Markets see positive signs in China's economy, US inflation

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Positive signs in China

Gross domestic product for December suggests that China's reopening was more positive for the economy than many expected.

US inflation moderates

December marked the sixth consecutive year-over-year slowdown in the US Consumer Price Index.

The debt ceiling looms

US Treasury Secretary Janet Yellen sent a warning last week that the US could breach its statutory debt limit by Jan. 19.

We've certainly turned the page on the "annus horribilis" that was 2022. It's been a wonderful start to 2023, with stocks and bonds up globally in the first two weeks.

Positive economic signs emerge in China

The real standout has been Chinese equities, which have posted double-digit returns for the first two weeks of January.[1] There is clearly a lot of investor excitement about China's reopening and the rollback of COVID restrictions.

The question on everyone's minds since Chinese equities started rallying this fall is: When we will finally see the strong economic growth that we're all eagerly awaiting? Well, we just learned it may be imminent. Expectations were low for the gross domestic product (GDP) print, and 2022 was admittedly far lower than China's economic growth in 2021, but it came in above expectations at 3% for the year.[2] While the fourth quarter was negatively impacted by the re-opening, it was better than expected. December activity was actually encouraging, suggesting the reopening that began early in December was more positive for the economy than many expected.

That makes me more optimistic about the first quarter, which I have expected to be a mixed bag. That's because the Lunar New Year, which begins on Jan. 22 and lasts 15 days, is likely to be a double-edged sword. On the bright side, consumption should increase as people travel home to be with family for this ultra-important holiday. On the other hand, a surge in travel is likely to increase the spread of COVID and could result in a very large wave of infections, which could in turn tamp down consumption and cause supply chain disruptions. However, I would err on the side of the Lunar New Year being more positive for the economy than negative given December's economic activity.

In my mind, the worst-case scenario for the economy is that first-quarter activity is subdued, but we begin to see strong growth kick in during the second quarter of 2023, driven by greater household spending. Overall, we expect GDP growth in China to rise more than 5% for the year.

Improving sentiment in Europe and the US

But it's not just China. Economic sentiment is also improving in Europe. For example, the ZEW Economic Sentiment Index for Germany showed a dramatic improvement in the economic outlook for this major economy, helped by lower energy prices and enthusiasm about the re-opening of China.[3]

I'm even hearing that sentiment is improving on the outlook for the US economy, suggesting it may avoid recession. Philadelphia Fed President Patrick Harker sums up what is a growing view, "GDP growth will be modest, but I'm not forecasting a recession...What's encouraging is that even as we are raising rates, and seeing some signs that inflation is cooling, the national economy remains relatively healthy overall."[4]

US inflation is moving in the right direction

Inflation is also cooperating in the new year. As we learned last week, the US Consumer Price Index for December was in line with expectations, which means inflation showed continued moderation. December marked the sixth consecutive year-over-year slowdown in inflation, while the monthly decline of 0.1% was the first drop since May 2020.[5]

However, we are nowhere near the Federal Reserve's inflation target, nor will we get there this year, in my opinion. Not surprisingly, goods inflation has been driving the moderation in core inflation, while services and housing are more problematic with services in particular likely to remain higher for longer. But the key takeaway is that inflation is moving in the right direction and appears poised to continue. The question for investors is: How much moderation is enough for the Fed to hit the pause button on rate hikes? And that question is arguably the most important one that needs to be answered in the shorter term. I think the Fed will be satisfied if the progress we have seen thus far continues, and that suggests the Fed may hit the pause button in the next three or so months.

A looming deadline for the US debt ceiling

But there is a big fly in the ointment – the US debt ceiling. US Treasury Secretary Janet Yellen sent a warning last week that the US could breach its statutory debt limit by Jan. 19. Now, that doesn't mean the US government will be unable to pay its bills or service its debt that day – it means that the government will need to begin using extraordinary cash management measures in order to keep the government running. Yellen urged lawmakers to quickly raise the debt ceiling before the federal government has exhausted those extraordinary measures, which are likely to run out in early June.

While the debt ceiling has been on investors' radar as a risk for 2023 for some time now, it has taken on greater significance ever since the Speaker of the House election more than a week ago. Fifteen rounds of voting to elect the Speaker of the House was not on my bingo card for 2023, and suggests to me it could be more difficult than normal for Congress to raise the debt ceiling.

