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LOOKING AHEAD: STILL HAWKISH FED

Many things will be different in 2023. One key factor for investors will remain the same: the world's most important central bank is still firmly focused on driving down inflation. That means more interest rate hikes to come. What is less clear is how much further the Federal Reserve will raise rates before being satisfied that the job is done. And when will that be?

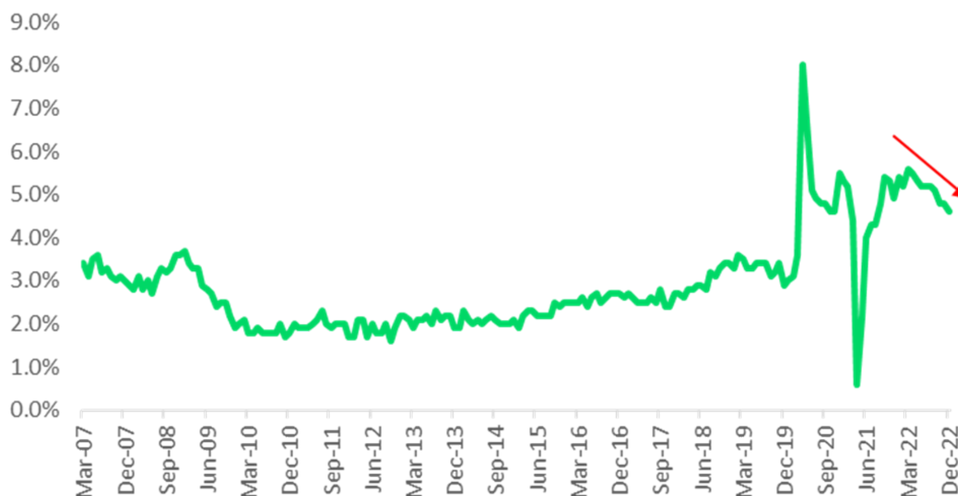
Unlike last year, inflation is now clearly trending down, as former Federal Reserve Vice-Chair Alan Blinder pointed out yesterday. But as long as the US labor market stays strong, the Fed will continue to keep policy tight. Chair Jerome Powell and colleagues believe that lowering labor market pressure on wages is critical to a sustainable return to low inflation. At their mid-December meeting, the majority of Fed members expected to raise policy rates by at least another 75 basis points in 2023, and maybe by as much as a full percentage point, to 5.1-5.4%. And yet, they have had trouble convincing markets of such.

Again, this week, financial markets pushed stocks and bond prices higher on the back of apparently benign news on wages. The S&P 500 was up roughly 1.7% for the week, with the tech-heavy NASDAQ up 1%. In the bond market, the US yield curve continued to invert, with 2-year Treasury yields falling 17 basis points to 4.26%, while 10-year Treasury yields fell 31 basis points to close the week at 3.56%.

One problem for both policymakers and investors: incoming data present a puzzle. Several jobs reports this week show that the labor market, while not as tight as earlier in 2022, remained strong through the end of the year. However, earnings data for December, together with unusually large revisions to earlier reports, suggest that wage growth was restrained, despite the tight market. This was a reversal from official data released just a month earlier. That showed hourly earnings climbing rapidly through the fall. As former CEA chair Jason Furman remarked, "One reason it can be hard to predict the future of the economy is that it is hard to even know the past of the economy." Adding to the puzzle – tech companies that pushed up hiring during the pandemic are now announcing large job cuts. Some financial institutions are also warning of layoffs.

The first week in January demonstrated, yet again, the resilience of the US jobs market – as well as the puzzle it presents. Friday's labor report showed employers still adding jobs at a healthy pace – 223,000 in December – and unemployment still at historic lows. Indeed, the jobless rate ticked down last month, to 3.5%, even as more workers joined the labor force. This followed data earlier in the week confirming that workers remain in demand, with 1.74 vacancies for every American looking for work.

