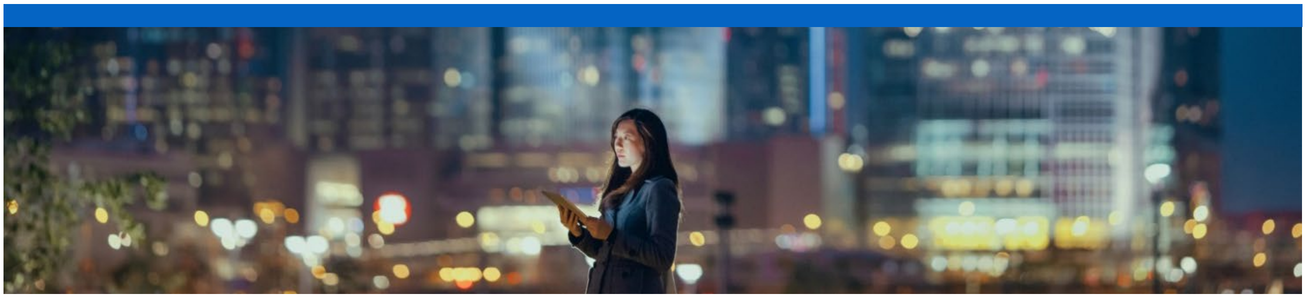
Citi Global Wealth Investments



October 29, 2022

CIO Strategy Bulletin

Bullish or Bearish?

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SUMMARY

- It's a perplexing market – both for contrarians and for investors seeking steady gains from long positions. US equities, which plunged as much as 25% this year, are down 17% (total return) as of Friday – and managed to notch an 8%+ gain in the past two weeks. As we see it, markets are rallying on hopes that the Fed will slow its rate increases soon and on unrealistic expectations that markets have already properly priced in economic declines to come in 2023.
- Despite some recent hints from Fed officials expressing concern over unintended consequences of rapid tightening, the Fed's focus on making up for its excessive easing last year leaves it unlikely to pivot, but merely to pause in the coming year.
- Sign of stress have appeared in the bond markets. Illiquidity has caused events in the UK gilts market to ricochet back to the Treasury market. Rapidly widening mortgage bond spreads have made mortgages more expensive for borrowers. When equities and bonds move in tandem, that's a further sign of risk aversion.
- We remind our readers: No prior equity market bottom has been reached before a recession has even begun. For investors who might want to take greater overall risk after this year's market decline, we believe it makes sense to understand when a recession might begin and assess its likely depth and duration. These are 2023 events, in our view.
- We are repositioning fully invested diversified portfolios toward potentially reliable sources of return: investment grade bond income and dividends paid by industry leading firms. We've increased our overweight to US investment grade fixed income to 14% of medium-risk global portfolios, and added most recently to short-duration US Treasuries with yields at 4.5%.

Bullish or Bearish?

What happens when markets go both up and down with “conviction”?

US equities have fallen as much as 25% this year, but have staged two rallies with double-digit gains over periods of as little as a month. As of Friday, the S&P 500 total return has recovered to -17% YTD, with the market up more than 8% over the past two weeks. The stronger Q3 headline GDP print contained inflation data that supports a record fourth 75-basis-point Fed rate hike. Yet, a good portion of the market’s most recent bounce is based largely on the hope that the Fed will *slow* its rate increases soon.

Undoubtedly, this is a confounding market for those seeking consistent gains from long positions or price declines to benefit short positions. As we see it, markets are rallying on hopes of both Fed rationality and unrealistic expectations that markets have properly priced in the economic declines to come in 2023.

The Fed is indeed showing hints of concern about unintended consequences from their rapid tightening steps. The speed of the Fed’s actions does not allow for contemporaneous observations on economic or market impacts. That speed reflects the Fed’s focus on reversing its excessive easing in 2021. This makes it less likely to “pivot,” but perhaps instead to “pause” early in the new year. That is a time when downward pressure on the economy is more likely to be felt. Historically, markets have been unable to fully ignore weak data even if they anticipate it.

Hope for a Rational Fed

At every Fed meeting in 2022, officials have created uncertainty by ratcheting up rates and policy tightening expectations while simultaneously reducing lending to the bond market without an end point. (See our Oct. 9 CIO Strategy Bulletin.)

Most recently, Federal Reserve officials have hinted ever so slightly that their “rapid” policy tightening might have unintended consequences. In the Fed’s September minutes, some officials noted the possibility of greater-than-desired weakness in the US economy due, in part, to

indicative of the potency of the Fed’s rapid rate increases and quantitative tightening.

