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# Geopolitical Shocks, Inflation, and the Patient Portfolio

## Middle East News Update, Likely Market Reaction

- Iran's direct attacks on Israel via missiles and drones is a material escalation of an intensifying regional conflict. For markets, the event was well-anticipated and the initial reports of casualties from the bombardment were few. This may limit the response in financial markets, with crude oil still likely to have a large initial move.
- This was the first direct state-to-state attack between Israel and Iran after the events of October 7, 2023. This changes the parameters of the regional conflict. In such events, the initial reaction is very often an "overshoot." The oil price - a key metric for global impact – typically moves as a multiple of any feared production loss, followed by a drop.
- Tragic military conflicts and global growth have co-existed through most periods. While markets will recalibrate future risks over the coming days, rarely do such events change the direction of the world economy.
- As we discussed in Wealth Outlook for 2024, security risks to world oil supplies represent a danger, and energy-security investments deserve a larger place in portfolios than otherwise. At the same time, the majority of the world's petroleum supplies no longer rests in the hands of one cartel or country and the possibility of an inflationary recession as seen during the OPEC embargo of 1973/1974 is notably less.

## Market Update: US Inflation Scare

- The US Consumer Price Index (CPI) rose for a third consecutive month in March exceeding expectations and stoking inflation fears. The Fed says it needs confidence that its preferred measure of inflation is lastingly on its way back to a 2% trend pace. This means a rate cut before July is unlikely.
- An "inflation scare" is creating opportunities in High Grade intermediate bonds which we believe offer good value to investors in this current environment. Equity risk hedges – for suitable investors – also appear attractive and historically cheap.
- We believe investing in economic development – generating capital appreciation and income – is still the paramount opportunity for wealth preservation and growth. The precise number of rate cuts in the remaining 8 months of 2024 is trivial by comparison.

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NOT GOVERNMENT INSURED · NO BANK GUARANTEE · MAY LOSE VALUE**

# State to State Conflict in the Middle East

News that Iran has directly fired missiles and drones at Israel this weekend marks a significant escalation of security risks in the region. The event was well-anticipated and viewed as a response to Israel's strike on Iranian military leadership in Damascus. The events since October 7th-to-now are all escalations of regional proxy wars between Iran and the West, beyond the war in Gaza between Israel and Hamas. As such, we see increasing tail risks as the direct involvement of both the US and the United Kingdom underscore this weekend.

For global markets, the largest impact of the conflict was always likely to be felt in the price of oil. We would still expect financial markets to immediately price in a higher possibility of enlargement of the conflict through higher risk premiums. Given the rapid timeframe for production and consumption of oil and related products, the oil price tends to move very sharply relative to actual supply impacts. As was the case following Russia's invasion of Ukraine in 2022 and Hamas's attack of Israel in late 2023, oil markets feared a larger supply disruption initially. These fears then faded as greater clarity around supply followed (see **FIGURE 1**). While we cannot know the future course of the Iran/Israel conflict, we believe there is a high probability that this pattern will unfold again.

In our Wealth Outlook for 2024, we note that geopolitical risk to oil supplies suggests a greater need for investment in energy security – redundant energy supplies – even as energy demand is being satisfied by a new mix of energy sources. Russia and Iran depend on petroleum exports for revenue and unlike the 1970s, the US has risen to be the world's largest petroleum producer (see **FIGURE 2**). Therefore, a repeat of the energy-rationing inflationary-recession of 1974 is unlikely.

