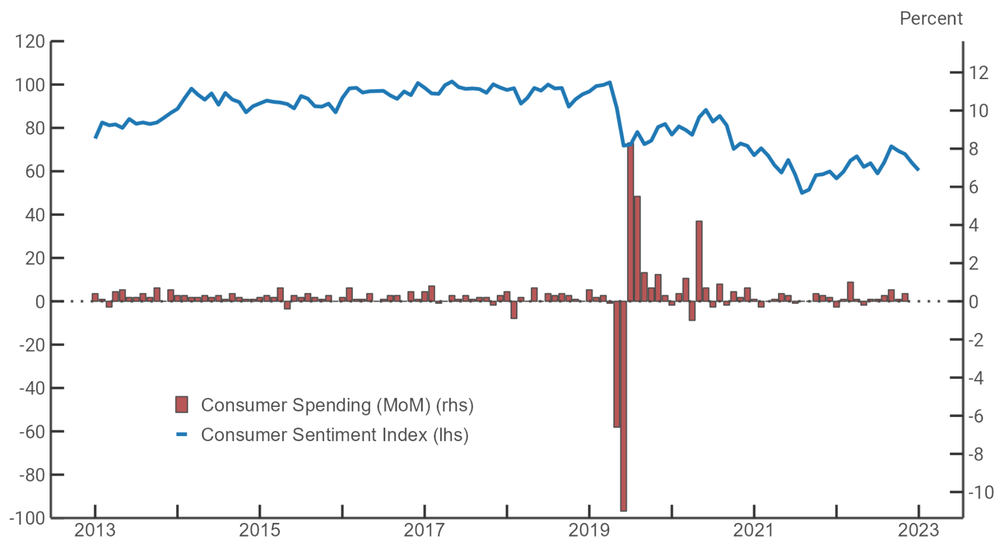
TWO CAMPS

The more economic data we get, the more uncertainty there seems to be. This data-rich week was a case in point. Good inflation news on Tuesday triggered an enthusiastic risk-on move. Weak retail sales and unemployment data led to a pull later in the week. By Friday, bond markets were up 1% while equities settled firmly higher, with this week's rally pushing the S&P and Nasdaq both up more than 2%.

Should investors look forward to further good news for the rest of this year, as one camp believes, or is the economy still set to slow, perhaps sharply, as the Fed holds tight? The answer is that we need still more data to be sure. Past relationships would dictate that squeezing inflation down to the 2% goal will require more job losses and higher unemployment than today's 3.9% jobless rate. But the pandemic recession and recovery have muddied past relationships. At RockCreek, we have remained cautiously optimistic, looking for ways to benefit from likely "higher for longer" interest rates– which we have expected for some time – while ready to move flexibly to respond to US economic strength.

Geopolitics do not affect markets directly. But the tensions of a conflict-ridden world, with wars raging in the mid-east and Europe, can bleed into sentiment. The Israel-Palestine conflict, following the horrifying October 7 assault on Israel by Hamas and subsequent Israeli attacks on Gaza, has led to particularly sharp divisions within and between countries. Continued stalemate in Ukraine's counter-

The growing disconnect between consumer sentiment and spending behavior



Source: RockCreek, Bloomberg.

offensive against Russia adds to concerns, including about possible energy disruptions and recession in Europe.

Against this background, markets took some cheer from the apparently successful meeting between the leaders of the two global superpowers. Presidents Biden and Xi were keen to show goodwill as they met for the first time in a year. Their accomplishments were less on trade and economics and more in the area of military cooperation, with a bonus agreement on curbing illegal fentanyl imports into the US. Lowering military tensions and the risk of accidental confrontation between China and the US is a good thing for the world, even if it falls well short of renewed economic ties. An agreement announced before the two Presidents met on a goal of tripling renewable energy production by 2030 may ease the way into the next COP. As a part of the 2023 APEC Summit, global government officials and corporate leaders, including RockCreek founder and CEO Afsaneh Beschloss, also gathered in San Francisco this week for the Partnership for Global Infrastructure and Investment (PGI) Indo-Pacific Economic Framework (IPEF) Investor Forum. Participants from both the public and private sector discussed investment in the energy transition and supply chains that help create resilient economies. Apart from this, hopes are not high for meaningful progress on government climate initiatives at the upcoming meeting in the United Arab Emirates (UAE).

STILL BALANCING

Since mid-summer, monetary policy has been balanced on a knife-edge. Too much tightening could tip the economy into recession. Too little, and inflation could take off again. With these risks seen as balanced since mid-year, the Federal Reserve has held rates steady after a July hike.

