Viewpoint | Citi Research

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Global Equity Strategy

The Fed and the Long End

CITI'S TAKE

Two years after delivering its first cut of the cycle, Citi economists believe the Fed will hike rates this week. Risks from more restrictive monetary policy (from the Fed and other key global central banks) compound preexisting worries around higher long-end bond yields. So, will higher yields derail the current equity bull market? On *the Fed*, we find that global equities tend to wobble around the start of hikes, while still climbing 6/12m later. On *the long end*, we find that underlying macro conditions remain key; equities can better digest higher bond yields when growth stays resilient, while falling inflation also helps. All this would suggest more short-term caution amid stagflationary risks from geopolitics. We nevertheless remain comfortable with our call for further earnings-driven upside for global equities to mid-27.

Global Equity Strategy

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Rates Risks Growing — Citi economists see the Fed hiking this week. The shift towards tighter monetary policy extends past the US; more global central banks are now hiking than cutting for the first time in years. Citi economics expect a BoJ hike this week, recently added ECB hikes to their forecasts, and now pencil in BoE hikes as well. Meanwhile, long-end bond yields continue to rise globally, with 10Y US Treasury yields notably climbing above 5%.

Fed Hikes: Lessons From History — We examine equity performance around the start of Fed hiking cycles going back to the 1970s. We find that global equities tend to wobble around the start of Fed hiking cycles, while still rising on average 6-12m later. The US market tends to underperform after the first hike, while Japan and Europe typically outperform. Value tends to outperform Growth. In EM, Brazil and India tend to outperform, while China lags.

Higher Long-End Yields: Lessons From History — We examine prior US bond selloffs similar to today (+50bps over a 3m period). We find that sharp rises in 10Y yields are not universally bad for equities. Underlying macro conditions remain key; equities can better digest higher bond yields when growth stays resilient, while falling inflation also helps. Citi economists see manufacturing PMIs falling (but still >50), but geopolitics may skew inflation risks to the upside. This all paints a somewhat cautious picture and suggests de-escalation in the US-Iran conflict could remain key.

What About the Yield Curve? — According to Citi Rates Strategists, oil prices remain a key driver of the yield curve over the near-term. Higher oil prices would likely imply flatter curves, while lower oil would imply steeper curves. We highlight performance in various yield curve regimes, as well as correlations among global regions, European sectors, and EM countries to yield curve developments.

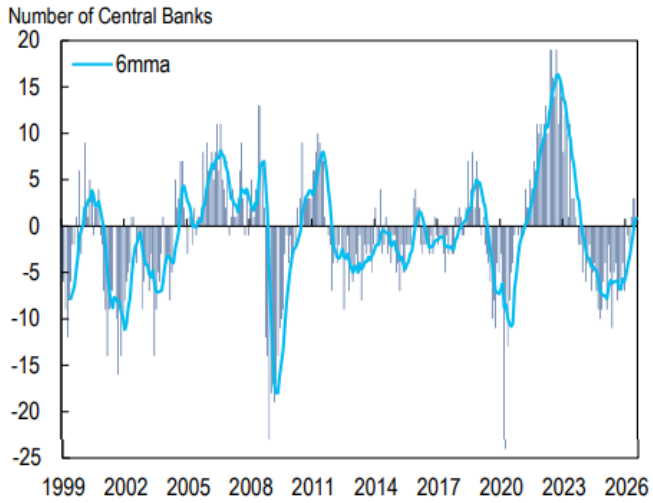
Implications & Views — It is not the first Fed hike that ends equity bull markets, although it does inject near-term volatility. Meanwhile, the impact of higher long-end yields is reliant on underlying macro drivers. This all emphasizes the importance of broader context. Given Citi's house view that global growth is likely to stay resilient, we remain comfortable with our call for further earnings-driven upside for global equities to mid-27. However, we must acknowledge rising stagflationary risks (via geopolitics) and growing market exuberance, as evidenced by our *Bear Market Checklist* at post-GFC highs.

See Appendix A-1 for Analyst Certification, Important Disclosures and Research Analyst Affiliations.

The Fed and the Long End

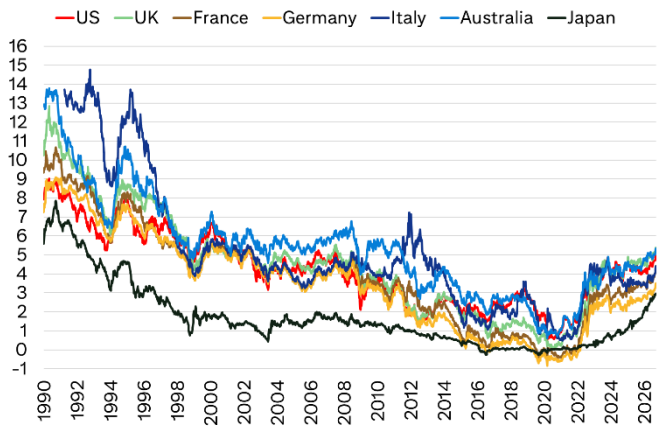
Almost two years ago exactly, the Fed delivered its first rate cut of the cycle. This week, Citi economists see US policy rates rising again. A sustained Fed hiking cycle remains unlikely, in their view, and the rate increase is likely to be presented as a "calibration". But a shifting narrative on policy rates extends past the US. The ECB has already begun its hiking cycle, and Citi economists recently added two more hikes to their forecasts. The team also shifted their view on BoE and now expect two rate rises from here. And the BoJ is expected to deliver a total of four hikes—this week, then in January, June, and December next year. And broadly speaking, the number of central banks hiking rates over the past six months now exceeds those cutting (Figure 1).
Risks from policy rate hikes compound preexisting worries around higher long-end bond yields. Even if hikes can ultimately help anchor the long end, global bond yields have risen meaningfully in past years, even against a global rate cutting cycle (Figure 2).

