RockCreek

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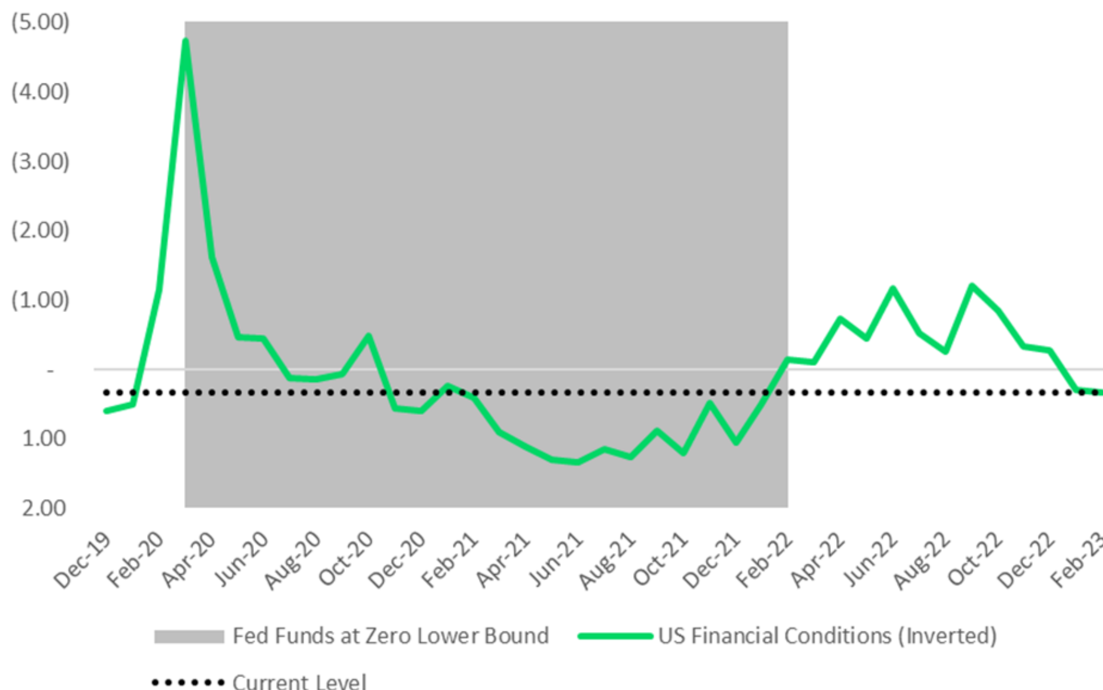
# SOME (DON'T) LIKE IT HOT

**What's up with this economy? Just as hopes were rising of a soft landing – with inflation declining as the economy gently cools – Friday's jobs data showed the labor market is still very hot. Unemployment ticked down to 3.4% in January and employers added an astonishing 517,000 to payrolls. This was followed by a stronger than expected services PMI.**

**Markets did not like the news, anticipating higher interest rates for longer than had previously been priced in. Fed Futures for December 2023 added almost one full additional hike on the day and equities dropped. But even a white hot labor market didn't fully erase the gains of the week, with the S&P up 1.98% and the Nasdaq up 4.11%.**

**The reset of expectations may please monetary policymakers. January's strength in US financial markets made for looser overall financial conditions at a time when the Federal Reserve is still trying to tighten. It is not alone. All three major central banks raised their policy rates this week, and all three promised further hikes to come. Until the jobs data hit, it seemed that investors were blocking out the warnings. In the US, there was more focus on the fact that the Federal Reserve slowed the pace of hiking, to a more usual 25 basis points. The European Central Bank and Bank of England moved by 50 basis points.**




**Source:** RockCreek, Bloomberg

The new data illustrate how hard it is for the Fed to navigate this post-pandemic economy. There is some justification for optimism. Inflation is clearly coming down in the US and Europe. The jobs release was much stronger than expected, but it reaffirmed that wage increases have not taken off as feared. Hourly earnings in January rose 0.3% from December, leaving them 4.4% higher than a year earlier. Stronger than expected global growth will boost the chances of a soft landing for the US.

