4 July 2022

Assessing the Fed's Damage Before a Strike

Life isn't as easy after a boom. Losses "invalidate" a sizeable share of the investment gains achieved in boom times, possibly even undermining the economy itself.

Yet investors need to endure, not self-destruct. The US Federal Reserve recently delivered its first 75-basis-point rate hike since 1994 and seems to be pre-committed to a 50- or 75-basis-point hike next month. Also, the European Central Bank seems close to pre-committing to 25- and 50-basis-point hikes in July and September.

After another round of price declines, US bond markets are strongly anticipating further sharp policy tightening steps. The European bond market has only lately adjusted, suffering a "catch up" to the US bond market's painful first half.

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Market Performance

US equities tumbled in June with the Dow Jones Industrial Average down more than 7%, the S&P 500 down nearly 9%, and the Nasdaq Composite losing just over 9%.

The losses were mirrored in Europe and Asia. The European Stoxx 600 lost 8.3% while the FTSE100 fell 5.5%. In Japan, the Nikkei 225 fell 1.45%

The MSCI Emerging Markets ended June just over 4% lower while MSCI Emerging Europe plunged 8.65% while MSCI Latin America slumped nearly 18%.

Elsewhere, MSCI Asia ex-Japan was down by 1.73%, while the Hang Seng China Enterprises Index (HSCEI) slipped 8.25%.

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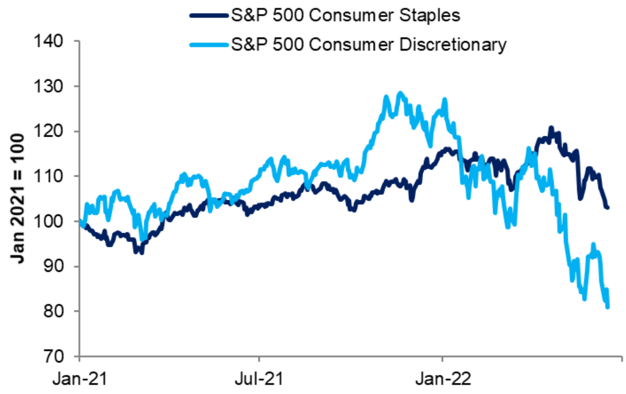
Ever more tightening won't slow inflation faster. It will, however, make the ultimate economic slowing worse.

Looking to how the economy will evolve, positive supply developments that will slow inflation are accumulating. In recent months, CIO has highlighted the US production rebound and strong rise in imports as developments reversing the consumer goods shortages of 2021. In April, the US reported the largest nominal gains in retail inventories for a one-year period on record. With further gains in production and slowing spending, large gains in physical units will pile up through the remainder of 2022. This is already generating markdowns by US retailers and profit warnings. Of course, discretionary merchandise is not where the acute needs are. Food and energy supplies disrupted by the war in Ukraine are generating upward price pressures and human suffering for those with the least secure household budgets.

> Large losses have been suffered by consumer discretionary equities as inflation for consumer essentials eats into other spending

S&P Consumer Staples vs Discretionary



Source: Bloomberg, June 16, 2022.

Transportation and logistics seem to be the larger part of the shock rather than actual output losses in both Russia and Ukraine. In theory, these issues could resolve more quickly than a permanent loss of productive capacity. However, Citi prefers to allocate investment capital to increasing output of impacted commodities given the risk of a lasting disruption.

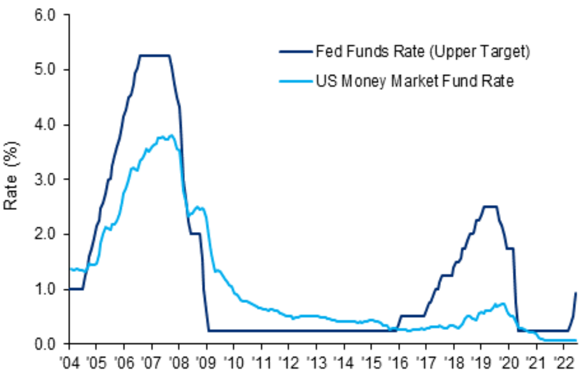
Large losses have been suffered by consumer discretionary equities as inflation for consumer essentials tramples on other spending. "Tech" firms have seen shares fall on reduced valuations for innovation. This points to a potential recovery opportunity in the future. At some point, peak interest rates and trough corporate profits will be priced into markets. Meanwhile, the 7 percentage points of CIO's medium-risk portfolios allocated across commodities, commodity equities and inflation-linked bonds will likely underperform in a period of sustained stronger growth and falling inflation. For now, however, CIO continues to favor a more defensive, "stagflation hedged" approach to markets. CIO must also assess how much damage Fed tightening will do to the economy relative to how much weakness financial assets already price in.

