CIO continue to see near-term headwinds for markets with the potential for episodes of high volatility until investors have greater clarity about the economic outlook. (ddp)

Expect market swings until economic uncertainty clears

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Investors continue to pivot between hopes of a soft landing and concerns that more aggressive rate rises will tip the US economy into recession. So far in 2023, we have had two market performance regimes. Until the strong employment data released on 3 February, economic releases had been pointing to a Goldilocks outcome—with inflation falling, while a healthy labor market ensured no abrupt decline in consumer spending. That positive outlook was reflected in asset prices.

Global equities returned 9.5% between the start of 2023 and 2 February. Sectors benefiting most from a healthy economy outperformed, including a 20.8% return for consumer discretionary.

However, strong January payrolls, which showed the jobless rate falling to a 53-year low, revived fears that the Federal Reserve would need to hike rates further to curb inflation—raising the threat of a hard landing. This contributed to a 2.3% decline in global stocks from after the payroll data to 10 February, with cyclicals like consumer discretionary and communication services down 5.3% and 8.7%, respectively.

Such swings reflect the fact that the inflection points we anticipate in inflation, monetary policy, and growth have not yet been reached. Investors should expect continued volatility for now due to uncertainty on several key issues:

The downward trajectory for inflation has become less clear following recent data revisions. US monthly consumer prices climbed in December, rather than falling, as was initially reported. While the 0.1% rise for the month was modest, it did represent a swing from a 0.1% decline in prices. In addition, data for November and October were revised higher, along with core inflation readings. Economists are also braced for mixed news from today's consumer price index release, with the consensus for a 0.4% rise in January. Core CPI is also expected to accelerate to 0.3% from 0.2% in December. Even such small moves in the wrong direction have the potential to add to worries about how far the Fed will need to go to bring down inflation.

Employment data continue to send mixed messages. Investors were encouraged yesterday by the New York Fed's survey of consumer expectations, which showed the largest drop on record in expectations for household income. This kindled hopes that salary demands may moderate—an important development given the Fed's focus on slowing wage growth. However, this contrasts with the December payroll data, which indicated the US added 517,000 net new jobs in January with unemployment falling to the lowest level since 1969. Job opening data also pointed to excess demand for workers, with 1.9 vacancies for every unemployed American, close to a record high. Such data raise the risk of sustained high wage growth and hence, stubbornly elevated inflation.

Technical support for a smooth rise in markets has faded. Many investors started 2023 with a light positioning in risk assets, reflecting concerns in prior months over the growth outlook for China and worries over the potential for energy shortages in Europe. The speed of the rally at the start of the year was partly due to a shift in positioning, as hedge funds covered shorts and added new longs. With investor positioning now more balanced, markets are more likely to be impacted by any bad economic news.

So, we continue to see near-term headwinds for markets with the potential for episodes of high volatility until investors have greater clarity about the economic outlook. Against that backdrop, we like strategies that provide exposure to equity market upside while adding downside protection. We incorporate a combination of defensive (consumer staples and healthcare), value, and income opportunities that should outperform in a high-inflation, slowing-growth environment, alongside select cyclicals that should perform well as and when markets start to anticipate the inflections.

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