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US recession?

Data suggests the US economy is certainly slowing down, but it does not tell us a recession is definitely underway.

China's rebound

Recent data has shown a cooling of China's economic growth, but I believe it's temporary, and also lopsided.

European inflation

The eurozone headline inflation rate has fallen, but the risk is that the European Central Bank could overdo rate hikes.

What investors need to know about a US recession, China's recovery, and eurozone inflation

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Well, I'm breathing a sigh of relief. The debt ceiling has been suspended until January 2025, and we no longer have to worry about the US defaulting on its financial obligations. It's been said that if you want a friend in Washington, D.C., get a dog, yet politicians were able to reach a compromise and get a deal done before the X-date, positively surprising markets. (I'm also personally breathing a sigh of relief — not only has the US made it through the drama of the debt ceiling, my family has made it through the drama of prom season, which involved choosing multiple dresses, planning elaborate "promposals," forgetting boutonnieres, and finding florists who could fulfill last-minute orders before the X-date of the big event.)

With the debt ceiling drama behind us, it's a great time to look at the bigger picture of what's happening in the global economy. Below, I answer the most common questions I'm hearing from clients.

On one hand we've seen strong US jobs data, but we've also seen warnings from companies such as Costco, which recently said chicken purchases foretell a recession. Is the US economy going into recession?

There's a "recession obsession" with the US economy, as many market participants are fixated on this question. Long-time readers of my column may remember that my younger son and I are horror movie aficionados, and the best analogy I can find is when a victim is bitten by a zombie, and it's automatically assumed they will turn into a zombie as well. Some are pre-emptively killed. Others are restrained, or at least nervously watched, as their zombification is thought to be a foregone conclusion. Market participants assume that the Federal Reserve's 525 basis points in hikes since March 2022 is the economic equivalent of a zombie bite, and that the economy will certainly go into recession. However, economic data has been confusing and somewhat contradictory.

It's true that recent US jobs data has been very strong. In the last week, the April Job Openings and Labor Turnover Survey showed that job openings rose above 10 million again – well above the <7 million level seen before the pandemic.¹ However, the quit rate fell to 2.4%, suggesting less job mobility.¹ In addition, the survey response rate was low, which can cause an upward bias, and there have been reports of "phantom" job openings, where companies post job listings without any real intent to fill them — just to see how robust the job applicant pool is. And it's true that we got a strong May US employment situation report, with nearly 150,000 more jobs created than expected.² However, the more important labor metric for me during the Federal Reserve's (Fed) tightening cycle has been average hourly earnings, because that provides an important measure of wage inflation. And that is clearly moderating.

Taking a step back, it's important to recognize that the labor market tends to be a lagging economic indicator, and that there is typically a significant policy lag in between implementation of monetary policy and its impact on the real economy. Right now we are seeing a Fed-engineered slowdown in the US economy, and it hasn't had much of an impact on the very strong labor market yet. And, given how strong the labor market is, it may ultimately make only a small dent in the labor market, with unemployment still remaining relatively low.

But it is having an impact on the US economy in other ways. Credit conditions have tightened as a result of the regional banking mini-crisis, which was brought on by Fed tightening. The most recent Federal Reserve Beige Book indicated financial conditions are stable to tighter in most districts, and that a "freight recession" is underway. Large retailers, including Dollar General and Macy's, are reporting changes in consumer tastes that suggest a "belt tightening" on the part of households. One large retailer, Costco, reported that consumers are bypassing expensive meats such as beef in favor of less expensive options such as chicken, a trend it has seen in previous recessions.³ Most signs point to a meaningful slowdown for the US economy. The most recent evidence is the May Institute for Supply Management survey results. The services Purchasing Managers' Index (PMI) fell to 50.3 in May.⁴ It's still in expansion territory, but it's at its lowest level in three years. The new orders sub-index, a helpful leading indicator, fell materially. The good news is that inflation is moderating even in services, with the prices paid sub-index down to 56.2.⁴

Getting back to my zombie analogy, those who are zombie experts know that zombie bites are not always fatal – there are exceptions to the rule in some walking dead movies. For example, as my son has carefully explained to me, if the bite is on a limb, quickly lopping off that limb can usually save a victim from "turning" and spending eternity shuffling around in rags, chasing humans. And so, I believe there are exceptions where economies can avoid recession, especially a deep recession, despite an aggressive rate hike cycle. Don't get me wrong – there will be damage, but they may still be able to avoid a serious, broad-based recession.

Given the conflicting signals about the US economy, what will the Fed do in June?

I think the Fed will not hike rates at the June meeting. As I said before, while the Fed's messaging at its May meeting was confusing, I believe it enacted a conditional pause. (Read more: A 'conditional pause' by the Fed appears to be underway). That means the bar is much higher than before for the Fed to hike rates again.

We've received messaging in the past week from Federal Open Market Committee (FOMC) participants advocating for a "skip" in June, and their arguments have been compelling. In particular, Fed Governor and Vice Chair nominee Philip Jefferson posited that, "Skipping a rate hike at a coming meeting would allow the Committee (FOMC) to see more data before making decisions about the extent of additional policy firming..."⁵ A skip would give the Fed more time to see weakness appearing in the data, which I expect to be coming, and I think it would prevent future rate hikes as well. This is a dangerous time for the Fed, in my view – if it becomes impatient in waiting for data to show perfect disinflation, it risks "overkill" on rate hikes. Inflation is moving in the right direction; as I've said before, the journey will be imperfect, but I say that's no reason to tighten more.

