Citi Global Wealth
Investments

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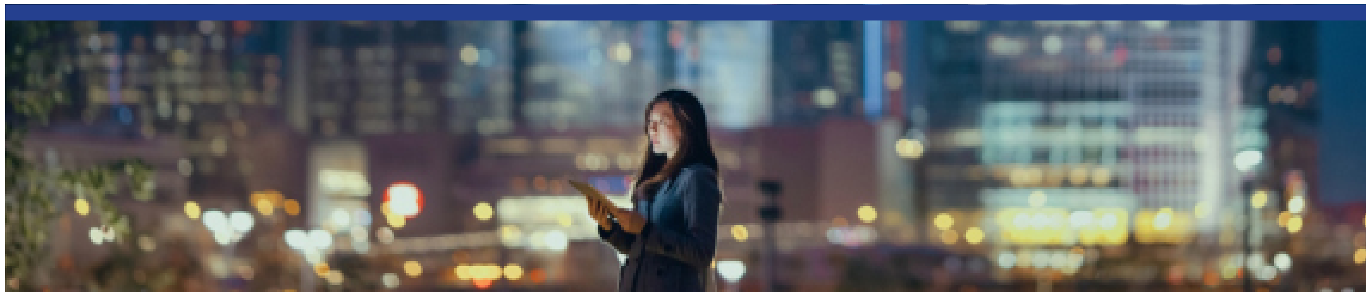

July 2, 2023

CIO Strategy Bulletin

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Moving Thoughtfully from Defense to Offense

- For the past 18 months the fear of recession has left investors sidelined, waiting for a single economic collapse. Their behavior fails to acknowledge that the stampede out of equities and bonds last year accounted for a substantial portion of the market's collapse and that the economy is in a rolling recession, with some industries far into their own downtrend.
- Good portfolio management is not about market timing. Rather, strategic asset allocation followed by specific tactical allocations is the best way to help optimize potential opportunities and diversify risks. While we moved from -1% in equities to neutral, we are no longer underweight US small and mid-cap shares. We have also reduced our US large cap and Chinese equity exposures slightly (Please see our latest Quadrant).
- We raised emerging market hard currency debt to an overweight position with a 2% initial increase. Mostly investment grade and globally diversified, EM USD debt yields about 7.5%, nearly double that of comparable US Treasuries. While we've maintained a 5.5% overweight in US Treasuries, we pared this position by 3% to finance our reallocation.
- We expect to make significant further increases to small and medium-sized companies (SMID) over time. US SMID trades at 14.2x 2023 estimates vs 19.9x for the S&P 500. Our exposure to non-US SMID is likely to be higher in the future, as well. Our non-US share exposure is up by 3.5% percentage in 2023. (Non-US shares trade at a record 41% valuation discount to the US.)
- We continue to suggest clients move from cash to bonds. With a variety of mostly investment grade credit opportunities, we believe investors can potentially lock in attractive fixed income portfolio yields for 5-6 years, which is much higher than the estimated cash yield over that future period.

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Beneath market excess lies opportunity

Fear and greed drive bull and bear markets, often to excess. Remember the Nasdaq's five-year run of 88% per year through 1999? But more recently, in 2020, consider the drop in nominal 30-year US Treasury yields to 1%. In both cases, severe asset class corrections followed.

In 2022, global stocks and bonds both saw double-digit declines. For a 60/40 index blend of S&P 500/10-Year US Treasury, the annual loss was the largest since 1931 (**Figure 1**). 1931 and 1969 were the only two prior years this century when both stocks and bonds declined together. But what followed?

After those rare double-dip equity and bond declines, strong returns were earned just two years later. In the two years post-1931 and 1969, 60/40 portfolios earned more that 20% over 24 months.

Today's record short interest, unusually large cash and money market balances and crowded defensive trades have seen 2023 generate contrarian market gains. While we expect subpar global economic growth in both 2023 and 2024, the wide discrepancies in market values globally and in the US suggest that opportunities for incremental returns are widely available.

Too Smart for Their Own Good

Today's investor is armed with information on historical performance and descriptive statistics showing, for example, what has happened following an inversion of the US yield curve. Some might fall into the trap of assuming they alone possess this knowledge for their trading advantage. Others seem to believe they can "out-trade" a recession, wait on the sidelines until an inevitable collapse occurs and deftly step back in to reap all the reward without any of the risk.

For investors who sold by the end of 2022, a part of the market recovery has passed. A 60/40 portfolio is up 10.5% through June 30, 2023. Those who shorted the markets have been sadly disappointed as a wave of short covering is evident (**Figure 2**).

