2020. We believe the positive correlation between high quality bonds and equities will break down, as has been evident in recent days as the equity selloff intensified. In our view, long-term government bonds should soon take comfort in a slowing growth outlook, and (with a lag) decelerating inflation. In the five previous cases of significant joint stock/bond losses during the past 60 years, long-term US Treasury returns were positive in all five cases.
- To illustrate Citi Global Wealth’s Investment philosophy, we conducted a hypothetical analysis of investor behaviors during five market crises over the past 50 years. In one scenario, staying invested – *or better yet, deploying cash sitting on the sidelines* – may lead to outperformance versus a de-risking strategy.

The Market's Near Panic

A very fast-moving correction is gripping equity markets. In just seven weeks, the S&P 500 has nearly reached bear market territory. The Dow's eight-week decline is its longest streak since 1923. Thirty percent of Nasdaq-listed companies have lost half their value over the past 12 months. The decline in market value as of Friday is equal to about 60% of US GDP.

The primary issue at the center of the \$14 trillion evaporation in markets is inflation and the Fed's pivot to fight it with urgency. This is an unusual bout of inflation occurring from unusual circumstances. The pandemic, the (over)stimulus used to combat it and the war in Ukraine are cumulatively distorting consumer and business demand, supply chains and the availability of raw and finished goods.

As the S&P 500 approaches bear market territory, investors are looking to the Fed to see if it can engineer a "soft landing." But the very use of that phrase ignores its definition. To achieve a soft landing, the Fed would typically need to raise interest rates just enough to slow inflation in an overheated economy without causing a severe economic downturn.

And therein lies the stock market's anxiety. The economy is slowing and the Fed is still taking its fastest and most aggressive rate stance in decades. The Fed's recent actions have propelled a record, large, combined drop in equities and fixed income markets, with both US stocks and long-term US Treasuries falling more than 10% in the last six months for the first time ever.

Market action does not seem to worry the Fed, either. Chairman Powell noted that the Fed might "push rates beyond neutral", imagining a "softish landing" for the economy. Thus, with limited new inflation data in the near term, it appears highly likely that the Fed will proceed with its June 50 basis point increase. Even dovish Fed members are advocating for tight policies regardless of the equity slide.

Is Jerome Powell Tom Brady?

If your team is losing at the end of an American football game, it would be best to turn to Tom Brady. During his 22-year NFL career, Brady has engineered 42 fourth-quarter comebacks and a total of 53 game-winning drives. Brady rarely chooses to use the "Hail Mary," a long pass made by a desperate quarterback in the final seconds of a game. According to [ESPN Sports](#), the probability of success for such passes is 9.7%. Tom Brady has made only one such attempt in his career and it failed.

What about Jerome Powell?

If this is the fourth quarter for the post-pandemic economy, an unrelentingly linear Fed policy has some of the hallmarks of a Hail Mary pass. Using a playbook that would have been more appropriate to cool 2021's economic boom, the Fed is raising interest rates quickly in a cooling economy in an attempt to lower inflation caused by exogenous shocks and its own excessive stimulus.

Fear of the Fed

[Last August](#), Jerome Powell said, "The main influence of monetary policy on inflation can come after a lag of a year or more. If a central bank tightens policy in response to factors that turn out to be temporary, the main policy effects are likely to arrive after the need has passed."

In practice, this means that if the Fed raises rates too quickly and undertakes too much quantitative tightening, it may "win" its battle with inflation later by causing an unintended recession sooner. While we note that while the Fed does not have a history of ending recessions quickly once underway, the Fed

does have a history of pausing rate hikes sooner than markets expect. For example, in 2019, the Fed cut rates 75 basis points when it had been expected to raise rates by the same amount.

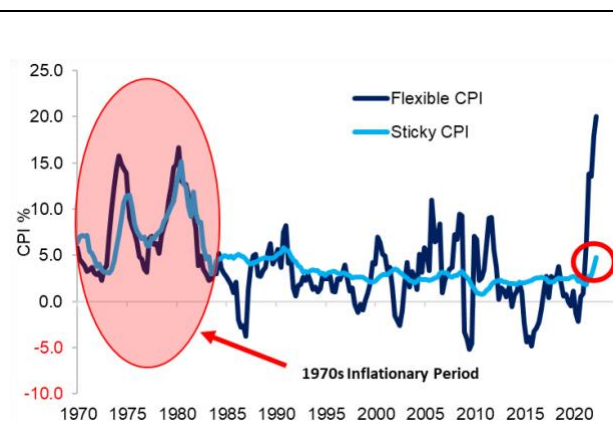
What makes this period more fraught than usual is the Fed's active media presence, which has made clear two points. The first is its determination to "do what it takes" to tame inflation (Powell told the *Wall Street Journal* on May 17, "If that involves moving past broadly understood levels of neutral, we won't hesitate at all to do that"), and the second is to let markets know that there is no "Fed put", instead signaling a desire to see financial conditions tighten further from current levels in an effort to slow the real economy.

