4 May 2022

The Late, Late, Late Fed Show

Taken at its word, the Fed will begin “rapid” Quantitative Tightening roughly two months after halting Quantitative Easing. Its projected short-term interest rate increases in the year ahead will roughly match the largest for any annual period in history. The Fed has positioned policy to be pro-cyclical rather than countercyclical, likely adding to financial market and economic volatility.

Lagging indicators such as employment and inventory restocking provide “inertia” for economic growth to continue this year. However, a demand slowdown is inevitable.

Therefore, Citi analysts have further shifted their asset allocation to better absorb greater market volatility and less robust economic growth following a strong recovery.

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Market Performance

US equities tumbled in February with the Dow Jones Industrial Average down 6.56%, the S&P 500 down 10.79%, and the Nasdaq Composite losing 15.63%.

The European Stoxx 600 lost 7.29% while the FTSE100 ticked 0.10% higher. In Japan, the Nikkei 225 and Topix fell 4.97% and 4.62% respectively.

The MSCI Emerging Markets ended April 5.30% lower. The MSCI Emerging Europe plunged 16.70%, and the MSCI Latin America slumped 13.54%.

The MSCI Asia ex-Japan lost 4.75%, while the Hang Seng China Enterprises Index (HSCEI) slipped 2.85%.

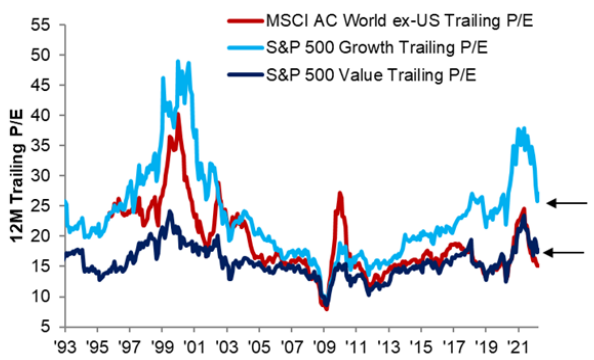
IN THIS ISSUE

When growth becomes harder to achieve, it becomes more valuable in portfolios

- The new supply shortages are not the sole source of continued high inflation – but they will extend the shock. Compared to CIO's view last year that US Consumer Price Inflation would end 2022 at a year/year pace near 3%, Citi now sees it near 6.5% before falling to about 3.5% over the course of 2023. This assumes CPI inflation peaks in the near-term at about 8.5%. In other words, CIO believes the most rapid price rise in consumer prices has already occurred. The absence of fiscal support this year amid high inflation is now forcing consumer demand to drop. The US Federal Reserve cut its median real economic growth view by 1.2 percentage points for 2022, and similarly, CIO cut its US growth forecast by a more severe 1.6 percentage points to 1.9% from 3.5%.

While never cheaper than their value peers, growth equities have already experienced a significant de-rating amid the "rate shock" year-to-date.

US growth value and non-US growth valuations



Source: Bloomberg and FactSet as of April 7, 2022.

- In our CIO's view, one way to play the equity market in the current environment is via defensive, quality growth.
  - CIO's base case RESILIENT scenario assumes slowing economic growth but not a recession. It's important to find opportunities that will provide sustainable, positive returns even in a decelerating growth environment.
  - CIO's expectation for government bond yields to peak this year is potentially supportive for those sectors most reliant on a low discount rate to justify their valuations. It does not, however, support firms that need to borrow to survive.
  - As an exception to CIO's negative view on many cyclical sectors, medium-term disruptions to commodity supply warrant bolstered allocations to energy and natural resources producers.
- When growth becomes harder to achieve, it becomes more valuable in portfolios. Citi believes that in a slowing economic environment, the value of companies with dependable, visible growth increases. This is why Citi is looking at defensives over cyclicals. History also supports a bias toward high-quality growth, as mid-cycle slowdowns over the past three decades tended to see large-cap growth stocks outperform other equity size and style factors on average.
- What's more, while never cheaper than their value peers, growth equities have already experienced a significant de-rating amid the "rate shock" year-to-date. This means that growth stocks can stage a comeback once rates have peaked.

