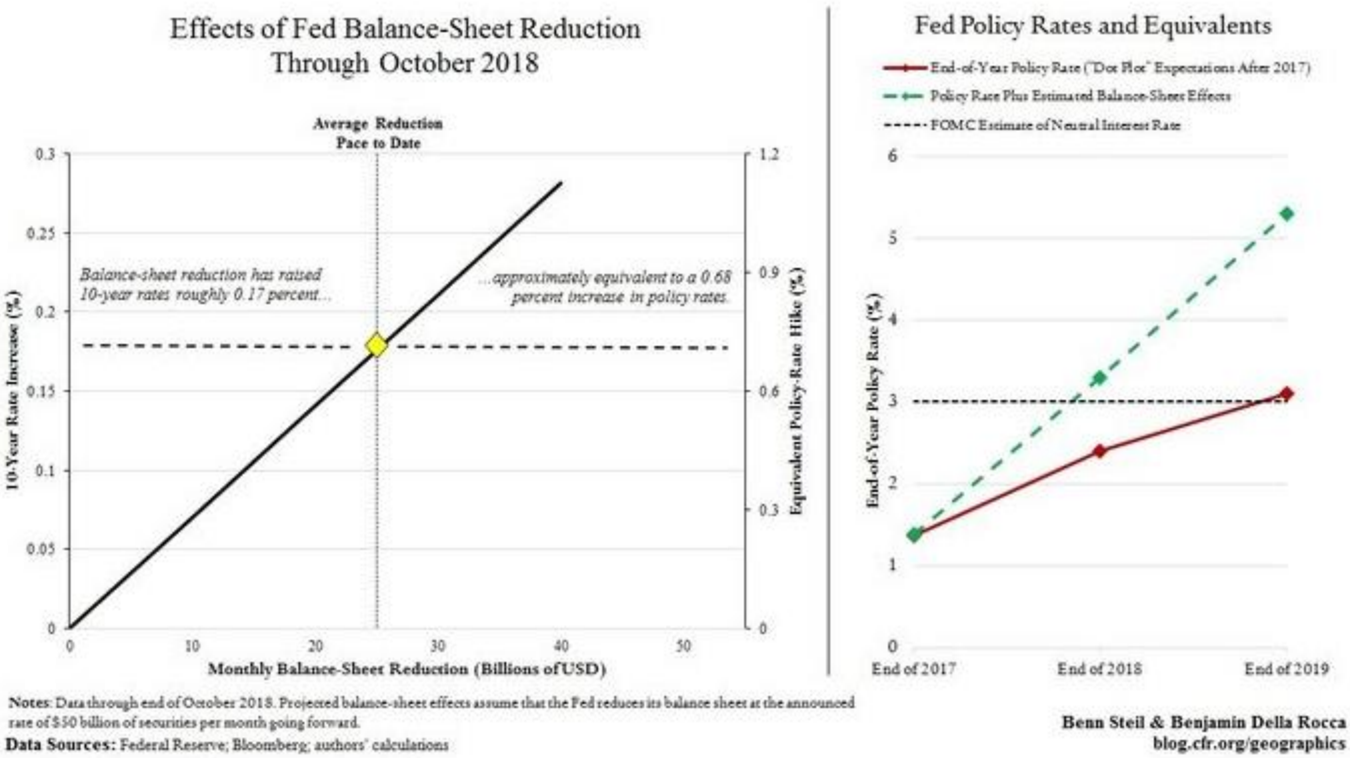
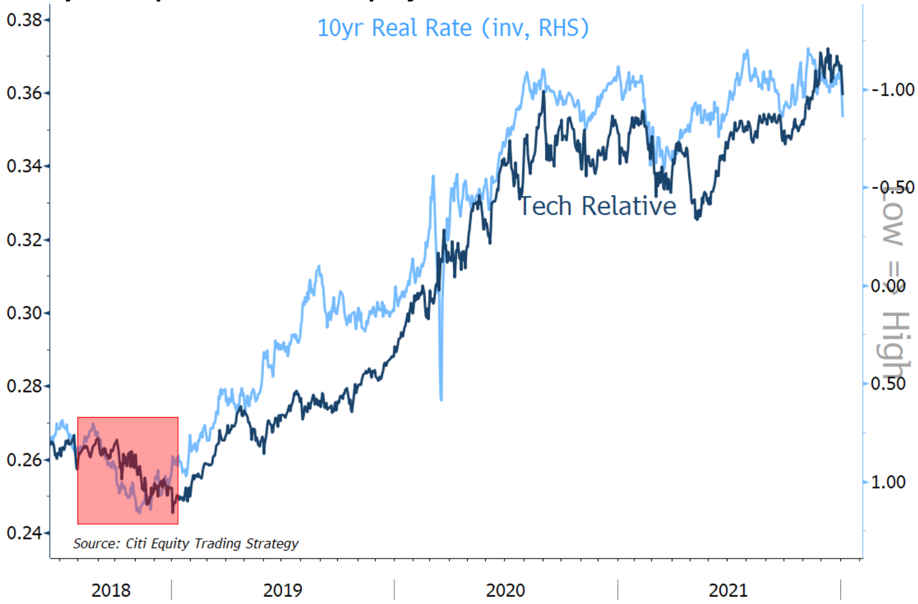
In the immortal words of Ron Burgundy, "*well that escalated quickly*". If the surprising beat in ADP data this morning was not enough to sharpen investor focus first thing then the Fed minutes delivered a swift crack to the head that the sequencing on hikes/balance sheet size may not be as straightforward as many have been led to believe. Citi Econ Andrew Hollenhorst's official reaction can be found [here](), but by way of personal addendum I would flag that not in the darkest corner of my mind did I really conceive that the Fed would consider a 2018 redux. And before you start to highlight the differences between 2018 and today, let us not forget that ultimately it is the fact that **balance sheet reduction has an equivalency effect of interest rate hikes that got us into trouble in the first place**. I dug out an old piece written in 2018 by the Council of Foreign Relations that broke down an [analysis]() estimating what at the time was a targeted $50bn/mo runoff in Fed balance sheet and the equivalency that would have on front-end rates. The conclusions were quite frankly profound, and was one of the reasons that equities reacted so violently in Q4'18. CETS are doing their own analysis of this using the most recent period of balance sheet expansion, but it is worth skimming through the piece as a reminder of what balance sheet reduction can do.



