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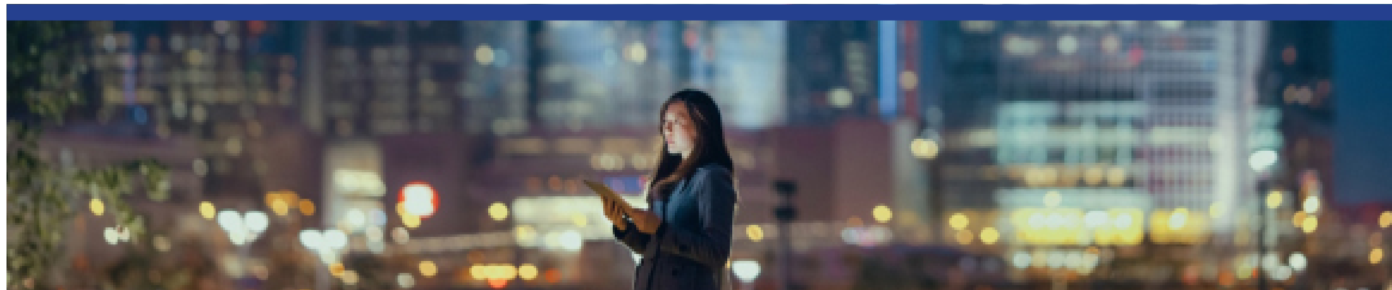

April 30, 2023

CIO Strategy Bulletin

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What Happens After the Fed Reaches Peak Rates?

SUMMARY

- Markets expect the Fed to raise short-term interest rates for a last time next week to the 5%-5.25% range and continue Quantitative Tightening. The Fed is acting even as the US banking system remains under pressure. The Fed's tightening only increases the probability it will reverse course more forcefully in the future, in our view.
- As the Fed proceeds, it will be doing so even as the Index of Leading Economic Indicators has dropped by 8% over the past year. The central bank will be tightening even as US money supply contracts meaningfully for the first time since the late 1940s.
- While a mild recession for the US is our base case, some unpredictable, negative tail risks are at play, including Congressional negotiations over the US debt ceiling. We think direct hedging of portfolio risks may be appropriate for suitable investors concerned with near-term performance risks. This is particularly the case now that many defensive investments have arguably become "crowded trades."
- A strong decade of US dollar outperformance in currency markets is ending. This possibly suggests stronger returns for portfolios via global portfolio diversification. While we don't expect this will necessarily help portfolios in the few key months ahead, we see a potential chance it will support investor returns measured in USD over coming years. We don't believe US equities will remain above a 60% share of global market capitalization, nor do we think non-US shares will perpetually trade at a 40% valuation discount to the US.
- Our Global Investment Committee took a second more sizable step to reallocate away from US dollar assets to improve long-run returns. While we held overall equities at a slight underweight, we shifted 3% of portfolios to non-US equities in Asia, Europe and Latin America. (See our Asset Allocation table below.)

What Happens After the Fed Reaches Peak Rates?

The end of the US rate hiking cycle appears imminent. At its early May meeting, the Fed is expected to raise rates by 25 basis points even as the Index of Leading Economic Indicators has fallen nearly 8% over the past 12 months (**Figure 1**). The US central bank is continuing to tighten even as the US broad money supply is contracting for the first time since the late 1940s. In short, the Fed is determined to blunt the post-Covid recovery and secure a period of disinflation ahead.

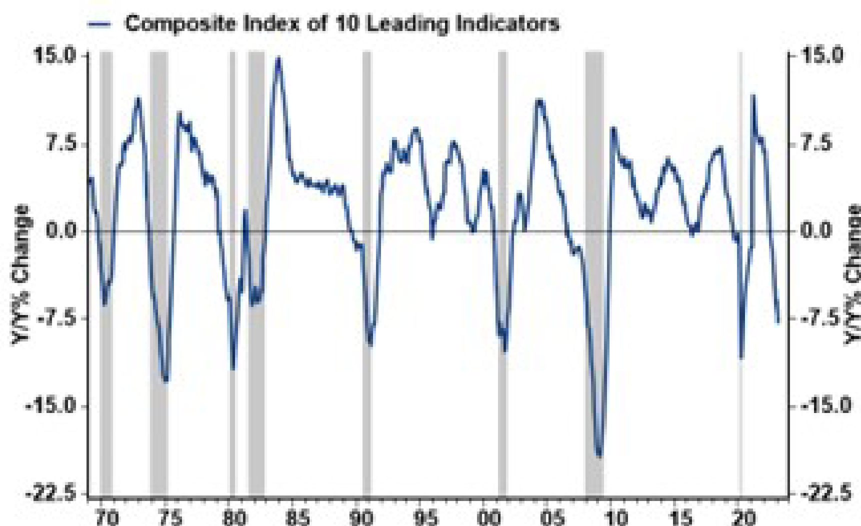
With the release of bank earnings this week and the possible rescue of a fourth US bank this weekend, the likelihood that banks will lend less and raise costs for borrowers has risen materially. Many depositors are thinking more deeply about T-Bills and money market funds due to the uncertainties around bank balance sheets. Over the coming weeks, the Fed's senior loan officer survey for the second quarter will illuminate any further restraint banks are placing on lending looking forward. Remember that data for the past three quarters already suggested a contraction prior to the Silicon Valley Bank surprise.