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

- Whatever monetary policy is "right" or "least wrong" for the period of economic turmoil the world is enduring, one thing should be undeniable: The Federal has made one of its most abrupt "about faces" in history. Assuming the Fed does what it says, the central bank will begin "rapid" Quantitative Tightening (QT) roughly two months after Quantitative Easing (QE). It will go from accommodating a sharp fiscal expansion to reinforcing a fiscal contraction. Its short-term interest rate increases in the year ahead will roughly match the largest for an annual period in history.
- Of course, an inflationary recovery *should* generate higher bond yields. But will this continue forever? The value of 30-year US Treasury securities – the benchmark "long bond" – has fallen nearly 18% in value in the year-to-date. Its cumulative total return has been -34% from the 2020 peak. Compared to the start of the last cycle, inflation is higher, yields are lower, and the spike in rates has been less abrupt. With that said, the drop in long-term bond valuation has still been equal to the largest in history (after the Global Financial Crisis in 2009).
- With these valuation changes, CIO sees an opportunity to add back the factor that drives higher risk-adjusted returns in diversified portfolios: negative correlation. Long-term US Treasuries are one of the few traditional assets that usually have a negative correlation to equities during severe corrections. During equity market drawdowns of 20% or more during the past 35 years, long duration US Treasuries have had an average return of +12%.

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Total Return Indices S&P 500 vs 30-Year US Treasury

Source: Haver as of April 15, 2022.

- At the miniscule yield of 0.5% for 10-year US Treasuries and 1.0% for 30-year bonds at the low of 2020, Citi saw asset allocation itself as a challenged portfolio concept. But CIO sees it differently with 2.5%-3.0% US government bond yields in a period of fiscal and monetary contraction.
- As CIO began to reduce its overweight to "risk assets" from a peak of 11% nearly a year ago –unwinding the comparable underweight to fixed income – the team has gradually added a sizeable investment in intermediate US Treasuries and Investment Grade Corporate Bonds. In February, CIO noted that the significant overweight could be shifted to longer-duration bonds when yields rose further. In Citi's view, that time is now.

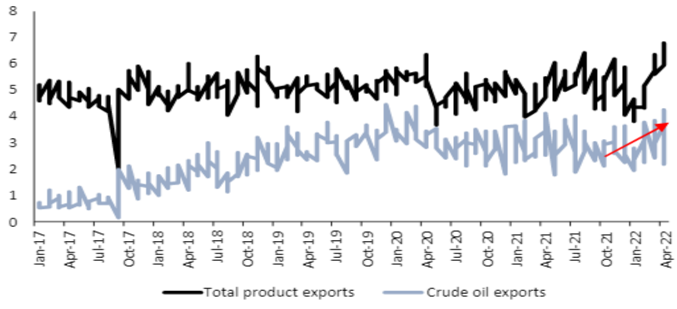
Commodity markets in spotlight as geopolitical conflict rolls on

The geopolitical situation remains fluid and an escalation in the Russia-Ukraine conflict may buttress risk-on investor flows. Even as Russian production slides, a global GDP slowdown is hitting oil demand, relief for sanctions on Iran could be on the way, and non-OPEC+ supply is growing fast while Strategic Petroleum Reserve releases could now total 300-m bbls this year.

Commodities continue to outperform other USD-denominated asset markets with ~30% year-to-date return, versus -13% for US equities. The outperformance has been led by a ~60% gain in the energy sub-index and ~26% gain in the agriculture sub-index followed by the industrial metals sector with a ~21% price gain YTD and precious metals with ~5% gain.

Citi sees US net oil exports potentially set for explosive growth

US Crude and Product Exports 2017-present (m b/d)



Source: Citi Research, EIA.

Oil: Barring a full escalation, prices should soften by year-end. Russian oil exports and output are at risk with dwindling capacity over time. Meanwhile, recent data point to potential explosive growth of US total and net oil exports, providing significant relief for countries shunning Russian exports and with significant implications for global oil trade. Recent net US exports hit a record alongside record gross exports.

Gold: Citi's global commodity team sees gold prices moderating from fresh all-time highs hit in March but holding a high(er) range for the balance of 2022 as financial markets grapple with surging headline inflation, geopolitical uncertainty, and recession tail risks. 2022E forecast is $1,910/oz, and 2023E forecast is $1,725/oz. Much hinges on whether the Fed can dampen inflation without significant growth pains. On balance, macro and micro factors tilt positive for the yellow metal this year.