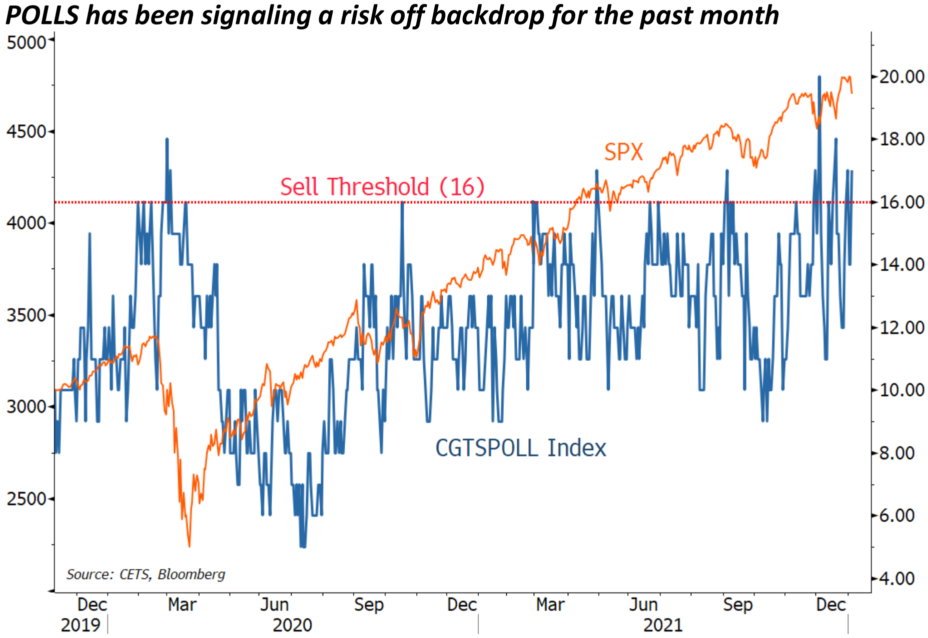
So roll forward to today and although we are just dealing with Fed *minutes* and not announced policy, the fact that the FOMC is even considering this option at a *faster* pace than 2018 is enough to send shivers down the spine of the market, especially given how sensitive the Growth complex has become to real interest rates. The market was trading on 20x trailing P/E back then versus today on 26x, and witnessed a meaningful period of NDX/Tech underperformance, so one would have to work off an assumption that there would be a multiplier effect in today's environment.

