JANUARY 27, 2023

EVERYTHING EVERYWHERE ALL AT ONCE

Real life may not be quite as confusing as in the Oscar-nominated movie. But the fiction of a parallel universe – or several – would help explain wildly differing views of the global economy for 2023.

Recession, or soft landing? Overshooting tight monetary policy, or a premature pivot? Cascading lay-offs, as earnings disappoint, or still strong demand for labor? A China rebound that pushes up commodity prices and inflation, or one that reduces price pressures from supply chain problems with the end of lockdowns? Each story abounds with arguments and evidence that can be used to bolster it. The bottom line: deciphering the post-pandemic economy is tricky. Pity the Federal Reserve, which must navigate the opposing risks of recession and inflation this year.

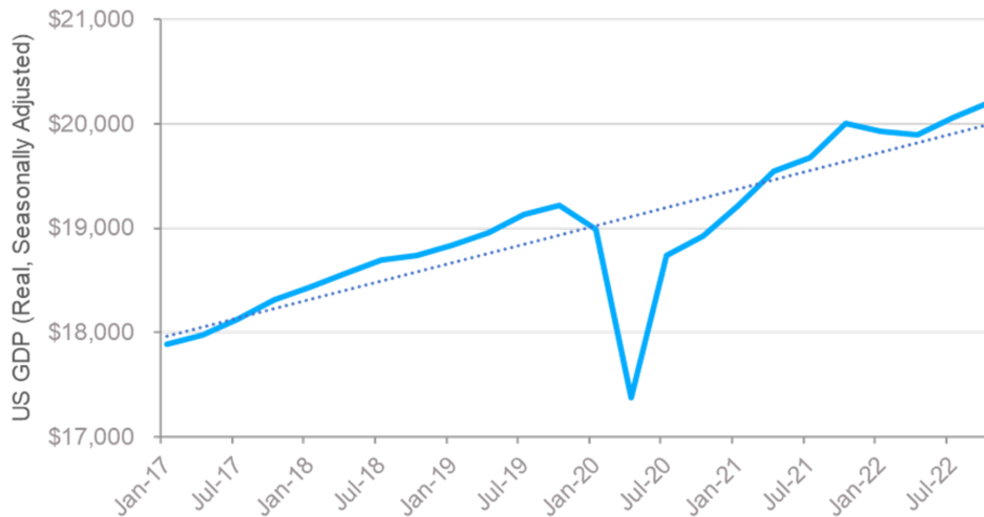
Next week's Fed decision will not be so difficult, after muted US inflation and growth numbers this week, in line with expectations. Notably, the Fed's preferred measure of inflation confirmed a slowdown in core inflation to 4.4% from a year ago, with the 3-month annualized rate at just under 3%, the lowest for two years.

The Fed is likely to deliver the 25 basis point increase in its policy rate that is baked into market pricing. What happens after…well, that is less certain. There will be a 7-week gap before the central bank next meets in late March. At that meeting, it will update its projections for the economy and the expected path – dot plot – of interest rates this year and next. By then, the Fed will have had a chance to review two more months of price and jobs data for early 2023.

Financial markets are optimistic. Equities rose again this week, continuing the upward trend this month, with the S&P up roughly 2.5% this week, while the Nasdaq was up over 4.3% for the week. Expect Fed Chair Jerome Powell, when he speaks next week, to point out again the disconnect with the Fed's own expectations laid out in December – that the Fed Funds rate will top out above 5% and stay there throughout the year. If he remarks on the better inflation performance for December, markets will likely go to town. Treasury Secretary Janet Yellen was cautious this week, acknowledging that inflation has "come down substantially" but also noting the unusual strength in the jobs market, the fact that services inflation is still high and that "we expect and want to see a slowdown in the economy in order to help get inflation under control."

At RockCreek, we see four main macro themes, as outlined in our quarterly letter:

- **Will the US have a hard or soft landing?**
- **Will improving inflation affect the timing of the monetary cycle?**
- **Will the energy shock from war in Europe continue to be contained?**
- **How successfully can China exit from "Zero Covid"?**



Source: RockCreek, Bloomberg

Some clarity

The uncertainty that has plagued economic forecasts in the pandemic era will continue. But not everything is up for grabs in 2023. The Federal Reserve, and other major central banks in the West, are going to hold money tight, maybe for so long that unemployment rises more rapidly than many hope. As financial conditions tighten further, the US economy will slow down from the growth rate of close to 3% in the second half of 2022, as will Europe. In contrast, China, the second largest economy in the world, will rebound from its dismal performance last year.

