What happens when central banks' chickens come home to roost?

Weekly Market Compass | September 12, 2023

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United States

Markets have been quick to react to individual data points without taking a step back to look at the bigger picture for the US, which is one of economic slowing and disinflation.

Canada

The Bank of Canada erred on the side of caution and enacted another pause, but then suggested the next day that rates may not be high enough.

Eurozone

Concerns are arising that the European Central Bank's aggressive tightening may have done too much to slow economic growth.

"Chickens coming home to roost" is an idiom that's been on my mind lately — the idea that your actions will ultimately come back to you. I look at it in parenting terms; how children are raised will be reflected in who they become. For example, my mom helped care for my children when they were little, and she was a "neat freak" who constantly cleaned. Not surprisingly, my oldest quickly became obsessed with cleaning. He stored Windex and paper towels in his toy box, and would wipe restaurant windows with his napkin. Because of my mom's influence, we had a very clean little chicken roosting in our home.

I can't help but think of that saying in economic terms as well. After aggressive monetary policy tightening by some central banks, we're waiting for those chickens to come home to roost. There are differing opinions on what those chickens (both the "inflation chickens" and the "growth chickens") will look like — and markets can get nervous about unexpected consequences.

A few good data points spur fears about US rate hikes

In the US, a "good news is bad news" narrative took hold last week, with positive economic data spurring fears that the Federal Reserve (Fed) will feel the need to hike rates further:

- US initial jobless claims for August came in lower than expected, continuing a run of increasingly lower claims.[1]
- The US ISM Services Purchasing Managers' Index (PMI) for August positively surprised, clocking in at 54.5, up 1.8 from July. The new orders sub-index was particularly strong at 57.5 and the prices sub-index rebounded to 58.9.[2]

Other reports indicate US economic growth was modest this summer

However, other data suggests the US economy is cooling:

- S&P Global's Services PMI for the US was 50.5 for August, indicating the slowest growth in services activity in the past seven months.[3]
- The most recent Job Openings and Labor Turnover Survey (JOLTS) data, for July 2023, showed that there are 8.8 million job openings in the US — still not at pre-pandemic levels but well below the 11.4 million job openings in July 2022.[4] Quit rates are down and labor force participation is up, all suggesting that the labor market is cooling.

- Most importantly, in my opinion, wage growth is moderating. Emblematic of a loosening labor market is Walmart's announcement last week that starting wages for some of its entry-level jobs will actually be lower than they previously had been.

Anecdotal information found in the most recent Federal Reserve Beige Book also indicates that US economic growth was modest this summer. There was selective consumer spending in areas like travel, but other retail spending continued to moderate, especially non-essential retail spending.

Some of those interviewed for the Beige Book even articulated concerns that household savings are being exhausted and consumers are borrowing in order to support spending — most Federal Reserve districts reported that consumer loan balances are increasing, and so are consumer credit line delinquencies.

My views on the labor market were supported by the Beige Book. Job growth was reported to be subdued across the nation. More importantly, nearly all districts expect wage growth will slow in the near term. And my view that overall inflation will continue to moderate, albeit imperfectly, was also supported by the Beige Book. Most districts reported price growth eased, with greater deceleration in the manufacturing and consumer goods sectors.

Now all is not rosy. Not surprisingly given recent headlines, several districts reported very significant increases in property insurance costs. It is also worth noting that a few districts reported input price growth did not drop as much as selling prices, which led to a narrowing of profit margins in those districts.

And then there is the potential for a United Auto Workers strike, which could threaten to temporarily exert upward pressure on inflation by disrupting supply chains — and could have a bigger impact on already-jittery markets.

The lagged effects of monetary policy complicate the Fed's job

The reality is that central banks are largely flying with blindfolds on because of the lagged effects of monetary policy. In channeling his inner Lord Byron at Jackson Hole, Fed Chair Jay Powell eloquently explained, "We are navigating by the stars under cloudy skies."

Because of this uncertainty, markets are quick to react to individual data points without taking a step back to look at the bigger picture for the US, which is one of economic slowing and disinflation. They are making assumptions about their returning chickens based on a few data points.

I think it's important to pay attention to a study published last week by Chicago Fed economists.[5] Their model indicates that the tightening that has already occurred is sufficient to bring inflation back near the Fed's target by mid-2024 — and without bringing about a recession.

I agree with that assessment, including that the US can avoid a recession (although as I've said many a time, including last week, it will be a bumpy landing). Those are chickens that will be welcomed back to the nest with open arms if they return.

Canada pauses tightening, but for how long?

There is also a lack of clarity around what chickens will come home to roost in Canada as a result of its aggressive monetary policy tightening. Because of that, the Bank of Canada (BOC) erred on the side of caution and enacted another pause on tightening last Wednesday.