Figure 1. Global Central Banks: Hikers vs. Cutters



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Source: Citi Research, National Statistical Sources, Haver Analytics

Figure 2. Global 10Y Bond Yields



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Source: Citi Research, DataStream

In this report, we lean on history to explore both sides of the rates story—the Fed and the long end—and their implications for equities. Ultimately, we find that global equities wobble around the start of Fed hikes, but initial tightening does not mark the end of bull markets. And on long-end rates, we find that the reason for higher rates remains key. Should global growth remain resilient, equities can remain similarly strong in a rising yield environment. Rate rises associated with stagflationary dynamics are more problematic. For now, this leaves us comfortable with our call for further earnings-driven upside for the MSCI AC World to mid-27, although stagflationary risks are clearly rising against signs of market exuberance.

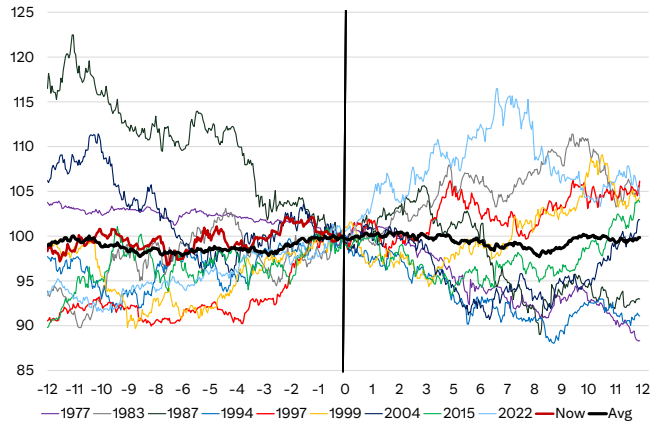
Part I: Fed Hikes: What to Do

To understand the impact of Fed hikes, we first look at asset price performance at the start of previous Fed fund cycles. This includes macro assets (USD and bond yields), regional equity market differentiation, and style performance.

Macro: USD and UST

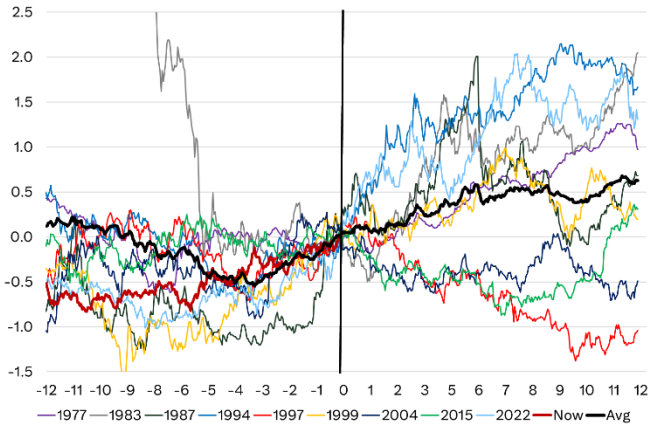
- **On average the dollar was relatively flat one year after the first Fed hike, albeit with a wide range of outcomes.** DXY strengthened significantly in 2022, while 1977 and 1994 were characterized by dollar weakness.
- **There is a clearer pattern for bonds, with 10Y US Treasury yields rising 50-100bp one year after the first Fed hike.** Yields notably fell in 1997 when the Fed delivered a single hike before going on hold and then cutting rates in 1998 around international market volatility (e.g., AFC)

Figure 3. DXY Around First Fed Hikes



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Figure 4. US 10Y Yield Around First Fed Hikes

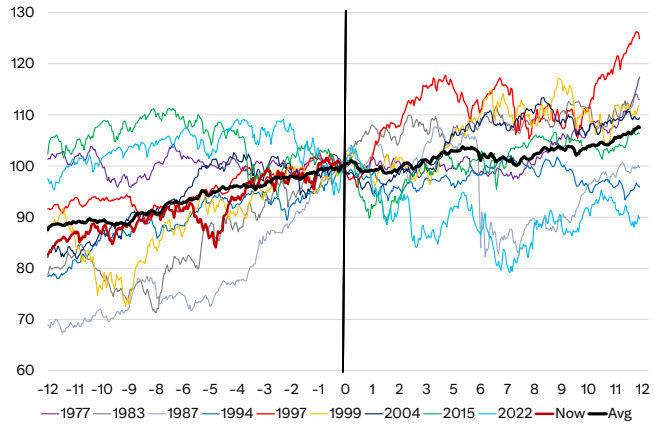


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Equities: Regions, Sectors, Syles

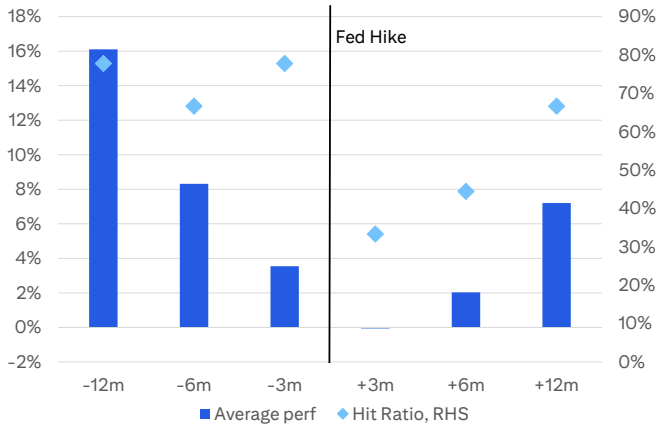
- **Global equities tend to rise into the start of Fed hikes (Figure 5).** In only two cases (2015, 1994) did global equities fall in the 12m preceding hikes (Figure 5). On average, we find that global equities have risen 16% on average in the year preceding Fed tightening, and c4% in the 3m prior.
- **History is less consistent after the hike, with equities wobbling in the first 3m following a rate-rise (Figure 6).** Three months after the first, equities have risen in only around one-third of cases. However, stocks have risen in the majority of cases 12m later, rising c7% on average.

