Private Bank

CIO Strategy Bulletin

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The Coming Financial Repression and Why Investors Will Not Be Paid To Sit On the Sidelines

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Summary

- **We think 2021-22 will be a period of strong economic growth and solid market performance. Markets will be driven by a recovery in depressed industries and a consolidation of gains for sectors that have already boomed. The four reasons are 1) highly likely viable and available vaccines 2) a rebound in trade and industrial production 3) pent up demand for services and 4) fiscal stimulus globally.**
- **The Fed is likely to keep shorter-term interest rates atypically low for years to come. This "Financial Repression" has major implications for portfolios. Higher equity allocations are recommended as bonds will provide fewer diversification benefits. Our most important observation is this: We think that investors who are waiting for attractive real interest rates and depressed equity valuations may spend a great deal of their investment lives waiting for a "better time to invest."**
- **Many investors assign greater anxiety to the fear that that their decision to invest today will be poorly timed and suffer immediate losses. Therefore, investors appear to believe that if they enter markets "early" and suffer initial losses, they will lose more than if they had "just waited". Case in point: During 2020, when markets were in turmoil due to the largest exogenous shock in a century amid COVID-19, missing just the two best days would have reduced an investor's return in US equities by 19.3%.**
- **Global investors have always behaved tentatively before recent elections. Tentativeness – fear of policy uncertainty – has abated only after the election uncertainty has lifted. Yet, when we look back, global equity fund inflows have followed each of the prior four US elections.**

Election Uncertainty Begets Investor Inaction

Polling data show Trump's odds of retaining the presidency would make his victory in 2020 more surprising that 2016. Then, Trump was a complete political novice who surprised highly confident pollsters by defeating a former Secretary of State, US Senator and First Lady. Now Trump is a known figure who has confounded pundits and defied political norms for his entire Presidency. Without Covid and the economic shocks of a global recession, Trump's economic record would likely have been sufficiently strong to overcome increased division in the US public, a limited legislative record and a foreign policy that has separated the US from traditional allies.

If Trump pulls off another surprise victory, he will still preside over a divided government with Democratic control of the US House of Representatives a near certainty. He has been blocked by the Democrats since 2018. But, as we have all learned, there is still a lot a President can do without Congress. The POTUS almost single-handedly determines US foreign policy. Consider that the US came *very close* to entering a trade war with the European Union in 2019. Thus, with 2016 fresh in the minds of voters and investors, global markets will have much to react to the instant they have a clear grasp of who is the next US President.

As for the state of the election, Joe Biden retains a 9.0% lead nationally based on the average of national general election polls. This is a far greater lead than Hillary Clinton's enjoyed this close to the 2016 election. Markets recognize this and the forward volatility curve suggests that there is a lower chance of an inconclusive or disputed US election. As **Figure 1** shows, equity implied volatility for the period *just after* the US election has collapsed. This means markets no longer anticipate a protracted court (or street) battle to determine who is President (please see [Quadrant: *More Certain About the New and Uncertain*]).

If Biden wins a decisive popular vote and the Electoral College, his ability to govern domestically will depend on the control of the Senate. At this point in the polling, a change in Senate control appears too close to call. With close races and unusual rules dictated by each US state, financial markets may not have answers to the Senate control question until well after November 4. If the Senate does not change hands, Biden will not be able to create vastly new domestic tax and spending initiatives in his first two years at minimum.

Looking internationally, Joe Biden's approach to "trade wars" and tariffs is almost certain to contrast markedly with Trump's. For this reason, US trade policy uncertainty measures have collapsed while tax policy uncertainty has surged **(see Figure 2)**. Therefore, just knowing who will occupy the White House in January is likely to be a powerful driver of international risk premia as expressed in currency markets. Investors have broadly set short positions in the US dollar in recent months (see figure 3). We believe that election uncertainty has caused many to cover their short positions due to the unlikely risk of a surprise that would engender potential larger losses. A Trump surprise victory could prove very powerful for the US dollar after the declines of 2020 **(see Figure 3)**. A Biden victory would reinforce this year's drop.

This makes our first main point of this Bulletin: Global investors have behaved tentatively before recent elections. Tentativeness – fear of policy uncertainty – abated only after the election uncertainty has lifted. With earlier Trump promises of a contested election, including litigation and even the threat of "not leaving" the White House, global investors are more wary than normal, in spite of the polling data. Yet, when we look back, global equity fund inflows have followed each of the prior four US elections **(see Figure 4)**.

