Citi Global Wealth
Investments

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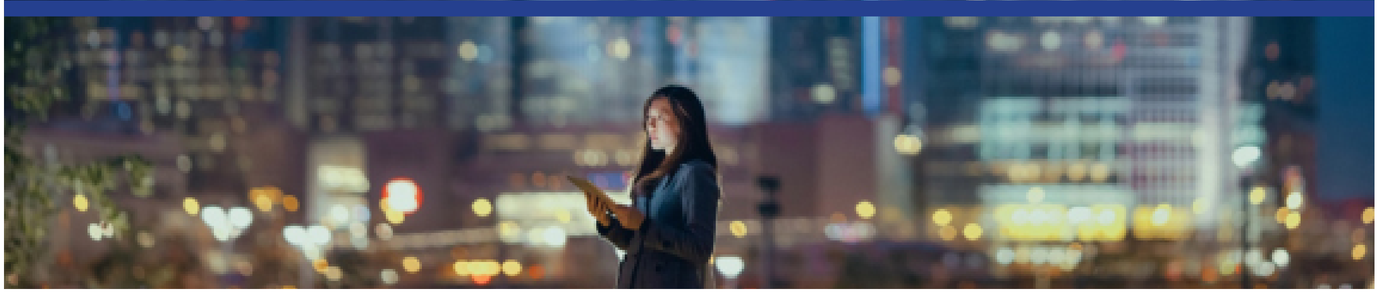

October 22, 2023

CIO Strategy Bulletin

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Investing in Uncertain Times

- It is not lost on us that investing at a time of increasing geopolitical uncertainty is difficult. Though risks appear higher than average today, we are entering a period when adding to core portfolios, including equities, bonds, and alternatives, simply makes sense for qualified investors.
- High current yields on deposits and short-term treasuries compete with equities in terms of current yield and expected returns. This puts near term pressure on asset prices, especially equities, that have been largely resilient in 2023 in the face of increasing geopolitical risks.
- With that said, when we look at likely equity returns over 12-18 months (our CGW Global Investment Committee's (GIC) tactical return window) we expect US EPS to reach a new record high by 2025. We foresee a time in 2024 when rate pressures recede and the US dollar declines. This could help set the stage for stronger global growth in 2025.
- Investment grade corporate debt yields, even those with low durations, now sit at 6%. If inflation were to end 2024 at 2.5%, real corporate bond yields will be approximately 3.5%. Such real yields are rare, last seen in the late 1990s. Furthermore, the risk of entering new bond positions is less now than it was just 18 months ago.
- This week, we elected to make a significant portfolio allocation within equities. Small and medium sized growth companies (SMID) in the US have outgrown their large counterparts, yet they trade at a record 32% valuation discount to their larger peers based on current year earnings estimates.
- The right mix of equity and debt makes the value of the "60/40" or balanced portfolio potentially valuable given the benefits of diversification. And if we find ourselves in a more peaceful world someday, that benefit may multiply across both markets. However, given current market events risks should be considered by investors..

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Investing In Uncertain Times

It is not lost on us that investing at a time of increasing geopolitical uncertainty is difficult. The war in the Middle East has raised security risks across the region. And the fact that the Ukraine-Russia war has overlapping players further complicates matters. However, such events are most often not a long-term driver of world financial markets. The key is whether these events catalyze a turning point in regional economies or the global economy. More than 90% of history's shocking geopolitical events did not reach the critical threshold, collapsing the world economy (**Figure 1**). As of October 20, 2023, the oil price has dropped 8% despite the greater risks to regional oil producers.

The Fed intends for higher rates to slow economic growth and that dynamic is underway. Higher rates reduce the demand for borrowing and that is evident in lackluster lending data to businesses and consumers alike. Higher rates also change the relative value of assets. High current yields on deposits and short-term treasuries compete with equities in terms of current yield and expected returns. This puts near term pressure on asset prices, especially equities, that have been largely resilient in 2023 in the face of increasing geopolitical risks.

