



**Kristina Hooper**  
Chief Global Market Strategist



## Global growth

China and the eurozone reported strong manufacturing numbers. The US jobs report dramatically exceeded estimates.

## Central banks

How the Federal Reserve and other central banks interpret the positive economic data will impact what happens next.

## Our base case

We believe we're getting closer to an end to Fed tightening with one or two more 25 basis point rate hike.

# Can you have your cake and eat it too?

## Weekly Market Compass | February 6, 2023

There is an old expression that I have heard a lot over the years: "You can't have your cake and eat it too." It's so old that the first reference to it appears to have been found in a letter from Thomas, Duke of Norfolk, to Thomas Cromwell in 1538.<sup>1</sup> Even the poet John Keats made reference to it in one of his poems, 'On Fame (ii): "'You cannot eat your cake and have it too.' – Proverb."<sup>2</sup>

To "have one's cake and eat it too" is defined by Merriam-Webster dictionary as "to have or enjoy the good parts of something without having or dealing with the bad parts." Humans seem very focused on this concept — and treat it as a rule — that you can't have the upside without the downside of a particular event or happening.

However, after recent data releases, I can't help but wonder whether there are exceptions to this rule, and we are having our cake and eating it too...

### China

Consider China. Last week saw China's official Purchasing Managers' Index (PMI) released for January. January manufacturing PMI clocked in at 50.1, up from its previous reading of 47.0. Services PMI had an even stronger showing at 54.4, up from 41.6 in December.<sup>3</sup> At the same time, it appears COVID cases peaked in late December and hospitalizations peaked in early January. Some thought a re-opening couldn't occur without very substantial COVID-related issues (i.e., major increases in infections, hospitalizations, and deaths), but that doesn't seem to be the case. China's high vaccination rate may have helped in this regard. It appears China is having its cake and eating it too.

### Eurozone

Consider the eurozone. Eurostat's preliminary flash eurozone GDP estimate for Q4 was better than expected, up 0.1% over the prior quarter. And the first estimate of annual growth for the eurozone for 2022 is an impressive 3.5%.<sup>4</sup> Eurozone composite PMI for January climbed back into growth territory for the first time since June, beating expectations, with services PMI hitting a six-month high.<sup>5</sup> Eurozone manufacturing PMI for January, while still in contraction territory, improved from December; but input cost inflation is actually at a 26-month low.<sup>6</sup> The eurozone economy is in better shape than many expected, and the probability of avoiding a recession is improving, while inflation continues to moderate. Energy prices have eased significantly thanks to a warm winter, conservation measures, and substitutes for Russian oil and gas from the US, Norway, and the Middle East North Africa region (MENA). It seems the eurozone could be having its cake and eating it too.

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## US

And then there is the United States. The US jobs report showed a job market on fire, with 517,000 non-farm payrolls added in January<sup>7</sup>, which dramatically exceeded the estimate of 189,000. The unemployment rate dropped to an extremely low 3.4%<sup>7</sup>. However, labor force participation improved, and wage growth was relatively tame — meeting forecasts of 0.3% for the month and 4.4% year over year.<sup>7</sup> This comes on the heels of a similarly tame Employment Cost Index reading showing compensation costs for workers increased 1.0% for the fourth quarter of 2022.<sup>8</sup>

It appears the US may be able to have its cake and eat it too. We could be witnessing a relatively painless 'disinflationary' scenario underway, one in which inflation continues to moderate with relatively little damage to the job market or broader economy (think soft or softish landing).

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## UK

It is worth noting that the United Kingdom does not seem to have much cake or to be eating it. The new government under Prime Minister Rishi Sunak is having to raise taxes, curb public spending growth, and deal with a series of major strikes by critical workers in health, transport, and public services. Inflation remains stubbornly high and is negatively impacting living standards. A UK recession appears very likely even though the Bank of England is near the end of its rate hiking cycle. In fact, the International Monetary Fund's most recent economic outlook showed upward revisions to its global growth forecast, but it downwardly revised expectations for UK growth; the United Kingdom is the only advanced economy that the IMF expects to contract this year.

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## How will central banks respond?

Yes, it does seem some major economies are enjoying better-than-expected economic growth without some of the negative aspects that were expected to go hand in hand with that; in the case of China, a major COVID wave, and in the case of the eurozone and the US, higher inflation.

