Citi Global Wealth Investments

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# CIO Strategy Bulletin

## Why We Believe Bonds Are Back

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### SUMMARY

- Financial markets got a bit of a reprieve this past week as investors took some comfort in comments from the Federal Reserve's May meeting minutes.
- Inflation is still a problem for the economy and will likely continue to be for the rest of the year. But signs that demand will slow while supply recovers give us comfort that the Fed has a path to a lower inflation rate without requiring a truly hard landing.
- If the Fed is successful in its fight to bring inflation down without causing a recession, we expect low single-digit gains for global equities and bonds through the end of 2022. If the Fed is unsuccessful and constrains growth too quickly or reduces liquidity too severely, a recessionary scenario can unfold with more severe consequences for equities. While our base case is that the expansion will endure, we see the risk of US recession as higher than usual in 2023 (35%) – a material risk.
- This leads us to one of our key calls, which focuses on high quality fixed income. We think there are compelling opportunities to bring high-quality bonds back into portfolios.
- In our view, most of the expected US tightening is now embedded in Treasury yields. We believe that rates will peak this year, as US GDP growth decelerates rapidly. In turn, this will likely see a slow reduction in inflation readings, perhaps allowing the Fed to relax its hawkish stance by late 2022.
- For investors, these higher yields may represent an attractive level at which to buy. We believe certain fixed income assets now offer an "antidote" to the "cash thief," given their higher yields.

**A Market Reprieve**

In the past week, world financial markets started to breathe a sigh of relief. They seemed to say, "I think we've got this." Investors took comfort in comments from the Federal Reserve, which said rate hikes in

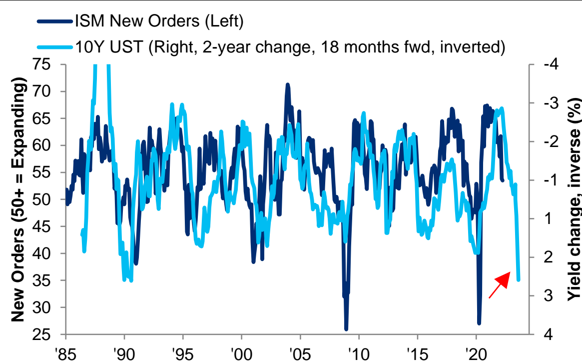
the near-term "would leave the Committee well positioned later this year to assess the effects of policy firming." This is another way of saying, "We may pause. The economy still matters."

Inflation, of course, is still a problem, and is likely to be one through year-end with near certainty. We expect the year/year CPI reading to slow to 6.5% at year-end from 8.5% at the end of 1Q 2022. So why should the Fed be gradual? It is because of the long lead time for the full impact of changing monetary policy to be felt.

Monetary policy easing in 2020-2021 is impacting this year's inflation rate. The expected tightening of US monetary policy that is priced in now should slow the economy far into 2023 if the Fed "follows through."

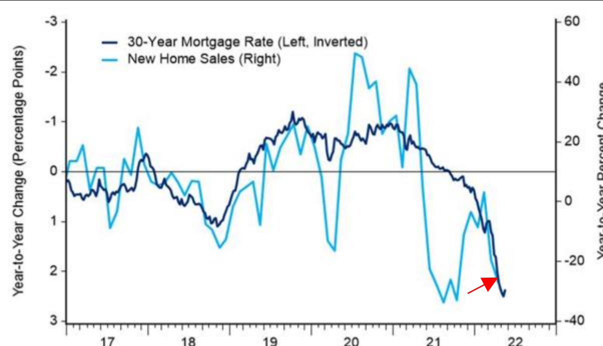
As figure 1 shows, rising and falling interest rates take a full 18 months to impact coincident economic indicators. The Fed will need to guide the right policy for the future, not the demand picture of last year. This is particularly notable as interest-rate-sensitive economic activity already is showing decline (see figure 2).

**Figure 1: Change in 10-year Treasury vs. US Manufacturing Purchasing Managers Orders**




Source: Haver Analytics as of May 26, 2022.

**Figure 2: 30-Year US Mortgage Rate (Inverted) vs. US New Home Sales**




Source: Haver Analytics as of May 26, 2022.

Signs confirming that demand will slow while supply recovers give us comfort that the Fed has a path to a lower inflation rate without requiring a truly hard landing (see figure 3). With that said, the path to hit industry analysts' estimates for nearly 10% EPS growth *both* this year and next is, frankly, absent. If we could propose an industry holiday, it would be called "annual EPS cut day." Unlike Fed policy, cutting unrealistic estimates slowly and continuously through the year won't help matters (see figure 4).

