



September 11, 2022

CIO Strategy Bulletin

Beware Consensus Trades in Uncertain Times

David Bailin, Chief Investment Officer and Head of Citi Global Wealth Investments

Steven Wieting, Chief Investment Strategist and Chief Economist

SUMMARY

- Investor positioning, including very large net short positions in non-US currency futures, US stocks and bonds, is indicative of bearish expectations across much of the world. The US appears to be a “safer haven.” While that may be true, unwinding positions held by a very widespread consensus of investors can lead to sharp contrarian movements across asset classes. We see overbought and oversold markets in wartime as reasons to maintain the highest quality, income-oriented investments for the present time.
- History suggests that US dollar rallies often last longer than fundamentals justify. For now, our asset allocation is effectively overweight US dollar assets, and USD strength has benefited these positions. We are carefully watching, however, for signs of an overshoot that could reverse in 2023.
- Surging energy costs in Europe and Japan have compounded the effects of the Fed’s rapid tightening pace, sinking the euro, pound and yen in a way that might remind some observers of EM currency crises of the 1980s.
- Our most recent forecast update ([August Quadrant](#)) estimates the forthcoming economic impact of rapid central bank tightening steps. While we are quite confident the US and other world economies will slow, we need to be mindful of the volatility inherent at this uncertain time. We must, therefore, proceed with caution and discipline in how we manage portfolios that seek to protect and build wealth.

Beware Consensus Trades in Uncertain Times

The pandemic and the war in Ukraine, as well as the very different political and economic responses to these events, have led to extreme price movements in many markets. We may apply “logic” to understand prices, but the fact is that macro traders, liquidity and even the language used by central bankers influence the speed and direction of markets more than fundamentals in extraordinary times.

A strong US dollar, a hawkish Fed, a slowing world economic outlook and acute European misery are consensus expectations. Speculators and hedge funds have built sizable short positions in non-US currencies, US equities and US bond futures (see figures 1-3). And similarly, assets around the rest of the world reflect bearish expectations that we cannot measure as directly.

As we have seen over the past two months, consensus market action leads to substantial counter-trend rallies. Equity market rallies during bear markets and rapid falls in developed and emerging market currencies can lead investors astray. They may even convince some investors that the economic outlook has changed even when such an assessment is premature. Things may look cheap or expensive, but neither may be true.

Our most recent forecast update ([August Quadrant](#)) estimates the forthcoming economic impact of rapid central bank tightening steps. While we are quite confident the US and other world economies will slow, we need to be mindful of the volatility inherent at this uncertain time. We must, therefore, proceed with caution and discipline in how we manage portfolios to protect and build wealth.

Figure 1: USD Net Long Speculative Futures Position vs US Dollar Index

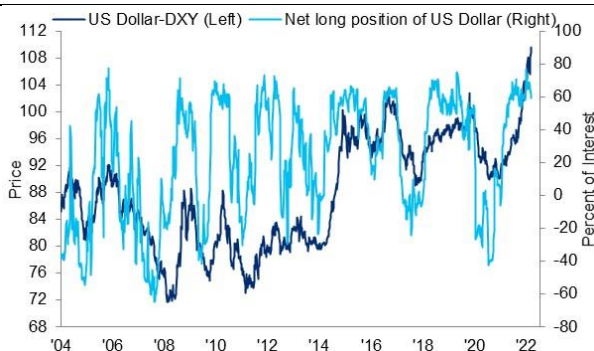
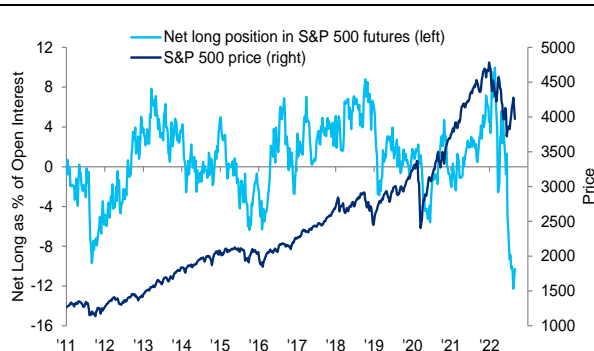


