Citi Global Wealth
Investments

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CIO Strategy Bulletin

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Fading Momentum, Potential New Opportunities

- Investors have been inundated with dire warnings of endless inflation and a return to 1970s-style labor unrest. (US equity and bond total returns were both off about 3% in the 3rd quarter). This reminds us of the overwhelming (but incorrect) consensus view that a Fed-driven recession was inevitable, leading to 2022 and its rare, combined equity and bond market losses. We remind investors that after 1931 and 1969, when both asset classes fell together, strong returns were earned by patient investors just two years later.
- A combination of strong US Treasury issuance, Fed redemptions and stronger economic forecasts has pushed US yields above their recent range. Inflation-Indexed bond yields (real return bonds) have surged to their highest rate levels since October 2008.
- As rates move higher, it has increased Treasury market volatility and reduced liquidity. Higher rates and a surging oil price have broken the upward momentum of equity markets. Equities had benefited from a difficult-to-maintain combination of rising EPS growth expectations, falling inflation and expected rate cuts priced into US Treasuries.
- Washington's dysfunction, labor union rancor and the reinstatement of student loans payments are providing an added degree of consumer anxiety.
- Equity corrections begin when short-term traders try and protect profits and the "momentum shifts" downwards. For bonds, we expect the gradual slowing in US employment to eventually limit the upward pressure on yields. When a new equilibrium level of rates and petroleum costs is clearer, the cheaper valuations of both equities and may offer stronger returns in 2024.
- As we noted last week, distinct value opportunities are becoming evident in segments of US growth equities.
- We believe intermediate securities held to maturity will deliver solid returns with greater assurance. We would suggest investors consider adding intermediate.

When Good Economic News is Bad News for Markets: The Fed

The Fed doubled its forecast for US GDP growth in 2023 and raised its growth forecast for 2024 to 1.5% from 1.1%. It also reaffirmed its forecast for lower inflation over time. The impact of projected higher growth was a smaller estimated rise in unemployment, leading FOMC members to forecast smaller rate cuts over the coming two years.

To summarize: "Higher for longer", a headline markets did not like. This accelerated equity market declines with the S&P 500 down about 7% since July after rising 19.5% in the first half 2023.

The Fed is not the only reason for equity market jitters.

Headwinds Building

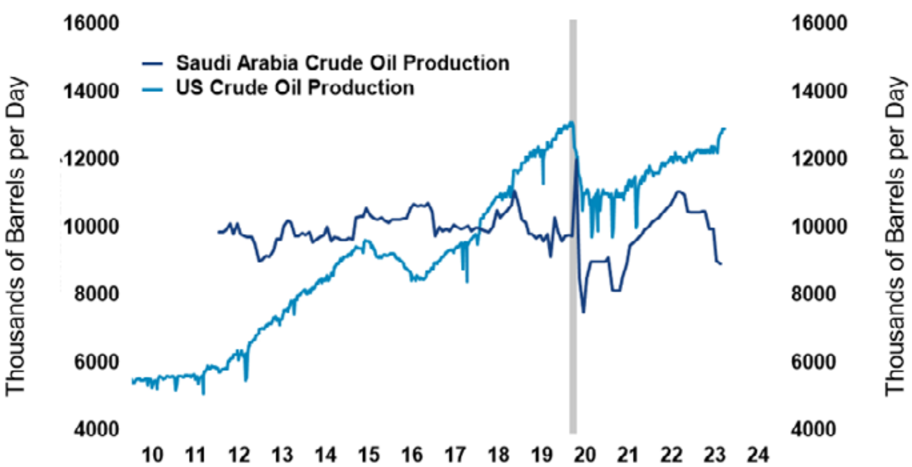
Oil prices have risen by 10% in September alone. The "easy disinflation" which drove the CPI from a 9% year/year pace to 3% at mid-year is being challenged by OPEC. Even as US oil production is rising toward record highs, OPEC production cuts have been larger (**Figure 1**). This has come at a time when the US has already drawn down its Strategic Petroleum Reserve by 40%.

The shift higher in energy costs at a time of rising rates means energy expenditures will displace other consumer purchases. The jump in fuel prices arrested an earlier rebound in consumer sentiment that was based on falling inflation.

Comparative market dynamics also impact equities. Contradictory data has generated a wider range of possible outcomes for interest rates. When investors in other asset classes cannot determine where yields will eventually settle, valuations become harder to determine (**Figure 2**). In short, "*yield uncertainty"* has contributed to an equity market slide. (**Figure 3**)

US student loan payments jumped very quickly from near zero to $10 billion over the past two weeks. Add in the pending government shutdown due to government dysfunction and a widening UAW strike at US automakers, and you get further fuel for equity market jitters. The combined impact of these events may potentially drag down retail spending by as much as 1% in the near-term.

