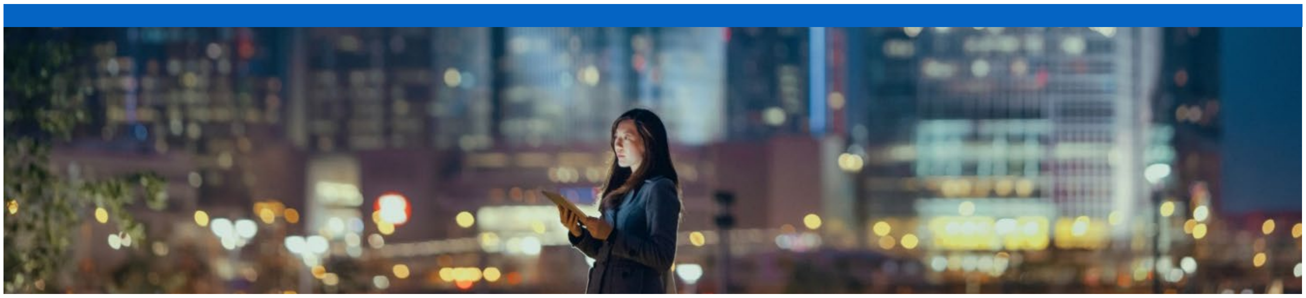
Citi Global Wealth Investments



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CIO Strategy Bulletin

ATTENTION INVESTORS: THAT WAS NOT A RECESSION

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SUMMARY

- **The recent stock market rally suggests there is a recovery underway from a recession that hasn't happened yet.**
- **This is not a recession, nor have we just had one. The July payrolls proves the US is still growing. Non-farm employment jumped by 528,000 in July.**
- **Tighter financial conditions this year will affect labor markets negatively in 2023. We expect that there are employment declines to come, assuming the Fed does not pause its rapid tightening path.**
- **While Friday's employment data was widely viewed as too strong for the Fed to ignore, recent market action suggests many think that much of the Fed's work has already been done.**
- **We are skeptical the Fed will pause its tightening soon. Its 2% inflation target isn't yet visible – primarily because it's looking backwards and sees a 5.4% increase in the CPI in the first half of 2022. We think the Fed will stay resolute in its inflation fight until it sees employment dropping or disorder in credit markets – neither of which are likely in the near term. This makes a shallow recession likely.**
- **The rise in US Treasury yields on anticipated Fed tightening points to at least a modest decline in profits in the coming year. Thus, we are focused on equities with the most secure dividends and investment grade US bonds.**
- **Investors should remember that bear market rallies are common – and can be painful for those who shunned risk or shorted assets that have risen. We are not "all clear" at this time.**

THE NON-RECESSION

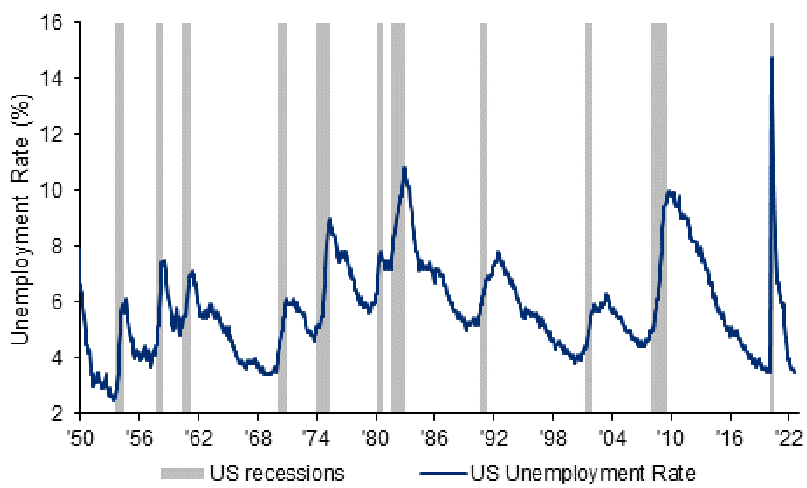
This is not a recession, nor have we just had one. The July payroll data proves that the US economy is still growing. Non-farm employment jumped by 528,000 in July. As we discussed in the July 31 Bulletin, "The 'R' Word: What Powell and Markets Are Telling Us, recession periods are simply not times of growing employment and corporate profits. And we do not see a recession occurring in 2022.