But we have not yet returned to price stability. And getting there will likely involve a cooling off in labor markets. Central banks that missed the inflationary surge of 2021-2022 do not want to be caught out again by loosening too soon. They would prefer to err on the side of overtightening than to loosen policy prematurely. And while more jobs and lower unemployment are generally reasons to cheer, a strong labor market gives policymakers more room to tighten without fear of going too far – and more reason to worry that stronger growth could yet undermine the progress on inflation since the peak last summer.

***Jobs and wages still a puzzle***

This week brought a welter of new information on US jobs and wages, including private sector reports of job losses that were in opposition to Friday's broader official labor market report, and a broad indication of labor costs that was, on balance, benign.

On wages and earnings first: the quarterly "employers cost index" or ECI, considered the best measure of the labor costs that will feed into prices, showed a deceleration in the last quarter of 2022 from earlier in the year to an annual rate of 4%. Hourly earnings reported for January, as part of the payroll and jobless release, showed a 0.3% increase from December, right in line with expectations.

So far, so good. What is more difficult to judge is whether the continued demand for workers that is evident in the macro data will pull in labor supply without accelerating wages. There was a small increase in labor participation in January, according to the official data. There is also the puzzling discrepancy between company layoff announcements and the overall picture of job strength from economy wide data. Just this week, the Challenger Job Cuts Report (which publishes announced layoffs monthly) showed layoffs last month at the highest for any January since 2009.

Fed Chair Jerome Powell and his colleagues will likely pay more attention to the broader government data. Even before the Friday jobs release, there were suggestions that the jobs market was tighter than the headlines of layoffs suggested. Reported vacancies rose again, to 11 million in December, pushing the ratio of vacancies to job-seekers back up to 1.9. This was consistent with a drop in unemployment claims, to just 183,000 in the last week of January. It's not so surprising that Chair Powell characterized the labor market as still "very, very strong."

***Equities – Earnings point to slowing economy***

Corporate earnings season got off to a mediocre start in January with early signs pointing towards S&P 500 companies, on the whole, underperforming Street expectations. Financial services firms had been the largest contributors to the underperformance, driven by capital markets volatility and a reduction in deal activity last year. With more than a third of S&P 500 companies set to report this week, including a handful of mega-cap tech companies, investors were watching intently for any further signs of weakness in the economy.

Mega-cap tech has been on the defensive and subject to stiff negative sentiment. That played to the benefit of Meta. Management reported its third straight quarter of losses but pleased investors by announcing a $40 billion share buyback and sizable cost cutting. The degree of its operating expense decline, coupled with guidance towards further reductions, led to the best day for its stock in more than a decade. Amazon's margins disappointed and its cloud business fell just shy of expectations, but its retail business posted solid results for the holiday season. Alphabet's cloud business exceeded expectations, but overall earnings narrowly missed due to slowing advertising demand hurting its core search business. Apple reported disappointing product revenue and saw its share price move definitively lower.

At this week's conclusion, a little more than 70% of companies in the S&P 500 will have reported Q4 results. The message appears to be that broad swaths of the economy are indeed slowing.

***Momentum reversals lead to scrambles***

Many of last year's biggest losers have seen extreme moves so far in 2023. One can use ARKK as a proxy as the ETF has jumped +46% this year with single names like Carvana (+208%), Coinbase (+142%), Wayfair (+122%), Peloton (+109%), and Tesla (+74%) clawing back a portion of last year's massive declines. Much of the move is technical in nature as shorts get squeezed by the historically poor performance of the momentum factor. According to Goldman Sachs research, their long/short momentum factor (12-month winners vs. losers) had its worst month ever in January (-18%) and was followed by a -6.6% decline on Thursday. Similarly, FactSet's most shorted basket has gained 30% on the year, which they attributed to a "heighted retail impulse" (i.e., FOMO).

