Citi Wealth

CIO Strategy *Bulletin*

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Earnings Defy Policy Pressures

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- **Key takeaways:** Mostly benign inflation data and solid bank earnings supports our view that the US economy is in good health, despite the sentiment overhang from tariffs and policy shifts. We continue to believe that the data does not argue for the Fed to ease policy rates this summer – even as the White House has increased its criticism of current Fed policy. With US equity markets hovering around all-time highs, investor reception to a very solid start to 2Q reporting season has been somewhat muted – reflecting already strong positioning. As the bulk of companies report over the next two weeks, we will be focused on any signs of tariff-related margin pressure and changes in investment guidance. We maintain our strong preference for large-caps and secular growth themes.

- **Good news: inflation data shows only subtle hints of tariff pressure.** While headline CPI in June (2.7%) was close to expectations, the underlying data reveal a more nuanced and emerging inflationary pulse. The breakdown of core CPI (ex-food and energy prices) affirmed a continued disinflation in housing-related costs, yet goods prices were firm and broke a multi-year flat or falling price trend. We noticed the sharpest rise in prices centered in specialized goods areas where substitutes are limited, such as window and floor coverings, which increased by 4% in June (vs. just 2% for appliances). In contrast, recent corporate commentary indicates that larger multinational companies with diverse supply chains and revenue segments have the ability to build inventory and get creative in sourcing, softening the price pass-through to consumers in goods. Taken together, **we see the impact of tariffs as uneven across and within industries, as companies with diverse supply chains will have more flexibility in managing costs than those operating with fewer product sources. It will ultimately take time to measure the shared impact on margins and consumers, with this earnings season as a key checkpoint**. Beyond the raw data, we are monitoring consumer inflation expectations surveys for the psychological pass-through of initial tariff pressures into consumer behavior.

- **More good news: Bank earnings reflected a resilient economy in 2Q.** So far, bellwether bank earnings have curbed concern about an imminent economic slowdown. However, tepid price reactions to solid beats suggest already-stretched positioning among the largest Financials. While all 17 Financials names reporting through Thursday beat consensus EPS estimates, only 7 outperformed in the session after releasing results. **We view diversified banks as beneficiaries in a higher-rate, more volatile environment, but valuations near post-GFC highs and crowded ownership are headwinds for top bank**

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outperformance. In positive signs for the health of the consumer and deal activity, net loans deemed uncollectible (charge-offs) were below expectations while major investment banks highlighted growing M&A activity. If financial conditions remain loose with range-bound rates and strong equity prices, we see this as a good sign that the nascent recovery in M&A can continue as focus turns to deregulation. **Overall, earnings season initially points to a benign economic environment in 2Q, supporting the recent recovery in lagging sectors and small companies that are also popular shorts. However, we are hesitant to add broadly to risk at current stretched valuations with effective tariff rates slowly climbing towards the new August 1st trade deadline.**

- **Volatility news: political pressure on Fed continued to escalate.** White House sources stated that Trump was ready to fire Fed Chair Powell this week, and the market reaction was immediately negative: the USD index fell almost 1%, 30y Treasury yields spiked 5-6bps, and gold jumped almost 1.5%. We view the independence of the Fed as critical to a stable economy. President Trump read the market reaction and walked back the threat within two hours. **We see two key implications from this escalation: 1) political pressure to subvert Fed independence will likely continue until Chair Powell's term ends in May 2026; and, 2) the President will demand the next Chair nominee share his bias towards lowering policy rates.** Importantly, however, the decision to lower policy rates is a committee vote, and the Chair holds limited sway on where votes land. We see the FOMC remaining steadfast in their data dependence regardless of the Chair and maintaining current policy rates through 3Q, until either a significant deterioration in labor market data or further disinflation. **With political pressure on the Fed mounting and shifting investor preferences away from US Treasuries pressuring yields higher, we continue to prefer a short-to-intermediate duration exposure for core fixed income portfolios of 3-5 years.**

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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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