Figure 2: US Equity Futures Net Short Position vs S&P 500



Source: Haver Analytics as of September 8, 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: US 10-Year Treasury Futures Net Short Position vs Yield (%)



Source: Haver Analytics as of September 8, 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 Consequences of War

Wars are inherently unpredictable and our ability to comprehend the reverberations of war is limited by their unique circumstances and the human tendency to assume that today's news flow will be sustained. No one could know how Russia would pursue the war, how Ukraine and its people would respond, nor predict the solidarity that the West would exhibit in isolating Russia with economic sanctions and weapon shipments to Ukraine. Beyond the tragic loss of life on the battlefield are global impacts on food and energy supplies that affects the lives of billions day-to-day. How and when the war will be resolved is equally unpredictable and the waves of changes that will emanate from its resolution will last for decades.

At this moment, there are immediate crises that governments are addressing and that markets are responding to. Will Western Europe have Russian natural gas supplies again at any level? When might that be, if ever? What is the long-term impact on competitiveness for European industry? What positives does the conflict mean for alternative supplies, from liquefied natural gas (LNG) to wind and solar? Where does this leave the economies least impacted, or able to access Russian oil at cheaper prices? Answers to these questions will evolve over time.

How “War” Looks on a Financial Terminal

Foreign exchange markets demonstrate the depth and speed of the impacts of war most clearly, Commodity prices also reflect supply developments, security issues and macroeconomic demand. Most recently, we have seen a sharp revaluation of the currencies of energy importers (see figures 4-5). With central banks competitively raising interest rates to combat the inflation associated with the war, these currency movements are major and impactful. Economies experiencing these combined shocks will see varied responses from policy makers based on their economic pain thresholds. Central banks have not synchronized their policies.

Figure 4: Plunging Euro: Euro Area Terms of Trade (Export Prices Relative to Import Prices) and Euro vs USD

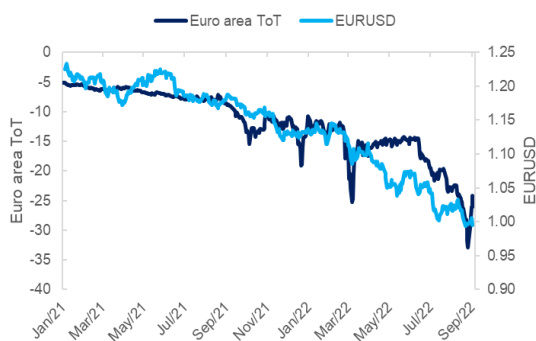
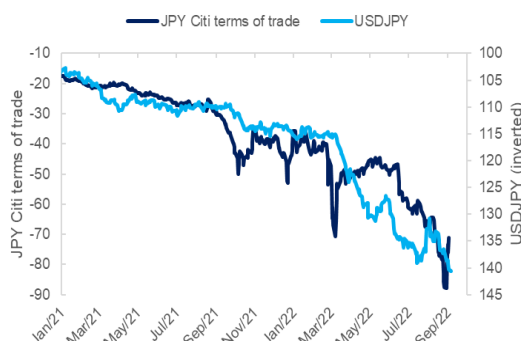


Figure 5: Plunging Yen: Japan Terms of Trade (Export Prices Relative to Import Prices) and JPY vs USD



Source: Factset and Bloomberg through September 8, 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.

Back to the '80s?

Despite very different circumstances as described in our [August 27th CIO Bulletin](#), the extreme exchange rate environment of the early 1980s provides some useful insights for currency movements in the period ahead. Over a three-year period ending in mid-1983, the US inflation rate plunged 12 percentage points and real long-term interest rates rose 13%. Inflation in emerging markets did not collapse. This set the stage for the largest historical bull market for the US dollar in history, peaking in 1985, leading to currency crises in Latin America (see figures 6-7).

Interestingly, in the 1980s, real interest rates and inflation followed the same path in the UK as in the US, yet the pound also fell to a record nominal low of 1.05 to the US dollar by early 1985. This period culminated in the historic Plaza Accord in which European governments and Japan agreed to strengthen their currencies.

Figure 6: US CPI vs Non-US CPI



Figure 7: US Real Rate and Exchange Rates



Source: Haver Analytics as of September 8, 2022. Note: 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.

