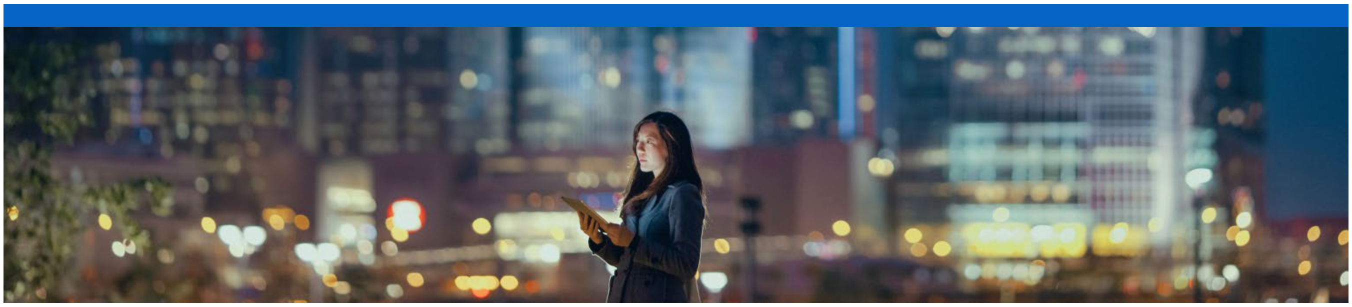

July 16, 2022

CIO Strategy Bulletin

Now (2022) and Then (2019)

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SUMMARY

- When trying to make sense of current market turmoil and economic uncertainty, it often helps to look at comparable periods from the past as a guide.
- The big difference between now (2022) and then (2019) is that today's inflation is much higher than the Fed's 2% target. Then (2019), the Fed was receptive to the negative impacts of its own policies. The Fed recognized the damage balance sheet reduction was having on market conditions and decided to end its policy a few months early. Now (2022), the Fed is set on a firm policy tightening course. In the absence of a rapid and sharp reversal in inflation, it is hard to imagine a scenario in which the Fed changes course without a material worsening in unemployment or credit markets.
- We acknowledge that economic risks in the US are rising. However, a recession isn't a fait accompli. If the Fed was more forward-looking and relied on data still to come, it may not need to tighten as much as it has planned. This would be a positive sign for markets and our Resilient scenario. 2019 may be a guide in this regard.
- As uncertainty rises, our job is to build portfolios that seek diversification while minimizing exposure to economically sensitive sectors and regions.
- We have shifted to our most cautious – but still fully invested – portfolio stance since Q1 2020. We hope that economic conditions evolve to enable 2022 to look more like 2019, but we are constructing portfolios for the economic and policy realities we face today – not for the path we wish policymakers would have taken.
- At our recent Global Investment Committee, we cut our global equities allocation to neutral by taking down commodity-linked equities. We further raised exposure to high quality bonds, including US investment grade corporate securities. Details herein.

"It isn't where you came from; it's where you're going that counts." – Ella Fitzgerald

Now and Then: Will the Fed Remember 2019's Rational Policies?

For many profitable and high-quality companies, share prices have reversed their entire post-COVID rally, even as underlying profits have grown over the past two years. Yet, this week, our Global Investment Committee took steps to further de-risk portfolios, in an acknowledgement of lingering risks that may or may not spur further declines in equities and credit markets. If we were willing to add risk at similar valuations before COVID, why are we being more cautious today?

The two-plus years since the outbreak of COVID-19 have seen several major market distortions that will take time to resolve. A surge in "stay at home" stocks has largely reversed, though remote work is likely here to stay for many employees. Firms selling household goods and electronics struggled with supply chain bottlenecks last year only to be stuck with too much inventory today. Energy companies went from bust to boom, while technology has gone from boom to bust.

As asset allocators and risk managers, we look to historical data, economic conditions and the behaviors of decision makers to guide our decision making. No two periods are identical, but contrasting moments in time can be illuminating.

Across a number of indicators, the economic backdrop just months before the outbreak of COVID looks quite similar to today. US unemployment was below 4%, manufacturing activity was steady, and the yield curve was extremely flat. Equity valuations were about "average," neither expensive nor cheap. And in 2019, concerns about a possible recession were growing.

There are significant differences between 2022 and 2019, as well. Oil prices are nearly double their 2019 level. Inflation is significantly higher than the Fed's 2% target, spurring an aggressive hiking cycle and reduction in lending to the bond market. And, at least for now, the Fed seems much less willing to consider any policy reversals as it did in late 2018.