Figure 5. Global Equity Perf Around First Fed Hikes (USD)



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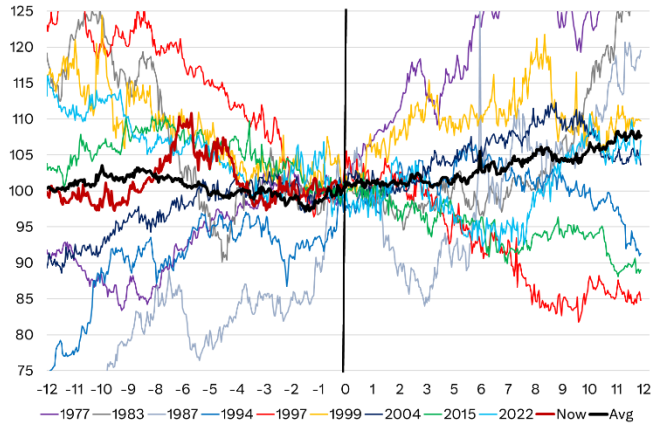
Figure 6. Global Equity Perf Around First Fed Hikes (USD)



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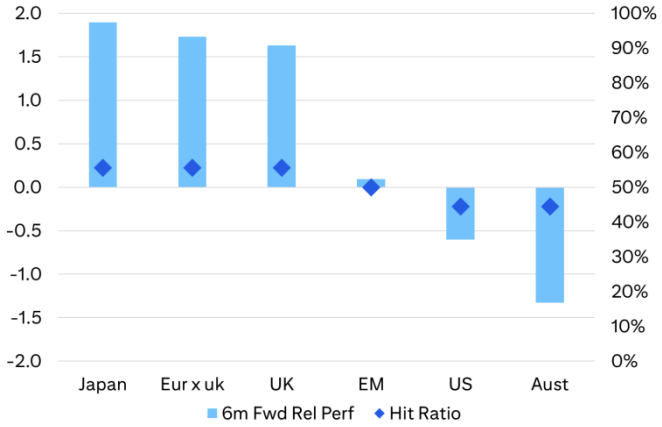
- **The US market tends to underperform after the first hike (Figure 7).** While not always the case, DM ex-US (EAFE) has outperformed the US market by 5-10% on average one year after the start of Fed hikes. **On a 6m horizon, median relative performance for Japan and Europe looks best, while the US and Australia lag (Figure 8).** Hit rates for positive performance remain relatively similar across regions but are just north of 50% for both Japan and Europe.

Figure 7. EAFE rel US Perf Around First Fed Hikes (USD)



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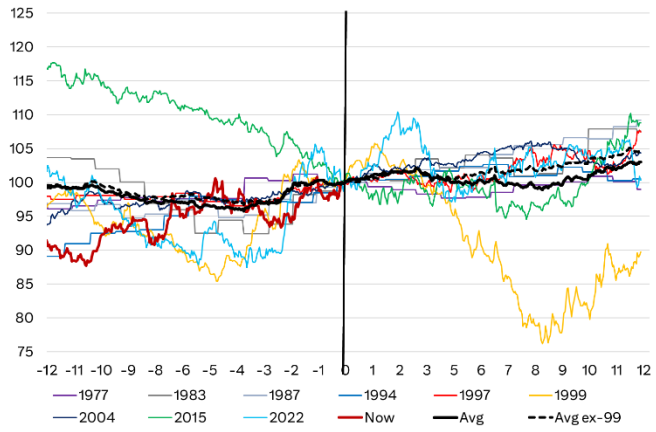
Figure 8. Median Relative Perf Around First Fed Hikes (USD)



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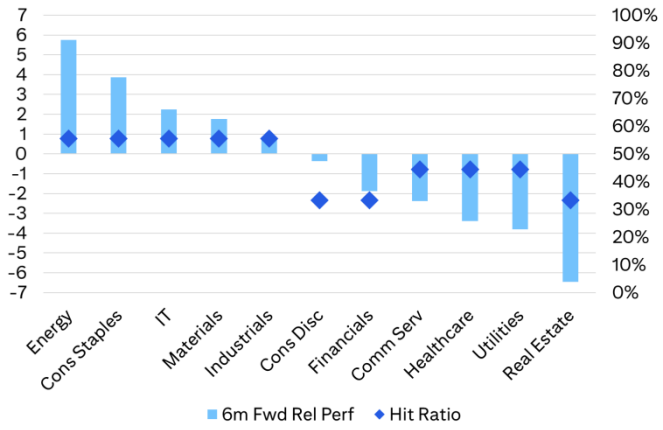
- **Value also tends to outperform 3m and 12m following the first Fed hike (Figure 9).** While the 1999 experience (i.e., the build-up to the TMT bubble) is a clear outlier, Value sectors have typically ou
Growth following the start of a hiking cycle. On average
do better than Defensives after the Fed hikes.