Fund managers weren't positioned for the move higher this year, and this week's next leg up had investors scrambling: Thursday represented the highest call option volume ever in US equities, which represented twice the average daily volume seen during the prior year. Similarly, put-call skew in many mega cap tech names plummeted as demand for upside exposure surged.

The "junk rally" has created an interesting dynamic around earnings as even some companies reporting negative earnings surprises have been rewarded. According to FactSet, shares of these companies have seen an average price increase of 0.7% around their release, much larger than the 5-year average price decrease of -2.2% that is typical of a disappointing report.

***Despite all the noise, Europe actually had a pretty good 2022***

One unexpected piece of news this week: Europe's economy notched up a faster growth rate last year than either the US or China. A repeat is not expected in 2023. China's rebound from zero Covid policies is projected to push its growth up to just over 5%, according to the latest IMF projections released this week. The IMF sees Europe steering clear of recession but slowing more than the US under the impact of rising interest rates. After the European Central Bank (ECB) raised rates by 50 basis points this week, President Christine Lagarde warned that more large increases are in store.

Brighter news from this week's data on business conditions: this month's PMI survey showed the Eurozone as a whole pushing into positive territory – particularly when it comes to services – buoyed, in particular, by better news out of Germany, Italy, and Spain. PMI data from France and the UK were also stronger for the month, yet composite and services figures remain below 50 for both countries while those previously mentioned are already back in expansionary territory.

***What is price stability – and are we nearly there?***

Chair Powell has repeatedly stated that the Fed's goal is to restore price stability as the base for sustainable growth. He has defined the goal in numerical terms as 2% – the inflation target that the Fed, and most other major central banks, have pursued for some time. As inflation soared towards double digits last year, some economists suggested that 2% was too ambitious. Getting inflation back down to that rate would be too costly in terms of lost jobs and output.

So far that has not been evident. Chair Powell was confident enough of the progress in fighting inflation to comment at the FOMC press conference this week, "We can now say, I think for the first time, that the disinflationary process has started." The labor report the next day underlined that, so far, this has come without much visible economic cost, at least in terms of the jobs market. If the economic costs to households and businesses do accumulate this year, as is still likely, there will no doubt be pressure for the Fed to pause or even pivot, as the market has been betting, even if inflation is sticky above 2%.

Many economists are cautioning against this. The monetary experts at the IMF acknowledge that there is a conundrum for central bankers as investor expectations of inflation have declined, boosting financial markets in both emerging and advanced economies. But these economists argue that investors "may be too sanguine about progress on disinflation." After all, the recent good news on inflation still leaves price and wage increases running well above 2% in both the US and Europe. The pandemic has played havoc with usual patterns of supply and demand making the future path of inflation particularly difficult to predict. Prices have turned down for energy and for many of the goods that were in high demand and short supply during the post-pandemic recovery. But prices for services are still rising rapidly. Does a bit more inflation matter?

Most would agree that the economy will function better in a world where economic decisions – by investors, savers, households, and companies – are made without the uncertainty of high and variable changes in prices. An interesting definition of price stability is behavioral: a state when no one thinks about inflation, because it is so low and steady. Former IMF Chief Economist Olivier Blanchard has argued that 3% is just as good as 2% from this point of view – and may be a better target for the long term as it allows more scope for rate cuts when – and if – inflation dips below target, as it did for much of the decade before the pandemic.

Blanchard's argument has not convinced today's central bankers. And with the experience of an inflationary surge fresh in people's minds, they are likely right. As Chair Powell noted this week, concerns about inflation are probably the reason for still weak consumer sentiment, which in turn is depressing spending. Why else would consumers feel the most disheartened they have in the past decade, as sentiment surveys showed late last week?

***Working from home (or not)***

Several highly visible CEOs spent time in 2022 fighting to bring their employees back to the office. New data show the trend moving in their favor: return-to-office hit a milestone this week, with average office use in 10 of the largest US cities surpassing 50% for the first time since the start of the pandemic.

