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CIO Strategy Bulletin

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At the Intersection of Policy and Markets

SUMMARY

- This week we raised our global GDP forecasts for 2023 to +2.0% from +1.7%, while downgrading 2023 US growth estimates.
- Recent data suggest the Fed's heavy-handed monetary policy is impacting a broader set of economic factors more deeply month over month. The sharp rise in consumer goods and new home inventories this past year are leading to reductions in construction, trade activity and industrial production.
- With short-term interest rates up more than 400 basis points over 10 months and asset prices suffering losses, consumer activity still appears OK. But residential housing contractions and slowing business investment will ultimately affect household spending. The decelerations associated with a pending recession are at work.
- Once unemployment starts to rise, it tends to keep rising until monetary policy eases and producers have cut "too much." Only then can an upcycle begin.
- We see the Fed's fixation on inflation and positive January employment data combining to revive the growth and inflation fears of 2022. A broad near-term rise in interest rates after an exceptional downward move is also possible.
- These changes in markets are why we have made our first small, preliminary changes to our asset allocation. We have sold our 2% gold position and reallocated it to buy European and Japanese equities and even more short-term US fixed income. Our enlarged bond position will be a future source of funds for even more global equities when a bottoming in the US economic cycle is closer at hand.

At the Intersection of Policy and Markets

This week we have downgraded 2023 US growth estimates and increased those for China, the EU, UK and Japan. Therefore, we have raised our global GDP forecasts for 2023 to +2.0% from +1.7% (see our January [Quadrant](#)). Most of this is driven by China's earlier-than-expected move to end its Covid-zero policy and clear indicators that Europe's energy shock is abating. As regional natural gas prices retreat, the scope of the income drag on the entire region is abating. While this won't spark a European boom, it does mean bearish expectations were too bearish. This means the severity of a prospective global slowdown is lessening.

But in the US, the coffee pot is boiling as we head toward a likely contraction a bit earlier than most expect. Recent data suggest the Fed's heavy-handed monetary policy is impacting a broader set of economic factors more deeply month over month. The sharp rise in consumer goods and new home inventories this past year are leading, predictably, to reductions in construction, trade activity and industrial production.

Once output in these sectors starts falling, it is likely that their declines will deepen. Therefore, labor markets are likely to slow sharply into the spring. We have already seen declines in total hours worked and the initiation of substantial layoffs by major tech companies. With high expectations set by analysts for all but the near term (see last week's [CIO Bulletin](#)), we believe the US faces a substantive risk of downward earnings estimate revisions over the coming few quarters.

While reporting earnings this week, a major technology CEO said, "Actors outside [our] control have contributed to both the inventory and production issues, with a slowing PC market pressuring [our] margins and forcing retailers to 'correct' their inventories. While we know this dynamic will reverse, predicting when is difficult."

And here is a fine point. Our 2023 US GDP forecast notably **assumes** the Fed will change its course once again when it finds itself with a rising unemployment situation in the second half of this year.

The Last Really Strong Employment Report

We believe the upcoming January employment report is likely to be the last to show large gains. We expect the report to show a 200,000 gain due principally to expected, seasonal distortions in the employment count. While the jobs data will be released just after the Fed's February 1 press conference, we expect it to reinforce a hawkish message Chair Powell delivers. This is because financial markets have been countering the Fed's tightening with rallies in bonds and equities this year. While the US central bank is downshifting because of the weaker data, looking back at the inflation of the year past, Powell is likely to argue that the Fed's work is not done.

The start of 2022 has seen equity markets soar. The S&P 500 is up 5% and Nasdaq shares have risen by 11% in less than a month. Elsewhere, China shares and EU equities have risen 17% and 12%, respectively. The European rise is related to falling imported gas prices, lowering the input costs of firms, and reducing the scope of a shock to consumers and government budgets. The Asian rise can be attributed to a boom in economic activity in China post-Covid, not dissimilar to the one both China and other nations experienced in 2020.

But in the US, the Fed will likely disregard slowing headline inflation until it sees "real" declines in US employment. And though the Fed knows falling US money supply (M2) is a strong predictor of future falling inflation, it will still stand firm against inflation. All this suggests that global equity markets face near-term risks.

