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CIO Strategy Bulletin

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The Shape of the World Economy is Changing and So Are Our Portfolios

- We've made offsetting upward revisions to US growth forecasts for 2023 and downward revisions to China. This has led us to reallocate our Global Investment Committee (GIC) equity positions within global markets.
- As noted [last week](#), China's outlook appears increasingly dependent on a change of approach from China's policymakers. The US, meanwhile, is seeing a virtuous cycle of demand strength outlasting contractionary forces. (This can be seen in falling business inventories.)
- With Fed Chairman Powell hawkish and the US dollar rebounding, we have moved to add an Equal Weight S&P 500 Index position at the expense of China, Hong Kong and Brazil shares. This avoids adding much further to US large cap tech shares trading at 36X forward EPS estimates. In fact, the S&P Equal Weight Index is trading at the largest valuation gap to the market cap-weighted S&P since 2010.
- Nevertheless, we'd still expect a slowdown to come for the US, particularly for US labor markets in the coming year. Eventually, bearish bond investors will cover record high short positions in US Treasuries much as equities investors did in early 2023.

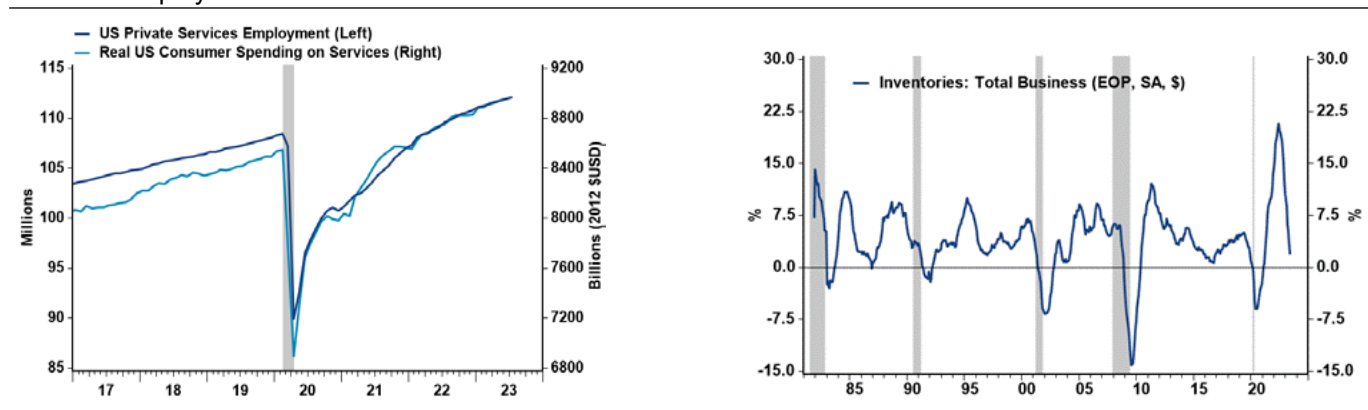
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The Shape of the World Economy is Changing and So Are Our Portfolios

As we wrote [last week](#), China's economy is suffering from several material headwinds and its economic growth is in jeopardy. The US, by comparison, is outperforming our expectations as confidence in a stronger recovery is rising. A large rise in services consumption is boosting employment at the same time manufacturing is contracting. This bodes well for the future. Goods producers and importers are reducing current inventories that will allow for a later rebound in production (**Figures 1-2**).

Figure 1: US Real Consumer Spending on Services vs Services Employment

Figure 2: US Business Inventories Year-over-Year%



Source: Haver analytics through August 25, 2023. Shaded areas are recessions.

As a result of this change of circumstance, we have modified our economic forecasts¹. We've raised our 2023 US real GDP forecast by +1.3% and cut China's estimate the same amount (**Figure 3**). This is a substantial change in fortune for the world's leading economies. Our forecasts for China and the US in 2024 also reflect notable updates. Among these are a recognition that slowing growth in China has knock-on impacts for certain regional economies and Europe. We are mindful that the impact of tighter monetary policy in the US will increase in 2024. Higher rates must impact employment growth negatively even as services and manufacturing settle into more normal ranges. Moreover, Fed Chairman Powell's speech at Jackson Hole, Wyoming (August 2023) continued to emphasize the need for cooling labor markets almost regardless of their direct impact on inflation measures.