The UK-US Ricochet

In the last week of September, the UK Gilts market saw its largest daily and weekly rise in yields in history. The bond market action was squarely blamed on a short-lived UK government tax cut plan. Yet more than half of that rise passed straight through to the US bond market – even though the stock of UK debt is just 9% of the US’s outstanding marketable bonds.

Such market action is endemic in an environment of reduced global bond market liquidity stemming from rapid tightening. Many foreign central banks are understandably trying to keep up with the Fed to avoid capital flight, but such highly
increasingly vulnerable to “contagion.”

Unexpected Mortgage Market Impacts

While mortgage rates typically rise in concert with Fed actions, it's different this time. The average cost to borrow for a 30-year residential mortgage has surpassed 7%. But the real story is that the spread between mortgage rates and the equivalent yields on US Treasuries is at its highest level on record.

This "spread widening" is occurring because of a characteristic associated with mortgage securities. When yields rise sharply, borrowers move from their homes much less frequently, and mortgage prepayments plunge. As such, mortgage bond holders do not get the opportunity to reinvest their capital at today's higher rates. This asymmetry is always present, but the Fed's rapid rate increases have completely changed the risk profile of mortgage securities, and the result is a rise in the premium (or spread) demanded by investors to hold them now.

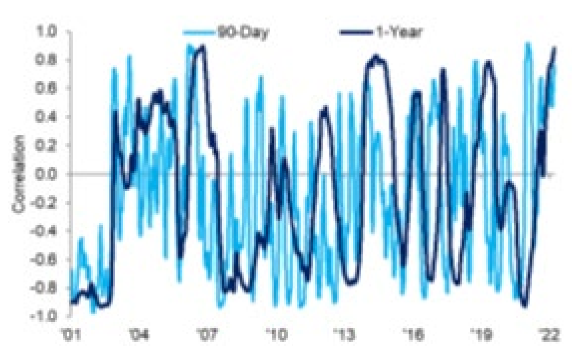
While the mortgage bond market has been crushed, the economic impact is still to come. Sales of homes are already down 31% year over year. Surging rates have caused US pending home sales to drop by 10% just this month. And the pending home sales index is at its lowest level since June 2010. Residential construction employment has not yet fallen, however. This lag effect will cause an estimated 300,000-400,000 job losses in 2023. We believe this will be consistent with about two million job losses overall in 2023 and a rise in the US unemployment rate of from about 3 ½% to 5 ¼%.

Equity and Bond Markets Have Fed Correlation Fever

When rates move abruptly and violently, market participants shy away from risk taking. As a result, "market liquidity" abates and risk premia rise. One can see this in bond market volatility and in the positive correlation between equities and bonds. Higher bond volatility is a sign that private market participants are much less willing to fill the Fed's shoes as a lender (see figure 1). Higher market correlations suggest that when investors want liquidity, bond and stock markets suffer at the same time (see figure 2). This type of illiquidity and volatility prompted a "rescue" from the Fed in 2020. The same is unlikely to happen now. US employment is still growing and the "12-month look back" at inflation is still well above the Fed's 2% target. Thus, the Fed is unlikely to relent.

Figure 1: US Treasury market liquidity index vs implied volatility. (Higher levels imply reduced market liquidity and wider expected price swings)

Figure 2: Correlation between US equity and long-term US Treasury returns % change



Source: Bloomberg and Haver Analytics through Oct. 27, 2022. Past performance is no guarantee of future results. Real results may vary.

Markets Tend to Rise *Before* a Recession

An inverted US Treasury yield curve – a sign of tight monetary policy – has correctly predicted a US recession in 90% of cases since 1960. That warning signal has been triggered. The average lead time for US recession has been 10 months from when the curve first inverts, though it has varied considerably. Yet during that "waiting window" – when the curve is foreshadowing recession, but before job losses have occurred – US stock market returns have generated positive returns, on average (see figure 3).

Figure 3: US equity market performance during periods of inverted yield curve, prior to recession

Start of Inversion	End of Inversion or Prior to Recession Beginning	S&P 500 Performance During Period	S&P 500 Performance 6 mths After End of Inversion or Prior to Recession Beginning	S&P 500 Performance 12 mths After End of Inversion or Prior to Recession Beginning
Sep-59	Feb-60	-5.84%	1.50%	13.04%
Dec-65	Feb-67	-5.27%	7.91%	2.97%
Apr-68	Nov-69*	4.00%	-18.40%	-7.05%
Mar-73	Oct-73*	-3.04%	-16.60%	-31.76%
Sep-78	Dec-79*	4.50%	5.84%	25.77%
Sep-80	Jun-81*	7.22%	-6.60%	-16.46%
Feb-89	Sep-89	17.37%	-2.64%	-12.34%
Apr-00	Dec-00	-11.90%	-7.26%	-13.04%
Jan-06	May-07	22.62%	-3.23%	-8.51%
Aug-19	Sep-19	-0.12%	-13.17%	12.98%
Avg		2.95%	-5.27%	-3.44%
Median		1.94%	-4.92%	-7.78%

*Denotes inversion continued but recession began the following month

Source: Haver Analytics and FactSet as of Oct 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. Index returns do not include any expenses, fees or sales charges, which would lower performance. Past performance is no guarantee of future returns. Real results may vary.