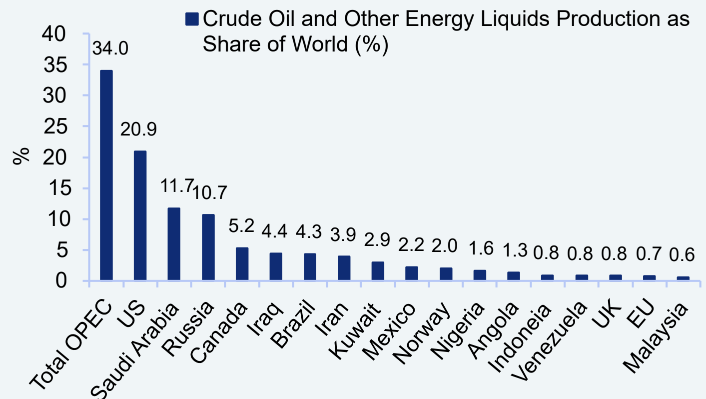
The events in the Middle East since October have resulted in a tragic loss of life. These events have set back the timeframe for potentially greater peace and economic development in some parts of the region. However, the need for peace accords has risen and many countries who sought them prior to October 7th are likely to reengage when the war in Gaza ends.

With this said, we advise global investors to consider regional security events and global economic activity independently. Multiple conflict zones and economic growth have generally co-existed for much of history. As Wealth Outlook showed, less than 10% of significant geopolitical shocks and conflicts have changed the direction of the world economy. Most have had very short-lasting impact on financial markets (see **APPENDIX 1**).

**FIGURE 1**: Crude Oil Price ($/Barrel) and Key Recent Events

Source: Haver Analytics through April 12, 2024

**FIGURE 2**: Largest Oil Producers as % of World Output




Source: Haver Analytics through April 12, 2024

# A US Inflation Scare

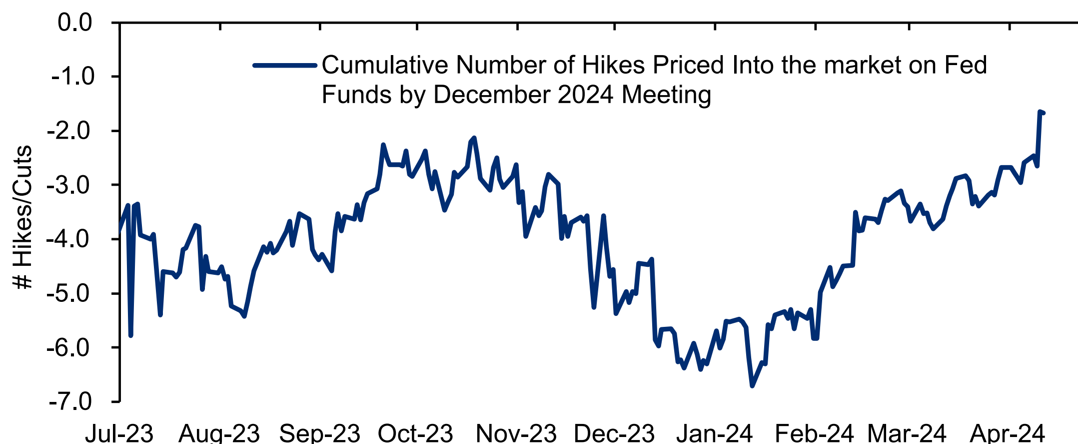
Since the release of our Wealth Outlook for 2024 in early December 2023, markets have enjoyed nearly the perfect combination of slowing inflation, rising corporate profits and falling interest rates. Sadly, such conditions never last indefinitely. A full quarter of rebounding inflation data has created greater uncertainty and caused interest rates to rise. Last week's setback in the US bond and stock markets has nonetheless been limited, but the "Goldilocks consensus" period has passed.

With last week's data, the US CPI posted three monthly upside surprises relative to consensus expectations. Last year, the consensus formed around a rapid decline in inflation. In the final quarter of 2023, inflation annualized at just 1.9%. Had this been sustained, the Fed would have had no reason to maintain its "considerably restrictive" policies.

We still expect the headline CPI to rise just 2.5% in the year through December 2024. We have not lost confidence that global demand and supply growth are gradually moving into balance. And we still believe that equity markets will benefit from higher than expected US corporate profits likely to be reported over the coming month (see last week's CIO Bulletin). Nonetheless, financial markets are prone to excesses of optimism and pessimism. Shorter-term US Treasury yields have moved broadly, with rate cut expectations moving from 2 cuts in 2023, to 7 early in 2024, and back to 2 cuts now (see **FIGURE 3**).

