RockCreek

DECEMBER 2, 2022

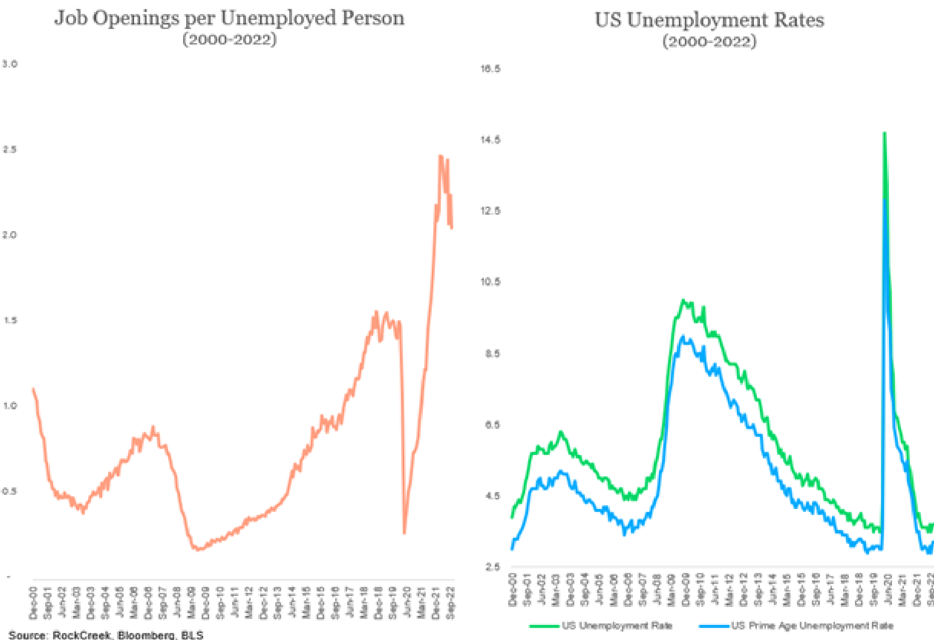
HOLIDAY CHEER CAME TOO SOON

Once again, markets got ahead of themselves this week, anticipating a Fed pivot that is not in sight.

It may seem strange to be gloomy about the strong US labor market. It is supporting consumer spending and economic growth. But with all eyes on the path for monetary policy, good news about jobs is often bad news on inflation and interest rates.

That was certainly true with Friday's jobs report for November. Unemployment was unchanged at the low level of 3.7%. Employers added a robust 263,000 jobs. But average hourly earnings grew rapidly, at 6.8%, far above the rate consistent with low inflation. Together with upward revisions to the data for September and October, the inflation picture darkened considerably. No surprise that Wednesday's market boost evaporated and the S&P dropped -0.31% on Friday, but still closed out the week up just shy of 1%.

The earlier optimism came from a strong signal by Federal Reserve Chair Jerome Powell that the Fed's next move up will be 50 basis points, marking a slowdown in the pace of tightening from the 75 basis point increases in the last four meetings. This should have come as no surprise. Bond markets have been pricing in a mid-December 50 basis point move since September of this year. RockCreek pointed to this several weeks ago, and to the debate around the pace of tightening in our Q3 letter. But equity investors, fearful of a hawkish surprise, were relieved just to hear the Fed Chair deliver the same message as last month. They soon backtracked. Friday's jobs report reminded everyone that inflation is alive and well. And the Federal Reserve is still planning to raise rates until they are high enough to restrict growth and push up unemployment.



For those looking for good news, Thursday delivered with confirmation that US inflation slowed in October on the Fed's preferred Personal Consumption Expenditure (PCE) measure. The better-than-expected reading for the Consumer Price Index (CPI) two weeks ago was followed this week by news that the core PCE rose by just 0.2% in October, up 5% from a year earlier. This inflation improvement came as the US consumer continued to show strength.

After closing out November in positive territory for the second month in a row, equities ended this week up nearly 1%. When the Fed meets in mid-December, its quarterly economic projections are likely to show rates going higher and staying higher for longer than the central bankers had predicted just three months earlier. Will markets be able to maintain some good cheer into the year-end holidays?