But there is a fly in the ointment on what is otherwise an improving economic scenario for western developed countries: central banks. We can't forget that it's not how we interpret the data, it's how central banks interpret the data.

For example, the Federal Reserve's (Fed) concern is services inflation. The most recent Institute of Supply Management Purchasing Managers' Index (PMI) reading — released on Friday — showed a rebound in the services sector, clocking in at 55.2 versus an expected 50.5. This is well above the previous reading of 49.2. Most notable was the New Orders Index, which clocked in at a red hot 60.4, a jump of 15.2 percentage points from the December reading of 45.2.<sup>9</sup>

So, while we are seeing improvement in goods and housing (the November S&P CoreLogic Case-Shiller national home price index fell 0.56% month-over-month, with housing prices now down for five consecutive months<sup>10</sup>), the Fed is focused on services — especially the tight labor market.

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## Outlook

Our view is that the US jobs report will not materially change the Fed's tightening cycle, although it increases the likelihood the Fed will not cut rates later this year as the US economy will be in good enough shape that the Fed will not feel justified in cutting.

We believe we are still getting close to an end of tightening by the Fed, and that we likely have one or two more 25 basis point rate hikes before the Fed hits the 'pause button.' [As I said last week](#), the Fed could even take a page from the Bank of Canada's playbook and institute a "conditional pause" with tough language around re-instituting hikes if economic data is not satisfactory. That could perhaps be enough to ease the fears of Fed hawks who worry about ending tightening too soon and not extinguishing the embers of inflation, which could leave an opening for them to re-ignite.

Now there is the possibility that the Fed is not comfortable with the tightness of the labor market, despite continued signs of easing inflation. This would mean the Fed tightens for longer because the labor market is proving to be even tighter than anticipated, thereby weakening the US economy and increasing the risks of recession. However, that is not our base case scenario.

In terms of markets, we continue to anticipate volatility in the near term, as there remains significant uncertainty about monetary policy and other risks, such as the debt ceiling. However, we expect an increasing global risk appetite as markets positively re-price recession risks, and ultimately look forward to and discount an economic recovery that could begin to unfold late this year.

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## Notes

<sup>1</sup>Source: Letters and Papers, Foreign and Domestic, Henry VIII

<sup>2</sup>Source: The Poetical Works of John Keats: Reprinted from the Original with Notes, by Francis T. Palgrave, pg. 257.

<sup>3</sup>Source: China National Statistics Bureau, February 1, 2023.

<sup>4</sup>Source: Eurostat, January 31, 2023.

<sup>5</sup>Source: S&P Global, as of February 3, 2023.

<sup>6</sup>Source: S&P Global, as of February 1, 2023.

<sup>7</sup>Source: US January Employment Situation Report, February 3, 2023.

<sup>8</sup>Source: US Bureau of Labor Statistics, December 2022 Employment Cost Index, January 31, 2023.

<sup>9</sup>Source: Institute for Supply Management, February 3, 2023.

<sup>10</sup>Source: S&P CoreLogic Case-Shiller National Home Price NSA Index, January 31, 2023.

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**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.

An investment cannot be made into an index.

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

A basis point is one hundredth of a percentage point.

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

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

Gross domestic product (GDP) is a broad indicator of a region's economic activity, measuring the monetary value of all the finished goods and services produced in that region over a specified period of time.

Inflation is the rate at which the general price level for goods and services is increasing.

Disinflation, a slowing in the rate of price inflation, describes instances when the inflation rate has reduced marginally over the short term.

The Institute of Supply Management's Manufacturing New Orders Index is one of the indicators used to calculate the Manufacturing Purchasing Managers Index. It reflects a change in new orders of industrial companies.

International Monetary Fund (IMF) is an organization of 189 member countries that works to foster global monetary cooperation, secure financial stability, facilitate international trade, promote high employment and sustainable economic growth, and reduce poverty around the world.

The Employment Cost Index (ECI) measures the change in the cost of labor, free from the influence of employment shifts among occupations and industries.

The S&P CoreLogic Case-Shiller Home Price Indices are the leading measures of U.S. residential real estate prices, tracking changes in the value of residential real estate nationally.

The opinions referenced above are those of the author as of Feb. 2, 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.