Citi Wealth

Investment Strategy *Bulletin*

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It's Not 2022; Disaster in LA

Key Takeaways

- In the young 2025 to date, fixed income and equities have been in a state of flux together. The market volatility, somewhat reminiscent of 2022, appears driven by inflation and interest rate expectations, not by economic growth fears. While the firm economy and fiscal policy uncertainties were never likely to yield a very sharp Fed easing cycle, inflation data this week calmed investors from fearing another Fed pivot as it did in early 2022.
- Equity investors began drinking from the fire hose of 4Q earnings season this week as large US banks posted generally positive results. Overall market direction will be driven by AI-related equities' results and its progression from capex to monetization. AI software and edge AI look to be the next stages of revenue capture.
- The unfolding tragedy in Los Angeles highlights the expanding risks to communities and investments from climate change. We are often asked how these events will impact the overall economy and markets, and the answers are not always what people expect. For the economy, natural disasters do not always detract from growth especially if, like is the case currently in Los Angeles, most of the damage is to residential property. If the LA fires *do* become visible in national GDP figures, it will be paradoxically viewed as positive for growth as communities rebuild and reinvest.

Potential Portfolio Implications

- Market yields have already hit our year-end 2025 expectation for 10-year Treasury bond yields of 4.75%. We believe an overshoot to 5% for 10-year US Treasuries would likely warrant adding some longer duration high quality bonds or perhaps extending portfolio duration. Given a mix of higher rates and our firm economic growth views, it may also suggest some greater allocation to credit at the expense of equities if yields become more attractive.
- Beyond tech and financials, 4Q results could in fact be somewhat mixed as only 7 of 11 sectors are expected to see a rise in profits, down from 8 in 3Q. Investors will as always be looking for 4Q beats and, more importantly, for a better outlook in 2025 as they consider diversifying exposures away from tried-and-true tech leaders. If tech continues to shine, we would expect the earnings momentum factor to continue outperforming. But if 4Q reporting season reveals sluggishness in AI monetization while other sectors clear a lower bar, then we could see this factor roll over, possibly signaling a resumption of the "broadening trade."

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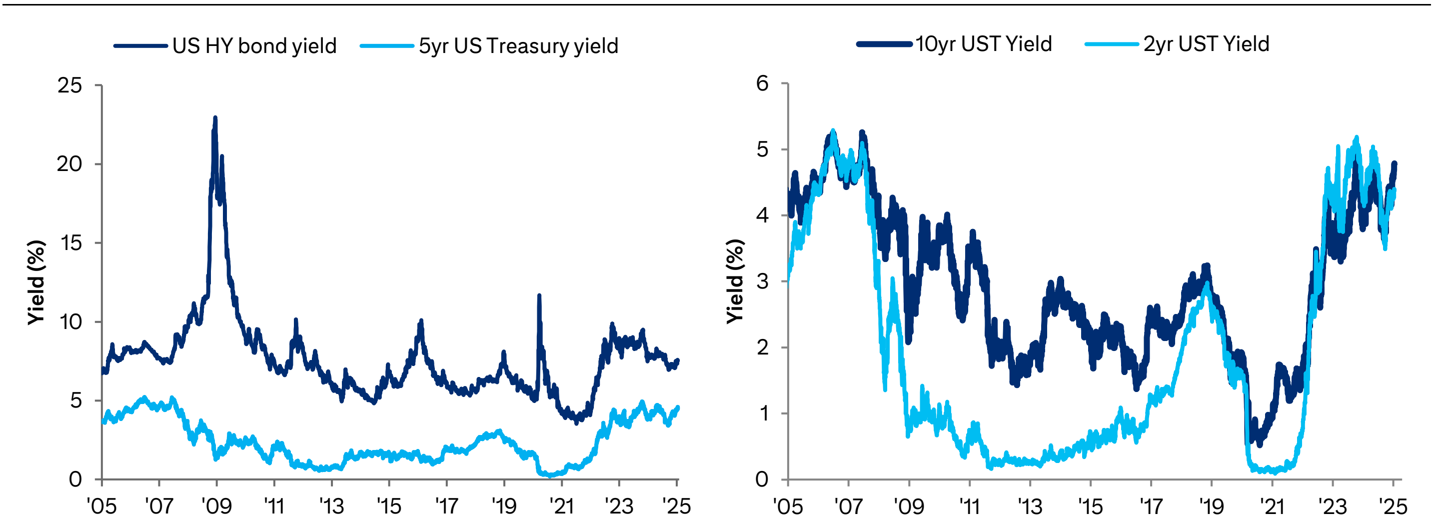
Déjà vu to 2022?