Figure 1: Markets Price Lower Risk of Disputed US Election: Term Structure of Equity Implied Volatility

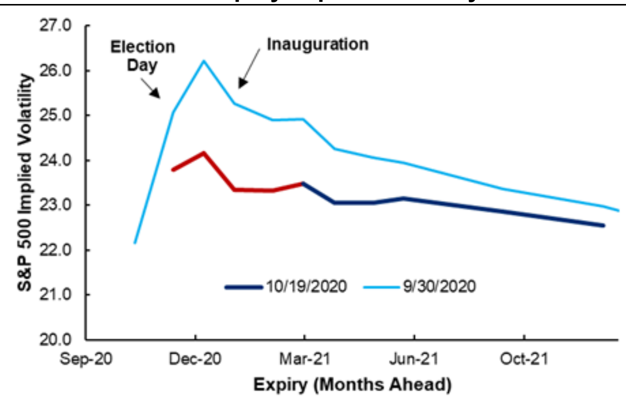
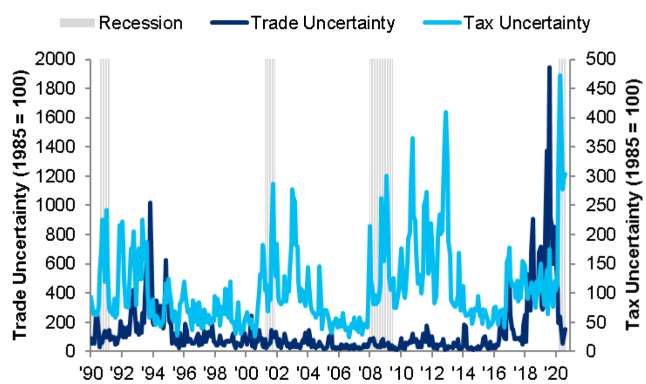


Figure 2: US Tax vs Trade Policy Uncertainty



Source: Bloomberg and Haver Analytics as of October 23, 2020. 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. All forecasts are expressions of opinion and are subject to change without notice and are not intended to be guarantees of future events.

Figure 3: US Dollar Index vs Net Long USD Index Futures

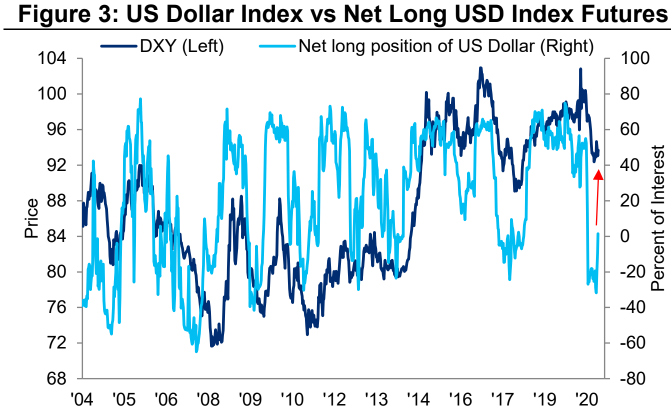
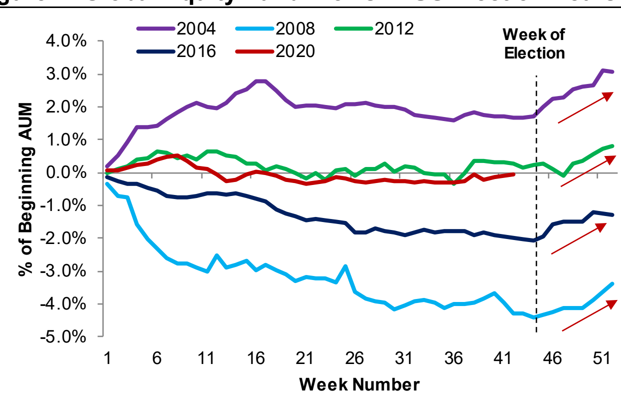


Figure 4: Global Equity Fund Flows in US Election Years



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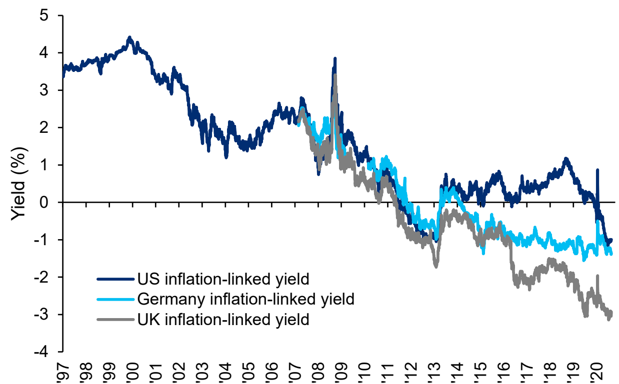
We Are No Longer Paid to Wait