The US Congress has legislated debt ceiling increases to ratify its spending and borrowing roughly annually for more than a century now. Will partisan conflict in the coming two months lead to unusually severe brinksmanship and severe emergency spending cuts (in order to avoid a US debt default)? In light of the consequences, the history of past action is favorable. Yet no one can make any promises. As such, we think direct hedging of portfolio risks may be appropriate for suitable investors concerned with near-term risks. This is particularly the case now that many defensive investments have arguably become "crowded trades" as we discuss below.

Ironically, US equities are priced as though a near-term recovery is already here (**Figure 2**) even as various impacts of policy tightening are still rippling through the economy.

US corporate profits have been falling mildly since the second quarter 2022 (**Figure 3**). We expect more aggregate profit declines in the near-term – in contrast to industry analysts who collectively see a new record high in corporate profits by end 2023. As such, we have maintained our "quality income vigil" in our global asset allocation. This means overweights to the highest quality bonds seeking to take advantage of the Fed's rate hikes. For equities, we continue to overweight the most consistent dividend growers and underweight small and midcap shares that have far more cyclical profits than large caps (**Figure 4**).

Figure 1: US Index of Leading Economic Indicators vs Periods of Recession



Source: Haver Analytics as of April 25, 2023. Grey areas note recession. The indexes 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.

Figure 2: S&P 500 (Leading 6 Months) vs EPS Y/Y%

Source: Haver Analytics as of Jan. 18, 2023. The indexes 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.

Figure 3: S&P 500 EPS: Analyst Estimates vs Citi Global Wealth Investments Estimates Y/Y%

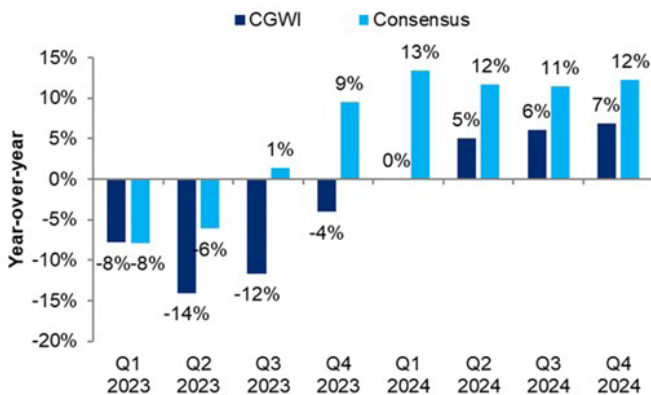
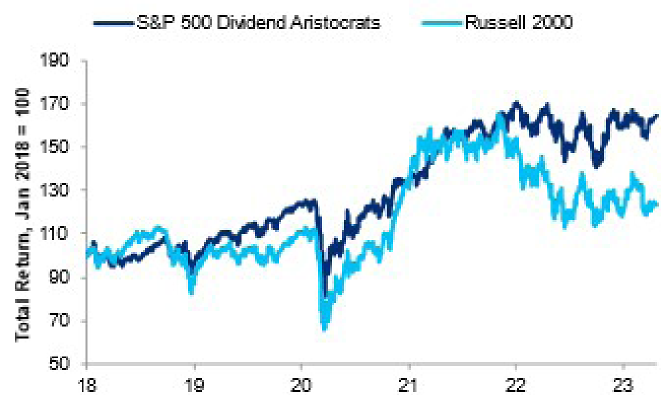


Figure 4: S&P 500 Dividend Aristocrats vs Russell 2000 Small/Mid Cap Shares



Source: CGWI, Factset and Haver Analytics as of April 25, 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.

