Citi Global Wealth Investments

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Being Ready for the Unexpected

Geopolitical Surprises Call for Diversification

Key Takeaways

- The clash between Israel and Iran highlights the less secure environment for global energy supplies. As we noted in last weekend's CIO Strategy Bulletin, for most investors, reacting to such news is too late to be effective. Portfolios should be prepared for a less-than-ideal world as embodied in our Wealth Outlook 2024 theme "Economic Security."
- Economic Security requires redundant energy supplies, defense deterrents, cyber-security defense and tech supply chain investment. These are all potentially robust long-term growth investments in equities markets, despite their usual volatility. We also suggest a "barbell" approach balancing income with growth opportunities. Intermediate US investment grade yields approaching 6% provide the former.
- **The "Fed Question" is back**. One pressing question for investors beyond unpredictable shocks is resurfacing from 2022-2023. Will the Federal Reserve be able to tame inflation without collapsing the economy? Markets now show "healthy concern." This may actually *improve* future returns. Among a variety of factors, without pricing in strong easing steps by the Fed, markets are much less vulnerable to disappointment.
- We would suggest caution in assuming markets now suddenly have the "right" forecast for US monetary policy. The Fed's own forecast for its policy rate 12-months out has missed the mark by 94 basis points on average over the last decade. A hawkish or dovish Fed view can flip on a dime in markets.

Portfolio Implications

Global supply shocks are very rare. The mere prospect for one still suggests we should invest with a range of possible positive and negative economic outcomes in mind, rather than build portfolios only seeking the highest absolute returns regardless of risk. At our Global Investment Committee (GIC), we held to a conservative 2% overweight in equities with a large position in safer intermediate US high grade bonds. We have also swerved tactically towards Healthcare within equities. In part, this is because of their "defensive" and "quality" characteristics. We continue to recommend risk hedges for suitable investors as equity hedging costs remain historically inexpensive.

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Don't Depend on Perfect Forecasts – They Don't Exist

In the hours after Iran launched missiles and drones at Israel on April 13, pundits were quickly jumping to conclusions. Some saw the moment as the tipping point for a far more destructive and wide regional conflict. Others were quick to dismiss it as a meaningless display of force. Collectively, traders acted on their hunches, guessing. This was all repeated in the immediate aftermath of Israel's retaliation on Friday.

As we noted in last weekend's CIO Strategy Bulletin, for most investors, reacting to such news is too late to be effective. Experience tells us it would more likely harm portfolios than help. Portfolios should be prepared for a less-than-ideal world as embodied in our Wealth Outlook 2024 theme "Economic Security."

Economic security requires redundant energy supplies, defense deterrents, cyber-security defense and increased tech supply chain investments. These are all robust long-term growth investments in equities markets, despite their usual volatility. Global supply shocks are very rare, but they still suggest we should invest with a range of possible positive and negative economic outcomes in mind rather than build portfolios that only seek the highest absolute return, regardless of risk.

This was what we had in mind as our Global Investment Committee (GIC) met this week and maintained a cautiously positive 2% overweight allocation in equities with a large helping of high-grade US bonds at a medium average duration. Our favored bond segments now yield close to 6% yield for a 4–5-year maturity (see **FIGURE 1**). We take this position to earn yields that will endure beyond the Fed's long-in-the-tooth tightening cycle. This is despite predictable warnings from US central bankers and markets fearing the short-term outlook for inflation (see **FIGURE 2**).

As we noted this week (please see our April Quadrant), if global equities showed a significant decline, we would likely add to our positions. However, potential increases must be balanced against the opportunities now presented by the higher yield environment.

