June 11, 2023

CIO Strategy Bulletin

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Mid-Year Outlook 2023

Opportunities on the Horizon, Investing in a Slowing Economy

- A decade ago, we predicted that the US dollar would achieve greater value and that the US would attract more investment. That's exactly what happened. Now, we see the USD as having peaked. This turning point creates potential opportunities that are reflected in our updated Strategic Return Estimates (SRE) for non-US assets.
- There are potential opportunities to diversify bond portfolios, add to duration, diversify risk and earn potentially higher yields. Investors should consider transitioning away from non-core cash and short duration fixed income investments. Higher yields may be achieved by prioritizing the selection of quality investment grade corporate credits. After a substantial yield rise a compelling case for adding to emerging market debt (US dollar-denominated) is building.
- A highly concentrated US tech rally this year masks the value still embedded in global equities following the 2022 bear market. Economic and profit growth should bottom in the next few quarters, which may lead to opportunities to diversify portfolios. We believe that small and mid-sized firms in the US, and select emerging markets, are becoming undervalued.
- While dividend growers tend to lag in early cycle recoveries, we still believe this strategy has a permanent place in core portfolios given their track record of long-term outperformance.
- **Access our full Mid-Year Outlook 2023 here.**

Investing through a slowing economy

Last week, we released our Mid-Year Outlook for 2023. Since the start of the year, we've upgraded economic forecasts globally even in the face of an extended monetary policy tightening cycle, political discord and deceleration in the US economy. Compared to the start of the year, we see greater clarity on both valuation opportunities and specific headwinds.

This is a time when investors are looking for investment opportunities, but are tempted to stay in cash due to high short term yields. While headlines about US Treasury issuance, the impact of artificial intelligence, US-China tensions and the war in Ukraine dominate the news, we believe the landscape for investing is likely to evolve positively. Our view, reflected in our updated Strategic Return Estimates, is that investors who stay invested and rotate their portfolios toward timely opportunities may be well-rewarded over the next decade (**Figure 1**).

At the moment, investor sentiment appears poor, and that itself creates potential opportunities. Bearishness, as measured by short equity interest, is at multi-decade highs while the amount of money in money funds and Treasury Bills (T-bills) is at a record high. Rates for short-term cash are at the highest level since 2007.[1] All these factors suggest that investors are waiting for a decline in market indices before shifting assets into equities. This may be the most anticipated bear market ever. It is also an argument for why market timing will not work. If everyone is waiting, any decline may be brief and untradable.

Markets are up so far in 2023, which might seem surprising given all the bad economic news — from high interest rates to persistent inflation, some might think this is surprising. But we are not surprised. We continue to suggest to our clients to stay invested. Even so, markets are behaving in an unusual fashion. For example, since the beginning of 2023, more than 90% of US stock market appreciation can be attributed to just seven stocks.

Asset allocation clearly matters, as does diversification. For the better part of 16 months, we have maintained our positions in conservative, income-oriented equities as well as in quality fixed income, leaning toward US assets. During 2022, the most consistent dividend payers in the US — our largest style overweight[2] — lost 6.2% while the broad US equities lost 19.2%.[3]

Figure 1: Strategic Return Estimates (SRE) Return Expectations Are Higher for 2023

ASSET CLASS	2023 SRE	2022 SRE
Developed Market Equities	7.0%	3.8%
Emerging Market Equities	12.9%	8.1%
Investment Grade Fixed Income	4.6%	1.8%
High Yield Fixed Income	7.4%	2.6%
Emerging Market Fixed Income	7.8%	3.6%
Cash	3.4%	0.9%
Hedge Funds	9.1%	4.1%
Private Equity	17.6%	11.6%
Real Estate	10.6%	8.8%
Commodities	2.4%	1.5%