But employment data are not a good leading indicator for recessions. The average time between periods of rising employment and the onset of new recessions is **zero** (see figure 1). We are experiencing rising business inventories and rising gross layoffs. Job openings fell by 1.2 million over the course of 2Q2022. These are clear signs of weaker job gains – and potential net job losses – to come.

In our view, a recession is still avoidable, but the probability of avoiding one is falling fast. Falling inflation can still provide a path to sustained economic growth and enduring job gains. This is possible because the buying power of consumers and businesses will rise as inflation falls. And the employment gains in July provide some fuel for consumers, in the aggregate, to tolerate higher inflation for longer.

However, the Fed's likely response to July's strong employment data will be to stay on its rapid tightening track, increasing the restraint on the economy over time. (At the time of writing this Bulletin, short-term debt markets moved to almost fully price in another 75-basis-point Fed rate increase in September.)

Figure 1: There is zero lead time on average between periods of rising employment and the onset of new recessions



Source: Haver Analytics as of Aug. 5, 2022. Grey areas note recessions.

IF THERE IS TO BE A RECESSION, IT IS MOST CERTAINLY AHEAD OF US

We still do not believe inducing a recession is the right public policy choice to address exogenous inflation sources like pandemic supply shocks and war-related energy shortages. Nonetheless, highly credible leading indicators for the US and other developed markets are increasingly pointing to such a policy mistake (see figures 2-3).

US job openings fell by 1.2 million during the 2022 second quarter based on just released data. Moreover, job openings are overstated. They have risen by nearly twice the level of actual employment over the last two decades as the technology for posting an "open" position has reduced the frictional costs of seeking labor.

We see evidence of a mistake in Fed Chairman Powell's overstatements regarding labor market strength. Job openings were near cycle highs just as employment began to plunge in each of the last three recessions (see figure 4). For the past four months, gross layoffs have increased. By 2023, they are likely to outnumber new hires.

Figure 2: US Treasury yield curve and recessions average lead time is 10 months

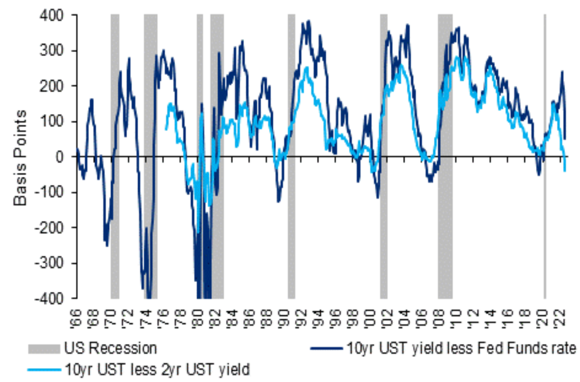
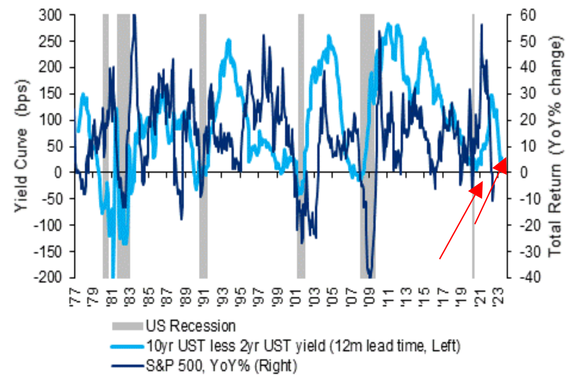


Figure 3: US Treasury yield curve (leading 12 months) vs S&P 500



Source: Haver Analytics as of Aug. 5, 2022. Past performance is no guarantee of future results. Real results may vary. 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. 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. In Figure 3, red arrows show shares now vs. yield curve 12 months ahead.

Figure 4: US job openings Y/Y %

Source: Haver Analytics as of Aug. 5, 2022. Past performance is no guarantee of future results. Real results may vary.