Figure 3: Citi Global Wealth Investments Real GDP Forecasts

	2020	2021	2022	2023	First Change from Previous ¹	2024 (Estimated)	Revised Change from Previous
China	2.2	8.5	3.0	4.5	-1.3	3.0	-1.5
US	-2.8	6.0	2.1	2.3	1.3	1.8	1.8
EU	-6.2	5.4	3.4	0.7	0.1	0.6	-0.5
UK	-11.0	7.6	4.1	0.5	0.2	0.8	-0.3
Global	-3.2	5.9	3.3	2.4	-0.1	2.0	-0.4

Source: CGWI and Haver Analytics as of August 22, 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.

A recovery in China cannot be ruled out, of course. Should policy makers provide substantial assistance to the real estate sector, implement incentives to boost domestic consumption and encourage more investment in productive assets, China has the wherewithal to return to a higher rate of growth. In addition, more consistent policies regarding the governance of their technology and other "socially impactful" companies are necessary to restore investor confidence.

For the moment, the collective challenges are substantial, as reflected in our revised economic forecasts. A lack of policy action in China during a period of slow inflation and high unemployment risks a self-reinforcing deflation. Under the current circumstances, a Chinese export price plunge would likely reduce global goods prices, reestablishing the prior two decades of tradeable goods deflation that many believed was a thing of the past. This potential disinflationary impact adds a catalyst to our view that year end inflation in the US will be 2.5% or less by the end of 2024.

¹ Previous economic forecast shared in the May 18, 2023 [Quadrant](#)

Powell Speaks: 2% Personal Consumption Expenditures Inflation or Bust

As we described in [our bulletin two weeks ago](#), Fed Chairman Powell's tone regarding monetary policy and inflation in the coming year changed markedly between the last two FOMC meetings. Perhaps for this reason – and the strength of recent US demand data – he chose to emphasize the near-term task still at hand. “Although inflation has moved down from its peak—a welcome development—it remains too high. We are prepared to raise rates further if appropriate and intend to hold policy at a restrictive level until we are confident that inflation is moving sustainably down toward our objective.”²

Much in agreement with our view, Powell noted that the rise in inflation over the past two years came from a “collision” of pandemic-constrained supply and temporary stimulus (see our latest [Data Watch](#) for more). However, the need for slower demand growth in the US was paramount. “We will proceed carefully as we decide whether to tighten further or, instead, to hold the policy rate constant and await further data...We will keep at it until the job is done.” Digesting this modestly hawkish tone – and world-beating economic surprises - the US dollar continues its recent rebound.

Our GIC Portfolio Adaptation

Reflecting our forecast updates, our Global Investment Committee (GIC) shifted its equity² allocations from specific non-US markets to the US (please see [Quadrant](#) for full details). Our weighting in China equities moved to neutral and we eliminated over-weights in Hong Kong, Australia and Brazil, some of the most directly impacted markets (**Figure 4**).

Figure 4: Global Investment Committee current tactical asset allocation

LARGEST OVERWEIGHTS		Previous	LARGEST OVERWEIGHTS		Current
+2.0%	Asia equities	↓	+2.5%	Equal-weighted S&P 500	↑
+1.0%	Brazil equities	↓	+1.0%	Cybersecurity (US Large Cap)	
+1.0%	Cybersecurity (US Large Cap)		+0.5%	India, Korea, Taiwan (non-China EM)	
Neutral	Total equities		Neutral	Total equities	
+7.0%	All Short-, Intermediate-term US IG bonds		+7.0%	All Short-, Intermediate-term US IG bonds	
(+5.5%	US Treasuries)		(+5.5%	US Treasuries)	
+2.0%	Investment Grade Preferred Stock		+2.0%	Investment Grade Preferred Stock	
+1.2%	Global EM Debt		+1.2%	Global EM Debt	
LARGEST UNDERWEIGHTS		Previous	LARGEST UNDERWEIGHTS		Current
-10.3%	European, Japan bonds		-10.3%	European, Japan bonds	
-2.5%	Non-US DM SMID		-2.5%	Non-US DM SMID	
-1.5%	US Large Cap		-1.0%	Cash	
-1.0%	Cash				
Neutral	Total fixed income and cash		Neutral	Total fixed income and cash	

Source: Global Investment Committee as of August 23, 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

Simultaneously, we raised our allocation to US equities by an equal 2.5 percentage points. This leaves our allocation to Global Fixed Income overweight by 1 percentage point (highly concentrated in high quality US bonds), Global equities neutral and Cash underweight by 1 percentage point.