Shifting 2% of medium-risk global portfolios into long-duration UST

- The timeframe for a turnaround could depend on the Fed's recognition of policy lags amid impatience with inflation. The probability the Fed will swerve away from a dangerous course for the economy seems to be falling. CIO would subjectively raise the odds of recession in 2023 to 40% from 35%. This is barely below the 45% CIO assigns to the "resilient" scenario of slow growth and gradual deceleration in inflation over the course of 2022-2023.
- Future equity returns are strongly enhanced after a 20% decline, and particularly a 30% decline. In a recession scenario, however, the timing of economic recovery would still be far ahead of financial markets usual discounting mechanism. Equities typically rise six months before gains in profits. Profits have yet to fall.
- With this in mind, and despite the steep correction to date, Citi is keeping its tactical focus on high-quality US fixed income and equities with strong dividend delivery in industries with durable demand.
- Investors 20 years ago who did not have the patience to wait or the courage to re-engage with the investments responsible for true growth and innovation missed out on the strongest returns of the two decades past.

The sharp rise in yields on higher quality fixed income and a consequent slowing in the US and world economy has raised the value of bonds in portfolios.

Fed Funds Target v WSJ Money Market Yield



Source: Haver Analytics, Bloomberg June 16 2022.

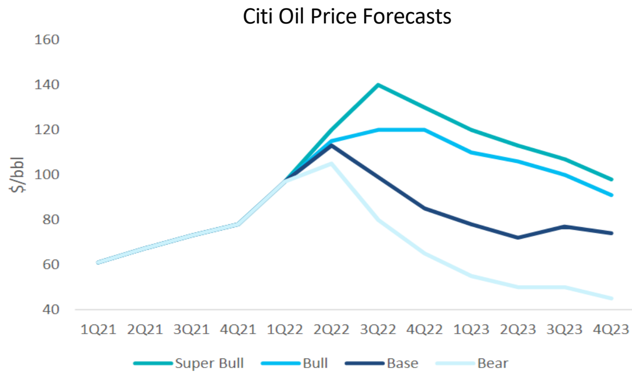
- "Pro-cyclical" Fed tightening argues for higher US fixed income allocations and relatively cautious equity positioning. CIO continues to believe broader financial markets cannot find stability until interest rate markets define a range. With this in mind, the 200-basis-point rise in US investment grade bond yields offers a compelling return for the economic environment ahead. In the past two decades, cash deposit rates peaked about 150 basis points below the Fed's policy rate on average.
- Unfortunately for the economy, the transmission of monetary policy tightening to borrowing costs is taking place much faster than to personal interest income. Long-term US mortgage rates have doubled to more than 6% in a single year. Long-term US corporate debt yields have risen 200 basis points – a return that could be earned over a period much longer than heightened inflation is likely to persist.

Commodity markets in spotlight as geopolitical conflict rolls on

Oil prices should soften by year-end. Even as Russian oil output falls, with EU banning waterborne imports of Russian oil by year-end, a global GDP slowdown, high prices, and China's zero-COVID policy are all hitting demand. Non-OPEC+ supply is growing fast, while SPR releases could now total 300-m bbls this year. However, the Iran nuclear deal looks heavily delayed.

High oil prices are outweighing demand growth in the US. Despite the historically busy summer period, demand is staying at multi-year lows, comparable to periods when WTI prices were high. The need for European markets to find substitutes for Russian oil is exerting a strong pull on US crude and product exports.

Citi expects oil prices to remain volatile but with downward bias



Source: Citi Research, Bloomberg.

Oil: Citi expects oil prices to continue being volatile, but with a clear downward bias through the end of the year. Given the uncertainties of conflict, there could be further supply disruptions from Russia this year. However, given the strong headwinds to growth resulting from both higher prices of commodities and central bank actions, Citi projects a trendline downward in prices through 2023. While Brent prices are swinging between $114-124 so far in June, and could remain spiky through the summer, Citi's base case is that prices could ease to the 80s by 4Q'22, and could be in the $70s in 2023, trending down to the USD50-60 per barrel range thereafter.