Looking forward, both bond and equity markets are offering potential wealth creating opportunities for 2024 and beyond. In the bond market, we see compelling real yields. Real US yields in TIPS are approaching a record high (**Figure 2**). We expect slowing employment growth to mitigate inflationary pressures and the recent rise in US rates as we move into 2024 (**Figure 3**). In the equity markets, we see 2024 corporate profits rebounding with a likely slowdown in US labor markets. We also believe there is an opportunity to invest in "growth at a reasonable price", or GARP, at a time when growth in revenues and income will be harder, not easier, to come by.

Having cash on hand to "provide liquidity" when markets dislocate is a potentially beneficial, opportunistic strategy. That said, maintaining and growing core portfolios remains central to building and preserving wealth over time. Though risks are higher than average today, we are entering a period when adding to core portfolios, including equities, bonds, and alternatives, may simply make sense.

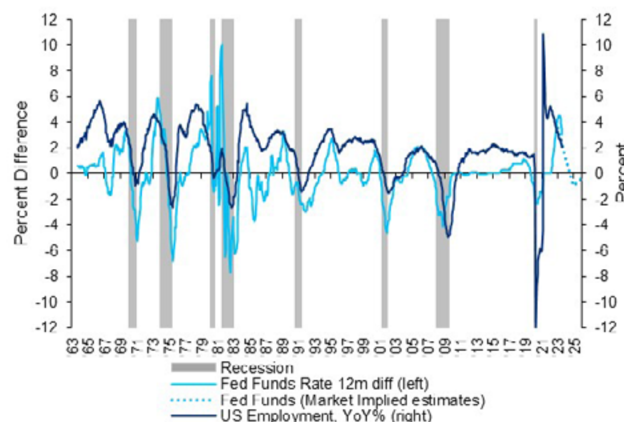
Figure 1: Geopolitical events have rarely altered the course of the global economy

S&P 500	Initial Reaction %	30 Days %	90 Days %
Average of all events	-3.5	0.7	2.3
Average ex WW2	-3.3	0.9	2.9
Average ex WW2 and Oil Embargo	-2.7	1.0	4.4

Source: Bloomberg as of October 12, 2023. Average of all events includes all geopolitical events reflected in **Figure 7** which span December 1941 through February 2022. "Initial reaction" on the day of the event, "30 Days" after the day of the event and "90 days" after the event are defined as the periods spanning the market reaction associated with each event. 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 2: 10-year US Treasury Inflation Protected Security Yield

Figure 3: US Employment Year-over-Year (Y/Y)% vs Fed funds rate Y/Y Difference



Source: Haver Analytics and Bloomberg as of October 17, 2023. All forecasts are expressions of opinion and are subject to change without notice and are not intended to be a guarantee of future events. Past performance is no guarantee of future results. Real results may vary.

Adding Growth to Portfolios

When we look at possible equity returns over 12-18 months (the GIC's tactical return window) we expect US EPS to reach a new record high by 2025, even as we are skeptical of analyst estimates for 2024. In the near-term, seasonal trends might help broad equity markets reset before year end.

At our most recent GIC, we elected to make a significant portfolio allocation within equities. Small and medium sized growth companies in the US have outgrown their large counterparts. These small and mid-cap growth firms trade at a record 32% valuation discount based on current year earnings estimates. Profitable US SMID also trades at a lower-than-average historical valuation (15.2x trailing earnings vs 21.3x). These portfolio additions were represented by overweights to the S&P 400 and S&P 600 growth firms.

Growth at a Particularly Reasonable Price

Taken together, the SMID growth indices trade at 15.2x trailing EPS, 29% below their 25-year average absolute valuation. Very few asset classes trade below their long-term averages now.

The discount in profitable SMID growth shares is not the result of poor EPS performance. Their EPS growth has been nearly 12% per annum over the past 10 years, faster than the 9% for large cap US growth companies. It turns out that smaller firms have more room to grow before they dominate their industries (**Figure 4-5**).