In the meantime, investors need to be keenly aware of valuations while leaning into stocks that seem attractively priced on near-term fundamentals. Any hint of waning growth for companies trading at elevated multiples may result in steep near-term losses. How much further can the market go even with stable earnings when P/E multiples remain elevated?

A remarkable case in point this week was Crowdstrike Holdings. The cybersecurity technology company reported record free cash flow for the quarter as well as solid sales and earnings, all well ahead of analyst expectations. The company further guided towards another earnings beat for the fourth quarter. Normally, this would have been enough to drive Crowdstrike's price significantly higher. Instead, Crowdstrike dropped 20% the next day. Digging into the figures, net new annual recurring revenue was weaker than expected, which probably spooked the market. At a 52x free cash flow valuation, substantial growth was already priced in, making it increasingly difficult to see even more upside in the stock. We hope this is a sign that fundamentals are beginning to take hold again. Crowdstrike remained down significantly on Wednesday, even as markets cheered Chair Powell's comments.

Growth is slowing – but is recession a certainty?

The US economy has continued to surprise on the upside this year. Remember the recession talk in the first half of 2022? And successive mark-downs in growth projections as bad news kept coming – from the war in Europe, the consequent energy shock, food price increases, and a sharp slowdown in China? So far, while a number of indicators suggest a slower pace of growth, the recession has not arrived. Interestingly, the same is true in Europe, although the picture there remains bleaker than on this side of the Atlantic.

Some hope that this strength increases the chances of a "soft landing," with inflation gliding down while unemployment stays low and the economy continues to grow. Unfortunately, history is largely not on this side of the argument. Previous inflationary bouts have required a jump in unemployment to curb the dynamic of higher prices and wages and re-anchor expectations. Much will depend on whether workers who have disappeared from the labor force will return and fill still high vacancies.

So far during this tightening cycle, the Fed – and other developed country central banks – have been playing catch up, not just raising interest rates at successive meetings but also raising projections of future inflation and therefore of the likely endgame for rates.

This could now change. Look for a higher dot-plot when the Fed's Summary of Economic Projections (SEP) is released on December 14th. Strangely, if the Fed is gloomy enough about the future path of rates, investors should be reassured – even if markets do not initially like the bad news. It would mean that the central bank is determined to get ahead of inflation next year. Fed policymakers would like to put the 2021-22 inflationary surge behind them. They increasingly accept that regaining price stability means tighter money for longer than they had envisaged at the outset of 2022. This view is widely shared on the policymaking committee, including by new members.

This week brought news of another new Fed member: former Obama economic adviser, Austan Goolsbee, has been appointed President of the Chicago Fed, in place of retiring Charles Evans, and will rotate onto the Federal Open Market Committee (FOMC) immediately when he takes up his position next month. It will be interesting to see if he brings a different perspective.

Policy dominance: fiscal, financial, mortgage, or just monetary?

Central banks, intent on meeting their monetary policy goals of price stability, do not like to be thrown off course by other factors.

Traditionally, the biggest fear has been of "fiscal dominance" when government overspending puts pressure on a central bank to accommodate bigger deficits with easier monetary policy, leading to higher inflation. Fiscal dominance turned upside down in the years before the pandemic. As governments trimmed their deficits, unemployment stayed high and inflation bumped along below target in the US and Europe, central banks were seen as "the only game in town" to keep the economy moving. It may be hard to remember now, but central banks called for fiscal easing – essentially more deficit spending – to help out as they fought against inflation undershoots.

More recently, as the world's central banks have been tightening rapidly, there have been concerns that financial instability or a housing collapse could conflict with the Fed's monetary policy goals; with "financial dominance" or "mortgage dominance" undermining the monetary path to price stability. Despite the cascading problems in the crypto world and a September panic in the UK markets, the core financial system has remained robust. This is good news. In the US, housing and construction will continue to suffer from the jump in mortgage rates but declining prices will eventually help to tame inflation.