The Rolling Recession Rolls On

Unlike the Covid shock of 2020 that depressed the economy in an instant, the economy in 2023 remains uneven. Higher rates have depressed some industries, like real estate, quickly and sharply. But continued gains in services activity, which lagged the goods sector in 2021, is masking a contraction in cyclical industries. Manufacturing, trade and key parts of the housing industry are likely to bottom before services strength wanes.

With some industries falling and others rising or resilient, the overall economy slows but doesn't stall. Our expected growth forecast of 1%-1.5% through 2024 is the outcome. Here is what investors miss if that is true: A prolonged period of below-trend growth will achieve the same trough in economic activity that a sharp, short recession would.

Why the Fed Hasn't Crushed the Whole Economy

It is undeniably true that the Fed's control of risk-free short-term interest rates can crush the economy. But we also believe many investors have been misled to expect that the US or world economy will collapse rapidly as it did in 2020 or 2008. The present outlook differs from these periods of severe financial vulnerability.

Consider that private sector credit did not boom during the Covid years. Government stimulus did. The corporate bond market is healthy and spreads don't suggest a future collapse (**Figure 3**). Perhaps the greatest risk in today's market are small and mid-sized banks whose exposure to commercial real estate is too high.

Labor Markets Can't Outperform Forever

Despite a rapid slowdown in inflation – as fast as the decline in the 1980s – US labor markets have outperformed through the Fed's sharp tightening. While we don't expect a plunge in employment, this labor resilience is not likely to be sustained. We expect the Fed to achieve its "goal" of raising US unemployment over the next two years. However, business output has already fallen for five quarters, mostly as a result of declining investment (**Figure 4**). In other words, those waiting for a contracting economy should recognize that lower output is recessionary.

Moving Thoughtfully from Defense to Offense

This week, the Global Investment Committee voted to shift both equity and bond allocations to take advantage of widening valuation disparities around the world. The chart below shows the before and after allocations in our Level 3 (moderate risk) portfolios.

Global Investment Committee Current Tactical Asset Allocation

LARGEST OVERWEIGHTS	Previous	LARGEST OVERWEIGHTS	Current
+2.5% China, other Asia equities		+2.0% Asia equities	↓
+1.0% Brazil equities		+1.0% Brazil equities	
+1.0% Cybersecurity (US Large Cap)		+1.0% Cybersecurity (US Large Cap)	
-1.0% Total equities		Neutral Total equities	↑
+10.0% All Short-, Intermediate-term US IG bonds		+7.0% All Short-, Intermediate-term US IG bonds	
(+8.5% US Treasuries)		(+5.5% US Treasuries)	↓
+2.0% Investment Grade Preferred Stock		+2.0% Investment Grade Preferred Stock	
		+1.2% Global EM Debt	↑

LARGEST UNDERWEIGHTS	Previous	LARGEST UNDERWEIGHTS	Current
-10.3% European, Japan bonds		-10.3% European, Japan bonds	
-5.0% Global SMID		-2.5% Non-US DM SMID	↑
-1.0% Cash		-1.5% US Large Cap	↓
		-1.0% Cash	
+2% Total fixed income and cash		+1% Total fixed income and cash	↓

Source: Global Investment Committee as of June 29, 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. 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. The above table does not constitute a portfolio recommendation. It was generated without taking into account any individual's specific circumstances or requirements. Investors looking to develop their portfolio should contact their Private Banker or Investment Counselor for further guidance.

We made the following changes to portfolios:

- We moved from -1% in equities to neutral, however, we are no longer underweight US small and mid-cap shares. We have also reduced our US large cap and Chinese equity exposures slightly (Please see our latest Quadrant.)
- We raised emerging market hard currency debt to an overweight position with a 2% initial increase. Mostly investment grade and globally diversified, EM USD debt yields about 7.5%, nearly double that of comparable US Treasuries. While we've maintained a 5.5% overweight in US Treasuries, we pared this position by 3% to finance our reallocation.
- We expect to make significant further increases to small and medium-sized companies (SMID) over time. US SMID trades at 14.2x 2023 estimates vs 19.9x for the S&P 500. Our exposure to non-US SMID is likely to be higher in the future, as well. Our non-US share exposure is up by 3.5% percentage in 2023. (Non-US shares trade at a record 41% valuation discount to the US.)
- We continue to suggest clients move from cash to bonds. With a variety of mostly investment grade credit opportunities, we believe investors can potentially lock in attractive fixed income portfolio yields for 5-6 years, which is much higher than the estimated cash yield over that future period.