Sitting “it out” in less volatile asset classes used to make the question of “when to invest” easier on investors. From 1981 through the Global Financial Crisis (GFC), investors could earn positive real returns in-low risk sovereign bond markets with lower returns, but about 1/4th the volatility of equities. After an interlude from 2013-2019 when US real yields rose while European yields stayed negative, inflation-adjusted yields are now negative in the US again **(see Figure 5)**.

The nature of the temporary COVID-19 shock might suggest a short period of economic weakness compared to the GFC when the Federal Reserve kept policy rates at zero for seven years. Yet, the Fed has changed its inflation targeting regime indicating a preference for higher inflation over the coming years. The Fed has said this means policy rates will again not budge from zero deep into the coming recovery.

Figure 5: Inflation Linked Government Bond Yields: US, UK, Germany



Source: FTSE Russell Indices as of October 23, 2020. 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.

Under ideal conditions, a sustained economic recovery can be initiated and maintained without central bank manipulation. In a broad and enduring expansion, investment and consumption will strengthen in harmony, pushing real interest rates higher with inflation remaining under control.

Yet, present circumstances are not ideal. While we are quite optimistic on a post-COVID future given this is the beginning of a New Economic Cycle, we believe there are several reasons, including the enormous increases in government debt, for the Fed to enter us into a period of “financial repression.”

The Very High Cost of Waiting

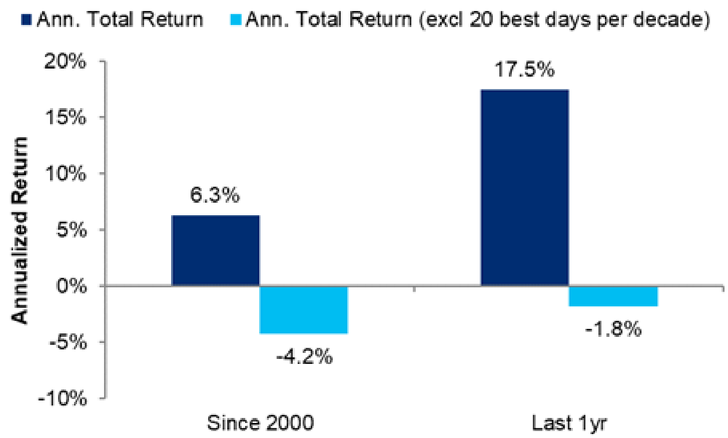
Investor portfolios rise and fall every day. Yet, when contemplating adding to portfolios, many investors are paralyzed into inaction due to their fear of the same market volatility that their portfolios already experience. Said another way, many investors assign greater anxiety to the fear that a decision to invest today will be poorly timed and suffer immediate losses. Therefore, investors appear to believe that if they enter markets “early” and suffer initial losses, they will lose more money than if they had “just waited”.

It turns out that waiting is a very expensive and poor behavior. Fear of an initial loss is most often a false fear. In fact, whether or not one chooses the lowest entry point to add new dollars to the market, being fully invested is what matters most.

Over the past two decades, missing the two single best “up” days in each year would reduce portfolio returns in an S&P 500 portfolio by 10.5% per annum. Since 2000, missing those two “best days” each year would turn a 6.3% annual gain into a -4.2% loss **(see Figure 6)**.

During 2020, when markets were in turmoil due to the largest exogenous shock in a century in Covid-19, the cost of “market timing” was even larger. Missing the two best days of 2020 would have reduced an investor’s return in US shares by 19.3%.

Figure 6: S&P 500 Total Return, Return Missing 20 Best Days Per Decade, Return Missing Best 2 Days of Past Year



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Remember, We Are Optimistic About 2021-22

In our September 27 CIO Bulletin, Politics and the Economy: A Lot to Worry About and A Lot To Look Forward To, we cited four major reasons why 2021 and 2022 are likely to be positive years for the global economy and global markets. We reiterate these views:

1. **Vaccines on the Horizon**

   There no fewer than 14 major vaccine trials and late stage, Phase 3 testing is underway. Pfizer, Moderna and J&J are proceeding quickly and carefully toward releasable vaccines. The earliest of these may be announced in November 2020. We believe that the arrival of effective vaccines will be an important turning point in market sentiment.