Here are three interesting observations and reflections from the 1980's experience:

- It only took modest positive real US yield premiums over other currency zones to generate extreme US dollar strength in the early 1980s (see figure 8).

- In both the 1980s and early 2000s, the US dollar **continued to appreciate** even after the fundamental causes of the dollar surge had long ended.
- Emerging market currencies weakened sharply in the 1980s and 1990s as the US tightened monetary policy. In the present case, much of the EM currency world is benefiting from high commodity prices, proactive central banks and market exchange rates. It is DM currencies that currently bear the greater brunt of the “terms of trade shock” from the loss of Russian energy supplies.

In the present situation, the Bank of Japan appears unwilling to raise interest rates as long as its current Governor remains in office until the Spring 2023. Precedent may suggest that today’s dollar surge will endure versus the yen. Yet like many strong and widely held assumptions, if it turns out to be wrong, there is potential for a very painful reversal in the yen’s weakening with spillovers to other global markets.

Figure 8: 10yr Real Yields Across Key DM Countries in 1980s



Source: Haver Analytics as of September 8, 2022. Note: Shaded areas are recessions. 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 Huge Cost of Fighting Markets by Policy Makers

In the UK, facing rampant energy inflation, new Prime Minister Liz Truss announced that the government would cap household energy bills at £2500 for two years with “equivalent” support for businesses over the coming six months. Details of the plan are incomplete, but it appears that the UK government will borrow billions to subsidize utilities to provide cheaper energy to consumers at an extraordinary cost. The actual cost of energy remains to be seen, but is theoretically limitless. It is possible, for example, for the UK to need an additional £100 billion of borrowing to finance this pledge.

Historical energy shocks such as the OPEC embargo of 1974 demonstrate the impacts of energy shortages on economic activity rather than just changing relative prices. (In other words, one could still get sufficient energy supplies at a higher price). A macro-level contraction among most oil-importing economies was the result.

Under present circumstances, lower energy supplies and higher near-term prices are acting as a severe brake on economic activity, particularly in the EU and UK. With prices evolving quickly (see figure 9), energy-intensive industrial activity in Europe’s most costly regions will shutter and relocate to less costly regions. Consumers will likewise have to curtail purchases of goods to pay for energy bills. This is why we expect the most severe contractions in the region with full-year declines of 0.5% and 1.0% in the EU and UK, respectively, for 2023.

Over the longer term, the war in Ukraine will likely lead to a lengthy redirection of Russian energy supplies to Asian economies from Europe and probably some absolute loss of Russian gas output for a

period of time. Energy supplies such as LNG, solar and wind power will expand to limit the damage (see figure 10). However, they cannot be built up as quickly as the valves on existing pipelines can be switched on and off.

Figure 9: Extreme Local Cost Divergence: US Natural Gas Price vs German

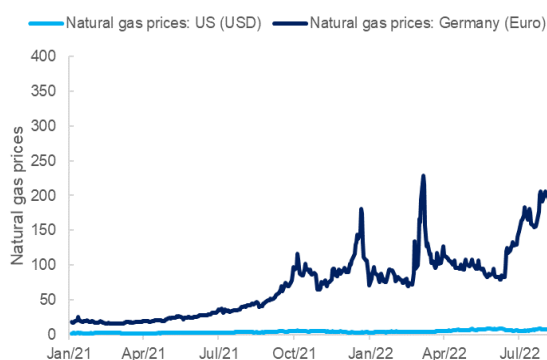
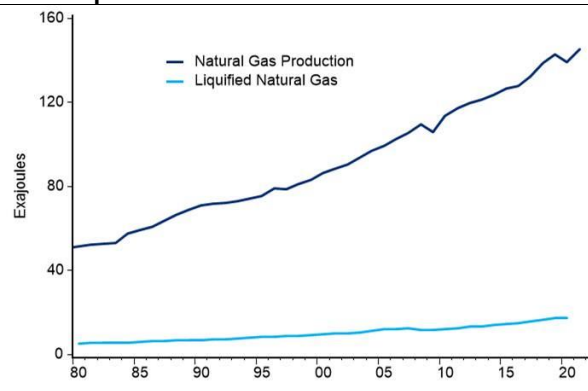


Figure 10: Global Liquefied Natural Gas vs Piped Gas Output



Source: Factset and Bloomberg through September 8, 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.