Rate hiking and cutting cycles typically last longer than a calendar year. The Fed believes it will be moderating its restrictive monetary policy through at least 2026 (see the CIO Bulletin of March 31,2024). But history suggests growth and inflation news at mid-year can get extrapolated too far. For example, expectations that inflation is back will likely dominate markets for a time.

**FIGURE 3**: "Roller Coaster" of Fed Easing Expectations

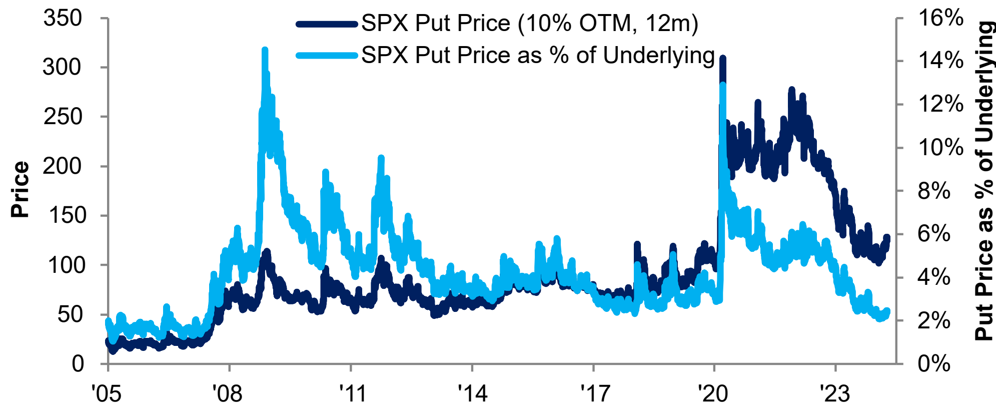



Source: Bloomberg as of April 11, 2024.

## Concerned About Inflation? Hedge, Don't Liquidate

We continue to believe current market pricing for hedging strategies appears favorable (see **FIGURE 4**). This means that call premiums are high and that put costs are lower than recent historic average. This allows investors to consider exchanging upside for downside protection. Such a strategy – for suitable investors – should help them stay the course during the "bumps" in what we expect to be an enduring expansion.

**FIGURE 4**: Still Historically Low Cost to Hedge Equity Risk




Source: Bloomberg as of April 11, 2024. 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.

## This String of Hotter Inflation Data May Linger

While large sources of upward pressure on the CPI are waning, complex factors are causing spikes in small components of the CPI. Shortages of high-tech parts for autos are causing repair costs to jump, leading to higher insurance costs. This is likely a remnant of the pandemic era supply chain problems and is not likely to persist. And there is no "wage/price" spiral underway (**FIGURE 5**).

Last week's "bad news" helps to "immunize" markets from further inflation surprises. After three strong inflation reports, economists may raise their expectations for the April CPI. Nonetheless, policymakers led by Chair Powell are unlikely to do anything. The Fed has not cut policy rates yet in spite of massive swings in market interest rates. However, we expect Fed rhetoric to shift in a more hawkish direction. The data over the near-term aren't giving them evidence to sound an "all clear" signal and move away from restrictive monetary policy.

Our own preferred measure of core CPI inflation has bounced from a 2.0% to a 2.4% pace over the last five months (**FIGURE 6**). Therefore, we expected the Fed to maintain a restrictive stance until the deceleration of inflation resumes. In our own view, this could come sooner than markets now expect, but not likely in the next two months. During this time, markets are more vulnerable to rate fears and the latest geopolitical escalation.