Gold: Gold markets are not likely to inform financial markets of imminent recession. Whereas rates, inflation, and FX are co-determined with some commodity prices (e.g. crude oil), gold prices are reactive. Yet the negative performance of gold in recent months does not contrast with mean or median annualized returns preceding significant US growth contractions over the past four decades. Citi maintains a 3Q'22 gold price forecast of ~$1,845/oz, bottoming to an average of ~$1,750/oz in 1Q'23, and then rallying to $2,000/oz into 2024. The US falling into recession (sooner than later) might see gold prices rally a bit sooner.

Bulks and metals: In the scenario that global growth continues to weaken over the next 3-6 months, zinc and nickel appear to have the furthest to fall in percentage terms, while aluminum the least. Citi expects Chinese smelters to be responsive, as Chinese steel mills have been, to ongoing weakness in the market in China, and in line with recent history.

Eyes on Fed Minutes; RBA Action

USD: Fed Chair Jerome Powell in his most recent semi-annual testimony gave his most explicit acknowledgment to date about the possibility of a US recession, saying one is possible and calling a soft landing "very challenging." He also pointed to the other risk, being that the Fed "would not manage to restore price stability and would allow this high inflation to get entrenched in the economy." Powell currently sees the latter as the greater risk. The Fed chief also noted that recent events have made it harder for the Fed to lower inflation while sustaining a strong labor market. Citi now raises their aggregate probability of recession approaching 50% which leaves USD a "sell on rallies" - the recent move lower in US rates adds to mounting signals that DXY may be rapidly approaching a peak. With market pricing of Fed Funds now below the terminal rate implied in the June FOMC Fed dots for the first time, and with USD positioning at extended longs, there seems little incentive to price additional hawkishness. As a result, the 105.00 level in DXY now appears to be signaling the peak in the current cycle.

JPY: One of 3 drivers is needed to strengthen the Yen more sustainably to send USDJPY back to the pre-2022 levels of 110 – 115. These include – (1) a sharp improvement in Japan's terms of trade if energy prices drop to pre-Russia – Ukraine conflict levels; (2) BoJ abandons its ultra-accommodative easing policy and commences tightening financial conditions; or (3) a US recession. The first two look unlikely anytime soon although Citi attributes a 30-40% probability to the BoJ tweaking, but not making a wholesale shift, to its policy parameters after Japan's Upper House elections in July. Tweaks to BoJ policy are likely to slow Yen's weakness momentum and may even see limited Yen gains (back to the 125-130 level) but are unlikely to be enough to cause a more fundamental shift.

SGD: Citi appears to be opening the gate towards an inter-meeting MAS tightening in July (50 basis point slope steepening) to be followed by a further October tightening (a further 50 bps slope steepening). Much depends on Singapore's inflation outcomes relative to MAS forecasts with the central bank already having tightened policy over the last 3 successive meetings starting with the scheduled meeting in October 2021, an inter-meeting tightening in January 2022 and the latest in April 2022. Altogether, the MAS has steepened the SGD NEER 12-month slope by 1.5% pa together with a "close to the top of the policy band" upward re-centering of the SGD NEER band by 200 bps (a 2% outright appreciation of the SGD NEER band). This now makes SGD a strong buy on any dips on any pullback towards 150 pips above the mid NEER band, or in outright terms, levels approaching 1.4000 in USDSGD. SGD is also likely to outperform its Asian peers (CNH and JPY) as well as GBP within the G10 FX space on any renewed volatility in the FX space.

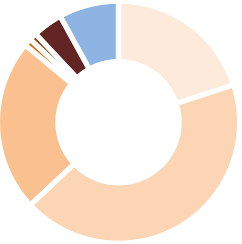
CNY: USDCNH remains centered around the 6.70 level with a tug-of-war emerging between broader USD gains and new rounds of inflows into Chinese assets (despite the negative carry) as foreign buying flows via stock connect return (the 10-day rolling average inflows now sits at the highest levels of the year in the wake of series of positive developments around tech and unlocking of Shanghai and removal of restrictions in Beijing). The recent shift in policy tone/actions towards platform companies, real estate etc. is also noticeable as Chinese policymakers provide calibrated stimulus to the economy. For RMB however, the gradual weakness of the CFETS basket is likely to retain USDCNH's bias to the upside even if momentum has slowed. Due to the incremental challenges to China's export sector relative to SME input costs, and the need for monetary policy to stay supportive, a tacit policy consent is still probably in play towards a weaker RMB for now. Looking beyond July however when DXY may potentially peak, China's growth momentum may swing to more positive while the rest of the world faces a more challenging environment of higher rates and slower growth. This divergence may then lead to USDCNH to stage a moderate reversal back to the 6.50 – 60 area.