Five months later, and a month before the Fed has its final policy meeting of the year, investors and observers fall into two camps. On one side are the optimists. They believe that the surprising strength of the US economy this year, combined with declining inflation, augurs well for a soft landing, with no more rate hikes to come. Others are more wary, noting that even with flat inflation in October on the headline CPI measure, underlying price increases in recent months remain above the Fed's 2% goal for price stability. They wonder if the rest of the disinflation can take place with as little pain in the real economy as has happened so far.

Markets have decided that the Fed – and central banks in other advanced economies – are done with raising rates. After the CPI release, the probability that the Fed funds rate would be left unchanged at 5.25-5.5% in December reached 100%. US investors are now looking intently at what the Fed's continued quantitative tightening will mean for markets. And investors wonder when the Fed might start to cut rates. Across the Atlantic, where recent inflation data have also been better than expected, central bankers have pushed back on hopes for early rate cuts by the Bank of England or European Central Bank (ECB).

Recent moves in Treasury markets illustrate a paradox for monetary policymakers. Their main policy tool is the control of short-term interest rates. But these rates are not what directly affects the real economy and inflation. The impact of monetary policy on the broader cost of borrowing, or attractiveness of saving, comes from how changes in short-term policy rates affect the level of longer-term interest rates, e.g., those charged on business credit, mortgages, auto loans, and so on. The feedthrough from Fed actions to broader financial conditions is thus intermediated by markets. And long-term rates can sometimes move in ways that frustrate the intentions of policymakers.

As Fed Chair Powell commented earlier this month, the sharp rise in bond yields in October tightened financial conditions with no change in Fed policy. That made it a simpler decision for the Fed to hold short-rates steady at their last meeting. Now, if markets anticipate looser policy as a result of benign inflation data and bond yields decline, financial conditions could ease more than would be consistent with the Fed's view of what is needed to complete the "last mile" on inflation.

IS INFLATION REALLY LIKE DIETING?

Getting inflation down to 2% was not expected to be easy. But the decline from a peak of just over 9% year-on-year in June 2022 to last month's 3.2% was achieved with little impact on jobs or economic growth. Indeed, employment has expanded and, in Q3 of this year, GDP growth has accelerated. Some now argue that the most difficult days lie ahead, comparing it to the difficulty of getting rid of the last few pounds of weight when on a diet.

Core consumer prices were up 3.4% at an annualized rate over the three months to October. That is slightly higher than the 3.1% in the prior 3 months, when a good surprise in June and July data reinforced hopes of a painless disinflation. At that point, it seemed possible that the inflationary surge would dissipate easily, owing more to pandemic disruption than to excessive fiscal and monetary stimulus or economic imbalances. Unwinding of supply bottlenecks and adjustments to a post-pandemic world were helping to ease inflation while growth stayed strong – at least in the US.

Some cautious observers – including former President of the New York Fed, William Dudley – have continued to believe that further improvements in inflation will only come with a slowdown in the economy and a significant rise in unemployment. In a conversation this week, Dudley and Rory MacFarquhar, Chief Economist of Gemsstock, agreed that US economic strength so far had been impressive. But the "last mile" of bringing down inflation would be the most difficult, they said.

IS A SLOWDOWN ALREADY STARTING?

It is possible that the US slowdown they and some others envisage is already beginning. Consumers have kept the US economy powering ahead. Could they now be faltering? Retail sales in October were flat, after stronger data in Q3. That may partly reflect lower inflation – as the data are reported in nominal terms. But it could be a harbinger of slower spending growth.

Unemployment is still below 4%. But the three-month moving average rate has risen by 33 basis points from its low. The Sahm rule, named after former Fed economist Claudia Sahm, notes that a rise of 50 basis points in the jobless rate has always signaled the start of a recession. That regularity may not hold this time around, as Claudia Sahm herself has said, given pandemic distortions. But there is other evidence that the jobs market is becoming less favorable to workers. Unemployment claims were higher this week than expected. Most importantly, continuing claims – among those who have been unemployed for more than a week – have been rising steadily.

A gentle slowdown in consumer spending and gradual easing in labor markets could be consistent with a soft landing rather than a full-blown recession, if the Fed's balancing act is successful.

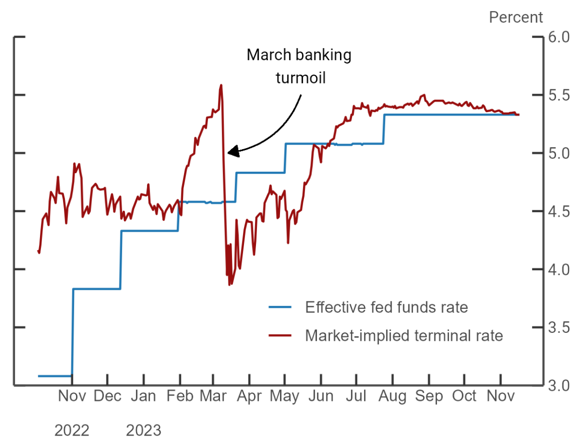
DON'T FORGET FISCAL POLICY

Life is full of trade-offs.