This begs the question asked by many investors: Why can't it be different this time? Why can't we just avoid recession? This is, after all, the third major rally since the Fed began its tightening policy. What explains the rise in US shares?

With short-term interest rates up more than 400 basis points over 10 months and asset prices from homes to equities suffering losses, consumer activity still appears OK. But that is certainly not the whole story. The "bright news" driving markets up may, in fact, be the higher inventory of prospective "buyers of equity." Short positions in US markets have rarely ever been higher than now (**Figure 1**). But investors should consider that the shorts may have it right for the near term.

Figure 1: S&P 500 net short positions (futures)



Source: Haver Analytics as of Jan. 27, 2023. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Past performance is not indicative of future returns. Real results may vary.

Gravity and Momentum

Residential housing contractions and slowing business investment will, ultimately, affect household spending. In fact, gravity is at work. Initially, much higher rates hit the most interest rate sensitive sectors like property. The recent GDP report indicated that residential fixed investment was down by 27%. While peak negativity in real estate may have been reached, the damage follows in employment and personal income.

We are likely seeing the very end of “Covid Cabin Fever” in the US, as well. While Americans were wealthier as government subsidies and “stay at home” savings grew, they are now being spent down. To remain in spending mode, households will need to borrow more – and we have seen evidence that they have in surging credit card balances (**Figure 2**). Nonetheless, this is unsustainable.

Figure 2: US consumer credit card balances (\$ billions)



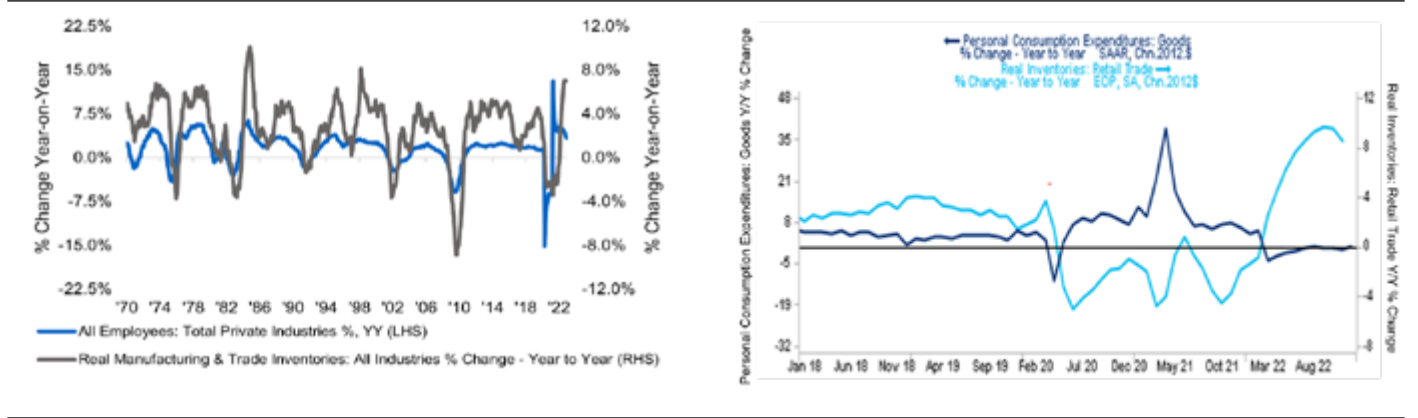
Source: Haver Analytics as of Jan. 27, 2023. Gray areas note recessions.

Gravity in markets works like this. Once producers overestimate the path for consumption and inventories rise, they cut back (**Figure 3**). Corporate profits fall and labor markets weaken together. As we have written before ([Quadrant](#) November 2022), once unemployment starts to rise, it tends to keep rising until monetary policy eases and producers have cut “too much.” This is the “gravity of the recession” where cost cutting leads to lower investment and more unemployment.

It might be tempting for investors to ignore gravity, but they do so at their peril. It was rising inventories that made the GDP data in Q42022 look stronger than expected, adding half of the 2.9% annualized gain. In spite of household sentiment indicators that surprised to the upside in January, household spending is insufficiently strong to avoid a US inventory recession (**Figure 4**).