Figure 9. Global Value vs. Growth Around First Fed Hikes (USD)



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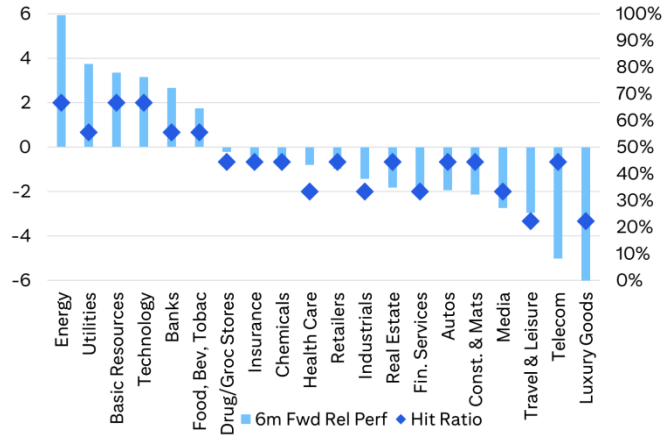
Figure 10. Global Sectors Median Rel Perf Around First Fed Hikes



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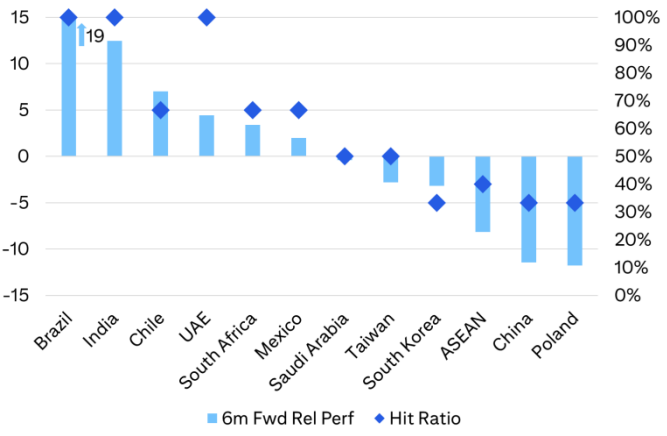
- **Global Energy, Consumer Staples, and Tech tend to outperform around the start of hikes, while Real Estate, Utilities, and Health Care lag (Figure 10).** In Europe, Basic Resources and Banks also outperform, while Lux Goods and Telecoms lag on average (Figure 11). In EM, Brazil and India tend to outperform Poland and China (Figure 12).

Figure 11. Eur Sectors Median Rel Perf Around First Fed Hike



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Source: Citi Research, DataStream, MSCI

Figure 12. EM Countries Median Rel Perf Around First Fed Hike



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Implications & Views: Equities and Fed Hikes

Ultimately, history suggests three key takeaways for investors:

1. **It is not the first Fed hike that ends equity bull markets.** While stocks tend to wobble around the first hike, it has typically paid to buy into any volatility with a one-year horizon. The same can't be said for bonds, where it has generally paid to sell US Treasuries.

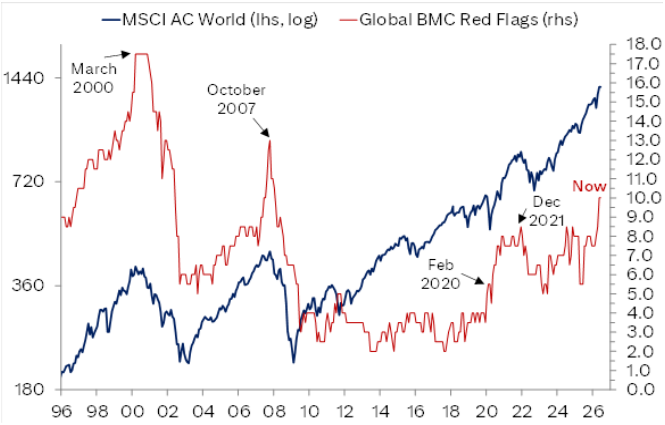
2. **Regional rotation favors RoW.** While global equities still tend to rise following the start of hikes, US underperformance has been a consistent trend, with Japan and Europe consistently outperforming.

3. **Lean into Value (and more mildly in Cyclicality).** This generally aligns with regional performance trends, suggesting intra-market rotation.

Of course, there is no "average" Fed hiking cycle, and much could be different this time around (indeed, Citi economists don't view this hike as the beginning of a cycle)—but our findings leave us comfortable with our call for more global equity upside to mid-27. Indeed, history leads us to the conclusion that Fed tightening is a reason to expect near-term volatility, but hikes alone do not precipitate the end of bull markets. And should EPS growth remain solid—with both economic growth and AI sentiment remaining in-tact—there is reason to believe equities can rise even against US policy rates. History would also support the general path towards market "broadening" with an ex-US and Cyclical/Value tilt.

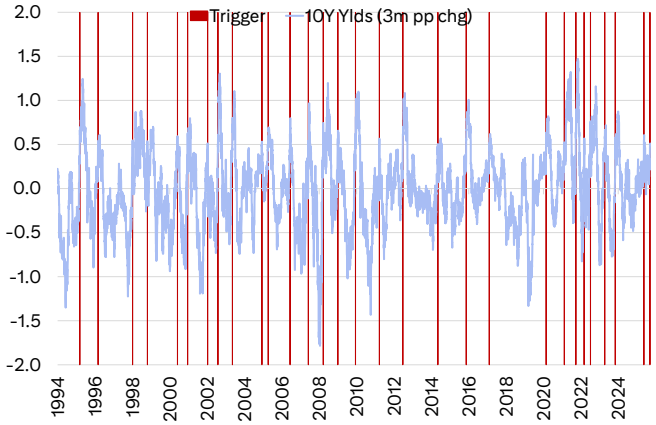
However, we must admit that our preferred gauge of market exuberance—the Bear Market Checklist— is now at its frothiest level since the GFC (Figure 13). This means the broader market context around rate hikes has already become more difficult to navigate. As we have previously noted, global capex growth has risen significantly, mostly attributable to AI hyperscalers. The announced/expected IPOs of several megacap US companies pushed the global IPO factor into amber category for now. Global EPS is getting stronger, and sentiment is picking up (via stronger flows, bullish stock analysts, and a "euphoric" Levkovich indicator). Only a few factors in our BMC, such as select leverage measures and credit spreads, remain at more benign levels.

