LETTING THE AIR OUT...GENTLY?

After a summer of benign economic news in the US, investors and policymakers will be watching next week's August inflation report carefully. A third month of gradually improving inflation data would cement hopes that the Federal Reserve will pause rate hikes when it next meets on September 20. This would raise the odds of a soft landing to the Fed's 2022/23 tightening cycle – one of the most rapid in recent history.

A soft landing does not mean no landing. The US economy is slowing. Air is coming out of the labor market. And some risks that have diminished have not disappeared, from Covid, which has surged again this summer, to rising food and energy prices.

Most significantly for the economic outlook, oil prices briefly climbed above $90 several times this week to some of the highest levels since November 2022, settling just under $90/bbl by Friday. Cheaper energy helped to drive down headline inflation over the past year. But a jump in gas prices this fall will make it harder to reach the Fed's 2% goal for inflation.

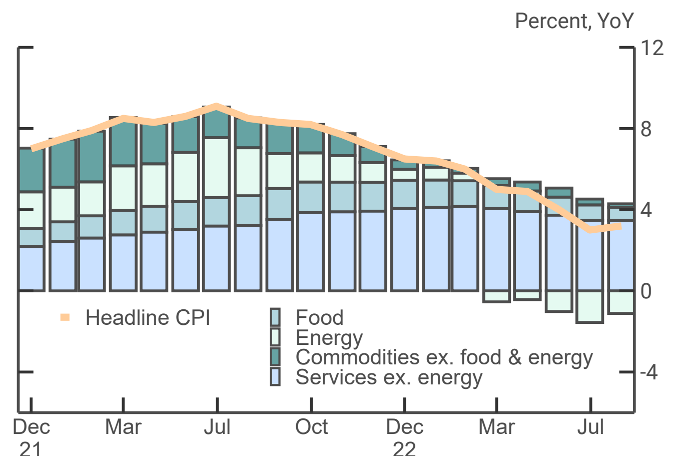
Against this backdrop, the Fed may combine a September pause in rate hikes with hints that a final interest rate rise could still be ahead in November. Central bankers, led by Chair Powell, are determined not to risk a resurgence of inflation by easing too soon. For investors considering how to balance their portfolios, what matters is not just when the interest rates peak, but what happens to rates after that.

America's economic resilience so far, combined with the Fed's fear of doing too little to defeat inflation, means that US monetary policy is set to remain restrictive well into 2024. Markets this week seemed to be

OPEC+ oil cut spurs rally...

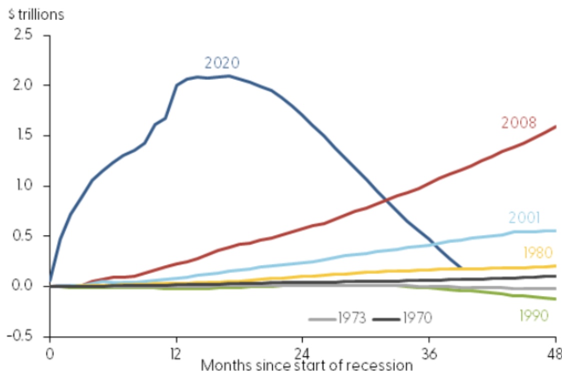
Source: RockCreek, Bloomberg.

...and heightens inflation worries



Source: RockCreek, Bloomberg.

Excess pandemic savings are set to run out by year end



accepting what RockCreek has been saying for a while: rates are likely to stay higher for longer. After two consecutive daily losses, the S&P recovered to end the week slightly in positive territory.

Prospects for the rest of this year and next depend on whether the US strength reflects a shift in underlying economic relationships or a delayed response to the rapid monetary tightening of the past 18 months.

The argument for the latter, more pessimistic, view is that pandemic-related policies cushioned households and many businesses from the impact of rate rises –but only temporarily. As money stays tight to fight inflation, the impact on demand will gradually rise. A more optimistic take is that the burst of inflation post-pandemic was largely a response to the enormous disruptions to supply and demand from the pandemic, and then war in Europe. With relative prices now adjusted to these disruptions, the Fed's firm policy will push inflation down further without requiring a sharp contraction in demand and rise in joblessness.