WHY THE FED MATTERS SO MUCH NOW

In 2021, Fed easing helped pave the way for a 29% US equity market return. 2021's excessively strong returns set the stage for this year's correction (-12% year-to-date). Similarly, this year's employment strength reflects last year's easy financial conditions.

Tighter financial conditions this year will affect labor markets negatively in 2023. We see employment declines to come, assuming the Fed does not pause its rapid tightening path.

MARKETS ASSUME THE FED WILL RELENT

Fed policymakers love their TV time these days. All of them highlight their unrelenting commitment to curtail inflation down with a series of additional future interest rate increases. They take no comfort in rallying financial markets. In fact, until the magic 2% number for inflation is in sight, the Fed may view any rally – based on the assumption the Fed will relent or otherwise – as a negative.

While Friday's employment data was widely viewed as too strong for the Fed to ignore, recent market action suggests that many have concluded that much of the Fed's work has already been done. Here is what bullish market participants point to:

- US home sales have fallen 26% from their peak. This will induce a decline in construction, employment and consumer spending that will generate decelerating housing inflation next year.
- Commodities markets are pointing to reduced food and energy costs in the nearer term.
- Discretionary consumer merchandise inventories are now overflowing, pointing to price discounting. Abundance is more apparent than shortages, indicating that supply chain issues are abating.
- US auto production is rising again as semiconductor imports have surged. While we await related CPI data next week, a private measure of used auto prices (Manheim) has fallen 5.1% since February.

WE ARE NOT CONFIDENT THE FED WILL PAUSE SOON

The Fed doesn't see its 2% inflation target in sight. That's because the Fed is looking backwards more than forwards. And if one is looking backwards, the CPI already rose 5.4% in the first half of the year (non-annualized). Barring a deflationary shock, it will take patience to see 2% gains in US consumer prices over a 12-month period. Yesterday's inflation is, by definition, hard to overcome.

When we look ahead at present inflation, we see brighter news. The CPI core rate and lagging components such as shelter most likely posted another robust rise last month, but with energy costs down 10% in July, **a zero inflation print for July 2022 is possible.**

As we see it, the Fed's one-two punch of higher rates and QT are likely to remain in place until it sees falling employment or disorder in credit markets, neither of which are likely near-term events.

If the Fed ignores the present reduction in inflation by focusing on a target that is very hard to achieve, a shallow recession becomes highly likely. However, if the Fed shows any sign of relenting, markets will behave as if the worst is behind us – as they have this past five weeks. This is why predictions for the economy are so difficult.

WE THINK CORPORATE PROFITS WILL FALL IN 2023

Second-quarter corporate profits were well above our estimates at 6.5% year over year. This comes after a 47% surge in 2021. And industry analyst estimates suggest these gains can continue over the coming quarters. With the Fed delivering the rate hikes the market predicts, the end of 2022 is predictably showing deceleration in economic growth.

The typical lags between tightening steps and impact points to 2023 for EPS declines. We believe profits are more likely to decelerate over the remainder of 2022 and see a modest drop likely over the coming year (see figures 5-6).

The US economy has not risen sharply above pre-pandemic levels. Recovering supplies of goods has already limited related inflation. With the services sector barely above early 2020 levels of activity now, there is no need for the economy or profits to retrench sharply.

The rise in US Treasury yields on anticipated Fed tightening is pointing to at least a modest decline in profits in the coming year. The Fed's continued tightening steps are designed to curtail growth in the coming year by reducing demand to fight inflation.

Nonetheless, the outlook for cyclical industries will only brighten when a new economic recovery is in sight, or the Fed removes the retrenchment threat. This leaves us focused on equities with the most secure dividends. It also leaves us overweight investment grade US bonds with yields that reflect a sharp rate hiking cycle (see figures 7-8).