Inflation is set to decline in the US and Europe, leaving real interest rates positive, for at least a while. Not so in Japan – the dark horse – which is finally moving out of deflation as Central Bank Governor Haruhiko Kuroda gets ready to leave office this spring.

On the political front, the war in Ukraine will continue to draw in the US and its allies in support of Ukraine as Russian President Putin signals his readiness for a long war. This week's decisions in the US and Germany to supply Leopard and Abrams tanks stand as important markers. The West would like to help Ukraine to reach a position of strength on the battlefield that would enable a faster end to the war.

Hard or soft landing?

2022 already seems long ago. Gloom and recession were the dominant themes. But as January unfolded, the mood shifted, markets rebounded, and 2023 projections were recalibrated. Even the normally staid International Monetary Fund (IMF) seemed affected. From recession warnings in her new year message, Managing Director Kristalina Georgieva shifted tone along with others at the Davos gathering. Her IMF predecessor and current head of the European Central Bank (ECB), Christine Lagarde, sounded a positive note about Europe.

There is good reason to be hopeful. The combination of cooling inflationary pressures with apparently still strong labor markets bodes well for the US. China's about-face on Covid has been chaotic and messy, but reopening will support global growth. Europe is holding up better than seemed likely in the face of prolonged conflict in Ukraine.

Nevertheless, risks still abound for US and global growth. Last year's rapid monetary tightening has not yet played out fully, and the Fed and ECB have more tightening planned. Recent data are confusing, including data in this week's first estimate for Q4 growth. The headline growth number was reassuring at a solid 2.9% annual rate. But underlying growth in private consumption and private investment was running at only 0.2% in the quarter, pulled down by investment.

The strength of US labor markets in the face of Fed tightening has been a puzzle. Once again, this week saw a drop in new claims for unemployment insurance although continuing claims stayed up. Next Friday's jobs report for January, on the heels of the Fed decision, will provide more pieces of information. Pessimists note that rapid shifts in the pattern of demand during the pandemic recession and then recovery may have made employers, who were caught short with the sudden revival in demand a year ago, reluctant to lay off workers too quickly. Some evidence of a slowdown comes from a sharp decline in temporary work towards the end of last year. Typically, temporary workers are let go sooner than permanent employees.

Part of the employment puzzle may come from the roll-out of large-scale spending authorized in 2021-22 legislation, both the bipartisan infrastructure bill and the inflation reduction act. Unusually, construction employment continued to grow as monetary policy tightened last year. This source of strength for the economy will continue as projects are slowly defined and begun.

Equities – layoffs, earnings

Global equities were set up for continued volatility when markets opened Monday morning. This week, technology stocks resumed their most recent run of outperformance, buoyed by announcements of sizable layoffs and other cost-cutting measures at giants SAP and IBM. These layoffs are in line with those announced by their large tech peers in recent weeks, including Microsoft, Alphabet, Amazon, Meta, and Salesforce. To further complicate matters, activist hedge fund Elliott announced Salesforce as its newest target with a multi-billion-dollar stake in the firm and plans to nominate a slate of new directors to the company board.

Earnings season is also starting to pick up and this week – Microsoft, Johnson & Johnson, Tesla, Visa, Mastercard, Intel, and Chevron among others reported. Microsoft and Intel surprised to the downside, both issuing weak forward guidance, while Tesla's bottom-line beat, and Chevron's $75 billion share buyback announcement, broadly boosted performance, further adding to volatility in domestic equities.

But it's not just tech anymore

It was IBM and SAP this week, but job losses have rocked the tech and financial industries all month, with over 200,000 positions eliminated so far. With activist investors pushing for further cuts, and as Q4 earnings are released, the potential for additional job losses remains high. And while not the case with IBM or SAP, upon announcing jobs cuts, many companies have seen their stock price spike. Investors interpret the layoffs as an indicator of prudent cost-cutting in a rising rate environment where every marginal dollar of profit matters to compel investors away from alternatives.

So far, these staff reductions have been confined to the tech and financial sectors; however, this week, conglomerates such as 3M and Dow Chemical announced plans to reduce their payrolls as they prepare for a leaner 2023. While these cuts may not be as severe as those made by tech giants such as Microsoft and Google, they do open the door for other industries to follow suit. Companies are often hesitant to be the first to make such cuts, but as the trend of job reductions becomes more prevalent in a specific sector, others may use the less-than-ideal economic outlook for 2023 and the "everyone else is doing it" mentality as justification for reducing staffing numbers.

