



Macro Environment

The fourth quarter of 2022 was a microcosm of the year for investors, albeit not so painful. Early in the quarter, markets again got ahead of the Federal Reserve, rising in hopes of an easing signal to come. When the Fed clarified in November and again in December that it was not yet done fighting inflation, sentiment turned. By the end of the year, the quarter's early gains had partially evaporated.

For 2022 as a whole, the tally was grim. US bonds experienced their worst year on record. Global equities fell sharply. As a result, returns from a traditional 60:40 portfolio of stocks and bonds were the worst since 2008.

The new year began with markets again more optimistic about the path of interest rates than policymakers. Incoming data confirmed a slowdown in US price and

wage inflation in Q4, even as the labor market stayed strong. Expectations grew that there will be a further slowdown in the pace of Fed rate hikes from December's 50 basis points to 25 basis points in February, with a further 25 basis points likely in March and a question mark thereafter. The arrival of earnings season, which began with a mixed bag from the major banks, turned attention towards the economic impact of the Fed's past moves. Concerns about growth were amplified in mid-January by disappointing data releases for retail sales and manufacturing at the end of Q4.

There remains a disconnect between market expectations that rates will ease sooner rather than later and the central bank's hawkish Q4 projections, outlined in December, which showed rates rising by a further 75 basis points or even a full percentage point, and staying

above 5% through 2023. There are different explanations for the disconnect. Do investors expect a weakening economy and softening consumer sentiment to push the Fed to loosen policy, perhaps prematurely before inflation is beaten? Are they betting instead that inflation will dissipate more rapidly than the Fed anticipates, with less economic pain, resulting in the oft-hoped-for soft landing? Or are financial markets looking beyond today to anticipate the recovery that will eventually come?

Against this backdrop, RockCreek sees four key macro themes for 2023:

- 1. Will the US have a hard or soft landing, as monetary tightening feeds through to the real economy?**
- 2. When will an improving inflation performance cause the monetary cycle to turn?**
- 3. Will the energy shock from war in Europe continue to be contained, helped by winter warmth, European subsidies, and the US tapping the Strategic Petroleum Reserve?**
- 4. How successfully can China exit from “Zero Covid”, and will a return to robust growth be hobbled by longer-term trends of demographics, shifting trade patterns, and focus on state owned enterprises?**

One thing we know about 2023: it will be different

A year ago, as inflation accelerated around the world, US growth appeared to stumble. There was much discussion about whether the economy was already in recession. The Federal Reserve was on the verge of tightening policy in what became the sharpest rise in interest rates since the Volcker squeeze of 1980. As inflation gathered speed last year, reaching forty-year highs, Fed Chair Jerome Powell and colleagues raced to raise rates and toughen their message, repeatedly undercutting market hopes for a reprieve. They focused increasingly on what was happening in the labor market, concerned that wage pressures would undercut their focus on bringing down inflation. And the window for achieving a soft landing seemed to narrow, as the labor market remained tight in Q4 and initial wage data was strong.

The recession did not come. And [inflation almost certainly peaked](#) in the middle of last year. It is still too high, with a headline rate at 6.5% year-on-year in December, compared to the Fed’s 2% target. But the year-on-year rate masked a sharp deceleration since last summer. In Q4, core consumer prices rose by only 3.2% at an annualized rate while wage gains were only a little over 4%. Interest rates will go up further in the coming months. But the Fed’s focus in 2023 will increasingly be on how and when to pause. Investors will be watching to see how much pain occurs before then and how quickly recovery can come.

At RockCreek, we expect that the economy will slow and unemployment will rise as monetary tightening – much of it already in the pipeline – squeezes housing and construction and slows down investment and spending. In Q4, retail sales disappointed, with an unexpectedly large decline of 1.1% in December, reflecting both prices and lower volumes, after a smaller drop in November. We also believe that markets are likely underestimating the Fed’s determination to crush inflation and its willingness to risk overshooting and hurting the economy.

Two factors that buoyed the US economy in 2022 may help to cushion the slowdown this year and explain why expectations now are that any recession will be mild. The first is the underlying strength in employment and consumption that has come from pandemic-related fiscal support in the US and Europe. That complicated life for central banks by helping to push up inflation. But, as described below, it benefited many.

The second factor is the continued strength of the core financial system, unlike in the global financial crisis when the reverberations from systemic failures inflicted great damage on the real economy. Financial institutions are hurting now and laying off staff. But they are not in crisis. Despite a year of swift and steep monetary contraction, volatile markets, and sharp corrections in almost every asset class from bonds and equities to emerging markets, core financial institutions weathered the many storms of 2022, and markets continued to function.

What was good: a stronger economy, higher wages for the poorer

The US and global economy in Q4 remained surprisingly strong, despite the continued war in Europe, a Covid crunch in China and a gradual spending slowdown.

With full Q4 GDP numbers to be released later this month, real time trackers suggest that the US continued to expand through year-end, but spending growth may have petered out at the end of the quarter. Retail sales weakened in November and December following a strong month in October, with a quarter-over-quarter decline of roughly -1.3% to close out the year. The strength of the labor market, which has underpinned the post-pandemic economy, surprised again in Q4. Unemployment, a lagging indicator, dipped back close to pre-pandemic lows, ending the year at 3.5%. Payrolls rose by a monthly average of 247,000 during Q4, not much below the 269,000 reported in September. Job vacancies and quit rates – key indicators that the Fed watches for labor market tightness – drifted down only slightly during 2022.

