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The US economy

The US economy is cooling, but I believe that's a good thing if it's in moderation and inflation is cooling along with it.

Lagged effects of tightening

But, we have to worry about what will happen when the full impact of the Fed's tightening finally hits the economy.

What is the Fed thinking?

We'll get more insights into the Fed's thinking with the release of March Federal Open Market Committee meeting minutes.

As someone who grew up in America in the 1970s and 1980s, my school friends and I often laugh about our childhoods and how oblivious we were to the dangers around us. We marvel at how we survived not being required to wear seatbelts in cars or helmets on bicycles. One close friend of mine actually fell out of her mom's car — with a cat on her lap — while we were driving down the road. I'm happy to report both were unharmed. But being footloose and fancy free didn't always work out. There was the time my mom — who was so blissful because she had gotten a new car with a moon roof — forgot to get an oil change or even just put motor oil in her car for about a year. She was enjoying a sunny day out when the engine seized and the car ceased to operate. All the fun quickly came to an end as we watched the car towed away on a flatbed truck.

I share these anecdotes because I wonder if policymakers are becoming oblivious to the risks around us — or at least complacent. Yes, economic data has largely been what we hoped for. But there is a significant risk created by the kind of aggressive, rapid tightening we have seen in the past year; we haven't seen all the effects yet because of the time lag between policy implementation and real economy impact. My base case remains that we will avoid serious damage and end up like my friend and her cat, a bit shaken up but with just a few scrapes. However, we have to consider the risks and follow them closely so that we don't end up like my mother's car on the flatbed truck.

Last week brought with it a slew of data indicating a jump in demand for services in Europe and China, and a cooling economy in the US that appears to be tamping down inflation. Will the US Federal Reserve (Fed) and other central banks be satisfied with this progress in its fight against inflation? Let's dig into the details.

Demand for services picks up in Europe, China

S&P Global's Purchasing Managers' Indexes (PMI) for the eurozone indicate an increasingly strong economic environment, with the services PMI hitting a 10-month high in March.¹ Similarly, while China's Caixin PMI surveys showed a tepid manufacturing environment, the services PMIs are robust, climbing significantly since China's economic re-opening began in late 2022. The Caixin Services PMI rose from 55 in February to 57.8 in March, and the New Orders sub-index is at a 28-month high.² As I have said before, "revenge living" is underway as a high level of pent-up demand is starting to be acted upon.

A slowing US economy may be good for inflation

Last week we also got more signs the US economy is slowing:

- The Institute for Supply Management's (ISM) manufacturing PMI for March was 46.3, and the ISM services PMI for March was 51.2, both below consensus expectations.³ In particular, the New Orders

sub-index, while still in expansion territory, plunged more than 10 points, from 62.6 to 52.2.³

- February US construction spending dropped 0.1%, while February US factory orders were down 0.7%.⁴
- And perhaps most significant of all, Job Openings and Labor Turnover Survey data showed a substantial drop in job openings.⁵

So the US economy is cooling, but arguably that's a good thing if it's in moderation and inflation is cooling along with it. That appears to be the case so far. Let's focus on services inflation — the category of inflation that Fed Chair Jay Powell worries will be very sticky. While the US ISM Services Prices Paid sub-index is still high, it has eased significantly in the last year, dropping to 59.5 in March 2023 from a sky-high 83.80 one year ago.⁶ Clearly, prices have been moving in the right direction – and that movement has picked up speed recently.

In addition, the very tight US labor market – a major driver of services inflation – is showing signs of normalizing. My key takeaway from the March jobs report is that it shows significant progress on the path to normal.⁷

- Non-farm payrolls have moderated significantly from the very hot prints we've seen in recent months — the March number of 236,000 is the lowest level we've seen in over a year.
- Private sector jobs were weaker than expected, rising just 189,000 – which is the lowest level since February 2020.
- Average hourly earnings were up 0.27% month-over-month for March, which was lower than expected, and February's figures were revised down. Year-over-year, average hourly earnings rose 4.2%, indicating substantial moderation. If we were to annualize the last six months, we'd see an increase of 4%. If we were to annualize the last three months, the increase would be a relatively tepid 3.2%.
- What's more, labor force participation is at the highest rate since the pandemic at 62.6% (In March 2020, the labor force participation rate was 63.3%). Greater labor force participation is critical to easing a tight labor market and easing wage growth pressures further.

Simply put, the US economy seems to be in a relatively good place right now, clearly on the path to a more normal, pre-pandemic environment. However, we have to worry about the lagged effects of monetary policy and what will happen when the full impact of the Fed's tightening finally hits the economy. The question for the Fed and investors is whether the central bank believes it has done enough to control inflation and, perhaps more importantly now, whether it has done too much to avoid a recession.

Could banking issues flare-up again?

In addition, we still have to worry about a flare-up in banking industry issues.

- The American Bankers Association Index of Credit Conditions, released last week, showed that conditions are at their tightest level since the start of the pandemic.⁸
- The Dallas Fed Banking Conditions Survey for March showed a continued substantial tightening in credit conditions. There are concerns about the impact of rising rates on businesses and the

loss of confidence in the banking system, at least the regional banking system, created by the bank failures last month. One survey respondent articulated: “The effects of rising interest rates on balance sheets (are a concern) – as are recent bank failures in the news and the possibility of contagion, the rising debt of the federal government and other possible bank failures internationally.”⁹

- The Chicago Fed National Financial Conditions Index as of March 31 also shows a tightening of financial conditions.¹⁰ While that tightening wasn’t severe, keep in mind that credit conditions are only one component of this index.