Bulks and metals: Though Citi analysts expect metals prices and demand to remain robust in developed markets in the near term, recession risks in 2023 are rising, with the most pressure from a commodity inflation standpoint likely to be on Europe. Zinc has rallied beyond our bullish $4,200/t target and is being traded as the sustained European energy shortage play. The Citi Global Copper End-Use Tracker for 2M'2022 suggests that copper consumption has been holding strong. Citi analysts remain bullish in the near-term, as the level of consumption is running ~8-10% above 2019 levels, justifying high prices in order to continue to incentivize supply to respond.

DXY driven higher by a hawkish Fed and global vulnerabilities

- USD: The broad-based USD Index (DXY) is at near 2Y highs with gains as much due to weakness in other major G10 currencies (EUR, GBP, JPY and CNY) as from a more hawkish repricing of the Fed. For DXY to go even higher would require either – (1) a Fed determined to stamp out US inflation at all costs by following through on the aggressive rate hike/ balance sheet reduction cycle priced by markets – this runs the risk of dislocation within risk asset markets that may encourage safe haven inflows into USD, or (2) further weakness in other G10 FX (EUR, GBP, JPY, CNY) as the terms of trade shock deepens from higher energy costs and weaker growth in China from extended Covid lockdowns. More probable however, is that the Fed signals a willingness to respond to slower growth by moderating its own stance on rates/ balance sheet reduction (possibly by the July meeting) which may then cause US rates to decline more substantially, leading to a weaker DXY.

- EUR: There appear to be 4 reasons as to why EUR is not strengthening even as markets price higher ECB rates to reign in euro area inflation – (1) at a (expected) 1% peak in the ECB deposit rate (Citi analysts), this would still leave rate differentials favoring USD; (2) a risk premium in EUR from the terms of trade shock from higher energy prices that could deepen and plunge the euro area into recession should there be a ban on Russian gas and oil imports; (3) headwinds from China's slowdown and a weaker CNY; and (4) French elections – Macron may have won the presidential elections but it is the parliamentary elections in June that hold more sway. None of these EUR negatives are likely to turn near term with July a possible timeline for any rebound in EUR when the ECB ends its bond purchases, and the Fed possibly moderates its current hawkish stance.

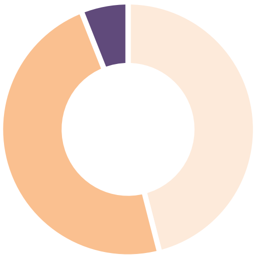
- GBP: The UK economy follows in the footsteps of the euro area with higher energy costs causing a sizeable terms of trade shock and higher inflation while growth slows. But unlike the ECB, BoE has already commenced its rate tightening cycle to reign in inflation which has led markets to downgrade UK's growth outlook further via a weaker sterling. Citi analysts still expect the BoE to hike rates by 25bps in May, June and August and then pause, taking the cash rate to 1.5% by year-end. Market pricing through is considerably more hawkish which if the BoE follows through on, could paradoxically result in even more sterling weakness in the short term.

- AUD: Market consensus has shifted to May for the timing of the first RBA rate hike as underlying inflation now runs at 3.4%, well above the RBA's 2-3% tolerance band. With the Australian unemployment rate also expected to ultimately reach 3% in 2023 and wages growth to pick-up (Citi analysts), domestic fundamentals are supportive of a more resilient AUD. That said, vulnerabilities lie with China's deeper slowdown though this needs to be balanced with the reopening of the Australian economy and expected rapid expansion in services exports. Overall, a brighter domestic and external outlook, notwithstanding possible headwinds from China's economic slowdown, creates a more resilient scenario for AUDUSD around the 0.7100-50 level.

- RMB: PBoC's recent announcement to cut its FX deposit RRR from 9% to 8% and release some USD10bn in USD supply may help to slow the pace of CNY depreciation but is unlikely to change overall direction. The PBoC is sensitive towards the damage that a rapidly weakening currency can do to sentiment in the SME sector (by raising input costs) and on foreign investment. But PBoC's easing bias has eroded the "positive carry" on Chinese assets while China's slowing export momentum coupled with USD strength is likely to continue to drive further CNY deprecation, albeit at a slower pace, potentially targeting the 6.75-80 level.