2. **Tailwind of Fiscal Spending**

   The US election has been the primary roadblock to enhanced fiscal support for the economy. A divided government would likely yield support for an increased safety net. A unified government would likely spend even more, but over a multi-year period. This might include a long-term infrastructure spending plan, perhaps with a focus on de-carbonization, if led by Democrats. In parallel, the Fed has committed to monetizing a great portion of any fiscal expansion while the economy is depressed, via high levels of net US Treasury purchases running at 5% of US GDP (excluding agency mortgage backed securities and corporate debt).

3. **Demand Leads Supply**

   Even with declines in US transfer payments to individuals since April, the economy has seen a demand resurgence with substantial substitution of social-close services activity for housing and consumer durables. With present demand far more solid than at the economy's April low, 1.5 million new unfilled job openings have been added in the past five months.

   As we pointed out in last week's CIO Bulletin, East vs. West: A Contrast in Covid Costs and Economic Outcomes, demand for consumer goods is outstripping supply. For example, US consumer purchases of housing and recreation merchandise have surged at the expense of "socially-close" services. The shift has arrested a drop in US imports from China due to the 2018-2019 trade war. China's industrial production and broader trade growth have accelerated, with its overall exports to all trading partners are up 9.9% from a year-ago in September. China's gains benefit the world economy. For example, China's imports have jumped to a 13.2% growth rate, outpacing its own exports.

4. **The Return of Wealthier Consumers**

   Raj Chetty, Harvard economist and MacArthur genius grant recipient, identified in April that the bottom quarter of wage earners, those making less than $27,000 a year, had lost almost 11 million jobs, more than three times the number lost by the top quarter (see Opportunity Insights Economic Tracker). His research also identified a surprising problem for the economy among high earners. High-income Americans make up a disproportionate share of overall spending, but have been spending less even after the economy and businesses reopened this Spring. This means, counterintuitively, that when a vaccine is available widely, there will be pent-up demand from wealthy consumers as they leave home and drive economic growth at rates higher than expected.

The Coming "Financial Repression"

Financial repression is the act of holding real interest rates artificially low. The 40 years after World War II was such a period. If one had invested in US 10-year Treasury bonds or held cash at the end of World War II, it would have taken 40 years and 38 years, respectively, to begin netting a positive inflation-adjusted return **(see Figures 7-8)**. In other words, it was a period when it did not pay to wait. Missing the long rebound in equities from depression and war, it was in fact very, very costly.

Figure 7: Real US Stock, Bond and Cash Returns

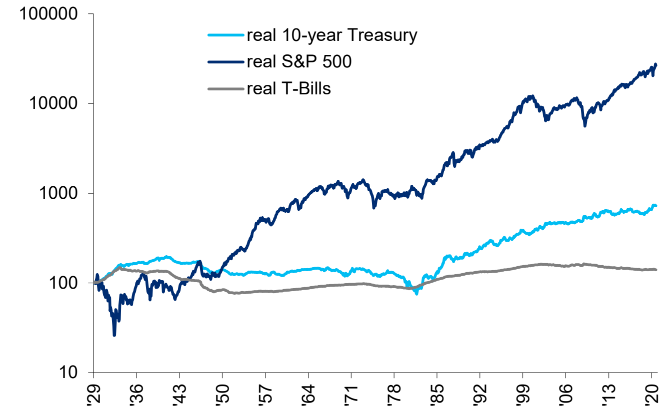
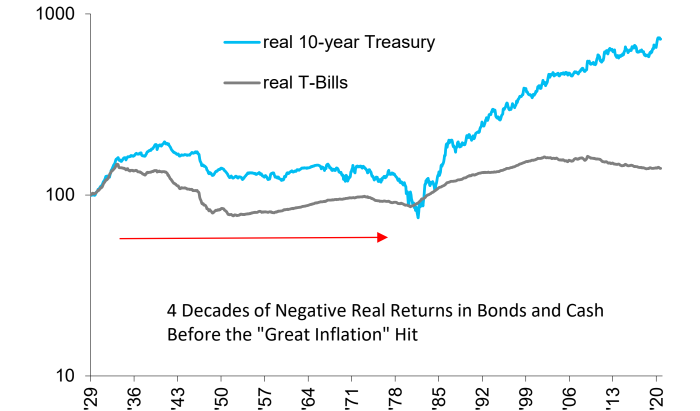


Figure 8: Real US Bond and Cash Returns



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There are three reasons why the Fed is going to hold interest rates lower for longer. The first is to pursue a higher inflation trend. The US central bank did not sustainably hit its inflation target in the 10 years following the GFC. Despite massive monetary easing over the past decade (please see our August Quadrant for full discussion) the Fed's preferred inflation measure rose at just a 1.6% average rate. Fed leaders believe that the labor market recovery could have been faster and less damaging for workers if the central bank had been even more accommodative.