Figure 1: Indicators and Conditions: 2019 vs July 2022

	July 2019	July 2022
Market Indicators		
Fed Funds Rate	2.40	1.58
10-Year Treasury Yield	2.01	2.97
2y10y Yield Spread	14	-8
S&P 500	2980	3819
Trailing 12m EPS	154	210
Trailing P/E	19.4	18.2
CAPE	30.0	29.5
WTI Crude Oil ($/bbl)	**59**	**96**
HY Bond OAS Spread	3.71	**5.32**
Economic Condition		
Unemployment Rate	3.7	3.6
Inflation	**1.8**	**9.1**
ISM Manuf. New Orders (50+ = Expansion)	50.5	49.2
Leading Indicators (6m % Change)	0.80%	-0.42%
Fed Policy		
Expected 12m Fed Funds Rate Change	**-0.80**	**1.73**
Balance Sheet Policy	**Ended QT Early**	**QT: $95bn / month**

Source: Bloomberg and Haver as of July 15. Note: Green and red figures highlight those items that materially differ between July 2019 (green) and July 2022 (red). Note: the CAPE means Cycle Adjusted Price/Earnings Ratio. The cycle adjustment is a 10-year moving average of EPS.

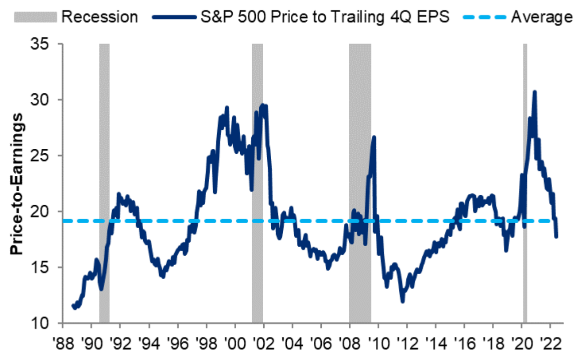
Valuations, Then and Now

A US market that was quite overvalued six months ago has returned to more average levels of valuation today – both on an absolute basis and relative to fixed income (figures 2-3). Most of the de-rating in P/E ratios this year can be attributed to rising interest rates ("discount rates"), while analyst expectations for earnings growth have held steady in the high single digits for this year and next.

Our skepticism of consensus estimates makes forward P/E comparisons for 2019 and 2022 difficult. Using our own forecasts for earnings in our three potential Robust, Resilient, or Recession scenarios, we are either fairly valued if recession is avoided or somewhat overvalued if we are to see a 15-20% earnings decline in 2023 as a result of a recession (see our March 27 CIO Bulletin, "Three Scenarios for the Economy and Markets").

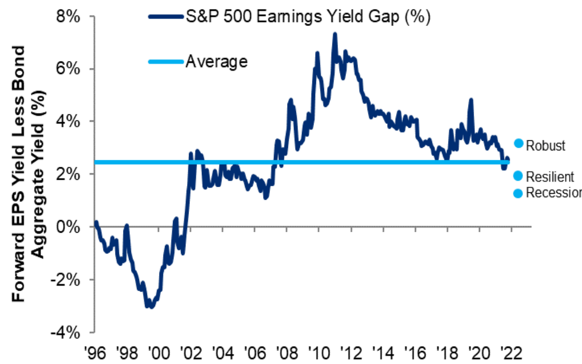
As the market shifts from concern over the Fed's terminal rate to worries about the economy's ability to weather Fed tightening, the path for earnings is likely to take center stage for investors in the second half of this year.

Figure 2: Trailing S&P 500 P/E Ratio vs Average since 1988



Source: Factset as of July 15, 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.

Figure 3: S&P 500 Earnings Yield Gap (vs Aggregate Bond Yield)



Source: Factset as of July 15, 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.

What We Were Thinking in 2019

How did we approach investing the last time markets traded at these levels? You may be surprised by what we were writing then. In our Mid-Year Outlook in 2019, we wrote:

> "Fears that the US might slide into a recession were exacerbated when the US yield curve briefly inverted in March. Such factors helped to distract attention from positive factors such as Fed's retreat from monetary tightening."
>
> "Currently, US equity multiples stand around their longer-term average."
>
> "Today's valuations are one of the reasons we maintain a positive stance on equities. However, we are also very mindful of the need for earnings growth to drive this asset class higher for the rest of 2019 and in 2020."

