CIO thinks the recent and upcoming data releases that are most important to the Fed make a dovish pivot unlikely in the near term. (ddp)

US data still points to a hawkish Fed

09 March 2023, 1:03 pm CET, written by UBS Editorial Team

Federal Reserve Chair Jerome Powell on Wednesday indicated that no decision had yet been reached on whether to step up the pace of monetary tightening in March.

The outcome, he suggested, was likely to hinge on "some potentially important data coming up." In particular, the Fed is likely to be focusing on this week's employment release and next week's consumer price index, both for February.

Meanwhile, investors continued to brace for a more aggressive series of rate rises from the Fed along with a higher risk of recession. The yield on the 2-year US Treasury—which is heavily influenced by expectations for Fed policy—rose 6 basis points to 5.07%, the highest since 2007. In addition, the yield premium offered by 2-year over 10-year US Treasuries—a popular sign of market concern over a looming recession—stretched to 109 basis points. This yield curve inversion is the widest since 1981.

We believe the most important focus for markets is not the outcome of Fed policy in a single meeting, but rather expectations of how high rates will go and how long they will remain high for. In our view, the recent and upcoming data releases that are most important to the Fed make a dovish pivot unlikely in the near term.

Job openings data continued to point to excess demand for workers. While the number of available positions fell modestly to 10.8 million in January from 11.2 million in the prior month, this was higher than the 10.5 million economists had been expecting. The data also included significant upward revisions to openings over the past year, including a new record of 12 million in March 2022. The latest release continues to suggest there are around 1.9 openings for every unemployed American, close to a record high. Such elevated demand for labor adds to the risk that wage growth will remain unacceptably high for the Fed.

The February employment report looks likely to show unemployment at, or close to, a five-decade low. The strength of the January jobs data came as a surprise to markets, with the jobless rate falling to 3.4%, the lowest since 1969—the year of the moon landing. Job creation at 517,000 was roughly double the consensus forecast from economists.

While an upside surprise of this magnitude looks unlikely, the February report could remain too strong for comfort, from the Fed's perspective. The consensus is for the unemployment rate to hold steady at historical lows and for job creation on the month to reach about 200,000—neither of which would point to the kind of cooling the Fed would like to see. This perception was supported by the release on Wednesday of the ADP National Employment report, suggesting that 242,000 private sector jobs were created in February—versus the consensus forecast of 200,0000 in a Reuters poll. Data for January was also revised higher.

Core inflation, excluding volatile food and energy prices, has remained higher than expected. While the annual headline measure of inflation for January has been on a downward trend since a June peak of 9.1%—falling every month since to 6.4%—core inflation has proved sticky. On a monthly basis, this held steady at 0.4% in December and January. Economists expect this core consumer price index measure to remain at this level again in February. The Fed's favorite gauge of price pressures—the core Personal Consumption Expenditure index—suggested core inflation is accelerating. Annual core inflation sped up to 4.7% in January from 4.6% in December, and on a monthly basis to 0.6% versus 0.4% in December.

Against this backdrop, we believe the risks are tilted toward more hawkish pronouncements from the Fed. We continue to expect 2023 to be a year of inflections for inflation, monetary policy, and economic growth. But recent developments have reinforced our view that inflection points are unlikely to be reached in unison. Investors will therefore need to take a more regionally selective approach to risk decisions, rather than make blanket "risk-on" or "risk-off" calls. We prefer high-quality fixed income. In equity markets we favor value stocks, including energy, which should be relatively resilient if inflation remain stubborn. With Europe and China likely to reach inflection points ahead of the US, we recommend diversifying beyond the US market and growth sectors.

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Content is a product of the Chief Investment Office (CIO).

Original report - US data still points to a hawkish Fed, 9 March 2023.