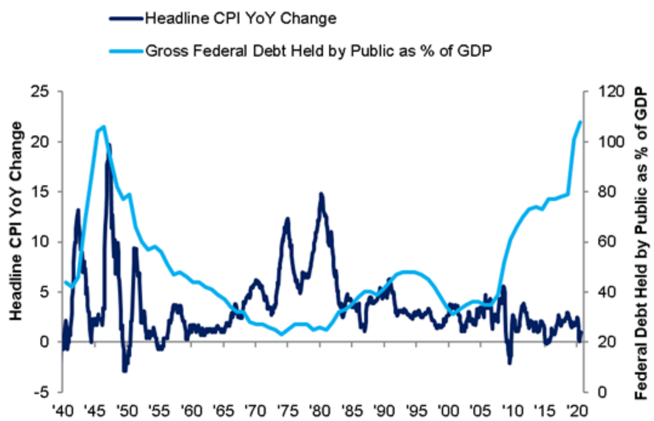
Second, the Fed wants to achieve a higher "inflation buffer" and have higher nominal interest rates over time. In the event that nominal interest rates were higher, the Fed could return to using interest rate targets as its primary monetary policy tool rather than undertaking large-scale asset purchases as they do today.

And there is a third reason that the Fed is likely to keep rates down, though central bankers do not come right out and say this casually. By keeping rates artificially low, debt burdens are less likely to impede an economic recovery. To have debt become less burdensome, real yields have to be low enough for inflation to gradually erase the value of debt over time.

At the end of World War II, US government debt as a share of GDP was similar to levels today **(see Figure 9)**. In response, the Fed controlled long-term interest rates explicitly from 1942 to 1951. With hindsight, monetary policy was still set too easy to avoid an accelerating inflation rate for many years. In the post WWII period, it took about 20 years for nominal interest rates and inflation to begin a sustained climb in a period some call the "Great Inflation."

We think this period has parallels to the years after WWII. The Fed is likely to keep shorter-term interest rates atypically low for years. Though we think the Fed will allow some level of market forces to drive intermediate and long-term interest rates higher to effectuate a steeper yield curve, it will still be more likely to intervene significantly if tightening financial conditions impede economic growth.

Figure 9: US Federal Debt as % of GDP and Inflation Y/Y%



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Implications of Financial Repression

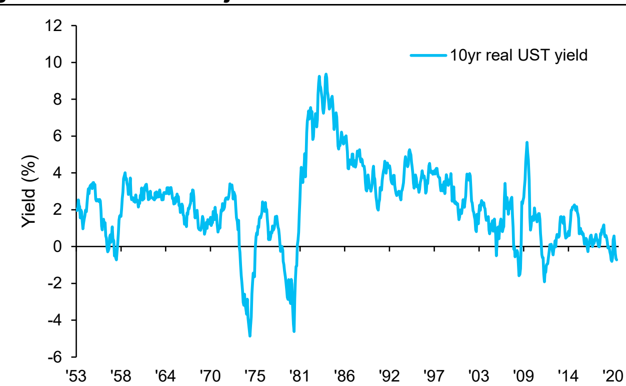
Less Safe Bond Portfolios

Fed Chairman Paul Volcker was appointed in 1979 and sought to stabilize US purchasing power. He wanted to undo the potentially destabilizing inflation acceleration that occurred over the decade before his Chairmanship. He "broke the back of inflation" with double-digit nominal interest rates.

With a devastating rise in inflation risk premia (high real interest rates), by 1981, bonds were priced for a secular bull run. It was the end of "Financial Repression." A sustained drop in real interest rates provided a tailwind for all asset returns for decades. But this period has formally ended as real yields are now negative **(see Figures 10-11)**.

Figure 10: Nominal UST Yields (%)

Figure 11: Inflation Adjusted UST Yields



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Investment grade bond markets used to provide both safety and income. Today, one can have only one or the other (please see our September 20 CIO Bulletin covering credit opportunities). To obtain "safety" now there is an inflation tax that means real returns are mostly negative. There is a further risk for investors as bond values will fall in the event that inflation accelerates.