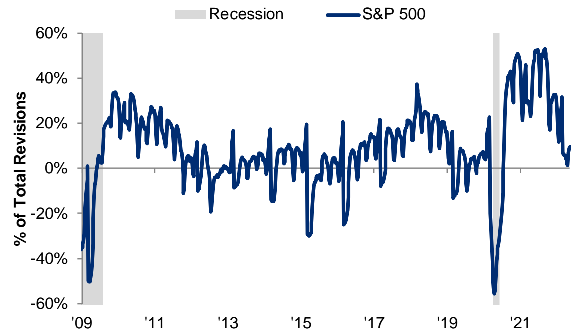
The Fed is there to deliver the best economic outcomes for the US public. Critical observers should read the Federal Reserve Act carefully: Monetary policy doesn't have a mandate to support asset prices for the sake of investors alone. If equity and credit investors rush to assume the "Fed put" is back, we strongly suspect they will be disappointed.

In essence, markets must "live within the means" the economy can provide. Higher interest rates and diminished positive EPS growth point to a slower recovery in equity markets than the speed of the early 2022 selloff. Still, early pre-conditions for market stability came into focus in the past week. As figure 4 shows, bond investors are exhibiting somewhat more confidence. The expected ranges for US interest rates now show slightly more restraint in options markets (see figure 5). Bond and credit market stability is a prerequisite for equity market stability while investors price in the coming slowdown in economic growth (figure 6).

**Figure 3: US Consumer Goods Production and Consumption**

Source: Haver Analytics as of May 26, 2022.

**Figure 4: S&P 500 Net Upward EPS Estimate Revisions**




Source: Haver Analytics as of May 26, 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. Gray areas note recession.

**Figure 5: US Treasury and S&P 500 Implied Volatility**

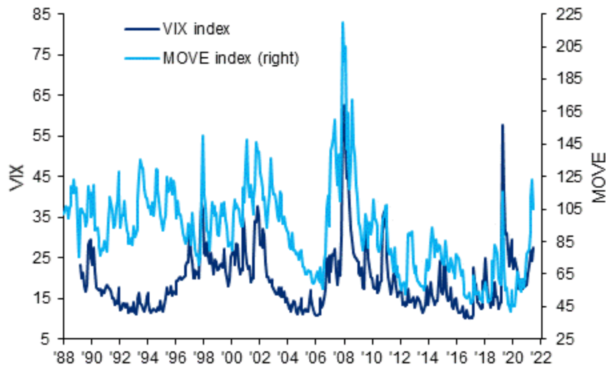



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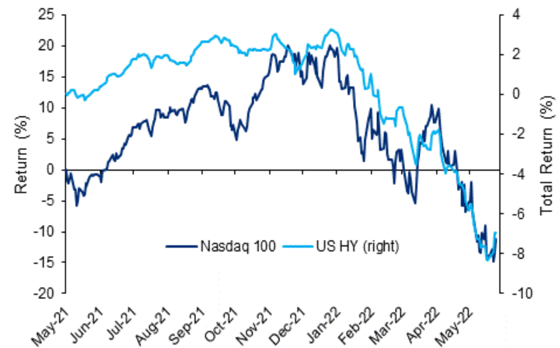
**Figure 6: Nasdaq Composite and High Yield Bond Total Return**

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## WHY WE BELIEVE BONDS ARE BACK

### This unusual period

The global economy has endured a series of severe, unusual, and unexpected shocks over the past three years. COVID shutdowns, unprecedented stimulus, snarled supply chains and Russia's invasion of Ukraine have all created significant challenges for consumers, businesses, and governments. The most obvious result of these shocks is inflation. Across developed economies, consumer prices have been rising faster than they have in decades. In response, policymakers are withdrawing the fiscal and monetary boost they provided when COVID struck. And now they are turning their attention to "fighting inflation" with urgency.

The US Federal Reserve is leading the inflation fight, having pivoted from easing to a fast rate of upward interest rate adjustments and a reduction in its balance sheet.  We think there's a clear danger the Fed will go too far. The global economy is already slowing as high inflation and less stimulus hit consumer spending. We now forecast global growth of around 2.6% in both 2022 and 2023, about 1% lower than our previous expectations.