Our Thinking at This Time

The poor performance of US private businesses has already been digested by the equity markets. For example, a handful of AI-themed shares have seen sharp gains, but market breadth (even for IT shares) has been poor (**Figure 5**). As investors sought safety in strong balance sheets, an unusually large valuation gap has opened up in favor of smaller companies, an underperformance consistent with a mild recession (**Figure 6**).

As we discussed in April when we took profits on our overweight in large cap pharmaceuticals shares, we see diminished benefits from "playing defense" in equities. The relative valuation of defensive industries and quality balance sheets has surged. Many of these firms now offer neither growth nor value, but rather a static performance that doesn't suit the returns we seek in the equity component of portfolios (**Figure 7**). After deep relative underperformance, we have neutralized our SMID underweight, and after strong outperformance in 2022, we've neutralized our dividend growth overweight.

The US high yield bond market has outperformed small-cap stocks on a risk-adjusted basis (**Figure 8**). Instead of adding to US high yield at relatively tight spreads, we continue to hold an overweight in high grade US preferred securities at a yield premium to sub-investment grade corporates. We've also now chosen to take credit risk in emerging market (EM) sovereigns and "quasi-sovereigns" who borrow in US dollars. These largely investment grade borrowers across the world collectively yield near 7.5%, nearly double the comparable US Treasury (**Figure 9**).

With a variety of mostly investment grade credit opportunities, we believe investors can potentially lock in attractive fixed income portfolio yields for 5-6 years, which is much higher than the estimated cash yield over that future period. While this is merely as high as T-bills now, the Federal Reserve's own forecast for its "long run normal" policy rate is 2.5%. In line with history, we suspect that cash yields will average less than this level over most of the next decade.

Figure 1: Lowest 60/40 Returns for US stocks, Bonds in the past Century, Subsequent Returns

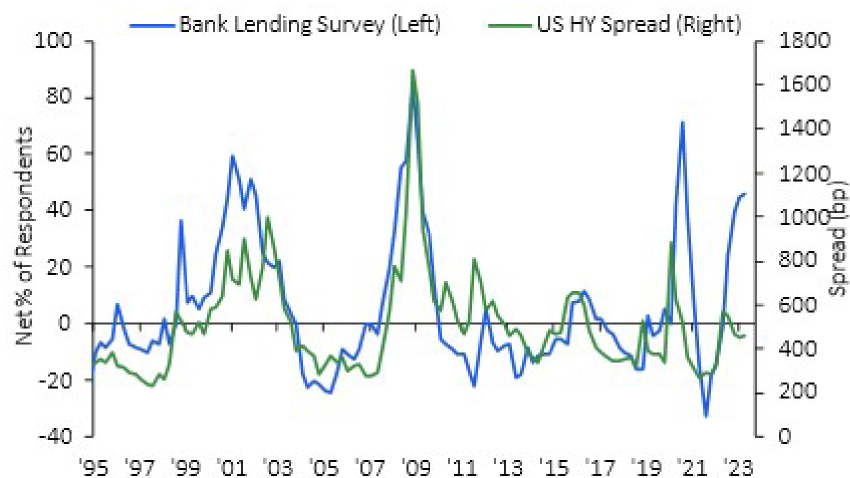
YEAR	S&P 500 TOTAL RETURN YoY % CHANGE	10-YEAR TOTAL RETURN YoY % CHANGE	*60 / 40	*1-YEAR FORWARD 60 / 40	*2-YEAR FORWARD 60 / 40
1931	-43.9%	-2.6%	-27.3%	-1.8%	28.0%
1969	-8.5%	-5.6%	-7.3%	10.5%	24.3%
2022	-19.5%	-12.3%	-16.6%		

Source: Bloomberg/MSCI/Barclays and Global Financial Data as of May 10, 2023. Note: 60/40 columns show the combination of the annual total return of the S&P 500 and the 10-Year US Treasury with 60% allocated to the S&P, and 40% allocated to UST. Indices are unmanaged and an investor cannot invest directly in an index. Indexes are used to proxy for the asset class. Index returns do not include any transaction costs, expenses, fees or sales charges, which would lower performance. The 60/40 Allocation in this chart represents moderate risk level allocation, which includes allocations to equities, and fixed income. Risk levels are an indication of clients' appetite for risk. A moderate risk level - Seeks modest capital appreciation and, secondly, capital preservation. Asset Allocation seeks to represent the general asset allocation strategy, and the chart is for educational purposes designed to show the historical perspective of asset allocation rather than any particular strategy. *All performance information shown above is hypothetical not the actual performance of any client account. Hypothetical information reflects the application of a model methodology and selection of securities in hindsight. No hypothetical record can completely account for the impact of financial risk in actual trading. The returns shown above are for indexes and do not represent the result of actual trading of investable assets/securities. The asset classes used to populate the allocation model may underperform their respective indexes and lead to lower performance than the model anticipates. 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: S&P 500 Futures Net Long/Short as % of Open Interest