Stress on Asset Allocation

The extreme drop in real and nominal rates also raises a difficult problem for asset allocation. As **Figure 12** illustrates, a combination of bonds and equities has historically generated attractive risk-adjusted returns. In periods when equities and credit markets weakened, safer fixed income would rally in price. This is diversification in action. But this could only occur during periods when real interest rates were falling. After such a 40-year run, that tailwind no longer exists.

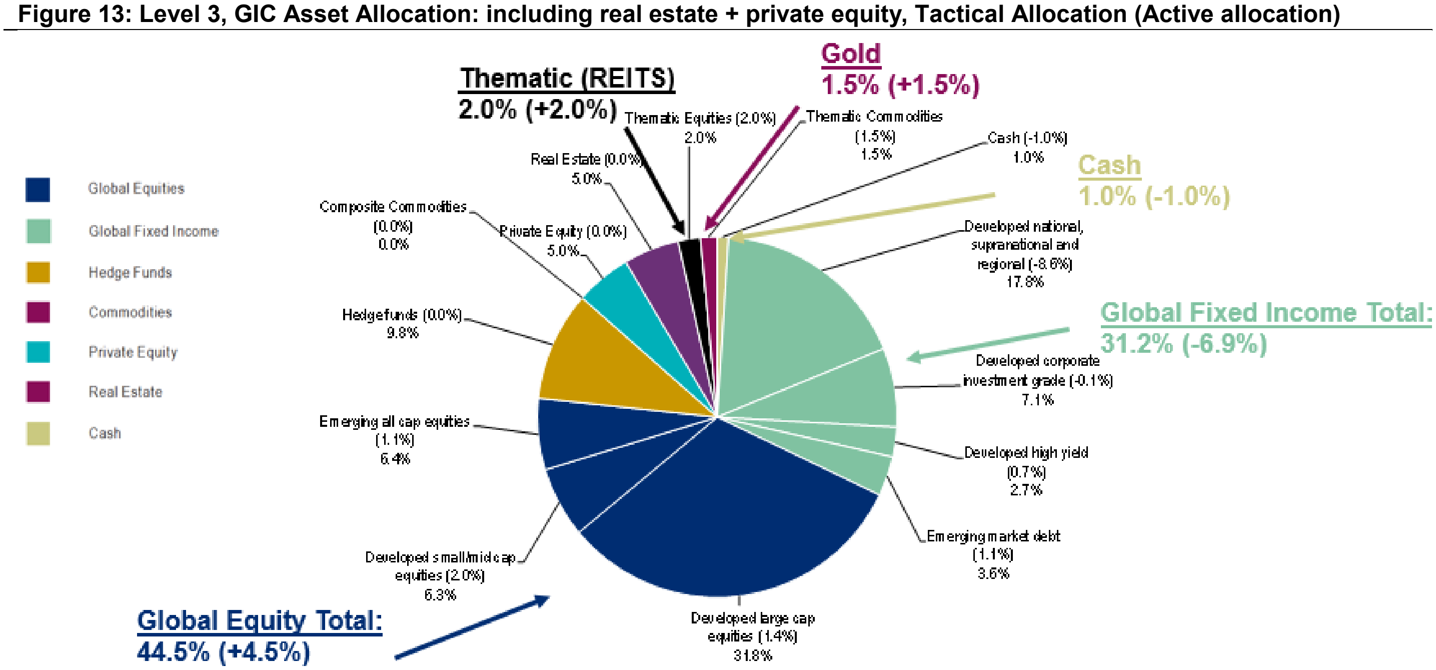
Figure 12: Returns by Decade for Individual Asset Classes and Asset Allocation Mix

