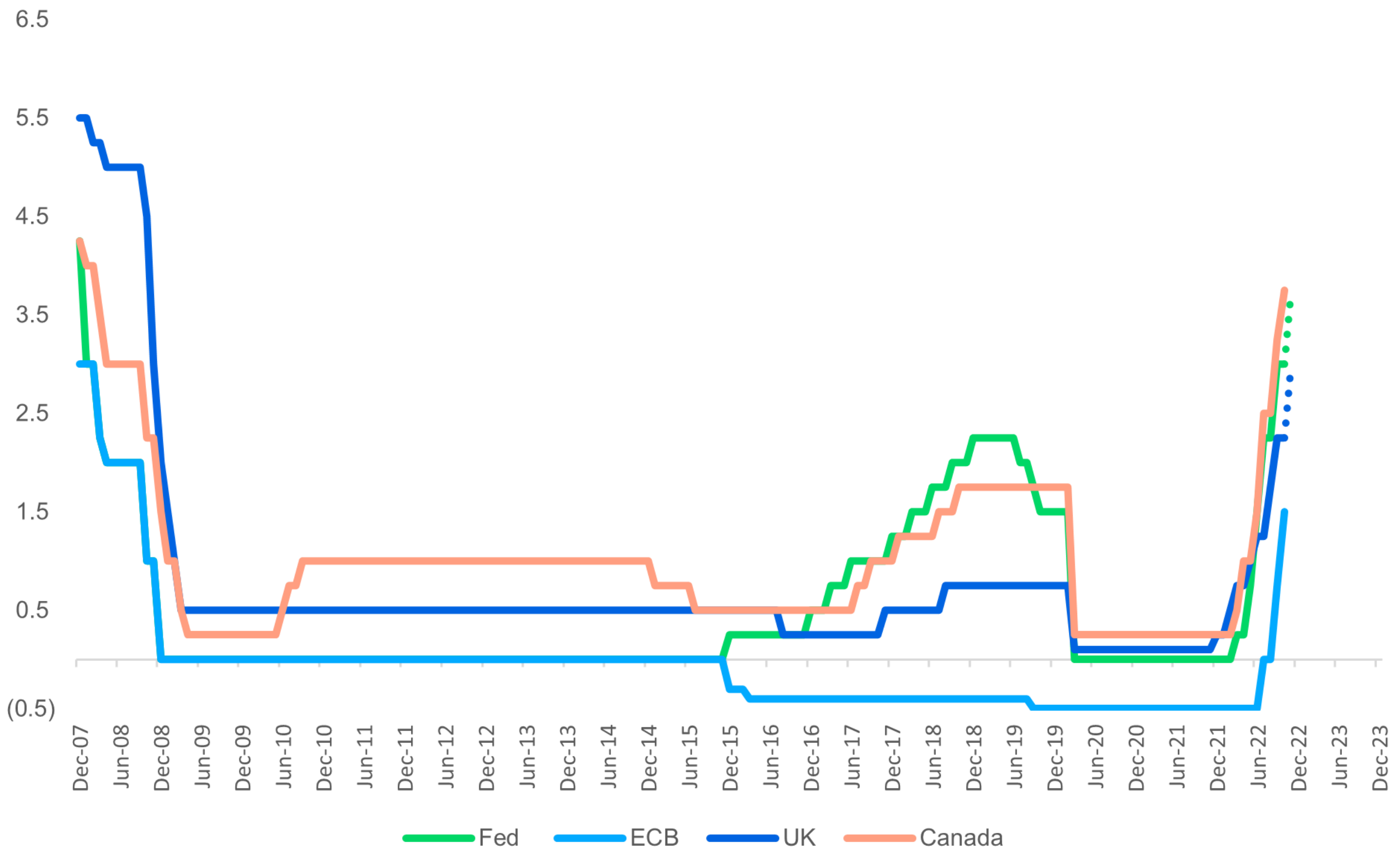
RockCreek

OCTOBER 28, 2022

STILL TO COME...

