



The past few months have demonstrated that markets move very fast when narratives change, and it's hard to win when you're not even in the game. (UBS)

Monitoring the ebbs and flows in markets

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When is bad economic news good news for the markets because it implies easier monetary policy and when is it bad because it means higher recession risk? There's no clear threshold to delineate the two states, and even if there was, it's a thin line between data that's bad enough to trigger a Fed response yet not so bad as to suggest that a recession is inevitable. That makes the "bad news is good news" assessment subjective, and easy for the markets to toggle between the two narratives based on only a few data points.

Such was the case last week, when disappointing retail sales, manufacturing surveys, and industrial production data led to chatter of "bad news is bad news", just as investors were embracing the soft-landing thesis.

It's never wise to overreact to a few new data points, especially when the data has been so noisy, with large month-to-month fluctuations and revisions. It's better to contextualize the data within big picture dynamics. On that basis, we make three observations.

First, US economic growth slowing to below the long-term trend (~2%) isn't surprising, it's the expected outcome of Fed policy. Nor should a few poor data points have much impact on recession expectations. In fact, by some estimates the negative growth impulse from tighter financial conditions will peak this quarter and then fade. That's helped by real incomes now rising because inflation is below wage growth. Moreover, growth data last week was not as bad as the headlines suggest. Unemployment claims fell to four-month lows, while seasonal adjustments to the retail sales data may have overstated the weakness. In short, the US economic outlook isn't any different today than it was a week ago.

Second, investors have become more concerned about slowing US growth at the same time that they've become comfortable, if not complacent, that inflation will fall rapidly. But recent trends in both could be [head-fakes](#). While a mild recession is our base case, growth may stabilize at a positive but below-trend level for this year, and that may keep

inflation at an unacceptably high level for the Fed, especially if labor market strength persists. Thus, a “good news is bad news” narrative could well emerge by 2Q.

Third, diverging growth across regions is becoming more evident, with the US economy likely to keep slowing, while China and Europe should start to improve in 1Q and 2Q, respectively. The boost to China from reopening is obvious, even if it will take a couple of months to show up in the data. Meanwhile, economic surprise indexes and manufacturing surveys (e.g., ZEW in Germany) are surging in Europe and falling in the US.

This thinking informed our latest [House View update](#), in which we gauged the status of inflection points for growth, inflation, and interest rates. The first two observations above allude to the fact that key US inflection points are not imminent, while the third point suggests that they’re closer in other major economies. The overall investment outlook has become more balanced, though still warrants cautious portfolio positioning, favoring defensive, value, and income opportunities, while selectively adding cyclical positions. This month we did the latter by adding preferences, consistent with the diverging regional trends, for commodities, EM equities, and EM USD sovereign bonds, and upgrading the EUR up to neutral from least preferred.

Not reflected in preference changes, but an important tactical asset allocation consideration is the economic outlook that’s being priced into Treasuries, and the influence of positioning and flows. The fall in Treasury yields this year indicates a market pricing for a recession and benign inflation. Falling yields have also gotten a tailwind from strong inflows into bonds as investors rebalance portfolios and seek carry trades to start the year. This leaves yields vulnerable to backing up once those flows abate and if growth and/or inflation are higher than expected. The implication is that we expect better entry points to add new long Treasury positions.

The bottom line: Investors are eagerly anticipating the key inflection points for central bank policy rates, growth, and inflation. But the paths to those points will likely entail narrative flip-flops between bad data being good versus bad news, and slowing growth versus sticky inflation being the bigger risk. Thus, markets should remain challenging to navigate, with ebbs and flows reminiscent of the past nine months, albeit with perhaps smaller amplitudes and shorter durations. Despite that, it’s important to stay invested and to selectively add exposure when attractive risk-reward opportunities arise. The past few months have demonstrated that markets move very fast when narratives change, and it’s hard to win when you’re not even in the game.

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