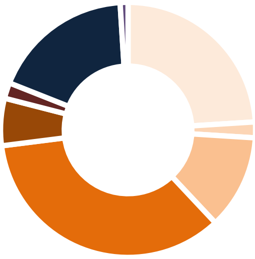
2Q22 Model Portfolios

Risk Level 2: Conservative



	Weight	Change (QoQ)
Global Investment Grade Bonds	46%	2%
APAC ex JP / Emerging Market Bonds	48%	1%
Cash	6%	-3%

Risk Level 3: Moderate



	Weight	Change (QoQ)
Global Investment Grade Bonds	24%	4%
Global High Yield Bonds	2%	-2%
APAC ex JP / Emerging Market Bonds	12%	1%
US Equities	35%	3%
Europe Equities	6%	-4%
Japan Equities	2%	-1%
Asia ex Japan Equities	18%	-1%
Cash	1%	0%

Risk Level 4: Aggressive

	Weight	Change (QoQ)
Global Investment Grade Bonds	6%	3%
Global High Yield Bonds	1%	-2%
APAC ex JP / Emerging Market Bonds	3%	1%
US Equities	42%	3%
Europe Equities	6%	-4%
Japan Equities	2%	-2%
Asia ex Japan Equities	22%	-2%
GEM ex-Asia	1%	0%
Commodities	3%	3%
Hedge Funds	12%	0%
Cash	2%	0%

Risk Level 5/6: Very Aggressive / Specialized

	Weight	Change (QoQ)
US Equities	49%	5%
Europe Equities	5%	-5%
Japan Equities	1%	-3%
Asia ex Japan Equities	26%	-1%
GEM ex-Asia	1%	0%
Hedge Funds	14%	0%

World Markets at a Glance

	Last price 29-Apr-22	52-Week High	52-Week Low	Historical Returns (%) 1 week	1 month	1 year	Year-to-date
US / Global							
Dow Jones Industrial Average	32977.21	36952.65	32272.64	-2.47%	-6.56%	-2.65%	-9.25%
S&P 500	4131.93	4818.62	4056.88	-3.27%	-10.79%	-1.18%	-13.31%
NASDAQ	12334.64	16212.23	12202.41	-3.93%	-15.63%	-11.66%	-21.16%
Europe							
MSCI Europe	475.98	574.20	446.80	-2.69%	-7.29%	-11.03%	-15.74%
Stoxx Europe 600	450.39	495.46	405.61	-0.64%	-2.53%	2.97%	-7.67%
FTSE100	7544.55	7687.27	6787.98	0.30%	0.10%	8.25%	2.17%
CAC40	6533.77	7384.86	5756.38	-0.72%	-3.80%	4.22%	-8.66%
DAX	14097.88	16290.19	12438.85	-0.31%	-4.87%	-6.86%	-11.25%
Japan							
NIKKEI225	26847.90	30795.78	24681.74	-0.95%	-4.97%	-6.82%	-6.75%
Topix	1899.62	2120.18	1755.14	-0.29%	-4.62%	0.07%	-4.65%
Emerging Markets							
MSCI Emerging Market	1076.19	1395.02	1024.17	0.05%	-5.30%	-20.14%	-12.65%
MSCI Latin America	2313.83	2768.55	2007.51	-6.15%	-13.54%	-2.60%	8.64%
MSCI Emerging Europe	33.47	217.30	32.60	-7.52%	-16.70%	-80.27%	-81.79%
MSCI EM Middle East & Africa	226.97	299.22	221.07	-0.63%	-4.04%	-14.06%	-17.67%
Brazil Bovespa	107876.16	131190.30	100074.60	-2.88%	-10.11%	-9.27%	2.91%
Russia RTS	1081.52	1933.59	610.33	16.51%	22.68%	-27.17%	-32.23%
Asia							
MSCI Asia ex-Japan	686.53	903.64	648.79	0.64%	-4.75%	-22.38%	-13.02%
Australia S&P/ASX 200	7435.01	7632.80	6758.20	-0.51%	-0.39%	5.82%	-0.13%
China HSCEI (H-shares)	7298.69	11036.97	6051.62	4.68%	-2.85%	-32.58%	-11.38%
China Shanghai Composite	3047.06	3723.85	2863.65	-1.29%	-4.90%	-11.60%	-16.28%
Hong Kong Hang Seng	21089.39	29490.61	18235.48	2.18%	-3.82%	-26.58%	-9.87%
India Sensex30	57060.87	62245.43	48028.07	-0.24%	-1.52%	16.97%	-2.05%
Indonesia JCI	7228.91	7355.30	5742.04	0.05%	3.10%	20.57%	9.84%
Malaysia KLCI	1600.43	1620.44	1475.37	-0.10%	1.07%	-0.08%	2.10%
Korea KOSPI	2695.05	3316.08	2591.53	-0.36%	-1.68%	-14.38%	-9.49%
Philippines PSE	6731.25	7552.20	6080.94	-3.82%	-5.39%	5.66%	-5.49%
Singapore STI	3356.90	3466.23	3023.95	-0.13%	-2.24%	4.31%	7.47%
Taiwan TAIEX	16592.18	18619.61	15159.86	-2.54%	-5.45%	-5.55%	-8.93%
Thailand SET	1667.44	1718.55	1501.02	-1.37%	-1.32%	5.33%	0.59%
Commodity							
Oil	104.69	130.50	61.56	2.57%	0.43%	64.66%	39.20%
Gold spot	1896.93	2070.44	1690.61	-1.79%	-1.17%	7.22%	3.70%