This Unusual Inflation

The type of inflation we are experiencing has been caused by exogenous shocks and Federal overspending. It is not likely to abate quickly of its own accord, but there are already meaningful signs it will abate over time. We see evidence that demand will be satisfied through an ongoing supply recovery. US industrial production is finally catching up to the rapid growth of imports. Both are now rising faster than consumer demand, measured in real units. This is the way a substantial portion of the inflation that we are experiencing can be addressed.

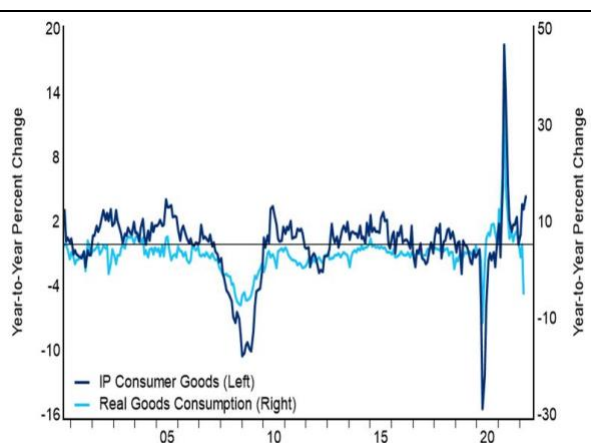
Therefore, a recession is not the only way for the Fed to stabilize inflation. A policy of gradual rate increases and patience may achieve the same goal.

Figure 1: US Inflation: Atlanta Fed Measure of Flexible vs Sticky Price Components



Source: Haver Analytics and Bloomberg as of May 1, 2022. Flexible CPI represents components of consumer prices that tend to vary regularly. Past performance is no guarantee of future returns. Real results may vary. 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.

Figure 2: US Consumer Goods Production and Real Consumer Spending



Source: Haver as of May 6, 2022. Past performance is no guarantee of future returns. Real results may vary. 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.

Watch Corporate Earnings

With the rapid market declines, several price/earnings measures for the S&P 500 P/E are approaching long-term averages. Normally, this would buoy markets. But we have recently revised our S&P 500 EPS expectations downward. Our estimates are 13% below analysts' consensus "bottom up" projections for 2023 and suggest that EPS downward revisions are on the horizon (see [figures 3-4](#)). While our estimate reductions are short of recessionary and would leave 2022 full year earnings growth at +5.5%, strong actual second half earnings will be critical to achieving them.

Given that employment gains are still being made across the US economy, markets are now reflecting a potential future recession in 2023. To provide fuel for that view, earnings estimates would have to fall by more than the -2.5% we expect. Looking at the strength of corporate balance sheets and the lessons learned by many in adapting to the pandemic, one can expect managements to respond quickly to changes in the economy. Markets will respond more quickly as well, both downward and upward, making market timing -- the precise moment for “getting back into equities” – nearly impossible.

Figure 3: Revised Citi Global Wealth Investments Real GDP Forecasts

	2020	2021	2022		2023	
			Previous	Revised	Previous	Revised
China	2.4	8.0	4.5	4.0	5.0	5.0
US	-3.4	5.5	3.5	1.9	2.6	2.0
EU	-5.9	4.8	3.9	2.3	2.4	1.8
UK	-9.7	6.0	4.2	3.0	2.5	2.0
Global	-3.2	5.6	3.8	2.6	3.5	2.7

Figure 4: Citi Global Wealth Investments Forecasts vs “Bottom Up” Consensus for S&P 500 EPS

	2021	2022	2023	2024
Citi GW	209.06	220.5	217.5	226.0
Y/Y%	+49.6%	5.5%	-2.5%	+5.1%
Bottom Up Consensus	209.06	228.58	251.06	
Y/Y%	+46.9%	+9.8%	+9.8%	

Source: Bloomberg and Citi Global Wealth Investments OCIS, as of May 16, 2022. Notes: “Bottom Up” consensus is the aggregation of views of individual equity analysts across all firms in the S&P 500. Previous forecasts for GDP growth were from January of 2022. All views/ forecasts are expressions of opinion, are not a guarantee of future results, are subject to change without notice and may not meet our expectations due to a variety of economic, market and other factors. The probabilities mentioned above contain no assurances that this will occur and is solely an opinion of OCIS. Past performance is no guarantee of future returns. Real results may vary. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only.

