MARCH 10, 2023

HOW MANY SHOES STILL TO DROP?

This week's jobs reports showed that the US labor market remains hot. But just how hot was unclear. Payrolls jumped by 311,000 in February, following the 517,000 rise in January. Vacancies are still high. But unemployment crept up to 3.6%, while fewer people left their jobs voluntarily. Most importantly, average earnings growth ticked down. That makes next week's consumer price inflation report all the more important for the Federal Reserve's next rate hike decision. Equity markets sold off this week with the S&P trading down -4.5%, wiping out nearly all of its 2023 gains.

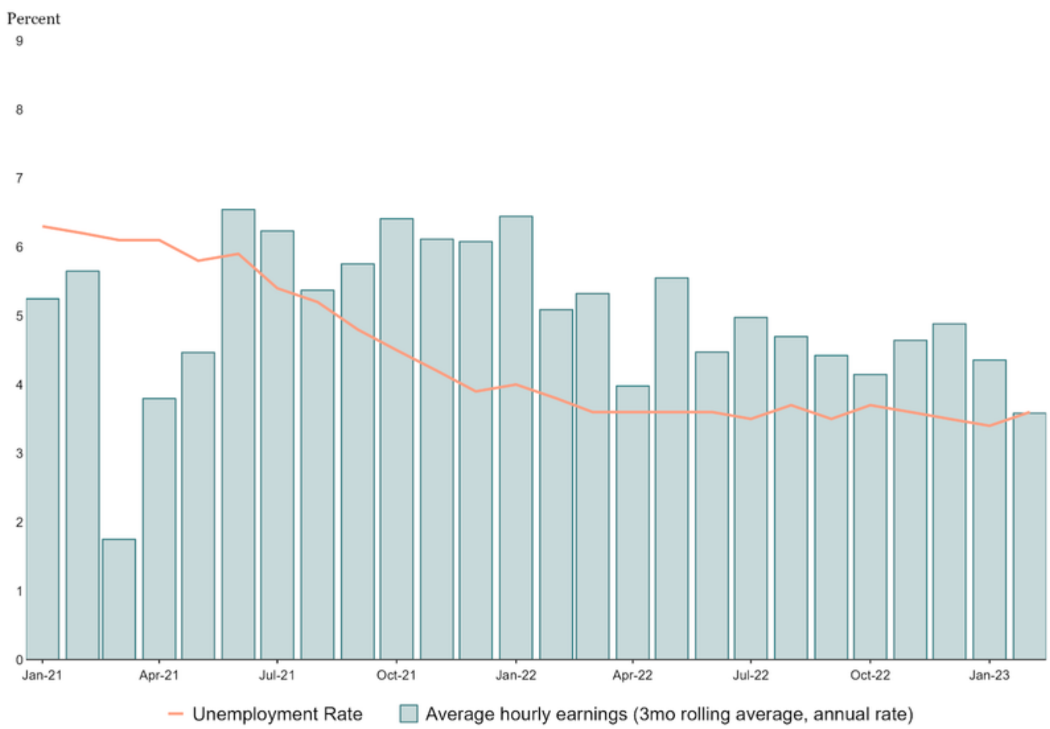
Financial instability will also be on the table. The sudden collapse of two banks this week -- one of them the 16th largest bank in the US and the biggest failure since Washington Mutual in 2008 -- showed that tight money is stressing parts of the financial system. Fed policy makers will need to assess the potential for broader contagion from Friday's implosion of Silicon Valley Bank (SVB), the go-to bank for tech and venture, on top of the collapse earlier this week of the crypto-friendly Silvergate bank. In addition to triggering possible deposit runs on similar, niche banks, the forced closure of SVB leaves cash-strapped tech and venture business clients who had deposits above the insured level of $250,000 with potential losses and -- more immediately -- looking urgently for liquidity to meet payroll and other cash needs.

North of the border, Canada's central bank decided to hold rates steady this month, to avoid an overshooting that could crush the economy. That won't happen in Washington. The question here is whether the Fed will hike by 25 basis points later this month, as it did in February, or 50 basis points as in December. Markets are evenly divided. As we have noted before, the Fed will not be put off its tightening path by stock market losses or a slowing economy. Financial instability at the fringes of the system – like crypto, but not necessarily venture – is also of little systemic concern. But central bankers will be keen to minimize threats to the core, that could unsettle trust in the system.

We laid out four macro themes at the beginning of the year for investors to watch: the chances of a hard/soft landing in the US; inflation and interest rates; energy; and China.