It is clear that the US policy of sizable and direct fiscal funding of households during the pandemic worked to buoy spending and speed recovery. The labor market adjustment required by dramatic shifts in demand and consumer preferences was remarkably smooth. As the Fed pushed interest rates up, many expected a financial accident or collapse in business or household spending. But strong balance sheets among households, financial institutions, and businesses allowed the economy to absorb the steep rise in rates. Households had built up savings during the pandemic. Stronger regulation after the global financial crisis (GFC) pushed banks to raise capital buffers. And many businesses took advantage of low interest rates post GFC to borrow longer-term.

The outlier in this story is the government. The government deficit this year is now expected to swell to as much as $1.7 trillion, or 6.3% of GDP. More worryingly, even for those who are not traditional fiscal hawks, there is little prospect of a political agreement to raise taxes or cut spending in the near term. Congress this week dodged another bullet, avoiding a government shutdown. But that will only last until early in 2024. At some point, Democrats who control the Senate (as well as the White House) and Republicans who control the House will have to reach agreement on spending levels – including on foreign aid for Ukraine and Israel. That looks very difficult. Already the new Speaker of the House, Republican Mike Johnson, is coming in for strong criticism from other Republicans for pushing through a short-term deal that relied on crucial support from Democrats.

Good economic news helps erase all market expectations for one more hike from the Fed



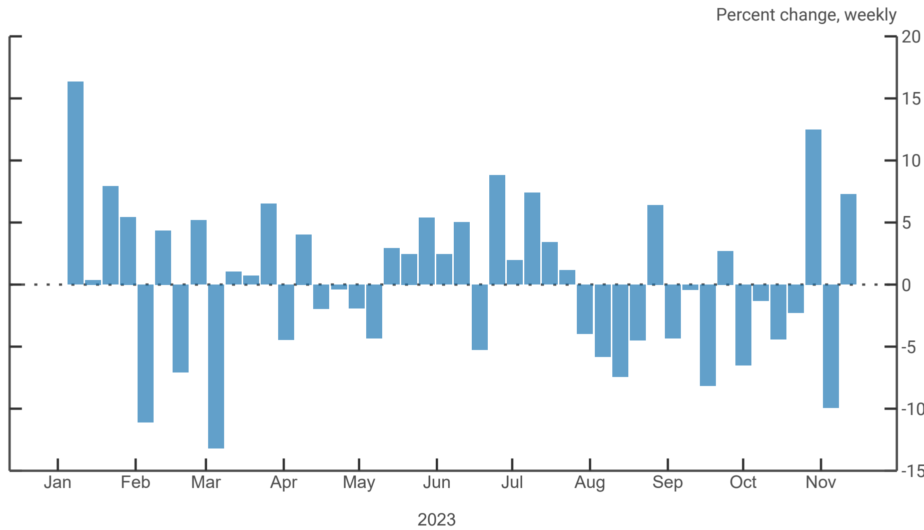
Source: RockCreek, Bloomberg, Daily Shot.

DURATION STRIKES BACK

Following Tuesday's dovish CPI print US duration continued its November rally with the 2-year to 30-year Treasury yields falling anywhere from 16-24 bps. Notably, the 10-year experienced its biggest single day move since the mini banking crisis earlier this year. Thanks to the dramatic moves, the Bloomberg US Treasury Total Return Index has gained 2.6% so far this month.

Meanwhile, short term interest rate markets all erased expectations for one more hike from the Fed in December. The Fed still has one more rate hike baked into its economic projections, so it will be interesting to see what the new "dot"s reveal at the next meeting in mid-December.

Ongoing quantitative tightening (QT) – a focal point of many fixed income experts – is also working on asset prices. As the Fed shrinks its balance sheet and reserves fall, many point to the funding hiccups in September 2019 as a cautionary tale. This time, however, the Fed has more tools at its disposal.



