Citi Global Wealth Investments

CIO Strategy Bulletin

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Prepare to Make Volatility an Asset

Key Takeaways

- In the evening of the past two US presidential elections – featuring the same candidates of 2024 excluding Joe Biden – financial markets saw large moves and, at moments, false assumptions about final results. S&P 500 futures averaged a 5.9% price swing. US 10-year Treasury yields moved 27 basis points and the broad US dollar gained or lost about 2.5%.
- Some of the early reactions misled investors. A month after the 2016 election, US equities returned +4.7%. A month after 2020, they gained 7.6%. Long-term US yields rose 40 bps in 2016 and rose 7 bps in 2020. The US dollar index rose 2.6% in the month after Trump's election. The dollar fell 2.9% in the month following Biden's election.
- There is no guarantee that markets will move markedly in the evening of November 5th, 2024 or repeat the general tendency of rallying in "relief" once election uncertainty ends. It is clear, however, that Trump's policy proposals – income tax cuts and increases in tariffs – are consistent with domestic "reflation" and a "toll" on foreign markets. Domestic-focused equities have rallied with Trump's polling. Non-US markets have rallied with Harris's (please see the September 28th CIO Bulletin).
- We see new record highs for US corporate profits in 2025 regardless of the US election victor. However, the interest rate, foreign exchange, and industry outlook will indeed be impacted by US election policy choices.

Potential Portfolio Implications

- Because Trump and Harris economic policies are so different, if polls remain tight until election day, we do expect a large reaction to election results. A severe spike in implied volatility could be a potential opportunity to generate income or take new positions as we last did in early August (see the August GIC Statement). Our asset allocation has been overweight US assets in both equities and bonds. While election results may be unpredictable, any *overreaction* could offer potential opportunity.
- Candidate Trump's polling data and betting markets have moved in his favor in the past month. During that time, 5- and 10-year inflation expectations have risen about 0.25%. This coincided with strong employment data and higher inflation surprises, but we think investors are also focused on the potential for more inflationary US policies.
- Fiscal action substantially depends on uncertain Congressional results. The sunset of tax cuts at the end of 2025 argues against a radical US fiscal easing. Nonetheless, it is possible that reconciliation procedures could result in meaningful new US tax cuts in a "red sweep." Yet given present market pricing and polling data, a "blue sweep" would be a significantly larger market surprise.
- Beyond election issues, markets are pondering just how fast and sustainably the largest tech firms are investing in AI infrastructure as firms report their 3Q quarterly earnings.

Be Patient, But Ready

By early next month, much of the world will be gripped in US election frenzy. We suspect that the "power" of the two US candidates' words are an increasing influence on markets now. The correlation between key market variables and the candidates polling has increased since July (see **FIGURE 1-2**).

FIGURE 1: Real Clear Politics polling for Trump victory probability vs US dollar index

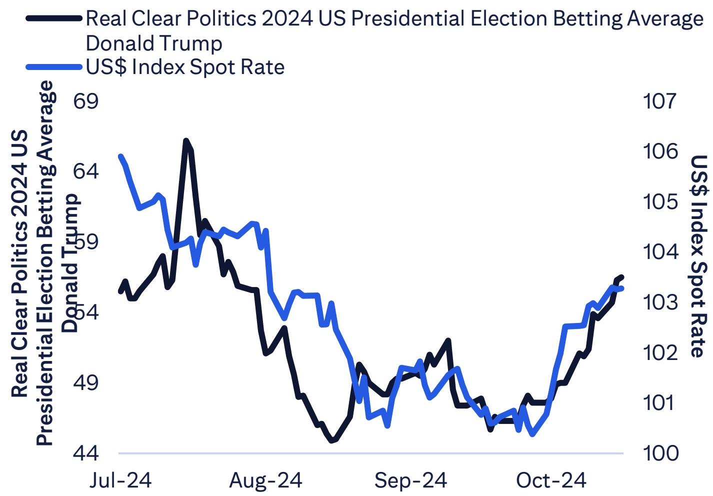


FIGURE 2: Real Clear Politics polling for Trump victory probability vs 5yr US Treasury inflation expectation

Source: Bloomberg as of October 16, 2024. 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.**

It is virtually impossible to untangle the influences of today's economic data and tomorrow's policies in market pricing. For example, a rise of about 25 basis points in long-term inflation expectations in the past month has been augmented by a strong US employment report and a surprisingly large initial Fed easing step. But the rise has also coincided with an upswing in key polls and other measures of former President Trump's election prospects.