If the Fed is successful, reducing inflation while not causing a recession, we expect low single-digit gains for global equities and bonds through the end of 2022. If the Fed is unsuccessful and constrains growth too quickly or reduces liquidity too severely, a recessionary scenario can unfold with more severe consequences for equities. While our base case is that the expansion will endure, we see the risk of US recession as higher than usual in 2023 (35%). This is a material risk.

This leads us to one of our key calls, which focuses on high quality fixed income. We think there are compelling potential opportunities to bring high-quality bonds back into portfolios.

In 2022, bonds have suffered a brutal run, selling off hard on monetary tightening fears. As their prices have gotten crushed, yields have risen substantially (figure 7). Given this uplift in yields, we believe many high-quality bonds can again produce portfolio income and diversify equity risk. Investors don't agree with us just yet: Bond mutual funds and ETFs have averaged net outflows of $1.8 billion over the last four weeks (see figure 8).

**Figure 7. Yields surge in early 2022**

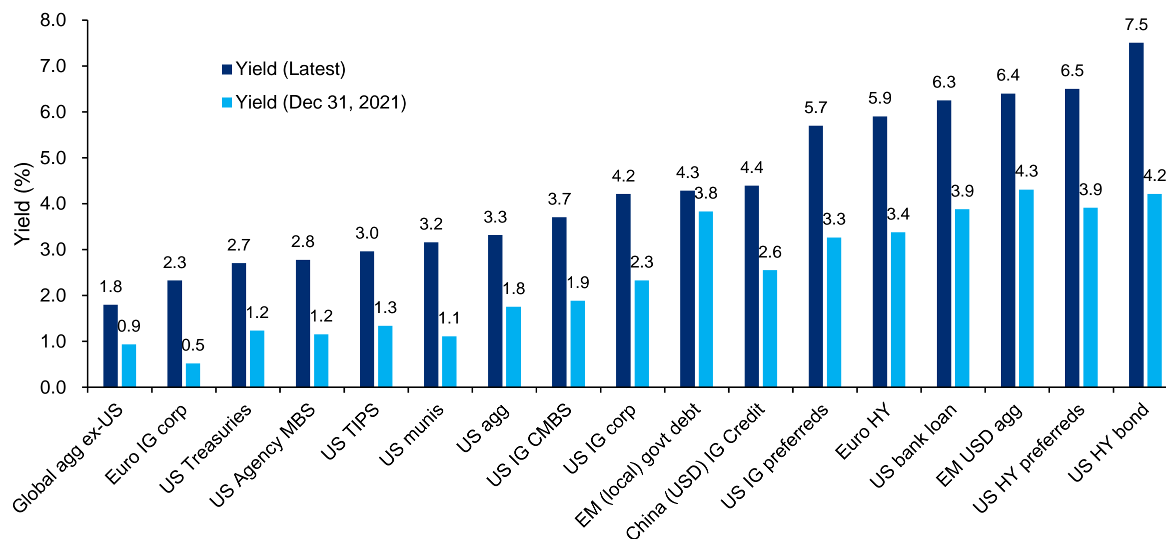


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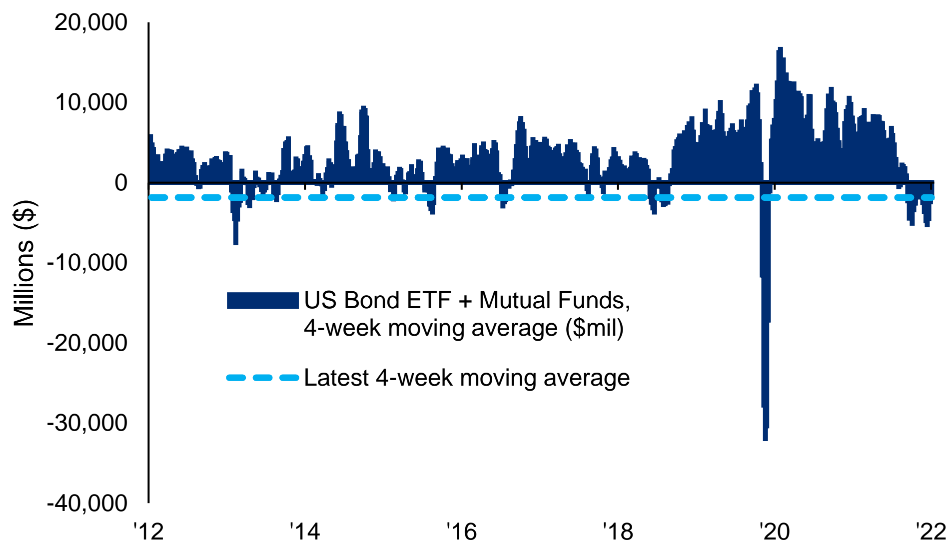
**Figure 8: Bond Mutual Fund and ETF Flows (4-week average)**