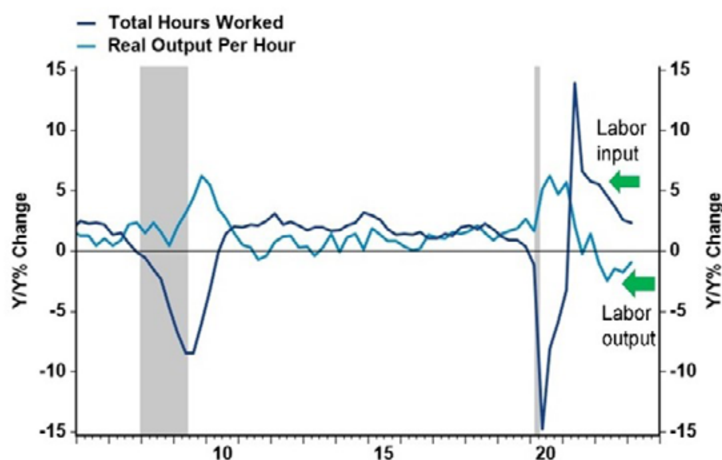
Source: Bloomberg as of June 26, 2023. All forecasts are expressions of opinion and are subject to change without notice and are not intended to be a guarantee of future events. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do 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 3: US High Yield Spread vs Share of US Banks Tightening Lending Standards for Commercial & Industrial Loans



Source: Haver Analytics as of June 26, 2023. 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 4: US Nonfarm Labor Input and Output Y/Y%



Source: Haver Analytics as of May 18, 2023. Note: gray areas are US recessions.

Figure 5: Nasdaq Composite vs Market Breadth

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Figure 6: Nasdaq vs SMID Valuations

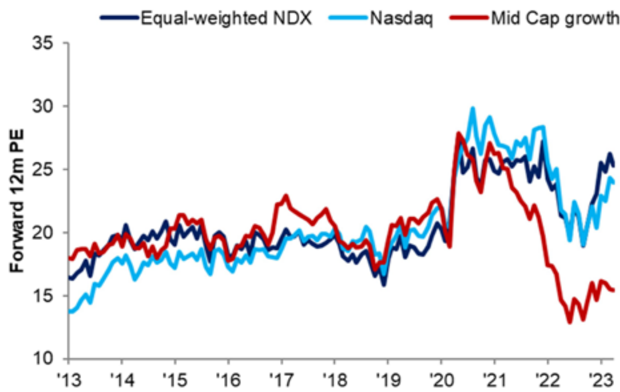

Figure 7: Dividend Aristocrats, Russell 2000, and Nasdaq Rebased (Jan 2018 = 100)

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Figure 8: US High Yield Spread vs SMID

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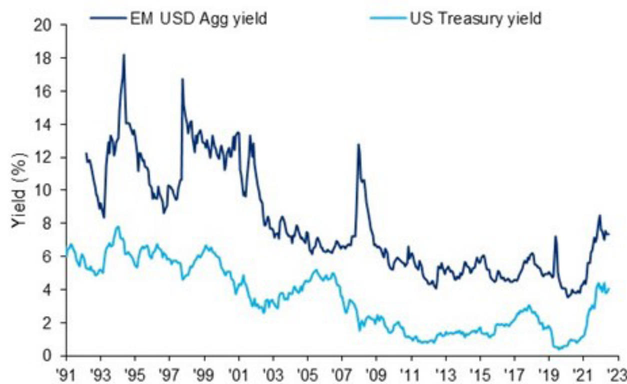
Figure 9: EM Hard Currency Yield vs US Treasury



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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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Mortgage-backed securities ("MBS"), which include collateralized mortgage obligations ("CMOs"), also referred to as real estate mortgage investment conduits ("REMICs"), may not be suitable for all investors. There is the possibility of early return of principal due to mortgage prepayments, which can reduce expected yield and result in reinvestment risk. Conversely, return of principal may be slower than initial prepayment speed assumptions, extending the average life of the security up to its listed maturity date (also referred to as extension risk).

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.

Alternative investments referenced in this report are speculative and entail significant risks that can include losses due to leveraging or other speculative investment practices, lack of liquidity, volatility of returns, restrictions on transferring interests in the fund, potential lack of diversification, absence of information regarding valuations and pricing, complex tax structures and delays in tax reporting, less regulation and higher fees than mutual funds and advisor risk.

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

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