In the young 2025 to date, fixed income and global share markets have been in a state of flux together. With small declines, the bond market return has been slightly worse than equities despite the overall price volatility of shares typically exceeding bonds by 4X when measured over annual periods. This market volatility, somewhat reminiscent of 2022, appears driven by inflation and interest rate expectations, not by economic growth fears. Amid surging rates, the high yield bond market has been more resilient than broad-based bond market indices year-to-date. Credit spreads have tightened while rates have risen sharply since October, but a slightly cooler inflation report this week allowed yields to simmer down (please see our CIO Bulletin from last week and **FIGURE 1**).

FIGURE 1: High yield and 5yr US Treasury yield

FIGURE 2: 2yr and 10yr US Treasury yield



Source: Bloomberg as of January 16, 2025. Bloomberg US Corporate High Yield index used as proxy for high yield. 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.

The rise in interest rates across the board generates greater competitive pressure on other asset classes for return (see **FIGURE 2**). This is typically described as a "higher hurdle rate."

As we discussed last week, we believe an overshoot to 5% for 10-year US Treasuries would likely warrant our Global Investment Committee to add some longer duration high quality bonds or perhaps extend the duration of our bond weighting. As we've been somewhat bearish bonds, our duration is cautiously shorter than the market average. Given a mix of higher rates and firm economic growth views, it may also suggest some greater allocation to credit at the expense of equities if yields become more attractive (our combined global fixed income and cash allocation tactical weighting is -3.5%, while for equities it is +3.5%).

As we wrote in our Wealth Outlook 2025, we came into this year expecting upward long-term interest rate pressure. Some of this seemed likely as the unified Republican government seeks a stronger domestic growth agenda and restraints on foreign supplies.

Yet market yields have already reached and fallen back from our end-2025 target for 10-year note yields of 4.75%. As we noted in our early November CIO Bulletin, the annual range of US bond yields in recent years has been wide, near 200 basis points. Overshoots can be painful for long-duration bond holders. However, by taking a greater hit than the equity market on a volatility-adjusted basis, the bond market has "de-risked" by a greater margin, and so may warrant a higher portfolio allocation given our estimate of 4% on average during the years after 2025.

Quite simply, it's not 2022

As **FIGURE 2** shows, the bond market valuation is dramatically different than the conditions at the start of 2022. US Treasury coupon interest is literally 10X the low of 2021. History's lowest interest rates in that period set markets up for a joint decline in both equities and bonds in 2022 that was seen only twice before in the past century.

Some of what has driven the latest yield rise is quite predictable and unsustainable. After two severe hurricanes in the US Southeast that derailed hiring in October, it's taken two months of above-trend US employment gains to recover, with a likely further spur ahead from rebuilding efforts (see **FIGURE 3** and the Sustainable Investing team's Climate and Insurance: Winds of Change). Even so, the trend pace of US employment gains is still moderating (see **FIGURE 4**).

While the firm economy and fiscal policy uncertainties were never likely to yield a very sharp Fed easing cycle, inflation data this week dissuaded investors from believing the Fed would pivot yet again to tightening as officials did in early 2022.

