U.S. equities have little energy as recession fears mount

- Concerns over a U.S. economic slowdown drove markets last week, with equity and commodity prices falling despite news of relaxed Covid restrictions from China. The S&P 500 lost 3.4%, with energy stocks leading the slide.[1]
- Higher-than-expected U.S. producer price inflation caused the 10-year U.S. Treasury yield to edge up for the week, but at 3.57% it remains nearly 70 basis points below its late October peak.[2]
- While monthly U.S. employment reports have been reliably showing strong job creation, weekly initial and continuing jobless claims have been rising recently from extremely low levels.
- This week holds great significance for our 2023 economic outlook. On Tuesday, November's year-on-year U.S. Consumer Price Index inflation should continue to moderate. This may provide cover for the Fed to slow its pace of interest-rate hikes when it announces its decision on Wednesday.

Each week, we present our featured topics in the context of 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: "He who makes himself a dove is eaten by the hawk." – Italian proverb

What to watch when the Fed meets this week

Over the past few months, Americans have continued to spend and leave their jobs for higher-paying positions. Perhaps best of all, however, they've enjoyed healthy investment returns. Since mid-October, interest rates have fallen, corporate bond spreads have narrowed and stocks have rallied. Driving the bullish backdrop: market expectations for Federal Reserve interest-rate hikes through June 2023 have declined from their peak, and traders have priced in a slower pace of tightening through the first half of 2024.

In contrast, recent speeches from members of the Fed who vote on monetary policy, including Chair Jerome Powell and Vice Chair John Williams, have echoed the importance of lowering underlying price pressures. Powell went so far as to say, "Despite some promising developments, we have a long way to go in restoring price stability."

It appears as if investors are trying to loosen financial conditions on their own when the Fed is not inclined to do so, a challenging proposition at best. Such a scenario occurred earlier this year, when hopes for a dovish turn in monetary policy were greeted by rallies in stocks and bonds. But as soon as the Fed pressed down on the brake, those gains quickly evaporated.

So is this fourth-quarter rally different? Will investors end the year with a bang? November's Consumer Price Index (CPI) inflation report (to be released on Tuesday) and the Fed's response the following day should be telling.

Throughout the year, inflation prints have overtaken the jobs report as kings of the data docket. This CPI release, though, is especially important, with the potential to confirm if October's soft inflation results were either a) the start of a trend or b) an anomaly. In either case, the Fed will be able to quickly shape interest-rate expectations when it declares its policy decision — almost certainly a 50-basis-point (bps) hike, to a range of 4.25% to 4.50% — issues its policy statement and publishes an updated summary of economic projections (SEP), its first since September.

With the magnitude of the Fed's move practically etched in stone, we believe the SEP will garner the most attention, due in large part to the inclusion of the Fed's closely watched "dot plot," a chart that records each official's projection for rates over the next three years. In September, the median policy rate expectation for the end of 2022 was 4.375%, and we think that's going to be on target. But the prior projected fed funds rate of 4.625% at the end of 2023 is likely to be revised up based on the inflation-fighting rhetoric from Powell, Williams and others.[3]

Fed fund futures reflect a 4.75% to 5% terminal rate range by mid-2023, with rate cuts starting as soon as next September.[4] (Fed fund futures are used by traders to bet on the direction of interest rates.) But barring a severe, sudden downturn in the U.S. economy or unusually soft inflation data, we think another 100 bps to 125 bps of rate increases are on tap before the Fed finally pauses sometime next year. In our view, the Fed won't even begin *hinting* about easing policy until inflation seems to be well on its way down to its 2% target.

Next week, the Fed won't tell us precisely when or at what level it expects to stop hiking. However, Powell's press conference on Wednesday, in the wake of November's CPI release, could offer clues. Stay tuned.

Checking up on China

Dissecting the news out of China this year — let alone using that information to make informed investment decisions — has been challenging, to put it mildly. Markets have primarily focused on China's Covid restrictions, which have greatly inhibited both consumer spending and the real estate market. These two segments constitute the bulk of domestically driven growth.

At the same time, demand for Chinese exports (and products used as part of global supply chains) has fallen because of broader post-pandemic shifts in consumption from goods to services. Indeed, trade data for the 12-month period ending November 30 showed a sharp decline in exports, dealing a blow to Beijing's goal of reaching its 2022 GDP expansion target of around 5.5%. Imports also stumbled, as households hoarded cash during the severe Covid lockdowns.[5]

But the days of “zero Covid” policies in China may, at last, be ending. Following protests in Shanghai and other major cities, the government has made it more difficult for local governments to mandate testing, allowed those with mild cases to isolate at home rather than recuperate at quarantine centers, and eliminated the need for people to show negative virus tests to travel between different parts of the country. But policy changes will not automatically induce economic activity — particularly consumer spending — if Chinese citizens feel Covid restrictions will eventually return, as they have time and time again.

Oil prices have been especially sensitive to Chinese lockdowns. They’d already been falling as demand from China, a major oil consumer, has declined amid its Covid battle. But much to our surprise, oil prices have continued to tank in the face of rumors, and now confirmation, that China is looking to (once again) reopen its economy. To illustrate, the price of Brent crude oil is close to flat for the year (at around $80/barrel) after closing as high as $128/barrel in the wake of Russia’s invasion of Ukraine.[6]

In our view, there are other factors driving commodity markets. Fears of weaker growth in developed economies as central banks aggressively raise interest rates come to mind. But we believe stronger-than-expected economic performance from China next year will support oil prices at today’s level, if not somewhat higher.

So the question is: Will China’s economic growth top consensus forecasts in 2023 or at least approach the government’s target? Coming out of lockdown has been a challenge worldwide. How Chinese consumers and policymakers will react to this latest effort is anyone’s guess. On the geopolitical stage, both the U.S. and China have threatened to use military force to “settle” the issue over Taiwanese sovereignty. An armed conflict would not only lead to catastrophic loss of life and property, but likely crush the global economy and with it, equity markets. Such broad-based uncertainty makes investing in China a dicey proposition.

SOURCES:
1. Factset, Marketwatch
2. Federal Reserve via Haver
3. Bloomberg
4. Bloomberg
5. Bloomberg
6. Bloomberg

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