FIGURE 1: Intermediate duration investment grade corporate yield

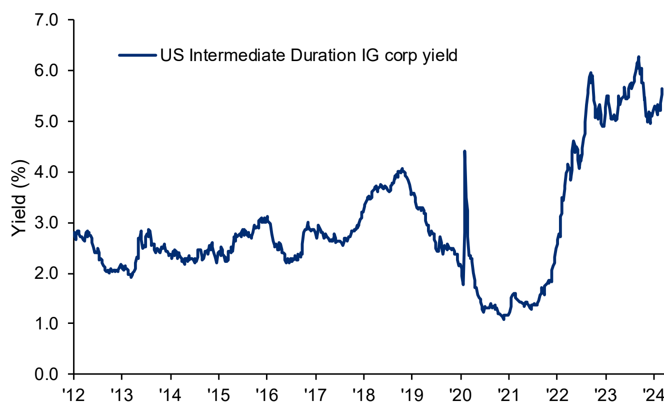
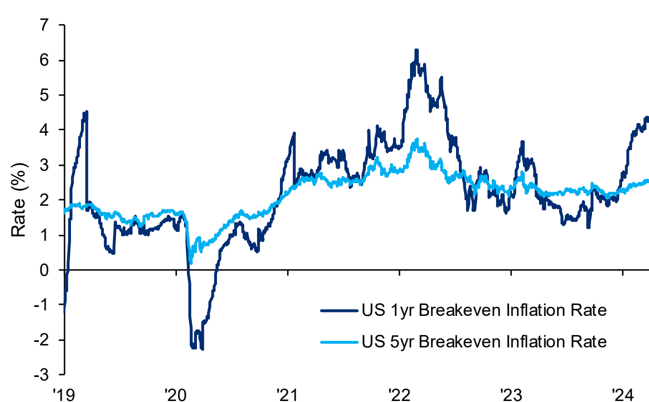


FIGURE 2: Inflation expectations in Treasury markets (TIPS) 1yr vs 5yr



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The "Fed Question" Is Back. Markets Now Show Healthy Skepticism

One pressing question for investors beyond unpredictable shocks, is resurfacing from 2022-2023. Will the Federal Reserve be able to tame inflation without collapsing the economy?

In the past two months, data have suggested further upward revisions to economic growth forecasts for the US and world. While the timing is out of sync with past precedent – particularly given the central bank rate hikes of 2022/2023 – many indicators hint at a new cyclical strengthening across the world.

At the same time, three months of upward surprises in US CPI data finally dented unusually strong confidence that both inflation and interest rates would fall while growth in corporate profits escalates (see **FIGURE 3 and 4**). This doubt is generating a faint "echo of 2022" in markets. This was a rare period of joint declines in equities and bonds together.

We continue to see a favorable rebalancing of global demand and supply amid exogenous risks. However, the path to realizing a happy mix of solid growth and weak inflation was priced-in unusually smoothly in markets during the past half year. For example, up until the past two weeks, US equities had not posted a single decline of 2% or more since October 2023.

US equities have been the strongest-returning major asset class for the past century and have posted positive returns in 74% of all years since WWII. Yet this includes an average inter-year decline of 12%. Nearly 40% of monthly returns for the S&P 500 have been negative. In short, higher return, higher risk assets usually don't enjoy such a smooth ride without interruption.

FIGURE 3: All components now show growth: global services and manufacturing purchasing managers index vs US manufacturing PMI

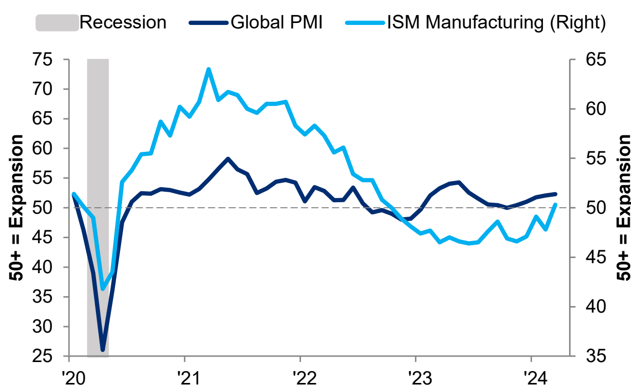
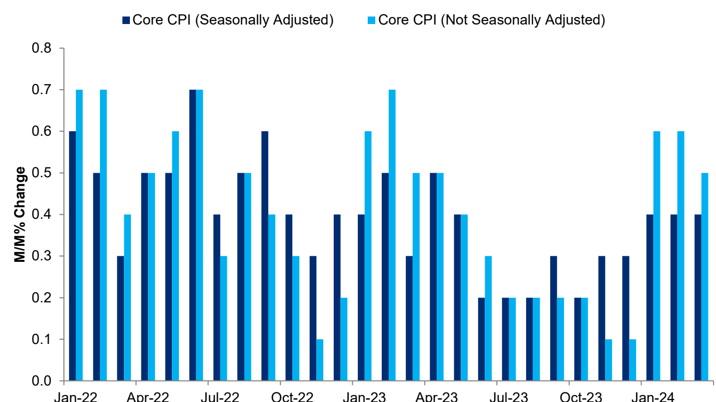


FIGURE 4: Upward Surprises in US core CPI for three years running in 1Q period



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Be Wary When Economists Give You Rate Cut Timing

The exact "mix" of market reactions to the inflation news (albeit delayed) is similar to an effective monetary policy tightening. This is even as the Fed has done nothing on the interest rate front other than "talk" since July of last year.

