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MARKETS POLICY PARTNERS
LOOKING AHEAD

Looking Ahead – Halftime Huddle

"Worst first half of a year since 1970 for US stocks" is the headline grabber stat from Q1-2 2022, as investors and analysts alike grapple with what is shaping up to be a punishing conclusion to the ultra-accommodative monetary policy era in the face of multi-decade highs in inflation with scant relief in sight. **Our view is that this is still going to be a year of two halves, as slowing growth and meaningful recession risk, alongside signs of a developing downtrend in price pressure metrics, facilitate a downshift in the Fed's pace of monetary tightening**.

For now, though, we are sitting tight with the neutral positioning in equities, rates, and currencies we adopted in mid-May as we wait for this sloppy/choppy early summer transition period to pass ahead of some clearing for the second half of this year.

Supporting our call for a more balanced macro picture in the second half of the year are the declines in US gasoline prices, global metals prices, the CRB Raw Industrials basket, used car prices, freight and shipping rates, etc. which we think in aggregate track a broad rollover in price pressures (please see last week's Looking Ahead – Summer Squalls for a set of these charts). TIPS breakevens, the key market-based gauge of inflation expectations, are tracking this narrative.

Even if inflation is in the process of moderating, however, this is not yet clear from the data, which has been like a Rorschach Test. Core PCE Prices were relatively encouraging but the Consumer Price Index (CPI) and Producer Price Index (PPI) were the opposite of reassuring, while increasing evidence of slowing growth in PMIs and Fed activity surveys, alongside dismal business and consumer confidence surveys, is being balanced to some degree but still robust labor market indicators. And without a clear trend, the headline risk associated with each discrete US inflation data release is so high that building long positions in anticipation of a better 2H2022 is still quite problematic – as was shown by the steep losses that followed the dispiriting upside surprise in May CPI, which may end up being an outlier in an overall deceleration.

We expect that trends will be clearer by the July meeting, where a 50 basis point (bps) hike, which is our base case, would look like a dovish surprise. If this is accompanied by more measured Fed rhetoric on inflation fighting and a more balanced stance, anticipation of similar restraint in September and beyond should help stabilize global risk assets after the drubbing they took in the first half.

What would change our minds? Top 5

1. US inflation and growth fail to slow in tandem into the second half of the year
2. Growth and inflation pressures do wane, but the Fed declines to downshift their tightening trajectory despite growing evidence of a slowdown and narrowing inflationary pressures, driving the economy into the ground (this is currently the base case reflected in financial markets)
3. Oil prices break higher out of their current trading range and march to record highs, all but ensuring global stagflation irrespective of central bank policy adjustments
4. Growth and inflation moderates, the Fed downshifts its pace of tightening, but the damage is already done to the economy and activity contracts much faster than expected before the Fed is able to contemplate cuts

5. Black swan event – candidates include EU debt crisis redux, the disorderly implosion of Tether, the collapse of the Bank of Japan's Yield Curve Control policy, failure of a major hedge fund, and a significant escalation in the Russia/Ukraine or other global flashpoint.

What is likely to follow a 2H2022 rebound? Coaches will always tell their teams not to look out to the next game, and while that's sound advice for athletes, investors don't have that luxury. Futures markets are pricing in Fed rate cuts in 2023, which is at odds with our base case, as it would take a sharply disinflationary episode (recession) to induce the Fed to take such a step even in the face of what is still expected to be above 2% target inflation. In short, we think markets are likely to get better for a time before likely relapsing in 2023 whereas the market seems to be suggesting more near-term pain followed by an easing of conditions in 2023.

Looking ahead, next week's holiday-shortened macro calendar in the US features the nonfarm payroll report for June, which is expected to remain robust despite percolating fears of an impending recession, while the June Fed and ECB Meeting Minutes will also be in the spotlight. The Reserve Bank of Australia has a decision, and G-20 foreign ministers are meeting in Bali, Indonesia. Other notable data includes additional global PMI readings and EU retail sales, industrial production, and wholesale prices.

- US Nonfarm Payrolls
- Fed Meeting Minutes
- ECB Meeting Minutes
- Global PMIs
- EU Retail Sales
- EU Industrial Production
- EU Wholesale Prices
- Australia Central Bank

MPP Holiday Publication Schedule – There will be no Market Viewpoints or Five Minute Macro on Sunday and Monday, respectively, due to the holiday weekend in the US – normal publications will resume on Tuesday. Here's wishing all our US subscribers a very happy 4th of July weekend!