Dollar Dominance Comes to an End

Why should investors reallocate to non-US currencies now? The US dollar has had three secular bull markets over the past 50 years and is likely beginning a third secular bear market. The exact timing isn't critical in our view. In fact, hawkish language from Fed Chairman Powell this week could temporarily lift the US dollar. However, if the Fed maintains its hawkish strategy, it only increases the probability it will reverse course more forcefully in the future. The US has the most cyclical labor market of major developed market economies. For this and other reasons, the Fed makes the most extreme monetary policy adjustments among developed market central banks.

The Backdrop of the Dollar Drop

In 2022, the Fed's unusually abrupt tightening cycle and the Russian energy shock sank many currencies to record lows against the US dollar. But looking more broadly, the US exchange rate had already enjoyed more than a decade of net gains previously. Powered by the US dollar rally, US equities rose to as high as 62% of global market cap last year on an unusually high relative valuation (**Figure 5**). Though we identified some exceptional technological opportunities in our latest CIO Bulletin, "exceptionalism" is already priced into the US exchange rate.

A Return to Global Diversification

The strong decade of outperformance behind us now suggests a return to value for global diversification (**Figure 6**). We don't know if this greater diversification will help portfolios in the few key months ahead. Yet with today's much lower valuations for non-US shares, some positive growth developments away from the US, and a pending turn in an aggressive Fed tightening cycle, we see a chance it will potentially support investor returns measured in USD over the coming year. In fact, positive currency-linked returns from global diversification may likely persist much longer.

Where Foreign Currencies May Rise

We believe the ECB and other central banks will likely withhold from rate cuts deep into 2024 while the Fed eases. After more than a decade of US dollar appreciation and the extreme USD spike of 2022, this should contribute to ongoing US exchange rate weakening. We would also expect some emerging markets, including China and Brazil, to ease monetary policy. Given the backdrop of US rate cuts in the coming year, this should have positive consequences for local markets. (See the changes we've made in our asset allocation table below and the April Quadrant.)

For Europe, the recent key pain point was the surge in natural gas import costs last autumn as Russian supplies were cut off. This generated a terms of trade shock and a brief economic contraction. While Europe will not become a growth paradise, we expect upward revisions to consensus views of European growth in the coming year just as we do for China. The US is unlikely to benefit much from these modestly positive external developments until US labor markets weaken and the Fed eases.

Figure 5: US Share of Global Equity Market Cap and Real Trade-Weighted Dollar Index

Figure 6: US Real Trade Weighted Dollar Index and Real US Equity Returns by Decade

Decade ending in December	Annualized Real Total Return S&P 500 (%)	Change in Real Broad Trade Weighted Dollar Index (%)
1970s	0.4	-22.3
1980s	13.8	-2.6
1990s	28.4	21.4
2000s	-0.9	-21.0
2010s	11.9	16.0

Source: Haver Analytics and Bloomberg as of April 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. The indexes 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.

Looking Toward the Future: Initial Positioning for 2024

We are also looking toward the future. Although we believe the bear market isn't over yet, there are potential opportunities to shift portfolios to take advantage of longer-term value. Investors shifted toward defensive sector and asset class positions already over the past year. This leaves less opportunity for core defensive strategies to outperform.

Corporate profit estimates are at risk to some degree everywhere. Yet it makes more sense to face these risks at a 12.9x estimated profits outside the US vs 19.3x for US shares (). US markets have sharply outperformed both during and post-Covid, raising performance risk over the coming year.

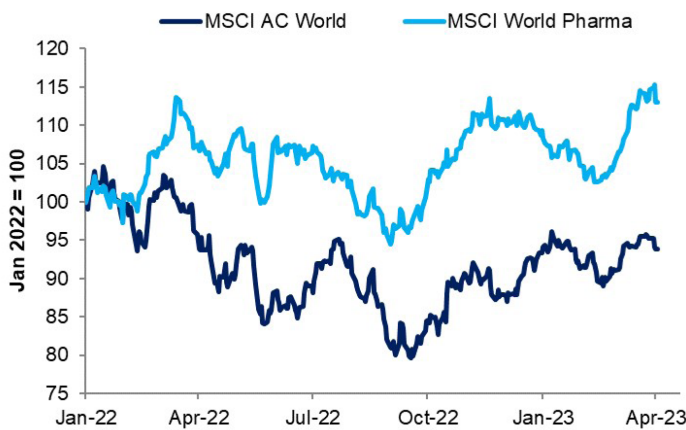
In the year to date, our overweight position in large cap US equities has outperformed an underweight in small caps by roughly 700 basis points. We're not yet ready to give up this component of our defensive position because small and midcap shares tend to be strong outperformers only once a decisive recovery cycle has begun. If there's a midyear correction in global equities, it might be reasonable timing to raise our holdings.