Financial markets took the initial good news as bad: concluding from Wednesday's numbers that a more resilient economy means a greater likelihood of higher interest rates. But the Friday jobs report raised spirits – for two rather different reasons. The underlying strength of the economy suggested that a soft landing in the US is still possible, and maybe even likely. At the same time, the report showed average hourly earnings up by just 3.4% at an annual rate in the month, with the three and six monthly rates running at 4-4.5%, a full percentage point lower than the government report a month ago.



Source: RockCreek, Bloomberg

Plus ça change (the more things change...)

The global outlook for 2023 promises some important changes for investors.

- **Inflation** – Last year, it accelerated to forty-year highs on both sides of the Atlantic; it will more likely surprise on the downside this year.
- **Recession** – The recession that was much anticipated but did not come in 2022 is expected to arrive before 2023 is out. It will hit Europe first, then the US. If we're lucky, the landing may be soft-ish, with the economy stagnating rather than contracting sharply.
- **Energy Prices** – They have come down in recent months, rather than shooting up. Record high temperatures have left European ski slopes empty but gas reserves fuller than many feared (so far). Wholesale gas prices in Europe have halved in the past month.
- **Ukraine** – As Russia has launched a devastating bombing assault on civilian infrastructure, using Iranian drones for reinforcement, Ukraine is getting more advanced weaponry from western governments, including Germany. Even if oil prices tick up again this quarter, as they may, the relief on gas prices has diminished fears that a cold and dark winter would sap Europe's support for Ukraine.
- **Capitol Hill Chaos** – Following a productive US legislative year in 2022, there has been an almost unprecedented start to a period of divided government. The House of Representatives – now with the GOP in a majority – has struggled to elect a Speaker to kick off its business.
- **China Back to Business** – China is joining the rest of the world in brushing aside Covid concerns and opening back up. Notwithstanding an immediate toll of soaring infections and deaths – and initial disruption to output from sickness rather than lockdowns – Chinese growth will likely rebound from the disappointment of 2022.

There is also a glimmer of hope on the diplomatic front. Qin Gang, China's new foreign minister and former Ambassador to the US, spoke kind words about America as 2023 began. President Xi may visit the US in the context of the fall meeting of APEC, to be held in San Francisco. This would be the first time since 2017 that Xi has been on US soil.

Inflation may have peaked…but interest rates will keep on rising

There is little doubt that the 2021-22 inflation surge that surprised most observers – and, more significantly, central bank policymakers – is now ebbing. The headline inflation rate in the US may even have peaked as long ago as last summer, when it touched 9.1% in June. Next week's consumer price release is likely to show price inflation running at a significantly lower rate at the end of 2022.

But having been caught out by high and accelerating inflation once, central banks are determined not to ease too soon. Minneapolis Fed President Neel Kashkari, who moves on to the Fed's policy-making committee this month, added his voice to the caution of Chair Powell and colleagues, calling for further rises to bring the policy rate to close to 5.5%.

In an essay released this week, Kashkari compared the sharp rise in inflation to the "surge pricing" that occurs to bring Uber demand and supply into balance when there is a sudden change in driver availability or in demand – imagine a sudden rainstorm. The inflationary surge may have had temporary beginnings in the pandemic-driven supply shortages and heightened demand for goods. But unlike in the case of Uber drivers and passengers, the surge sets off a distributional battle across sectors – goods price inflation leading to rising prices of services – and between employers and employees as firms and workers try to maintain profits and real earnings. A more general cooling of demand and inflation expectations is then needed.

This is why the Fed will not be dissuaded from further tightening by a rise in unemployment. Central bankers are expecting some increase to occur and believe that a cooler labor market will help alleviate inflationary pressures. The Fed has also not wavered in the face of last year's dismal performance in equity and bond markets and weakening in housing demand. Indeed, minutes released this week of the December meeting showed the central bankers concerned that their efforts to tighten financial conditions could be undermined by market strength. Ironically, the disconnect between the Fed's still hawkish intentions and hopeful markets, in evidence again this week, could add to the chances that the Fed moves by 50 basis points – not 25 basis points – at its February 1st meeting.

