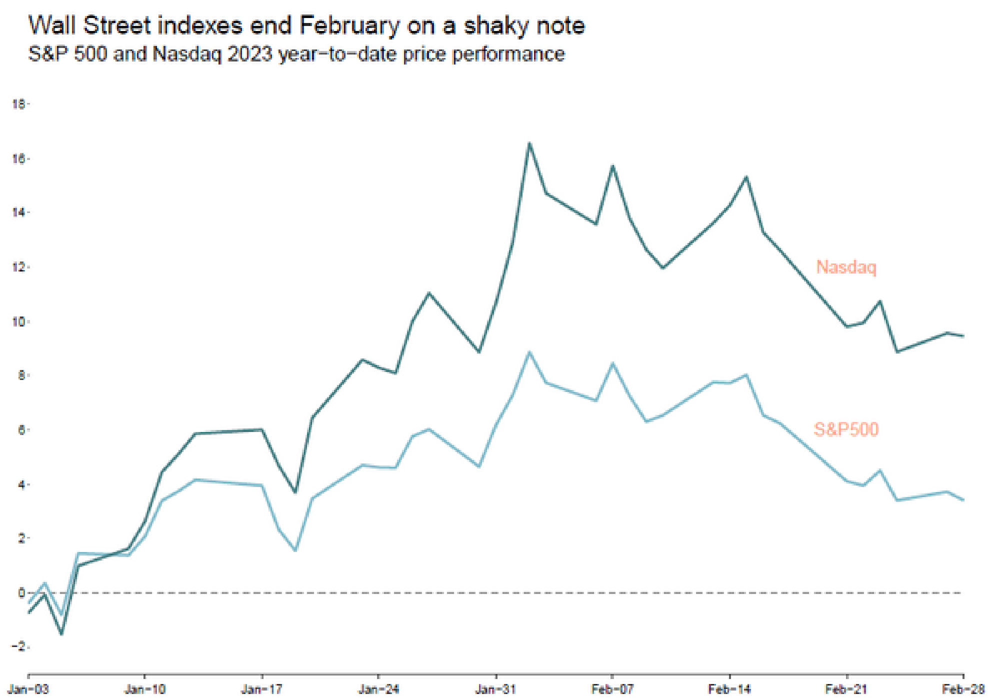
RockCreek

MARCH 3, 2023

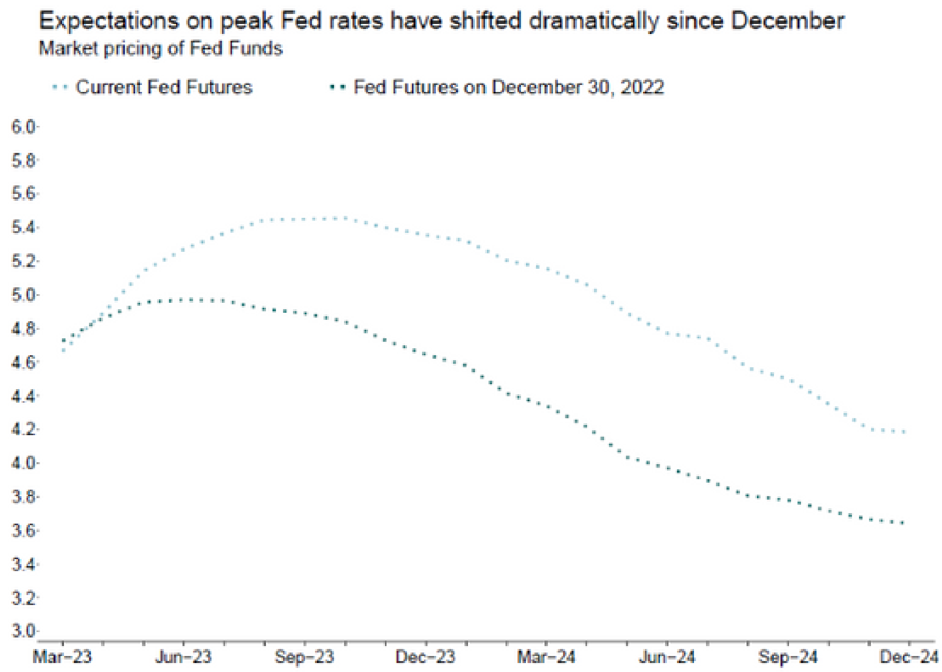
FLIPPING THE SCRIPT

February's macro news and market reaction turned January on its head. In one short month, the story of the US economy went from one of gently declining inflation, with surprisingly resilient growth, to one of persistent overheating and a prospective hard landing. The reason for the change? More jobs and more inflation than had been expected. Investors should brace for a similar story in March.