**FIGURE 5:** US Employment Cost Index: Private Wages and Salaries Year over Year %

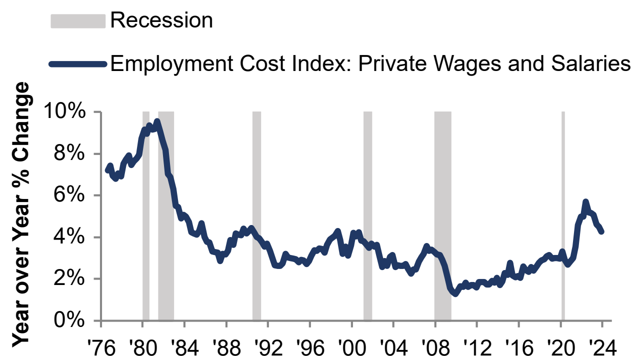



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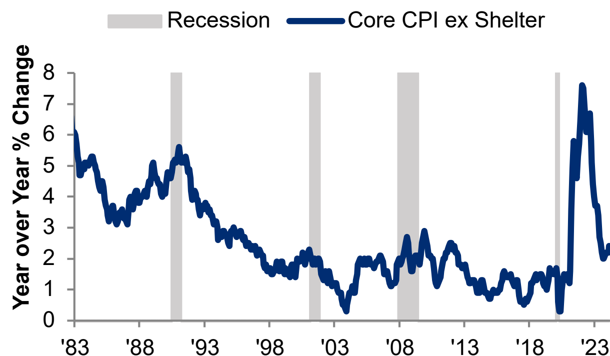
**FIGURE 6**: US CPI Ex-Food, Energy and Shelter Year over Year %

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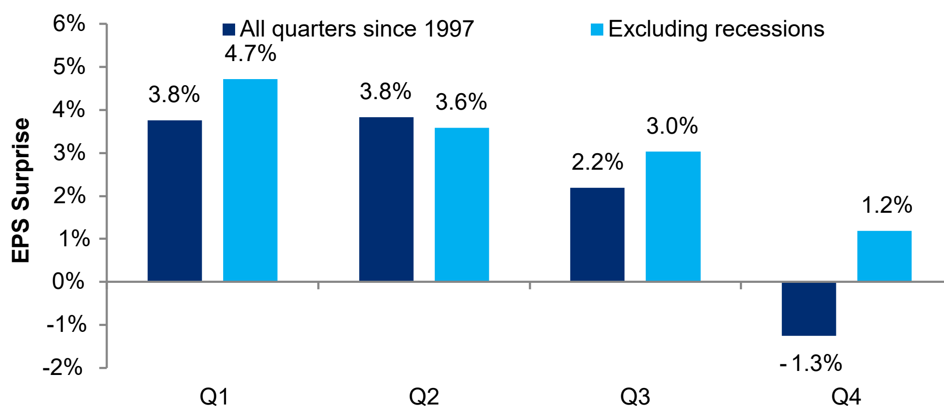
## The Intrinsic Value of the 60/40 Portfolio

As markets move away an unsustainable "Goldilocks view", they become more susceptible to exogenous concerns, including geopolitical and domestic political risks. Markets may take comfort from powerful earnings "beats" in Q12024 that we expect (see **FIGURE 7** and last week's CIO Bulletin). However, after a 25% gain in the S&P 500 over the past year, we would not be surprised if hawkish Fed rhetoric or another round of foul monthly data spooks markets. If this is the case, we see high grade intermediate US bonds offering good value for a Fed that is bent on attaining 2% inflation.