Figure 5: S&P 500 EPS quarterly level

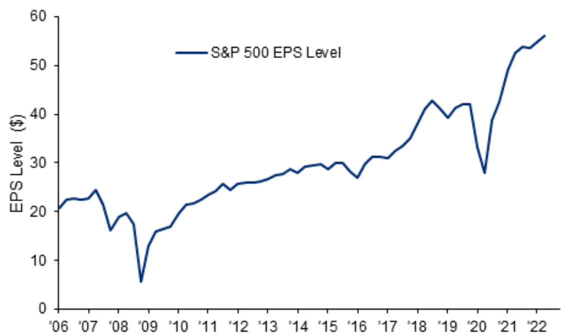


Figure 6: 2-year change in long-term US Treasury yield (leading 18 months) vs Y/Y% change in S&P 500 EPS

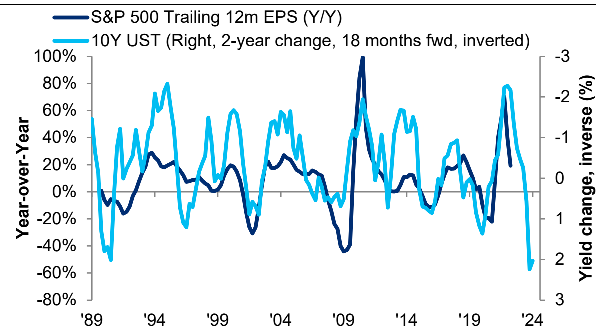


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Figure 7: S&P Dividend Aristocrats Relative to Small/Mid Caps

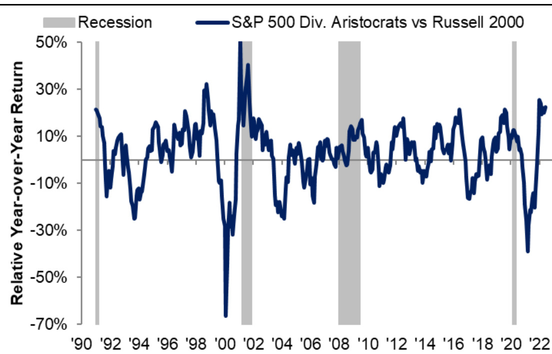
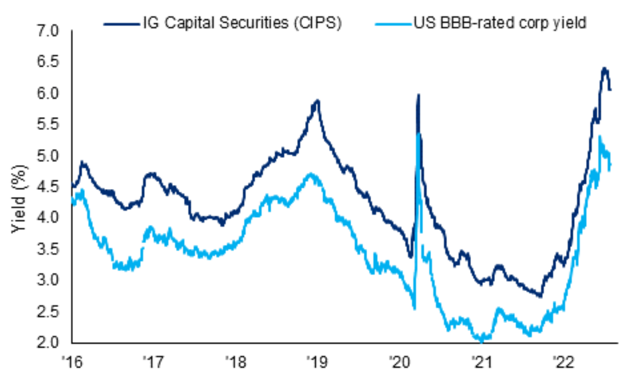


Figure 8: IG Corporate Yields and IG Preferred Yields



Source: Haver Analytics through July 27, 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. Note for Figure 7: Dividend Aristocrats are US firms that have raised dividend payments for 25 or more consecutive years. SMID is Russell 2000 Index.

DON'T BE COMPLACENT: BEAR MARKET RALLIES ARE COMMON

At the lows of this year, US equity markets may have discounted a mild recession. The recent stock market rally suggests there is a recovery underway from a recession that has not happened yet. Remember that meaningful economic declines have not yet occurred.

Following a strong rebound month for equities – July showed the strongest gain for the S&P 500 since November 2020 – markets traded nearly unchanged over the course of last week.

After two quarterly declines in real GDP, some pundits argue that "we now have another one of those nasty recessions out of the way." The problem is, the US has never experienced a recession with rising employment and rising corporate profits. Yet, that's exactly what has occurred in 2022-to-date.

Bear market rallies can be painful for those investors who shunned risk or shorted assets that have risen. A potential "head fake" can come from investors looking at historical data without context. Post-recession recovery phases have generated unusually strong US equity returns, and the S&P 500 has averaged a 22.4% 12-month return after the first two declines in US real GDP.

In short, investors should understand that rallying markets after a "non-recession" do not offer an "all clear" message for the economy in the coming year.