1950s	1960s	1970s	1980s	1990s	2000s	2010s	Avg 10-Year Return	Risk-Adjusted Return
World ex-US Equities 20.8%	US Small Caps 15.5%	EM Govt USD Bond 14.4%	World ex-US Equities 22.8%	US Equities 18.2%	EM Govt USD Bond 12.9%	US Equities 13.6%	US Small Caps 12.0%	Asset Allocation 0.53
US Equities 19.3%	US Equities 7.8%	US Small Caps 11.5%	US Equities 17.5%	US Small Caps 11.6%	G7 Govt Bond 6.4%	US Small Caps 10.5%	US Equities 11.6%	US Equities 0.49
US Small Caps 16.9%	Asset Allocation 5.4%	World ex-US Equities 10.1%	Asset Allocation 17.4%	Asset Allocation 11.0%	US Investment Grade 6.4%	Asset Allocation 7.7%	World ex-US Equities 10.5%	EM Govt USD Bond 0.43
Asset Allocation 12.1%	World ex-US Equities 5.1%	Asset Allocation 8.0%	US Small Caps 15.8%	G7 Govt Bond 8.0%	Asset Allocation 3.4%	EM Govt USD Bond 6.3%	Asset Allocation 9.3%	US Small Caps 0.38
EM Govt USD Bond 5.3%	Cash 4.1%	Cash 6.5%	US Investment Grade 12.8%	US Investment Grade 8.0%	Cash 2.7%	World ex-US Equities 6.0%	EM Govt USD Bond 8.1%	World ex-US Equities 0.37
Cash 2.0%	EM Govt USD Bond 3.5%	US Investment Grade 6.1%	G7 Govt Bond 12.8%	EM Govt USD Bond 7.7%	US Small Caps 2.2%	US Investment Grade 4.3%	US Investment Grade 5.8%	US Investment Grade 0.18
G7 Govt Bond 0.4%	US Investment Grade 2.4%	G7 Govt Bond 6.1%	Cash 9.1%	World ex-US Equities 7.3%	World ex-US Equities 1.6%	G7 Govt Bond 3.7%	G7 Govt Bond 5.7%	G7 Govt Bond 0.17
US Investment Grade 0.4%	G7 Govt Bond 2.4%	US Equities 5.8%	EM Govt USD Bond 6.4%	Cash 5.0%	US Equities -0.9%	Cash 0.6%	Cash 4.3%	

Source: Citi Private Bank as of October 23, 2020. Indices are unmanaged. Note: Average returns and risk-adjusted returns are from 1950 to present using Global Financial Data long-term database. 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.

As we've described in Quadrant, the current circumstances require a major shift in asset allocation. Relative valuations in equities, small segments of credit and capital markets offer better return prospects than broad fixed income. Hence, in our current asset allocation model for medium risk portfolios, the GIC holds a global fixed income allocation of -7% and cash at -1%. We think that investors who are waiting for attractive real interest rates and depressed equity valuations may spend a great deal of their investment lives waiting for a "better time to invest" **(see Figure 13)**.

Figure 13: Level 3, GIC Asset Allocation: including real estate + private equity, Tactical Allocation (Active allocation)



Source: Citi Private Bank, as of GIC meeting October 21, 2020. Risk Level 3 is designed for investors with a blended objective who require a mix of assets and seek a balance between investments that offer income and those positioned for a potentially higher return on investment. Risk Level 3 may be appropriate for investors willing to subject their portfolio to additional risk for potential growth in addition to a level of income reflective of his/her stated risk tolerance. Gold may be susceptible to adverse economic, political or regulatory developments due to concentrating in a single theme. The price of gold is subject to substantial price fluctuations over short periods of time and may be affected by unpredicted international monetary and political policies.

Let History Be Your Guide

As **Figure 12** showed, asset allocation strategies have always been in the top half of returns in each of the last seven decades. While that may not sound as exciting as choosing the winner in every decade, the fact is that by setting proper asset allocation, you achieve the highest risk-adjusted returns over time.

We have pointed out that asset allocation will be "harder" in the coming decade due to the inability of traditionally-safer bonds to provide a real return and negative correlation to equities. Broadly, equities are now the higher income generating asset with a dividend yield twice the global bond aggregate yield.

Yet there are many ways to be more diversified than less. This will especially include regional diversification in equities markets. Emerging markets, led most sustainably by Asia, are at the forefront of this (again see our latest Quadrant for details). Another key strategy employs capital markets, which can extract yield from the price investors pay to hedge. With equity implied volatility roughly twice the historic average level and interest rates far below average, this is now a historically attractive yield-generating strategy. In private equity and private credit markets, there is now a pipeline of distressed assets that will potentially generate returns in the recovery from the COVID-19 crisis period.

Two Questions Investors Should Ask Themselves Now

As we think about 2021-22, there are two critical questions for investors to ask themselves now, before the election results are in and before a COVID vaccine is released.

The first is, **"How much cash should I hold for the next 5 to 10 years"?** For the past decade, wealthy families have held 20% or more in cash or very short duration bonds. They have done so assuming that they needed the cash to be safe or to fund future investment opportunities. Yet, most never re-entered the equity markets.