Real yields up = Growth underperformance



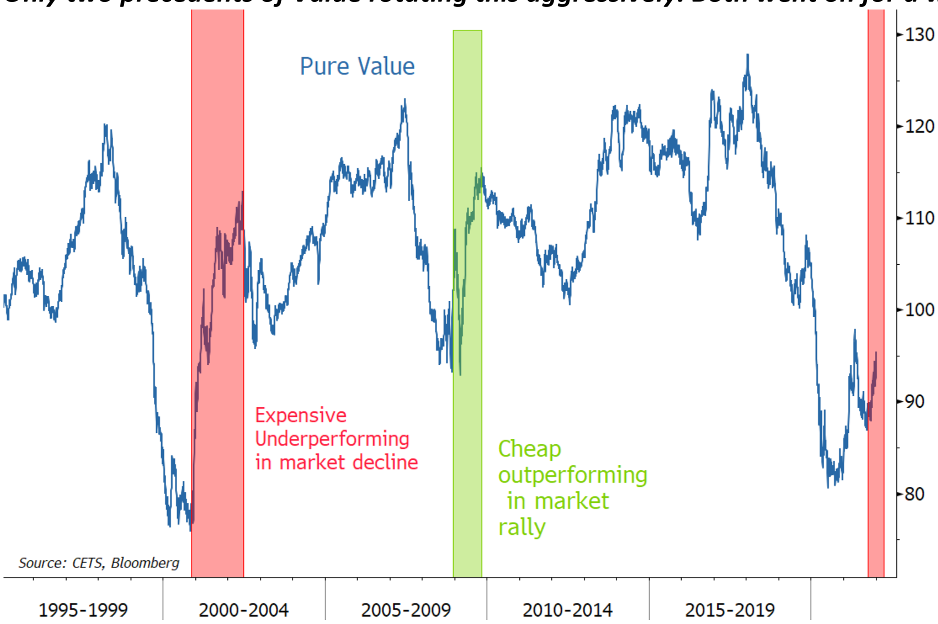
And speaking of real rates and Q4'18 comparisons, we saw 10y RYs move to the highest level since June 2021 by the close of business, which in turn has pushed our POLLS Model yet again back to a level of 17. If you're a regular reader of these notes and familiar with POLLS then you will be well aware that the model has been flashing warning signs for exactly one month, with the index hitting the highest level since Sep'18 back at the start of December (see **here** for the original note). December was choppy but ultimately proved to be a positive month for risk and yet our complacency model has continuously remained at warning levels. Today's messaging from the Fed only reinforces my view that we still need to see a LOT of exuberance to come out of risk – Growth especially – before investors can definitively say that the risk-reward looks attractive. **CTAs are back to within 1.7% of a sell trigger in SPX (4618 key level), with c$55bn of levered notional selling pressure if we definitively break that, and given the repeated flashing of warning within the POLLS model and indeed the technical break in crypto through its 55-week moving average, I could anticipate SPX testing the bottom end of the 4500-4800 range. That would represent 6-7% peak-to-trough drawdown and be broadly in line with what a repeatedly elevated reading of POLLS indicates compared to prior examples.**