Figure 13. Global BMC Red Flags & MSCI AC World Index



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Figure 14. US 10Y Yields: Rolling 3m Change (pp)



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Part II: Higher Long-End Yields: What to Do

What do swift/sizable rises in long-end bond yields typically mean for equities? To shed light on this, we examine US bond selloffs of similar magnitude to today (+50bps over three months, with trigger most recently activating last week). Using data going back to 1995, we identify ~30 distinct episodes that fit this description (Figure 14). Around these periods, we then look at performance (during the 50bp yield rise and afterwards) and developments in key macro variables (Figure 15). Thus includes the path of *inflation*, proxied by the YoY reading in headline US CPI, and *economic growth*, proxied by the US manufacturing ISM. We show correlations of key variables and forward performance in Figure 16.

Figure 15. Global Equity Performance and Macro Indicators Around +50bp Moves in US 10Y Bond Yields Over 3m

	Equity Perf			Macro					
Dates Trigger	Perf In 3m Yld Rise	Perf Next 1m	Perf Next 3m	ISM Start	ISM 3M Later	Chg (pts)	CPI Start	CPI 3M Later	Chg (pp)
08/03/1996	3.9	2.7	5.3	46.9	53.6	6.7	2.8	2.8	-0.1
28/02/1997	4.4	-2.9	6.2	53.1	56.1	3.0	3.0	2.2	-0.8
04/01/1999	26.0	1.6	7.5	50.6	52.3	1.7	1.7	2.3	0.6
19/10/1999	-7.0	11.7	17.6	57.2	56.7	-0.5	2.6	2.7	0.2
29/05/2001	0.9	-4.3	-9.6	41.3	46.3	5.0	3.6	2.7	-0.9
14/12/2001	5.6	2.0	5.2	45.3	52.4	7.1	1.6	1.5	-0.1
09/01/2003	11.8	-9.1	-6.5	51.3	46.1	-5.2	2.6	2.2	-0.4
29/07/2003	9.4	2.5	6.1	51.0	55.2	4.2	2.1	2.0	-0.1
07/05/2004	-1.4	2.3	-3.3	61.4	58.5	-2.9	3.1	2.7	-0.4
05/12/2005	6.6	2.7	4.4	55.1	54.3	-0.8	3.4	3.4	-0.1
06/04/2006	5.2	1.1	-4.7	55.2	53.0	-2.2	3.6	4.2	0.6
07/06/2007	6.3	3.3	-1.6	54.0	53.8	-0.2	2.7	2.8	0.1
30/05/2008	4.5	-9.2	-10.4	48.9	50.1	1.2	4.2	5.4	1.2
17/03/2009	-11.5	11.3	19.2	37.2	46.3	9.1	-0.4	-1.4	-1.1
28/12/2009	4.8	-3.1	3.5	55.8	58.8	3.0	2.7	2.3	-0.4
07/12/2010	9.1	3.0	4.9	56.6	58.4	1.8	1.5	2.7	1.2
19/03/2012	15.9	-3.1	-7.7	53.5	49.5	-4.0	2.7	1.7	-1.0
20/06/2013	-0.6	6.5	9.6	51.1	54.6	3.5	1.8	1.2	-0.6
06/05/2015	3.5	0.1	0.0	52.9	50.2	-2.7	0.0	0.2	0.2
09/11/2016	-0.7	4.8	6.7	53.2	57.7	4.5	1.7	2.7	1.1
02/02/2018	4.1	-2.5	-2.8	60.9	59.0	-1.9	2.2	2.8	0.6
19/02/2021	10.7	-0.9	3.3	60.4	61.6	1.2	1.7	5.0	3.3
08/02/2022	-4.1	-6.4	-11.3	58.1	55.9	-2.2	7.9	8.6	0.7
22/09/2022	-1.1	-0.3	2.5	51.1	48.0	-3.1	8.2	6.5	-1.8
02/03/2023	-0.5	2.1	3.2	46.3	46.3	0.0	5.0	3.0	-2.0
04/07/2023	6.4	0.6	-4.7	46.7	47.3	0.6	3.2	3.2	0.1
10/04/2024	7.9	1.3	6.9	48.8	47.0	-1.8	3.4	2.9	-0.5
01/11/2024	6.3	4.4	5.1	48.4	50.0	1.6	2.8	2.8	0.1
15/05/2026	**6.1**	*2.8*	*5.6*	**54.0**	54.6	0.6	**4.3**	3.4	-0.9
10/09/2026	***2.8***	*?*	*?*	***58.4***	*?*	*?*	***1.9***	*?*	*?*
Average (excl. '26)	**4.5**	**0.8**	**1.9**	**51.9**	52.8	1.0	**2.9**	2.9	0.0

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Source: Citi Research, DataStream, MSCI

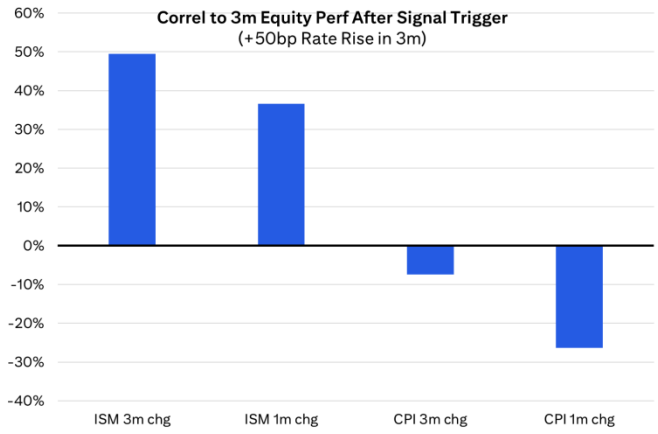
Based on this work, key lessons from history include:

1. **While there are a wide range of outcomes, sharp rises in 10Y bond yields are not universally bad for equities.** Global equities tend to rise on average as rates are climbing. Over the next 1-3m, equity performance is up slightly on average, but with a wide range of outcomes.

