MACRO ENVIRONMENT

OUR THEMES

01 **FINANCIAL VERSUS PRICE STABILITY** as Central banks move into the final phase of the tightening cycle

02 **THE IMPACT OF POSSIBLE CREDIT CRUNCH** with a "soft landing" still a possibility

03 **STICKY INFLATION** which is still too high for comfort

04 **THE LABOR MARKET PUZZLE** and its implications post-pandemic

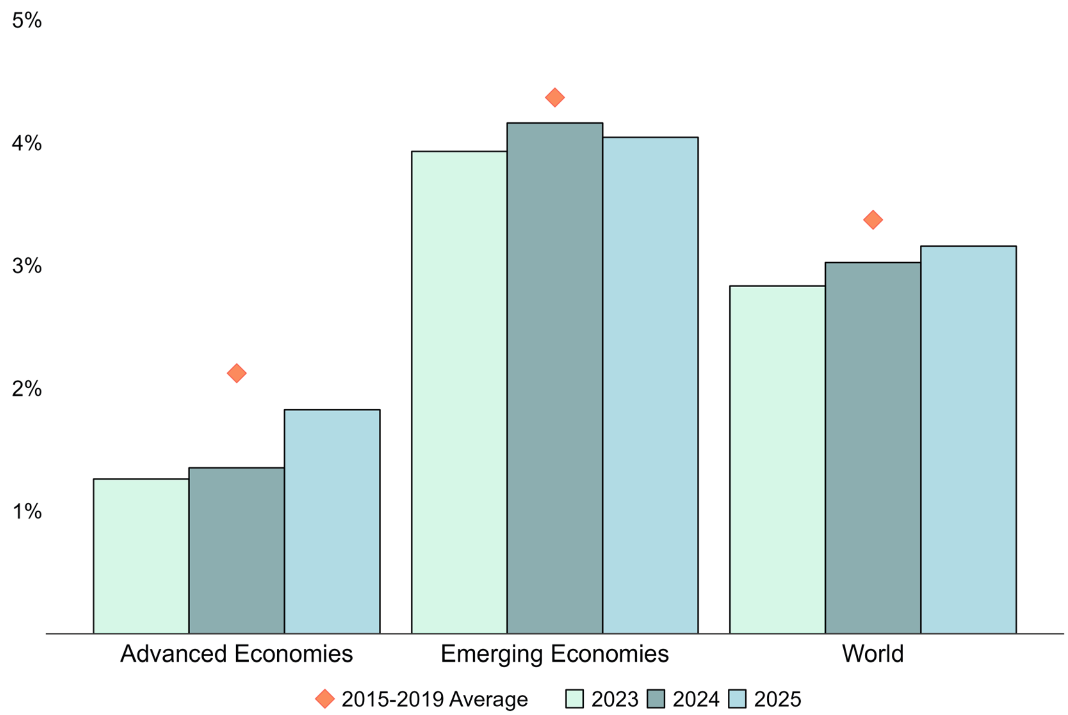
The long-awaited recession has not yet arrived. The first quarter of 2023 brought evidence that a global slowdown is indeed approaching. But it also showed that there is a way to go before central banks can declare victory in their fight against inflation and pivot to easier money. Despite these headwinds, investors in equity and bond markets had a good first quarter.

In the United States, the unexpected banking crisis in March – that spilled briefly into Europe – demonstrated that rising interest rates are biting. A credit crunch could result. Cooling labor markets both reflect and reinforce slowing demand. These signs of weakness in Q1 did not deter equity investors in public markets, although bond markets see-sawed violently during the quarter. Traders tried to make sense of confusing and changing economic information and predict its likely impact on central bank policymakers. Despite the turbulence, global equities finished the month on a high note, with gains across advanced economies and most emerging markets. The MSCI notched 7.7% in the first quarter, while the US S&P 500 and Stoxx Europe 600 gained 7.4% and 8.6%, respectively.

Investors saw two reasons for good cheer. First, hope persists that the Federal Reserve and the European Central Bank will soon ease monetary policy after one or perhaps two more notches higher in interest rates. At the same time, there is a scenario for a weakening US economy that could result in a pause in rate hikes and would make an early pivot towards lower rates more likely. At RockCreek, we continue to believe that such a pivot is unlikely to manifest anytime soon. Fed Chair Jay Powell and colleagues may pause monetary tightening by the end of Q2, as their counterparts north of the border did last quarter. But reversing rate hikes with inflation still so far above the 2% target would be a risky move for central banks that have seen inflation rise to forty-year highs. That is

Figure 1. The global economy has remained resilient in the face of higher interest rates

GDP growth estimates, 2023 - 2025



Source: RockCreek, IMF.

not to say that the Fed will wait for inflation to come all the way down to 2% before cutting rates. Indeed, a number of economists believe that achieving that target would be both costly, in terms of lost output and employment, and perhaps unrealistic given pressures on wages and labor shortages. One way to increase labor supply–immigration reform–seems out of reach in today's political climate. But even if the Fed quietly accepts inflation above 2%, it would not be comfortable with continued inflation at today's underlying rate of closer to 4-5%.