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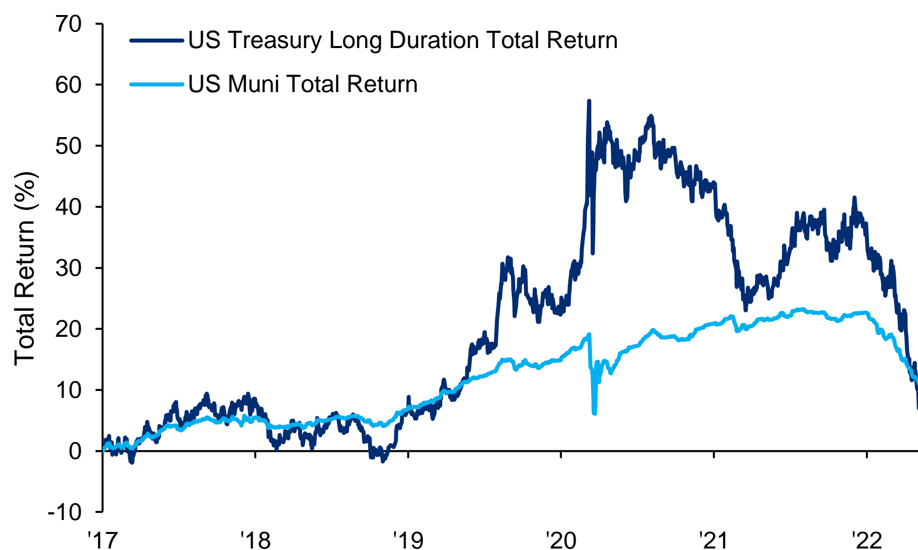
## Everyone Feels Higher Rates

With a sweltering 225-basis-point rise in mortgage rates, in the year-to-date, US new home sales have fallen 13% from 2021 and were 28% lower in the latest month. New US auto sales have fallen 17% in the year-to-date. And, as the Fed turns its intentions to actions, demand for labor will decline in 2022.

Interestingly, as markets assess the impact of higher rates on economic growth, rates have stopped going up as they had before. Over the last three weeks, long-duration US Treasury returns have rebounded 4.5%. This is after a 35% loss during the prior two years. The stabilization of Treasury yields is just starting to impact other higher quality bond segments, such as IG municipals, which also rebounded over the past week (see figure 9).

Thus, while we cannot say we have seen peak rates, we have seen a moderating in the inflation outlook.

**Figure 9: US Muni vs US Treasury long-duration total return, last 5 years**

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## The Two Most Likely Scenarios for the Economy

In our RESILIENT and RECESSION scenarios, we expect slower economic growth. (In fact, we modified our ratios for our ROBUST, RESILIENT and RECESSION scenarios to 20%, 45% and 35%, respectively, last week.) The increase in the RECESSION scenario percentage is linked to negative equity market action as equities typically lead the economy, particularly when a strong direction is sustained.

If the Fed hits the right combination of higher rates and QT, it can induce a slowdown without a recession. If the Fed errs or deliberately crushes the economy to fight inflation, a recession is likely to ensue. *But one way or the other, corporate profits could be lost in the process.*

## Investors Hold Too Much Cash.

During periods of market volatility, a common instinct among investors is to raise cash and wait for more certainty before adding risk back in portfolios. Unfortunately, that instinct can be destructive to long-term wealth, as markets will move faster than our ability to re-enter the market.

## ELEMENTS OF OUR "BONDS ARE BACK" VIEW

**1. Bonds Have Repriced**

*Bonds crushed, yields surging*

Early 2022 was a lousy time to be a fixed income investor. Bonds have suffered one of the worst total return periods in its history, with the Bloomberg US Aggregate Bond Index down 8.6% year-to-date as of May 26, 2022 (figure 10).