What next for rates – and fixed income markets?

The monetary cycle is going to shift this year. But markets are probably too optimistic about when and by how much. Chair Powell has made it clear that a worst-case scenario would be a pause, or pivot, that allowed a resurgence of inflation under his watch. The 2022 inflationary surge may be behind us. But it delivered a generational scare to central bankers.

Ironically, the more exuberance in financial markets about the inflation outlook, the more cautious the Fed will likely be in considering an end to the tightening cycle. As Fed minutes published this month showed, Chair Powell and his colleagues were worried last fall that rising equity and bond markets were causing an unhelpful easing in financial conditions, contrary to the Fed’s desired tightening. A 25 basis point increase now would deliver something for everyone: further tightening to reassure inflation worriers, but at a slower pace, with another notch down from December’s 50 basis point rise.

What can we infer from fixed income markets? We wrote in our quarterly letter about the attractive setup for bonds going into 2023, but the magnitude of the move in investment grade so far this month has been surprising. With the average yield to maturity in excess of 5%, investors have taken notice of high-quality corporate bonds, bidding up prices in the face of a substantial slowdown in issuance. The iShares Investment Grade Corporate Bond ETF (LQD) has rallied more than 5% month to date , supported by a 10-year Treasury yield that has dropped by more than 40 basis points to 3.5% and spreads that have tightened by an additional 10 basis points to their lowest level since last April. It would seem that the bond market continues to be optimistic about the prospect of a soft landing.

Energy and Europe

Almost a year after Russia’s invasion of Ukraine, it is clear that President Putin has lost his energy leverage over Europe. That is a result of both luck and policy. Unusually warm weather so far this winter has preserved energy supplies and mitigated the impact of the energy shock.

But smart energy policy has helped. Households and industry in Germany, the main European country dependent on Russian gas, have cut consumption dramatically – between a quarter and a third. Europe aggressively sought and secured gas supplies from Asia, as countries resold US LNG at higher prices into Europe, and Germany also partially subsidized residential energy bills.

The US decision to release oil from the Strategic Petroleum Reserve – with a promise to buy it back to stop prices from dropping too far – also relieved the global market, but renewed pressure is possible, as Fatih Birol detailed in a discussion on Friday at the Council on Foreign Relations.

China surprise – good or bad news?

The U-turn in China policy goes beyond the reversal of zero Covid lockdowns. Earlier this week, the crackdown on property and real estate speculation that contributed to the 2022 growth slowdown was also relaxed. Foreign investors may be chary of making a long-term bet on strong growth in China, but performance will likely be stronger this year though the market has already rallied 58% from its lows on October 31, 2022.

Will that help or hurt the world? Against the backdrop of monetary tightening and slower growth in the US and elsewhere, RockCreek sees a revival in China as a boost to the global economy more than an inflationary risk.

Emerging Markets

The run-up in emerging markets equities continued this week as investors' appetite for yield brought about record inflows into both EM equity and debt markets. This week alone saw over $1 billion per day in new equity and fixed income flows, according to the Institute of International Finance.

This is quite the about face after last year's in EM assets and underscores how quickly things can change. While Chinese markets were largely closed due to the Lunar New Year celebrations, the positive externalities of China's reopening continued to support the rest of EM, in particular Korea and Taiwan.

Moderating global inflation, and market hopes that the US Federal Reserve may stop tightening sooner than later, has relieved a major source of pain for emerging markets. Estimates of $4 trillion to $5 trillion of excess savings generated during the lockdown period in China should support consumption as the Covid shock fades this year.

Indian markets were the notable exception this week, weighed down by the selloff in Adani Group quoted companies, which resulted from short selling specialist Hindenburg Research's report of purported fraudulent activities at the Indian conglomerate. This unfortunate news aside, the momentum in favor of EM assets remains strong thanks to cheap valuations, stable currencies, and still record low ownership levels. At RockCreek, we view the rally in EM assets of the last few weeks as reflecting the removal of left-tail risks.

RockCreek Update

2023 Surveillance

Managing Director Alifia Doriwala joined Bloomberg Surveillance and shared her asset allocation perspective for 2023, views on fixed income strategies, energy's momentum as the lone survivor of 2022, and RockCreek's approach in a high interest rate environment. **Watch the full segment here**.

Taking Back Control?

Senior Global Strategist Caroline Atkinson participated in a discussion hosted by the Peterson Institute for International Economics about the structural consequences for the City of London from the British exit from the EU single market. **Watch the discussion here**.