It's not just CHIPS

Some believe that ensuring a safe supply of semiconductors – which are ubiquitous in today's economy, powering everything from mobile phones to high precision military weapons – is just as critical as securing energy supplies. Chips are not the only key input for the future. Looking ahead to a world transitioning from carbon fuels to green energy, it is clear that sourcing key minerals will be a high priority for every country.

Next domino to drop

As Sam Bankman-Fried (known widely as SBF) made the media rounds in a probably-doomed attempt to repair his image, the next crypto domino tumbled when BlockFi filed for bankruptcy on Monday. We wrote about the rumors of the company's demise two weeks ago, and the market was prepared for the news - Bitcoin and Ethereum finished higher on the week at $17,041 (up +3.2% week-over week) and $1,294 (up +8.0% week-over-week), respectively.

In July, it was FTX that delayed the inevitable for BlockFi when it extended a $400 million line of credit to the crypto lending platform to fill the gap left from Three Arrows Capital collapse – a hollow show of confidence it turns out. Despite the besmirched reputation of anything crypto, the still unleashed potential of blockchain technology, Web 3.0, smart contracts, and other innovations remains high. Use cases in all of these areas is something to closely follow as the rapid pace of change related to fintech continues to be inevitable.

Emerging Markets

Emerging markets experienced a strong rally this week, supported by news coming out of the US and Europe mid-week that indicated moderating price inflation, perhaps giving investors hope that a hard landing can be avoided after all. Developments in North Asia also provided support for emerging markets assets broadly.

Despite headlines showcasing the many anti-lockdown protests across major cities in China, EM equity markets have been pricing in a broader reopening now that the Party Congress is over. The China strength has added to an impressive run in North Asian markets. Starting in October with Korean markets, followed by Chinese and Taiwanese stock markets last month, the rally could signal an inflection point. To be clear, North Asian markets are still down about 25% for the year. But whether spurred by cheap valuations, hopes for a China revival, or simply portfolio rebalancing, these markets are finally seeing some bid after months of steady decline.

As for China, investors should keep in mind that a re-opening is different from a return to previous rates of growth. The Chinese economy has slowed down. The structural problems are many, as we've highlighted before. Nevertheless, a reopening would provide a short to medium-term boost to growth. Reflecting this dynamic, our local partners have been investing in consumer related companies, travel and leisure stocks, and essentially any company that stands to benefit from a return of the Chinese consumer, including in the ASEAN region. Interestingly, they continue to stay away from big tech platform companies which are increasingly seen as state owned entities.

RockCreek Updates

The big picture

At the year-end meeting of RockCreek's Advisory Board, Senior Global Strategist and Board Member Caroline Atkinson moderated a discussion with Board Members Alan Greenspan, DeAnne Julius, Jessica Einhorn, John Lipsky, Kofi Appenteng, Laura Tyson, and Liaquat Ahamed.

The Board focused on three areas that matter to RockCreek and investors: inflation and interest rates, navigating the slowdown, and how the green transition will unfold.

First – inflation and interest rates. With inflation at 40-year highs, central banks around the world are raising rates. There are some indications that inflation could be peaking, on both sides of the Atlantic. But it remains well above the 2% target that most central banks espouse. Some economists, including this week Olivier Blanchard of the Peterson Institute, have argued that it is time to raise the target to perhaps 3%. The RockCreek Advisers did not agree: a shift in target now would risk damaging central bank credibility in the inflation fight. If money is going to stay expensive, what does this mean for equities longer-term? As rates rise, perhaps we are moving back to a world where investing in bonds makes sense.

Second – the slowdown. The predicted recession is not yet here, but there will be slower growth going forward. Europe is likely to contract before the US, but the data show that they aren't there yet. Growth in the second largest economy in the world – China – has underperformed. This is likely to continue, impacting the global economy and in particular China's big trading partners in both Asia and Europe.

The third overarching challenge is how best to manage the climate transition, at a time of tensions among the major powers – and major emitters. RockCreek remains committed to doing our part in financing sustainable investments that have a meaningful impact on climate mitigation and adaptation.

With more to come,

Team RockCreek