Citi Global Wealth
Investments

CIO Strategy Bulletin

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David Bailin
Chief Investment Officer, Citi Global Wealth

Steven Wieting
Chief Investment Strategist and Chief Economist

Malcolm Spittler
Global Strategy and Senior US Economist

Maya Issa
Senior Investment Strategist

Joseph Kaplan
Senior Fixed Income Investment Strategist

Worries, Realities and the Red Sea

- Since peaking over 5% in late October, 10yr US Treasury (UST) yields have fallen on lower inflation readings and a less hawkish Fed.
- After the New Year, bullish economic data and a realization that a March rate cut was uncertain initiated market reversals. The S&P 500 fell roughly 2.5% the first week of 2024 while bond yields climbed higher as the 10yr UST traded back above 4%.
- The narrow pass at Bab-el-Mandeb in the Red Sea is now blocked as violence has erupted in the region. Houthi rebels in Yemen have attacked maritime vessels passing close to shore. In response, the Combined Maritime Forces (led by the US and UK) have undertaken air and missile strikes in Yemen.
- As a result, the number of vessels transiting the strait has plummeted by more than 50%. The owners of more than 2,300 merchant vessels restricted travel and insurers boosted rates 10-fold or stopped writing policies altogether.
- The initial market response to the October 7th Hamas attack was a large increase in both Baltic dry and wet shipping costs. Subsequently, the dry container shipping prices rapidly normalized, while the dirty wet shipping of crude oil have continued to rise. At the same time, the price of Brent crude oil has actually fallen since the later Red Sea conflicts erupted.
- Despite the importance to global trade of the Red Sea, we expect the final impact on consumers and markets around the world to be modest, in the aggregate. As we have written before, most geopolitical crises do not have durable market impacts including, for now, the war in the Middle East.
- The combination of both strong economic data (higher long-dated yields) and Fed easing (lower short-rates) has driven a bull steepening of the US Treasury curve that has been inverted since mid-2022. In fact, US 2s10s curve traded this week at the "least inverted" it has been for the entire cycle. This is a very welcoming sign and is consistent with the guidance in our 2024 Wealth Outlook regarding moving out of money markets and into the intermediate part of the yield curve[1].
- Citi Wealth's Global Investment Committee (GIC) holds a 12% allocation to both intermediate corporates and securitized credit. These ~4-year duration assets are yielding about 5-6% on average.

[1] Please see our 2024 Wealth Outlook article: Peak rates equals peak income: extend duration where we explain our views on the benefits of intermediate bonds.

Bonds Reprice as Equities Shake Off Geopolitical Risks

Since peaking at over 5% in late October 2023, 10yr US Treasury (UST) yields have fallen on lower inflation readings and a less hawkish Fed. Indeed, after Chair Powell indicated a desire to begin cutting rates in 2024, US rates fell even further. The 10yr UST dipped to 3.80% as investors began to price in 150bps of Fed Funds rate cuts for 2024.