"Reflation" ... so soon?

As we've covered previously in the September 28th CIO Bulletin, Trump has campaigned on universal tariff increases, a 60% tariff on imports from China, and markedly more restrictive immigration policies. Increasingly, his campaign has included a longer list of potential domestic tax cuts (these are domestic demand-boosting policies with restrictions on foreign-sourced supply). While some of these policies will face Congressional and legal hurdles, a Republican sweep of Congress appears mathematically higher in probability than a Democrat sweep as far more Senate Democrats than Republicans face elections next month.

At present, a "blue sweep" of the White House and Congress would be a large, market-moving surprise. Yet any and all potential election outcomes are likely to move markets in our view, given still close polling. Investors and traders simply can't depend on any particular results with confidence.

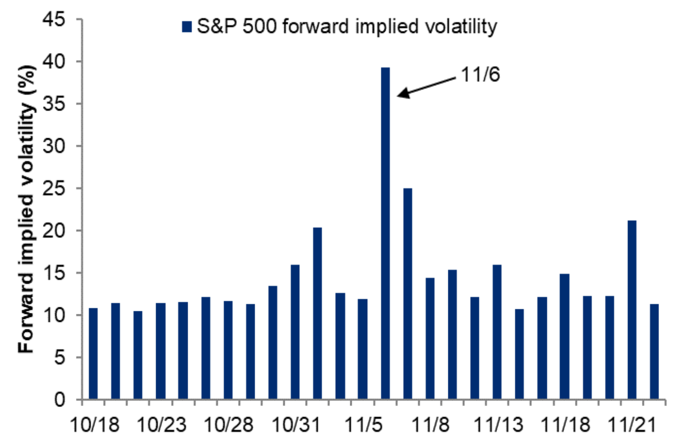
Don’t be misled by wild election night market swings

As **FIGURE 3** shows, markets swung wildly in the past two US presidential election nights as polling data drove traders to sometimes inaccurate conclusions. We don’t believe long-term investors have any advantages here. Uncertainty may be over quickly. Alternatively, it could take weeks for complete results in a very close election. However, any increases in implied volatility – a spike in uncertainty – is likely to be short lived (see **FIGURE 4**). For suitable investors, this could improve investment entry points or lock in immediate income.

FIGURE 3: Election night market madness, relief

	2024 US Election	2020 US Election		2016 US Election	
	Implied volatility range (+/-)	Price Range Day After (+/-)	Total Return/bp move 1-month later	Price Range Day After (+/-)	Total Return/bp move 1-month later
S&P 500 Futures	2.2%	4.9%	+7.7%	6.8%	+4.5%
US 10yr Treasury yield	15bp	19 bps	+1bp	34bp	+55bp
USD (DXY index)	1.53% (USDJPY) 0.98% (EURUSD)	1.1%	-2.9%	2.9%	+2.6%

FIGURE 4: S&P 500 volatility during election year



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We look for potential opportunity if markets exaggerate and misprice

For our global asset allocation, we don’t expect to immediately make changes in the frenzy of fast markets. Opportunity could arise if markets *exaggerate* the positive or negative impact of particular policies implied by election results.

As we discussed in the September 28th CIO Bulletin, trade policy uncertainty may move up or down swiftly as such policies depend most significantly on the choice of President. Meanwhile, the Fed’s expected easing steps have yet to flow through fully to declines in the US dollar and boost non-US asset prices measured in the US currency (see **FIGURE 5**). This is likely because of trade policy uncertainty and the potential for Republican-led tax cuts to generate a higher rate path from the Fed than Democrats would.