Two down, and two to go. Central banks in the West are still tightening, despite a backdrop of slowing global growth. Investors are looking beyond that, still hoping that inflation will ease sufficiently in coming months to bring forward the eventual end to rate hikes. Early in the week, big tech was front and center. Earnings missed badly as companies struggled against macro headwinds and failed to reign in expenditures. Markets punished them, knocking billions off valuations. But by Friday, spirits were recovering, and overall indices ended the week up once again.



Source: RockCreek, Bloomberg

The US economy expanded in the third quarter, according to Thursday's Commerce Department report. But the 2.6% annual rate rise in GDP came largely on the back of net exports and inventories. Final demand from US consumers, governments and business was flat.

Demand may be cooling, but inflation is still running too hot for comfort. The Federal Reserve's preferred measure – core PCE – accelerated again in September, up 5.1% from a year ago. Wage increases are flattening out or declining, a positive signal from Friday's employment cost index (ECI). But they are still running significantly above the rate consistent with 2% inflation, the Fed target. That leaves the Federal Reserve on track for another 75 basis point increase next Wednesday.

The Bank of England will likely follow the Fed's lead on Thursday, given continued inflationary pressures in the UK. That would leave the Bank of Canada (BOC) alone in bucking this summer's trend of mega rate rises. Noting the dangers of overshooting, BOC Governor Tiff Maklem announced an increase of 50 basis points this week, less than expected, but still much bigger than the 25 basis point moves typical in past tightening cycles, as we noted in our Q3 letter. The European Central Bank (ECB) held out against growing political unease about the costs of rising rates, with a second consecutive 75 basis point increase in its policy rate and a planned tightening of emergency lending to the banking system. As interest rates continue to march up, watch for changes in the investment climate.

Digital to Physical…

As we noted many times in 2020-21, the combination of extraordinarily easy money was an accelerator for growth stocks, notably the tech giants. The promise, or hope, that interest rates would stay low for longer – maybe much longer – drove up valuations reliant on expected future profits. Not only that, but the Covid lockdowns drastically shifted demand from the physical to the digital economy. Normalization in consumer and business behaviors along with the turn in the interest rate cycle from the start of this year were already undermining the narrative of a new paradigm.

This week's earnings reports from the tech giants further showed that strong headwinds remain.

Alphabet's and Microsoft's disappointing results on Tuesday reflected an increasingly cautious stance being taken by the corporate sector. Alphabet reported a material slowdown in its Google advertising revenue, while Microsoft cited a slowdown in its cloud computing business, Azure. Perhaps even more worrying, Texas Instruments lowered its Q4 guidance due to deteriorating demand in nearly every sector in the economy.

On the back of all that, Meta reported a second consecutive quarterly revenue decline on Wednesday amid a host of challenges, many of which are specific to the company as it is losing out to TikTok, has not solved for Apple's ad-tracking changes, and is making huge investments into its sputtering Metaverse ambitions. Rounding things out, Amazon reported weaker-than-expected revenue and earnings while also issuing disappointing Q4 guidance, and Apple's iPhone revenue disappointed, though it still exceeded overall revenue and earnings forecasts.

Despite the weakness from big tech, most companies are beating revenue and earnings expectations, with more than a third of S&P 500 companies having now reported. Data continues to show a resilient consumer, underscored by strong earnings from payroll provider ADP. Consumer-facing companies are still largely passing on higher costs.

On the industrial side, Caterpillar was a standout with strength across energy transportation and the construction and resource industries. The company was able to raise prices and still see higher volumes. Honeywell also reported strong growth in advanced materials, commercial aerospace, and building products. The only concerning area from Caterpillar's release was Europe where it is seeing falling demand, thus adding to the evidence that Europe is in a recession.

The winter is coming – but Europe is prepared

Unlike in the US, where fuel storage is at low levels for the time of year, European nations have successfully filled storage tanks in anticipation of a winter without ready access to gas supplies as Russia's war in Ukraine grinds on. Although gas prices in Europe are still up by some 40% compared to a year ago, the better outlook for this winter has brought them down from earlier peaks. It turns out that the price signal has worked to cut both consumer and industry use of gas by much more than many feared at the outset of the war. Germany's industrial use of gas is down by 20-25% from a year ago, without a drop in industrial output.