Source: RockCreek, Yahoo Finance

Markets almost caught up in February with the Federal Reserve's hawkish messaging, and have moved further in the first three days of March. Instead of a pivot to easing later this year, after two more increases in the Fed Funds rate, markets are now pricing three further moves, to reach a peak of close to 5.5% in the fall. If the data are disappointing between now and the Fed meeting later this month, look for calls for a return to a 50 bp rise, rather than another 25 bp as in February. The rise in rates is not all bad news: bonds yielding a decent return are a welcome development for many investors. The archetypal safe long-term investment, 10-year Treasury bonds, topped 4% this week, as RockCreek expected back in January (more below).



Source: Bloomberg, RockCreek

A robust labor market is also, of course, good news for employees. One positive aspect of the post-pandemic recovery has been that lower paid and often disadvantaged workers have benefited more from the labor market strength – at least in relative terms. But inflation has eaten into real incomes. As the Fed and other central banks continue their fight to restore price stability, they will be watching to see if workers and firms push to restore pre-pandemic relative prices and real incomes. If this happens, central banks will need to tighten more even at the cost of higher unemployment and lower corporate earnings.

The tight labor market is what the Fed worries about the most. Next Friday's jobs report will be one key piece of the puzzle informing this month's rate decision for Chair Jerome Powell and colleagues. When they meet later in March, they will also have in hand the CPI report for February inflation. The most likely outcome of the meeting remains a 25 basis point rate rise and the promise of more to come in May and June.

How high, and for how long?

To some extent, recent market moves are making life easier for the Fed. Back in December, some central bankers worried that rising equity and bond markets could undercut the monetary tightening underway. The recent market gloom tightened financial conditions even without a Fed meeting. Rising mortgage rates – which climbed above 7% again this week for the first time since mid-November – will further dampen the housing market, which is already showing signs of weakness. Falling housing sales affect the economy even if house prices appear to hold up. When people move houses, they also spend on appliances, renovations, new furniture and so on, helping to fuel economic growth.

Other signs of the impact of higher rates are evident in rising delinquencies for automobile credit. As the monetary squeeze tightens, more credit problems will emerge and banks will become less willing to lend. That is the way that monetary tightening works: through curbing demand, spending, and ultimately putting a brake on wage and price increases. The puzzle in this economy is that one of the sharpest rate rises on record has, so far, done little to impact overall spending, while leaving the labor market so far unscathed.

There are three reasons for this – which also give a guide to the way ahead. First, and most simply, the rate rises have not yet had time to work their way through the economy. It is barely a year since the Fed first raised the Fed funds policy rate. Higher rates curb demand, but it can take a while. And by most measures of inflation, interest rates are only now becoming positive in real terms. As long as inflation is running above the interest rate, some would argue, policy remains too loose.

Second, the peculiar nature of the pandemic recession-and-recovery makes traditional relationships – such as that between inflation and unemployment – harder to parse. In other business cycles, financial stress, unemployment and business failures have pushed spending and demand down. This in turn has put downward pressure on prices and wages. But despite the sharp drop in output during the pandemic, many people were left financially unscathed and keen to spend.

There are many opinions – and compelling stories – about the reasons for the inflationary surge of 2021-22. The truth is, the surge is still not well understood. Many of those on different sides of the debate have had to adjust their commentary as data surprises. This week, former Fed Vice Chair and Princeton professor Alan Blinder has pulled back somewhat in predicting a soft landing. Others, such as John Taylor, of the Taylor rule, are reinforced in their view that the Fed has much further to go. Taylor this week noted that the Taylor rule would indicate that a Fed Funds Rate of 6% is appropriate.

Certainly, expansionary US fiscal and monetary policy spurred demand and put unusual pressure on prices as economies reopened post-pandemic. But that does not explain the near-global phenomenon of rising prices. Global supply shortages caused by the pandemic lockdown were surely another factor. But while production lags and supply chains were transitory – inflation has been anything but.