A tightening of credit conditions could create substantial headwinds. For example, there are whispers about a few US banks that are potentially withdrawing lending to specific entities such as auto dealers. If lending conditions were to tighten too much and affect many industries, it seems likely a substantial recession could ensue. And so we will need to follow this measure closely.

Second, banks could still face headwinds. We believe the probability of a serious banking crisis is low, but there is still a risk that confidence could be undermined so much that there may be a “run” on another bank. This seems unlikely, especially given that there are policy tools available to prevent that and given that policymakers are hyper-focused on preventing another crisis, but we still want to be vigilant. What seems more likely is that banks remain in a challenging operating environment in the near term. They have to worry about depositors pulling their money out of banks and putting it into money market funds and other higher-yielding destinations. Banks may need to increase deposit rates in order to be more competitive in attracting deposits, which could in turn compress margins. Of course, we will want to follow this industry closely, which means paying close attention to what is being said on bank earnings calls this season.

Looking ahead

I will be very focused on insights to be gleaned from earnings season, especially bank earnings. I will also be looking forward to eurozone retail sales, to see if we get confirmation of the strength of the eurozone economy, and to the US Consumer Price Index, in the hopes that this inflation print helps convince the Fed to hit the pause button and stop hiking rates.

We’ll get more insights into the Fed’s thinking with the release of March Federal Open Market Committee meeting minutes — I’m hoping to see signs that the Fed is increasingly satisfied with its progress in fighting inflation. In addition, I’m hopeful the minutes will show a Fed that is thoughtful and sensitive to the lagged effects that its aggressive tightening cycle over the past year will have on the US economy.

I believe the prudent approach going forward is to remain defensively positioned tactically. Within equities, I favor the technology, health care, staples and utilities sectors and the quality and low volatility factors. Within fixed income, I favor investment grade credit. In terms of strategic positioning, I continue to advocate broad diversification both within and across the three major asset classes, with adequate exposure to assets with capital appreciation potential and income-generating assets.

With contributions from Andras Vig

Notes

¹Source: S&P Global, April 5, 2023

²Source: China Caixin Services PMI, as of April 6, 2023

³Source: Institute for Supply Management, April 3, 2023 (manufacturing) and April 5, 2023 (services)

⁴Source: US Census Bureau, April 3, 2023 (construction) and April 4, 2023 (factory orders)

⁵Source: Source: US Bureau of Labor Statistics, April 4, 2023

⁶Source: Institute for Supply Management, April 5, 2023

⁷Source: US jobs and wage data all from the US Employment Situation Report, April 7, 2023

⁸Source: American Bankers Association, ABA Credit Conditions Index – Q2 2023

⁹Source: Federal Reserve Bank of Dallas, Banking Conditions Survey, March 2023

¹⁰Source: Federal Reserve Bank of Chicago, National Financial Conditions Index, March 2023

Important information

Past performance is not a guarantee of future results.

This does not constitute a recommendation of any investment strategy or product for a particular investor. Investors should consult a financial professional before making any investment decisions.

All investing involves risk, including the risk of loss.

Diversification does not guarantee a profit or eliminate the risk of loss.

In general, stock values fluctuate, sometimes widely, in response to activities specific to the company as well as general market, economic and political conditions.

The health care industry is subject to risks relating to government regulation, obsolescence caused by scientific advances and technological innovations.

Many products and services offered in technology-related industries are subject to rapid obsolescence, which may lower the value of the issuers.

Low volatility factor investing identifies the least volatile stocks (using volatility rankings) in an effort to minimize the effects of market fluctuations. Of course, low volatility cannot be guaranteed.

Quality (in factor investing) characterizes companies with strong measures of financial health, including a strong balance sheet and stable earnings growth.

Fixed-income investments are subject to credit risk of the issuer and the effects of changing interest rates. Interest rate risk refers to the risk that bond prices generally fall as interest rates rise and vice versa. An issuer may be unable to meet interest and/or principal payments, thereby causing its instruments to decrease in value and lowering the issuer's credit rating.

Purchasing Managers' Indexes are based on monthly surveys of companies worldwide, and gauge business conditions within the manufacturing and services sectors.

Within the Services Purchasing Managers' Index produced by the Institute of Supply Management, New Orders and Prices Paid are components of the index.

The Job Openings and Labor Turnover Survey (JOLTS) from the US Bureau of Labor Statistics produces data on job openings, hires, and separations.

The Consumer Price Index (CPI) measures change in consumer prices. Core CPI excludes food and energy prices while headline CPI includes them.

The Federal Open Market Committee (FOMC) is a 12-member committee of the Federal Reserve Board that meets regularly to set monetary policy, including the interest rates that are charged to banks.

The ABA Credit Conditions Index is derived from the quarterly outlook for credit markets produced by the American Bankers Association's Economic Advisory Committee.

The Federal Reserve Bank of Dallas conducts the Banking Conditions Survey twice each quarter to obtain a timely assessment of activity at banks and credit unions headquartered in the Eleventh Federal Reserve District.

The Chicago Fed's National Financial Conditions Index (NFCI) provides a comprehensive weekly update on US financial conditions in money markets, debt and equity markets, and the traditional and "shadow" banking systems.

Tightening is a monetary policy used by central banks to normalize balance sheets.

The opinions referenced above are those of the author as of April 10, 2023. These comments should not be construed as recommendations, but as an illustration of broader themes. Forward-looking statements are not guarantees of future results. They involve risks, uncertainties and assumptions; there can be no assurance that actual results will not differ materially from expectations.