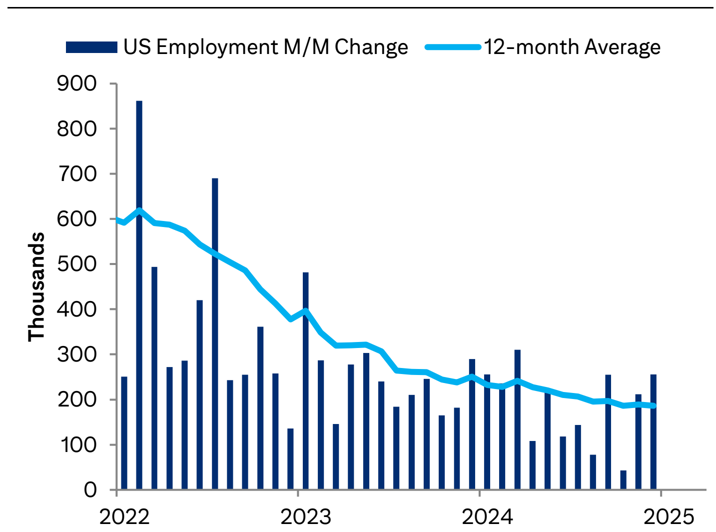
Looking ahead, we expect the "good news is bad news" global market reaction to US jobs data won't continue as we head into corporate earnings season as a news driver.

Fourth quarter corporate earnings reports have a historic tendency for managements to embed as much bad news as possible to "clear the decks" for stronger reports in the new year. Even so, if recent history is any guide, we would expect S&P 500 EPS gains for the fourth quarter to exceed analyst estimates by 5%. While we have been somewhat more encouraged by the lowering valuation of the bond market for new investor allocations, it is quite possible in our view that both stocks and bonds continue to rally together as inflation expectations stabilize (see **FIGURE 5**).

FIGURE 3: Employment gains following natural disasters

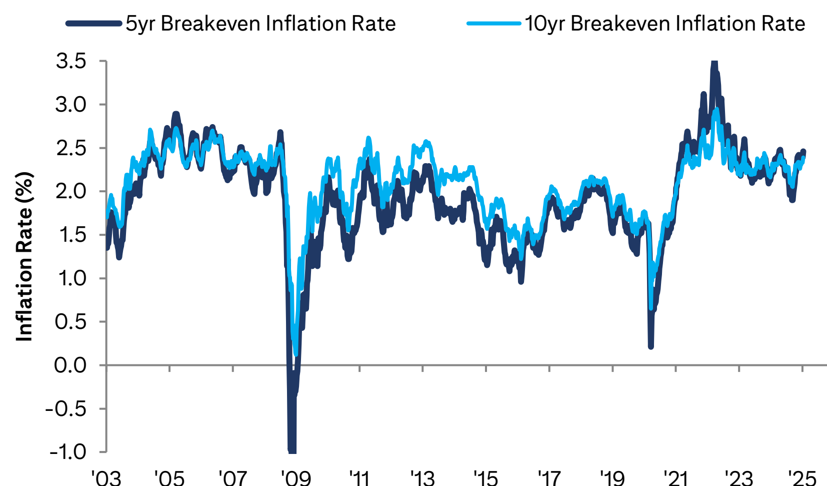
Hurricane	Date	Total Employment Gain in Following 2 Months (Thous)
Milton	Oct 2024	468
Helene	Sep 2024	255
Ian	Sep 2022	619
Ida	Aug 2021	1,340
Maria	Sep 2017	376
Harvey	Aug 2017	239
Sandy	Oct 2012	402
Ike	Sep 2008	-1,213
Katrina	Aug 2005	151
Average Following Disaster		**293**
Average 2 Month Gain Since 2000 (All Months)		**192**

FIGURE 4: US monthly employment and 12-month average



Source: Haver Analytics as of January 16, 2025. Past performance is no guarantee of future results. Real results may vary.

FIGURE 5: 5yr and 10yr TIPS inflation expectations



Source: Haver Analytics as of January 16, 2025. Past performance is no guarantee of future results. Real results may vary.