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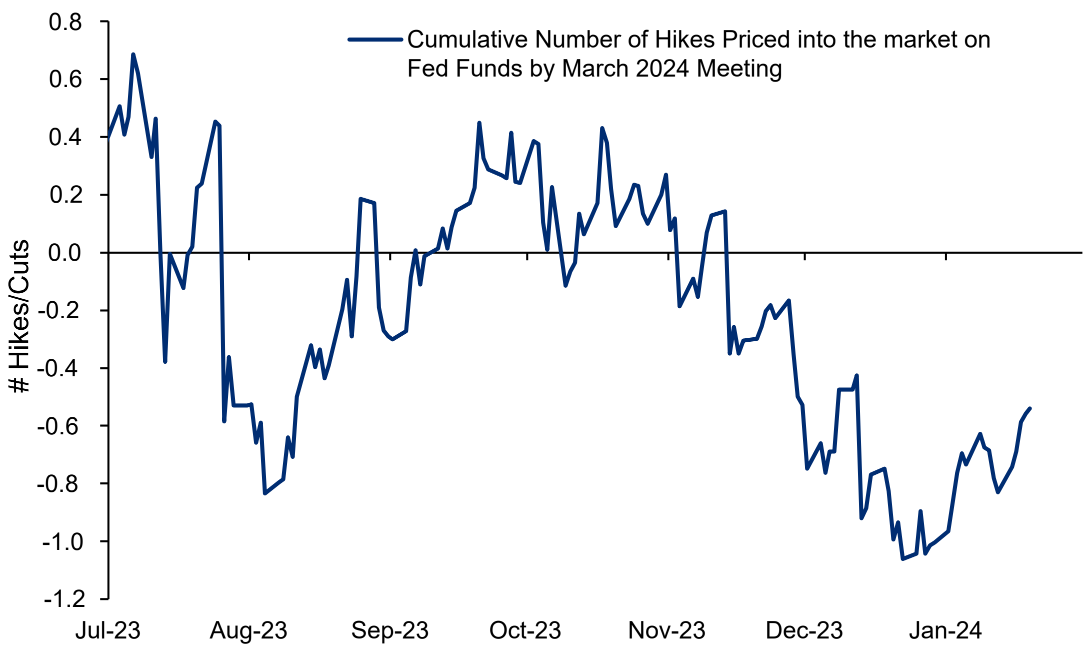
News from the Iowa caucuses, increasing tensions in the Middle East, passage of a continuing budget resolution and more sobering economic news from China failed to stall momentum in equities this week. The “Artificial Intelligence” story buoyed tech shares and UST bond yields continued to rise after some push-back from Fed officials on the timing of when the first-rate cut will be. Investors repriced a March cut to 50%/50% from a near 100% expectation coming into the year (**FIGURE 1**).

FIGURE 1: Implied number of rate hikes on Fed Funds by the March 2024 meeting



Source: Bloomberg as of January 19, 2024.

An Artery of Global Trade is Blocked

The World Economic Forum estimates that 90% of all international trade is transported by the sea[2]. And the Red Sea stands as a crucial artery, connecting the Mediterranean and the Indian Ocean. According to the Suez Canal Association, approximately 12% of global trade traverses through the Red Sea. Off the coast of Yemen, the Red Sea narrows to a choke point, just 14 miles wide at Bab-el-Mandeb (illustrated in **FIGURE 2**).

In an age of Artificial Intelligence, one rarely considers the size and frequency of passage by the enormous ships traversing Canals dug in the middle of the 19th century. But the share of global trade that is carried by ship is continuing to increase, not decrease, over time.

[2] See World Economic Forum in collaboration with Boston Consulting Group white paper: What Ocean Sustainability Means for Business, November 2022

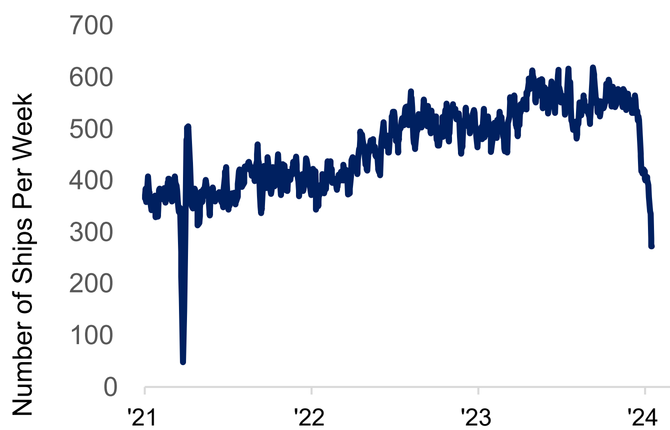
The narrow pass at Bab-el-Mandeb in the Red Sea is now blocked as violence has erupted in the region. Houthi rebels in Yemen have attacked maritime vessels passing close to shore. In response, the Combined Maritime Forces (led by the US and UK) have undertaken air and missile strikes in Yemen.

As a result, the number of vessels transiting the strait has plummeted by more than 50% (**FIGURE 3).** The owners of more than 2,300 merchant vessels restricted travel and insurers boosted rates 10-fold or stopped writing policies altogether.