Chart shows Citi Global Wealth investments 10-year annualized nominal asset class return expectations, in US dollars. Source: Global Asset Allocation Team data as of October 31, 2022. Strategic Return Estimates (SRE) based on indices are Citi Global Wealth's forecast of returns over a 10-year time horizon for specific asset classes (to which the index belongs). Indices are used to proxy for each asset class. Cash refers to the US Cash SRE. The forecast for each specific asset class is made using a proprietary methodology that is appropriate for that asset class. Equity asset classes use a proprietary forecasting methodology based on the assumption that equity valuations revert to their long-term trend over time. The methodology is built around specific valuation measures that require several stages of calculation. Assumptions on the projected growth of earnings and dividends are additionally applied to calculate the SRE of the equity asset class. Hedge Fund and Private Equity SREs are linked to equity SREs. Fixed Income asset class forecasts use a proprietary forecasting methodology that is based

1 Haver Analytics as of June 1, 2023.

2 Adaptive Valuation Strategies (AVS) is the Citi Global Wealth Investment's proprietary strategic asset allocation methodology. It determines the suitable long–term mix of assets for each client's investment portfolio.
The AVS portfolio used in the analysis is the Global USD Traditional Only Risk Level 3 portfolio. Risk levels are an indication of clients' appetite for risk. An AVS L3 - Seeks modest capital appreciation and, secondly, capital preservation. The Level 3 Diversification does not guarantee a profit or ensure against a loss of principal.

3 Dividend growers proxied by S&P 500 Dividend Aristocrats total return index and broad US equities proxied by Russell 3000 total return index.

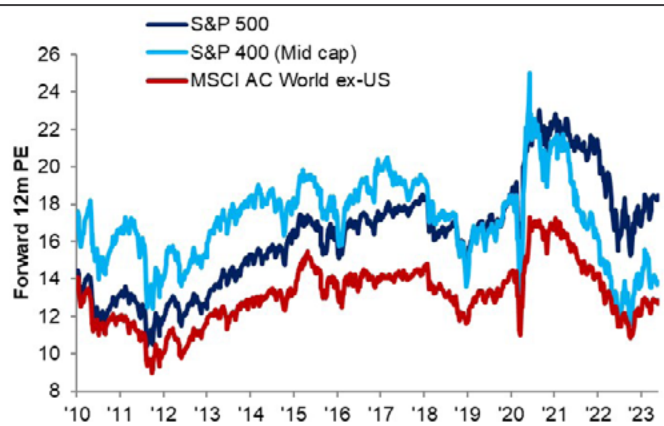
on current yield levels. Other asset classes use other specific forecasting methodologies. SREs are in US dollars. SREs are generally updated on an annual basis, however they may be updated off cycle based on market conditions or methodology adjustments. Strategic Return Estimates are no guarantee of future performance. SREs do not reflect the deduction of client fees and expenses. Future rates of return cannot be predicted with certainty. Investments that pay higher rates of return are often subject to higher risk and greater potential loss in an extreme scenario. The actual rate of return on investments can vary widely. This includes the potential loss of principal on your investment. It is not possible to invest directly in an index. All SRE 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.

Stay invested and be mindful of what and when to invest

As we describe in this 2023 Mid-Year Outlook, the economic policy “hangover” from the COVID-19 shock, government intervention and subsequent rate hikes still reverberate across the world economy (See Recession, recovery: A journey unfinished). As these issues resolve, we see significant, global investment opportunities unfolding. Value creation is, in fact, underway — this is one reason why our SREs are higher.

When we look at the value of small- and mid-cap stocks (SMID), international equities and emerging markets broadly, we see many assets around the world that have become unusually cheap on a relative basis (**Figure 2**). In our view, the landscape for investing suggests some major shifts in portfolios. We believe that active asset allocation may add value in the period just ahead. Here are some steps showcasing how these potential opportunities may evolve.

Figure 2: US Large- mid-caps and non-US equity forward PEs/year



Source: Bloomberg as of May 31, 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.

Less cash, more duration

With the positive resolution of the debt ceiling negotiations, we expect to see peak short-term interest rates. We anticipate that the US government will issue an unusually large amount of T-bills and bonds to refill its coffers. When that happens, this may crowd out deposits, drive up yields and increase the value of the US dollar.

