



Kristina Hooper
Chief Global Market Strategist



China's reopening

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Humphrey-Hawkins testimony

I expect Federal Reserve Chair Jay Powell to pledge to remain tough on inflation, but also to stay data dependent.

US jobs report

I'm hopeful February's report will be similar to January's report, in which job increases exceeded expectations more than wage growth did.

China's reopening gives service industry a boost

Weekly Market Compass | March 6, 2023

It's been more than three months since China loosened its zero-COVID protocols and reopened its economy. Many were skeptical about the benefit to China's economy, with concerns that this could unleash an enormous wave of COVID infections. However, I was an early China bull. I was encouraged by the high percentage of fully vaccinated in China's population – far higher than other countries that had successfully reopened. What's more, I thought the reopening could be a powerful juggernaut for the economy.

Why? I saw how demand increased quickly after Western developed countries reopened following the pandemic. And given that China's zero-COVID policy lasted far longer than these countries' stringent conditions, I assumed there would be a much higher level of pent-up demand, which could provide a large boost the services sector. Today, we're starting to see the evidence.

China's reopening gives services a boost

We're seeing signs that the reopening is having a substantial positive impact on the Chinese economy, especially the services sector. For example, the Caixin/S&P Global Services Purchasing Managers' Index (PMI) rose from 52.9 in January to 55.0 in February.¹ And the official NBS Non-Manufacturing PMI for China rose from 54.4 in January to 56.3 in February, its highest level since March 2021.² My key takeaway: the "revenge living" I had anticipated has begun. (It's also worth noting that manufacturing activity has improved as well.)

Not surprisingly, China bulls have multiplied since the reopening announcement last fall. But that sentiment has been called into question by the National People's Congress, which started last weekend with the delivery of the Government Work Report (GWR) by Premier Li Keqiang. Investors are disappointed by the "around 5%" target set for gross domestic product (GDP) growth this year by Chinese policymakers, as many had hoped for a target of 5.5% or even 6%.

Some are assuming the worst – that China set a low target because regulation is going to increase significantly this year. Others believe the message being sent is that China will not provide significant stimulus to its economy. However, I don't believe either is the case. Policymakers have said they would support the platform economy and have also pledged to protect the rights of private businesses and entrepreneurs. In addition, policymakers pledged more effective and significant accommodative fiscal policy. And so I have a simpler perspective on the growth target: After a challenging 2022, policymakers may just be more comfortable setting the bar low so that it's easier to handily beat it.

A big week for the Federal Reserve

This is a big week for the Fed. It started several days ago with the release of its Monetary Policy Report, which is a precursor to Fed Chair Jay Powell's semi-annual Humphrey-Hawkins testimony to Congress on March 7. And the US February jobs report will be released on March 10. This comes on the heels of some rather hawkish rhetoric from various Fed officials.

- Last week, Atlanta Fed President Raphael Bostic shared, "There is a case to be made that we need to go higher. Jobs have come in stronger than we expected. Inflation is remaining stubborn at elevated levels. Consumer spending is strong. Labor markets remain quite tight."³
- San Francisco Fed President Mary Daly said on Saturday, "It's clear there is more work to do. In order to put this episode of high inflation behind us, further policy tightening, maintained for a longer period of time, will likely be necessary."⁴
- And Fed Governor Chris Waller said, "...if those data reports continue to come in too hot, the policy target range will have to be raised this year even more to ensure that we do not lose the momentum that was in place before the data for January were released."⁵

I view these comments as part of the Fed's campaign to talk down markets and stop them from getting ahead of themselves by prematurely loosening financial conditions. I'm not spooked by these quotes – in fact, I'd be spooked if they weren't trying to talk down markets, as this should be part of the tools in their toolbox.

Fed report shows inflation is too high

Let's spend a little time on the Monetary Policy Report, which reiterated what we've heard time and again from the Fed: inflation is too high and the economy will need to slow. However, that should come as no surprise as the report is always largely backward-looking. I'm more interested in the "special topics" that give me a sense of what is on the Fed's mind.

