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The good

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The bad

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The ugly

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There's never a dull moment in the markets, but lately, the drama surrounding the US debt ceiling has captivated the attention of investors around the world. After an eventful long week of negotiations, it appears that an agreement has been reached. But other challenges lie ahead — which brings me to the good, the bad, and the ugly.

The good

It appears that the White House and House Republicans have struck a deal on raising the debt ceiling. However, I caution investors not to assume this is over until all the votes are counted in the House and Senate — passing the deal may not go entirely smoothly. According to most reports, Speaker Kevin McCarthy believes he can provide around 140 to 150 votes from his conference for passage. Minority Leader Hakeem Jeffries has been working based on the assumption that he'll need to bring roughly 100 votes from his caucus, with many of those supporters coming from the more centrist New Democrat Coalition.

Many members of Congress are publicly reserving judgment as they continue to digest the bill. As members return to Washington today and convene with their colleagues tonight, the whip count will become clearer as the vote is expected on Wednesday after the markets close. Once the bill passes the House and is received in the Senate, the expectation is that there will be a demand from certain Senators to allow for some "show" amendments to be considered, prior to receiving consent to expedite the floor process. The intent of leadership of both parties in both chambers is to ensure this bill reaches President Joe Biden's desk by June 5, the new X-date announced by Treasury Secretary Janet Yellen.

I harken back to a quote attributed to Otto von Bismarck, "Laws are like sausages. It's better not to see them being made." We might have some stomach-churning moments before the deal gets done, and there is still a chance the deal could be scuttled.

The bad

Assuming the debt ceiling is successfully lifted this week, I anticipate the relief rally will be short-lived. That's because investors can turn their attention more fully on central banks and what they will do in the face of some concerning inflation prints. And that is unlikely to be positive for stocks in the near term.

The Federal Open Market Committee (FOMC) released the minutes from its May meeting last week, which raised alarm bells for some investors. The FOMC was perceived to be rather hawkish, with the continued mantra that US inflation was still "unacceptably high."

Meeting participants articulated disappointment that core inflation wasn't easing more quickly, especially core services ex-housing inflation. More participants seemed to favor continued tightening beyond May, although "several" participants posited that "if the economy evolved along the lines of their current outlooks, further policy firming after this meeting may not be necessary."¹

That was followed up with a disappointing inflation print — the release of the Personal Consumption Expenditures price index for April, which is the Federal Reserve's favored measure of US inflation. The report showed core inflation rose 0.4% month over month, which was higher than expected. And it rose 4.7% year over year, which was higher than expected and higher than the previous month's reading. That was certainly not the inflation print we wanted to get, especially after the FOMC meeting minutes showed such nervousness among Fed members, some of whom are clearly inclined to hike rates further.

But stubbornly high inflation is not isolated to the US. We also got a very disappointing inflation reading in the UK. The UK Consumer Price Index (CPI) rose 8.7% year over year in April, with core inflation rising 6.8%, largely driven by higher prices in the services sector.² This hot print should keep pressure on the Bank of England (BOE) to continue hiking, which in turn should keep implied rates elevated. Interestingly, the mini-banking crisis in the US caused a lowering of the market-implied path of policy rates for the Fed and the European Central Bank, but not the BOE. Any downward pressure on BOE rate expectations has been countered with upward pressure caused by stubborn UK inflation. However, Bank of England Governor Andrew Bailey has seemed less concerned, "It's the stickiness downwards, and the question of how fast it is going to come down ... Quite a bit of that obviously depends on how inflation expectations are coming down, and they are coming down."³

Governor Bailey seems to be hanging his hat on consumer inflation expectations, and I think that's a good thing as expectations tend to be predictive of the direction of inflation. UK consumer inflation expectations for the year ahead have fallen from 6.1% in November 2022 to 5.2% in April 2023 – certainly nowhere near the standard 2% inflation target but certainly showing significant progress.⁴ In addition, energy costs have been falling, which should also help.

US consumer inflation expectations also improved slightly. The University of Michigan Survey of Consumers for May was released on Friday, and both the 1-year ahead and 5-year ahead inflation expectations readings were lower than the preliminary readings for May (although the 1-year has been very volatile in recent months and is well above its low for the year).⁵ In short, despite some hiccups, inflation expectations continue to be relatively well-anchored — especially longer-term inflation expectations.

The ugly

My takeaway is that the disinflationary process is very imperfect. There will be spikes along the way as inflation eases, causing some anxiety for market observers. I liken it to child-rearing. There may be tough times along the journey, but the finished product makes it all worthwhile. Let's hope that's the perspective of central bankers, given that we arguably have much more to see in terms of the lagged effects of monetary policy tightening that has already occurred.

Markets

Not surprisingly, stocks had a challenging week, especially Chinese and UK equities to name a few. US equities fared better, but that is because of strong performance from the technology sector – particularly anything related to artificial intelligence (AI). AI's effect may be helping US stocks defy the gravity of rising bond yields. Tech stocks tend to fall when Treasury yields rise, but during May this relationship has broken down — at least temporarily. This is a reminder that market breadth has become increasingly narrow for the S&P 500 Index in recent weeks, with a handful of names driving performance.

In terms of fixed income, yields surged last week. Certainly, debt ceiling negotiations played a role, but the big driver was fear that the Fed may not be finished with rate hikes. We could see more of the same in coming days.

Looking ahead

Looking ahead, we should assume there will be volatility and twists and turns in the coming days and weeks, as we hold our breath waiting for the debt ceiling deal to be signed, sealed and delivered – and as we worry about what central banks will do next. We should expect the disinflationary process will continue to progress, but not without some disappointing data points. And then there are the question marks around what central banks will do going forward (I would propose amending Otto von Bismarck's comments, as I firmly believe monetary policy decisions are also like sausages — it's better not to see them being made.)

Policy uncertainty is likely to benefit defensive positioning in the near term for tactical portfolios. Strategic portfolios could benefit from taking advantage of higher yields in fixed income by locking in rates on longer maturity core bonds, while looking for opportunities to dollar cost average into equities. We continue to believe markets will start to discount an economic recovery later this year, which would mean a market environment that is supportive of risk assets, especially sectors that are more cyclically sensitive.

With contributions from Jennifer Flitton, Paul Jackson and Ashley Oerth

Notes

¹Source: FOMC May Meeting Minutes, May 24, 2023

²Source: UK Office for National Statistics, May 24, 2023

³Source: Bloomberg News, "BOE Governor Says UK Inflation Is Taking Longer to Come Down," May 24, 2023

⁴Source: YouGov/Citigroup, May 1, 2023

⁵Source: University of Michigan, May 26, 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.

Fixed-income investments are subject to credit risk of the issuer and the effects of changing interest rates. Interest rate risk refers to the risk that bond prices generally fall as interest rates rise and vice versa. An issuer may be unable to meet interest and/or principal payments, thereby causing its instruments to decrease in value and lowering the issuer's credit rating.

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

Many products and services offered in technology-related industries are subject to rapid obsolescence, which may lower the value of the issuers.

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.

The Consumer Price Index (CPI) measures change in consumer prices. Core CPI excludes food and energy prices while headline CPI includes them.

The Survey of Consumers is a monthly telephone survey conducted by the University of Michigan that provides indexes of consumer sentiment and inflation expectations.

Strategic portfolios adhere to target allocations across asset classes. Tactical portfolios adjust the asset mix based on market opportunities.

The opinions referenced above are those of the author as of May 30, 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.