Figure 3: Total US private employment and real business inventories Y/Y%

Figure 4: US retailing inventories are surging at the present US consumer spending pace

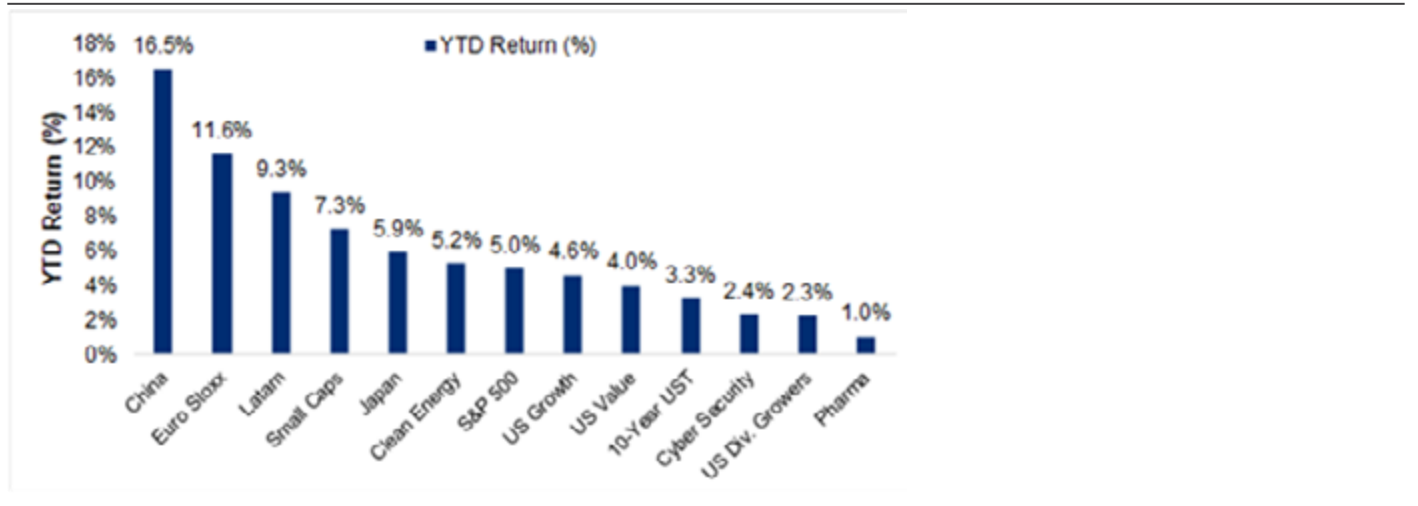


Source: Haver Analytics as of Jan. 27, 2023. Grey areas note recessions.

We Suggest Positioning for Realities, Not Hope

The global equity market outlook is unlikely to be a bright one in the near term. The “easy money” gains in Asian equities from China’s surprise reopening or the collapse in natural gas have come swiftly (**Figure 5**). With weak economic data in the US unlikely to tame the Fed’s fixation on inflation at their February 1 meeting, we see the Fed and January employment data combining to revive the growth and inflation fears of 2022. A near-term rise in interest rates after an exceptional downward move is also on the table.

Figure 5: Regional equity market returns in 2023 to-date



Source: Bloomberg through Jan. 27, 2023. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. All forecasts are expressions of opinion and are subject to change without notice and are not intended to be a guarantee of future events. Past performance is not indicative of future returns. Real returns may vary.