For example, the Fed tackled labor market conditions, looking at what caused low labor force participation and anticipating that conditions are likely to remain challenging going forward. The report also covered developments in the Fed's balance sheet and the impact on markets. The Fed noted that market liquidity is low in areas such as the Treasury market. The Fed recognized that it may need to alter its Quantitative Tightening strategy to manage market functioning and liquidity (this is likely to be a meaty topic during Powell's Congressional testimony as well). Interestingly, the report also noted that high interest rates have caused the Fed's interest expenses to increase significantly, which in turn has resulted in negative net income.

My biggest takeaway from the Monetary Policy Report has to do with its coverage of inflation expectations, which it deems to be well-anchored. It detailed examples of longer-term consumer and market-based inflation expectations remaining "broadly consistent with the FOMC's (Federal Open Market Committee) longer-run 2% inflation objective," and even mentioned that shorter-term inflation expectations are lower than where they were in mid-2022.⁶

What will Powell tell Congress?

With regard to Powell's Humphrey-Hawkins testimony, there is of course significant speculation about what he will say regarding how comfortable the Fed is with the current inflation picture and what its plans are for monetary policy. I think Powell will largely echo the hawkish rhetoric from Daly and Bostic, underscoring the problems caused by inflation and pledging to remain tough – especially maintaining the terminal rate for some time. However, I think Powell will also stress that the Fed will ultimately be data dependent.

So what could that mean? We need to read between the lines – statements like that don't mean the Fed has to hike rates to 6% or higher. I continue to believe the Fed is likely to give us two more 25 basis point hikes and then enact a "conditional pause" while continuing to talk tough. I believe the Fed will lean on tame inflation expectations as a reason to pause sooner rather than later. Recall that the Fed is a big believer in the importance of inflation expectations in determining future inflation, so I believe its positive assessment of current expectations will likely cause it to err on the side of fewer rate hikes. I do believe there will be no rate cuts this year – unless the US economy deteriorates far more than I expect – but that is appropriate given the current strength of the US economy.

Watching the US jobs report

Finally, the US jobs report will be released on Friday. I suspect job growth will be rather plentiful, but I'm hopeful it will be similar to January's report, in which job increases exceeded expectations more than wage growth did. Of course, key data points to focus on will be labor force participation and especially average hourly earnings, given the impact on inflation.

Looking at the bigger picture

This should be an interesting, eventful week. But I don't want to get too myopic. Investors are in a marathon, not a sprint, so we need to take a step back and look at the bigger picture. That means we should expect volatility in the next several months given monetary policy uncertainty – and a looming debt ceiling crisis in the US. It also means we need to take another step back and look at the even bigger picture – being well diversified across and within major asset classes for years to come, ignoring the background noise, and focusing on our long-term goals.

Notes

¹Source: China Caixin Services PMI, as of March 2, 2023

²Source: China National Bureau of Economics (NBS). Data as of March 5, 2023

³Source: Bloomberg News, "Fed's Bostic Open to Seeking Higher Rate Peak If Data Stays Hot," March 2, 2023

⁴Source: Bloomberg News, "Fed's Daly Says More Rate Hikes Likely Needed to Cool Inflation," March 4, 2023

⁵Source: Federal Reserve, speech transcript by Christopher Waller, March 2, 2023

⁶Source: Board of Governors of the Federal Reserve System, Monetary Policy Report, March 3, 2023

Important information

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

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 into an index.

Investments in companies located or operating in Greater China are subject to the following risks: nationalization, expropriation, or confiscation of property, difficulty in obtaining and/or enforcing judgments, alteration or discontinuation of economic reforms, military conflicts, and China's dependency on the economies of other Asian countries, many of which are developing countries.

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

The National People's Congress is the highest organ of state power in China, with approximately 3,000 delegates convening once a year.

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.

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

The terminal rate is the anticipated level that the federal funds rate will reach before the Federal Reserve stops its tightening policy. The federal funds rate is the rate at which banks lend balances to each other overnight.

A basis point is one hundredth of a percentage point.

The opinions referenced above are those of the author as of March 6, 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.