The implementation of our changes will not be in the typical fashion. We have elected to add an “Equally-Weighted” S&P 500 position reflecting our view that valuations matter more given the market action of 2023. We are avoiding adding additional concentration to the US Mega Cap shares that have led the rally. Just 10 companies now comprise a record 31% of S&P 500

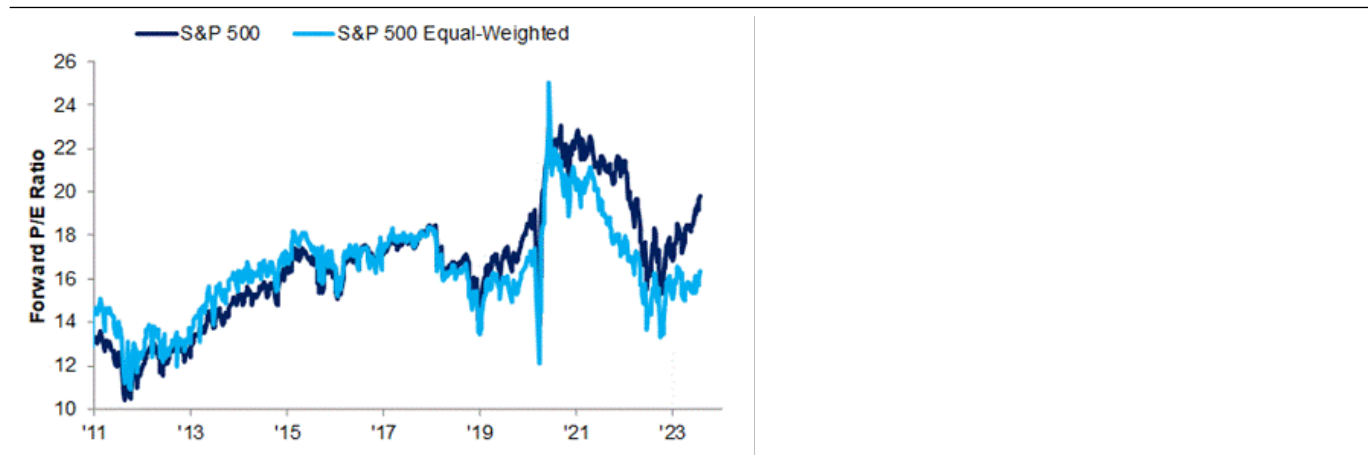
² Inflation: Progress and the Path Ahead” August 25, 2023, Federal Reserve Chair Jerome H. Powell

Index. While the so-called “Magnificent 7” have surged to a forward valuation of 36X, the Equal-Weighted S&P Index trades at 17X, a 16% valuation discount to the market cap-weighted Index, and the largest gap since 2010 (**Figure 5**).

While seeing near-term risks, we remain committed to equities with a 12–18-month outlook. We expect a broadening performance in global equities over time, even though our expectation of the benefits of a falling US dollar have been delayed. Economic and financial developments in China suggest US dollar strength and US asset outperformance at the present time. Persistent employment gains and declining inflation are keeping the US consumer spending pace solid even as manufacturing and housing contract. In contrast, China’s outlook is highly dependent on official steps to contain spillovers from property-sector financial troubles.

While bond prices have fallen recently, we continue to overweight US investment grade bonds, particularly Treasuries with increasingly attractive future real yields. Higher US yields reflect the view that US monetary policy can remain sustainably tight. This is not our view for 2024, as we see softening employment, a slower US economy and exported deflation from China as likely to reduce pressure on yields in 2024.

Figure 5: S&P 500 (market cap-weighted) vs Equal-Weighted S&P 500 valuation



Source: Bloomberg as of August 15, 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.

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Bond Position for Counter-Trend Investors

The GIC considered adding further to our Fixed Income allocations, particularly in the US. One of the reasons this can be appealing was the historically extreme negative positioning of markets. Just as short interest in equities at the start of 2023 was at a record high, so now is short interest in both US Treasury 10-year notes and 2-year notes (**Figures 6-7**). We believe that this positioning is indicative of fear that Powell will continue to raise rates and a secondary view that inflation will rise again. Following a strong performance of equities in the first half of 2023 – driven by covering of record high short positions - we may see a rally in fixed income next. This could be driven by any signs that the US is not sustaining miraculously strong growth.