Figure 1: US and Saudi Arabia Crude Oil Production (thousands of barrels per day)



Source: Haver Analytics as of September 28, 2023. Gray areas are recession.

Figure 2: US Treasury vs S&P 500 Implied Volatility

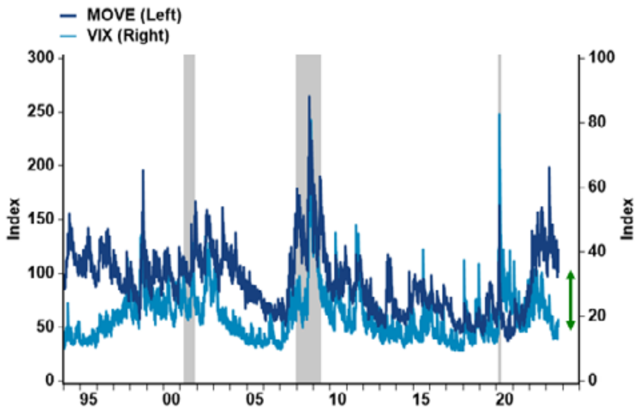
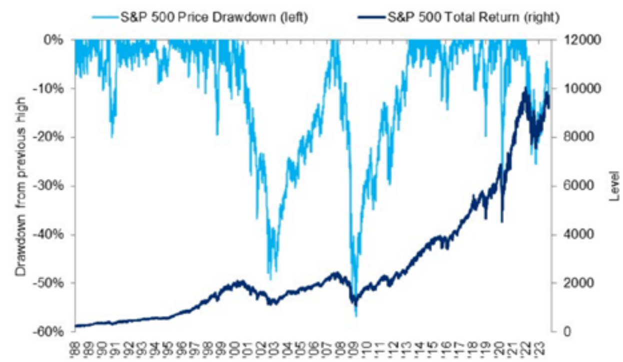


Figure 3: S&P 500 Drawdown



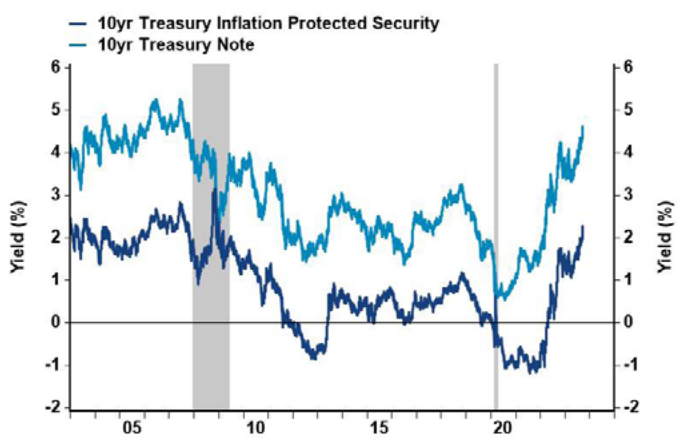
Source: Haver Analytics as of September 28, 2023. Gray areas are recessions. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Index returns do not include any expenses, fees or sales charges, which would lower performance. Past performance is no guarantee of future results. Real results may vary.

Rates Lurch Higher, Growth is Waning

Citi Global Wealth's forecast of GDP growth was modified upwards a month ago and is very similar to the Fed's views (see August Quadrant). And we weren't alone in our higher growth view. A "GDP Now" snapshot from the Atlanta Fed shows a 5% estimate for annualized US real GDP this quarter, though this looks like an exaggeration.

US 10-year Treasury yields have risen more than 30 basis points since the Sep 20 FOMC meeting, but just 5 basis points for 2-year notes, steepening the yield curve. Most importantly, the recent rise in rates was a "break out" for yields above post-COVID expansion highs (**Figure 4**).

Figure 4: 10-year US Nominal Treasury yield and 10-year Inflation Indexed US Treasury



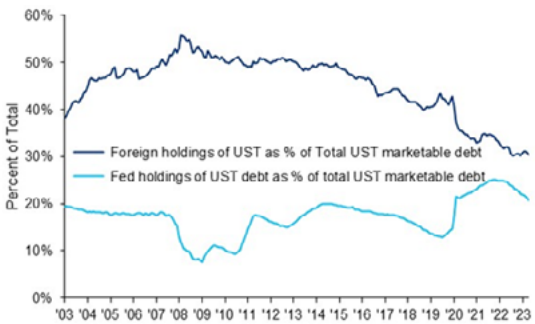
Source: Haver Analytics as of September 28, 2023. Gray areas are recessions. Past performance is no guarantee of future results. Real results may vary.