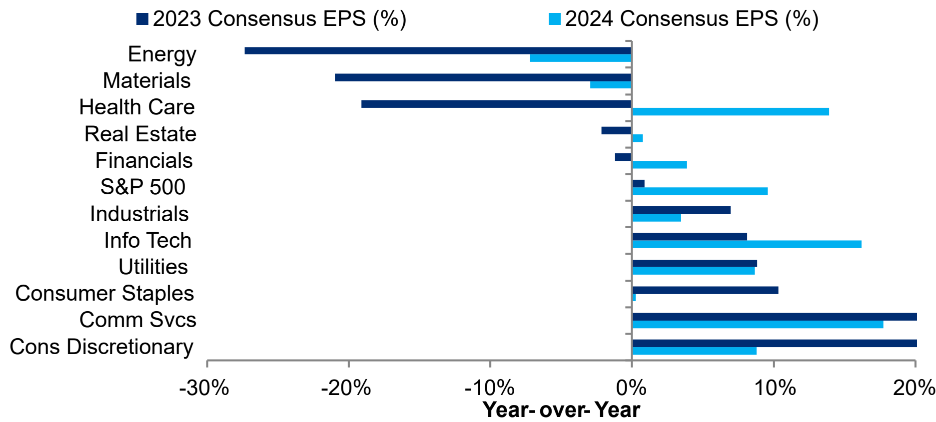
We believe 2024 will offer a broadening set of positive returns relative to 2023 as more sectors post EPS gains (see **FIGURE 8**). Our asset allocation reflects a broadening strategy to take advantage of wider gains. For example, we overweight the S&P 500 equal weight index to reduce concentration risk and seek to take advantage of "catch up" opportunities including healthcare in particular (please see the March Quadrant for discussion).

**FIGURE 7:** First Quarter S&P 500 EPS Beats Tend to be the Strongest of the Year




Source: LSEG I/B/E/S, Factset as of April 5, 2024. 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.

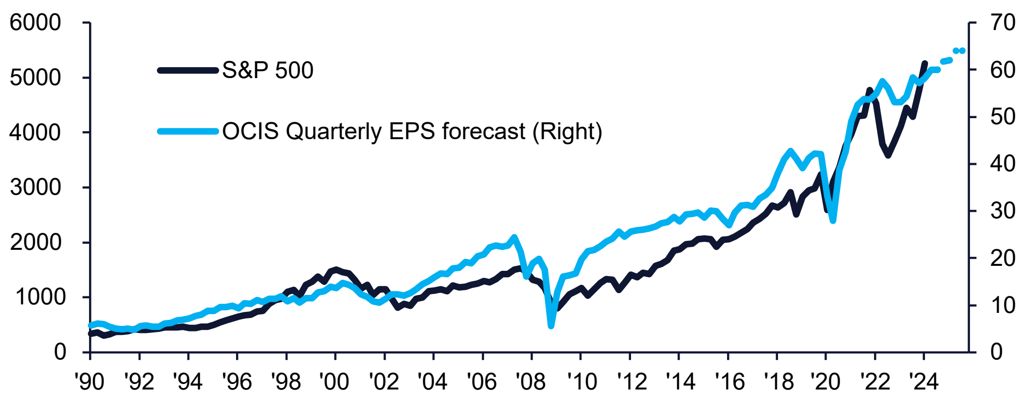
**FIGURE 8**: S&P 500 Economic Sector EPS Gains 2023 vs 2024 Consensus




Source: Bloomberg as of April 5, 2024. Sectors proxied using S&P 500 Sectors (Level 2). 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. All forecasts are expressions of opinion and are subject to change without notice and are not intended to be a guarantee of future events.

We believe 1Q S&P 500 EPS may rise meaningfully from a year, making a positive full year gain a possibility. We believe a record high for this key measure of US corporate profits has already been reached and expect further gains in 2025 and beyond (see **FIGURE 9**).