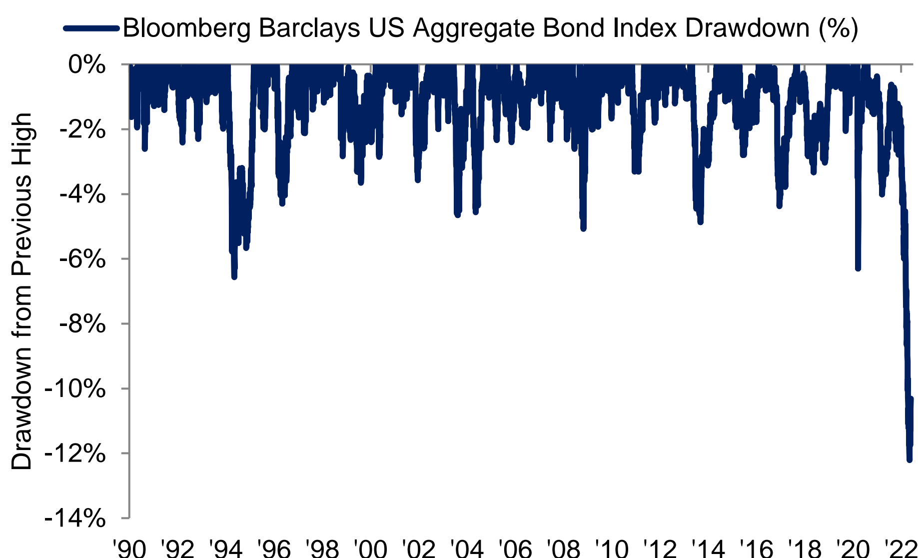
Monetary policy was the primary reason for this sharply negative performance. In early January, the US Federal Reserve suddenly pivoted away from its plan for measured and controlled tightening. Instead, the

Fed signaled a much more aggressive – almost emergency-type – approach to combat the risk of persistently high inflation it perceived.

Given the absence of a clear decline in inflation readings so far this year, combined with the "commodity price shock" imparted by the Ukraine conflict, the Fed has felt compelled to continually "talk rates" higher. This is in addition to its initial 25 basis point (bp) rate hike in March and a 50bp hike in May. The futures market is now pricing 8 more 25bp rate hikes in 2022. The Fed also announced that as of June, it will begin reducing the size of its near-$9 trillion balance sheet up to a cap of $95bn a month by the end of the summer, a process called "quantitative tightening."

Short-term US Treasury yields ratcheted up mechanically alongside monetary tightening expectations. As those yields rose, longer-term US Treasury yields and credit yields rose worldwide. The price of "near cash" instruments increased almost 200 basis points (bps) in four short months, a record move that reverberated through every fixed income class.

**Figure 10: US Aggregate Bond Index drawdown (%)**

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**2. Bonds Have Value in Portfolios Again**

*Why buy in this environment?*

In our view, most of the expected US tightening is now embedded in Treasury yields. We believe that rates will peak this year, as US GDP growth decelerates rapidly. In turn, this will likely see a slow reduction in inflation readings, perhaps allowing the Fed to relax its hawkish stance by late 2022.

For investors, these higher yields may represent an attractive level at which to buy. We believe certain fixed income assets now offer an "antidote" to the "cash thief," given their higher yields.

What's more, such assets may also help mitigate equity risk within a diversified portfolio. Historically, long-term US Treasuries are one of the few assets with a negative correlation to equities during large equity corrections. However, we emphasize the need for selectivity here. Neither long-dated European and Japanese government securities nor "risky credit" have the same historical hedging properties. This

is due more to active central bank intervention in those regions and because “risky credit” returns tend to track equity returns.

The opportunities we have identified in fixed income include:

- High quality bonds
- Portfolio diversifiers
- Structured investments

### 3. Historical Bond Performance After Like Periods

*After stocks and bonds decline together, bonds typically rebound*

The sharpest “about face” in Fed policy in modern history has propelled a record large, combined drop in equities and fixed income, with both US stocks and long-term US Treasuries falling more than 10% in the last six months for the first time ever. In fact, there are only five previous periods in the past 60 years when both asset classes have lost more than 4% during the same time over half-year periods. Following joint declines in both US stocks and bonds, returns were solidly higher for both in the six months that followed on average. The five periods since the 1960s show 5.5% average gains for US equities and 10.9% for 10-year US Treasuries (figure 11).

