The impact of tightening comes into focus

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It's the start of a new year, but in some ways it feels like it's just a continuation of 2022. After all, central banks are still having an outsized influence on markets. However, this year is different because we're getting closer to the end of central banks' tightening cycles. We're seeing the impact of their tightening thus far on both inflation and economic growth. And markets — as well as policymakers — are assessing the results.

The Federal Reserve

Minutes from December's Federal Open Market Committee meeting indicate that no participants anticipate cutting rates this year.

US jobs report

The US jobs report for December showed an easing of wage pressures without employment falling off a cliff.

A shift in focus?

I suspect markets may become increasingly less focused on inflation this year and more focused on economic growth.

Hawkish but hopeful: Notes from the Federal Reserve

Minutes from the December Federal Open Market Committee (FOMC) meeting were released last week, giving some insight in how the Federal Reserve is assessing its own progress and where it will go from here.

The minutes were perceived as hawkish by markets. But from my perspective, there were no surprises:

- First of all, it was clear that while FOMC participants welcomed the progress made in easing inflation so far, they wanted "substantially more evidence of progress" that inflation is moderating.
- They expressed concern about ex-shelter services inflation, something articulated by Fed Chair Jay Powell in a recent speech.
- They also made it clear that their priority remains controlling inflation, which includes ensuring financial markets don't get ahead of themselves: "an unwarranted easing in financial conditions...would complicate the Committee's effort to restore price stability."
- FOMC members also agreed they would "continue to make decisions meeting by meeting," a re-affirmation of their commitment to be data dependent.
- They also acknowledged the growing recession risks created by such rapid, aggressive tightening in 2022 and worried about "potentially placing the largest burdens on the most vulnerable groups" by increasing unemployment, a concern that is likely to carry more weight as economic data deteriorates.

So, what was so hawkish? The meeting minutes indicated that no participants anticipated cutting rates this year, something that markets have been expecting. It's worth noting that a speech from St. Louis Fed President James Bullard later in the week was more encouraging. Bullard articulated optimism about inflation moderating significantly in 2023, which struck a hopeful tone.

Markets heartened by the US jobs report

But most important to markets was the data, and the US jobs report delivered exactly what markets were looking for. I dare say it was as close to a "Goldilocks" report as we could ask for.

- The US employment report showed a solid but not hot 223,000 gain in non-farm payrolls, which is well below the average for the past six months.[1]

- The most important takeaway was the continued deceleration in wages, with average hourly earnings inflation falling to 4.6% from 4.8% in November.[1] This is a material improvement from its recent peak of 5.6% in March 2022.[1]

The reason I call this a Goldilocks report is that it shows an easing of wage pressures without employment falling off a cliff — the unemployment rate actually dropped slightly in December.

US PMI data indicate that demand is softening

Last week also brought us new data from the US ISM Manufacturing and Services Purchasing Managers Indexes (PMI), which are both showing a deterioration in economic activity:

- The US Manufacturing PMI reading for December was 48.4, its second month in contraction territory.[2] The New Orders sub-index fell deeper into contraction territory at 45.2, well below the 47.2 recorded in November.[2]
- US Services PMI clocked in at 49.6 for December, a whopping 6.9 point drop from November.[3] The New Orders sub-index fell an even larger 10.8 points, from 56 in November to 45.2 in December.[3] It is worth noting this is its lowest level since May 2020.

These readings certainly indicate a softening of demand and an easing of prices, which the Fed wants. Hence, markets celebrated the Services PMI release on Friday. However, these reports also raise concerns about how much damage the Fed has already done to the US economy, which is only appearing now.

Signs of resilience for the eurozone economy

We also got some insight into the state of the eurozone economy last week after significant rate hikes in 2022. The S&P Global Eurozone PMI readings for December clocked in at 47.8 for manufacturing PMI and 49.8 for services PMI.[4] While both readings remain in contraction territory, they have improved in December and are at the highest levels seen in months. The eurozone economy is proving rather resilient despite the aggressive tightening it has experienced thus far.

IMF warns of a tough year ahead

Also last week, Kristalina Georgieva, Managing Director of the International Monetary Fund (IMF), assessed the damage created by dramatic tightening in 2022. In a recent interview, she warned that 2023 would be a "tough" year for the global economy: "We expect one-third of the world economy to be in recession. Why? Because the three big economies — US, EU, China — are all slowing down simultaneously."[5]

A focus on economic growth

Looking ahead, I suspect markets will become increasingly less focused on inflation as it continues to show signs of moderating and being well under control. In turn, that would mean greater certainty around central bank behavior.

I think markets' attention will shift to economic growth. In particular, determining how much damage has been done by tightening in

Western developed countries and when economies will begin to rebound.

For China, the focus is about when it will begin to reap the benefits of rolling back COVID stringencies. Right now, China is experiencing theshort-term negative effects of the re-opening. For example, China's National Bureau of Statistics reported December PMIs, with manufacturing at 47.0 and non-manufacturing at 41.6, both weak and the latter deep into contraction territory.[6] However, I expect China to see improving growth as the year progresses, and I remain confident it will be a good year.

What's ahead this week?

In the coming week, all eyes will be on the US Consumer Price Index. Also important will be UK gross domestic product. I will also be interested to hear any initial information that can be gleaned about consumer activity now that China is re-opening and "revenge living" (this is much bigger than just "revenge travel") in China gets underway.

With contributions from Paul Jackson

Notes

[1]Source: US Bureau of Labor Statistics as of Jan. 6, 2023

[2]Source: Institute for Supply Management, Manufacturing PMI, as of Jan. 4, 2023

[3]Source: Institute for Supply Management, Non-Manufacturing PMI. as of Jan. 6, 2023

[4]Source: S&P Global as of Jan. 2, 2023

[5]Source: Bloomberg News, "IMF chief Georgieva warns of 'tough year' for world economy," Jan. 2, 2023

[6]Source: China's National Bureau of Statistics as of Jan. 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 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.

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.

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

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

The International Monetary Fund is a global organization of 190 member countries that supports economic policies that promote financial stability and monetary cooperation.

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.

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.

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