Out With the Gold, in With the New

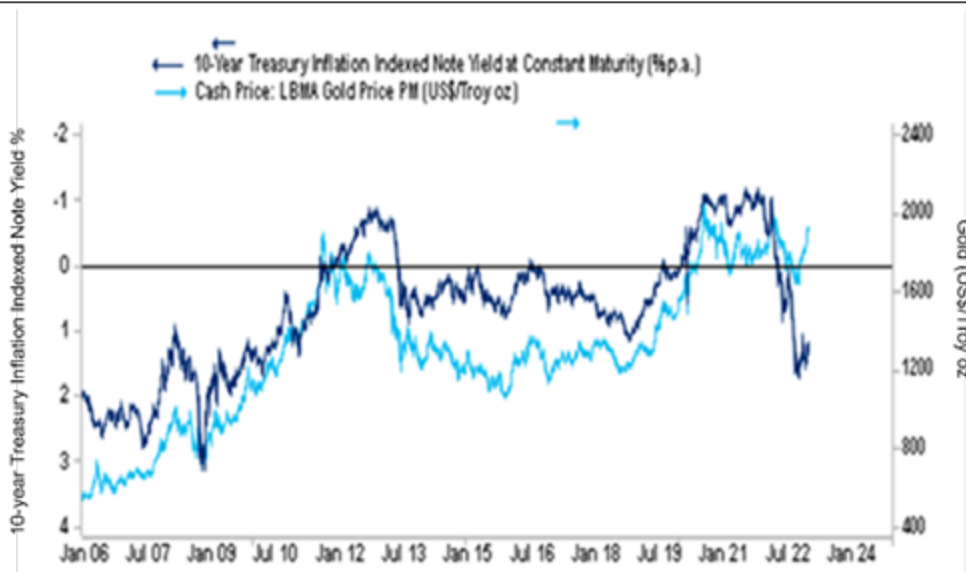
This is why the CGWI Global Investment Committee (GIC) has made its first small, preliminary moves in our asset allocation. We have sold our 2% gold position after recent solid performance that defied the Fed's hiking cycle (**Figure 6**). We have used that 2% to buy European and Japanese equities and even more short-term US fixed income. We believe our enlarged bond position will be a future source of funds for even more global equities when a bottoming in the US economic cycle is closer at hand. In the meantime, it will earn income at yields the US hasn't seen in nearly 15 years.

We see the very long bull market in the US dollar and exceptional valuation divergence between US and non-US equities as a strong potential long-term opportunity for global equity portfolios over the coming decade. These regional equity markets have meager 2023 EPS growth expectations compared to the US and trade at less than 13x expected earnings vs 18x for the US. In short, we are only in the very early stages leaning into non-US equity markets.

For now, we still think that bonds have considerable value at turning points in the market. Market interest rates doubled from all-time lows in 2021. When they doubled again in 2022 into a likely economic slowdown, we saw opportunity (**Figure 7**). This remains today with short-term US interest rates above 4% and some short-term investment grade bond opportunities yielding as much as 8%.

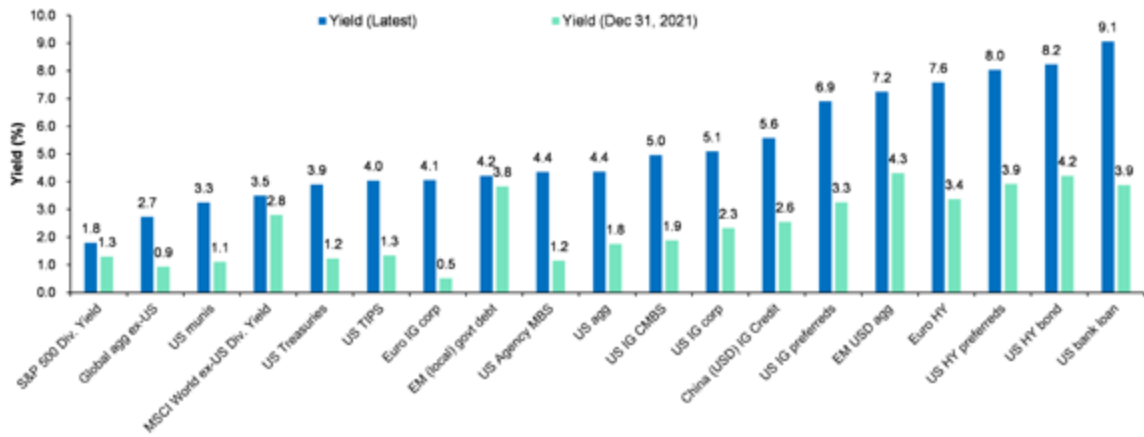
One thing is for sure: The Federal Reserve will not press on with rate hikes and Quantitative Tightening forever. They cannot because a recession will be upon us and they are likely to respond sooner than even they may expect.

Figure 6: Gold price vs the real US 10-year note yield (Treasury Inflation Protected Security)



Source: Haver Analytics as of Jan. 25, 2023. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Past performance is no guarantee of future results. Real results may vary.

Figure 7: S&P 500 net short global fixed income yields by segment end-2022 vs end-2021



Source: Bloomberg as of Jan. 25, 2023. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Past performance is no guarantee of future results. Real results may vary.

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