SMALL BUT MIGHTY

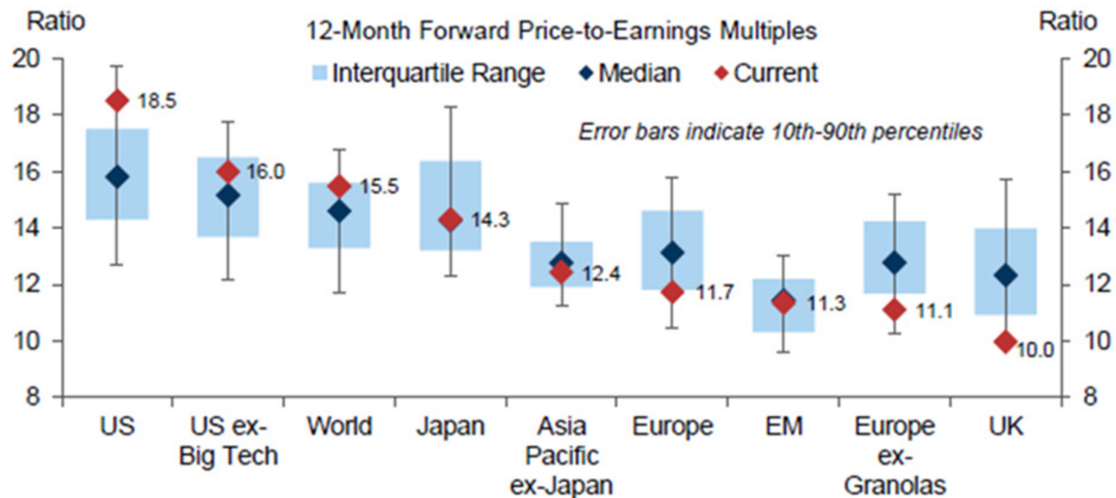
The moves in rates have laid bare how extreme positioning has been in some of the underperforming parts of the equity market. In the week ended November 3, some of the best performing stocks were some of the most shorted in the market. Those stocks gave back nearly all of their gains in the subsequent week – likely indicating the strong performance was reflective not of a change in outlook but rather a short squeeze triggered by technical moves in equities.

This week's price action has been more broad-based as top performers have been regional banks, commercial real estate, and other out of favor sectors. The performance of these sectors reflects the broader trend seen recently among small cap and emerging market indices. Both markets have underperformed the S&P 500 on a year-to-date basis but posted strong returns this week that has helped them achieve a respectable MTD outperformance.

Looking forward, an overall sideways equity market may be characterized by larger moves taking place under the surface. One possible scenario is a continued small cap outperformance at the expense of large caps, reflecting some catch up for underperformance in small caps. The Russell 2000 is closing in on a record amount of time under its last 52 week high, while drawdowns YTD are nearing highs only seen during recessionary periods.

Beyond this underperformance, valuations for small caps are quite compelling, as we wrote in our latest quarterly letter. But small cap US is not the only laggard with a potentially attractive valuation. Various international markets (both developed and emerging) range from fair to quite cheap, depending on the economic outlook for the region. Determining which valuations represent a true discount to the businesses fundamental position will be key. Thus successful active management will continue to play a vital role.

Aside from tech, aboslute equity valuations do not look particularly elevated



Note: Interquartile ranges and median are calculated from 2003-2023. GRANOLAS refers to 11 European stocks: GSK, Roche Holding, ASML, Nestlé, Novartis, Novo Nordisk, L'Oréal, LVMH, AstraZeneca, SAP, and Sanofi.

Source: FactSet, Goldman Sachs Global Investment Reserach

SLEEPING DRAGON

China has, perhaps unsurprisingly, been the center of focus lately for emerging markets. Uncertainty around the rule of law and the impact of the Party's policies have weighed on the entrepreneurial spirit in China and dampened prospects for investing domestically and from abroad. Even the small victories won at this week's meeting between Presidents Xi and Biden had little impact on market sentiment. But despite the general negative news on its economy, China continues to lead on the production of solar panels and on EV cars, of which it is also the largest exporter.

Chinese markets have risen moderately over the past two weeks, but not as much as the broader emerging markets and global indices. Some of the most notable price action came from the embattled property names, including Sunac, Evergrande and Country Garden. These three names jumped an average of 7.8% on November 15 after Bloomberg reported the government is planning an additional 1 trillion yuan ($137 billion) of low-cost financing to the housing sector. There has long been a call for more sweeping stimulus from the Chinese government to help shore up the housing sector, and while these measures, if they come to pass, may jumpstart sentiment, they do not seem enough to remove the property sector overhang which is, in turn, depressing consumer spending The slow and piecemeal roll out of stimulus thus far has exacerbated the broader economic weakness. While the PBOC has eased rates this year, the much larger drop in inflation has actually caused a tightening in real rates of nearly 2% – hardly conducive to supporting a faltering property market.

Elsewhere in emerging markets, the top performing countries of note have been Korea, and, to a lesser extent, Taiwan. Korean market performance was led by tech, particularly by index heavyweights Samsung and SK Hynix. In Taiwan, TSMC got a boost this week after announcing an increase in its cash dividend.

Among small markets, MENA markets have been leading the way with MSCI Egypt up 13% thanks to Commercial International Bank Egypt, which jumped 20% on the back of a strong earnings beat.