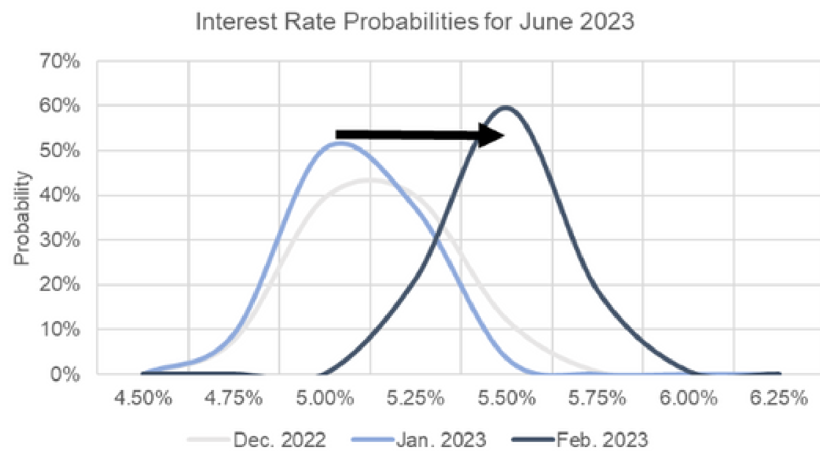
Finally, there is the mystery of the missing workers. As the economy rebounds, it is usual for workers who have stayed on the sidelines to come forward to get a job. This has not happened, helping to explain why the job market is still so tight.

Markets meet reality

It's been recently common for good news on the economy to send markets lower, given investor attention paid to Fed policy; however, this week marked a shift in that regard, partly due to the market's February slump, which eased valuations a bit. At the same time, bearish sentiment grinded higher. Most recently, the American Association of Individual Investors (AAII) reported 44.8% of investors were feeling bearish versus just 23.4% bullish. Investor sentiment often tends to be a contrary signal to future market performance. The S&P 500 gained 1.9% for the week, led by cyclical sectors like materials and industrials. Europe's Stoxx 600 and Japan's Nikkei 225 rose 1.4% and 1.7% in local currency terms for the week, respectively.

Bonds closed out a challenging month in February, giving back most of the prior month's strong gains. Bloomberg's US Aggregate Bond and Investment Grade Corporate indices declined -2.6% and -3.0%, respectively. Losses were primarily driven by interest rate duration as yields climbed along the curve – the headline 10-year Treasury yield rose 40 bp to 3.92% and has continued to climb through 4% in the early days of March.

Strong economic data has moved the market's expectations for Fed policy considerably over this time. Fed Funds futures are now indicating that the Fed will continue to hike through its June meeting, taking the terminal rate to 5.5% – two more hikes than what was expected a month ago.



Source: Bloomberg, RockCreek

The world is still a dangerous place

Russia's much-vaunted spring offensive in Ukraine has, so far, made almost no progress. It is unsurprising that the Kremlin is looking for a boost to its weapon supply – including from China. The White House believes China is capable of serious, and dangerous, errors. But it hopes that airing its concerns publicly will warn China off the terribly risky path of answering Russia's requests.

Across the pond

As inflation took off in the wake of the post–pandemic reopening in the US and Europe, it was conventional wisdom that the problem was worse in the US, largely because of the size of the fiscal stimulus packages in 2020 and 2021. The Ukraine war complicated the picture, pushing up energy and food prices much more sharply in Europe. Now, inflation in Europe is above that in the US. This week's Euro area data showed that it is also sticky: core inflation actually ticked up to a record high 5.6% YoY in February. In the past, bond investors were so keen for the safety of German bunds that yields fell to zero, bottoming out at -0.84% in March of 2020, only reemerging above zero in January of last year. This week they shot up to more than 2.7%.