2. **Sharp rises in 10Y bond yields accompanied by rising PMIs are associated with better equity market outcomes. Cooling inflation also tends to be positive for equity performance following sharp rises in bond yields.** This relationship is evident in simple sensitivities, with changes in ISMs strongly positively correlated to performance after a sharp rate-rise, while in the change in the YoY rate of headline CPI inflation is negatively correlated.

3. **US equities and Growth tend to outperform following sharp rises in 10Y bond yields.** In Figure 17, we show the average performance of various sectors and regions in the 3m following a +50bp rise in US 10Y bond yields over a 3m period, in line with the analysis above. The US screens a notable outperformer, while continental Europe tends to struggle most. As for sectors, IT and select Defensive sectors perform best in relative terms. More traditionally rates-sensitive sectors (Real Estate) alongside Consumer Discretionary and Materials tend to underperform. Notably, the Japanese Financials sector stands out as a relative outperformer following yield increases compared to local peers.

Figure 16. Corr of Macro Variables to 3m Fwd Equity Perf Around +50bp Moves in US 10Y Bond Yields Over 3m



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Source: Citi Research, DataStream, MSCI

Figure 17. Average 3m Fwd Perf After +50bp Moves in US 10Y Bond Yields Over 3m

	3m Forward Performance (USD)					
	ACWI	US	Eur ex UK	UK	EM	Japan
Headline	1.8	2.2	1.2	1.9	1.7	2.1
Energy	2.4	2.2	1.2	0.5	3.9	1.8
Materials	1.6	1.1	0.2	0.5	2.1	0.2
Industrials	2.4	2.7	1.1	2.8	1.3	0.9
Cons Disc	1.8	2.2	0.0	1.2	1.4	-0.2
Financials	1.8	2.7	1.3	3.6	2.4	3.7
Real Estate	-1.8	-1.1	-2.0	-1.1	-4.1	-2.0
IT	3.5	3.5	3.8	3.4	2.1	0.7
Cons Stap	1.1	1.5	0.0	1.1	1.1	1.4
Health Care	1.5	2.3	2.2	5.4	1.8	1.4
Comm Svs	0.7	0.4	0.2	-0.7	1.8	2.7
Utilities	0.6	1.0	-0.6	2.2	2.7	1.3
Growth	1.9	2.8	1.2	1.9	1.3	1.0
Value	1.5	1.4	1.3	2.2	2.0	3.3

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Note: Data on headline indices goes back to 90s, while sectors start in mid-2000s. History for Real Estate begins in 2016.

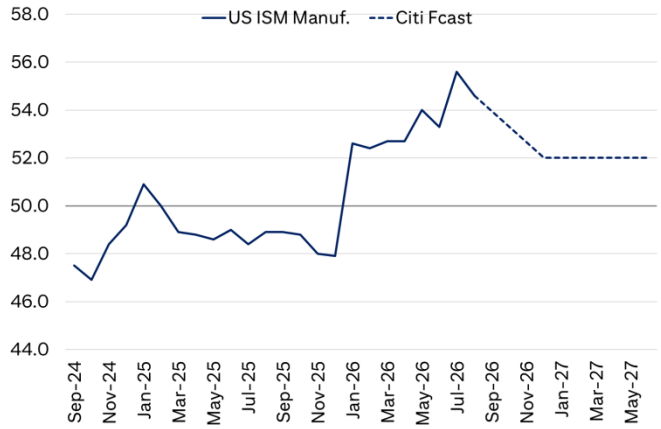
Source: Citi Research, DataStream, MSCI

Implications & Views: Equities and Higher Long-End Yields

So how does this all translate the current moment? Given the analysis above, the impact of rates on equities will likely be reliant on three key questions: (1) how will economic activity hold up in the months ahead? (2) how will inflation progress in the months ahead? We take each in turn below.

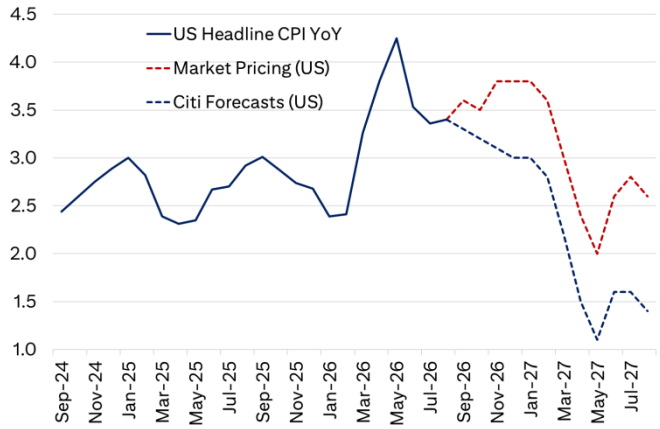
- As for **economic activity**, Citi US economists see manufacturing ISMs falling slightly but remaining in expansionary territory (Figure 18). This suggests activity could indeed hold up, in Citi economists' base case, albeit with a negative delta on PMIs.
- On **inflation**, Citi US economists see the rate of headline CPI continuing to move lower, although markets price in different near-term trajectory. The same goes for core CPI, which will fall slightly below 2% around April of next year, per our economist forecasts.
- On **rates**, Citi strategists still see 10Y US bond yields falling to year-end. Specifically, Citi US rates strategists continue to target 3.90% for 10-year Treasury yields by end-2026 (and 3.40% for 2-year yields).