So far, the data have suggested that the US economy is more resilient than widely expected, with higher than anticipated inflation leading markets to delay predictions of when the Fed will pause monetary tightening. In Europe too, growth has been stronger and core inflation higher than anticipated. Energy prices have remained muted, despite China's re-entry into the global economy. Hopes are high in Asia that China's consumers will boost the regional economy with the end of zero-Covid. This week, however, the Chinese government outlined a conservative growth estimate of 5% for 2023. Their commitment in the new "Two Sessions" congress to greater party control over the state – and greater state control over the economy – sits at odds with the promise of a stronger economy over the longer term.

Nominal wage growth declines as the unemployment rate ticks up



Source: RockCreek, BLS

Silicon Valley Bank

Silicon Valley Bank (SVB), among the twenty largest banks in the US, was placed into receivership on Friday after failing to stem an outflow of deposits. This followed an announcement on Wednesday from Silvergate Bank, a bank focused on servicing the crypto industry, that it would wind down operations and liquidate. As a result, bank stocks had their worst week since 2008 as the regional bank index declined more than -17%.

Since SVB made its name servicing innovative technology startups, its problems are old fashioned – a concentrated deposit base, niche borrower, and poorly timed bond purchases made them susceptible to a bank run. As of year-end, 88% of SVB's deposits were with accounts of more than $250,000 and it's estimated that the bank served half of US VC-backed startups.

SVB hoped that by proactively raising liquidity and trying to secure the backing of investors like General Atlantic, it could withstand building pressures from higher interest rates, weakness in public and private markets, and customer withdrawals resulting from elevated cash burn among smaller tech companies. Instead, VCs responded to the announcement of the search for funding by advising their startup portfolio companies to get their cash out, and triggering a crisis of confidence. Less than twenty-four hours later the FDIC had taken over.

What does this mean for depositors? It is possible that another bank or financial institution will step in to acquire the failed bank, assuming its assets and liabilities and servicing the existing deposit accounts. Some big institutions are already looking at ways to provide interim financing for companies unable to access needed cash flows. If there is no acquirer, it is up to the FDIC to sell the assets of the failed bank and settle its debts, including deposit claims in excess of the insured limit. Insured deposits (i.e., those less than $250,000) will be accessible no later than Monday morning, while uninsured depositors have been promised an advance dividend within the next week with the remaining balance to be paid as the FDIC sells the assets of SVB.

Valuations still high

Much of the doomsday forecasts about consumer balance sheets have been wrong. While savings are down from Covid highs, they are still relatively healthy on a historical basis. That being said, certain trends are very real. Spending is shifting from goods to services and the consumer is trading down to cheaper private label brands to save money. Most importantly, consumer balance sheets are still too strong for us to see a dire scenario where the bottom falls out of the economy.

This week provided further evidence that equity market valuations for riskier assets are still too high in relation to the current interest rate environment. Many investors have been pricing in a mild recession as part of their base case scenarios. Such a scenario would imply the Fed easing up on monetary policy sooner than later. Yet, the strength in the labor market keeps causing them to push those assumptions farther into the future, and the longer it takes for the economy to cool and inflation to subside, the higher the risk of an eventual recession that is much less mild than current forecasts are projecting.

Economically sensitive cyclicals and long duration growth are not set up well in this current environment and were penalized this week. Meanwhile, defensive growth, or growth-at-a-reasonable-price (GARP), is looking increasingly attractive. Institutional investors have been increasingly gravitating towards mega-cap stocks like Alphabet and Microsoft. Although not the most exciting names to own, many investors are finding them to be attractively priced given their ability to raise prices and cut costs for margin improvement while still growing market share.