Finally, Chair Powell and colleagues have also become more confident that the tightening path – steep as it has been – will not threaten core financial stability. The blow up in crypto has been largely contained. American financial institutions, after the post-2008 financial reforms, appear sufficiently well capitalized to withstand the fallout from a growth slowdown or recession.

In Europe, inflation was driven up in 2022 mostly by supply constraints, with the energy shock from Russia's invasion and the consequent sanctions adding fuel to the fire from pandemic shortages. As in the US, consumer prices continue to rise at rates far above central bankers' tolerance levels. But there too, inflation is beginning to slow. This week's data was better than expected, with Euro area consumer prices rising by "only" 9.2% in the year to December. This is extraordinarily high for most Euro area nations, notably Germany and France. But with energy prices now coming down, disinflation is on the way. Excluding energy and other volatile items, core inflation last year was 5.2%.

Good news is sometimes bad, but bad news is coming

The strong US labor market has helped support earnings, particularly at the low end of the scale, and has narrowed the traditional gap in unemployment between white workers and Black and Hispanic workers. These are good things for America. But as the Fed continues its monetary squeeze, these outcomes may not last.

Some economists believe that price inflation may slow down enough for the Fed to pause, or even pivot, sooner than later. Others expect that rates may need to go even higher than the Fed currently expects. In either case, relief on rates will only come when the economy has slowed. This brings a real risk that monetary authorities will overshoot. Much of the world is already heading into recession, as noted this week by IMF Managing Director Kristalina Georgieva.

Resilience in consumer spending and employment, which surprised on both sides of the Atlantic in 2022, owed much to government support for incomes during the pandemic, notably in the US. Consumers still have ample savings in the US, and European governments are committed to fiscal spending to support consumers and businesses in the face of high energy prices. Subsidies will be less than planned if energy costs turn out to be lower than feared, but government deficits are still set to expand.

Nevertheless, the fierce monetary squeeze underway will show up sooner or later this year. Third quarter corporate earnings were better than expected, but perhaps that's not surprising. Fed rate hikes have only had so long to work their way through the economy. With each successive quarter, the risks of negative surprises for companies, and the economy in general, will go up.

Emerging Markets

It was a relatively quiet first week of the year in emerging markets, albeit a positive one. In a continuation of a trend that began in Q4-2022, China, Korea, and Taiwan led performance, while the top performing markets of 2022 (Brazil, India, Indonesia) had a relatively weak start to the year.

All eyes are on China's reopening and the positive ripple effects it is expected to have on global growth, however subdued it may be compared to the glory days of yesteryear. The initial impact on growth of China's U-turn away from zero Covid will be tempered by the wave of infections and deaths now stretching the public health system to the breaking point (with tragic consequences). But recent data show many Chinese are ready to reclaim a modicum of freedom. This week, eleven major cities in China reported seeing a recovery in subway ridership. Likewise, during the three-day break over New Year's, domestic tourist trips grew year-on-year. The rise, of 0.5%, still left travel a far cry from 2019 levels, but it marked an inflection point. Chinese tourists accounted for 4.2% of worldwide tourism and 12% of the world's total spending on hotel rooms in 2019. At the end of 2022 it was essentially at zero.

China's position as the world's top energy importer could also have implications for crude prices, although the market remains oversupplied, and the prospect of a developed markets recession could limit any significant run up. Nevertheless, demand for everything from travel to sporting events, music festivals, and essentially any outdoor activity is expected to grow significantly in the next few months. The Chinese New Year will be an important litmus test of the extent of the initial rebound.

Any positive ripple effects would be felt far and wide, including for the tourist-dependent economies of Southeast Asia, but also for the more diversified economies of Korea, Japan, and even Taiwan. We also expect China to benefit from the US and Europe's move to more sustainable sources of energy and methods of transportation. China's position as the world's top refiner of lithium and cobalt ore, and its own push for greener energy solutions, should be positive for the country's battery and component manufacturers. Other emerging markets will also benefit from this trend given their position in the green supply chain, including India, Brazil, South Africa, and Indonesia.

With more to come,

Team RockCreek