Figure 18. US ISM Manufacturing (incl. Citi Forecasts)



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Source: Citi Research, Bloomberg

Figure 19. US CPI (incl. Market Pricing and Citi Forecasts)



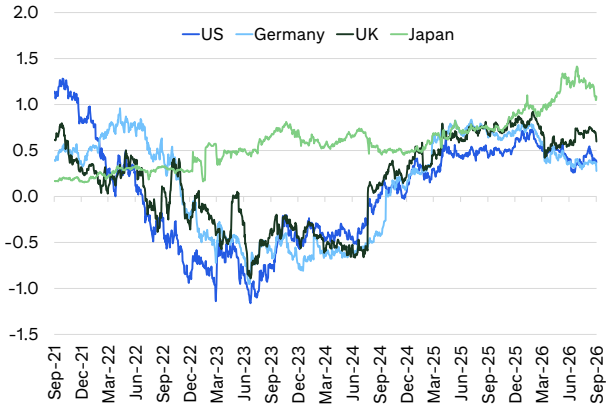
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Source: Citi Research, Bloomberg

This all paints a mixed, but somewhat cautious picture. Citi forecasts call for falling (but still >50 ISMs) and falling headline inflation over the next 3m. However, market pricing would imply somewhat higher headline CPI over the next quarter. This outcome would likely skew somewhat negative for equities. Should growth ultimately remain resilient and inflation cool, this would be the most positive scenario. This all paints a somewhat cautious picture and suggests relatively near-term de-escalation in geopolitical risks could be a key determinant as to how well equities digest the latest spike in long-end yields.

Part III: What About the Yield Curve?

Of course, the combination of the Fed policy and the long end is the shape of the yield curve. For context, global yield curves flattened/inverted in 2022 but had then been on steepening path until the start of this year. However, the war in Iran generally triggered flattening initially (outside of Japan), led by a sharp repricing of policy paths. 10s2s across regions have moved mostly sideways with some differentiation between regions in the past few months. We note that the yield curve tends to flatten on average around the start of Fed hikes (Figure 21).

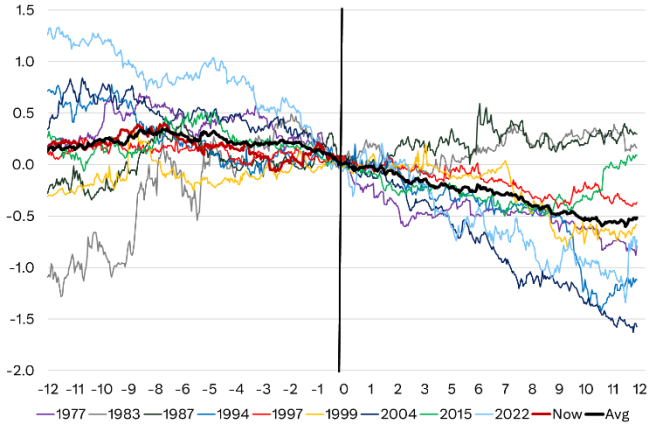
Figure 20. Global Yield Curves (10Y-2Y): Past 5Y



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Source: Citi Research, DataStream

Figure 21. 10Y-2Y Yield Curve Around First Fed Hike



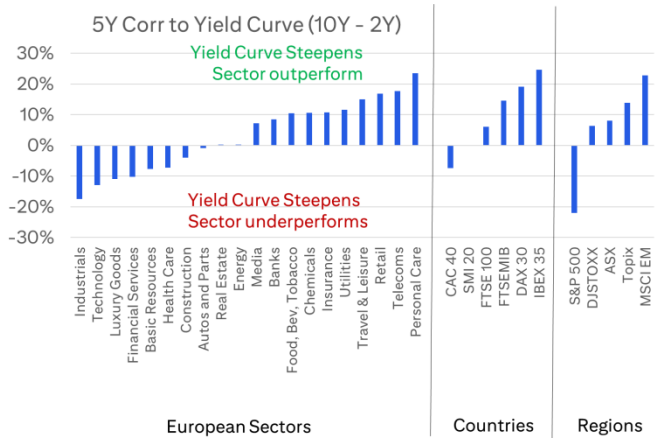
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Source: Citi Research, DataStream, MSCI

What does history tell us about yield curve dynamics and equity market performance? Key findings include:

- As for **correlations**, a steeper curve tends to favor more Cyclical (ex-US) markets (Figure 22). European sectors that tend to outperform include Travel & Leisure, Retail, Telecoms, and Personal Care. Spain and Germany fare best relative to European peers. When yield curves flatten, this instead supports the US along with European Industrials and Tech. Banks also benefit from a steeper yield curve, as well as generally rising yield environments more broadly.