Fighting the Inflation of War May Also Be Extra Costly

Meanwhile, Fed Chairman Powell has signaled a willingness to raise rates 75 basis points for a record third consecutive time later this month. We see this as somewhat akin to dosing a patient multiple times before the drug's effects can even be felt. US inflation likely peaked in July. There are even multiple elements of inflation that are falling now with the 12-month pace of core goods price inflation receding to 7.0% from 12.3% in the past five months. A roughly 15% drop in the price of gasoline in August will likely mean the overall CPI fell 0.3% last month. Lagging inflation indicators such as real estate values will take longer to decelerate in the CPI. However, the Fed has already engineered a 30% decline in US home sales, presaging a drop in 2023. In spite of this, the Fed will press on and could reach its policy rate peak in 2022, perhaps with a rate of 3.75%.

Powell isn't alone. The European Central Bank – which kept its key policy rate *negative* since 2014 – joined the “75 club” last week (see our Sept. 8 [Europe Strategy Bulletin](#)), with others such as the Bank of Canada also following the Fed's lead in tightening in very large steps. Yet, as history shows, for weaker economies and weaker currency zones such as the EU, the rate hikes might not stem capital outflows.

Conclusions: A Time for Patience, Not Complacency

The war in Ukraine has followed COVID in delivering upheaval to the world economy. While this will bring long-lasting change, much of the initial negative global shocks will fade as the economy adapts. However, the immediate challenges are numerous and reflected in swings in energy, commodity and currency markets that are underappreciated by many investors. Central banks have chosen to fight the shock with monetary policy tightening with effects likely to outlast the initial rise in inflation.

As [we discussed last week](#), we expect the US labor market to peak early in the coming year and for 1-2 million US jobs to be lost. After a very limited gain in labor markets since end 2019, we do not expect the drop to be historically large. However, the current path of Fed policy tightening is too extreme for the

current economic and inflation outlook, in our view. The extreme strengthening of the US dollar is just the latest sign that US policy rates cannot be sustained at the levels Fed policymakers now project.

As we note in this Bulletin, investor positioning is highly bearish, more so for Europe than the US for understandable reasons. However, “deep shorts” and extreme pricing for currencies can make for very volatile markets, with temporary gains and losses masquerading as a new, sustainable trends.

In this environment of rapid central bank tightening so fast and historically large that impacts cannot be measured contemporaneously, it makes sense to husband capital and earn income from stable and reliable sources. As we wrote in our latest [August Quadrant](#), we remain effectively overweight US dollar assets. While we are slightly underweight global equities and overweight global bonds, we have far higher weightings in US assets than non-US assets. This has benefited our portfolios as the US dollar returns of equity markets such as Japan (where we are underweight), have been dramatically worse measured in dollars than yen (see figure 11). For many non-US investors, unhedged US dollar bond holdings have added value simply through currency appreciation.

All of this creates the likelihood we will make major changes to portfolio composition this coming year. For now, our allocations continue to earn US dollar income from the investment grade company bonds and quality equity dividends. As conditions evolve in 2023, foreign exchange considerations – which have helped our current allocations – will be continuously reevaluated as events unfold and as the US dollar achieves unsustainable value relative to other currencies.

Figure 11: Year to date (YTD) returns for regional equities (using MSCI indices) across countries in local and USD dollars

Country / Region	YTD Return (local ccy)	YTD Return (USD)	YTD FX Return (vs USD)
Brazil	8.0	15.2	7.2
US	-15.0	-15.0	0.0
Canada	-7.0	-10.3	-3.3
Switzerland	-15.4	-20.5	-5.0
India	3.4	-3.3	-6.8
China (A shares)	-16.6	-23.8	-7.2
Australia	-1.2	-8.6	-7.4
Taiwan	-19.0	-27.5	-8.5
Europe	-11.6	-22.6	-11.0
Korea	-21.3	-32.4	-11.1
UK	3.6	-12.2	-15.7
Japan	-1.2	-21.1	-19.8

Source: Haver Analytics as of September 8, 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.