It is true that consumers who paid down debt and built-up savings during the pandemic lockdown are now dipping into savings and taking on expensive new debt to keep spending. So far, debt levels appear sustainable, as long as jobs remain plentiful. Household balance sheets have also been helped by continued resilient housing prices. Instead of widespread sales and foreclosures destroying wealth as in the 2008/09 financial crisis, rising rates have led to potential sellers holding on to their homes, reluctant to give up long-term low mortgage rates.

NOT SO GENTLE EVERYWHERE

Outside the US, the battle against inflation has been more testing, partly because of the very different impact of rate increases when long-term fixed interest rate markets for housing do not exist. The Bank of Canada this week put rates on hold, although at a still-restrictive level. Governor Tiff Macklem says this might be enough. Though GDP unexpectedly shrank in Q2, inflation shows little downward momentum, with July's numbers accelerating to 3.3% YoY. Canadian households are suffering as their housing loans reprice. Policymakers, who earlier this week uncharacteristically urged the central bank not to hike rates, called the pause "a welcome relief."

In Europe, the latest data for July show inflation for the eurozone as a whole at 5.3% on a year-on-year basis, compared to the 3.2% recorded in the US for the same month. Since last July, the European Central Bank (ECB) has raised its policy rate 425 basis points to 4.25% - a rapid increase that nonetheless still falls below the rate of inflation. This supports the argument for another rate rise when the ECB meets next week. But the economic outlook in Europe makes that a worrying prospect.

Unlike in the US, inflation in Europe was initially pushed up more by energy and food

price shocks than by government stimulus to demand. Also, unlike in the US, price increases pushed into double digits at the peak. But the inflation performance has been combined with a less resilient economy. Data this week reinforced concerns. Revised GDP numbers showed the eurozone as a whole barely grew in Q2. And in Germany, Europe's usual industrial powerhouse, the picture is worse. Industrial production dropped by 0.8% in July - the third consecutive month of decline - as energy prices, higher interest rates and weakness in China (see below) hit manufacturing across the board, with a particular blow to auto manufacturing.

PICK OF THE STOCK LITTER

Developed market equities showed further signs of softening this week – particularly in the technology sector – in the wake of higher yields. The S&P 500 and Nasdaq are down 1% and 1.7%, respectively, thus far in September. Europe has also had a poor start to the month, with the Eurostoxx down 0.8%. Investors have been taking heed of Germany's plummeting industrial output stemming from China's deteriorating economy and increasing isolationism. One bright spot: sentiment in Japan has remained good with the Nikkei 225 gaining 1.9% through September 6 before concerns over rising US yields and a struggling Chinese economy snapped the winning streak and sent the index back to where it started the month.

With angst over higher interest rates balanced against a still-resilient US economy, it is feeling very much like a stock picker's market domestically. Despite how narrowly concentrated market strength was in the most prominent mega-caps, small- and large-cap stock pickers had a strong first half of 2023, according to data from Morningstar. More diversified large-cap blend strategies were the only category that struggled due to the mega-cap effect while value, growth, and small-cap active portfolios outperformed overall. It also stands to reason that active investing should benefit from enhanced market breadth as other segments of the market catch up to the leaders and buy-the-dip opportunities arise among high-quality companies that are well-positioned to benefit from very long-term trends in AI and other technologies. This may be starting to play out now.

An area that appears to be gaining the attention of forward-looking investors is in cyclicals, particularly energy, industrials, and materials. We briefly highlight three key reasons. First, Saudi Arabia and Russia have demonstrated a commitment to sustaining higher oil prices with crude oil futures up well over 20% since the end of June. This is likely to help spur demand for oil services in the US and other regions. Second, we are now more than a year past the signing of the IRA into law, which means more of the related infrastructure projects should move on from their planning stages to shovels-in-the-ground. The US's energy infrastructure is currently not equipped to handle impending EV mandates and other electrification needs. This will require significant investments in aggregate materials and equipment. Third, we may see more stimulus from China than is currently anticipated. Historically, over the last 20 years, China has demonstrated a pattern of easing when the West is tightening and vice versa. As Xi's government faces a housing market meltdown and potential credit crisis, it would be reassuring to see a much stronger policy response from Beijing. So far, that has not been forthcoming. The recent slide in the renminbi suggests that China may be looking overseas for a boost in demand.