In July 2019, the Fed *recognized* the damage balance sheet reduction (QT) was having on market conditions and chose to end the policy a few months early. It cut interest rates in 2019 three times after nine previous rate hikes.

We also penciled in moderate earnings growth for 2019 and 2020 three years ago, not knowing a pandemic was around the corner.

What We Are Thinking Today

The Fed intends to raise rates significantly over the next 12 months, spurred by 9.1% inflation in June. They believe the economy is "strong," yet real consumer spending has already decelerated to a 1 ½% pace in the first half 2022. Like the strong initial reads on consumer spending they cited, inflation expectations data have also been revised down.

The nearly 50% earnings growth last year cannot be duplicated. In the last half of 2022, falling demand will make it difficult for firms to even raise prices in line with rising costs. This is in stark contrast with the low inflation environment that enabled a new rate cutting cycle in 2019 and decent profit growth before the pandemic hit.

There was a yield curve inversion in 2019 that did not lead to immediate recession. We, of course, doubt the Treasury market held any real warning about COVID in 2020. Now, with rates materially higher and inflation running hot, the risk is greater that the Fed will constrict economic growth too much as it seeks to bring down exogeneous sources of inflation.

The Fed is acting quickly and aggressively in 2022, not giving itself time to benefit from the information feedback loop between markets and policy impacts. It will undertake balance sheet reductions (Quantitative Tightening) – the very activity they chose to curtail abruptly in 2019 – while the economy is slowing. We believe this will cause investors to allocate more private capital to Treasuries and other safer fixed income, sapping liquidity from risky credit and vulnerable equities.

What the Fed Would Have to Do to Avoid a Recession in 2023

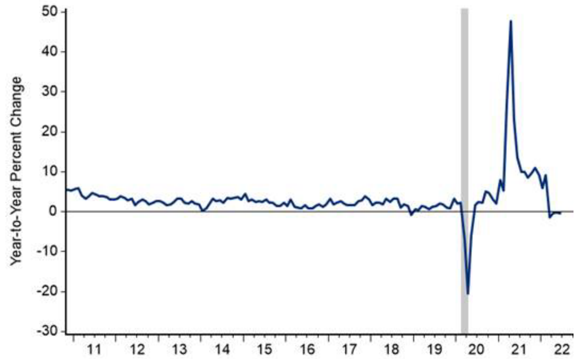
Fed leaders care a lot about the credibility of their institution. By so publicly committing to fighting inflation, Powell and team are unlikely to reverse their tightening and QT strategy without a material change in inflation or a change in credit availability or both. Signs that inflation indeed peaked in June would certainly help, though the speed with which inflation falls will matter for the Fed's future tightening plans. The pickup in "stickier" areas of inflation like shelter is likely to be of greater concern to the Fed than more volatile food and energy prices, which do appear to be peaking.

A sharp rise in layoffs would also force the Fed to consider the other side of its dual mandate of maximum employment. Potential distress in credit markets would raise financial stability alarm bells. Perhaps in that situation the Fed would reconsider the speed and open-ended nature of its balance sheet reduction program. *Unfortunately, in the absence of a faster-than-expected sharp reversal in inflation, we struggle to envision a scenario in which the Fed changes course without a material worsening of market conditions.*

While this would all seem to point to an "open and shut case for a recession," the situation remains unclear for several reasons. Inflation has been weakening the world economy, and a retreat in inflation would be a global economic stabilizer (figure 4). This is particularly true while employment growth is positive, and not at an excessive level. Remember that despite a 1.5 million increase in the population age 20 to 70 since 2020, employment has not eclipsed its pre-pandemic level (figure 5).

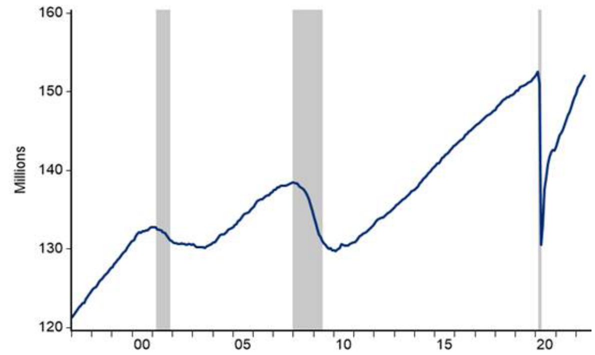
A large drag on US personal income growth from fading government support has passed into history while wage income is being sustained (figure 6). Therefore, only inflation itself is dragging down real income growth. Recovering supplies of goods and services should be given time to alleviate shortages as spending cools (figure 7). Thus, if the Fed looked forward at the data to come, it need not follow through on policies that could cause a downward spiral in the economy.