Earnings: Looking for Proof of Broadening Profits

While digesting new US policy pronouncements and accounting for a higher risk free rate, equity investors will also be drinking from the fire hose of 4Q earnings season in the coming weeks. Bottom-up consensus expectations are for earnings growth of 9% on the back of 4% revenue growth. We continue to expect 8% EPS growth in 2025 and 7% in 2026, driven by ongoing sales momentum and modest margin expansion (please see Global Equity Investment Strategy: Playbook for Navigating Early '25 Risks for a more detailed discussion).

What we heard from the big banks

First up as always during earnings season were the large US banks, who began to report this week. Results were generally positive across the board, with strength in trading, banking, and wealth management revenues driving top and bottom line beats. Continued commitment to return capital to shareholders was also a positive sign.

As sources of capital for consumers and businesses, banks are a helpful bellwether for the broader economy. Large banks reported solid credit card volumes during the Q4 holiday season, signaling that the US consumer remains resilient. Investment banking fees also rose across the board, with M&A momentum likely to continue in 2025.

Progress on AI monetization will be key for overall market direction

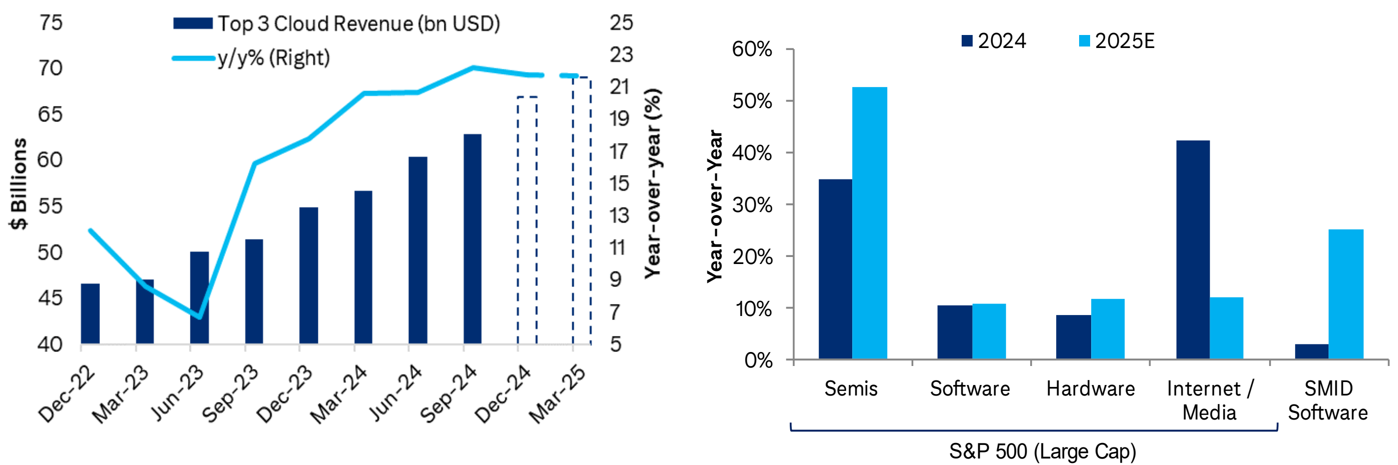
Given the critical importance of tech to broader market sentiment, AI will remain a key driver for equity markets this year. After almost two years of rewarding AI capex, investor focus is increasingly shifting to monetization. The first three quarters of 2024 already showed decent evidence of successful monetization from hyperscalers (big cloud providers), driven by accelerating enterprise adoption of AI tools. In the first three quarters of 2024, cloud revenue for the three largest AI services providers has reached $180bn and is expected to grow 22%y/y to $247bn for the entire year (**FIGURE 6**). All of the major cloud providers have highlighted much faster growth in their AI businesses than their overall cloud segments.

