Wave of interest-rate hikes sinks global equities

- Central banks stole the headlines last week, with the Federal Reserve, European Central Bank and Bank of England all raising interest rates by 50 basis points (bps). While none of the moves were unexpected, equity markets recoiled at the prospect of higher borrowing costs and a global slowdown in 2023. For the week, the S&P 500 Index lost 2.1%, while Europe's STOXX 600 Index fell 3.3%.[1]
- In the U.S. fixed income arena, the yield on the bellwether 10-year Treasury dipped 8 bps, closing the week at 3.49%, reflecting the market's expectations for decelerating economic growth.[2] Another possible explanation for the rally: investors anticipate that softer inflation will translate to lower interest rates. For that to happen, though, the Fed needs to pause or pivot on rates relatively soon. (Bond yields and prices move in opposite directions.)
- Shortly after the Chinese government eased the country's strict Covid protocols, Beijing was hit with a raft of new infections, shuttering businesses and emptying streets. Because China's data is notoriously unreliable and opaque, gauging how the outbreak is being handled will be difficult, if not impossible. In our view, this surge ensures that the government's goal of achieving GDP growth of 5%-5.5% this year will not be met.
- After a flurry of housing data (permits, starts, homebuilder confidence) early in the week, November's core Personal Consumption Expenditures Price Index — the Fed's preferred inflation barometer — will be released on Friday. We're expecting yet another decline in year-over-year inflation to mirror November's soft Consumer Price Index inflation report, along with greater evidence that real income growth has begun to turn up.

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: "In this great universe of ours, man is a mere insect, an ant, in his intellect, as compared with the boundless world about him, as measured by the intelligence capable of grasping the whole of truth and knowledge." – "Yes, Virginia, there is a Santa Claus"

A week of synchronicity among key central banks

Investors needed to keep their scorecards ready last week, and not just because of the World Cup's semifinal matches. The Federal Reserve, Bank of England (BoE) and European Central Bank (ECB) all "pitched in" with 50 basis point (bps) increases, continuing their fight against still-hot — yet decreasing — inflation.

The Fed kicked things off last Wednesday by breaking its run of four consecutive 75 bps hikes, raising its fed funds rate target to a range of 4.25% ─ 4.50%, the highest level since 2007. And the central bank doesn't appear to be done tightening. According to the dot plots, the median expectation for the fed funds rate at the end of 2023 rose to 5.125% from 4.625% in September.[3] Its forecast for 2024 was dispersed among individual policymakers but clearly called for rate cuts, with about 100 bps of easing on tap that year.

The Fed also issued economic projections that were generally more pessimistic than those released in September. Chair Jerome Powell and his colleagues expect just 0.5% GDP growth in 2023 (down from 1.2%) as unemployment rises to 4.6% (from 4.4%). They also believe inflation will be stickier than anticipated just a few months ago, falling only to 3.5% by the end of next year.[4] This figure, still well above the Fed's 2% target, is consistent with the view that interest rates should remain above 5% in a year's time.

In his post-meeting press conference, Powell pointed out that despite the recent (and welcome) decline in inflation, high prices persist, and the labor market continues to be out of balance. (See below for more on inflation.) This means demand for workers far exceeds supply, thereby putting upward pressure on wages — which the Fed would like to reverse.

Much to investors' disappointment, Powell didn't provide signs the Fed is looking to end its tightening cycle. U.S equities fell in the immediate wake of the Fed's decision, while the yield on the bellwether U.S. 10-year Treasury slipped as well, reflecting the slimmer possibility of an economic soft landing next year. Over the next two days, stocks fell even further, while the 10-year treaded water.[5]

Across the Atlantic, the ECB and BoE matched the Fed's 50 bps rate hike, but that's where the similarities ended. The Fed's policy statement wasn't overly hawkish, merely making the case that there's more work to be done to bring inflation to heel. In contrast, the ECB stated that *"interest rates will still have to rise significantly at a steady pace…*to ensure a timely return of inflation to the 2% medium term target." (Emphasis is ours.) The ECB's increase brought the rate of its main refinancing operations to 2.50%.

Of course, one could argue that such an aggressive stance was warranted, with eurozone inflation in double digits (10% year over year in November).[6] Markets certainly took notice, with the euro and yield on Germany's 10-year government bond spiking in the announcement's aftermath.

Meanwhile, the BoE dealt with a rebellion of sorts. Despite battling inflation of 10.7%, its decision to tighten by 50 bps, to 3.5%, wasn't unanimous. Two of its nine members voted to stand pat on rates, while one policymaker would have hiked by 75 bps.[7] But in the end, the BoE concluded that if its outlook signals more persistent inflationary pressures "it will respond forcefully, as necessary."

U.S. inflation's high but falling

Investors have long given up on the notion that inflation is "transitory" — a term coined by the Fed in 2021 to describe rising prices resulting from Covid-driven demand/supply imbalances. On the heels of October's cooler-than-expected Consumer Price Index (CPI) inflation, though, November's below-forecast CPI data, released during the Fed's two-day meeting, provided hope that prices have finally peaked and will continue to decline.

Headline CPI inflation dropped from 7.7% (year over year) in October to 7.1% in November, the smallest 12-month increase since late 2021. Meanwhile, core inflation, which strips away food and energy costs, slowed from 6.3% in October to 6.0%.[8]

While the Fed should be pleased with these softer figures, we don't think taking a bow is in order. In our view, its series of aggressive interest-rate hikes haven't had much of an inflation-fighting impact. Currently, there are two main drivers weighing on inflation. The first is falling prices for durable goods, which likely would have occurred even without tighter monetary policy as consumer preferences shift to services, and supply constraints ease. Used car costs continued to slip due to improving global manufacturing supply chains, not because of the Fed's action.

The second factor is falling energy costs, largely the result of ongoing uncertainty about demand from China, a major oil consumer, and global growth more broadly. Interestingly, lower gasoline prices shouldn't make the Fed more dovish. Paying less for energy allows households and corporations to boost spending on discretionary items, which may actually work *against* the Fed's goal of slowing the economy.

What's making policymakers furrow their respective brows is the jump in services inflation, particularly against a backdrop of a tight labor market and rising wages. This combination suggests the Fed isn't ready to cut rates.

Then there's the issue of rent. At the start of the year, Zillow's measure of rents on new leases showed annual increases of around 17%.[9] Throughout 2022 those surges have bled into average rent increases, the most persistent and — because they're such a large component of the CPI — most troubling category in monthly inflation reports.

Rent CPI is still accelerating year over year, but leading indicators like the Zillow and Apartment List series for new rents suggest that this upswing should stop sometime in the first half of next year.[10] Whether those expectations become reality and how they influence monetary policy is a key question for investors as we step into 2023.

Dear readers: This is our last Weekly Market Update for 2022. We will publish next on January 9, 2023.

SOURCES:
1. Marketwatch
2. Federal Reserve via Haver, Marketwatch
3. Bloomberg, Federal Reserve via Trading Economics
4. Federal Reserve
5. U.S. Treasury, Factset, Marketwatch
6. Eurostat

7. Bank of England
8. Bureau of Labor Statistics (BLS), BLs via Haver
9. Bloomberg
10. Apartment List Rent Estimates, Bloomberg

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