As **FIGURE 6** shows, the past two election results – first for Trump, then for Biden – generated opposite results for domestic and international equities. This is right in line with the recent vacillation of polls and market performance. While we can’t predict the election, what will be key for us is if investors misprice assets, taking any potential impact too far. We’ll need to be patient now, but also ready.

A positive outlook, with questions on US policy to be answered

As discussed below, our equity market view remains positive overall. US corporate profits have reached record highs in 2024 and we expect new records in 2025 (please see the August 31st CIO Bulletin). Analysts, as usual, bias down their immediate EPS forecasts and bias up the future estimates. Apart from a very brief contraction in the pandemic, both Trump and Biden presided over growing corporate profits and records each year. The composition of market performance, however, suggests which industries the candidates’ policies favor.

FIGURE 5: Real trade-weighted dollar index and expected path of Fed Funds rate

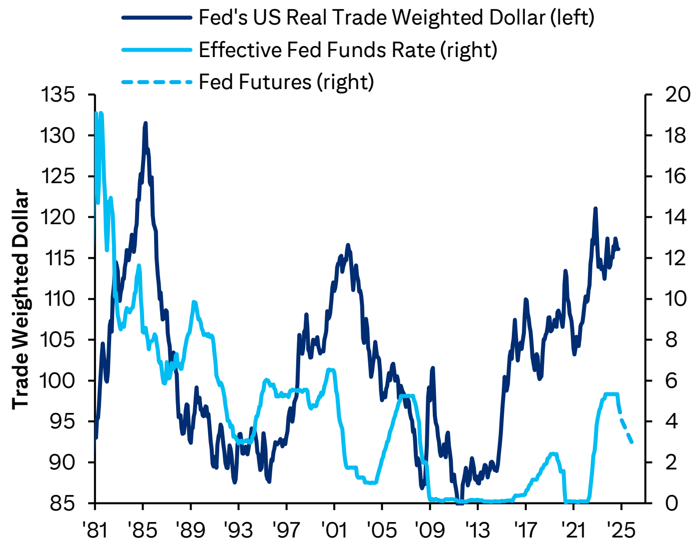
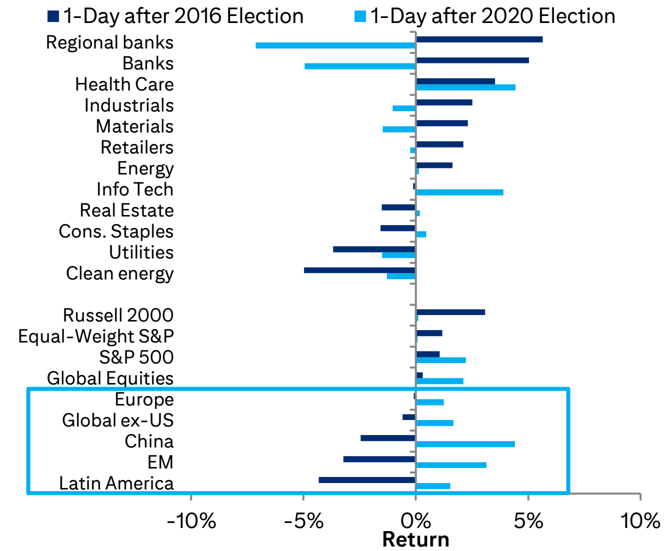


FIGURE 6: Regional and sector market performance the day after 2016 and 2020 elections