Figure 6: Net Short Futures Positions: US Treasury 10-Year Notes (share of open interest)



Figure 7: Net Short Futures Positions US Treasury 2-Year Notes (share of open interest)



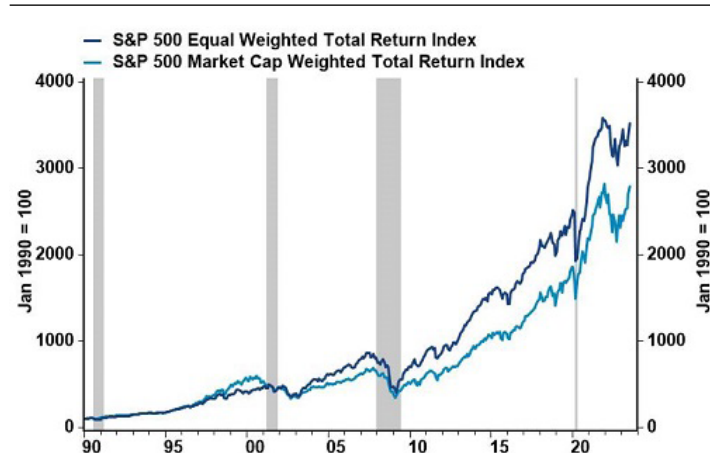
Source: Haver analytics through August 23, 2023. Past performance is not indicative of future results. Real results may vary.

Why Use an Equally Weighted Index?

Tactical changes in asset allocation come in two parts. The first is the strategic sizing (or normal/average) positions. For qualified investors, our Level 3 strategic weights are 59.9% in equities, 38.1% in bonds and 2% cash (assuming no alternatives) and 32% in equities, 40% in bonds and 15% in illiquid assets such as Private Equity and Real Estate. The second is in what we choose to tactically invest above or below these benchmarks. The decision to choose an equally weighted US S&P Index reflects several factors.

An equally weighted Index is a bit more active than a passive Index selling winners and allocating more to “losers”. Therefore, it is a mean-reverting, contrarian strategy. It is intrinsically diversifying. Nonetheless, it is not boring. There is meaningful research to suggest that such equally-weighted strategies have the potential to, for substantial periods, outperform market-weighted indices (**Figure 8**).

Figure 8: S&P 500 Equal Weight vs Market Cap Weight



Source: Haver analytics through August 24, 2023. Shaded 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.

As noted, the Equal-Weight S&P 500 Index trades at a 16% valuation discount to the market cap-weighted Index, the largest gap since 2010). We don’t seek to actively underweight the “Magnificent 7”. But we would also not overweight them (**Figure 9-10**).

While the US might suffer from overconfidence with its strong market and economic outperformance this year, this is not true for the majority of even large cap US shares. The Equal-Weight S&P 500 Index as posted a mere 3.6% gain this year, and we continue to see a likely broadening in global equity performance in the year to come, once investors look beyond the near-term challenges we've highlighted.

Figure 9: Forward P/E of S&P 500 market cap-weighted vs Equal-Weighted

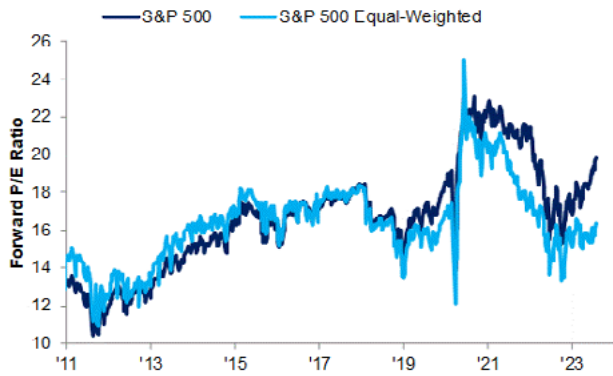
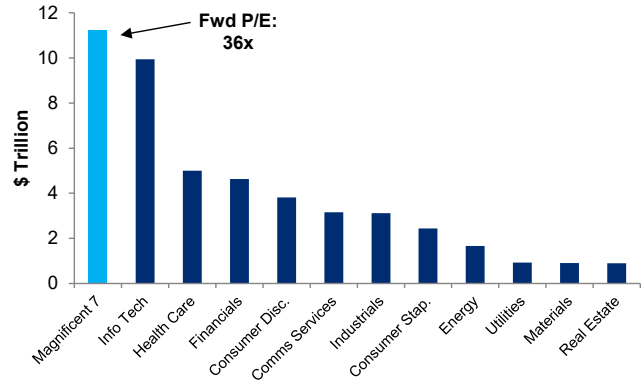


Figure 10: Seven large US tech-related shares are larger than all other S&P 500 sectors



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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

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.

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