We foresee a time in 2024 when rate pressures recede and the US dollar declines. This could help set the stage for stronger global growth in 2025. If this pattern unfolds, we would likely broaden our global equity overweight positions to include other regions, industries and market sectors. Examples include US and European energy producers whose low valuations, strong balance sheets, dividend income, and inflation protection are potentially appealing.

And How About Those Bonds?

Investment grade corporate debt yields, even those with low durations, now sit at 6%. This is two times the Fed's own estimate of its five-year policy rate during the next 5 years. And if inflation were to end 2024 at 2.5%, real corporate bond yields will be 3.5% or so. Such real yields are rare, last seen in the late 1990s.

Furthermore, the risk of entering new bond positions is materially less now than it was just 18 months ago. Treasury coupons have moved from near zero to almost 5% today and their price sensitivity (effective duration) has been sharply reduced. And the bond yields across the range of securities have more than doubled since 2021 (**Figure 6**).

While no one can predict the absolute peak for rates, we are likely at the top of the range. High rates, quantitative tightening of more than $1 trillion, and restrictive bank lending will act as "gravity", slowing the economy. Lags in the impact of monetary policy are common, but this post-Covid period has delayed their cumulative impact. For example, employment growth in the US has been stronger than GDP growth by the largest margin since 1974. That seems unsustainable to us.

Imagine if the US economy buckled under the weight of such strong monetary medicine. If the Fed saw a major rise in unemployment and halted rate increases, the entire yield curve would shift and future Fed actions would switch to protecting jobs. Inflation would become a minor issue. And that narrative would make real rates fall quickly.

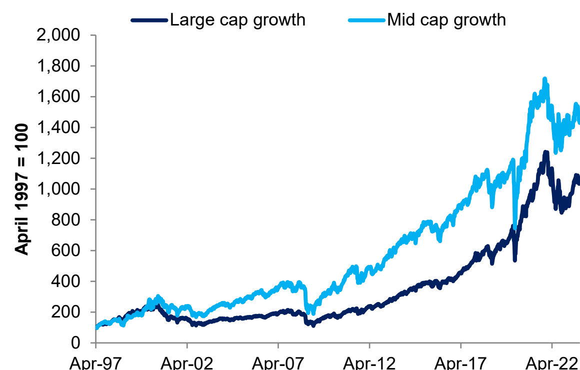
Conclusion

Both bond and equity markets are offering potential wealth creating opportunities for 2024 and beyond. In the bond market, we see compelling real yields. In the equity markets, we see 2024-25 corporate profits rebounding with a likely slowdown in US labor markets. And we think GARP shares present a very compelling potential opportunity. The right mix, based on investor suitability, of equity and debt makes the value of the "60/40" or balanced portfolio valuable given the historical benefits of diversification. And if we find ourselves in a more peaceful world someday, that benefit may multiply across both markets.

Figure 4: 10-Year EPS growth rates by style (CAGR)

	Value	Core	Growth
Large	4%	7%	9%
Mid	10%	11%	11%
Small	6%	10%	12%

Figure 5: S&P Mid-Cap vs Large Cap Growth total return



Source: Bloomberg as of October 17, 2023. The box on the left chart indicates the 10 year EPS compound annual growth rate, or CAGR, for SMID cap growth shares which we added to portfolios. Highlighted percentages highlight higher SMID EPS growth versus large cap US companies 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 6: 12-month total return estimates for US Treasuries under various scenarios for interest rates

	Interest Rates				
Treasury returns estimates	-100 bps	-50 bps	0 bps	50 bps	100 bps
2yr US Treasury	5.61	5.11	4.62	4.13	3.64
5yr US Treasury	8.62	6.61	4.65	2.72	0.84
10yr US Treasury	12.07	8.30	4.69	1.22	-2.10
30yr US Treasury	22.28	12.81	4.38	-3.12	-9.83
US Treasury Index	9.86	7.20	4.68	2.29	0.02

Source: Bloomberg as of October 12, 2023. Note: US Treasury bond index has an average duration of 5.8 years. Scenarios are based on parallel shift of the US Treasury curve. Estimates were calculated with 10yr US Treasury yield at 4.65%. All forecasts are expressions of opinion and are subject to change without notice and are not intended to be a guarantee of future events. 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 7: Geopolitical events have rarely altered the course of the global economy