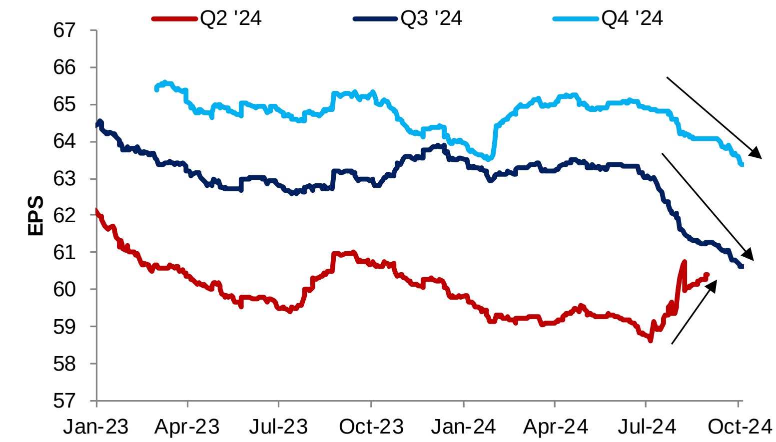
Source: Bloomberg as of October 16, 2024. The right box indicates the stark difference between international equity performance for each party win. Regions are using MSCI indices as proxy and sectors are using S&P 500 sectors as proxy. All forecasts are expressions of opinion and are subject to change 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.**

Earnings Add to the Election Noise

Equity investors will have to drown out the political noise over the next few weeks as they digest 3Q reporting season, which kicked off last week with the big banks. After a "beat and cut" 2Q earnings season which catalyzed significant downgrades to 3Q expectations, most firms should have no problem comfortably exceeding top and bottom line estimates for the quarter just past (see **FIGURE 7**). In fact, consensus expectations are for a 1.4% quarter-over-quarter *decline* in profits, which is inconsistent with solid macro data we received throughout the quarter. Indeed, tracking data from the Federal Reserve Bank of Atlanta predicts a 3.4% annualized growth rate for US real GDP in the quarter.

While predicting earnings beats is the easy part, more importantly for post-earnings performance will be corporate guidance. Equity investors are an impatient bunch, so key bellwethers that report early on in earnings season will likely set the tone for the rest of their industries. Large banks set a positive tone for the sector, while the reaction to early tech reports has been more mixed.

FIGURE 7: Q3 estimates set a low bar for firms to beat



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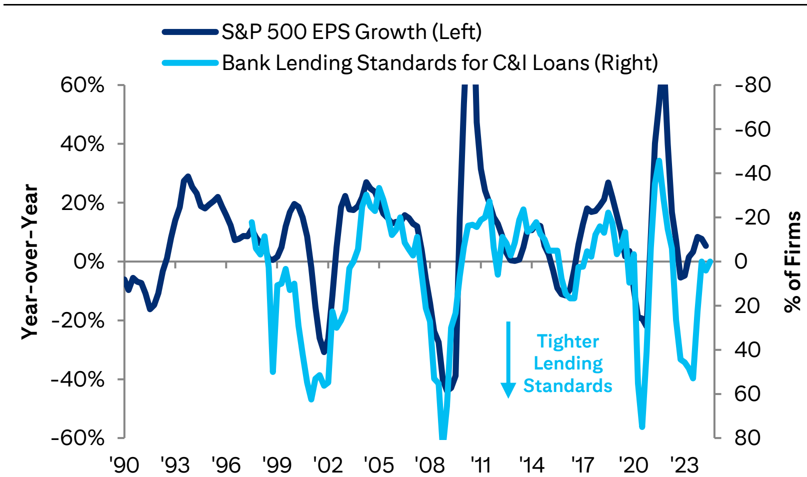
As go the banks, so goes the economy

The ultimate bellwether for the global economy is the banking sector, which conveniently tends to report early during each reporting season. While acknowledging stock-specific nuances, in general large banks reported very solid numbers, beating estimates for net interest income and fee-based revenues in 3Q. Large cap banks have quietly outperformed the broad market year-to-date, up 28%, driven by expectations for loan volumes to pick up and a steeper yield curve to improve net interest margins (see our August 17th CIO Bulletin). The banks rally has also coincided with rising odds of a Trump victory and hopes of deregulation. But importantly for our earnings outlook into 2025, an ongoing lending comeback would be a welcome sign for companies across sectors as they seek cheaper financing for their businesses.