At our Global Investment Committee meeting last week, we reduced our position in global pharmaceuticals to neutral. Since we added our thematic pharma position in January 2022, global drugmakers have returned 14% vs -5% for global equities, or a 19-percentage-point outperformance (**Figure 8**). Broader healthcare is our favorite sector for long-term outperformance, though this doesn't mean crowded long positions in pharmaceuticals will always generate greater portfolio value than other opportunities.

Figure 7: Non-US Equities P/E Discount to US

Source: Factset as of April 25, 2023. The indexes 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.

Figure 8: Global equities vs global pharmaceutical shares performance since January 2022



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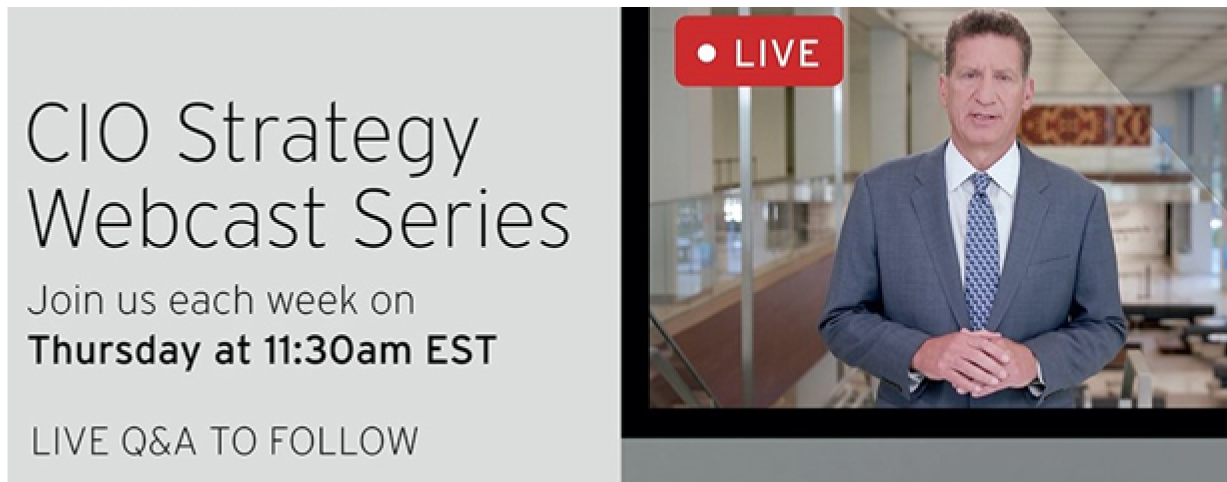
CGWI Global Investment Committee Asset Allocation Table

LARGEST OVERWEIGHTS	Previous	LARGEST OVERWEIGHTS	Current
+2.0% Global pharmaceuticals		+2.5% China, other Asia equities	↑
+2.0% China equities		+1.0% Brazil equities	↑
+1.0% Cybersecurity		+1.0% Cybersecurity	
-1.0% Total equities and REITS		**-1.0% Total equities and REITS**	
+8.5% US Treasuries		+8.5% US Treasuries	
+10.0% All Short-, Intermediate-term US IG bonds		+10.0% All Short-, Intermediate-term US IG bonds	
+2.0% Investment Grade Preferred Stock		+2.0% Investment Grade Preferred Stock	

10.7% of total allocation in US/non-US dividend growth, 4% overweight

LARGEST UNDERWEIGHTS	Previous	LARGEST UNDERWEIGHTS	Current
-10.3% European, Japan bonds		-10.3% European, Japan bonds	
-1.1% European, Japan Large Cap Equities		-5.0% Global SMID	
-5.0% Global SMID		-1.0% Cash	
-1.0% Cash			
+2% Total fixed income and cash		**+2% Total fixed income and cash**	

Source: CGWI Global Investment Committee as of April 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. Past performance is not indicative of future returns. For illustrative purposes only. Diversification does not guarantee a profit or protect against loss. Different asset classes present different risks. Asset allocation does not assure a profit or protect against a loss in declining financial markets.



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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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