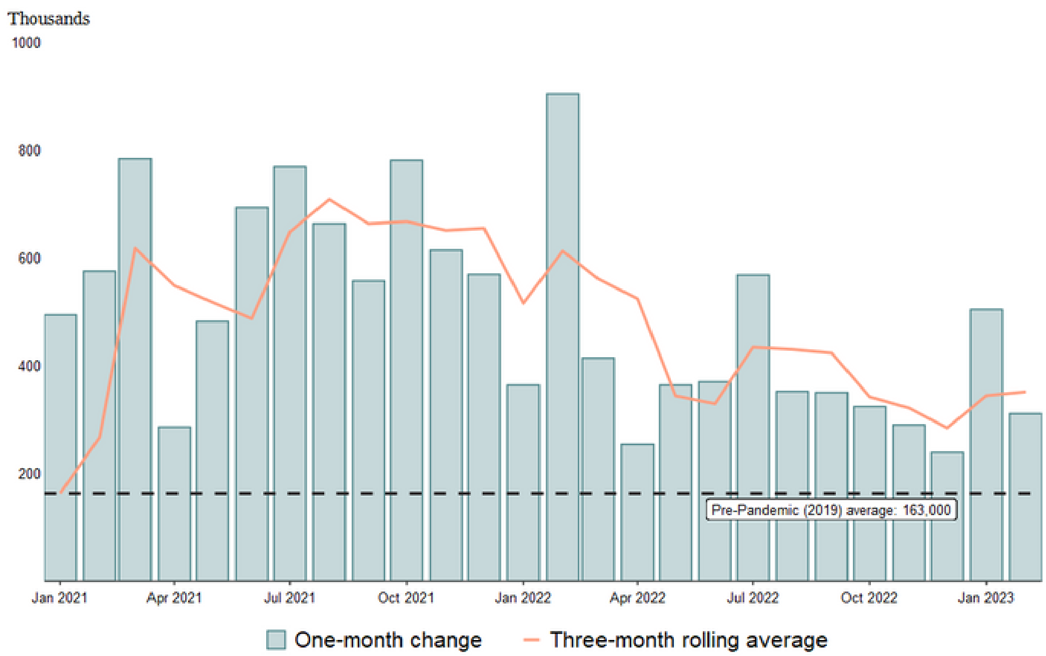
Advanced semiconductors are in a similar category where technological advances have created tremendous moats. ASML, TSMC, and AMD are being viewed as defensive holdings where secular tailwinds in cloud and AI are driving strong demand and after years of consolidation, there are only two or three companies with the ability to manufacture certain products. In the case of ASML, it is the only company in the world able to produce extreme ultraviolet (EUV) lithography equipment for making the most advanced semiconductors.

Tale of two economies – or two tales of the economy?

This week brought more signs of a divergence in the economy. The labor reports – from vacancies to quit rates – showed sectors that thrived during the pandemic are slowing after post-pandemic reopening and under pressure of higher interest rates – notably construction and tech. But the all-important services sector is still going strong. There is a further data puzzle: the official jobs numbers show an economy far from recession. Payrolls have risen by an average of 350,000 a month in the last three months, compared to a steady state rate of growth of perhaps 75,000. But other private sector measures show a very different story. The ratio of vacancies to job seekers on official measures is still close to its all-time high, according to the JOLTS report that Chair Powell noted last year as an important indicator.

But other private sector measures show a very different story. The ratio of vacancies to job seekers on official measures is still close to its all-time high, according to the JOLTS report that Chair Powell noted last year as an important indicator. But survey responses have been declining, calling into question the signal value of this indicator.

US non-farm employment numbers come in above expectations, but well below January's blockbuster numbers



Source: RockCreek, BLS

Sticky is the new nasty

Inflation in the US and Europe is proving “sticky”. Decades ago, that phrase was much in vogue to explain why inflation that accelerated rapidly was slow to decline. Workers and businesses are reluctant to cut wages and prices in “nominal” terms, even if there is downward pressure in real terms. That means that when demand slackens or input prices drop – as is happening now in some parts of the economy – wage and price inflation remains sticky.

To overshoot or undershoot?

Markets – and analysts – keep changing their minds about what Fed action is likely, or appropriate. That is inevitable when the data keep changing and policy is data dependent – as the Fed has reaffirmed. In the US, usually reliable official statistics have recently been revised substantially, changing the inflation and growth story for 2022. Unexpected revisions increase the risks of reacting too much or too little to each new report.

As Milton Friedman, the guru of monetary policy, noted decades ago, central bank policy affects the economy with “long and variable” lags. What is most important for investors is whether the persistence of inflation so far this year leads to higher interest rates for longer – and an economic downturn that hits earnings.

We predicted last week that talk would soon begin of the need for a 50 basis point hike in rates. Interest rates have further to climb. But just how far and how fast is still up in the air. Fed Chair Jerome Powell, in his two days of Congressional testimony, took care to say that the decision was not yet made. He also stressed that the Fed would be ready to adjust the pace of its hikes – and the expected “terminal” rate – if the economy continued to be stronger and inflation higher than had been widely expected in December.

RockCreek has been saying for a while that the Fed would prefer to err on the side of being too tight than too loose. But that could mean signaling a determination to keep raising rates for longer and an expectation of a higher end rate rather than a bigger rise in March.

Geopolitics: from bad to worse

Relations between the US and China – the world’s two economic superpowers – are of defining interest for the rest of the world. These relations have gone from bad to worse in a few short weeks. In part, this is accidental. The spy balloon that put a halt to planned Cabinet level trips to China by Secretary of State Antony Blinken and Treasury Secretary Janet Yellen may well not have been intended to drift over the US. But the speed and ferocity with which the incident blew up in both Beijing and Washington speaks to deeper underlying problems. Most experts now believe that the tensions between the US and China are at the highest level in decades. Risks are exacerbated by the lack of an effective communications channel, or backchannel, to defuse tensions.