What could it mean for markets if the US government doesn't raise the debt ceiling in time and extraordinary measures become necessary? That happened back in the summer of 2011.[6] Not surprisingly, stocks sold off very significantly. More surprisingly, US Treasuries rose as investors sought a "safe haven" asset class – even though that particular safe haven was in jeopardy of not being able to service its interest payments. Within stocks, low volatility outperformed. Gold also rose, while high yield bonds fell. I would expect a repeat of that scenario again this summer if an agreement is not reached to raise the ceiling.

The real risk is that it may not be a short-term crisis that is resolved quickly. The longer this issue continues without resolution, the deeper the stock sell-off and the stronger the Treasury rally may be. It also, of course, increases the likelihood that the US goes into recession. It is hard to predict how this will play out since many of the players are different than the ones involved in the 2011 debt ceiling negotiations.

Looking ahead: Bank of Japan and earnings season

This week, many eyes will be on the Jan. 18 Bank of Japan (BOJ) meeting as many are expecting it to mark the beginning of a very significant pivot on the part of the BOJ. The BOJ has been one of the few bastions of monetary policy accommodation in a world of aggressive tightening in the past year, but there are concerns it may itself be embarking on tightening. We don't agree. Ever since the BOJ widened its 10-year bond trading band from ±0.25% to ±0.50% on Dec 20, selling pressures on Japanese government bonds have risen sharply. In fact, the 10-year bond yield slightly exceeded the 0.50% outer limit of the band on Jan. 13.[7] Since the alteration of the trading band in December, the BOJ has had to conduct operations repeatedly to contain upward pressures on the yield curve. This seems unsustainable.

We do not expect this week's BOJ meeting to result in policy tightening since the BOJ most likely recognizes that it needs to continue to support Japan's economy as external demand has been slowing significantly. But there certainly is the possibility of a more minor policy modification related to yield curve control, which we will be watching out for.

Also on the radar is the start of earnings season. This is not only important in terms of what it tells us about how a specific company fared, but we also are typically provided with some guidance on expectations for the near term. In addition, we can glean broader economic insights from what is discussed on earnings calls. So I will be paying close attention to a myriad number of earnings calls in the coming weeks. Stay tuned...

With contributions from David Chao, Tomo Kinoshita and Brian Levitt.

Notes

[1]Source: MSCI. The MSCI China Index had a 12.1% return year-to-date as of Jan. 13, 2023.

[2]Source: China National Statistics Bureau, Jan. 17, 2023

[3]Source: Centre for European Economic Research, Jan. 17, 2023

[4]Source: The Federal Reserve Bank of Philadelphia, "The Local and National Economic Outlook," Jan. 12, 2023

[5]Source: US Bureau of Labor Statistics, Jan. 12, 2023

[6]Source: Bloomberg, L.P. During the 2011 debt ceiling debate (July 2011 to September 2011), the S&P 500 Index returned -15.1%, the S&P 500 Low Volatility Index returned -5.4%, the Bloomberg US Treasury Index returned 6.7%, the Bloomberg High Yield Bond Index returned -6.2%, and the price of gold returned 9.2%.

[7]Source: Bloomberg, L.P., Jan. 13, 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 into 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.

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.

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.

Junk bonds involve a greater risk of default or price changes due to changes in the issuer's credit quality. The values of junk bonds fluctuate more than those of high quality bonds and can decline significantly over short time periods.

Fluctuations in the price of gold and precious metals may affect the profitability of companies in the gold and precious metals sector. Changes in the political or economic conditions of countries where companies in the gold and precious metals sector are located may have a direct effect on the price of gold and precious metals.

Low volatility (in factor investing) describes investments that have consistently demonstrated lower volatility than other securities in the same asset class over time.

The US Consumer Price Index (CPI) measures change in consumer prices as determined by the US Bureau of Labor Statistics. Core CPI excludes food and energy prices while headline CPI includes them.

The ZEW Economic Sentiment Index is a monthly survey of about 350 analysts that measures economic sentiment in Germany for the next six months.

The MSCI China Index captures large- and mid-cap representation across China H shares, B shares, Red chips, P chips and foreign listings (e.g. ADRs).

The S&P 500® Low Volatility Index consists of the 100 stocks from the S&P 500® Index with the lowest realized volatility over the past 12 months.

The Bloomberg US Treasury Index measures US dollar-denominated, fixed-rate, nominal debt issued by the US Treasury.

The Bloomberg High Yield Bond Index covers the universe of fixed rate, non- investment-grade debt.

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.

Safe havens are investments that are expected to hold or increase their value in volatile markets.

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.

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

The opinions referenced above are those of the author as of Jan. 17, 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.