NOT SO FAST...

Just as hopes were rising of a soft landing in the US, markets took fright this week. For 10-year Treasuries, prices dropped back to the lows reached last October, and even beyond. Friday's better news on inflation – for both the US and Europe – helped to limit losses. But September still ended the month in the red.

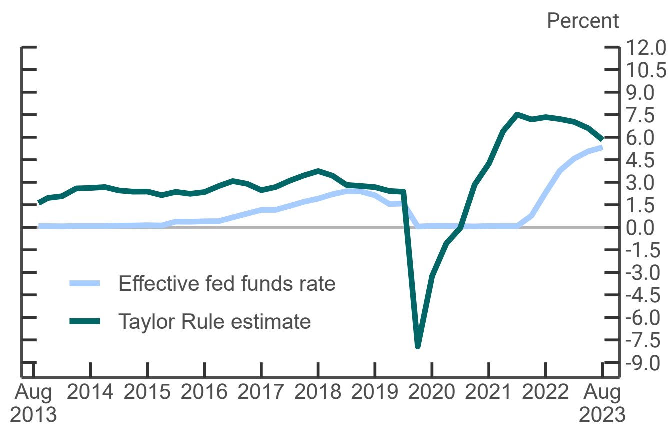
There are some new reasons for investor concern.

The auto workers' strike is spreading, with the potential to hurt a broad swath of the economy the longer it continues. Energy prices are set to rise on the back of a jump in oil prices to $95 a barrel, the highest level this year. Government dysfunction has been on full display in Washington, as Congress slides towards a government shutdown. Wednesday's second Republican presidential debate, boycotted again by former President Donald Trump, made it clearer that none of the other contenders can beat the popularity of the former President. A rematch with President Joe Biden is regarded with dismay by many Americans. It also raises the prospect of a divisive and perhaps chaotic US election year in 2024.

But perhaps more important than these new concerns is the market reaction to what the Federal Reserve is continuing to do: affirming the priority it places on fighting inflation. At their policy meeting last week, the central bankers delivered what was expected: a pause in rate increases, coupled with a warning that they may raise rates again this year and expect to keep them high throughout most of 2024. But this time, the higher-for-longer message hit home with a vengeance. Market interest rates for 10-year Treasuries jumped by 10 bps in the past week, with the repricing spreading to long-term rates.

There may yet be a reprieve. Friday's release of the Federal Reserve's preferred inflation measure for August – the core PCE– was more benign than the CPI data that the Fed had going into its policy meeting last week. Consumer inflation came down over the summer although it is still above the Fed's 2% price stability goal. Core PCE rose by a less-than-expected 0.1% month-on-month in August, a 3.9% increase from a year earlier, but only 2.2% at an annual rate over the last three months. US interest rates at over 5% are now clearly restrictive. Financial conditions are tight. Markets are realizing that the Fed would like to keep it that way until

The fed funds rate converges to Taylor Rule estimates



Source: RockCreek, Federal Reserve Bank of Atlanta, Bloomberg inflation drops further. It is only recently that the federal funds rate has reached the level that the traditional Taylor rule for monetary policy shows as consistent with the long-term inflation goal.

A NARROW PATH, WITHOUT CLEAR MARKERS

The Fed and fellow central banks in most advanced economies – not Japan – have been walking a narrow path all year between tightening money sufficiently to combat inflation while not overshooting. As the US economy has demonstrated its resilience, the Fed has clarified that it expects to keep rates high – and money tight – for much of 2024, even as inflation is coming down. This week, real rates, as measured by TIPS yields, rose in response before settling down by the end of the week. Markets could be signaling an expectation of stronger economic growth. The issue for the Fed is whether that market reaction may itself damage the prospects for growth, as broad financial conditions tighten. That would tilt the balance for policy.

Understanding the signals from upcoming economic data will be all the more important as the policy path narrows. Since central bankers realized that their old models of the economy didn't work in the post-pandemic world, they have stressed the importance of data dependence. One problem is that data signals have become harder to interpret in a world of shifting policies and politics. New Chicago Fed President Austan Goolsbee pointed to the difficulty this week.