**FIGURE 9:** S&P 500 vs EPS level including CGWI Estimates

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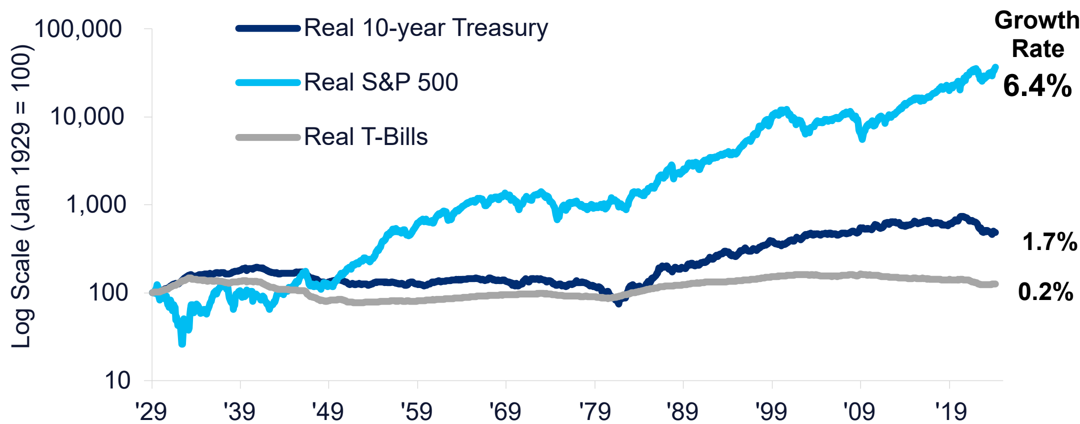
While we expect solid performance for both equities and bonds in 2024, "headline" index performance was never likely to be as strong as 2023, which followed sharp losses in 2022 (Wealth Outlook for 2024). Returns for the S&P 500 over the past six months would have annualized near 50%. In short, equity markets were appreciating too fast to be sustained.

We believe Investing in economic development – generating capital appreciation and income – is still the paramount opportunity for wealth preservation and growth. The precise number of rate cuts in the remaining 8 months of 2024 is trivial by comparison.

## A Memorable Ending

Pullbacks in financial markets are common. Staying invested is what has historically been required for portfolios to outpace inflation over the longer run (see **FIGURE 10**). As discussed in Wealth Outlook, based on our strategic return estimates diversified balanced portfolio may be able to achieve meaningful returns this year, enough to earn more than US inflation. By comparison, the Fed's expectation for its policy rate over the coming decade – a proxy for cash - would be less than 1% above inflation.

**FIGURE 10:** Inflation Adjusted (Real) Return Indices: S&P 500, US Treasury 10-Year and 1-Month Treasury Bills

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**APPENDIX 1:** Geopolitical shocks have *altered the course of the global economy* in less than 10% of the cases since WWII.

| S&P 500 | Initial Impact % | 30 days % | 90 days % |
|---|---|---|---|
| *Average all events* | -3.29 | 0.76 | 2.57 |
| *Average ex WW2* | -3.14 | 0.92 | 3.20 |
| *Average ex WW2 and Oil Embargo* | -2.55 | 1.02 | 4.60 |