The Kastle Systems Back to Work Barometer, which tracks keycard swipes from 2,600 buildings and 41,000 businesses, calculated that the average office occupancy of 10 large metro areas reached 50.4% this week. The Austin metro area saw the highest occupancy of the 10-city average, while San Jose was the lowest.

But post-Covid work routines haven't fully returned to the 9-to-5 "all taking and no giving" schedules of past decades – and may never do so for white collar workers who can work from home. A Kastle report from November found that office occupancy fluctuates 20-points between the highest days (Tuesday and Wednesday) and the lowest (Friday). Bosses may be able to bring workers back, but it seems sliding into the weekend is here to stay.

***Covid: even the Fed is over it***

President Biden has announced the end of pandemic public health emergencies – which have kept Covid testing and treatment free for everyone. President Xi of China has abandoned all attempts to limit the spread of the disease. And now the Fed assesses that Covid is "no longer playing an important role in our economy," as Chair Powell said on Wednesday. He added that Covid does not need to be in the Fed's monthly post-meeting statement as an ongoing economic risk as opposed to a health issue.

Unfortunately, the disease is not yet done with us. The number of Americans dying every week (those reported to the CDC) has risen from 2,508 the last week of December to 3,756 the final week of January.

***Sino Reset – not so much?***

After a swing through the Middle East, US Secretary of State Antony Blinken was due to end the week by heading to Beijing. That would have made him the first Biden Administration cabinet official to visit China, and in a sign of how much China wanted to make nice, Blinken was expected to meet with President Xi Jinping. The discovery of an apparent Chinese spy balloon flying above Montana put the planned trip east on ice. Apparently, the Pentagon and the White House do not buy the story that the balloon was a weather station that drifted off course.

If the meeting was planned as an attempt, on both sides, to "change the tone – if not the substance – of US-China relations," as one former White House China advisor described it, its cancellation is another indication of how difficult a reset is going to be.

When President Biden and President Xi met ahead of the G20 summit in Bali in November, the leaders of the world's two largest economies agreed to find ways to stabilize the recently turbulent US-China relationship. A first step was a revival of talks between Treasury Secretary Janet Yellen and her Chinese counterpart Liu He, who met in Zurich in January and promised to visit each other's countries this year. The US Treasury sees working with China as important to maintain a stable global economy. But their voice on this issue is weaker today, when more China hawks abound in the Administration – and in both parties – than at any time in recent decades.

***Emerging Markets***

The fallout from the Adani group scandal continued this week, culminating in the suspension of a planned and much hyped $2.5 billion share offering. In the last six trading days, the market capitalization of ten Adani Group companies has thus far dropped by 43%, a loss of roughly $100 billion.

| Adani Stock | Trailing 12 Month P/E | Fall from all-time high |
|---|---|---|
| ACC | 53 | -34% |
| Adani Enterprises | 198 | -49% |
| Adani Green Energy | 343 | -62% |
| Adani Ports and Special Economic Zone | 20 | -50% |
| Adani Power | 8 | -51% |
| Adani Total Gas | 412 | -52% |
| Adani Transmission | 215 | -59% |
| Adani Wilmar | 84 | -49% |
| Ambuja Cements | 37 | -44% |
| NDTV | 17 | -59% |

**Source**: RockCreek, ACE Equity

The swift drop in Adani shares has weighed heavily on Indian markets, in sharp contrast to the rest of emerging markets. Indeed, India holds the unenviable position of being the only major emerging market, apart from Turkey, to be in the red for the year. Turkey's President Erdogan is not only dictating monetary policy. His relentless crackdown on the opposition is wreaking havoc on local equities and has brought the cost of hedging Turkish Lira exposure above the cost of hedging the Russian Ruble.

At RockCreek, we expect conditions in India to normalize eventually as the Adani saga plays itself out. However, it's important to note that the market is still trading at a pricey 3x P/B, well above that of China. In the short term, flows may likely favor China, Korea, and Taiwan as the effects of Beijing's reopening policies are felt far and wide.

**With more to come,**

**Team RockCreek**

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