The second reason for markets to rally also helps to explain why rates are unlikely to come down quickly. Yes, the global economy is set to slow down. But the US and European economies have shown remarkable resilience in the face of the fastest monetary tightening in decades. Despite gloom from official forecasters at the World Bank and International Monetary Fund (IMF) this month about longer term prospects for the global economy, they believe that growth remained positive in Q1. The IMF's central forecast is for positive growth overall during 2023 (Figure 1).

FINANCIAL STABILITY VERSUS PRICE STABILITY: A NARROW ESCAPE?

Geopolitical tensions provided a somber backdrop to financial and economic issues last quarter. The one-year anniversary of Russia's invasion of Ukraine came and went with no progress toward ending the war. The US has mustered impressive support for Ukraine from many allies and partners. But much of the emerging world, including India, this year's G20 Chair, has stayed on the sidelines. China is the most important among them. Hopes of a return to regular exchanges between the world's two largest powers were undercut by sightings over American territory of a Chinese spy balloon. China's fumbled response – where quiet outreach by the US was met with official silence for more than 24 hours – demonstrated the dangerous absence of a functioning relationship.

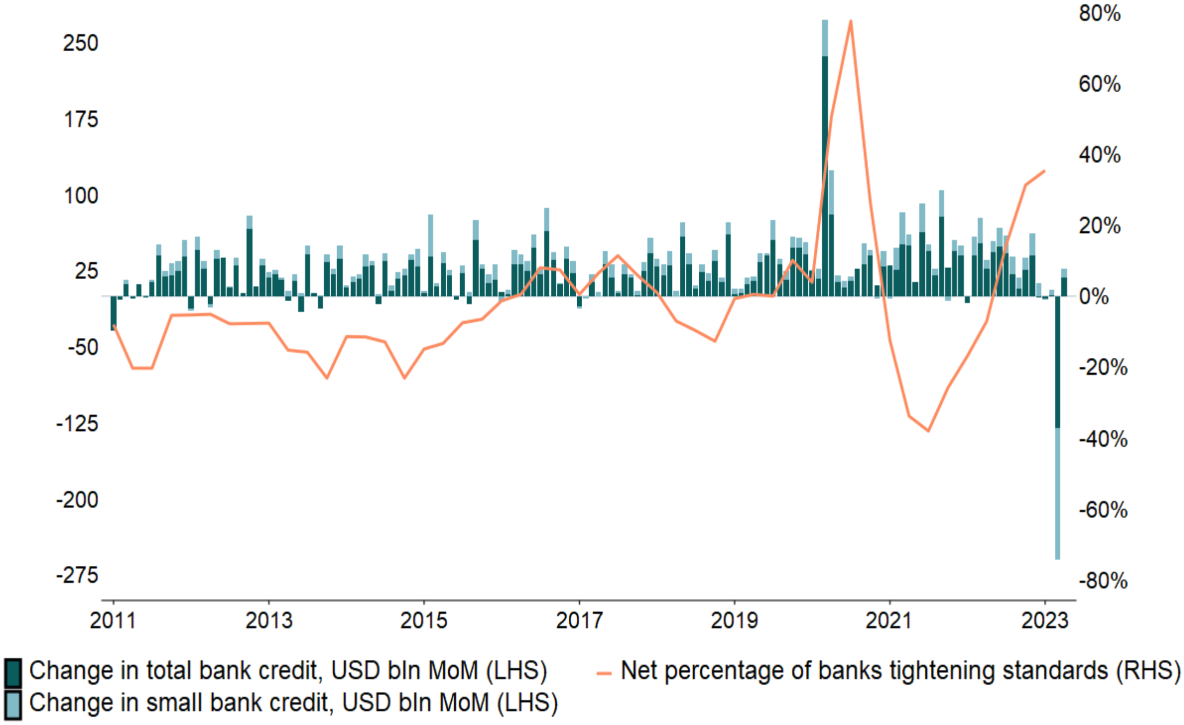
Despite growing mutual suspicion and US encouragement for companies and allies to rethink dependence on China, trade ties between the two economic giants deepened in Q1. China is – along with Canada and Mexico – among the country's top trading partners. With a smoother than expected exit from its stringent zero Covid policy in early 2023, growth in China is set to rebound substantially this year. Markets were further cheered by developments during the March "two sessions", where President Xi, with his third term secured and a new government in place, signaled an increased focus on economic growth and a roll back of the more stringent regulatory measures that crimped private tech companies and crippled the property sector in 2022. For US companies and investors, geopolitical risks need to be weighed against the advantages of doing business with the second largest economy in the world.

