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Economic & Market Update

MARCH 2023 OUTLOOK

The global economy is defying broad calls for a near term recession, but its continued growth is stalling progress on reducing inflation rates. Markets need clearer signs that global central bank monetary tightening policies are working and are close to being complete.

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GLOBAL ECONOMY

- The U.S. economy continues to defy calls for an impending recession following a revival in consumer spending at the beginning of the year after a late fourth quarter lull. Job and wage growth should begin to slow given the magnitude of short-term rate increases over the past year and the anecdotal evidence of large-scale layoff announcements in certain sectors of the economy. Business spending is slowing and may even contract in the manufacturing sector over the coming months, as inventories have been fully rebuilt and, in some cases, overstocked. The services sector should pick up the slack as demand there is rather strong with businesses largely retaining their current staff while still looking to attract employees.
- The surprising beginning of the year strength in consumer spending has caused a slight stall in the disinflationary progress the economy has seen since the middle of last year. The full restocking of inventories and unclogging of supply chains has helped reduce inflation in most goods prices although services prices have proven somewhat stickier as consumer demand has shifted to experiences. Monetary tightening and expiration of COVID-inspired fiscal initiatives should dampen demand and allow the disinflationary trend to resume as early as this month.
- The European economy, including the United Kingdom, may have dodged a recessionary bullet given the mild weather and the buildup in energy stockpiles, which has allowed inflation to begin to fall from very high levels. The end of pandemic-related restrictions in the domestic economies as well as the relaxation of mobility constraints in China has led to resiliency in both the services and manufacturing sectors. However, monetary tightening and the uncertainty around supply disruptions caused by the Russia-Ukraine war cast an ominous cloud over the economy and could lead to a more pronounced slowdown as the year progresses.
- The Chinese economy is still suffering from the short-term effects of its "zero-COVID" policies and the longer-term effects of trade wars with the United States and the country's challenging demographic profile. The government pivot on the COVID-19 policies and its promised fiscal and monetary support of the economy should lead to an increase in economic growth as long as the global economy stays out of recession.

MONETARY POLICY

- The temporary stall in inflationary progress and the perceived easing in financial conditions have caused the Federal Reserve (Fed) to be even more hawkish in its commentary, with the market assessment of the terminal federal funds rate, the point at which the Fed stops tightening, increasing to 5.50%. This would entail three more rate hikes of 25 basis points (bps) although renewed progress in the inflation statistics is likely to elicit a pause and an opportunity to assess the effects of the aggressive tightening implemented over the last year. Look for a 25-bps rate increase at this month's meeting and another hike of 25 bps in May as the tightening cycle comes to a close.
- The resilience of the European economies and still-high inflation rates should keep both the Bank of England (BOE) and European Central Bank (ECB) firmly in tightening mode as they both catch up to levels the Fed has already achieved. Unlike the Fed, which has been rather impressive in its unanimity of opinion, there have been some members of both the BOE and ECB who have warned of overtightening and have voted to pause at then-current levels.
- There was rampant speculation that the new Bank of Japan (BOJ) governor would scrap the zero-rate yield curve control policy overseen by current BOJ governor Haruhiko Kuroda. With the announcement of Kazuo Ueda as the next governor (whose term begins next month), expect a more gradual monetary normalization policy as opposed to an abrupt move to aggressively tighten policies in the manner of the other developed market central banks. The Japanese have been attempting to stoke some amount of inflation for years and do not want to prematurely fall back into a stagnant economic growth condition, which could revive deflationary concerns.

- While the People's Bank of China (PBOC) has promised to support the Chinese economy with monetary ease if needed, it will be careful not to fight the global tightening trend too hard as it could lead to unwanted capital flight given the already rancorous geopolitical environment. Expect little movement in rates from the PBOC for the rest of the year.

BOND MARKETS

- The apparent continuation of above-trend economic growth with the requisite threat of a more pronounced tightening response by the Fed has caused a shift up in the entire yield curve and a further inversion of the curve as higher short-term rates may lead to recession. With inflation rates expected to resume retreating after this recent flattening, the Fed should be able to stop tightening and allow intermediate- and longer-term rates to catch up to the current level of short-term rates. We continue to advise an underweight position to intermediate-maturity-fixed income securities under this scenario.
- Even with interest rates increasing and the yield curve further inverting, a classic sign of impending recession, interest rate spreads on high-yield bonds compared to like-maturity Treasurys have remained remarkably stable and provide some comfort in our view that economic growth will slow, but not recede. Yields are attractive in this space and a full weighting to this asset class is recommended.

EQUITY MARKETS

- Concerns around excessive monetary tightening and declining profit margins have injected heightened volatility into U.S. equity markets after the strong rally off the October 2022 lows. Earnings should continue to be challenged in the first half of 2023 until relative comparisons become easier in the second half. Until then, further equity market advances will be dependent upon progress on inflation and clearer signs the Fed is close to the end of its tightening cycle.
- Despite the rebound in the U.S. dollar during February, developed international equity markets are outperforming those in the United States, as short-term interest rate levels are not as high and the economies are so far skirting recession on the back of resilient consumer and business spending. It may be difficult for this outperformance to continue given the higher inflation environment, which should provoke a greater degree of monetary tightening, but the avoidance of a global recession should allow these markets to generate positive total returns for the remainder of 2023.
- The end of China's "zero-COVID" policy and a sustained global economic expansion served as tailwinds to emerging market equities at the beginning of the year but heightened geopolitical risk around the Russia-Ukraine war and a developing cold war between the United States and China have dampened enthusiasm recently. With Chinese growth beginning to notably increase according to both sentiment surveys and actual production/spending statistics, emerging market equities should perform basically in line with developed international equities. Less restrictive central bank monetary policies can be an additional boost to this volatile asset class.

COMMODITIES & CURRENCIES

- Crude oil has remained in a rather narrow trading range over the last three months as actual supply has increased while the threat of supply constraints from OPEC+Russia hangs over the market. The revival of Chinese economic growth should be somewhat bullish for energy markets although an expected pickup in U.S. shale production should prevent any notable price spikes.
- Questions around the magnitude of global growth this year have led to volatility in the industrial metals space. Better growth statistics out of China and avoidance of recession in the United States should allow for appreciation from current levels for metals such as copper. Markets will need to balance the stronger growth implications of such a move with the inflationary consequences.

- It will be difficult for gold to appreciate from current levels until the markets get clearer signs the Fed and other central banks are closer to the end of their respective tightening cycles, as high short-term rates are a major headwind to this non-yielding asset.
- After experiencing a roughly 10% peak-to-trough decline, the U.S. dollar rebounded a bit in February and has likely settled into a trading range bounded by the impending end of Fed tightening on the upside and heightened geopolitical tensions on the downside. Importantly, this trading range will allow the U.S. dollar to be less of a headwind to international investing and currency translation for U.S. multinational equities.

WHAT THIS MEANS FOR INVESTORS

- Global equity markets got off to a too strong start to the year given the macroeconomic and geopolitical risks under which economies are operating. The February market decline probably cleared out some valuation excesses. The lagged effects of synchronized global monetary tightening have yet to be fully reflected, but consumers around the world continue to spend to the extent that a near-term recession is not on the horizon. Inflation may stay sticky under this scenario although disinflationary forces should resume given the impact of rate increases to date on demand and the clearing of supply bottlenecks. The bear market lows in equities have likely been achieved last fall, but meaningful advances in prices from current levels will be largely dependent on clearer signs monetary tightening is near an end. We continue to favor U.S. equities in this slower-growth-but-no-recession scenario and remain cautious on assuming too much duration risk in our fixed-income portfolios.

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