A Poor Time to Be a Contrarian

Data indicate that traders are deeply short markets. Their bearish bias in equities is clear (see figure 4-5). In fact, there may be few investors left without a negative outlook. This sets in motion "short-covering rallies" with price gains exacerbated by illiquidity.

But it takes more than fear of a recession for a recession to come and go. And short-covering rallies won't make the economy grow. Once the Fed does pivot from restrictive policies, the economy will already likely be in trouble. While much is anticipated, the market will still suffer the impacts of higher unemployment and lower corporate earnings.

Figure 4: Individual investor net bullishness and S&P 500 12-month returns at extreme lows

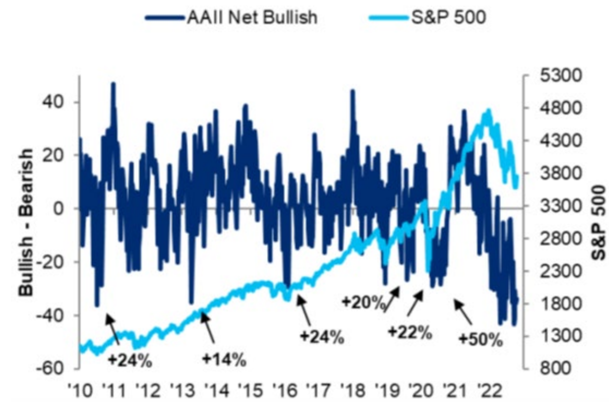


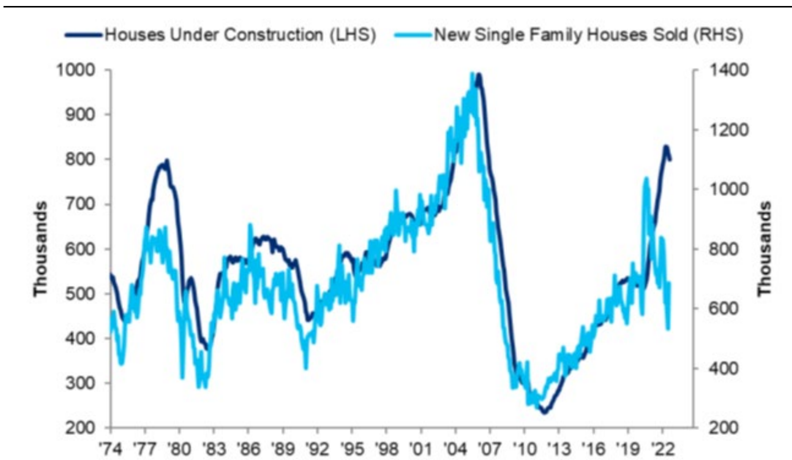
Figure 5: S&P 500 net short positions in futures

Source: Haver Analytics and Bloomberg through October 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. Index returns do not include any expenses, fees or sales charges, which would lower performance. Past performance is no guarantee of future returns. Real results may vary.

While market interest rates have soared this year, the economic pass-through to production and employment remains "expected," not "realized." Yet, there is burgeoning evidence that employment will slow soon:

- New US home sales have fallen 42%, but unfinished homes still under construction have only fallen 3% (see figure 6). This implies a 300,000 drop in residential construction employment and 400,000 drop in overall home construction jobs in the coming year as the pace of construction falls below the pace of sales.
- In the past year, inflation-adjusted inventories surged $146 billion. This is curbing imports (which fell at a 6.9% pace in 3Q) and will eventually curtail domestic industrial production.
- Softer consumer spending has led advertisers to slash spending. We believe over a million services-related jobs in marketing, sales and advertising positions will be lost in the coming year due to the combination of these factors.

Figure 6: New single family home sales vs unfinished units still under construction



Source: Haver Analytics through Oct. 27, 2022.

Rather than economics, investors appear more fixated on how high the Fed is willing to go. This "terminal rate" is currently priced by markets at about 4.75%. There has been some talk by Fed officials suggesting they are looking for an opportunity to slow down and assess the impact of their actions before committing to further major tightening.