So, why would rates jump dramatically with the Fed announcement?

One reason is that *price-insensitive* Treasury buyers of the past 15 years are moving to the sidelines. The Fed has reduced US Treasury and mortgage-backed securities holdings by more than $1 trillion since starting quantitative tightening (QT) in mid-2022. Foreign central bank buyers are not keeping pace with US issuance (**Figure 5**). Banks are another waning buyer. Regulatory and capital standard uncertainty are keeping banks sidelined.

Together, these changes require that private lenders and private capital must finance new US Treasuries issuance and the purchase of Fed balance sheet assets, driving *credit* availability down and interest rates up.

Figure 5: Fed and Foreign Holdings of US Treasuries as % of Total Marketable Debt



Source: Haver Analytics and Bloomberg as of September 27, 2023. Past performance is no guarantee of future results. Real results may vary.

Higher for Longer Will Slow Growth

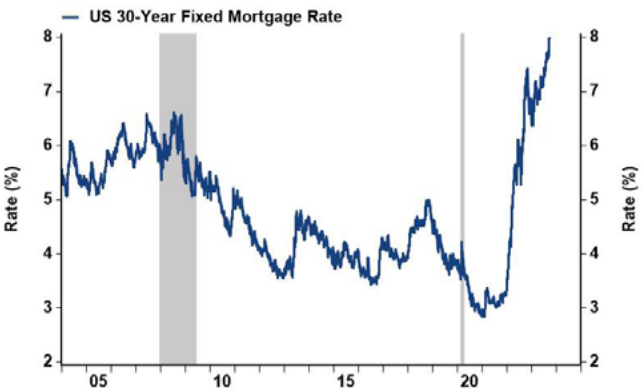
Renewed tightening of financial conditions reinforces the case for a slowing economy in 2024 (**Figure 6**). There is a lot of data that suggest no further upward US growth revisions. A bounce in 3Q GDP is not indicative of a new trend. In fact, revised data for the second quarter showed a slowing consumer demand picture.

Researchers from the Federal Reserve Bank of San Francisco have attempted to quantify the impact of Fed credit rationing. While subject to estimation uncertainty, their research shows that the rapid swing from Quantitative Easing to Quantitative Tightening will be on the order of 750 basis points rather than a 525 basis point policy rate increase.

An example of where growth will slow further is multi-family residential construction. The “long cycle” component of US construction activity – multi-family developments take three years or longer to complete – has yet to show the major impact of the rapid rise in financing costs of the past two years.

Therefore, we believe the maximum impact of higher rates and QT will slow the labor market and inflation in 2024 sufficiently to allow the Fed to begin backing away from its restrictive policies.

Figure 6: US 30-year Fixed Mortgage Rate



Source: Haver Analytics as of September 28, 2023. Gray areas are recessions.

When Will Rates Stop Rising?

The Fed's policy rate has risen above the unemployment rate. Data since 1985 suggests that a higher unemployment rate has followed this crossing point over the past four decades[1]. And historically, the Fed has been acutely attuned to the labor market - easing and tightening in near lock step - for much longer (**Figure 7-8**).

Market participants are questioning why the Fed would predict *any* future rate cuts when it does not forecast a recession. What is clearly embedded in the Fed's most recent estimates is that FOMC members *believe* that modest rate cuts will be necessary to limit the weakening in the labor market.

The question on everyone's mind is "When?". While we do not know a date and time, we do know that just as rates surged higher this past week, they are likely to decline faster once labor markets and wages cool. The yield curve is likely to initially flatten for a short period on negative labor market news. Ultimately, however, the yield curve will steepen as the Fed brings down short-term interest rates. Two-year note yields, for example, will price in more cuts through 2025 than the Fed initially delivers.

Figure 7: Fed funds rate and Unemployment Rate (%) Difference and market expected Fed funds rate