The robust growth in cloud-based AI workloads is likely to continue in the fourth quarter and in 2025, driven by corporate demand for scalable AI solutions. As AI workloads continue to ramp, demand for more cost efficient compute is likely to drive diversified AI chip productions, creating opportunities for broader chip makers – not just GPU leaders – to capture AI revenue.

Another area for monetization that's still in early stages is AI software, as firms build applications on top of "foundational" AI models. Some of this opportunity will naturally be captured by the same hyperscalers that are offering integrated AI platforms and subscription-based software. In the meantime, traditional software companies – both large and small – that have deployed AI in specialized areas also gathered some momentum late last year, but have underperformed big tech "cash cows" since rates started to rise in mid-December. We'd expect investors to focus on the coming earnings season to assess early signs of AI monetization among software players (**FIGURE 7**).

Lastly, edge AI is likely to lead the next wave of monetization in the commercial world, such as AI PC, AI smartphone and AI cars. In the just ended CES 2025, the world's largest chipmaker revealed new AI chips that could be used on personal computers, aiming to compete with incumbent PC chipmakers. We also expect the proliferation of AI chips to expand beyond GenAI to other use cases like industrial automation, household robotics, and drug discovery. The next leg of AI monetization is therefore likely to broaden from mega tech companies into users of that AI in other sectors in the years to come.

FIGURE 6: Top 3 cloud provider revenue since AI revolution **FIGURE 7**: Within tech, earnings could be more differentiated in 2025



Source: Bloomberg and Haver as of January 15, 2025. LHS: the dotted bars and lines represent consensus estimates from Bloomberg. RHS: SMID Software proxied using Russell 2000 Software Index. 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.

Can other sectors catch up?

While we see a runway for AI-driven productivity gains across sectors in the coming years, it's unlikely these investments will be the driver of broadening profits in the near-term. Beyond tech and financials, 4Q results could in fact be somewhat mixed. Only 7 of 11 sectors are expected to see a rise in profits, down from 8 in 3Q. Investors will as always be looking for 4Q beats and, more importantly, for a better outlook in 2025 as they consider diversifying exposures away from tried-and-true tech leaders.

Over 40% of S&P 500 market cap reports on the week of January 27th. We will be closely watching stocks with high and low earnings momentum during Q4 reporting season for real-time signs of potential shifts to the market and earnings leaderboard. If tech continues to shine, we would expect the earnings momentum factor to continue outperforming. But if 4Q reporting season reveals sluggishness in AI monetization while other sectors clear a lower bar, then we could see this factor roll over, possibly signaling a resumption of the "broadening trade".

FIGURE 8: Consensus expects a narrowing in growth between big tech and everyone else

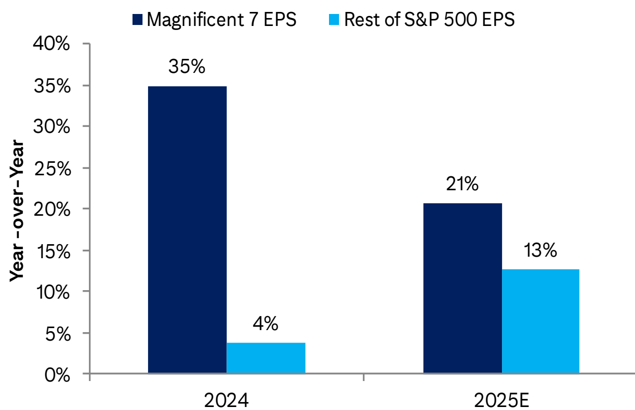


FIGURE 9: Stocks with strong earnings momentum have outperformed over the long run

Source: Bloomberg and Haver as of January 15, 2025. 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.

LA Fires and Natural Disasters in Perspective

The unfolding tragedy in Los Angeles highlights the expanding risks to communities and investments from climate change (please see the Sustainable Investing Team's Climate and Insurance: Winds of Change for a discussion of climate change and the insurance market). Humans' love of scenic beauty and nature have always come at some extra risk, but now some of the highest value real estate in the world is under siege from hurricanes in Florida and fires in California.