Source: Bloomberg as of 29 April 2022

Currency Forecasts

	Currency	Last price 29-Apr-22	Forecasts 0-3m	6-12m	long-term
G10-US Dollar					
Euro	EURUSD	1.05	1.07	1.10	1.12
Japanese yen	USDJPY	129.7	125	126	120
British Pound	GBPUSD	1.26	1.27	1.29	1.32
Swiss Franc	USDCHF	0.97	0.93	0.95	0.96
Australian Dollar	AUDUSD	0.71	0.77	0.76	0.76
New Zealand	NZDUSD	0.65	0.70	0.68	0.67
Canadian Dollar	USDCAD	1.28	1.23	1.25	1.25
EM Asia					
Chinese Renminbi	USDCNY	6.61	6.40	6.50	5.60
Hong Kong	USDHKD	7.85	7.83	7.80	7.76
Indonesian Rupiah	USDIDR	14,497	14,300	14,400	14,000
Indian Rupee	USDINR	76.4	77.5	76.0	77.0
Korean Won	USDKRW	1,256	1,240	1,200	1,150
Malaysian Ringgit	USDMYR	4.35	4.19	4.17	4.10
Philippine Peso	USDPHP	52.2	52.3	52	52.0
Singapore Dollar	USDSGD	1.38	1.35	1.34	1.30
Thai Baht	USDTHB	34.3	33.3	32.6	32.0
Taiwan Dollar	USDTWD	29.5	28.6	28	26.4
EM Europe					
Czech Koruna	USDCZK	23.3	24.5	24.3	24.1
Hungarian Forint	USDHUF	359	372	367	380
Polish Zloty	USDPLN	4.44	4.70	4.60	4.52
Israeli Shekel	USDILS	3.34	3.20	3.20	3.13
Russian Ruble	USDRUB	70.96	83	85.0	87.0
Turkish Lira	USDTRY	14.85	15.20	17.00	15.50
South African Rand	USDZAR	15.79	14.50	14.75	15.25
EM Latam					
Brazilian Real	USDBRL	4.97	4.70	5.20	5.10
Chilean Peso	USDCLP	851	770	775	765
Mexican Peso	USDMXN	20.4	19.7	20.9	21.3
Colombian Peso	USDCOP	3,961	3,750	3,725	3,700

Source: Bloomberg 29 April 2022
Source: Citi Research as of 07 April 2022

Citi Model Portfolio

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- Diversified asset allocations, made uniquely relevant for Asian investors
- Up-to-date asset allocations which are reviewed and revised periodically by Citibank's Research teams to reflect changing market conditions in respect of relevant asset classes
- Access to our best-in-class research from the Global Investment Committee

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