AUD: The RBA's June minutes devote a fairly large section to highlighting a 25 bps hike at each of the remaining meetings over 2022 – this would see the cash rate at 2.10% by year-end, which the RBA sees as constituting a "rapid tightening" by historical contexts. Governor Lowe also mentions that the board will likely consider a 25bps or 50bps hike at the next meeting (effectively ruling out 75bp). He further goes on to say that the (rather aggressive) rate hike trajectory implied by rates markets is not very likely. Citi Research expect the RBA to hike by another 50bps in July, August and September but then slow the pace to a further 25bps in November for a year-end cash rate of 2.60% and 3.1% by 2023-end, still significantly below market pricing of 3.75% by 2022-end and a terminal rate of 4.25% by the end of Q1'2023.

3Q22 Model Portfolios

Defensive

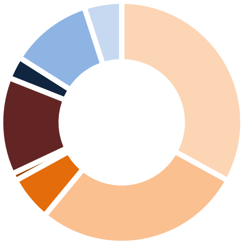
Seeking primarily capital preservation over time and only willing to accept very minor portfolio value fluctuations from month to month.



Cash	20%
Developed Govt Bonds	43%
Global IG Corp Bonds	23%
HY Bonds	1%
Emerging Market Debt	1%
US Equities	4%
Global Equities	8%
Global REITs	0%

Income Oriented

Seeking growth of wealth over time but unwilling to accept significant fluctuations in the value of portfolio from month to month.



Developed Govt Bonds	33%
Global IG Corp Bonds	28%
HY Bonds	6%
Emerging Market Debt	1%
US Equities	13%
European Equities	3%
Global Equities	11%
Global REITs	5%

Growth And Income

Seeking long-term capital growth foremost but unwilling to accept significant losses on value of portfolio over the medium term.

Developed Govt Bonds	18%
Global IG Corp Bonds	21%
HY Bonds	5%
Emerging Market Debt	4%
US Equities	23%
European Equities	10%
Pacific Equities	6%
EM Equities	5%
Global REITs	8%

Growth Oriented

Seeking long-term capital appreciation and willing to tolerate measured medium-term volatility in order to enhance longer-term performance.

Developed Govt Bonds	5%
Global IG Corp Bonds	16%
HY Bonds	6%
Emerging Market Debt	6%
US Equities	28%
European Equities	13%
Pacific Equities	8%
EM Equities	8%
Global REITs	10%

Aggressive Growth

Seeking long-term capital appreciation and can accept potentially large losses on portfolio over the near-to-medium term in order to maximize long-term performance.

Global IG Corp Bonds	7%
HY Bonds	6%
Emerging Market Debt	6%
US Equities	32%
European Equities	19%
Pacific Equities	10%
EM Equities	10%
Global REITs	10%