There are still 1.7 open jobs for every American looking for work, well above pre-pandemic levels.

Figure 1. The job market is still running hot, but the cooling has begun



Source: RockCreek

One reason for US economic resilience was that workers at the lower end of the income scale have done better, in relative terms, than those higher up the income scale. In contrast to most of the workforce, whose wage gains were eaten up by higher prices, low paid workers saw their real wages rise in 2022. And these workers tend to spend more of their incomes than those who are better off.

Labor force participation remains below its pre-pandemic level, leaving companies bidding up wages. Will this squeeze profit margins? As [Fed Vice Chair Lael Brainard has remarked](#), inflation can come from widening profits as well as the wage spiral that has gotten most of the blame.

An online debate among mostly mainstream economists broke out at the end of 2022 about the underlying causes of inflation. Former MIT professor and IMF Chief Economist [Olivier Blanchard made the case](#) that inflation was primarily a result of a distributional battle between workers, employers, and owners of capital. Others stuck to the view that monetary policy determines price inflation. A middle ground could be that a shock to supply or demand – both of which happened with the pandemic lockdown and resulting stimulus – ignites a distributional battle, which only then can be stopped by pressure from a cooling economy on both workers and companies.

A sure sign of a distributional battle for higher wages and better working conditions versus company profits is if workers decide to take collective action. Work stoppages and strikes have recently risen. This began even before the pandemic — hitting a 17-year high in 2019, when 25 major work stoppages occurred, per BLS data. A [broader measure of stoppages](#) from Cornell's School of Industrial and Labor Relations, which covers all collective actions, showed that some 78,000 workers walked off the job in the first half of 2022, compared with 26,500 in the first half of 2021.

In Europe, the economy has been weaker, and the energy shock has been a bigger component of decades-high inflation. But there too, consumer spending and production was not as weak as many had expected in Q4. A slide in growth and contraction are still likely in Europe in 2023, but European governments, excluding the UK, are set to cushion the blow from energy prices. Supportive fiscal policy may offset some of the impact from continued monetary tightening.

But that's also bad ... at least for interest rates, and risky bets

Resilient spending and employment have kept US inflation well above the Fed's 2% target. In Q4, [Chair Powell reaffirmed](#) again that 2% remains the central bank's goal. Last quarter's announcement was bad news for interest rates and for some risky bets. The big question is whether a stronger economy means the Fed will raise rates still further, to crimp hiring and force unemployment up, or whether price pressures will ease allowing for real wages to recover.

Some economists who called high inflation early and pressed for rapid interest rate increases last year are now wondering if the Fed will be able to pause after lifting rates above 5%. Both former Treasury Secretary Lawrence Summers and former New York Fed President Bill Dudley have softened recent calls for rate rises. Others expect further rate rises that would bring the fed

funds rate close to 6% at its peak, or "terminal rate."

The era of more expensive money had brought casualties among risky players, with the dramatic blowup of crypto darling FTX, and a 15% drop in Bitcoin during Q4. In the UK, a surge in government bond yields threatened to bring down the country's enormous pension industry. Instead, it brought down a government, as blame was heaped on Prime Minister Liz Truss' "dash for growth." Both of these events showed the risks to financial stability from tightening money. But they were also reassuring. Spillovers across sectors were limited, and the strengthening of the core financial system post-2008 worked to insulate banks from major damage.

Energy Rollercoaster

The war in Ukraine took a different turn in Q4, as both sides stepped up the fighting. Ukraine inflicted further battlefield defeats on the Russian army, most notably with the November recapture of Kherson – the only major city taken by Russia in its initial advance. Russia, in retaliation, launched a relentless bombing assault across Ukraine, targeting civilians and civilian infrastructure with wave after wave of bombing and drone attacks. At home, President Putin shifted course. No longer ignoring the war, he called on Russians to unite in a fight that he characterized as being against the West.

With both sides digging in, the conflict in the middle of Europe will continue into 2023. But the economic impact this year is likely to be smaller. And Europe has the weather to thank for that. This winter has, so far, [been unseasonably warm](#), making the frequent power cuts in Ukraine caused by Russian bombing less painful than they might have been and mitigating the costs of the energy shock across Europe from the loss of Russian energy. It has also allowed storage tanks to remain much closer to full and prompted falling gas prices after last on year's surge. Agreement in Brussels and major capitals subsidies to shield consumers and businesses, at least partially, from energy price hikes will also help.

Sanctions on Russia have not led to a domestic crisis as some had hoped. But they are gradually making it harder to produce weapons to fight the war and to sell oil to finance imports. So far, the ban on Russian oil imports into Europe that came into effect in December – covering shipping, insurance, and purchases – has not led to the feared spike in global oil prices as that oil was redirected increasingly to China and India at lower prices.

China Pivot

While the rest of the world largely “moved on” from Covid in the first half of 2022, the disease continued to hamstring China throughout the year. Indeed, in Q4 China’s economy weakened still further, even as the government suddenly abandoned its Zero Covid policy. Rising infections and illnesses, rather than mandatory lockdowns, undercut production and consumer spending. The November data show a drop in retail sales from a year earlier and contracting output.

China’s economy will rebound in 2023, in part just reflecting the low base from last year. But it seems likely that reopening and recovery will come with a terrible price as Covid runs through a population with low vaccination rates and poor health facilities. There may be a longer-term hit to confidence in China from both the mishandling of Covid and abrupt policy reversals on technology and property that took businesses and ordinary citizens unaware. President Xi won his historic third term in Q4, but he may face greater challenges ahead than expected.