OIL: STILL A GEOPOLITICAL GAME, WITH MARKET CONSEQUENCES

Russia and Saudi Arabia's agreement on September 5 to maintain production cuts seemed to go under the political radar. That reflects President Biden's calculus on how best to further US interests in today's more complicated world. The Administration would like to deliver a historic Middle East initiative, building on former President Trump's Abraham accords to bring Saudi Arabia and Israel together. This makes a rebuff to Saudi Arabia over oil policy riskier.

A confluence of factors have pushed oil prices higher without stirring too many headlines until this week. A reason for the lack of fanfare is possibly that the outlook for the commodity has seemed rather dim, particularly on the demand side. One of the biggest headwinds all year has been the disappointing growth rates out of China. In addition, resilience in the US has been unmatched in Europe, where economic data has deteriorated significantly in the last few months. These concerns are starting to be outweighed by the supply side dynamics. Notably global crude inventories are at their lowest point since at least 2018.

The combination of low inventories, continued draws, and ongoing OPEC+ cuts point to a physically tight market. And technical factors could continue to support a rise in prices as well. CTA positioning flipped long in late July and commitment of trader data points to significant shortness in the market – leaving ample room for a price trend to feed on itself from a positioning perspective.

RISKY WORLD

Covid, which most of us have tried to forget about, ratcheted up again over the summer, even snagging first lady Jill Biden this week. Hospitalizations and deaths are still far below previous peaks, at around 80,000 cases over the last four weeks, according to CDC data. And the economic impact of the summer surge is likely to be contained, with new vaccines on the horizon. But living with periodic returns of Covid – especially among the unvaccinated as well as medically vulnerable populations and the elderly – is likely to be part of the "new new normal".

A different element of the "new new normal" is the continued splintering of support for the global institutions that have in the past promoted trade and investment ties and enabled coordinated action among major countries to support the global economy.

China's President Xi is not attending this week's G20 leaders' meeting in Delhi, after pressing earlier this month for expansion of the emerging markets group of BRICS nations, widely seen as a counterweight to the G7 grouping of advanced economies. Russian President Putin will also skip the G20 meeting. China's call this week for government employees to stop using Apple products hit US tech stocks. At the same time, Russia rejected efforts from Turkey's President Erdogan to revive the deal allowing Ukraine grain exports through the Black Sea. Food prices and depriving Ukraine of needed income.

As a part of its appeal to emerging markets and low-income countries, the Administration is setting out ambitious plans for reforms to the international institutions to support more financing to emerging and low income countries. National Security Advisor Jake Sullivan noted on Tuesday that President

Biden will propose additional climate and infrastructure funding that provides credible alternatives to current unsustainable lending practices. For the US to play its role, the White House would need to win congressional support for increased funding, including for the IMF. Treasury Undersecretary Jay Shambaugh had cautionary words for the IMF this week: stay true to the macro economic core of your expertise and don't shy from delivering tough message.

STRESSES KEEP PILING UP FOR CHINA

August weakness in emerging markets showed no signs of abating this week. After an initial rally on the back of a stamp duty tax reduction last week, Chinese markets returned to their downward trend, reacting to data that showed a fourth consecutive monthly decline in Chinese exports. Foreign investors sold over $650 million in onshore Chinese equities, extending an already dire year-to-date trend. Meanwhile, the unfavorable interest rate spread between ten-year US and Chinese Treasuries continued to put pressure on the Chinese Yuan, which dropped close to a 15-year low this week. Investors are demanding forceful stimulus measures from Chinese authorities who seem stuck between reviving domestic demand and protecting the prestige of the Chinese Yuan.

Latin America also experienced a difficult week, with all major equity markets selling off. In Brazil, market participants have grown impatient with the pace of proposed tax reforms while in Mexico, investors have been spooked by the nomination of candidates for next year's elections who are not deemed business friendly. Losses were amplified by a selloff in Latin American currencies as markets priced in lower carry rates on the back of local central banks easing monetary conditions against rising US yields.

Good news this week was centered around re-shoring darling Vietnam, with markets there more than offsetting August losses, and closing in on a 20% year-to-date return as measured by the MSCI Vietnam Index (USD). The government has been actively working to stimulate the economy after largely addressing the issues that overshadowed the market last year. Much of this year's momentum has been driven by domestic retail activity whereas foreign premiums - where they exist - are still low. We believe there is still room for further upside, even in the face of a slowing global economy. President Biden plans to visit this month while in Asia for the G-20 meetings, further underscoring the country's growing economic importance.