"Tying monetary policy too closely to contemporary output and labor market readings today risks giving a decidedly wrong answer", he said.

The Fed may face even more difficulty in charting their path forward if the threatened government shutdown cuts back on official statistics. In past shutdowns, the Fed has turned to private data sources to fill in the gaps left in the wake of delayed data releases. This time around, with monetary policy at such a critical juncture, the stakes are higher.

SLOWING DOWN

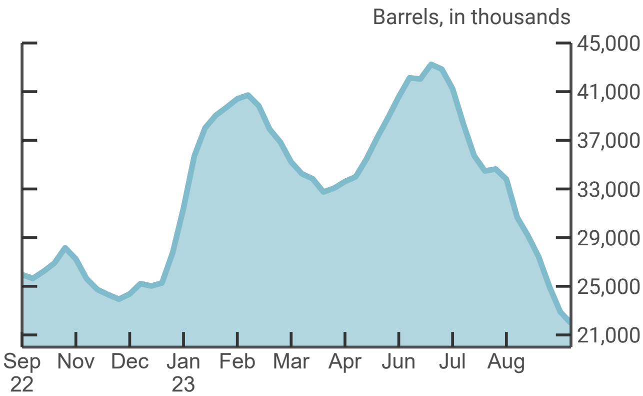
Global growth was stronger than expected in the first half of 2023. But forecasters still predict a slowdown for the year as a whole, with a weakening in Q4 that will continue into 2024. A full-fledged global recession is unlikely. But projections for medium-term global growth of just 3% – likely to be reaffirmed next month by the World Bank and International Monetary Fund (IMF) at their flagship annual meetings – fall far short of what is needed to reduce poverty and raise living standards in the emerging and developing world.

This week's Global Economic Prospects from the Peterson institute followed the Paris-based OECD in predicting global GDP growth dipping below 3% in 2024. This largely reflected an expected slowdown in China, to just over 4.5% after meeting the 5% government target this year. Both expect growth in Europe to be only slightly positive this year, pulled down by a likely economic contraction in Germany, the area's biggest economy, with a slow and fragile recovery in 2024.

BRING IN THE WOMEN

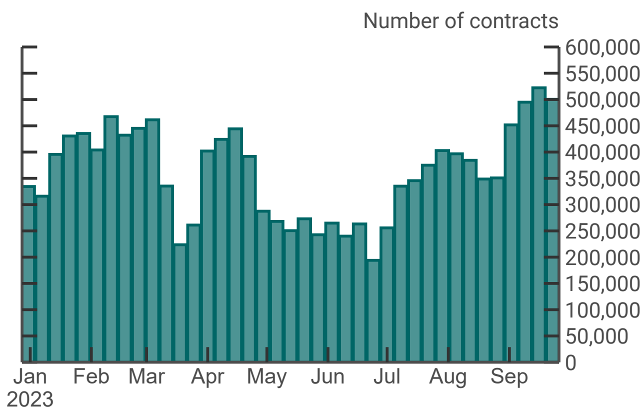
In the US, one pleasing aspect of recent developments has been the renewed influx of women into the labor force. In August, the labor force participation rate for prime age women reached an all-time high of 77.8%. Of course, the gender pay gap remains a problem. And the ending of pandemic-related spending support

US key crude oil stockpile in Cushing continues to fall



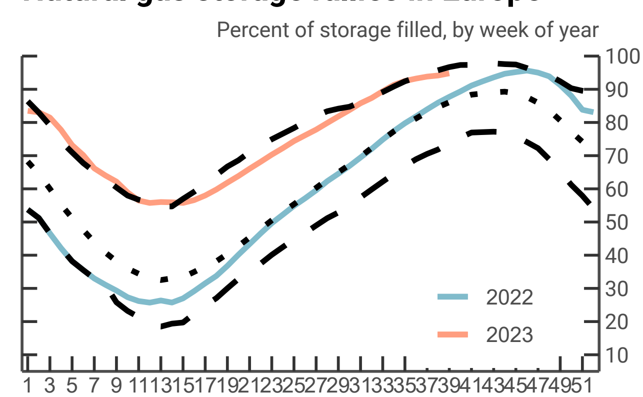
Source: RockCreek, Bloomberg

Hedge funds pile back into oil



Net long positions in Brent and WTI.
Source: RockCreek, Bloomberg

Natural gas storage rallies in Europe



Dashed lines are 2015-2022 min and max values, while the dotted line is 2015-2022 averages.
Source: RockCreek, Bloomberg