FIGURE 2: Bab-el-Mandeb the "Gate of Grief"

Source: Mapchart.net as of January 19, 2024.

FIGURE 3: Shipments through the Suez Canal Have plummeted



Source: Haver Analytics as of January 17, 2024.

Flexible Supply Chains Mitigate Inflationary Pressures

For those shippers that wish to avoid the Red Sea, there are two options: either wait and hope the situation improves or undertake the long trip around the Cape of Good Hope. The latter option doubles the shipping length and time.

The initial market response to the October 7th Hamas attack was a large increase in both Baltic dry and wet shipping costs. Subsequently, the dry container shipping prices rapidly normalized, while the dirty wet shipping of crude oil have continued to rise. At the same time, the price of Brent crude oil has actually fallen since the later Red Sea conflicts erupted.

The tight trade relationships between Asia and Europe will face greater shipping costs from the longer container routes, putting greater pressure on export-heavy countries. And while the US receives the bulk of its trade goods from Asia across the Pacific, as much as 30% of shipping to the US east coast does pass normally through the Suez Canal.

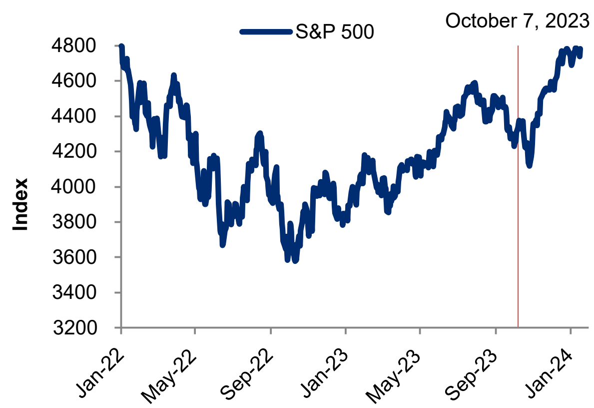
A recent IMF paper presented to the World Bank has estimated the impacts of increases in shipping costs on inflation in different regions of the world[3]. The authors reported that a one standard deviation increase in shipping costs boosted inflation globally by about 0.1 percentage points, but that the variation between nations was extreme, with poorer countries and island nations experiencing much larger impacts.

As we have written before, most geopolitical crises do not have durable market impacts including, for now, the October 7th attack in Israel and the war that has followed. **FIGURE 4** shows the brief dip, and rapid rebound for the S&P 500 from the current outbreak of violence and **FIGURE 5** shows how, for major conflict touchpoints for the past 80 years, there is only a short-run market impact that fades quickly as economic realities and "business as usual" elsewhere dominate headlines.

[3] See Shipping Costs and Inflation IMF Working Paper Asia & Pacific Department by Yan Carrière-Swallow, Pragyan Deb, Davide Furceri, Daniel Jiménez, and Jonathan Ostry, March 2022.

Despite the importance to global trade of the Red Sea, we expect the final impact on consumers and markets around the world to be modest, in the aggregate. As we have written before, most geopolitical crises do not have durable market impacts including, for now, the war in the Middle East.

FIGURE 4: Brief dip, and rapid rebound for the S&P 500



Source: Haver Analytics as of January 17, 2024.

FIGURE 5: Geopolitical crises do not typically have enduring market impacts

S&P 500	Initial impact (%)	30 days %	90 days %
Average all events	-4.8	-0.8	1.9
Average ex WW2	-4.7	-0.6	2.6
Average ex WW2 and oil embargo	-4.1	-0.2	3.5

Source: Haver Analytics, Bloomberg data sourced as of November 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.**

FIGURE 5 (detail): Geopolitical crises do not typically have enduring market impacts

(% since event date)		S&P 500			Nikkei			MSCI World ex USA			DXY Dollar Index		
Event	Date	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