The good news has led some to worry, instead, about the cost and supply of energy for Europe a year from now, in winter 2023. That seems far away in the context of the determined response this year to the Russian-induced energy shock. It is also far away in terms of the battlefield. Russia is clearly on the backfoot, with the invasion it launched nine months ago looking more ill-judged by the week. But as we pointed out from the war's earliest days, the fight on the battlefield and its spillover into markets will be a prolonged conflict.

The Ukraine paradox and Russian irony

Despite President Vladimir Putin's best efforts to split the West and scare the world, most recently with warnings of possible "dirty bomb" explosions, the US and its allies and partners have stayed firm. Most governments have dismissed as an attempted "false flag" operation the recent warnings from Russia's defense minister that Ukraine may unleash a dirty bomb – i.e., a conventional weapon spiked with nuclear material that spreads radiation across a limited area. But while Russia is looking increasingly weak, the possibility of escalation in the conflict in Ukraine is real – and of great concern. The so-called Ukraine paradox is worrying US officials. If Ukraine were to lose the war that is clearly bad news. But if Ukraine is winning, that raises the risk of an unconventional and dangerous response from a cornered President Putin.

There is another paradox – or irony perhaps – in Russia's aggression. Its economy has held out unexpectedly well so far against western sanctions. But the long-term damage to its major income source – fossil fuels – is severe and growing. Russia has continued to earn significant amounts from energy exports since the war began, supplying willing buyers at a discount and out of the net of sanctions. But a slow squeeze is likely as sanctions bite on key inputs for the economy – and for Russia's military.

Other bad news for Russia's long-term economic health, as well as for other nations reliant on oil and gas exports, came this week from the International Energy Agency (IEA). In comments on its annual World Energy Outlook, Fatih Biron, head of the Paris-based agency, predicted the "end of the golden age of gas." Russia's invasion of Ukraine has triggered a sharp turn in European energy policies that will be felt for decades as nations reduce dependency on gas and oil and build up renewable and sustainable energy supply. The IEA forecasts a rapid increase in green investments, to $2 trillion a year by the end of the decade. This would be twice today's annual investments in fossil fuels.

Tightening the monetary screws in Europe

Although the energy situation may have eased, it is true that 2023 will be a difficult year in Europe, with tighter money exerting an increasing damper on demand. Steadier energy prices would help Europe's inflation battle. But ECB President Lagarde warned this week that the central bank is not yet done. This week's rate rise brought the euro area policy rate to 1.5%. This is the highest level since 2009. But while euro area inflation last month neared 10%, back in 2009 inflation was running at a mere 0.9%.

Political concerns about tightening money are a complication for President Lagarde and colleagues. French President Emmanuel Macron added his warning to the less surprising caution from new Italian Prime Minister Georgia Meloni. But with the ECB already under fire from others for delaying too long before moving rates up, do not look for an easing up in the near future.

US housing boom no longer

Mortgage rates topped 7% in the US this week. At the start of the year, the comparable rate was 3.11%, according to Freddie Mac's weekly survey. Housing, or real estate more generally, is a traditional channel through which monetary tightening impacts the real economy. The rapid pace of Fed tightening this year has translated into a speedy response in housing markets, taking many by surprise. Although still up significantly from a year earlier, house prices actually declined month-on-month in both July and August. The drop was most notable in some of the markets that had seen the biggest pressure since the pandemic. It will take time for this to feed through to rents and shelter costs recorded in the inflation numbers. But for those who worry whether the Fed may be moving too fast, the housing market is one to watch.

Currency crunch

This year's dollar strength shows the Fed tightening is having a clear impact through the second traditional channel for central bank policy. When inflation is global, currency moves just shift around where the pressure shows up. A strong dollar is good for US inflation – although bad for US corporates that earn significant profits overseas. The strong dollar also makes life harder for central banks and governments fighting inflation in their currency.

There has been some relief this week for the ministers and central bank officials who complained of dollar strength when in Washington for the World Bank and International Monetary Fund (IMF) meetings earlier this month. The restoration of governing calm in the UK helped. But the two Asian giants that have resisted monetary tightening – China and Japan – have seen their currencies continue to weaken. This will help their exporters. But it has made both governments uneasy. After Japan intervened to prop up the yen, first on September 22nd and then again on October 21st, the People's Bank of China (PBOC) this week appeared to go into the market to sell dollars and buy yuan.