More notable is that forward returns for the 10-year US Treasury note were higher after all five periods when both stocks and bonds fell together. The returns for US equities were higher in only three of the five. What delineates these five periods is the path of corporate earnings. During periods when earnings were about to decline significantly, equities severely underperformed bonds. Meanwhile, the unusually high inflation rates during some of these periods never hampered the bond market from rebounding.

**Figure 11: Periods when 10-year U.S. Treasury bond and S&P 500 losses were both above 4.5%**

| Periods When 10-Year U.S. Treasury Bond and S&P 500 Lossess Were Both Above 4.5% | | | | | |
|---|---|---|---|---|---|
| Six-Month Period | | Six-Month Returns During (%) | | Six-Month Returns After (%) | |
| Start | End | S&P 500 | 10-Year U.S. Treasury | S&P 500 | 10-Year U.S. Treasury |
| 03/31/1969 | 09/30/1969 | -8.3 | -5.2 | -3.7 | 6.8 |
| 09/30/1979 | 03/31/1980 | -6.6 | -12.9 | 22.9 | 10.0 |
| 03/31/1981 | 09/30/1981 | -14.6 | -7.0 | -3.6 | 16.4 |
| 11/30/1983 | 05/31/1984 | -9.5 | -6.5 | 8.7 | 21.0 |
| 12/31/1993 | 06/30/1994 | -4.8 | -7.5 | 3.4 | 0.2 |
| 10/31/2021 | 04/30/2022 | -10.3 | -10.5 | ? | ? |
| | **Average:** | **-9.0** | **-8.3** | **5.5** | **10.9** |

| Periods When 10-Year U.S. Treasury Bond and S&P 500 Losses Were Both Above 4.5% | | | | |
|---|---|---|---|---|
| Six-Month Period | | 10-Year U.S. Treasry Year (At the Start of the Period) | | S&P EPS Gain/Loss % |
| Start | End | Nominal | Real (Less CPI) | 12-Months later (end date) |
| 03/31/1969 | 09/30/1969 | 6.3 | 1.1 | -9.0 |
| 09/30/1979 | 03/31/1980 | 9.4 | -2.8 | -4.6 |
| 03/31/1981 | 09/30/1981 | 13.1 | 2.6 | -11.2 |
| 11/30/1983 | 05/31/1984 | 11.6 | 8.3 | -0.9 |
| 12/31/1993 | 06/30/1994 | 5.8 | 3.1 | 22.8 |
| 10/31/2021 | 04/30/2022 | 1.6 | -4.7 | ? |
| | **Average:** | **9.3** | **2.5** | **-0.6** |

Source: Haver Analytics and Bloomberg as of April 30, 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.

## 4. What Bearish Equity Views Mean for Bonds

*The asset allocation value of bonds has risen*

In the event the Fed overreaches and slows the economy "too much," we will reach peak rates quickly. Then, long duration bonds will be quite valuable in portfolios. Long-term US Treasuries are one of the few traditional assets that most often maintain a negative correlation to equities during severe corrections. During equity market drawdowns of 20% or more during the past 35 years, long duration US Treasuries have had an average return of +12% (see CIO Bulletin, April 24 and figure 12).

**Figure 12: Total Return in Fixed Income During 20% US Equity Correction (%)**

| Date of Drawdown | # Days | US Treasury | UST Short | UST Inter | UST Long | US IG Corp | US IG Corp Short | US IG Corp Inter | US IG Corp Long | US HY Corp |
|---|---|---|---|---|---|---|---|---|---|---|
| Mar-01 | 251 | 12.4 | 9.1 | 12.6 | 14.8 | 12.4 | 9.9 | 12.4 | 13.2 | |
| Jul-08 | 197 | 7.6 | 5.1 | 8.4 | 9.4 | 2.2 | 3.9 | 3.2 | 0.4 | -4.4 |
| Mar-20 | 17 | 4.3 | 1.5 | 3.1 | 10.7 | -4.0 | -0.7 | -2.4 | -7.0 | -10.8 |
| **AVERAGE** | **155** | **8** | **5** | **8** | **12** | **4** | **4** | **4** | **2** | **-8** |

Source: Bloomberg as of May 12, 2022.