Markets price in future action from the central bank (tightening or easing). This market impact effectively "leads the way" for monetary policy actions (see **FIGURE 5**). While stronger growth indicators and rising corporate profits have somewhat shielded markets, "taking the easing" out of financial asset prices now is effectively a tightening.

We are struck by several things which bear noting:

1. **An obsession with the number of easing steps to come within a shrinking calendar 2024:** Clearly most investments have a duration of more than eight months. The economic *conditions* under which the Fed will ultimately ease is most critical. All else constant, having fewer Fed easing steps priced in leaves markets less vulnerable to the risk of disappointment.

2. **The subjectivity of the inflation data**: For just one example, nearly 20% of the rise in total US consumer prices in the past year can be accounted for by auto insurance quotes. These price changes are subject to lagged government approval and their volatility will be largely absent from the Fed's preferred inflation measure to be reported this week.
3. **With almost identical inflation data to the US and a firming economy, investors appear virtually certain the European Central Bank will ease in June**. The strength of the US expansion and stronger underlying trend growth pace may warrant a different US interest rate from the Eurozone. Yet the differences between the two regions from a monetary policy/inflation perspective are likely being overstated. *Confidence* that the two regions are parting ways on inflation seems particularly absurd in light of the data.
4. **The inconvenient truth is that even good forecasts are only rough impressions of what is to come:** Fed policymakers control the Fed funds rate. Yet even they could not accurately anticipate the peaks, troughs, and timing of their key policy rate during the last 12 years of public dissemination of policymaker forecasts (see **FIGURE 6**).

Over the past decade, the Fed's forecast for its policy rate has been off the mark looking ahead 12 months by an average of 0.94 percentage point. Their forecasts have been off as much as 3.7 percentage points for the year ahead. We noted this after markets have swung from an assumption of two rate cuts to seven and back already this year. We would suggest great caution in assuming markets now suddenly have the right forecast for US monetary policy.

FIGURE 5: Markets vacillate wildly in the number of expected Fed rate cuts

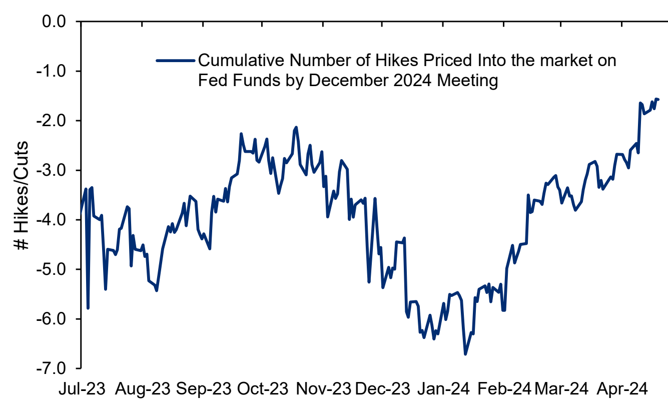
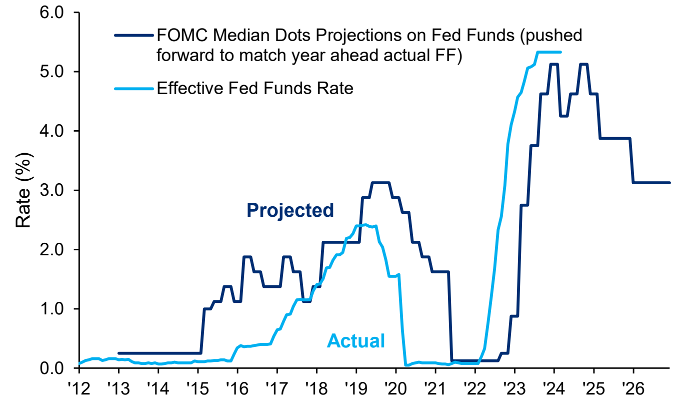


FIGURE 6: Even the Fed's forecasts are only rough impressions of what is to come



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"Zoom Out" and See Inflation Remains Poised to Decelerate

Rising inflation tends to erode the value of all financial assets. It is an indicator of imbalances that can precede economic weakening. It erodes fixed income returns, and as shown in last week's bulletin, large spikes in inflation frequently precede recessions.

