Hawks and banks batter U.S. equities

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The last week's market highlights:

- Investors perhaps had too much to digest last week, leading to a bout of heartburn. Fears of overly aggressive rate hikes from the Federal Reserve gave way to more acute concerns about banking system liquidity (see the Silicon Valley Bank bullet below). Equity investors didn't like what markets were serving, leading to a 4.6% loss for the S&P 500 — its worst week since last September.[1]
- Bank stocks sank on Thursday and Friday on a cascade of bad news surrounding Silicon Valley Bank (SVB), a small, technology-focused lender that was brought into FDIC receivership due to its inability to service deposit withdrawal demands. Investors feared that the portfolios of other U.S. banks were equally brittle, as rising interest rates have weighed on bond prices due to the Federal Reserve's aggressive rate hikes designed to tame persistently high inflation.
- Amid the risk-off sentiment, the yield on the bellwether 10-year Treasury plunged 23 basis points on Friday alone, finishing the week at 3.70%.[2]
- European Central Bank President Christine Lagarde has stepped up her hawkish rhetoric, and with good reason, in our view. Headline inflation in the region has fallen more slowly than anticipated, while the core measure of price pressures, which strips out food and energy costs, hit a record high in February. Against that backdrop, she recently stated that "inflation is a monster that we need to knock on the head."
- This week's economic headliner will be the U.S. Consumer Price Index inflation report, which after last Friday's mixed employment data will likely determine whether the Fed will accelerate its pace of interest-rate hikes from 25 basis points (in February) to 50 basis points at its March 22 meeting. We will also hear from the European Central Bank, which is expected to hike its policy target rate by 50 basis points.

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, while the labor market remains strong.
- **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:

"Sometimes you have to make decisions without knowing all that you would like to know. That's part of the job." – Janet Yellen

A dizzying week mercifully ends

Last week, investors were prepared for three potential market movers: 1) China's announcement of a 2023 growth target; (2) Federal Reserve Chair Jerome Powell's Congressional testimony and (3) February's payroll report. Unexpected and unwelcome financial sector fireworks courtesy of Silicon Valley Bank (SVB) late in the week provided an additional jolt. Well, move the markets did. Stock prices fell throughout the week, while demand for safe haven assets fueled by the SVB saga boosted the price — and sunk the yield — of the bellwether 10-year Treasury.

First, China. The government is looking for GDP growth of "around" 5% in 2023. This represents a step-up from last year's 3% GDP expansion — a disappointing showing due in large part to the country's severe Covid lockdowns. Still, it's well below the Chinese economy's annual GDP run rate of at least 7% from 2000-2015 and a far cry from the 10%-14% registered from 2003-2007.[3]

Why the subdued outlook? China's most recent trade data may provide a clue. Compared to a year ago, exports fell 6.8% in January and February combined amid slowing global demand. (China merges trade results for the first two months of the year to account for January's extended lunar holiday, when businesses are closed.) Imports, meanwhile, plunged 10.2%, driven by lower commodity prices and lower global demand for manufactured goods, many of which China imports as unfinished before completing and shipping off to customers.[4]

Next up, the Fed. News of China's not-so-lofty economic ambitions was likely music to Powell's ears. He and his colleagues are trying with all their monetary policy might to cool off the U.S. economy. A more ambitious target from China could have required a dose of stimulus that boosted China's demand for oil and gas, contributing to higher prices worldwide precisely when central banks are trying to lower inflation.

Powell's Herculean task, of course, is to subdue U.S. inflation without substantially increasing unemployment, and his mission has become even more challenging thanks to January's unexpectedly robust retail sales, payroll and inflation data. Therefore, we weren't surprised that in his Congressional testimony on Wednesday, he acknowledged for the first time what markets have already priced in: To tame inflation, the Fed will have to raise interest rates above 5.1% — last December's projected peak rate for this tightening cycle.[5]

How much further tightening is in store? We should get some clues on March 22, when the Fed will release its first set of 2023 economic forecasts and dot plot of interest-rate projections.

Third on the docket was February's jobs report. Employers added 311,000 positions, ahead of forecasts for 225,000.[6] Unemployment ticked up to 3.6%, but for a good reason — the number of people looking for work increased, as labor force participation among prime-age workers (those 25-54 years old) matched a pre-pandemic high of 83.1%.[7]

The employment data included some positive news on the inflation front. Year-over-year average hourly earnings (AHE) rose 4.6% yet undershot forecasts, while AHE in February (+0.2%) grew at its slowest pace since early 2022.[8] Over the past two years, job switchers have garnered most of the wage gains. However, fewer people have been quitting their jobs, contributing to the slowdown in AHE, while the number of job openings has been steadily declining. Taken together, this suggests the labor market is softening, albeit gradually. Powell and his colleagues likely approve of this development.

Events surrounding SVB rounded out the week. To cover customer withdrawals, the bank sold bonds worth about $21 billion but recognized a loss of roughly $1.8 billion in the process, as the value of its holdings in long-dated securities have declined as interest rates have risen sharply. (Bond yields and prices move in opposite directions.) On Friday, SVB was shuttered by U.S. regulators after a failed effort to raise new capital. Investors feared other banks with similar balance sheet profiles would suffer a similar fate, triggering steep losses in the financial sector that spilled over into the broad equity market.

While many of SVB’s struggles may be specific to its operating model and customer base, there is little doubt that the cumulative rise in interest rates and the inversion of the yield curve over the past year are putting additional stress on borrowers and lenders alike. We believe the Fed will take the concerns about financial conditions into account when considering how heavily to continue applying the brakes to the U.S. economy.

Sources:

1. Marketwatch, Bloomberg
2. Federal Reserve via Haver
3. Bloomberg
4. General Administration of Customs via Trading Economics
5. Bloomberg
6. Bureau of Labor Statistics (BLS), Marketwatch
7. Bloomberg
8. BLS, BLS via Haver, Marketwatch

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