FIGURE 8: S&P 500 EPS growth vs bank lending standards

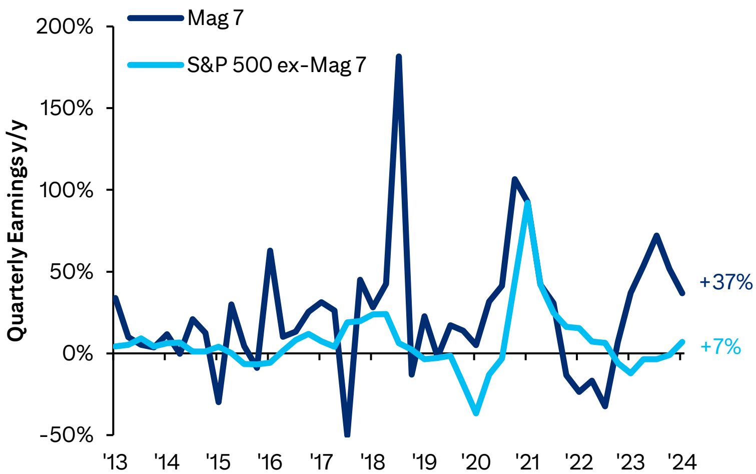


Source: Haver Analytics of October 17, 2024. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Index returns do not include any expenses, fees or sales charges, which would lower performance. **Past performance is no guarantee of future results. Real results may vary.**

In tech, there's AI and there's everything else

Intense focus on early reporters consumed the tech conversation this past week when the world's top semiconductor equipment and fabrication players reported earnings. While post-earnings reactions couldn't have been more divergent between the two firms (ASML sold off nearly 17% post-earnings while Taiwan Semiconductor rallied 9.8%), investors combed through earnings call transcripts parsing through drivers of AI and non-AI related demand. With megacap tech names due to begin reporting in the coming weeks, the question remains whether AI investment will be sustainable after five consecutive quarters of double-digit earnings growth (see **FIGURE 9**). Mixed results during 2Q earnings season marked the first time since 2022 that megacap tech wasn't able to exceed heightened AI-driven expectations. Since mid-July, the "Magnificent 7" as a group has failed to make new all-time highs.

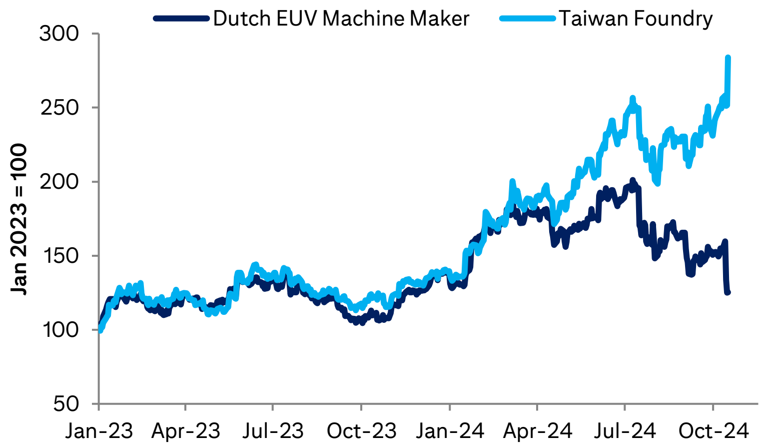
FIGURE 9: Mag 7 earnings have grown at high double-digits for five consecutive quarters