Last year, the US CPI slowed from a peak of 9% last year to a recent low of 3%. Data in 2024 suggest this overstated the progress that was made in dropping headline US inflation (see **FIGURE 7**). Measures of non-housing services costs - including health insurance and auto insurance - dipped much faster than payments to insurers last year. With the lagged approval of regulators, administered insurance prices are catching up quickly to underlying costs. Following this, a major source of acceleration in the CPI should cease (see **FIGURE 8**).

In the meantime, a large component of the CPI is still overstating current inflation and is decelerating predictably (see **FIGURE 9**). Among other factors, this should re-establish slowing in core CPI measures over the balance of 2024. Shelter costs make up roughly 40% of the core measure.

Security threats to supply, such as the conflict in the Middle East, are also a key risk to short-run price stability. We consider supply fundamentals critical to maintaining what has been a global pattern of decelerating inflation following the pandemic surge.

Commodity prices are getting much attention of late, but let's recall that global crude oil quotes were $89 before the massive shift in global supply following the Russian invasion of Ukraine and are near that level even now after the shocking new events in the Middle East.

Russia's petroleum supplies have been redirected East. OPEC has cut output, allowing US and European producers to increase output at a relatively higher price. Keeping critical energy supplies flowing to the world's consumers is one component we had in mind for our thematic investment in "economic security" (see **FIGURE 10**).

FIGURE 7: sharp declines in the US CPI measure last year likely overstated disinflation progress

FIGURE 8: Input costs for insurers are slowing while insurance costs "catch up"

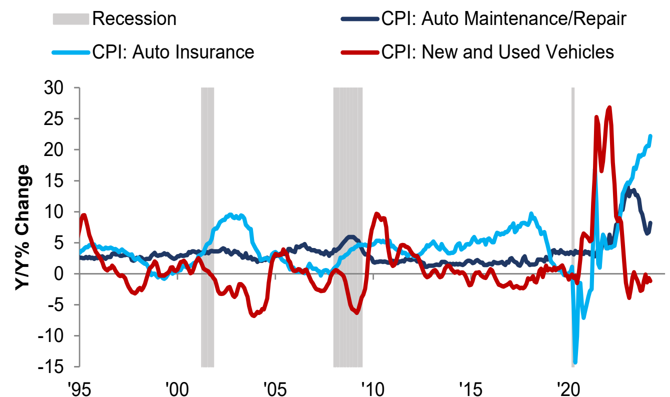

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FIGURE 9: The CPI for rent is still lagging new leases by a year, a large source of deceleration

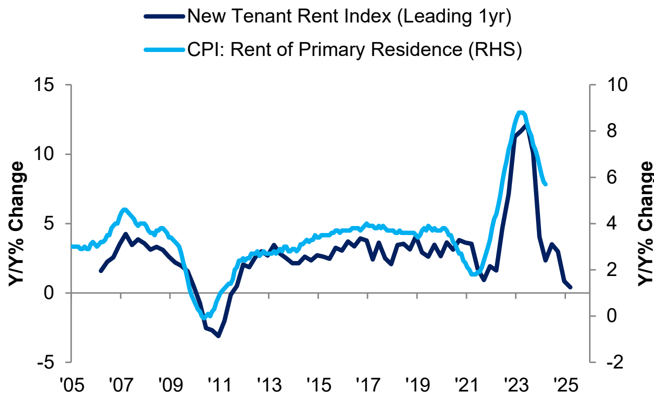
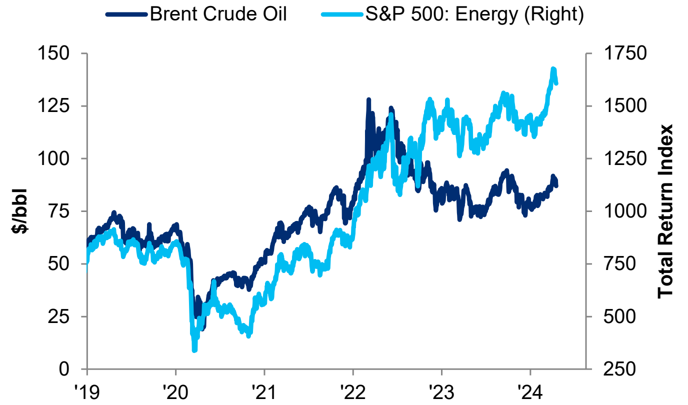


FIGURE 10: the global oil price steady in ranges, but US energy-related equities benefit from growth in output, security of supply