| Geopolitical Event | Trading day before event | Trading day after Geopolitical Shock | S&P 500 (% since event date) | | | Crude Oil (% since event date) | | |
|---|---|---|---|---|---|---|---|---|
| | | | Initial Reaction | 30 days | 90 days | Initial Reaction | 30 days | 90 days |
| *Pearl Harbor* | *12/7/1941* | 12/10/1941 | -6.87 | -2.90 | -12.02 | | | |
| *Cuban Missile Crisis* | *10/19/1962* | 10/23/1962 | -3.78 | 7.61 | 17.16 | | | |
| *JFK Assassination* | *11/21/1963* | 11/22/1963 | -2.81 | 3.06 | 8.28 | | | |
| *US Bombs Cambodia* | *4/29/1970* | 5/26/1970 | -15.30 | -6.43 | -4.94 | | | |
| *Arab Oil Embargo* | *10/15/1973* | 12/5/1973 | -16.26 | -5.61 | -15.11 | | | 287.04 |
| *USSR Invades Afghanistan* | *12/24/1979* | 1/3/1980 | -2.27 | 5.37 | -7.78 | | | 8.33 |
| *Iraqi invasion of Iran* | *9/9/1980* | 9/11/1980 | 1.28 | 5.62 | 5.17 | | | 6.66 |
| *US Bombs Libya* | *4/15/1986* | 4/21/1986 | 2.95 | -1.39 | 0.16 | -3.91 | 8.70 | -15.65 |
| *US Invades Panama* | *12/15/1989* | 12/20/1989 | -2.06 | -3.73 | -3.43 | 2.82 | 5.08 | -6.21 |
| *Gulf War* | *12/24/1990* | 1/16/1991 | -4.16 | 0.09 | 12.10 | 17.75 | -20.67 | -31.32 |
| *World Trade Center Bombing* | *2/26/1993* | 3/1/1993 | -0.31 | 1.67 | 2.04 | -0.18 | -3.44 | -5.81 |
| *911* | *9/11/2001* | 9/21/2001 | -11.60 | 0.45 | 4.34 | -4.09 | -17.68 | -31.98 |
| *US Invasion of Iraq* | *3/20/2003* | 3/21/2003 | 2.49 | 2.06 | 15.57 | -8.16 | -5.86 | -6.54 |
| *Russian Annexation of Crimea* | *2/26/2014* | 3/21/2014 | 1.16 | 0.68 | 3.62 | -3.77 | -2.43 | -0.92 |
| *Russian invasion of Ukraine* | *2/23/2022* | 3/8/2022 | -3.11 | 5.54 | -8.44 | 19.04 | 17.26 | 18.98 |
| *Hamas attack on Israel* | *10/6/2023* | 10/9/2023 | 0.63 | 1.33 | 9.02 | 2.77 | -0.29 | -8.60 |
| **North Korea Related** | | | | | | | | |
| *Korean War* | *6/23/1950* | 7/13/1950 | -12.80 | -8.67 | 1.20 | | | |
| *Operation Paul Bunyan* | *8/18/1976* | 8/24/1976 | -3.15 | 1.64 | -4.32 | 0.00 | 0.00 | 0.00 |
| *2006 Nuclear test* | *10/9/2006* | 10/12/2006 | 0.90 | 2.60 | 4.60 | -1.46 | 1.09 | -7.43 |
| *2009 Nuclear test* | *4/25/2009* | 4/28/2009 | -1.28 | 5.09 | 13.05 | -3.73 | 19.56 | 36.56 |
| *2013 Nuclear test* | *2/12/2013* | 2/15/2013 | 0.02 | 2.88 | 7.53 | -0.27 | -8.18 | -12.49 |
| *2016 Nuclear test* | *9/9/2016* | 9/14/2016 | -2.55 | -0.81 | 2.97 | -3.38 | 14.12 | 16.54 |
| *2017 Escalation* | *8/7/2017* | 8/8/2017 | -0.24 | -0.64 | 4.44 | 2.19 | 7.00 | 21.65 |
| *Missile test over Japan* | *8/28/2017* | 8/29/2017 | 0.08 | 2.69 | 6.43 | -0.83 | 10.37 | 23.06 |