However, on Thursday, BOC Governor Tiff Macklem talked tough in a speech, suggesting rates may not be high enough. This was a perfect segue to Friday's release of the jobs report for Canada, which showed far more jobs created in August than expected.

Macklem, like Powell, needs to talk tough to help keep a lid on inflation. However, I suspect Canada will not have to tighten again. Their chickens will likely look similar to the ones in the US.

Australia pauses rate hikes, but stands ready to reverse course

The Reserve Bank of Australia (RBA) also decided to pause at its meeting last week because it believes it has done enough to drive inflation down to its target within a reasonable timeframe. However, there was also a recognition of uncertainty around the outlook, and a pledge to tighten further if necessary.

RBA Governor Philip Lowe appears to be hanging his hat on inflation expectations. As he explained in a statement last week: "…if high inflation were to become entrenched in people's expectations, it would be very costly to reduce later, involving even higher interest rates and a larger rise in unemployment. To date, medium-term inflation expectations have been consistent with the inflation target and it is important that this remains the case…"[6]

We will want to follow them closely, as they are likely to dictate the kind of inflation chicken that comes home to roost in Australia.

Falling growth in the eurozone could lead to a pause

In the eurozone, concerns are arising that aggressive tightening may have done too much, as evidenced in the most recent PMIs. All eyes will be on the European Central Bank (ECB) meeting later this week. There is a lot of uncertainty about whether or not it will hike, given the uncertainty about the consequences of its past hikes.

Because of the significant deterioration in growth prospects in a short period of time, it seems more likely the ECB will err on the side of caution and sit on its hands at this week's meeting.

Could Japan alter its accommodative monetary policy?

Over the weekend, Bank of Japan (BOJ) Governor Kazuo Ueda addressed its ultra-accommodative monetary policy stance, which is very different than other major developed market central banks.

He suggested that the BOJ will have enough data by the end of 2023 to decide whether wages and prices warrant a reduction in its stance. Gross domestic product growth has been strong recently, but Ueda is waiting for more signs of what may come before he alters policy. If he believes the Japanese economy is on the path to the BOJ's inflation target, he seems comfortable tightening modestly. In the meantime, while waiting for his inflation chicken, his words have helped strengthen the yen.

Conclusion: Central banks' impact on markets won't go away soon

In short, central banks continue to have an outsized impact on markets because of the lagged effects their policies are having on their respective economies. That impacts currency markets, bond markets, and equity markets.

So what does this mean for markets in the short term?

Because growth is improving and the odds of a recession are decreasing for the US economy, I believe we are likely to see stronger near-term performance of cyclical sectors such as industrials, materials, and energy, as well as smaller-cap stocks. That's especially so if the very important core US Consumer Price Index print later this week supports the disinflation narrative.

While Europe and the UK have had more growth headwinds, cyclicals and smaller-caps could perform well in these regions — especially if growth starts to improve. In addition, valuations are far more attractive for European and UK equities. A weakening US dollar should also be a positive driver for international equities — especially emerging markets, many of which have been benefiting from a positive macroeconomic backdrop.

In fixed income, "risk on" asset classes such as US high yield, bank loans, and emerging markets hard currency debt look attractive given the favorable macroeconomic backdrop and their higher relative yields.

Having said all that, there could be more data points that trigger the kind of market behavior we saw last week, with long Treasury yields rising and depressing equities. It is to be expected that there will be some days when markets reflect uncertainty about which chickens are coming home to roost.

Notes

[1]Source: US Bureau of Labor Statistics, Sept. 7, 2023

[2]Source: Institute for Supply Management, Sept. 6, 2023

[3]Source: S&P Global, Sept. 2023

[4]Source: JOLTS Report, Bureau of Labor Statistics, August 29, 2023

[5]Source: Chicago Fed Letter, No. 483, "Past and Future Effects of the Recent Monetary Policy Tightening" by Stefania D'Amico and Thomas King, Sept. 2023

[6]Source: Reserve Bank of Australia Statement by Philip Lowe, Governor: Monetary Policy Decision, Sept. 2023

The Summary of Commentary on Current Economic Conditions by Federal Reserve District (commonly known as 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 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.

Disinflation, a slowing in the rate of price inflation, describes instances when the inflation rate has reduced marginally over the short term.

The European Central Bank (ECB) is responsible for the monetary policy of the European Union.

The Eurozone (also known as the euro area or euroland) is an economic and monetary union of 18 European Union member states that have adopted the euro (€) as their common currency.

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.

Inflation is the rate at which the general price level for goods and services is increasing.

The job openings and labor turnover survey (JOLTS) is a monthly report by the US Bureau of Labor Statistics of the U.S. Department of Labor counting job vacancies and separations, including the number of workers voluntarily quitting employment.

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

Tightening monetary policy includes actions by a central bank to curb inflation.

The opinions referenced above are those of the author as of September 11, 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.