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### Central banks.

The economies of the US, eurozone and Japan are all in different places, which means central banks must tailor their policies accordingly.

### Earnings season.

The overall statistics have been relatively good so far, but it's been on diminished expectations, and with some high profile misses.

### "Golden handcuffs."

High mortgage rates are one of the reasons why there are structural obstacles to having adequate US housing supply on the market.

# Thoughts from a road trip: Musings on parenting, central banks, housing, and earnings

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A few months ago, I was lucky enough to be invited to speak at a conference in Quebec City, Canada, set to occur last week. Unfortunately, my appearance at the conference (and that of many attendees) was threatened by aberrant weather and a cancelled flight. So to ensure I made it, I decided to drive to and from Canada. A jumble of thoughts ran through my head on that eight-hour journey each way. (That's a lot of time to sit and think!) I organized these random thoughts as best I could into a variety of miscellaneous observations ...

### Parenting multiple children can help one understand central bank policy

As a mom of three, I can say with certainty that children from the same gene pool can be very different. My children often complain that I don't treat them equally, and they're right. I treat them fairly based on their strengths, weaknesses, and needs. For example, we require my daughter to have two jobs — even though she's a talented athlete with a busy social life. Why? Because she likes to spend a lot and needs to learn the value of a dollar. (Side benefit: Every minute she's working is a minute that she cannot shop.) Conversely, our older son doesn't have a paying job this summer. He's taking classes to ensure he meets all his requirements for college graduation next spring — since it's a priority that he graduate on time — and he has an unpaid internship in his field of interest. They're definitely not treated equally because each one needs different "treatment" and support in order to be successful.

It's no different with economies. Take the United States. It seems clear from the Federal Open Market Committee (FOMC) press conference last week that the Federal Reserve is at or near the end of its rate hike cycle. And it should be — the fed funds rate is now at a 22-year high, and inflation continues to move in the right direction. That was confirmed on Friday, with reports that the Personal Consumption Expenditures (PCE) price index, the Fed's preferred measure of inflation, showed more progress in June:

- June US PCE was 0.2% month-over-month and 3.0% year-over-year, both in line with expectations.<sup>1</sup>
- Core PCE was 0.2% month-over-month and 4.1% year-over-year, slightly better than expected and at a two-year low.<sup>1</sup>

We also saw a tempering of wage growth, although still elevated, in the US Employment Cost Index, also released last Friday.

Having said that, the Fed seems increasingly comfortable with the idea that the US will avoid a recession and experience a soft landing,

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which gives it a certain level of hubris about being able to continue rate hikes. The first estimate of second-quarter gross domestic product growth, which was well above expectations, underscores that view.<sup>2</sup> At the expense of sounding like a broken record, I'll say it again: That view can be dangerous given the significant policy lag between implementation and impact.

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### **The European Central Bank must tread carefully**

The eurozone is in a different place than the US, with its economy showing less resilience recently. The flash eurozone composite Purchasing Managers' Index (PMI) is at an eight-month low, although services PMI remains in expansion territory. Manufacturing continues to deteriorate.<sup>3</sup> The European Central Bank (ECB) must tread carefully, and future rate hikes are not a foregone conclusion, which came across in its meeting last week. ECB President Christine Lagarde even altered her carefully chosen words, eschewing the phrase she used in June, "...the key ECB interest rates will be brought to levels sufficiently restrictive..." in favor of "...the key ECB interest rates will be set at sufficiently restrictive levels..."

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### **Bank of Japan makes a surprise policy tweak**

And then there's Japan. Many had wondered how long the Bank of Japan (BOJ) could go without further alterations to its yield curve control policy given rising inflation, but it came as something of a surprise when alterations were announced last week that would allow for more flexibility in letting interest rates rise.