Once you have determined what cash you truly need to hold for a "rainy day or year", here is the second question: **"Where do I allocate capital and when?"**

We have already set forth that timing is a bad idea. Entry points are less important than being exposed to markets, especially at the beginning of a New Economic Cycle. Thus, it is extremely important for investors with an average risk profile and return goals to hold a substantial Core portfolio, allocated predominantly to equities with both growth and income prospects. Among the higher equity allocations should be certain categories of stock that can, in our view, serve as fixed income substitutes. Dividend equities, focused on companies that have strong earnings prospects and a history of maintaining dividend payouts, is one example. At a lower allocation, we favor mortgage REITs that offer much higher income returns as long as one is willing to endure higher volatility. And there are preferred stocks that can serve as a fixed income proxy during periods when rates are being held down artificially.

What if We Are Wrong?

What if we are wrong about financial repression and the Fed allows nominal bond yields to rise? This occurred in 2010, when 30-year US Treasury bond yields rose from 3.7% to 4.8% for a brief time. The mark-to-market loss on that bond's value was 27%, the greatest market value drop in the bond's history. Price sensitivity (duration) rises as coupon yields are lower.

We also think that intermediate duration bonds have risk for investors. As we have discussed, we do not believe the Federal Reserve will cap bond yields entirely. Though the US central bank will be unusually sensitive to periods like the "taper tantrum" of 2013, a steeper yield curve has been a routine feature of every economic recovery since the 1950s. US 10-year Treasury yields began 2020 at a 1.9% yield. If yields rebounded only partially to 1.5%, taking until the end of 2021 to do so, the total return on the note would be about -7% **(see Figure 14**).

We do not advise investors to overweight long duration bonds at this time, though this may add some risk to portfolios. During periods of severe economic distress, only Treasuries have a dependably negative return correlation to equities, with higher yielding investment grade corporates lagging **(see Figure 15**).

Figure 14: Estimated US Treasury Returns if 10-Year Yield Rises to 1.5%

US Treasury Return Scenario Analysis[1]				By maturity bucket:	
Maturities	Duration	Price return	Total return	Average return during 10% equity corrections	Average yield during these periods
1-3yrs	1.8	(1.6)	0.2	0.7	4.0
3-5yrs	3.9	(2.3)	(0.3)	1.0	4.5
5-7yrs	5.8	(3.5)	(1.6)	1.1	4.4
7-10yrs	7.8	(5.3)	(3.0)	1.2	4.5
10-20yrs	15.3	(10.2)	(7.5)	2.1	4.8
20yrs+	20.0	(13.9)	(11.3)	2.6	4.7

Note [1]: Returns are generated using a 14-month time horizon, with the 2yr going to 0.30%, the 10yr going to 1.50% and a gradual shift of the remainder of the curve

Source: Haver Analytics as of October 23, 2020. 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 aforementioned scenario analysis is based on a movement Treasury rate. All forecasts are expressions of opinion and are subject to change without notice and are not intended to be guarantees of future events. There is no assurance these forecasted scenarios will be met or achieved. Shown for illustrative purposes only.

Figure 15: US Treasury and Investment Grade Corporate Bond Returns in Years When the S&P 500 Has Declined

	S&P 500 Total Return Index	Index duration 7.2 year Bloomberg Barclays US Treasury Index	Index duration: 8.3 years Bloomberg Barclays US Corporate Index
1974	-26.5	7.1	-5.9
1977	-7.2	2.7	3.2
1981	-4.9	9.2	3
1990	-3.1	8.5	7.1
2000	-9.1	13.5	9.1
2001	-11.9	6.7	10.3
2002	-22.1	11.8	10.1
2008	-37	13.7	-4.9
2018	-4.4	0.9	-2.5
	Correlation to equities in decline years	**-0.51**	**0.45**

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Concluding Recommendations

Investors may still achieve substantial diversification by avoiding the concentrated positioning that passive portfolios have produced. These are now dominated by a handful of US large cap technology stocks (please see our July 12 Bulletin) and richly valued bonds. Long-duration US Treasuries which have returned 17% over the past 12-months on yields that have fallen to roughly 1%.

Against benchmark global asset allocations, we would tactically overweight:

- Global Small and Mid-Cap Shares including the US
- Emerging Markets equities including Asia and Latin America
- Global equity and mortgage REITS as asset prices collapsed on COVID-19, and forward looking yields average 6%
- US and EU high yield bonds, and selective opportunities within preferred stock
- Healthcare shares, for the moment foremost among our “Unstoppable Trends” (see our Mid-Year 2020 Outlook)
- Consistent dividend growth shares, globally
- Gold, but in reduced scale from our weighting at the crisis high point.

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