We are often asked how these events will impact the overall economy and markets, and the answers are not always what people expect. For markets, shifting risk is pushing more and more insurance into quasi-state funded entities in both liberal and conservative states with the juxtaposition of Florida and California. Both have seen flight into state-sponsored insurance entities as wildfires, flooding and hurricanes made swaths of real estate uninsurable at reasonable rates in the private markets. This dynamic could drive up risks for municipal bonds in the highest risk locations, and the unprecedented magnitude of claims could threaten profitability of traditional insurers. For the economy, natural disasters do not always detract from growth especially if, like is the case currently in Los Angeles, most of the damage is to residential property.

This reflects in large part how we measure the economy, as it is the growth in output that we call the "economy" and not the total store of wealth our civilization has accumulated. Clearly the ongoing fires are destroying real wealth and cultural heritage in the LA hills. But GDP will not show those losses anywhere. Instead, it will count the hotel rooms filled by displaced citizens as economic activity, and it will count the clearing of the ground and the rebuilding as investment even though it's just trying to get back what previously was there (see **FIGURE 10**).

On the one hand this may seem like a perverse way of measuring the economy as the country will be no richer once the houses are replaced and the land begins to heal. But for things like employment, it is clearer. The stock of wealth in housing has limited impact on employment, but rebuilding LA will require an enormous flow of insurance dollars which will go to contractors, architects, and construction workers to rebuild. If the LA fires *do* become visible in national GDP figures, it will be paradoxically viewed as positive for growth, which also may help explain the paradox of why economists seldom get invited back to parties.

One thing that's clear in the wake of these tragedies is the increasing rate of multi-billion dollar natural calamities from climate change (see **FIGURE 11)**, and that in addition to measures to mitigate the worst effects of climate change, measures to adapt and become resilient to the unavoidable changes are increasingly important.

FIGURE 10: Annualized GDP with natural disaster quarters highlighted

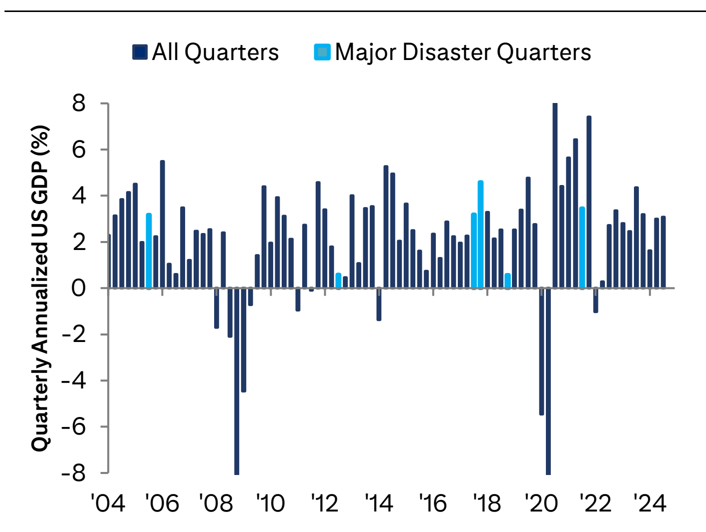


FIGURE 11: Insured losses of major disasters

Date	Natural Disaster	Insured Losses (Billions of 2023 $)
Q3 2005	Hurricane Katrina	$194
Q4 2012	Hurricane Sandy	$87
Q3 2017	Hurricane Harvey	$148
Q3 2017	Hurricane Maria	$107
Q3 2017	Hurricane Irma	$59
Q4 2017	California Wildfires	$18
Q4 2018	California Wildfires	$24
Q3 2021	Hurricane Ida	$80

Source: Haver Analytics and National Oceanic and Atmospheric Administration as of January 14, 2025.

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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.

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.

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