for childcare will make life harder for working mothers. But the picture in the US contrasts favorably with that in many other countries, particularly in the developing world, which have lower access for girls and women to education, health care, land and legal rights and other services, as well as discriminatory attitudes and other barriers to work outside the home.

New research from the IMF shows that this has a cost. Only 47% of women globally are active in today's formal labor markets, compared to 72% for men, the IMF says. This may overstate the gap, as women typically play a larger role in the informal and rural sectors, but worse pay and conditions prevail in those sectors. While some countries have managed to shrink the gender gap in labor participation – by almost 6 percentage points over 5 years in the best performers – many have not. The IMF paper estimates that emerging and developing countries could boost output by as much as 8% if they implemented reforms that promoted a similar rise in female labor force participation.

ENERGY CONTINUED TO CLIMB

Energy prices are once again making headlines, and stoking fears of an inflationary resurgence. Oil rose 2.6% this week, bringing the monthly increase to 10%, with the international benchmark, Brent, trading briefly above $96. As RockCreek has written, physical inventories are tight, and US IEA data suggest they are getting tighter.

In addition, as highlighted before, the positive price momentum in the commodity markets has driven more financial institutions to bet on further rising prices – creating a cycle of increases. One can see the traders net long position increasing since the summer.

European natural gas also rallied this week with Dutch TTF rising 4% during the week and bringing the MTD jump to nearly 20%. This is on the back of supply fears as Russia reduced supplies of refined product to Europe in recent weeks. This fear is despite strong storage in Europe ahead of winter.

FALTERING STOCKS

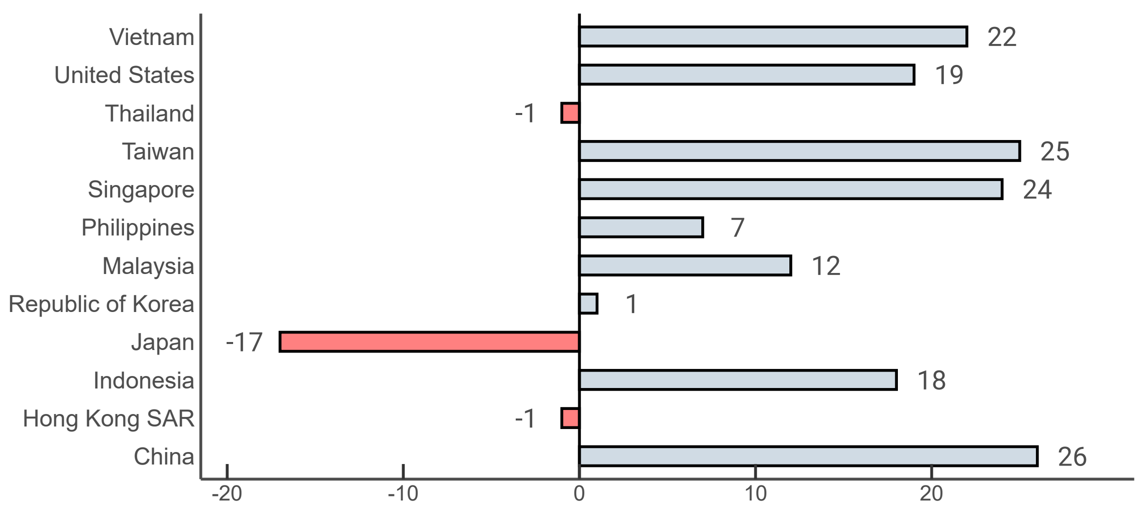
Major US equity indices had a tough week, with the S&P 500 falling 0.5% and the Nasdaq eking out a small gain of just 0.14%. Reflecting developments in the oil market, the S&P 500 energy sector added to gains this week and is the top performing sector this month, gaining 6% versus the next highest performing sector, materials, which rose by less than 1%.