Unusual Bearishness is Usually a Positive

As we have noted previously, indiscriminate selling could cause markets to plunge further. The average full-on bear market losses over the past 100 years have been 36% (peak to trough) and bear markets have lasted an average of 383 days.

Recent contrarian indicators signal there may be stronger returns ahead. Poor investor sentiment, building demand for downside protection and spiking industry sector correlations all point to potentially stronger equity returns in the near term (see [figures 5-6](#)).

That said, if the Fed does not heed the data, the likelihood of a recession becomes higher. We have modified the ratios for our ROBUST, RESILIENT and RECESSION scenarios to 20%, 45% and 35% respectively this past week. The increase in the RECESSION scenario percentage is linked to market action as markets typically lead the economy, particularly when a strong direction is sustained. The loss of confidence and the actual loss of buying power can be self-reinforcing.

Figure 5: S&P Sector/Sector Correlation Shows Indiscriminate Selling of Equities

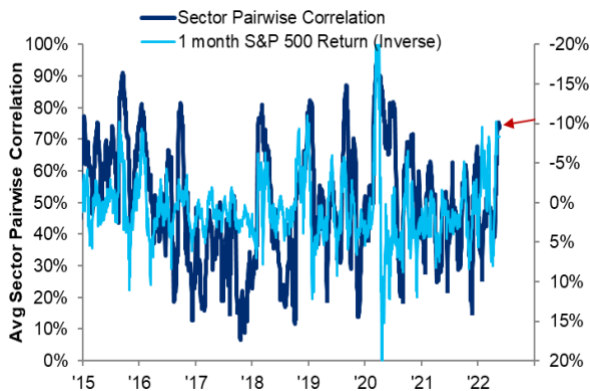
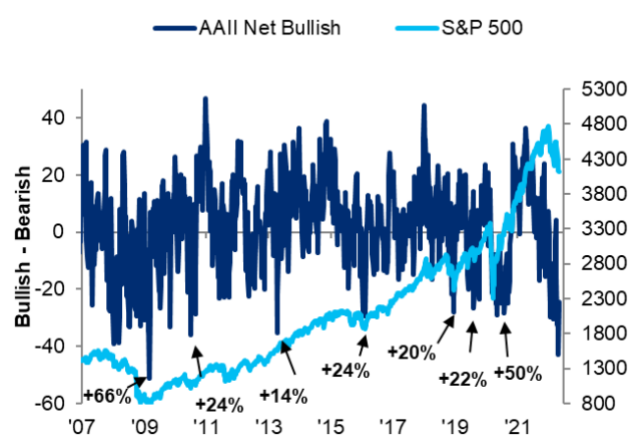


Figure 6: Individual Investor Net Bullish Survey vs S&P 500



Source: Haver Analytics and Bloomberg as of May 19, 2022. Past performance is no guarantee of future returns. Real results may vary. 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.

Recent Portfolio Actions

Citi Global Wealth is maintaining its conservative portfolio and equity stance: The Global Investment Committee (GIC) left its asset allocation unchanged at its May meeting, with global equities overweight by 2% including a 4% inflation hedge position in global commodity producers. We also recommend adding to long duration bond positions, reflecting our primary view that the Fed will be unable to sustain higher rates for very long. We believe that there is a 70% probability that we are at or near peak rates for 2022 (see our latest [Quadrant](#)).

Last month, the [GIC raised](#) long-duration US Treasuries to an overweight for the first time since yields bottomed in 2020. We believe the positive correlation between high quality bonds and equities will break down, as has been evident in recent days as the equity selloff intensified. In our view, long-term government bonds should soon take comfort in a slowing growth outlook, and (with a lag) decelerating inflation. In the five previous cases of significant joint stock/bond losses during the past 60 years, long-term US Treasury returns were positive in all five cases.

The GIC also maintained a 6.5% overweight in US fixed income, concentrated in investment grade bonds. Treasury yields have roughly doubled over the past year, making fixed income far more useful to diversification of portfolios.