Figure 4: Inflation-Adjusted US Retail Sales Y/Y%



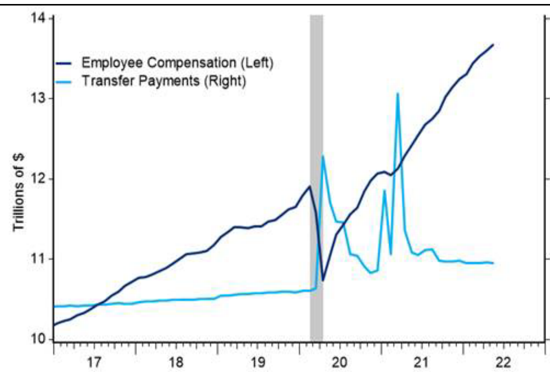
Source: Citi, Census Bureau, Bureau of Labor Statistics, Haver Analytics as of July 15. Grey areas note recessions.

Figure 5: US Employment (thousands)



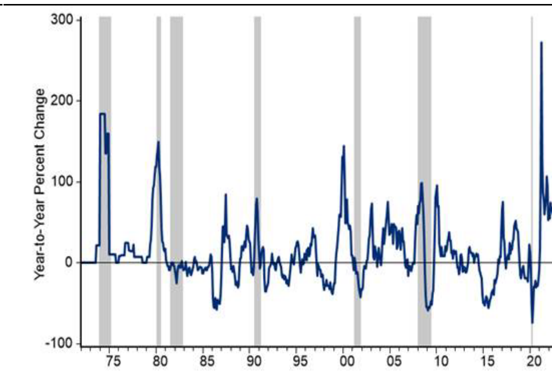
Source: Citi, Census Bureau, Bureau of Labor Statistics, Haver Analytics as of July 15. Grey areas note recessions.

Figure 6: Employee compensation vs government income support (billions of $)



Source: Citi, Bureau of Economic Analysis, Haver Analytics as of July 15, 2022. Grey areas note recession.

Figure 7: US crude oil price Y/Y%



Source: Citi, Energy Information Institute, Haver Analytics as of July 15, 2022. Grey areas note recession.

Why We Are at An Inflection Point

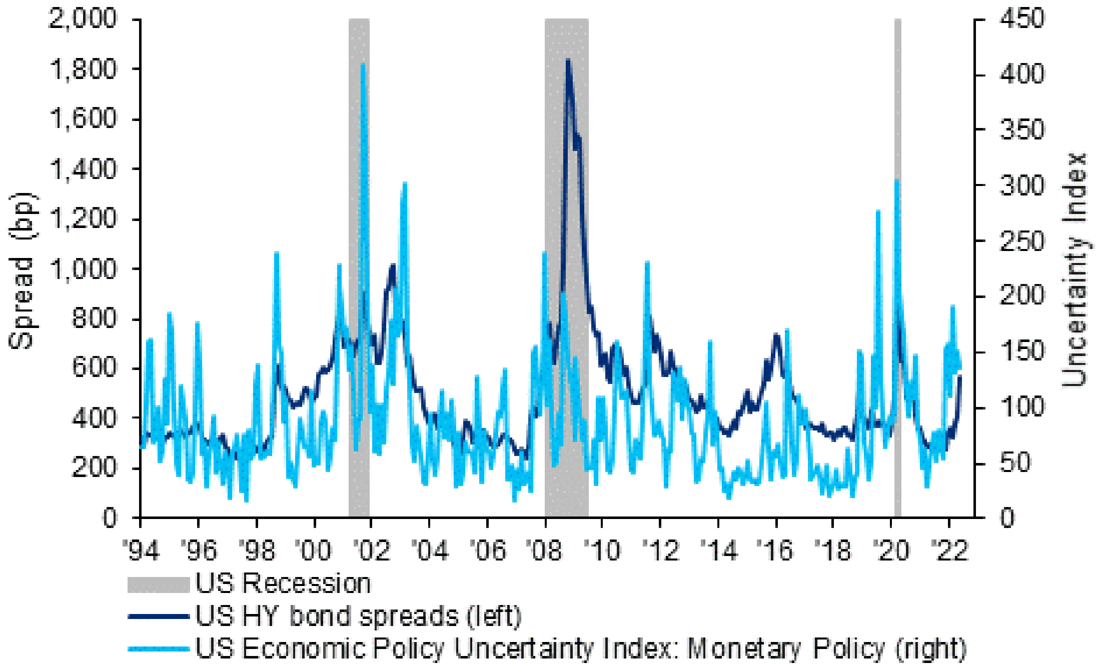
While the economy has not "broken down" given today's rising employment, it will be hard for us to ignore the numerous impacts an ever-tighter Fed policy will have, especially QT. Ironically, the lack of net US employment declines thus far is keeping the pressure to fight inflation alive at central banks. This is why many call for ever larger and sustained Fed tightening steps.

