Rising rates are no problem for U.S. equities — at least for a week

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The last week's market highlights:

- Stocks shrugged off another week of higher interest rates, as inflation hawks continued to circle over a still-hot U.S. economy. The S&P 500 rose 1.9%, led by cyclical sectors like materials and industrials.[1]
- Members of the Federal Reserve's Open Market Committee, which votes on monetary policy, voiced concerns publicly about the recent uptick in inflation, leaving the door open for interest-rate increases well into the summer. U.S. Treasury markets took notice, with the 2-year note, which tends to track the direction of Fed monetary policy, closing the week at 4.86%, near its highest level since 2007.[2] Meanwhile, the bellwether 10-year security topped 4% late in the week for the first time since November.[3]
- Eurozone inflation was higher than anticipated in February, which will push the European Central Bank to be more restrictive despite lukewarm business investment and consumer spending in the currency bloc.
- Surveys for China's manufacturing and service sectors topped forecasts in February as the country continues to recover from last year's Covid-driven lockdowns. While that's encouraging news, solid "real" data (e.g., retail sales and housing starts) are needed to help confirm the durability of China's rebound.
- On Friday, February's U.S. employment report is expected to show a significant decline in the pace of job creation after January's surprisingly strong reading. Should the payroll data continue to run hot, we anticipate a further rise in interest rates and lower equity prices — at least in the short term — driven by fears over Fed tightening.

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:

“There are colors we can’t see, but they’re connected to the ones we can. There’s a connection between everything.” – Wayne Shorter

Did the global economy heat up in January or did the data mislead us?

Financial news outlets have latched onto the narrative that the global economy — and the U.S. in particular — is overheating again, just six weeks after it was on the precipice of a recession. We didn’t believe that pessimistic account then, and we’re skeptical of the portrayal now that the global economy has *really* gained that much momentum.

Let’s turn back the clock a bit. Central banks hiked rates aggressively during the second half of 2022, so the effects of tighter monetary policy could have kicked in within a few months, bringing with it concerns over growth, and along with it, lower long-term yields.

In the U.S., that decline, which helped drive down mortgage rates from early November through early February, almost certainly contributed to the recent spell in improving housing data, such as in homebuilder confidence, traffic of prospective buyers of new homes and, most recently, new home sales, which bounced 7.2% in January.[4] (Existing home sales are less likely to rebound, as homeowners remain reluctant to sell, given that most of them have taken out extremely low-rate mortgages.)

But it wasn’t just the housing market that provided the juice in January. U.S. consumers, the economy’s backbone, may have been aided in January by increases in monthly Social Security payments and adjustments to income tax brackets — which lowered tax rates — leading to unexpectedly robust retail sales. Lastly, warmer weather could have fueled the continued burst in services consumption.

Of course, a hotter economy signals a combination of stronger growth and higher inflation. Indeed, after a month of upside inflation surprises — the first since October, according to Citibank’s Inflation Surprise Index — market-based measures of inflation expectations are rising again. The 1-year rate of inflation implied by the U.S. TIPS market has jumped from 2% to over 3.6% in about six weeks.[5]

So there it is — seemingly ironclad evidence that the U.S. economy began the year full of vim, vigor and vitality. But what if data are wrong, or at least have vacillated less than previously reported?

Seasonal adjustments — the process by which economists attempt to smooth out normal calendar-driven changes in data — may have been the culprit. To illustrate, the data show that real (i.e., after inflation) U.S. personal spending fell in December 2021 and 2022 before recovering the following January. However, those dips and bounces probably never took place and were products of seasonal adjustments made to the data. Real goods spending has been remarkably stable over the past two years as consumers have opted to allocate more of their disposable income to services.

Such statistical “tweaks” are also made to inflation and employment numbers, and we may need to sift through several more months of data — including revisions — to determine how much of 2023’s swift start *actually* took place and how much was due to seasonal fine tuning.

What's next for investors and the Fed?

February delivered a heaping scoop of 2022-like conditions for investors, pleasing nobody (except, perhaps, short sellers). The good news is that without *too* much damage to asset prices – at least relative to recent drawdowns — markets are now much better aligned with major central banks' likely paths of policy tightening. That said, there is some risk that markets have gone *too far* in pricing in (1) the likelihood of a 50 basis-point hike when the Federal Reserve meets later this month and (2) the possibility of the Fed keeping its foot on the brake longer than traders — and even the central bank itself — had previously anticipated. While investors generally recoil at the prospect of higher borrowing costs, anticipating the worst offers the opportunity for dovish surprises, which often ignites rallies in both stocks and bonds.

In order to get those dovish surprises, however, U.S. economic data releases will have to confirm that January's strong start, as we discussed above, was an anomaly and not the beginning of a new, hot trend. That process will begin on Friday with February's employment report, which is expected to show that employers added fewer than half the number of payrolls than they did in January (a forecast-shredding 517,000).[6] Meanwhile, average annual hourly earnings growth should continue to decelerate to around 3% - 4% — a range that's far more compatible with the Fed's 2% core inflation target.

Beyond next week, February's inflation releases – which are already topping expectations in the eurozone – will, in our view, be the final determinants in how much Fed Chair Jerome Powell and his colleagues will raise rates. A 50 basis-point hike, which markets would frown upon in the short term, is on the table if the data continue to run hot. Over the longer term, tightening of such magnitude, even if followed by a series of 25 basis-point increases, is unlikely to tip the economy into recession. Moreover, a scenario with a somewhat higher terminal policy, or peak rate for this tightening cycle, is better than one in which the economy crashes.

Against that backdrop, we still believe a soft economic landing (one with lower inflation and low unemployment) is the most probable outcome, followed closely by "no landing" (persistent inflation, low unemployment). A hard economic landing, the least desirable of the three potential "runways," remains possible, but unlikely.

Sources:

1. Bloomberg
2. Federal Reserve via Haver
3. Bloomberg
4. Census Bureau
5. Bloomberg
6. Bureau of Labor Statistics

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