Emerging Markets

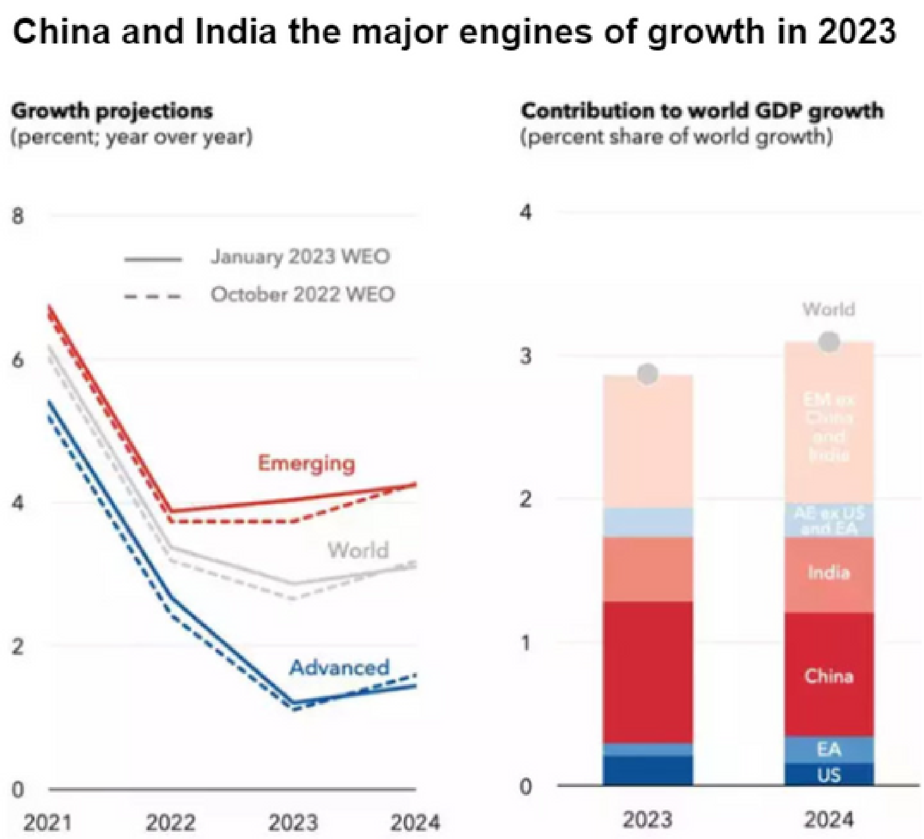
Emerging markets closed February in negative territory, bookending a very volatile eight-week period and leaving investors wondering what's next.

Afsaneh Beschloss joined CNBC to discuss the inspired choice of Ajay Banga, the nominee for World Bank President, as well as the increasing debt burden on lower income countries and the close to $100 trillion debt in emerging markets.

China, as always, remains top of mind, as the re-opening story plays itself out. This week's China data reaffirmed that the country's reopening from zero Covid is happening more quickly than seemed likely. On the one hand, earnings recovery across Chinese corporates is expected to yield better equity markets performance. On the other, the rules of the game for investing in China have changed significantly. Investors can no longer rely exclusively on bottom-up company fundamentals and/or government driven tailwinds for individual sectors.

Indeed, if the last few years have taught us anything, it's that investors should learn to expect the unexpected. It seems, from what we are seeing on the ground in China, that the financial sector is the latest target of Beijing's ire, with the government not too pleased with banks' performance, particularly when it comes to real estate related debt, a veritable third rail of Chinese politics. Going after companies catering to the basic needs of everyday Chinese citizens could be the best chance of capturing earnings expansion without attracting the ever-seeing eye of Beijing.

The signals from this weekend's all important meetings in Beijing – that mark the end of the traditional period of change kicked off with the Party Congress in October – will be important to watch.



Source: IMF

Outside of China, there is a strong opportunity set in India. As the Adani news fades into the background, investors can, once again, focus on the many opportunities afforded by an economy expected to grow rapidly. In the case of India, we see a broader base of opportunities divorced from government interference. The one good thing to come out of the Adani fiasco is more measured valuations, giving investors a chance to invest in world class consumer, healthcare, and IT companies at reasonable prices.

Some not so good news on gender, as International Women's Day approaches

A new Pew study of median hourly earnings of both full- and part-time workers found that progress to reduce the gender gap between pay for men and women has essentially stalled this century. In 2002, women earned 80% as much as men; today, in 2022, they earned 82% as much as their male counterparts. The gap is wider for minority women, both Black and Hispanic. Small wonder that it has been difficult to entice women back into the labor force, post-Covid.

RockCreek continues to be a significant investor in women-owned companies. Also, in celebration of International Women's Month, RockCreek team members are leading and participating in events focused on strengthening women's economic empowerment, scaling investments that support gender equality, and developing the next generation of female leaders.

Today, Sherri Rossoff, board member of 100 Women in Finance, spoke at the 100 Women in Finance Global JumpStart Program, which provides college-age students with an introduction to the finance industry; career guidance; and opportunities to interact with professionals, recruiters, and fellow students from around the world. Learn more about the program here.

Alifia Doriwala will speak at the 5th annual Bloomberg Diversity Drives Returns conference at Bloomberg headquarters in New York on March 9th at 4:25 pm. The event will explore the importance of diversity as a driving factor in the investment and asset allocation process. Register here.

Look out for more events to come throughout International Women's Month.

With more to come,

Team RockCreek

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