With policy tightening rapidly, many investors are sidelined, looking for a recessionary collapse as a signal to buy, just as they could in the spring of 2020. In short, the investor's point of view is clearly at odds with that of policymakers whose primary goal is stability – balancing inflation and employment.

Once fundamentals are deeply depressed and poised to recover, future returns are usually strong, and risks are in the rear-view mirror. Distress serves up investment opportunity. Yet, it is the job of policymakers to avoid an *unneeded* collapse in the first place.

As we wrote in the July 9 CIO Bulletin, "Assessing This Bear Market's Depth and Duration," credit markets are a leading indicator of financial distress in this cycle. Today, credit markets are becoming less liquid as one goes down the quality curve. Without attention to the speed of economic deceleration in the face of declining credit availability, the day may be close at hand when it will be too late for the Fed to balance its fight against inflation with sustained employment (figure 8).

Figure 8: High yield spreads vs monetary policy uncertainty index



Source: Bloomberg, as of July 12, 2022. Red arrow points to rise in both high yield bond spreads and broad policy uncertainty. All forecasts are expressions of opinion and are subject to change without notice and are not intended to be a guarantee of future events. Indices are unmanaged and forecasts are expression of opinion. 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. Index returns do not include any expenses, fees or sales charges, which would lower performance. For illustrative purposes only. Past performance is no guarantee of future results. Real results may vary.

Why We Chose to Take Risk Down

At our Global Investment Committee, we see markets that heavily discount tighter monetary policy and higher inflation, but *not* a deep economic collapse. And, in parallel, markets do not contemplate relief from these conditions. While recession is not inevitable, recent inflation readings are likely to embolden central bankers to greater tightening while economic weakness lies ahead. This has potential unexpected consequences.

As uncertainty rises, our job is to build portfolios that are both optimally diversified while minimizing exposure to the most economically sensitive sectors and regions.

Our Portfolio Changes

Cutting global equities to neutral while raising exposure to high quality bonds

After this past week's portfolio adjustments, we are neutral on global equities, or -2% excluding our hedge against high commodity prices. We maintain large **underweights** in global SMID (small and medium sized stocks) and Europe, while we maintain core **high-quality overweights** in dividend growers, global pharma, and cyber security. We have also **raised quality on the fixed income** side, shifting from HY loans to preferred stock issued by higher quality investment grade firms. We remain significantly overweight US Treasuries and US IG credit. All of this is part of our **Bonds are Back** theme. (See the July Quadrant.)

More quality fixed income

The 12-month increases in medium-duration US Treasury yields has been among the largest in US history (see figure 9). The yield on US investment grade corporate securities has risen to the highest level since 2010 (see figure 10). In the long swath of history, this is not a "high" interest rate level. However, we believe this is an attractive investment in the current cyclical backdrop, with US municipal bonds even more attractive for certain US taxed investors.

Figure 9: 12-month change in 5-year US Treasury yield

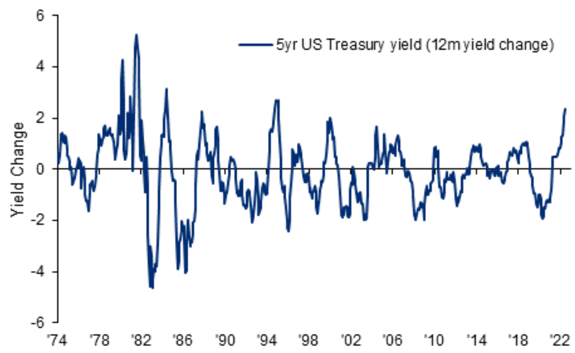
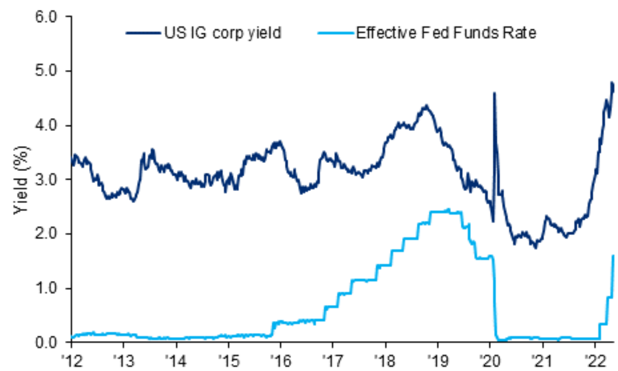