Though investors will be tempted to concentrate assets in T-bills and money market funds, we think this will ultimately hurt their returns. A different strategy is to extend duration by allocating to intermediate duration corporate bonds, US municipal bonds and preferred equity securities. By doing so, investors can potentially retain higher yields for longer and may profit if and when interest rates fall, as they will likely do when the Federal Reserve reverses course and starts cutting rates.

Adding non-US debt exposure

The peaking US dollar, now near its highest level in 50 years, is likely to begin a gradual, uneven decline. This trajectory suggests that creditworthy, non-US sovereign debt could be a solid addition to fixed income holdings (See As US dollar dominance ends, currencies may drive returns). Not only may these securities offer higher yields, but the falling dollar may provide a higher total return to maturity.

Investing in non-US equities

Non-US equities present good value. Non-US shares are trading at historically wide valuation discounts to US shares (**Figure 3**). At the same time, the prospects for growth outside the US suggest that non-US earnings may grow substantially. We have already increased our weighting to Asian, European and Latin American equity markets, while reducing some of our defensive equity exposures that outperformed during 2022, like large cap pharmaceuticals. As the global recovery unfolds, we will likely look to boost non-US equities further across a range of industries, focusing on sectors and companies with the potential for sustainable revenue growth and profits.

Seeking value within US markets

Within US markets, we believe there are areas of relative value worth investing in as we enter and recover from a rolling recession. An important area of note are small- and mid-cap (SMID) stocks, which currently trade at a 30% valuation discount to US large caps for profitable firms.[4] SMID stocks generally perform best in the first year of a recovery when their earnings are expected to rebound.

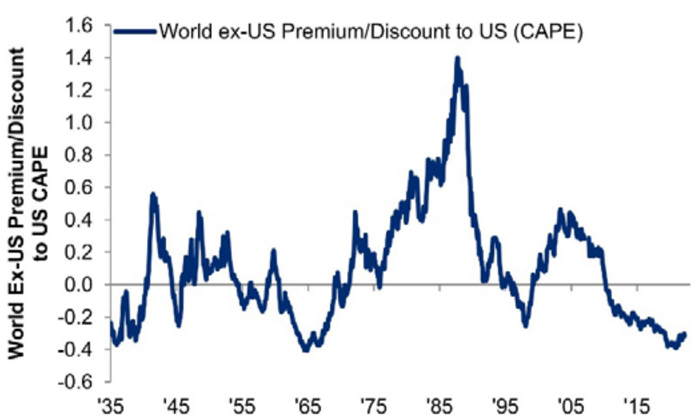
The S&P MidCap 400[5] and the S&P SmallCap 600[6] are two additional categories that may provide profit opportunity. Focusing on profitable small- and medium-sized companies is advisable when the Fed reduces rates to fight unemployment, as we believe it will soon.

Broadening our tech and growth equity exposures

Early in the pandemic, from 2020-2021, the valuations of large tech stocks surged. Then, in 2022, we saw a reversal. Valuations of growth shares dropped as the Fed increased the Fed Funds rate at an unprecedented pace. But as the yield curve inverted, investors have started to refocus their attention to technology companies with strong balance sheets and growth prospects.

Even though US industries have powerful and promising growth prospects, 2023's tech gains have been limited to a handful of companies. Large Cap US IT is up 37% year to-date.[7] Firms providing the infrastructure for a new form of artificial intelligence, known as generative AI (See Generative AI: The beginning of (another) technological revolution) are responsible for a lot of that gain. And while we will add further exposure to generative AI, many other future portfolio opportunities may lie in small- and medium-sized tech companies whose valuations do not yet reflect their future growth potential.

Figure 3: US vs non-US relative CAPE



Source: Factset as of April 21, 2023. Using MSCI World ex-US and MSCI US indices. 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 CAPE ratio is a valuation measure that uses real earnings per share (EPS) over a 10-year period to smooth out fluctuations in corporate profits that occur over different periods of a business cycle.