| Geopolitical Event | Trading day before event | Trading day after Geopolitical Shock | MSCI World ex USA (% since event date) | | | DXY Dollar Index | | |
|---|---|---|---|---|---|---|---|---|
| | | | Initial Reaction | 30 days | 90 days | Initial Reaction | 30 days | 90 days |
| *Pearl Harbor* | *12/7/1941* | 12/10/1941 | | | | | | |
| *Cuban Missile Crisis* | *10/19/1962* | 10/23/1962 | | | | | | |
| *JFK Assassination* | *11/21/1963* | 11/22/1963 | | | | | | |
| *US Bombs Cambodia* | *4/29/1970* | 5/26/1970 | -10.45 | -17.01 | -16.07 | -0.20 | -0.23 | -0.51 |
| *Arab Oil Embargo* | *10/15/1973* | 12/5/1973 | -14.68 | 1.96 | -18.53 | 6.98 | 4.68 | 12.31 |
| *USSR Invades Afghanistan* | *12/24/1979* | 1/3/1980 | 3.94 | 3.94 | 11.85 | -1.06 | -0.71 | 5.91 |
| *Iraqi invasion of Iran* | *9/9/1980* | 9/11/1980 | 0.00 | 3.70 | 5.81 | -0.27 | 0.36 | 6.26 |
| *US Bombs Libya* | *4/15/1986* | 4/21/1986 | 0.00 | 6.19 | 8.16 | -4.15 | -4.80 | -5.30 |
| *US Invades Panama* | *12/15/1989* | 12/20/1989 | 0.00 | 3.67 | -7.04 | 0.31 | -1.69 | -0.44 |
| *Gulf War* | *12/24/1990* | 1/16/1991 | 1.75 | 1.75 | 15.96 | -0.21 | -3.61 | 4.90 |
| *World Trade Center Bombing* | *2/26/1993* | 3/1/1993 | 0.00 | 8.52 | 18.62 | 0.18 | -1.15 | -4.79 |
| *911* | *9/11/2001* | 9/21/2001 | -8.48 | 3.24 | 5.48 | -1.08 | 0.29 | 1.85 |
| *US Invasion of Iraq* | *3/20/2003* | 3/21/2003 | 1.53 | 4.58 | 22.05 | 0.84 | -1.85 | -7.89 |
| *Russian Annexation of Crimea* | *2/26/2014* | 3/21/2014 | -2.42 | -0.45 | 3.25 | -0.40 | -0.31 | -0.10 |
| *Russian invasion of Ukraine* | *2/23/2022* | 3/8/2022 | -8.76 | -0.36 | -7.10 | 2.99 | 2.70 | 5.89 |
| *Hamas attack on Israel* | *10/6/2023* | 10/9/2023 | 0.08 | 2.12 | 11.09 | 0.04 | -0.96 | -3.42 |
| ***North Korea Related*** | | | | | | | | |
| *Korean War* | *6/23/1950* | 7/13/1950 | | | | | | |
| *Operation Paul Bunyan* | *8/18/1976* | 8/24/1976 | 0.00 | -0.26 | -7.60 | 0.07 | -0.57 | -0.12 |
| *2006 Nuclear test* | *10/9/2006* | 10/12/2006 | 0.46 | 4.33 | 8.09 | 0.43 | -1.32 | -2.21 |
| *2009 Nuclear test* | *4/25/2009* | 4/28/2009 | -2.32 | 12.28 | 21.21 | 0.52 | -5.54 | -7.04 |
| *2013 Nuclear test* | *2/12/2013* | 2/15/2013 | -0.99 | 1.15 | 5.73 | 0.59 | 3.12 | 3.96 |
| *2016 Nuclear test* | *9/9/2016* | 9/14/2016 | -2.06 | -0.81 | -0.72 | -0.01 | 1.36 | 6.05 |
| *2017 Escalation* | *8/7/2017* | 8/8/2017 | -0.26 | -0.49 | 3.60 | 0.23 | -1.22 | 1.62 |
| *Missile test over Japan* | *8/28/2017* | 8/29/2017 | -0.25 | 1.80 | 5.45 | 0.05 | 1.25 | 0.62 |

Source: Haver Analytics, Bloomberg as of April 14, 2023. "Initial Reaction" is defined by the time period between the trading day before the event and the trading day after the Geopolitical shock time period (as determine by Citi Wealth Investments). 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.

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Alpha and/or numeric symbols used to give indications of relative credit quality. In the municipal market, these designations are published by the rating services. Internal rating are also used by other market participants to indicate credit quality.

| Bond credit quality ratings | Rating agencies | | |
|---|---|---|---|
| **Credit risk** | **Moody's [1]** | **Standard and Poor's [2]** | **Fitch Rating [2]** |
| **Investment Grade** | | | |
| Highest quality | Aaa | AAA | AAA |
| 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 |

1 The ratings from Aa to Ca by Moody's may be modified by the addition of a 1, 2, or 3, to show relative standing within the category.
2 The rating from AA to CC by Standard and Poor's and Fitch Ratings may be modified by the addition of a plus or a minus to show relative standings within the category.

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- 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.

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