It's important to note that BOJ Governor Kazuo Ueda mentioned during the press conference that 1) he did not anticipate that the 10-year bond yield would rise to 1% since the 1% level is just considered to be an upper limit, and 2) that the BOJ is expected to continue to control the yield curve (and control the 10-year bond yield) by adjusting bond-purchase operations and conducting fixed-rate purchase operations. The expectation was that the market will observe the extent to which the BOJ will allow the 10-year bond yield to rise, and under what specific conditions, while monitoring the status of actual operations. This is already happening, as the Bank of Japan just announced "unscheduled" Japanese government bond purchases of 300 billion yen.

There are significant investment implications arising from the BOJ's policy tweak. The Japanese yen has been much weaker than usual (on a trade-weighted basis) because the BOJ is one of the few central banks that hasn't tightened so far. A move toward tightening could see the yen rise sharply. This would have implications for stocks, given that yen weakness has been at least partially responsible for the strong performance by Japanese stocks earlier this year. Therefore, yen appreciation would likely lead to underperformance by Japanese stocks.

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### **Chinese stocks experience a mini-rally**

I recently mentioned that Chinese stocks might get a significant boost from the potential for more stimulus. And we saw a mini-rally in Chinese equities in the past week, which continued as Chinese economic policymakers released plans for consumption-related stimulus. Some of the policies are reminiscent of US policies in the face of the Global Financial Crisis such as “cash for clunkers” and subsidies for energy efficient home renovations. Those US policies helped spread what we called “green shoots,” and I think these policies could certainly be positively impactful in China.

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### **Corporate earnings vary in a lopsided economy**

We’re in the heart of earnings season, and while the overall statistics have been relatively good, it’s been on diminished expectations. And that’s why I don’t think many stocks have gotten much of a pop when they’ve produced a positive earnings surprise. What’s more, there have been some high profile misses this earnings season. I expect this environment to continue. As we know, developed economies are rather lopsided, with some sectors and industries faring better than others, and some business models in the same industry faring better than others. I enjoyed hearing that one large fast food chain benefited from a viral campaign centered around one of its mascots. Creativity and cleverness can do wonders driving sales, especially for consumer-driven businesses.

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### **High mortgage rates take the suspense out of reality shows**

In looking at last week’s US housing data, especially the Case-Shiller home price index actually rising for the fourth month in a row, it made me wonder if one of my favorite TV shows, “Love It or List It,” will be able to continue in the US.

For those of you not familiar with the format, it’s a show in which homeowners who are unhappy with their homes pursue two simultaneous paths: their house is renovated to better fit their needs, and at the same time they are shown other homes that might be a better fit. At the end of the show, they’re asked if they are going to love their renovated home and stay put, or if they will list their house and buy one of the homes that was shown to them. It just occurred to me that in the US, with mortgage rates so high, homeowners will be much more motivated to love it rather than list it. High mortgage rates act as a set of “golden handcuffs” created by the Fed, which is one of the reasons why there are structural obstacles to having adequate housing supply on the market (which in turn causes prices to rise). So maybe the show will have to scout new filming locations where those golden handcuffs don’t exist...

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### **Quote of the week**

Last week at the FOMC press conference, Fed Chair Jay Powell made it clear that the Fed will be data dependent going forward, saying that it will have eight weeks of data to assess before it meets again: “We’ll be comfortable cutting rates when we’re comfortable cutting rates, and that won’t be this year...”

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I really wish the press conference room had a DJ who could play songs to sync with the Fed's messaging. That would have been an opportunity to queue the chorus of an old Kenny Rogers country song: "You've got to know when to hold 'em / Know when to fold 'em / Know when to walk away / And know when to run."

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### **Is the Fed poised to make a mistake?**

To bring this column back around to the subject of parenting, one thing I've learned about being a parent is that we make mistakes. I can personally vouch for that. Just as fallible, if not more fallible, are central bankers. That's because parenting and central banking involve significant lags between taking action and seeing the results. The reality is that we are largely flying with blindfolds on. Will my daughter's experience as a teen in the workforce impact her spending decisions as an adult? We'll find out several years from now.

