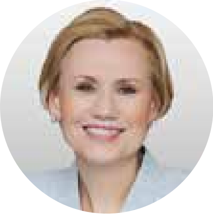
Global market roundup: Eight investor takeaways from last week

Weekly Market Compass | August 7, 2023



Kristina Hooper
Chief Global Market Strategist

Important to the Fed

Tighter lending standards, sticky US wage growth, and moderating job growth, may weigh on a September Fed rate decision.

Some negatives

US credit downgrade, more signs of global manufacturing weakness, and a Bank of England rate hike were negatives.

Some positives

US earnings surprises, Japan's strong service economy, and potential policy and funding support in China were some positives.

Last week was a busy one for US and global market- and economic-related news. In the US, lending standards are tightening, and job growth is slowing. Wage growth isn't, however, which may concern the Federal Reserve (Fed). Around the globe, the eurozone service sector displayed some signs of weakening, and global manufacturing is deteriorating as economic growth softens.

Here are some key takeaways for investors to keep in mind.

1. Clouds for US lending

The Fed's July Senior Loan Officer Survey (SLOOS) reported tighter lending standards and weaker loan demand for commercial and industrial (C&I) loans to firms of all sizes during the last quarter.[1] The survey included some special questions, one of which was about how current lending standards compared to lending conditions in the past two decades. In response, banks reported that current lending standards are on the tighter end of the range for all loan categories for the period since 2005.

This will certainly have a negative impact on economic growth. Those clouds, however, could have a silver lining since the Fed has typically backed away from tightening when lending standards become too tight. It suggests that the Fed's recent sizeable interest rate increase is unlikely to be sustainable. A shift in Fed policy towards a more accommodative stance has tended to be supportive for risk assets.

2. Jobs: Reason for the Fed to lean hawkish

US wage growth remains sticky. The July US jobs report showed a moderation in job growth — a development that's likely to be well received by the Fed as it tries to slow the US economy.[2] Average hourly earnings, however, are likely to be a concern for the Fed, as wage growth remains stubbornly high. Average hourly earnings came in at 0.4% m/m and 4.4%, y/y, both higher than expected.[2] No wage growth moderation during the past several months could cause the Fed to err on the side of being more hawkish in order to tamp down inflation. Even though we're seeing progress in the loosening of the US labor market, it might not be enough for the Fed given the wage picture.

3. Downgraded US creditworthiness

Fitch downgraded US credit from AAA to AA+ last week.[3] Three broad reasons were given: rising government debt, deteriorating fiscal conditions, and a deterioration in governance standards. While these conditions are well-known — there were no surprises in Fitch's rationale — the timing was a surprise. As I suspected, the immediate market response was more muted than the S&P downgrade of US credit in 2011. This downgrade will hopefully serve as a wake-up call to policymakers, given that higher debt levels are being exacerbated by higher interest rates, significantly increasing debt servicing costs, and the possibility that political dysfunction could rear its ugly head again this fall with a possible government shutdown in the offing.

4. US consumers show strength in earnings season

This earnings season isn't one size fits all. There've been significant differences by industry and even for companies in the same industry. Among S&P 500 companies, there has been notable strength among consumer discretionary companies, with the sector experiencing some impressive positive earnings surprises. This speaks to the strength of the US consumer, which in turn has been helped by the tight labor market.

5. More signs of manufacturing weakness in the global economy

A global shipping company warned of a steeper decline in global demand for shipping containers this year because of softening economic growth and a reduction in customer inventories. This underscores the deteriorating manufacturing picture globally caused by central banks seeking to cool demand in a strong economy. It's also due to the pronounced shift we have seen from goods to services purchases by many consumers around the globe, triggered by post-pandemic economic re-openings.

6. Challenges — and positives — outside the US

Eurozone manufacturing continues to weaken, but that's no surprise. The S&P Global/HCOB Eurozone Manufacturing PMI fell to the lowest level in three years.[4] What's more concerning is that services, which had been the far more resilient part of the eurozone economy, is starting to face headwinds as well. The July S&P Global/HCOB Eurozone Services PMI was revised lower to its lowest level in six months.[5] What's more, deterioration in the services new business orders is concerning and suggests bigger headwinds in the coming months.

The Bank of England (BoE) put more pressure on the UK economy by increasing its base rate by 25 basis points to 5.25%. It did strike a dovish tone though, stating rates "may" rise as opposed to a conviction there would be further rate hikes in the near term. While it is welcome that the Bank of England appears to be becoming more cautious in its monetary policy tightening, it needs to recognize the risks of lagged effects of monetary policy. The UK GfK Consumer Confidence indicator experienced its first decline in six months, as higher interest rates and stubborn inflation seem to be weighing on consumers.[6]

We have to recognize there is a scenario where inflation could fall even faster than the BoE has forecasted. Global inflation is dropping quickly, and domestic inflationary pressures are also improving: UK unemployment recently climbed, and its unusually low level of labor force participation relative to other developed markets has begun to fall. This is particularly good news given that the tight labor market has been one of the key reasons for sticky core inflation. Should inflation fall more rapidly it may prove that the BoE was too slow to react on the way up and needlessly restrictive on the way down.