Geopolitical Event	Date	S&P 500 (% since event date)			Nikkei (% since event date)			MSCI World ex USA (% since event date)			DXY Dollar Index		
		Initial Reaction	30 days	90 days	Initial Reaction	30 days	90 days	Initial Reaction	30 days	90 days	Initial Reaction	30 days	90 days
Pearl Harbor	12/7/1941	-6.87	-2.90	-12.02									
Cuban Missile Crisis	10/19/1962	-3.78	7.61	17.16									
JFK Assasination	11/21/1963	-2.81	3.06	8.28									
US Bombs Cambodia	4/29/1970	-15.30	-6.43	-4.94	-15.93	-12.49	-7.64	-10.45	-17.01	-16.07	-0.20	-0.23	-0.51
Arab Oil Embargo	10/18/1973	-16.23	-8.45	-13.04	-1.81	-1.44	-4.47	-14.68	1.96	-18.53	7.48	5.28	14.04
USSR Invades Afghanistan	12/24/1979	-2.27	5.37	-7.78	0.57	2.63	0.68	3.94	3.94	11.85	-1.06	-0.71	5.91
US Bombs Libya	4/15/1986	2.95	-1.39	0.16	3.09	3.73	16.08	0.00	6.19	8.16	-4.15	-4.80	-5.30
US Invades Panama	12/15/1989	-2.06	-3.73	-3.43	0.63	-3.71	-14.63	0.00	3.67	-7.04	0.31	-1.69	-0.44
Gulf War	12/24/1990	-4.16	0.09	12.10	-6.95	-4.43	10.47	1.75	1.75	15.97	-0.21	-3.61	4.90
World Trade Center Bombing	2/26/1993	-0.31	1.67	2.04	-0.44	12.36	23.00	0.00	8.52	18.62	0.18	-1.15	-4.79
911	9/11/2001	-11.60	0.45	4.34	-6.28	1.48	3.68	-8.48	3.24	5.48	-1.08	0.29	1.85
US Invasion of Iraq	3/20/2003	2.49	2.06	15.57	4.77	-1.02	12.94	1.53	4.58	22.05	0.84	-1.85	-7.89
North Korea Related													
Korean War	6/23/1950	-12.80	-8.67	1.20									
Operation Paul Bunyan	8/18/1976	-3.15	1.64	-4.32	-0.75	-0.21	-4.52	0.00	-0.26	-7.60	0.07	-0.57	-0.12
2009 Nuclear test	4/25/2009	-1.28	5.09	13.05	-2.46	6.92	14.20	-2.32	12.28	21.21	0.52	-5.54	-7.04
2016 Nuclear test	9/9/2016	-2.55	-0.81	2.97	-2.03	0.39	10.65	-2.06	-0.81	-0.72	-0.01	1.36	6.05
2017 Escalation	8/7/2017	-0.24	-0.64	4.44	-0.30	-3.89	12.43	-0.26	-0.49	3.60	0.23	-1.22	1.62
Political Events													
Nixon/Watergate	3/15/1974	-1.72	-7.28	-8.04	-1.80	1.05	4.42	0.00	-2.57	-6.12	-1.04	-1.57	-2.12
Clinton intern scandal	8/20/1998	-12.30	-6.20	5.59	-8.34	-11.66	-6.74	-12.75	-12.75	-6.37	-1.76	-5.18	-6.58
Brexit	6/23/2016	-2.30	4.30	3.72	-6.93	3.50	4.62	-5.31	-0.37	1.70	1.85	4.00	2.46

Source: Bloomberg as of October 12, 2023. Average of all events includes all geopolitical events reflected which span December 1941 through February 2022. "Initial reaction" on the day of the event, "30 Days" after the day of the event and "90 days" after the event are defined as the periods spanning the market reaction associated with each event. 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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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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Asset allocation does not assure a profit or protect against a loss in declining financial markets.

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