China is now assembling its cabinet (or equivalent thereof) and laying out policy goals for the period ahead, in the “Two Sessions” process which will end on March 17th. At the same time, the country brokered a deal to resume diplomatic relations between Iran and Saudi Arabia after seven years of tensions.

These tensions matter for American business. Unlike in the cold war between the US and the Soviet Union, the Chinese and American economies are closely intertwined. China, along with Canada and Mexico, is a key market for American goods – and the main importer of American farm products. Most of the rest of the world also has trading and financial links with both economies. That makes countries reluctant to pick sides between the two economies.

Emerging Markets

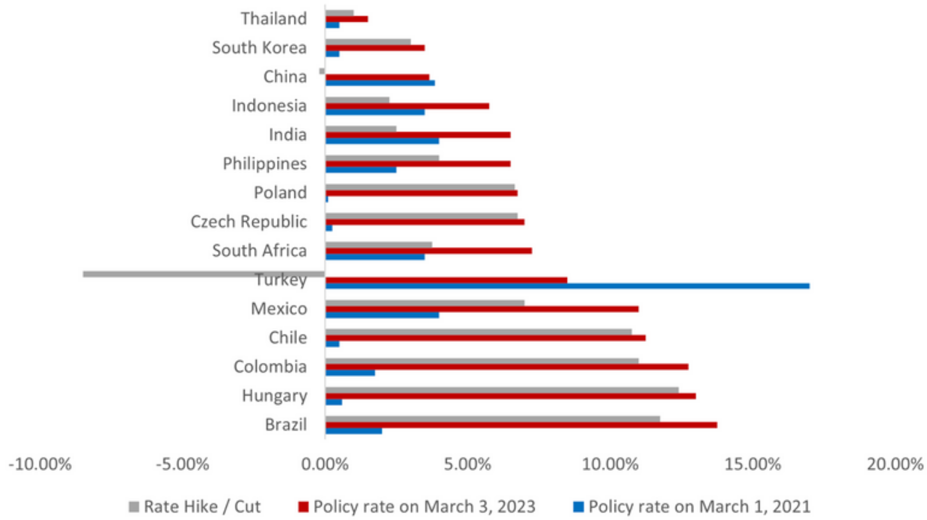
Amid all the market noise, it’s easy to overlook the fact that real value has been created over the last five years in certain areas of emerging markets. Comparing performance of high flying developed market equity indices to counterparts in emerging markets, the results for some major emerging markets stand out. A top performer like MSCI Taiwan would still have 6.5% annualized performance over the last five years, even if one removed TSMC from the equation.

5 Year Annualized Performance

MSCI Taiwan	10.7%
Nasdaq	10.3%
S&P 500	9.7%
MSCI Taiwan ex-TSMC*	6.5%
MSCI India	6.4%
MSCI Saudi Arabia	5.9%
EuroStoxx	5.9%
MSCI Mexico	5.0%
FTSE 100	2.6%

Source: RockCreek - as of March 8th, 2023 - all USD returns
*Estimated

What is also surprising is that these returns were largely generated in an environment of rapid monetary tightening, a pattern that shows no sign of slowing after this week's Fed-related news.



Source: Refinitiv Datastream - as of March 7, 2023

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Market expectations coming into 2023 were near unanimous that emerging markets central banks, having raised interest rates earlier than the Fed, would be in pole position to start normalizing policy as soon as this month. In the meantime, current EM rates are providing investors with some of the most attractive yields available, even when taking recent US dollar strength into account.

Upcoming Events

Caroline Atkinson will moderate a discussion on the global economy with Harvard Professor and former World Bank Chief Economist Carmen Reinhart and University of Michigan Professor and former member of President Obama's Council of Economic Advisors Betsey Stevenson on March 20th. Be on the lookout for the event link in next week's letter.

Maria Woodman will speak at the Berkeley-Haas conference, organized by RockCreek advisor Dr. Laura Tyson, *Mobilizing Capital to Achieve Net-Zero by 2050* on March 22nd. Register here to view online.

RockCreek Update

As part of RockCreek's ongoing celebration of International Women's Month, Sherri Rossoff held a discussion with RockCreek directors Jackie Bleicher, Marion Sierpinski, and Nafees Clay about the lasting workplace impact of the pandemic and building and leading teams in the new hybrid reality. Watch here.

Afsaneh Beschloss spoke with NPR's *All Things Considered* about the $100 trillion emerging market debt crisis, dwindling private sector investment in many frontier markets, and the challenges and opportunities for Ajay Banga, the US nominee to lead the World Bank. Listen to the story here.

Sudhir Krishnamurthi spoke with BQ Prime about navigating the mixed clues from global markets, the Indian economy, and what could lead the Chinese market recovery. Watch the discussion here.

With more to come,

Team RockCreek

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