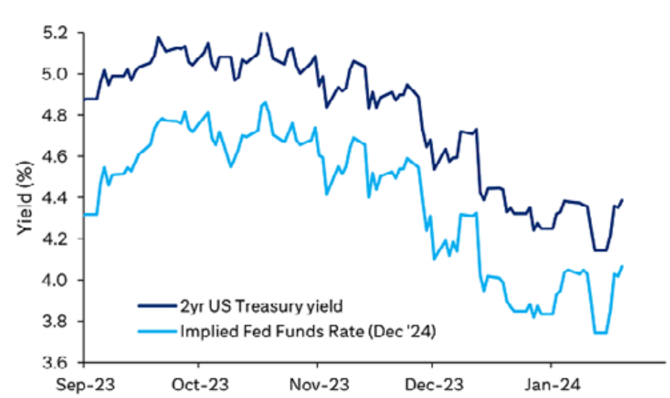
(% since event date)		S&P 500			Nikkei			MSCI World ex USA			DXY Dollar Index		
Event	Date	Initial reaction	30 days	90 days	Initial reaction	30 days	90 days	Initial reaction	30 days	90 days	Initial reaction	30 days	90 days
North Korea Related													
Korean War	6/23 1950	-12.80	-8.67	1.20									
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: Haver Analytics, Bloomberg as of November 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.

Keep an Eye on the Bond Market

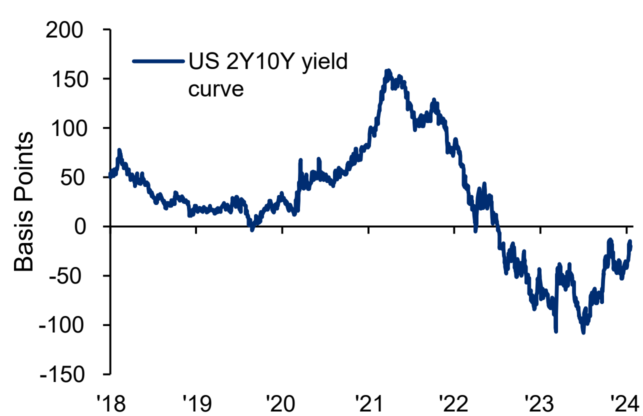
Despite some cuts being taken out of the market for March, investors still price in roughly 5-6 more rate cuts by the end of this year. This would bring the Fed Funds rate to roughly 4% down from 5.5% (**FIGURE 6).** Meanwhile, strong US Retail Sales and Consumer Sentiment readings out this week helped to drive the long-end of the US Treasury curve higher on still strong growth prospects.

FIGURE 6: 2yr UST and Dec 2024 Fed Fund rates



Source: Bloomberg as of January 19, 2024.

FIGURE 7: 2yr and 10 Yr UST yield curve



Source: Bloomberg as of January 19, 2024.

The combination of both strong economic data (higher long-dated yields) and Fed easing (lower short-rates) has driven a bull steepening of the US Treasury curve that has been inverted since mid-2022.

In fact, the 2 and 10 UST yield curve traded this week at the "least inverted" it has been for the entire cycle (**FIGURE 7**). This is a very welcoming sign and is consistent with the messaging in our 2024 Wealth Outlook to have clients allocated out of money markets and into the intermediate part of the yield curve.

Our Positioning

Citi Wealth's Global Investment Committee (GIC) holds a 12% allocation to both intermediate corporates and securitized credit. Taken together, these ~4-year duration assets are yielding about 5-6% on average, well above declining T-bill rates and avoiding the issue of re-investment risk. A yield curve that is normalizing emphasizes the consideration for clients to move from shorter duration cash equivalents into more duration assets to lock in higher yields.

Conclusion

While there is increasing risk of a broader Middle East confrontation, the current outbreak of fighting between the US, UK and Yemen is limited. Meanwhile, the flexibility of supply chains and the adaptability of markets is evident in the pricing of goods in spite of materially higher shipping costs. If the current conflict expands, it could pose a setback for global progress on inflation, especially in Europe. However, the disruptions to date should not significantly alter measured inflation in the US and is unlikely to shift the favored easing course of major Central Banks.

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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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