



Investors may be putting too much faith in the fundamental improvements and not giving enough credence to the risk of them being a head fake. (UBS)

Market performance: Real or fake?

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Financial market performance so far in 2023 has been the opposite of what happened in 2022. Assets that were down, substantially in many cases, in 2022 (e.g., equities, bonds, bitcoin) are up by decent amounts in only two weeks in 2023.

In contrast, commodities and the USD, two of last year's big winners, are down slightly this year. Moreover, it's been a procyclical rotation, led by US small caps and Eurozone, emerging market, and China equities. Also, consumer discretionary and communication services are the leading US sectors this year after being the biggest losers in 2022. Quite a turnaround, although I'm certainly not complaining about this good start after a terrible 2022.

But this market action begs the questions of what comes next and what should investors do, as many assets have already rallied by double digits from their 4Q22 lows. The answers depend on how much of the rallies are "real," meaning whether they are justified by better-than-expected economic fundamentals, how much of the fundamental improvement is already priced in, and how much improvement (or deterioration) is yet to come. But the answers also hinge on whether the price action is "fake" and simply a consequence of investors covering short positions and reducing underweights, which have definitely been a factor. Also, investors may be putting too much faith in the fundamental improvements and not giving enough credence to the risk of them being a head fake. These questions require more analysis than can be covered in a blog, so we only highlight the key factors that could suffer from a "real versus fake" outcome.

On the fundamentals, economic data and developments over the past month have increased the probability of a soft-landing and reduced downside tail risks, and markets have responded accordingly. The three widely-cited factors are China dropping its zero-COVID policies and re-opening much sooner than anticipated, Europe benefiting from better-than-expected weather and steeply falling energy costs, and "Goldilocks" inflation and jobs data in the US. We expected 2023 to be a year of inflections, with economic growth bottoming and then improving, inflation rolling over where it hasn't already, and central banks pausing rate hikes and potentially even cutting. The timing of the inflection points for

China's and Europe's growth has likely been brought forward, and quite possibly the pause in the Federal Reserve's hiking cycle too.

That's good news for financial markets. The challenge is in assessing whether the improvement in key variables is an indication of better times ahead, which should support a continuation of the market rally, or are head fakes for economic conditions that will ultimately disappoint. Three factors at risk of being head fakes stand out.

First, multiple US inflation data points surprising to the downside has made investors confident that headline inflation will fall rapidly back to 2%, but core inflation could prove to be far stickier than investors are currently presuming without more Fed rate hikes than are forecast.

Second, evidence of US labor market resilience even as wage growth moderates is the critical data for the soft-landing narrative, but deterioration (i.e., job losses) could accelerate quickly and may still be necessary for wage growth to fall sufficiently.

The third potential head fake pertains to the impact of monetary policy tightening. A widely-held view is that the peak drag on US economic growth stemming from tightening financial conditions last year is taking place right now; and with conditions easing over the past two months, growth could actually start to recover by mid-year. But another plausible scenario is that the economic pain of higher policy rates will only really start to bite later this year as households and small businesses have to re-finance at much higher interest rates. While the former scenario is consistent with a soft-landing, the latter is much less so.

The bottom-line: A subjective reading of the markets suggests that investors are confident US inflation will fall rapidly as expected (i.e., no head fake) and that China's economic growth will re-accelerate once it gets through its current COVID wave. There's less conviction that the US labor market, and by extension the entire US economy, can achieve a soft-landing, or that the Fed will avoid making a policy error, if it hasn't already. In our view, these relative conviction levels are reasonable. But given how noisy the data continues to be, it's hard to say with a high level of conviction that none of the fundamental improvements will end up being a head fake. Yet, pricing across markets is moving in that direction, which makes them vulnerable to pullbacks. The strong start to the year is definitely welcome, but that's not a reason for investors to become too confident about the outlook or to fear that they have already missed the rally.

Main contributor: Jason Draho, Head of Asset Allocation, CIO Americas

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