Global Economic Calendar: Summer jobs

Monday

The German trade surplus fell sharply to €1.3 billion in April from €9.7 in the previous month, marking its lowest level since 1992 as imports jumped 25.2% year-on-year to €120.9 billion compared to a much smaller 9.2% increase in exports to €122.2 billion. On a seasonally adjusted basis, German exports rose 4.4% compared with March as shipments to the EU and US rose 4.2% and 7.7%, respectively, although exports to Russia fell another 10% after falling 62.3% in March due to sanctions imposed. Meanwhile, imports increased 3.1% from the previous month boosted by purchases from China (up 12.3% from March) the UK (up 5.6%), and the Eurozone (2.4%), while imports fell from the US (-1.2%) and Russia (-16.4%).

The annual inflation rate in Turkey increased for the 12th consecutive month to 73.5% in May, the highest since October 1998 and up from 69.97% in April and a much lower 16.6% in May 2021. Figures came below market forecasts of 76.6% but remained extremely elevated as the lira continued its plummet and as real interest rates remained largely negative. Upward price pressures were recorded across sectors, including food and non-alcoholic beverages (91.6% vs 89.1% in April); housing and utilities (63.5% vs 61.1%); furnishings and household equipment (82.1% vs 77.6%); hotels, cafes, and restaurants (76.8% vs 69.3%); and transportation (107.6% vs 105.9%), which was fueled by surging prices for energy (121.1% vs 118.2%). On a monthly basis, prices rose 3% from April.

The Caixin China Manufacturing PMI increased to 48.1 in May from April's 26-month low of

46.0, marginally beating market forecasts of 48.0 but marking the third straight month of declining factory activity amid continued COVID-zero restrictions. Both output and new orders fell amid further declines in export orders and employment – albeit at a softer pace than the previous month. Meanwhile, backlogs of work and delivery times continued to increase due to COVID-related disruptions and travel curbs, prompting firms to cut purchases in order to cut down on inventory. Looking forward, business sentiment fell for the fifth consecutive month as managers remained wary of the continued impact of COVID restrictions and the war in Ukraine.

Tuesday

The Reserve Bank of Australia increased interest rates by 50 bps at its policy meeting in June in its first back-to-back rate hike in 12 years, bringing the cash rate up to 0.85% as the board said its prior position of huge monetary support is no longer appropriate given the strength of the economy and elevated inflationary pressures. The central bank also said labor markets have remained strong as employment numbers continued to make gains and the jobless rate fell to its lowest in nearly 50 years. “The Board expects to take further steps in the process of normalizing monetary conditions in Australia over the months ahead,” RBA Governor Philip Lowe said in a statement.

US factory orders rose 0.2% month-over-month to $533.2 billion in April following a downwardly revised 1.8% gain in March, falling short of market expectations of a 0.7% gain. Orders slowed for durable goods (0.5% vs 0.7% in March), namely for primary metals (0.8% vs 3.3%) and computers and electronic products (0.1% vs 1.8%), while those for fabricated metal products (-0.1% vs 1.2%) and electrical equipment, appliances, and components (-0.2% vs 2.6%) declined. Still, orders accelerated for machinery (1% vs 0.6%) and transport equipment (0.7% vs -0.3%). Among nondurable goods, orders slowed to 0.2% from 0.9% in the previous month.

Wednesday

The ISM Manufacturing PMI for the US unexpectedly rose to 56.1 in May from 55.4 in April, beating market forecasts of 54.5 as new orders (55.1 vs 53.5 in April), production (54.2 vs 53.6), and inventories (55.9 vs 51.6) all posted faster increases. In addition, price pressures decreased for the second consecutive month, falling to 82.2 from 84.6. Meanwhile, employment contracted to 49.6 from 50.9, although firms reported improved progress on addressing moderate-term labor shortages at all levels of the supply chain. Business sentiment remained robust regarding demand, although managers reported continued concern over supply chains and pricing issues.

The Jobs and Labor Turnover Survey (JOLTS) showed the number of job openings in the United States was 11.400 million in April, down from a revised record 11.855 million in March. Figures came in line with market expectations. Job openings decreased in several industries, with the largest declines in healthcare and social assistance (-266,000), retail trade (-162,000), and accommodation and food services (-113,000). Job openings increased in transportation, warehousing, and utilities (+97,000); nondurable goods manufacturing (+67,000); and durable goods manufacturing (+53,000). Meanwhile, the so-called quits rate was unchanged at 2.9% as some 4.4 million Americans quit their jobs.