POLLS has been signaling a risk off backdrop for the past month



That does not mean that the rotation has to come to a grinding halt either, but it may well pause for breath in the short term given the sheer magnitude of moves this week. A few of you enquired over the past couple of days as to whether this Value rally was another flash in the pan, akin to what was witnessed in June 2020. Recall that episode was driven by a meaningful short squeeze but resulted in a 'top 10' event for Value's performance over a cumulative three-day window. Today we have not observed the same kind of squeeze given the factor's performance has come from both the long *and* short legs of the basket, which got me thinking about how to frame the current environment. **The *cumulative* 3-day rotation from Growth into Value is now as large as any witnessed in modern factor history: 8.1% this week is comparable to the previous record set in April 2009 of 8.8%, and from an outright pure perspective Value is up 4.6%, which puts it into competition with the start of the dotcom bust in 2000/01. So although we have two very different scenarios for precedent here (early cycle vs late cycle), the commonality is that in both cases Value continued a structural rally for well over a YEAR.** Readers with a long memory may recall I attempted to address where we were in the rotation back in March last year (see **How far are we into the Value rally?**) with the very unscientific conclusion being around the "2nd innings". Today the narrative has evolved, but to me it is hard to argue that we are late in this rotation process.

Only two precedents of Value rotating this aggressively. Both went on for a while.



Given the starting point of valuations today (note that the top 10 SPX weights have almost the same **median P/E** today as they did at the top of the dot-com bubble) I personally lean towards this being a different flavour of the 2000/01 period, not only fueled by the ongoing unwind of new issuance (-5.2% today after a 4% fall yesterday and 1.3% on Monday) but equally the ongoing enquiries about buying dips in profitless Tech after only a 20% correction… but failing the smell test when a valuation discussion emerges, or even the fact that many of these companies rallied 100-200% before the recent dip. I shouldn't pick on one company, but I am going to anyway; SNOW. Whether you believe in the business model or not, this is a company that is forecast to generate $1bn of revenue, which means it trades on 90x sales and requires a view out to FY3 or FY4 to become comfortable with valuation. It is a well held name in 13F filings and has no sell ratings on the street (*although I'm told by my excellent Software analyst that 16 buys and 14 holds is actually not that bullish*). **Now, there will inevitably be a cohort of readership that will kindly present the counterargument as to why SNOW is an amazing company – and they are probably right (!) – but the point I am trying to illustrate is that investor faith in this part of the market has yet to be tested at present, and that I believe needs to/will change before considering this rotation ending.** Maybe at the margin that is starting to happen given instruments such as ARKK outflows are now the largest in almost a year.

Crypto breaking through meaningful technical levels, following moves in ARK Innovation

So tin hats? Hate to say it, but I think so. Even if the Fed do not execute on what is being insinuated from the last meeting, the move in real yields *should* be enough to take some froth out from risk assets without the Fed panicking. We obviously have CPI data next week where the forecast is another increase to 7.1% headline and 5.4% core; and that may represent a cathartic flush for investors to scoop up some 'cheap' stocks.

Alty

Alexander Altmann
Head of US Equity Trading Strategy
Office +1 212 723 1999

Market Commentary and a not a product of Research. Intended for Institutional use.

All charts/data sourced from CETS, Bloomberg and Citi, unless otherwise indicated.

This communication is issued by a member of the Sales and Trading Department of Citigroup Global Markets Inc. and intended for institutional investors only. For important disclosures and disclaimers please see https://icg.citi.com/icg/data/documents/ST_ExternalDiscl.pdf. This message is for the internal use of the intended recipients and may contain information proprietary to Citi which may not be reproduced, redistributed, or copied in whole or in part without Citi's prior consent. My cell phone number has been provided to you in order to enhance continuity of business. Please note that Citi personnel are prohibited from conducting any business through the use of text messaging and may not engage in communications regarding CFTC products via cellphone voice functionality.