DISCLOSURES

This email contains promotional materials. If you do not wish to receive any further promotional emails from Citi Global Wealth Investments, please email donotspam@citi.com with "UNSUBSCRIBE" in the subject line. Email is not a secure environment; therefore, do not use email to communicate any information that is confidential such as your account number or social security number.

This Communication is prepared by Citi Global Wealth Investments ("CGWI") which is comprised of the Investments and Capital Markets capabilities of Citi Private Bank, Citi Personal Wealth Management and International Personal Bank U.S.

Citi Private Bank and Citi Personal Wealth Management are businesses of Citigroup Inc. ("Citigroup"), which provide clients access to a broad array of products and services available through bank and non-bank affiliates of Citigroup. Not all products and services are provided by all affiliates or are available at all locations. In the U.S., investment products and services are provided by Citigroup Global Markets Inc. ("CGMI"), member FINRA and SIPC, and Citi Private Advisory, LLC ("Citi Advisory"), member FINRA and SIPC. CGMI accounts are carried by Pershing LLC, member FINRA, NYSE, SIPC. Citi Advisory acts as distributor of certain alternative investment products to clients of Citi Private Bank. Insurance is offered by Citi Personal Wealth Management through Citigroup Life Agency LLC ("CLA"). In California, CLA does business as Citigroup Life Insurance Agency, LLC (license number 0G56746). CGMI, Citi Advisory, CLA and Citibank, N.A. are affiliated companies under the common control of Citigroup. Outside the U.S., investment products and services are provided by other Citigroup affiliates. Investment Management services (including portfolio management) are available through CGMI, Citi Advisory, Citibank, N.A. and other affiliated advisory businesses. These Citigroup affiliates, including Citi Advisory, will be compensated for the respective investment management, advisory, administrative, distribution and placement services they may provide.

International Personal Bank U.S. ("IPB U.S."), is a business of Citigroup which provides its clients access to a broad array of products and services available through Citigroup, its bank and non-bank affiliates worldwide (collectively, "Citi"). Through IPB U.S. prospects and clients have access to the Citigold® Private Client International, Citigold® International, International Personal, Citi Global Executive Preferred, and Citi Global Executive Account Packages. Investment products and services are made available through Citi Personal Investments International ("CPII"), a business of Citigroup which offers securities through CGMI, member FINRA and SIPC, an investment advisor and broker-dealer registered with the Securities and Exchange Commission. CGMI investment accounts are carried by Pershing LLC, member FINRA, NYSE, and SIPC. Insurance is offered by CPII through CLA. In California, CLA does business as Citigroup Life Insurance Agency, LLC (license number 0G56746). Citibank N.A., CGMI, and CLA are affiliated companies under common control of Citigroup Inc.

[Read additional Important Information](#)

Past performance is not indicative of future results. Real results may vary.

Citi and its employees are not in the business of providing, and do not provide, tax or legal advice to any taxpayer outside Citi. Any statement in this Communication regarding tax matters is not intended or written to be used, and cannot be used or relied upon, by any taxpayer for the purpose of avoiding tax penalties. Any such taxpayer should seek advice based on the taxpayer's particular circumstances from an independent tax advisor.

MBS are also sensitive to interest rate changes which can negatively impact the market value of the security. During times of heightened volatility, MBS can experience greater levels of illiquidity and larger price movements.

Important information, including information relating to risk considerations can be found in the link above.

Views, opinions and estimates expressed herein may differ from the opinions expressed by other Citi businesses or affiliates, and are not intended to be a forecast of future events, a guarantee of future results, or investment advice, and are subject to change without notice based on market and other conditions. Citi is under no duty to update this presentation and accepts no liability for any loss (whether direct, indirect or consequential) that may arise from any use of the information contained in or derived from this presentation.

© 2022 Citigroup Inc.. All Rights Reserved. Citi, Citi and Arc Design and other marks used herein are service marks of Citigroup Inc. or its affiliates, used and registered throughout the world.

**INVESTMENT PRODUCTS: NOT FDIC INSURED · NOT CDIC INSURED ·
NOT GOVERNMENT INSURED · NO BANK GUARANTEE · MAY LOSE VALUE**