## 5. Bonds Are Better Than Cash

*Inflation is eroding the value of cash*

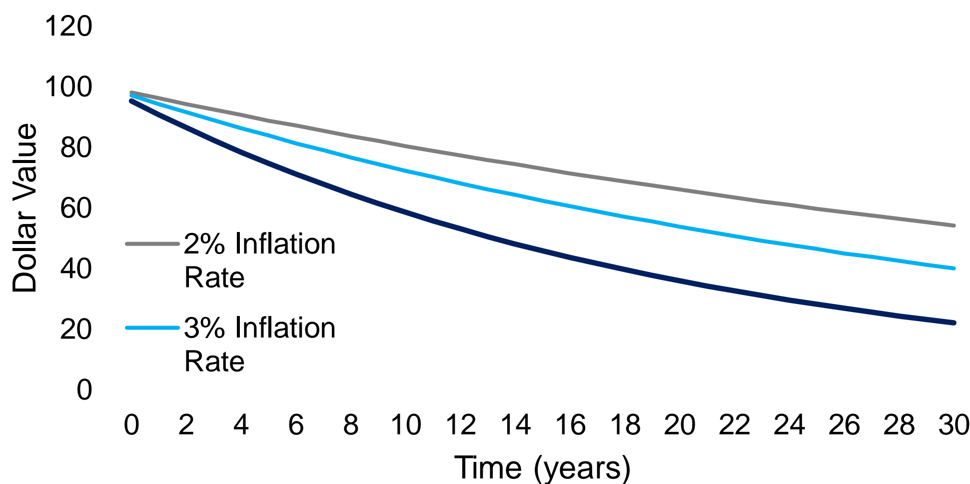
The US bond market is currently pricing in one of history's largest rate increases over the next two years. But we doubt that the Fed will actually tighten as much as that. Instead, we expect rates to peak some time in 2022. And even if the Fed did tighten as much as it's indicating, history suggests it would then be cutting rates again just six months later or so. Amid all the uncertainty, we're hearing many investors ask the same question: "Isn't now a good time to hold cash?"

Despite the rise in interest rates, things haven't really changed much for owners of cash. After adjusting for inflation, interest rates in most leading economies remain deeply negative. In the US, consumer price inflation hit 8.5% in April. While readings may not stay this extreme, interest rates below the rate of inflation could be a fact of life for some time to come. The effect for owners of cash is painful.

It's akin to a cash thief silently stealing your purchasing power year after year. Far from offering safety, we warn that sitting on lots of cash risks leaving you much poorer over time. Our preferred approach is to seek out assets that may generate a positive real income for portfolios. In recent years, ultra-low yields on many bonds have left them as vulnerable as cash. A few months into 2022, however, the situation looks different.

If you've been waiting for a rise in yields, in our view the wait is now over. And while inflation has risen more than almost any yield over the past year, we don't believe inflation will be 2 to 3 percentage points higher for every year going forward. That's how much various high quality bonds' yields have increased in 2022. As well as now offering more attractive income, they also have the potential to diversify portfolios.

**Figure 13: Hypothetical purchasing power of the initial $100 over time under differing inflation rates**




Source: Citi Private Bank Asset Allocation team, Haver Analytics, BLS, June 30, 2021; Inflation-adjusted subtracts estimated 10-year CPI rate of 2.5%. Strategic Return Estimates are in US dollars; all estimates are expressions of opinion and are subject to change without notice and are not intended to be a guarantee of future events. Strategic Return Estimates are no guarantee of future performance. Past performance is not indicative 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. All information shown above is hypothetical, not the actual performance of any client account. Hypothetical information reflects the application of a model methodology in hindsight. No hypothetical record can completely account for the impact of financial risk in actual trading. For example, there are numerous factors related to the equities, fixed income, or commodities markets in general which cannot be, and have not been accounted for in the preparation of hypothetical performance information, all of which can affect actual performance.

## CONCLUSION

Equity investors have endured a brutal year so far with the S&P 500 off roughly 13% as of Friday. And even more notable amid the market selloff is that broader bond market has gotten slammed as well on monetary tightening fears. This double whammy may tempt investors – who may be struggling to find refuge amid inhospitable markets – to lay low for a while, park their cash until the volatility subsides.

But it's important that clients not allow their cash to lie fallow.

As bond prices have gotten crushed, yields have risen substantially, and we see value emerging from the bond market wreckage. We believe many high-quality bonds can again produce portfolio income and diversify equity risk. Investors don't seem to be on board with our view just yet: they've pulled $1.8 billion from bond mutual funds and ETFs over the last four weeks.

After a significant setback for both equities and bonds together, data show a path remains for the economic recovery to weather the inflation shock without recession. Nonetheless, after a rough doubling in US government bond yields in the last 12 months, we see fixed income better placed to help manage downside risks.

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