”Goldilocks” jobs report keeps bears at bay

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The last week’s market highlights:

- Markets had a confused start to 2023: U.S. Federal Reserve speakers and minutes from the central bank’s December meeting suggested interest rates would be moving higher, yet the preponderance of new data releases pointed to economic conditions that are solid but softening.
- Although U.S. stocks as measured by the S&P 500 Index ended higher to close the first week of the year, non-U.S. equity markets outperformed considerably. Warmer temperatures in the Northern Hemisphere this winter have eased pressure on natural gas prices, improving the outlook for consumers in Europe and emerging markets.
- Short-term interest rates rose on the Fed’s more hawkish rhetoric but retreated on Friday following a “Goldilocks” U.S. employment report and an unexpectedly large drop in a closely watched gauge of services activity.
- The main event this week will be U.S. consumer price inflation. We’re expecting little change in overall prices thanks to continued drops in gasoline. Core prices (which exclude food and energy costs) should also show signs of softening.

Each week, we present our featured topics in the context of the major themes from Nuveen’s most recent **global investment outlook**:

- **U.S. economy:** Inflation risks may be fading, but recession risks are growing.

- **Global economy:** Still nursing a hangover from the post-pandemic binge, hampered further by higher borrowing costs and diminished savings.

- **Policy watch:** Central banks worldwide have fixated on inflation fighting at the expense of economic growth.

- **Fixed income:** Modestly extend duration and focus on higher-quality areas of the bond market.

- **Equities:** Favor U.S. stocks (especially large caps) over non-U.S. developed and emerging market shares, as they offer better opportunities for both defensive positioning and growth.

- **Asset allocation:** Diversification benefits remain elusive, but fixed income continues to be valued more attractively than equities.

Quote of the week:

“Write it on your heart that every day is the best day in the year.” – Ralph Waldo Emerson

A nearly perfect U.S. employment report kicks off the new year

This past Friday’s release of the December U.S. employment report gave investors everything they could have hoped for in seeking a “soft landing” for the economy in 2023. Very slight decline in net job creation? Check. Small downside surprise to average hourly earnings growth with a downward revision to last month’s alarming increase? Check. Falling unemployment rate despite more people entering the workforce? Big check.

Whatever one’s estimated recession probability was before the release of this report, it should be at least 5%-10% lower now, in our view. The unemployment rate has fallen to 3.5%, and the employment rate among prime-age workers (ages 25-54) bounced back above 80%, within sight of its pre-pandemic high.[1]

Crucially, with the alarmingly high average hourly earnings growth rate from November revised downward, this measure of compensation growth — while still higher than normal — continued its gentle path of deceleration in the fourth quarter of 2022. Average hourly earnings for non-supervisory workers increased 5% in 2022, down from 6.2% in 2021 and the peak of 6.7% for the 12 months ending in March 2022.[2]

Even before this "main event" report was released, we were seeing other employment data showing that the U.S. labor market remained quite strong heading into the end of the year. December's ADP private payroll gain of 235,000 was accompanied by a significant upgrade to last month's estimated tally.[3] Investors who had been anticipating the Job Openings and Labor Turnover Survey (JOLTS) for November to show increased layoffs or falling job openings instead found the numbers little changed from October. U.S. job openings still outnumber unemployed workers by well over four million.[4]

In short, recent reports show a labor market that is still quite robust but is well into the process of normalizing as growth in both hiring and wages slows. The elevated "quits" rate — reflecting a job market that still has a lot of "churn" — may cause wage growth to fall more slowly than the Fed would like, giving Chair Jerome Powell and his colleagues reason to tighten monetary policy further. Market pricing for the target federal funds rate rose last week, as Fed speak and meeting minutes came across as hawkish, signaling the "higher for longer" rate environment may still have longer to go.

60/40: "I'm not dead yet!"

"Reports of my death have been greatly exaggerated," Mark Twain famously did not say. Accurately attributed to the great American humorist or not, a similar sentiment sometimes applies to investment performance. For example, while the so-called 60/40 portfolio (60% U.S. stocks and 40% U.S. bonds) has endured its worst period of rolling three-year returns since the global financial crisis, investors are still up from their levels at the start of the pandemic.[5]

One reason is that the surge in interest rates during the first half of last year acted as a sort of automatic stabilizer for diversified portfolios, with higher yields able to provide an income cushion against falling bond prices. In fact, the path of performance for markets last year wasn't the straight line down that many investors may remember. The 60/40 portfolio was basically flat over the second half of 2022 and finished up from its June and October lows. In other words, one lesson investors should *not* take away from 2022 is that the 60/40 allocation is dead. It isn't, especially not with "the 40" providing a 4.4% yield today compared to just 1.8% at the start of last year.[6]

If you had told us on 1 January 2020 that we were about to enter a massive global pandemic but that diversified portfolios would still be up in excess of 12% nearly three years into it, we probably would have said that sounded optimistic.[7] A reasonable rejoinder to this would be to point out that investors have not experienced as poor a 3-year average return since the period that began in the second half of 2008 — a time no one looks back on with fondness.

If the demise of the 60/40 portfolio has been declared prematurely, the most obvious lesson for investors to take away from 2022 is this: Make sure not everything in your portfolio requires stable/low/falling interest rates to perform well. Most types of fixed income as well as stocks of high-growth companies and public real estate all benefited for many years from low interest rates. But last year, with inflation forcing rates higher, that stable, friendly underpinning for valuations vanished almost immediately. The S&P 500 dropped from its all-time high on 3 January 2022, not to approach it again, while the 10-year U.S. Treasury yield rose from 1.52% to as high as 4.25% in late October before dipping to 3.88% at the close of the year.[8]

Sources:

1. Bureau of Labor Statistics, Bloomberg
2. Bloomberg
3. MarketWatch

4. Bloomberg
5. Bloomberg
6. Bloomberg
7. Bloomberg
8. Bloomberg

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