European equities ended the week lower with the STOXX Europe 600 declining 0.55%. Dual pressures of high inflation and slowing economic growth drove a five-day losing streak that was finally snapped on Thursday due mainly to better-than-expected inflation data out of Germany. That welcome news was followed on Friday by a drop in Eurozone inflation to 4.3% from a year earlier, the lowest rate for two years. So far, sentiment indicators in Europe have remained low.

Japan's travel industry is one of several promising segments. Inbound tourism has been on a steady upward trend over the last decade except during the Covid outbreak and the Japanese government is targeting 60 million visitors by 2030 compared to around 32 million before the pandemic. The weaker yen has also made Japan a more attractive destination. According to IMF data, Japan's US-denominated GDP fell 17% between 2019 and 2022 versus increases of 26% for China and 22% for Vietnam, two of Japan's key sources of tourism growth. That translates to purchasing power increases of approximately 40% for inbound tourists into the country.

Japan is more attractive for tourists as buying power has increased

Change (%) in USD-denominated GDP, 2019 - 2022



GDP has decreased in Japan owing to a weakened Yen, while GDP in other countries has grown due to inflation, economic growth, and forex impact.
Source: Nomura, IMF.

BOND VIGILANTES RIDE AGAIN?

US 10yr treasury yields hit their highest level since 2007 (again) this week reaching 4.56%. The move higher in rates was predominantly driven by the market's growing acceptance of the Fed's higher for longer mantra. There are, however, additional pressures pushing rates higher – particularly longer duration points. The growing debt burden of the US seems to be playing a role as bond investors demand incrementally more term premium. Yields in the US weren't alone in feeling the pressure from fiscal policy. Italian yields hit their highest level (on an absolute basis) since the end of the Eurozone crisis a decade ago. Their spread over German equivalents is around the 200 bps. While these concerns are based in fundamentals – nominal yields at their highest levels in decade(s) are worth evaluating as a potential opportunity to add duration.

MIXED RETURNS IN EMERGING MARKETS

Emerging markets experienced a difficult week, with most major markets in the red. The markets' poor run masks some otherwise notable news coming out of China. In a mid-week speech, President Xi Jinping emphasized the benefits of China's participation in multilateral trade organizations and pledged to further open China to foreign investors. More interestingly, relatively little was said on issues related to external and domestic security, a trademark of the President's previous speeches. While nuanced, this shift in tone does serve as a belated acknowledgement that not all is well, and that a course correction is badly needed. Investors are – for the moment – remaining on the sidelines, however, and will need more than official statements to regain confidence.

One source of confidence may come from the upcoming 'golden week' holiday, which this year combines the Mid-Autumn Festival and National Day. Early data looks promising. For instance, Chinese online travel operator Trip.com reported that airline booking volume rose nearly five times, year-on-year, and that hotel booking volume had increased by more than eight times. Similarly, China railway expects close to 200 million train trips will be taken over the next ten days. In a bid to boost consumption, many cities across the country are issuing 'consumption vouchers' at local shopping centers and markets. Investors will pay close attention to third quarter results in the coming weeks.

Elsewhere in emerging markets, investors continued to wrestle with the prospect of higher-for-long interest rates in the US, and in the case of India, Korea, and other oil importers, the steady rise in crude prices. Closer to home, Mexico, one of the best performing equity markets this year has had a string of difficult weeks as negative sentiment about US economic prospects build. The Mexican Central Bank too has made it clear that easing of monetary policy is off the table for the foreseeable future, adding further pressure to investor expectations. While the long-term story remains solid in our view, the short term may continue to be bumpy.