Work and workers

Labor shortages have been a major factor behind the surge in US inflation. We have written before about the hidden costs to the economy of long Covid. New research suggests that for many who do come back to work, Covid may still have a lingering impact. The proportion of the disabled in the working population has gone up considerably, according to new research from the New York Fed.

Politics – and Covid – have also inhibited labor supply through their impact on immigration. Much support for tightening up the borders is based on the view that this will help US workers, who are otherwise undercut by cheap foreign labor. Not so, according to a new paper from the National Bureau of Economic Research (NBER). The study finds that firms which increased employment of foreign workers, through the lottery system, not only boosted production but also increased the number of American workers on their payrolls.

Our Emerging Markets Conference 2022: the Future of Sustainable Investing kicked off with a question: in the pantheon of leading EM economies, could India be the next China? Likely so, Rockefeller International Chair Ruchir Sharma told RockCreek CEO Afsaneh Beschloss, citing India's solidifying position as an economic powerhouse, building its growth around the green economy and investing in health innovations, while China's demographic challenges leave it primed for slow growth.

World Bank Chief Economist Indermit Gill noted to RockCreek's Senior Global Strategist, Caroline Atkinson, how strong economies like India, Indonesia are in a position to shape the new era of globalization. Council on Foreign Relations President Richard Haass discussed how global challenges ranging from Ukraine to energy, cyber, and eroding democracy could affect emerging markets; former IFC COO Stephanie von Friedeburg led a discussion about impact and sustainable opportunities in emerging markets; and RockCreek's Alberto Fassinotti, Yan Wang, and John O'Brien led deep dives into Latin America, China, and ASEAN countries.

Catch the whole discussion here.

Despite the relative respite in Chinese equities performance this week, the gap between China and the rest of emerging markets has grown more in the month of October than it had for the year through the end of the third quarter. Through September 30th, the MSCI EM Index, which includes China, was down 27.2% versus 25.2% for the MSCI EM ex-China Index, or a difference of 2%. Through the end of this week, this year-to-date gap has grown to over 5%. As discussed at our Emerging Markets conference this week, global investors are still digesting the implications of China's new leadership structure and closely studying developments in China. It is also true that China's equity markets (still heavily dominated by technology names) were further weighed down by this week's rout in US technology names. While there may be room for short term mean reversions in Chinese equities, the mid to long term picture remains murky.

In the meantime, investors in emerging markets are rewarding exposures in the tech hardware, IT, and materials sectors, specifically benefiting the markets of Korea, India, and Indonesia. RockCreek has been closing its bearish positioning in Korea as it pulls away from China and Taiwan, reduced China and Taiwan exposures, and is maintaining bullish stances on India and Indonesia and ASEAN as well. Brazilian markets should in theory have benefitted from investor interest in materials, but this weekend's Presidential election looks much closer than previously anticipated and is creating some jitters at the local level. We'll know more next week, but if Brazil is uncertain in the near term, we like the long-term outlook – between elevated commodity prices, a central bank looking to stimulate the domestic economy, and energy and food self-sufficiency, the country is in an enviable position.

On the currency front, things continue to look broadly positive for many emerging markets. Except for the Chinese Yuan and Korean Won, most of the consequential emerging markets currencies are holding their own against the strong Dollar and are outperforming developed markets peers. How long this trend lasts, given Fed and ECB hikes is unknown, but the fundamentals look strong and are certainly much better than they were in prior cycles.

China's action to support its currency may have been designed to combat the thumbs down delivered by markets on the news from the historic 20th Party Congress that President Xi has won a third term and consolidated power.

Markets rethought the initial reaction, rightly in our view. China is too big for investors to ignore. Much will depend on how President Xi decides to move now that he has crossed the hurdle of the Party Congress. We will be watching the outcome of his meeting in Indonesia with President Biden in mid-November, on the margins of the G-20 summit. President Xi struck a welcome conciliatory tone in his letter this week.

With more to come,

Team RockCreek