Source: Bloomberg and Factset as of October 17, 2024. The Magnificent 7 stocks include Amazon.com (AMZN), Apple (AAPL), Google parent Alphabet (GOOGL), Meta Platforms (META), Microsoft (MSFT), Nvidia (NVDA) and Tesla (TSLA). 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 key AI bellwethers, major semiconductor players globally are key to provide hints on AI development. The majority of tech companies won't report until the week of October 28, but the earnings release from the global largest foundry in Taiwan and EUV machine maker in the Netherlands this week may have provided some preview for tech earnings. The results from these two companies have underscored an increasing divergence between the strong demand for AI chips and applications, and sluggish demand for non-AI markets, such as PC and smartphones (see **FIGURE 10**). The Dutch EUV machine maker's share plummeted 21% in three days after it missed expectations on bookings and guidance on October 15, primarily due to slower recovery in PC, smartphone and memory markets. The company in the meantime continued to view AI as a key driver of industry recovery. The Taiwan foundry's strong beat on October 17 confirmed the extremely robust demand from AI data centers and chips, easing concerns around broad AI slowdown. Its comments about AI supply/demand also indicated potential upside revisions for AI revenue outlook in 2025, which could benefit the largest AI chipmaker in particular. The Taiwan foundry also saw early signs of increasing demand from advanced processors from the latest iPhones. AI on edge/devices could drive the next wave of demand if AI PC and smartphones were to pick up momentum.

FIGURE 10: Markets have increasingly differentiated between AI and non-AI revenues



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How rapidly are the largest tech firms spending on AI infrastructure?

It's quite possible that the tech sector continues to see narrow leadership in the coming months as semiconductor names with the greatest scale and the largest exposure to AI capture the majority of the profits in this high-growth early cycle, while spending on lagging edge chips and traditional software continues to be pushed out. Hyperscalers that provide cloud services that are empowered by AI data centers and advanced computing are likely to capture the second layer of profitability, but their spending levels will also face scrutiny.

Investor attention will now turn to capex and margins for the major cloud providers who are competing to spend heavily on AI infrastructure. The Mag 7 still account for 31% of market cap for the S&P 500. While we expect 3Q earnings will continue to show earnings breadth, we still believe the market will float or sink along with tech over the next few weeks – until the election recaptures our attention in early November.


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Medium grade	Baa	BBB	BBB
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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.

An investment in alternative investments can be highly illiquid, is speculative and not suitable for all investors. Investing in alternative investments is for experienced and sophisticated investors who are willing to bear the high economic risks associated with such an investment. Investors should carefully review and consider potential risks before investing. Certain of these risks may include:

- loss of all or a substantial portion of the investment due to leveraging, short-selling, or other speculative practices;

- lack of liquidity in that there may be no secondary market for the fund and none is expected to develop;
- volatility of returns;
- restrictions on transferring interests in the Fund;
- potential lack of diversification and resulting higher risk due to concentration of trading authority when a single advisor is utilized;
- absence of information regarding valuations and pricing;
- complex tax structures and delays in tax reporting;
- less regulation and higher fees than mutual funds; and
- manager risk.

Individual funds will have specific risks related to their investment programs that will vary from fund to fund.

Asset allocation does not assure a profit or protect against a loss in declining financial markets.

Diversification does not guarantee a profit or protect against loss. Different asset classes present different risks.

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.

International investing entails greater risk, as well as greater potential rewards compared to US investing. These risks include political and economic uncertainties of foreign countries as well as the risk of currency fluctuations. These risks are magnified in countries with emerging markets, since these countries may have relatively unstable governments and less established markets and economics.

Investing in smaller companies involves greater risks not associated with investing in more established companies, such as business risk, significant stock price fluctuations and illiquidity.

Factors affecting commodities generally, index components composed of futures contracts on nickel or copper, which are industrial metals, may be subject to a number of additional factors specific to industrial metals that might cause price volatility. These include changes in the level of industrial activity using industrial metals (including the availability of substitutes such as manmade or synthetic substitutes); disruptions in the supply chain, from mining to storage to smelting or refining; adjustments to inventory; variations in production costs, including storage, labor and energy costs; costs associated with regulatory compliance, including environmental regulations; and changes in industrial, government and consumer demand, both in individual consuming nations and internationally. Index components concentrated in futures contracts on agricultural products, including grains, may be subject to a number of additional factors specific to agricultural products that might cause price volatility. These include weather conditions, including floods, drought and freezing conditions; changes in government policies; planting decisions; and changes in demand for agricultural products, both with end users and as inputs into various industries.

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