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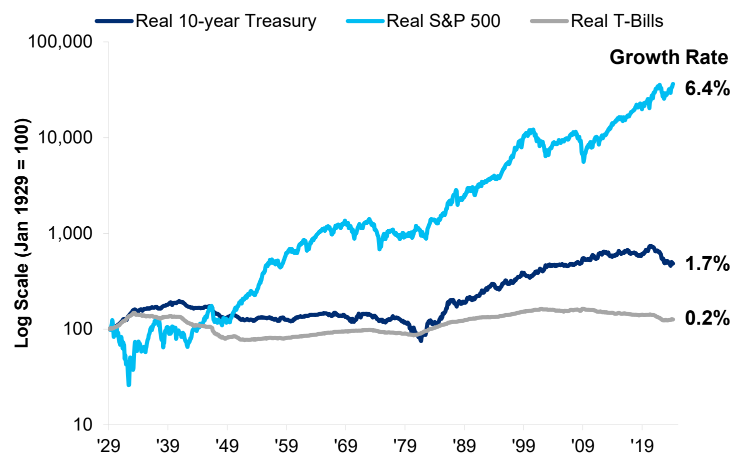
Conclusion – Awakened to Risk, Less Room for Disappointment

Let's remember what followed the Fed's tightening of 2022/2023 – disinflation, stronger growth and stronger returns for both equities and bonds. Many issues, from geopolitical risks to a possible "Fed error," might make the "echo" of 2022 less profoundly positive once it is past. But "healthy doubt" and normal volatility should not derail investors from exposure to economic development and technological progress – the drivers of equity returns (see **FIGURE 11**).

As we've described in recent months (please see our February and March Quadrants), we would expect to hold a larger allocation to global equities than our present net 2% over the course of an economic expansion. This is particularly true if global interest rates are "tamed." But present risks, firm equity markets and rising rates leave us holding to a more conservative asset allocation for now (please see April Quadrant).

FIGURE 11: Inflation-adjusted stocks vs bonds vs cash



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High quality (very strong)	Aa	AA	AA
Upper medium grade (Strong)	A	A	A
Medium grade	Baa	BBB	BBB
Not Investment Grade			
Lower medium grade (somewhat speculative)	Ba	BB	BB
Low grade (speculative)	B	B	B
Poor quality (may default)	Caa	CCC	CCC
Most speculative	Ca	CC	CC
No interest being paid or bankruptcy petition filed	C	D	C
In default	C	D	D

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Additionally, the underlying collateral supporting non-Agency MBS may default on principal and interest payments. In certain cases, this could cause the income stream of the security to decline and result in loss of principal. Further, an insufficient level of credit support may result in a downgrade of a mortgage bond's credit rating and lead to a higher probability of principal loss and increased price volatility. Investments in subordinated MBS involve greater credit risk of default than the senior classes of the same issue. Default risk may be pronounced in cases where the MBS security is secured by, or evidencing an interest in, a relatively small or less diverse pool of underlying mortgage loans.

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. Price volatility may also occur from other factors including, but not limited to, prepayments, future prepayment expectations, credit concerns, underlying collateral performance and technical changes in the market.

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- loss of all or a substantial portion of the investment due to leveraging, short-selling, or other speculative practices;
- lack of liquidity in that there may be no secondary market for the fund and none is expected to develop;
- volatility of returns;
- restrictions on transferring interests in the Fund;
- potential lack of diversification and resulting higher risk due to concentration of trading authority when a single advisor is utilized;
- absence of information regarding valuations and pricing;
- complex tax structures and delays in tax reporting;
- less regulation and higher fees than mutual funds; and
- manager risk.

Individual funds will have specific risks related to their investment programs that will vary from fund to fund.

Asset allocation does not assure a profit or protect against a loss in declining financial markets.

The indexes 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 results.

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Factors affecting commodities generally, index components composed of futures contracts on nickel or copper, which are industrial metals, may be subject to a number of additional factors specific to industrial metals that might cause price volatility. These include changes in the level of industrial activity using industrial metals (including the availability of substitutes such as manmade or synthetic substitutes); disruptions in the supply chain, from mining to storage to smelting or refining; adjustments to inventory; variations in production costs, including storage, labor and energy costs; costs associated with regulatory compliance, including environmental regulations; and changes in industrial, government and consumer demand, both in individual consuming nations and internationally. Index components concentrated in futures contracts on agricultural products, including grains, may be subject to a number of additional factors specific to agricultural products that might cause price volatility. These include weather conditions, including floods, drought and freezing conditions; changes in government policies; planting decisions; and changes in demand for agricultural products, both with end users and as inputs into various industries.

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