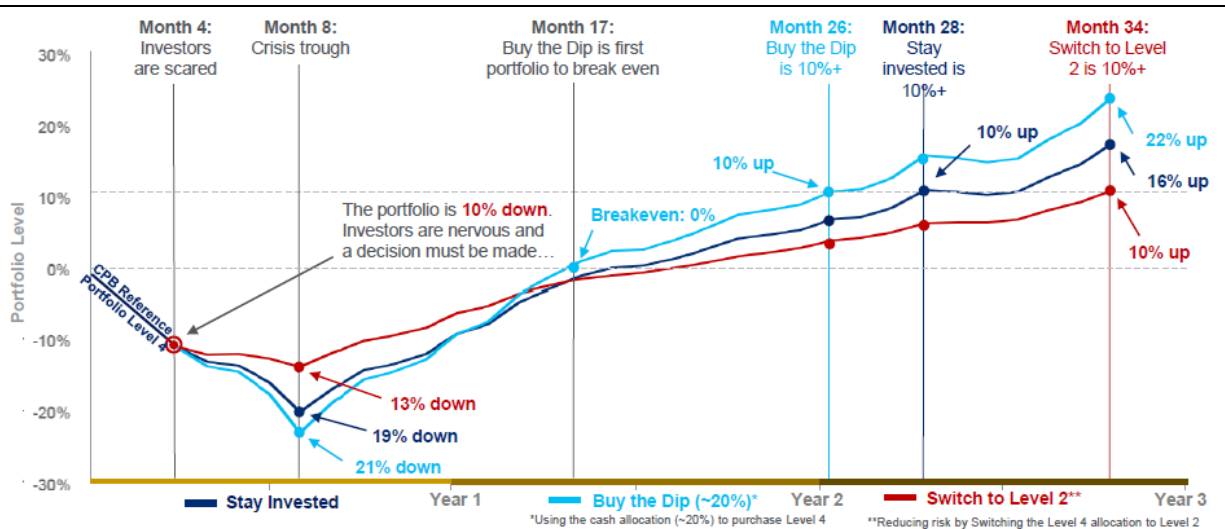
Our Investment Philosophy in Action

Our investment philosophy at Citi Global Wealth incorporates the potential benefits of tactical asset allocation while disavowing the myth of successful “market timing.” To illustrate this point, our Global Investment Lab studied market conditions during major crises over the last 50 years, and stress tested the performance of different investment strategies once portfolio losses reached -10%. They start with 3 possible decisions an investor could make after seeing their wealth fall meaningfully at the beginning of a crisis:

1. Reduce risk by selling stocks and buying bonds
2. Buy the dip with excess cash
3. Stay invested

What the hypothetical analysis showed was that staying invested – or better yet, *deploying cash sitting on the sidelines* and taking on more risk – may lead to outperformance versus a de-risking strategy. As an example, less than 3 years out from the onset of the average bear market, the illustrative portfolios that took on more risk as markets fell experiences growth of 22%, versus just 10% for illustrative portfolios that reduce risk along the way (figure 7).

Figure 7: Illustrative average portfolio performance during the last 5 major crises



For illustrative purposes only. Average of 5 crises: 1. Great Financial Crisis (2008-2009) 2. 2001 Recession (2001) 3. First Gulf War (1990) 4. Black Monday (1987) 5. OPEC Oil Crisis (1973-1974). Source: Bloomberg, CPB Global Investment Lab Latin America as of Dec 31st, 2021. Past performance is no guarantee of future results. Data measured for the period between January 1955 to Dec 31, 2021. For each investment horizon, a 5 year rolling window was used in the measured period. The portfolio assumes a moderate risk portfolio with 10% illiquidity rebalanced annually. Benchmark indices were used to proxy asset classes. The portfolio performance and return information presented herein was obtained using historical back testing analytics, it does not reflect returns of an actual portfolio and is not indicative of future returns. Rather, the portfolio performance and return information contained herein, which is for illustrative purposes only, was prepared by retrospectively combining performance data of a hypothetical group of investments using certain quantitative criteria assumptions and estimates, as if an investor had invested in a portfolio comprised of such investments during the period presented. Hypothetical performance results have many inherent limitations. The portfolio performance and return information reflects the benefit of hindsight and does not reflect the impact that material economic and market factors might have had on decision making of the Investment Lab or its affiliates were actually advising an investor in investing in these investments or managing an actual portfolio. Since the trades of the simulated performance results have not actually been executed, the results may have under or over-compensated for the impact of certain economic and market factors, such as lack of liquidity. Also, hypothetical trading cannot fully consider the impact of financial risk, such as ability to withstand losses. An investor's investment in an actual portfolio will be made in different economic and market conditions than those applicable during the period presented. It should not be assumed that an actual investor portfolio will experience returns comparable to the portfolio performance and return information presented herein. Past performance does not guarantee future results. Real results will vary. As a result of market activity following the date of the period presented, current performance may be different from that shown herein.

No Market Timing – Using Tactical Reallocations

Adjusting portfolio allocations in response to evolving valuations, sentiment, and fundamental indicators is the job of tactical asset allocation. Attempting to jump wholesale between risky portfolios and riskless cash in an effort to “beat the market” is market timing. At Citi Global Wealth Investments, we believe in providing guidance to investors across complex markets and, when necessary, suggest adjustments to fully invested portfolios. However, while we certainly believe tactical asset allocation can add incremental value for our clients, most portfolio returns over time will potentially come from strategic asset allocation – from staying invested over the long-term.

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