Similarly, we have to worry that what a central bank thinks is appropriate monetary policy now will ultimately not be enough to control inflation — or we could find out that it was overkill, sending its economy into recession. That's why we need to stay vigilant as central banks attempt to do their best to "treat" what ails their respective economies. Let's hope they will know when to hold them and when to fold them; otherwise, we could see some running.

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### **On deck**

Speaking of the impact of monetary policy on the economy, we want to pay close attention to bank lending surveys.

- The ECB Bank Lending Survey released last week showed that credit standards tightened on increased concern about non-performing loans. In addition, it showed there was a very substantial drop in demand for commercial loans caused by rising rates and other factors such as lower consumer confidence. I'm sure that had an impact on ECB deliberations.
- On Aug. 7, we're slated to receive the next Fed Senior Loan Officer Opinion Survey, which will give us important insight into lending conditions for the second quarter in the US. We will not want to miss this.

Also on deck are more earnings reports and more central bank meetings this week – specifically the Bank of England and the Reserve Bank of Australia.

*With contributions from Tomo Kinoshita*

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## Notes

<sup>1</sup>Source: US Bureau of Economic Analysis, July 28, 2023

<sup>2</sup>Source: US Bureau of Economic Analysis, as of July 27, 2023

<sup>3</sup>Source: S&P Global HCOB, July 25, 2023

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## Investment risks

The value of investments and any income will fluctuate (this may partly be the result of exchange rate fluctuations) and investors may not get back the full amount invested.

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## Important information

The opinions referenced above are those of the author as of 31 July 2023.

This document is marketing material and is not intended as a recommendation to invest in any particular asset class, security or strategy. Regulatory requirements that require impartiality of investment/investment strategy recommendations are therefore not applicable nor are any prohibitions to trade before publication. The information provided is for illustrative purposes only, it should not be relied upon as recommendations to buy or sell securities.

Where individuals or the business have expressed opinions, they are based on current market conditions, they may differ from those of other investment professionals, they are subject to change without notice and are not to be construed as investment advice.

The risks of investing in securities of foreign issuers, including emerging market issuers, can include fluctuations in foreign currencies, political and economic instability, and foreign taxation issues.

Investing in securities of Chinese companies involves additional risks, including, but not limited to: the economy of China differs, often unfavorably, from the U.S. economy in such respects as structure, general development, government involvement, wealth distribution, rate of inflation, growth rate, allocation of resources and capital reinvestment, among others; the central government has historically exercised substantial control over virtually every sector of the Chinese economy through administrative regulation and/or state ownership; and actions of the Chinese central and local government authorities continue to have a substantial effect on economic conditions in China.

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.

Personal consumption expenditures (PCE), or the PCE Index, measures price changes in consumer goods and services. Expenditures included in the index are actual US household expenditures. Core price exclude food and energy.

The S&P CoreLogic Case-Shiller U.S. National Home Price NSA Index is a composite of single-family home price indices for the nine U.S. Census divisions and is calculated monthly.

The Senior Loan Officers Survey is conducted by the US Federal Reserve to provide qualitative and limited quantitative information on bank credit availability and loan demand, as well as on evolving developments and lending practices in the US loan markets.

The European Central Bank's Bank Lending Survey provides information on bank lending conditions in the euro area.

The federal funds rate, or fed funds rate, is the rate at which banks lend balances to each other overnight.

The Employment Cost Index details changes in US businesses' cost of labor. It is prepared quarterly by the Bureau of Labor Statistics.

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

An investment cannot be made into an index.

Gross domestic product 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.

Tightening monetary policy includes actions by a central bank to curb inflation.

The yield curve plots interest rates, at a set point in time, of bonds having equal credit quality but differing maturity dates to project future interest rate changes and economic activity.

The Bank of Japan's yield curve control policy seeks to fix yields on 10-year Japanese government bonds around zero, tolerating moves of up to 50 basis points above or below that level. A basis point is one hundredth of a percentage point.

"Green shoots" is a term that references signs of recovery or positive data during an economic downturn.