CREDIT CRUNCH COMING?

So far, so good for financial stability. Deposits in US regional and other smaller banks stabilized by the end of Q1, after substantial outflows in the wake of the bank failures, which included a smaller third bank, Silvergate, and sustained pressure on a fourth – First Republic Bank. But the ramifications of the bank crisis for the economy are not yet over. Longer-term, it is possible that regional and community banks – which are important sources of credit for local businesses, especially in commercial real estate – will gradually shrink, subject to a slow walk of deposits, if not a run. Consolidation in the US banking sector would open up opportunities. But it may also curb employment and growth as small businesses that rely entirely on these smaller local banks face tighter credit conditions as they search for new lenders.

In the near-term, the shock from the banking crisis, together with sustained higher interest rates, will increase the pressure on potentially vulnerable banks to improve their balance sheets, another curb on lending (Figure 2). Will a resulting credit crunch be sufficient to tip the US into recession? As Chair Powell and colleagues acknowledged in their March meeting, the economic impact of the banking turbulence is uncertain. But it adds to the downside risks. This is particularly clear in the real estate sector. The office sector – hurt by the pandemic and now by extensive remote work – is most vulnerable. Multifamily and warehouse are in a stronger position – and account for a larger share of the sector. But regional banks that have been put on notice by the March crisis

Figure 2. Bank lending contracted sharply at the end of the quarter amid on-going credit tightening



Source: RockCreek, FDIC, Federal Reserve.

will be wary of increasing lending as credit impairments threaten.

New forecasts from the World Bank, the International Monetary Fund (IMF) and others project the global economy to grow overall this year – but at a lower rate than in 2022, which in turn was weaker than in 2021, when a post-pandemic rebound took place across the world – except in China. As China has now left behind its zero Covid policy, it has become the lone bright spot where growth is accelerating, though we don't yet see significant new investments, including by Chinese companies.

For the US, there is still a chance that the longed-for "soft landing" from pandemic recovery can be achieved. Under this scenario, a gradually slowing economy would push inflation down further without triggering a sharp rise in unemployment. The key factor is what happens to inflation.

THE PROBLEM WITH INFLATION ...

As the period of high – and variable – inflation lengthens, the problems it causes abound. Families are faced with higher prices for essentials – food, housing, heating, and transport – and forced to make difficult choices. Those with fixed incomes suffer, especially if they are dependent on savings, which are losing their purchasing power. These are concrete difficulties. There is a more abstract problem that makes inflation so pernicious: we lose the measuring stick which guides economic decisions for workers and businesses, and investors and consumers.

THE LABOR MARKET PUZZLE

As the Fed has tightened monetary policy, it has watched for an impact on the labor market. The central bank has been fearful of a price-wage-price spiral, where rising prices lead to stronger wage demands, a tight jobs market leads employers to raise wages to attract and retain workers, and higher labor costs push up prices further. When the pandemic recovery began, labor shortages were widespread, especially in the service sector, where demand sprang back to life as Covid fears receded. Some of those who called the inflation risk early, such as former Treasury Secretary Lawrence Summers, cautioned that unemployment would have to rise significantly to hold wage increases in check and achieve a significant drop in inflation. The Fed's own projections are for unemployment to climb a percentage point to 4.5% by end-2023 as the economy reacts to its monetary squeeze.

Instead, the jobs market remained strong throughout 2022. Even as companies began to report sizable layoffs, it seemed that claims for unemployment insurance benefits remained low, vacancies were high, and an unusually high number of workers remained on the sidelines. Average earnings, however, were not matching price increases.

This labor market puzzle eased somewhat in Q1. Part of the reason was yet another set of data revisions, a reflection of the difficulties for government statisticians in catching up with pandemic-related shifts in seasonal patterns. Unemployment claims are now estimated to have climbed, as quits have reduced and the number of vacancies – though still high – slipped further during January to March. Labor market participation is also now creeping back up, as would be expected when the jobs market is strong. This is particularly true for prime age workers – those between 25 and 55 – and for women, as Professor Betsey Stevenson notes. But the labor market is still tight, especially for this time of the cycle. The puzzle remains, with a key question: does unemployment need to rise sharply to meet the Fed's inflation goals?

The tight labor market has led to some welcome trends that continued in Q1. Workers at the lower end of the scale have seen relatively larger wage increases, in percentage terms, during this cycle and the gap between white and Black unemployment has narrowed, to 1.8 percentage points in March, the smallest in over 50 years.