Minutes of June’s FOMC Meeting will provide more clarity on the Fed’s decision to hike interest rates by 75 bps. Chair Powell said at a European Central Bank conference that the US economy is in “strong shape,” and the central bank can reduce inflation to its target of 2% while maintaining a solid labor market. “We will not allow a transition from a low inflation environment to a high inflation environment,” he said. Nonetheless, policymakers are cautious of acting too aggressively. In testimony to the Senate banking committee last Wednesday, Powell acknowledged that steep interest rate hikes may cause a recession and that avoiding it mostly depends on factors outside of the Fed’s control. “The other risk, though, is that we would not manage to restore price stability and that we would allow this high inflation to get entrenched in the economy,” Powell added. “We can’t fail on that task. We have to get back to 2% inflation.”

Australia's trade surplus widened to AUD 10.50 billion in April from an upwardly revised AUD 9.74 billion in March, beating market forecasts of a AUD 9.3 billion surplus. It was the largest trade surplus since January, as exports grew by 1% from a month earlier to a new record high of AUD 50.38 billion, while imports dropped 0.7% to AUD 39.88 billion. For the first four months of the year, the trade surplus increased to AUD 40.80 billion from AUD 34.48 billion in the same period last year.

Thursday

Canada's trade surplus narrowed to CAD 1.5 billion in April from a downwardly revised CAD 2.3 billion in the previous month, falling well short of market expectations of CAD 2.9 billion as imports rose by 1.9% to a record high of CAD 62.8 billion compared to a slower 0.6% rise in exports to CAD 64.3 billion, also a record high. The rise in imports was fueled by increased purchases of clothing, footwear, and accessories (24.2%); metal and non-metallic mineral products (10.5%); and energy products (5%), with natural gas and refined petroleum product purchases rising 57% and 52.6%, respectively, to offset a 20.9% reduction in crude oil imports. On the export side, shipments were lifted by sales of consumer goods (5%) and motor vehicles and parts (3.9%), although energy exports fell 0.9%.

The Ivey Purchasing Managers Index in Canada rose to 72 in May from 66.3 in the previous month as employment climbed to its highest level in 11 months (67.9 vs 65.1 in April), inventories rose (69.8 vs 64.1), and price pressures edged down (82.4 vs 90.2). Supplier delivery times, however, continued to lengthen (42.3 vs 37.8).

Friday

Canada's unemployment rate fell to 5.1% in May from 5.2% in April, the lowest rate since comparable data became available in 1976 and marginally below market forecasts of a sustained 5.2%. The rate in four provinces – British Columbia (4.5%), New Brunswick (7.1%), Prince Edward Island (7.8%), and Newfoundland and Labrador (10.0%) – was similar or below previous all-time lows, and employment gains were especially pronounced among young and core-aged women and in Alberta.

The US unemployment rate was unchanged at 3.6% in May, remaining at its lowest level since February 2020 for the third consecutive month but slightly above market expectations of 3.5%. The number of unemployed people increased by 9 thousand to 5.950 million, while employment levels rose by 321 thousand to 158.426 million. The labor force participation increased to 62.3%, up from April's three-month low of 62.2%. Meanwhile, the Nonfarm Payroll Report showed the US economy added 390K payrolls in May, the least since April 2021 but above market forecasts of 325K. Payrolls increased across several sectors, including leisure and hospitality (84K), namely food services and drinking places (46K) and accommodation (21K); professional and business services (75K); transportation and warehousing (47K), namely warehousing and storage (18K), truck transportation (13K), and air transportation (6K); and manufacturing (18K). In contrast, payrolls fell in retail trade (-61K), mainly due to job losses in general merchandise stores (-33K).

Russia's annual inflation rate eased to 17.1% in May from April's 20-year high of 17.8% and below market estimates of 17.3%. On a monthly basis, consumer prices increased 0.1% after rising 1.6% in April, with price inflation slowing for food (0.6% vs 2.9% in April) and reversing for non-food (-0.1% vs 0.5%), and services (-0.3% vs 1.1%).

China's annual inflation rate remained at April's five-month high of 2.1% in May, below market forecasts of 2.2%. Food prices increased the most since September 2020, up for the second straight month (2.3% vs 1.9%) in April, as consumer activity picked up amid easing COVID restrictions in many major cities. Non-food inflation fell slightly (2.1% vs 2.2%) as price pressures cooled in housing (1.0% vs 1.2%), transportation & communication (6.2% vs 6.5%), and culture (1.8% vs 2.0%), although inflation in clothing (0.6% vs 0.5%), household goods and services (1.4% vs 1.2%), and healthcare (0.7% vs 0.7%) costs remained at or above April's figures. China set a target of CPI at around 3% for this year, the same as in 2021. On a monthly basis, consumer prices fell 0.2% in May, the first monthly decline in five months, compared with consensus of a 0.3% drop and after a 0.4% rise in February.