Is China's economic rebound done?

China's rebound is far from over, in my opinion. Yes, most recent data has shown a cooling of economic growth, but I believe it's temporary, and also lopsided. Manufacturing has been disappointing – reflecting slowing global demand – but I believe services will be robust for some time to come. The most recent evidence supporting my view comes from the Caixin Services PMI reading for May; it clocked in at 57.1, up from 56.4 in April.⁶ This is the fifth straight month in expansion territory. We've seen a similar pattern of rotation to services spending with other economies as they re-opened following the pandemic. After several years of COVID restrictions, I think China is a long coiled spring, and its economic rebound is far from over.

What is happening to the eurozone economy? Inflation?

The S&P Global/HCOB Eurozone Manufacturing PMI for May was 44.8, down from 45.8 in April.⁷ There is a significant manufacturing contraction underway with Germany hit very hard — its manufacturing PMI is at a 36-month low.⁷ (Having said that, it's worth underscoring that manufacturing weakness can also be seen in many other economies, such as China and the US.) However, services thus far have fared better, with eurozone services PMI clocking in at 55.1,⁸ and I think that will continue thanks to the strong labor market. It's part of the lopsided post-pandemic economic environment many economies find themselves in (as noted in the question on China above).

In terms of inflation, the eurozone headline inflation rate fell more than expected to 6.1% in May, mostly driven by a further moderation in goods inflation, including energy and food prices.⁹ The risk is that the European Central Bank (ECB) could overdo rate hikes. ECB President Christine Lagarde reiterated last week that there is no clear sign that underlying inflation has peaked, and so the ECB will continue tightening. Hopefully she will err on the side of caution, especially since inflation expectations are becoming better anchored.

What is happening with the Japanese stock market?

Multiple factors appear to be behind the recent Japanese stock market rally, many of which are likely to be sustained toward the end of 2023. The most important factor seems to be the expectation that the Japanese economy should grow faster than US and European economies in the second half of this year, thanks to the continuation of accommodative monetary policy by the Bank of Japan — which of course stands in stark contrast to other major developed economies' central banks — and rising inbound tourism. In addition, valuations look relatively attractive.

Japanese stocks are also likely to be supported by structural factors. Corporate governance reform has moved forward in Japan after the Tokyo Stock Exchange recently asked companies to think more about shareholders. A recent, substantial rise in wages raised investors' expectation that Japan may be able to accelerate its medium-term economic growth potential.

Looking ahead

Now that the debt ceiling drama is behind us, attention will be more finely tuned to what central banks will do going forward, and that will in turn be affected by the data. The Bank of Canada (BOC), which has become a policy leader in the last several years, will meet this week to assess whether it can maintain its conditional pause in light of recent growth and inflation data. This is an important meeting, given that the BOC's policy decisions have a tendency to spread to other central banks — they can be as infectious as a zombie bite.

Also meeting will be the Reserve Bank of Australia and the Reserve Bank of India. We will also be getting some important economic data for Japan, including gross domestic product (GDP) and leading indicators, as well as eurozone GDP, eurozone employment and Canada's jobs report for May. My hope is that central banks err on the side of caution, and that their respective economies prove more resilient than the inflation that is plaguing them.

With contributions from Tomo Kinoshita

Notes

¹Source: US Bureau of Labor Statistics, May 31, 2023

²Source: US Bureau of Labor Statistics, June 2, 2023

³Source: Business Insider, "Costco customers are bypassing the beef aisle to shop for chicken and pork as a recession looms," May 30, 2023

⁴Source: Institute for Supply Management, June 5, 2023

⁵Source: London South East, "Pressure cooker," May 31, 2023

⁶Source: Caixin Media and S&P Global, June 5, 2023

⁷Source: S&P Global and Hamburg Commercial Bank, June 1, 2023

⁸Source: S&P Global and Hamburg Commercial Bank, June 5, 2023

⁹Source: Eurostat, June 1, 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.

An investment cannot be made directly in an index.

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

A basis point is one hundredth of a percentage point.

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

The Summary of Commentary on Current Economic Conditions by Federal Reserve District (the Beige Book) is published eight times per year. Each Federal Reserve Bank gathers anecdotal information on current economic conditions in its district, and the Beige Book summarizes this information by district and sector.

The Purchasing Managers' Index (PMI), a commonly cited indicator of the services and manufacturing sectors' economic health, is calculated by the Institute of Supply Management in the US. The new orders sub-index monitors the level of new orders across several industries in the manufacturing sector. The prices paid sub-index reflects changes in prices paid for products and services received by survey participants.

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 Caixin Purchasing Managers' Index (PMI) is considered an indicator of economic health for the Chinese manufacturing sector. It is based on survey responses from senior purchasing executives.

The HCOB Eurozone Manufacturing PMI is compiled by S&P Global from responses to questionnaires sent to survey panels of manufacturers in Germany, France, Italy, Spain, the Netherlands, Austria, Ireland and Greece.

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.

The opinions referenced above are those of the author as of June 5, 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.