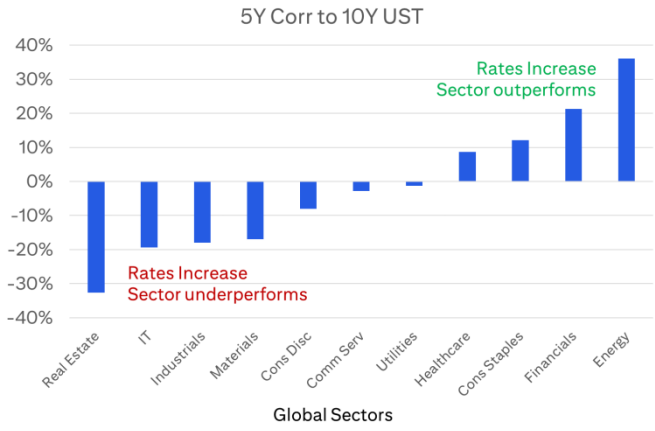
Figure 22. Regions and Eur Sectors Corr of Rel Perf to US YC



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Source: Citi Research, DataStream, MSCI

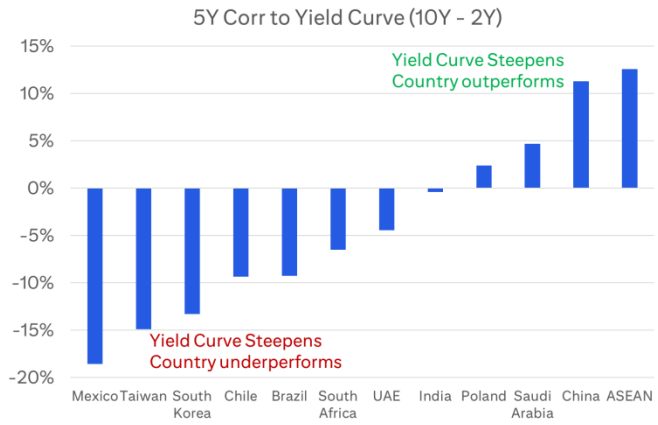
Figure 23. Global Sectors: Corr of Rel Perf to US Yield Curve



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Source: Citi Research, DataStream, MSCI, Note: Underlying data from 2003 for all regions/sectors/countries, maximum history where the series starts after 2003.

Figure 24. EM Countries: Corr of Rel Perf to US Yield Curve



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Source: Citi Research, DataStream, MSCI

Figure 25. Avg. Monthly Equity Perf by Yield Curve Regime

	Regime	ACWI	US	JP	EUR	AU	EM
Avg 1m Perf	Bull Flattening	1.0	1.1	0.8	0.7	1.0	1.3
	Bull Steepening	0.1	0.2	-0.2	0.1	-0.4	0.2
	Bear Flattening	0.2	0.3	0.0	0.1	0.1	0.2
	Bear Steepening	1.5	1.7	1.5	1.3	1.7	1.3
	Flattening	0.6	0.7	0.4	0.4	0.6	0.8
	Steepening	0.9	1.1	0.8	0.8	0.8	0.9
Hit Ratio	Bull Flattening	69%	72%	54%	58%	55%	67%
	Bull Steepening	61%	59%	51%	65%	55%	61%
	Bear Flattening	57%	55%	52%	54%	59%	53%
	Bear Steepening	64%	71%	71%	56%	67%	54%
	Flattening	63%	63%	53%	56%	57%	60%
	Steepening	63%	66%	63%	59%	62%	57%

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Source: Citi Research, DataStream, MSCI

- **We also highlight average performance historically in different yield curve regimes (Figures 25).** In general, our analysis would suggest that equity performance in steepening environments is somewhat more positive than flattening, although with meaningful nuance beneath the surface. Bear steepening and bull flattening tend to be the two best yield curve regimes for equities. The relative performance between regions stays relatively consistent in flattening and steepening regimes.

Figure 26. Avg. Monthly European Sector Perf by Yield Curve Regime

	Regime	Europe	Energy	Materials	Industrials	Cons Disc	Cons Stap	Health Care	Financials	IT	Comm Svc	Utilities	Real Estate
Avg 1m Perf	Bull Flattening	0.7	0.0	0.5	1.0	1.2	1.0	1.0	0.1	1.5	0.4	0.8	1.5
	Bull Steepening	0.1	-1.6	0.1	0.6	0.0	0.7	0.2	-0.5	0.5	0.3	1.2	0.4
	Bear Flattening	0.1	1.2	0.4	0.2	-0.4	-0.1	0.3	0.3	-0.4	-0.6	0.3	-1.4
	Bear Steepening	1.3	1.6	1.9	2.0	1.7	0.6	0.7	2.1	2.1	0.8	0.1	0.1
	Flattening	0.4	0.6	0.4	0.6	0.4	0.4	0.6	0.2	0.5	-0.1	0.6	-0.4
	Steepening	0.8	0.3	1.2	1.4	1.0	0.7	0.5	1.0	1.4	0.6	0.6	0.3
Hit Ratio	Bull Flattening	58%	47%	56%	58%	59%	56%	68%	56%	58%	45%	56%	59%
	Bull Steepening	65%	45%	63%	65%	65%	67%	55%	57%	55%	61%	67%	58%
	Bear Flattening	54%	60%	54%	54%	48%	51%	59%	57%	51%	45%	54%	46%
	Bear Steepening	56%	51%	61%	64%	58%	60%	56%	57%	67%	51%	53%	54%
	Flattening	56%	54%	55%	56%	53%	53%	63%	57%	54%	45%	55%	50%
	Steepening	59%	49%	62%	64%	61%	63%	55%	57%	62%	55%	59%	56%

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Source: Citi Research, DataStream, MSCI, Note: Underlying data from 2003 for all regions/sectors/countries, maximum history where the series starts after 2003.

- **We also highlight average performance for European sectors and EM countries (Figures 26-27).** For European sectors, steepening tends to be more clearly pro-Cyclical with better relative performance from Industrials, Materials, Tech, and Financials. Returns are more similar in flattening regimes. In general, Taiwan and Korea outperform in steepening, while Brazil and India fare better in flattening.