For investors who might want to take greater overall risk on this year's market decline, we believe it makes sense to understand when a recession might begin and watch to assess its depth and duration. There are likely 2023 events.

We remind investors that, in history, no equity market bottom has been reached before a recession has even begun (figure 7). Yes, this could be the first time, but the Fed has moved so fast and so far that we think an exception to the precedent is unlikely.

Figure 7: Bear market bottoms during recessions: Upturns in equities don't begin before contractions start, but always before they end

Recession	Depth into Recession that trough occurred	Recession	Depth into Recession that trough occurred
Aug 29-Mar 33	77.3%	Nov 73-Mar 75	63.5%
May 37-Jun 38	76.7%	Jan 80-Jul 80	31.0%
Feb-45-Oct 45	11.5%	Jul 81-Nov 82	77.4%
Nov-48-Oct 49	60.8%	Jul 90-Mar 91	30.5%
Jul 53-May 54	14.6%	Mar 01-Nov 01	70.5%
Aug 57-Apr 58	21.6%	Dec-07-Jun 09	79.0%
Apr 60-Feb 61	59.3%	Feb-20-Apr 20	56.5%
Dec 69-Nov 70	43.5%		
		Average	**51.6%**
		Median	**59.3%**

Source: Haver Analytics and FactSet as of Oct 27, 2022. Proxy for equities data is S&P 500 Index. 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. Index returns do not include any expenses, fees or sales charges, which would lower performance. Past performance is no guarantee of future returns. Real results may vary.

Conclusion: Resilient Portfolios Seek to Prosper

A sober view of macro policy risks, geopolitics and the economic outlook does not lend itself to near-term optimism. Even so, human ingenuity should never be underestimated. Adaptations may come just as they did following the COVID shock two years ago, as technologies helped avoid a harder landing.

As we noted in our October 2 CIO Bulletin, we are not siding with market timers who would look to shed exposure to long-term portfolios and in all likelihood fail to reinvest until asset prices are higher (see figure 8). However, we are actively repositioning fully invested diversified portfolios toward potentially reliable sources of return. We believe these are investment grade bond income and dividends paid by industry leading firms.

We've increased our overweight to US investment grade fixed income to 14% of medium-risk global portfolios. We added most recently to short-duration US Treasuries with yields at 4.5%. Quite simply, the stunning 400-basis-point rise in these yields over the last 12 months – the lowest risk bond assets – is a compelling opportunity to outperform cash that is trailing well behind (see figure 9).

As we did in 2020, we would expect to swerve from defensive positioning in 2023 using such holdings as dry powder when we can see more clearly the depth and speed of this economic cycle. We know where potential opportunities lie when circumstances turn for the better.

Figure 8: S&P 500 total return since 1990 and missing strongest daily returns

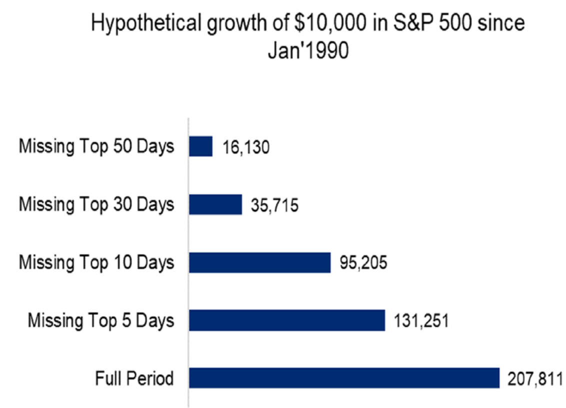
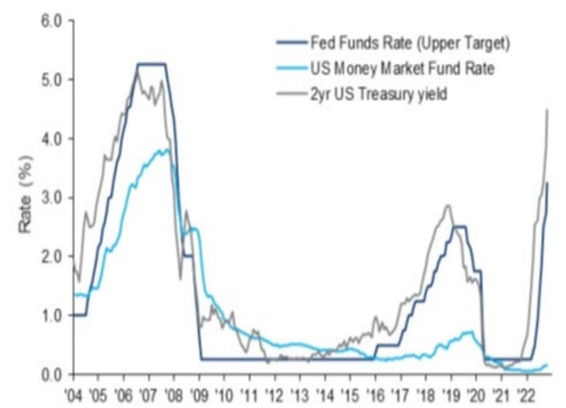


Figure 9: Fed policy rate, 2-year US Treasury yield and US money market rate average



Source: Bloomberg as of Sept. 29, 2022, and Haver Analytics as of Sept. 30, 2022. 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. Past performance is no guarantee of future results. Real results may vary. 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.

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