Japan's service economy remains strong. Its July manufacturing PMI is in modest contraction territory (no surprise given the global manufacturing picture), but services PMI remains strong.[7] Japanese economic strength could continue, although the specter of monetary policy tightening, albeit from ultra-accommodative levels, could hang over its stock market.

China gave more signals that policy support is coming. The People's Bank of China said it would increase funding support for the private sector after meeting with property industry executives, which should help increase market confidence.[8] China is also expected to introduce a plan to address local government debt risks.[9] And so while the economic re-opening has been bumpy, there is the potential for a boost to Chinese equities in the near term given policy stimulus in the offing.

7. Rising long rates in the US

The 10-year US Treasury yield went on a wild ride last week, hitting an intraday level not seen since November; it closed lower, but remains above the 4% level. A confluence of forces is likely responsible for at least some of the rise in the 10-year US Treasury yield: The Fitch US credit downgrade; the issuance of more US debt (now that the debt ceiling is resolved); Fed Chair Jay Powell signaling that quantitative tightening (QT) could continue for some time; and the Bank of Japan's alterations to its yield curve control policy. We have to be aware of the risk that higher yields could place downward pressure on stocks, especially tech stocks, which have typically been more sensitive to rising yields.

8. A new vocabulary word: Inflation smile

It's the concept that inflation could experience a resurgence if it's not properly extinguished, taking on the shape of a smile in a chart. First of all, I refuse to use the term "inflation smile" since we won't be smiling if that comes to fruition. (I'm calling it the inflation upside down frown.) More importantly, as I have said before, I think it's an unlikely outcome. We're in a strong disinflationary trend in developed economies, especially the US, although some types of inflation are stickier than others.

What to watch

Fed Chair Jay Powell made it clear that the coming weeks before the next Fed meeting in late September are critical for the data-dependent Fed. They'll assess incoming data before making a decision on any more rate hikes. More signs of persistent inflation could compel the Fed to raise rates further, so every inflation-related data point will be important, including the July Consumer Price Index (CPI). It goes without saying that I'll be paying close attention.

Also this week will be the preliminary University of Michigan consumer survey — I am, of course, very interested in US consumer inflation expectations, which figure into the Fed's calculus. But the reality is that most central banks are very data dependent as they come to the end of their respective rate hike cycles, so economic data will take on more importance, such as CPI for Germany and gross domestic product (GDP) for the UK.

With contributions from Brian Levitt and Emma McHugh

Notes

[1]Source: The July 2023 Senior Loan Officer Opinion Survey on Bank Lending Practices, Federal Reserve, July 31, 2023

[2]Source: US Bureau of Labor Statistics, August 4, 2023

[3]Source: Fitch Ratings, August 1, 2023

[4]Source: S&P Global/HCOB, as of August 1, 2023

[5]Source: S&P Global/HCOB, as of August 3, 2023

[6]Source: GfK UK Consumer Confidence, July 20, 2023

[7]Source: au Jibun Bank Japan PMI Survey, as of August 1, 2023

[8]Source: China Central Bank PBOC Pledges More Financial Resources for Private Firms, Bloomberg, August 3, 2023

[9]Source: Further Measures to Tackle China's Local-Government Debt Risk Probable, Fitch Ratings, August 6, 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.

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

Credit ratings are assigned by Nationally Recognized Statistical Rating Organizations based on assessment of the credit worthiness of the underlying bond issuers. The ratings range from AAA (highest) to D (lowest) and are subject to change. Not rated indicates the debtor was not rated, and should not be interpreted as indicating low quality. Futures and other derivatives are not eligible for assigned credit ratings by any NRSRO and are excluded from quality allocations. For more information on rating methodologies, please visit the following NRSRO websites: standardandpoors.com and select "Understanding Ratings" under Rating Resources and moodys.com and select "Rating Methodologies" under Research and Ratings.

The Senior Loan Officer Opinion Survey on Bank Lending Practices (SLOOS) is a quarterly survey of up to 80 large domestic banks and 24 branches of international banks conducted by the Federal Reserve Board.

Core inflation is the change in the costs of goods and services but does not include those from the food and energy sectors.

A basis point is one hundredth of a percentage point.

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.

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 Purchasing Managers' Index (PMI) is an index of the prevailing direction of economic trends in the manufacturing and service sectors.

The GFK UK Consumer Confidence Indicator (Consumer Confidence Index) measures overall consumer confidence in the UK.

Quantitative tightening (QT) refers to monetary policies that contract, or reduce, the Federal Reserve System (Fed) balance sheet.

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

The eurozone is an economic and monetary union of European Union member states that have adopted the euro as their common currency.

The Consumer Price Index (CPI) measures changes in consumer prices.

Gross domestic product (GDP) is the total monetary or market value of all the finished goods and services produced within a country's borders in a specific time period.

The opinions referenced above are those of the author as of August 7, 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.