4 S&P 400 and S&P 600 vs S&P 500 on 2023 EPS estimates.
5 Also known as the S&P 400, the index tracks 400 mid-sized companies in the US equity market.
6 Tracks 600 small-sized companies in the US equity market that meet specific inclusion criteria.
7 S&P 500 Information Technology Index. 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.

Alternative investing and private credit

Finally, we see an opportunity within alternative investments for qualified investors. A shortage of capital now exists in private credit. Banks have pulled back their lending due to deposit woes and an overexposure to commercial real estate assets, like office space. The Fed is continuing quantitative tightening, while the Treasury is ramping up borrowing and investors are hoarding cash and short-term investments. For qualified investors, it may be possible to earn equity-like rates of return in selected debt securities.

Loans for private equity buy-outs, lending to later stage venture companies, mezzanine debt for real estate refinancings and other similar lending opportunities are yielding more than 10% per annum.[8] Unlike in 2008-09, we do not see a credit collapse on the horizon. Corporate balance sheets are in good shape with future credit problems likely to be concentrated in commercial real estate. Capital shortages do not occur frequently, so this is an area where qualified private investors may benefit for the next three to five years.

Watch for signals

The double-digit declines in both stocks and bonds in 2022 — the worst combined return for 60/40 portfolios since 1931[9] — reset valuations and the relative value of different portfolio investments. In anticipation of poor market conditions in 2022, we doubled up on defensive investments in 2021. Though we prefer the long-term return properties of dividend growth shares, we expect to return to a normal weighting. And while we currently enjoy a high yield on short-term high-grade bonds, we will rotate from them to intermediate US and Emerging Market credit to continue to seek income and potentially benefit if and when rates fall. We will move from defensive to overweight risk assets as a result of valuation improvements and market dislocations as they arise.

The US Treasury hit its debt ceiling at the start of 2023 and took emergency steps to limit debt issuance. Now, we expect $1.3 trillion in new borrowings, likely by the end of the third quarter of 2023. When the Treasury needs to raise a huge amount of capital and the Fed continues to tighten, we anticipate that fears about more Fed policy tightening lower prices of already attractive assets.

Looking ahead

One of the reasons we are seeking to diversify equity exposures from the S&P 500 is that large cap stocks have performed above expectations over the past two years yet actual S&P 500 earnings per share has declined in 2023. This means we see them as expensive on a relative basis. While they may rise in value in 2024, US large cap shares are less likely to lead the market higher.

To capture the potential of our updated Strategic Return Estimates, we will consider rotating toward different risk assets, geographies and strategies in the second half of 2023 and into 2024. We will diversify our equity selections and "go overweight" across equity strategies as potential opportunities become apparent.

We expect US bonds to act as a foundation for portfolios, seeking positive real yields and negative correlation to reduce portfolio volatility. Here we will seek diversification to non-US bonds and to longer dated securities, but as we expect rates to decline, we see a reallocation to equities as likely.

The risk of being early versus staying on the sidelines

When T-bill rates and cash balances are high, it is tempting to do nothing. In the near-term, that may seem safe, but looking out one year, we believe that those who do not own core portfolios may be less well-off. After the double market shocks of the pandemic and an overly reactive Fed, the next decade looks like one where returns may be above average. Those who stay in cash will not see returns when markets are recovering.

Market timing hurts portfolio returns. The worst and best days in a market often occur near one another, and you cannot afford to miss the big up days. What investors should focus on is the value of active asset allocation which is about choosing what to invest in and when.

Over the coming months, we strongly urge investors to reduce their exposure to cash as an asset class. Extending duration should be an investor's first step. While we may be early when buying certain equities or bonds, our goal is to capture the "total return" of an underperforming asset class. This requires foresight and a willingness to act.

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8 Private equity firms lend less as demand cools, March 3, 2023, by Chibuike Oguh, Reuters.

9 Source: Global Financial Data as of June 5, 2023.

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Bond rating equivalence
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 ratings 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 Ratings[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

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