Figure 10: Investment grade US corporate bond yields and effective Fed Funds rate



Source: Haver as of July 11, 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.

Seeking to reduce overall portfolio credit risk

With credit risk rising for economically sensitive low-grade borrowers, we eliminated our riskier loan positions. We did this in favor of IG corporate bonds and another fixed income opportunity that has seen a greater correction. While the high yield bond market has now partially priced in an economic contraction, hybrid preferred securities appear to be a higher quality, stronger yield opportunity that has suffered in parallel. The preferred stock of highly capitalized large banks pays dividends of 6.5% today, this after a 12% downward price correction (see figures 11-12).

Figure 11: Bank preferred return IG Capital Securities total return

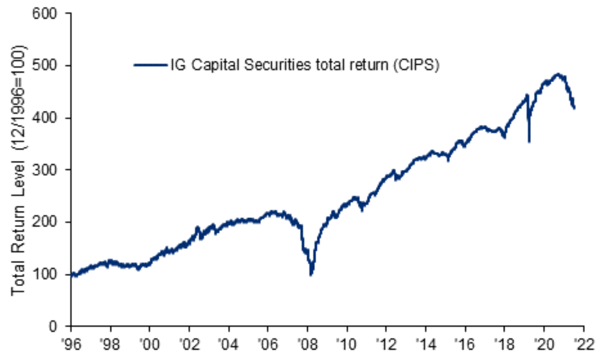


Figure 12: Bank preferred return IG Capital Securities yield

Source: Haver as of July 11, 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.

Figure 13: Global Investment Committee Asset Allocation

LARGEST OVERWEIGHTS	Previous	LARGEST OVERWEIGHTS	New
+4.0%	Global Natural Resources/Oil Services	+2.0%	Global Natural Resources
+2.0%	Global pharmaceuticals	+2.0%	Global pharmaceuticals
+2.0%	Cybersecurity/Fintech/Payments	+2.0%	China equities
+2.0%	Gold	+2.0%	Gold
+1.0%	China equities	+1.0%	Cybersecurity
+2.0%	**Total equities and REITS**	**0.0%**	**Total equities and REITS** ↓
+6.4%	Long-term and Intermediate US Treasuries, US TIPS	+6.4%	Long-term and Intermediate US Treasuries, US TIPS
+1.5%	Intermediate-term IG bonds	+3.5%	Intermediate-term IG bonds
+2.0%	Variable rate loans	+2.0%	Investment Grade Preferred Stock
			10.7% of total allocation in US/non-US dividend growth or yield, 4% over

LARGEST UNDERWEIGHTS	Previous	LARGEST UNDERWEIGHTS	New
-9.7%	European, Japan government bonds	-9.7%	European, Japan government bonds
-2.1%	European, Japan Large Cap Equities	-2.1%	European, Japan Large Cap Equities
-5.0%	Global SMID	-5.0%	Global SMID
-2.9%	Cash, short-term US Treasuries	-2.9%	Cash, short-term US Treasuries
-4.0%	**Total fixed income and cash**	**-2.0%**	**Total fixed income and cash** ↑

Source: Office of the Chief Investment Strategist as of Jul 13, 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 no guarantee of future returns. Real results may vary. Sub totals may not add to 100% as not every smaller position is shown. Red arrows indicate upgrades/downgrades at our July GIC meeting.

Conclusion

While risks are rising, we still believe that recession is not inevitable. If we start to hear Fed officials shift focus toward data dependence and forward-looking inflation indicators, this can be a positive sign for markets and our Resilient scenario. If a recession does occur, we would likely see risk assets trade lower, while high quality bonds should rally. Given the binary nature of these two outcomes, we've shifted to our most cautious – but still fully invested – portfolio stance since Q1 2020. We hope that economic conditions evolve to enable 2022 to look more like 2019, but we must construct portfolios for the economic and policy realities we face today – not for the path we wish policymakers would have taken.

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