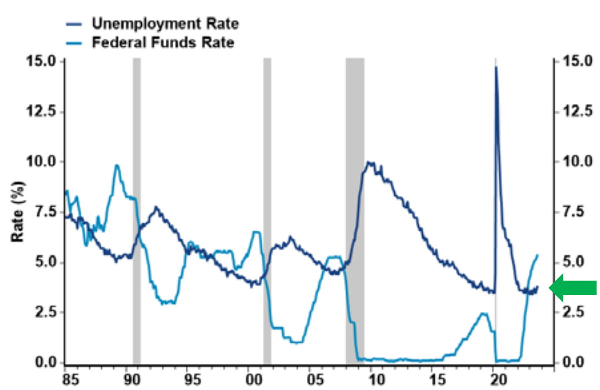
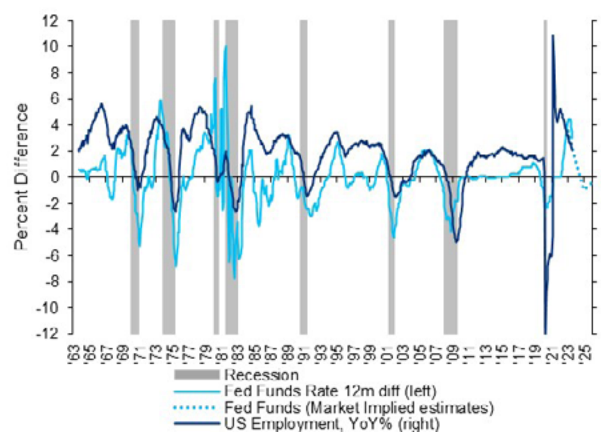


Figure 8: US Employment Y/Y% and Fed Funds Rate Y/Y



Source: Bloomberg as of September 27, 2023. Gray areas are recessions. Past performance is no guarantee of future results. Real results may vary.

[1] Source: Bloomberg as of September 28, 2023. The four-decade period start date is indicated as 1985 and end date is 2023.

Investment Opportunities Ahead

Recent University of Michigan data reported declines in both 1-year and 5-year consumer expectations for inflation over the last month[2]. Real bond yields, as reflected Treasury inflation protected securities, have surged. If the US yield curve is an indicator that Treasury market investors anticipate recession, surely real return bonds now do not. US yield premiums to non-US markets have also risen towards the higher end of historical records.

For Your Consideration…

Major market moves create potential opportunities.

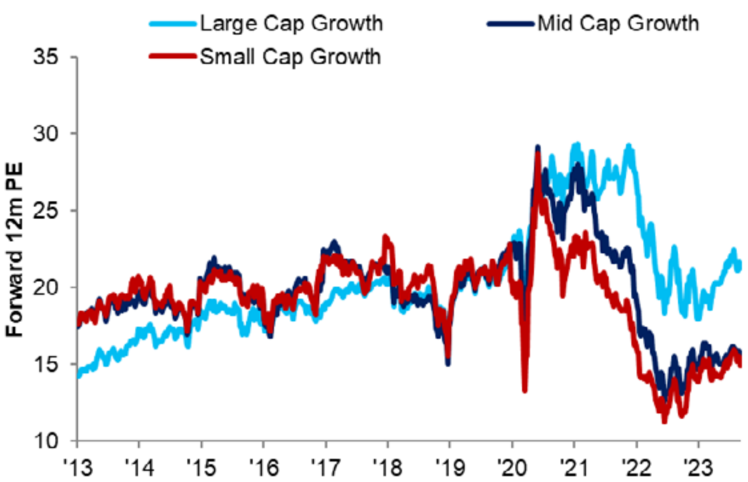
- We believe intermediate securities held to maturity will deliver solid returns with greater assurance. We would suggest investors consider adding intermediate.
- While the issuers have more credit risk than IG-rated issuers, high yield (HY) bonds with a BB-rating for suitable investors might also be worth considering for higher potential income.
- USD-denominated emerging market debt can be an interesting way to take advantage of higher longer-term yields while also earning reasonable compensation for the credit risk of emerging market issuers.
- As the equity market is forced to absorb the bond and commodity pressures, some attractively valued growth investments are becoming even more reasonably priced and increasingly worthy of adding to portfolios. As we noted last week, profitable small and mid-cap US growth equities are priced at a nearly 30% discount to large caps (**Figure 9**). In the latest selloff so far, profitable S&P 400 and 600 firms with a 5-year EPS growth rate of 11% have fallen to an attractive 14.6X expected earnings.

As we noted on September 10, we believe current bond yields are closer to long-term sustainable levels today than they were in 2020 when global yields reached their lowest levels in history. At present levels, holding 5-year average bond portfolios to maturity should yield returns **far in excess** of the shortest-term yields over the same period. Despite the Fed's latest optimism on the economy, it still expects its "long-term normal" policy rate to fall to 2.5% on average.

Most recently, investors have been stunned with dire warnings of endless inflation and a return to 1970s-style labor unrest. This reminds us of the overwhelming consensus view that a Fed-driven recession was inevitable, leading to 2022 and its rare, combined equity and bond market losses.

On the flip side, we remind investors that after 1931 and 1969, when both asset classes fell together, strong returns were earned by patient investors just two years later.

Figure 9: US Large-Cap, Mid-Cap and Small Cap Price/Forward Earnings



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[2] University of Michigan: Inflation Expectation as of August 2023

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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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