World Markets at a Glance

	Last price	52-Week	52-Week	Historical Returns (%)			
	30-Jun-22	High	Low	1 week	1 month	1 year	Year-to-date
US / Global							
Dow Jones Industrial Average	30775.43	36952.65	29653.29	0.32%	-7.34%	-10.80%	-15.31%
S&P 500	3785.38	4818.62	3636.87	-0.27%	-8.97%	-11.92%	-20.58%
NASDAQ	11028.74	16212.23	10565.13	-1.81%	-9.09%	-23.96%	-29.51%
Europe							
MSCI Europe	428.13	574.20	420.94	0.63%	-10.12%	-21.89%	-24.21%
Stoxx Europe 600	407.20	495.46	400.03	1.19%	-8.27%	-10.08%	-16.52%
FTSE 100	7169.28	7687.27	6787.98	2.12%	-5.49%	1.87%	-2.92%
CAC 40	5922.86	7384.86	5756.38	0.67%	-9.10%	-8.99%	-17.20%
DAX	12783.77	16290.19	12438.85	-1.00%	-11.61%	-17.69%	-19.52%
Japan							
NIKKEI 225	26393.04	30795.78	24681.74	0.85%	-1.45%	-8.33%	-8.33%
Topix	1870.82	2120.18	1755.14	1.03%	-0.87%	-3.74%	-6.10%
Emerging Markets							
MSCI Emerging Market	1000.67	1368.33	982.71	0.54%	-4.07%	-27.20%	-18.78%
MSCI Latin America	2041.09	2768.55	1989.03	0.03%	-17.94%	-22.11%	-4.17%
MSCI Emerging Europe	30.01	217.30	29.30	0.00%	-8.65%	-84.12%	-83.68%
MSCI EM Middle East & Africa	194.10	299.22	193.26	0.26%	-7.93%	-29.53%	-29.59%
Brazil Bovespa	98541.95	129619.80	97231.18	0.47%	-11.97%	-22.29%	-5.99%
Russia RTS	1345.01	1933.59	610.33	-5.04%	18.61%	-18.67%	-15.71%
Asia							
MSCI Asia ex-Japan	653.12	886.36	627.58	0.84%	-1.73%	-26.59%	-17.25%
Australia S&P/ASX 200	6568.06	7632.80	6407.00	0.61%	-8.56%	-10.19%	-11.77%
China HSCEI (H-shares)	7666.88	10812.73	6051.62	2.73%	8.25%	-28.10%	-6.91%
China Shanghai Composite	3398.62	3723.85	2863.65	2.36%	8.57%	-5.36%	-6.63%
Hong Kong Hang Seng	21859.79	29146.28	18235.48	2.75%	5.62%	-24.17%	-6.57%
India Sensex30	53018.94	62245.43	50921.22	1.44%	-3.40%	1.02%	-8.99%
Indonesia JCI	6911.58	7355.30	5938.41	-1.24%	-1.63%	15.47%	5.02%
Malaysia KLCI	1444.22	1620.44	1427.78	0.92%	-6.63%	-5.77%	-7.87%
Korea KOSPI	2332.64	3313.51	2284.33	0.79%	-11.58%	-29.24%	-21.66%
Philippines PSE	6155.43	7552.20	6054.79	1.49%	-8.48%	-10.82%	-13.58%
Singapore STI	3102.21	3466.23	3037.79	0.30%	-3.97%	-0.90%	-0.69%
Taiwan TAIEX	14825.73	18619.61	14226.62	-2.31%	-8.86%	-16.50%	-18.62%
Thailand SET	1568.33	1718.55	1512.28	0.69%	-4.30%	-1.23%	-5.39%
Commodity							
Oil	105.76	130.50	61.74	1.43%	-8.09%	43.95%	40.62%
Gold spot	1807.27	2070.44	1690.61	-0.85%	-2.51%	2.10%	-1.20%

Source: Bloomberg 30 June 2022

Currency Forecasts

Currency Pair	Market Data	Forecasts		
	spot	0-3 months	6-12 months	long-term
G10				
Euro	EURUSD	1.07	1.02	1.05
Japanese Yen	USDJPY	129	138	130
British Pound	GBPUSD	1.23	1.18	1.2
Swiss Franc	USDCHF	0.96	0.98	1
Australian Dollar	AUDUSD	0.7	0.68	0.6
New Zealand Dollar	NZDUSD	0.62	0.61	0.62
Canadian Dollar	USDCAD	1.29	1.31	1.33
G10 Cross				
Japanese Yen	EURJPY	138	141	137
Swiss Franc	EURCHF	1.04	1	1.05
British Pound	EURGBP	0.87	0.87	0.88
Swedish Krona	EURSEK	10.75	10.5	11
Norwegian Krone	EURNOK	10.56	10.5	10.75
Norwegian Krone	NOKSEK	1.04	1	1.02
Australian Dollar	AUDNZD	1.11	1.12	1.12
Australian Dollar	AUDJPY	94	94	90
ASIA				
Chinese Renminbi	USDCNY	6.68	6.95	6.95
Hong Kong Dollar	USDHKD	7.82	7.85	7.84
Indonesian Rupiah	USDIDR	14933	14900	15100
Indian Rupee	USDINR	80.8	79	77.5
Korean Won	USDKRW	1275	1320	1270
Malaysian Ringgit	USDMYR	4.4	4.42	4.42
Philippine Peso	USDPHP	54.1	53.5	53.2
Singapore Dollar	USDSGD	1.38	1.39	1.37
Thai Baht	USDTHB	34.2	35.2	34.4
Taiwan Dollar	USDTWD	29	30	29.8
CEEMEA				
Czech Koruna	EURCZK	26.3	24.9	24.8
Hungarian Forint	EURHUF	430	410	403
Polish Zloty	EURPLN	5.01	4.75	4.7
Israeli Shekel	USDILS	3.36	3.4	3.35
Russian Ruble	USDRUB	91.8	60	65
Turkish Lira	USDTRY	26.84	18.35	22
South African Rand	USDZAR	16.38	16.25	16.4
LATAM				
Brazilian Real	USDBRL	5.52	5.15	5.3
Chilean Peso	USDCLP	874	860	850
Mexican Peso	USDMXN	21.8	20.8	21.3
Colombian Peso	USDCOP	4160	4085	3955

Source: Bloomberg, Citi Research 30 June 2022

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