MEKETA
INVESTMENT GROUP

Four Themes We Are Watching in 2023

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Overview

Meketa is focused on four themes for 2023 that we believe will shape the markets' performance. Our themes are interconnected as markets and economies recover from the economic and inflationary shocks of the past two years. The pace of recovery may be uneven, and uncertainties remain regarding inflation, monetary policy, and underlying economic resiliency as the global economy tries to return to pre-pandemic trends. We anticipate that some of the key themes that drove markets in 2022, such as inflation, monetary policy, a strong US labor market, and China, will continue to have a meaningful role in 2023. We will also likely see the full economic impact of aggressive policy tightening on growth, with many investors fearing the potential of a recession. Although the economic impact of the global pandemic and the war in Ukraine may be moderating, they still have the power to deliver unexpected outcomes that may also influence markets. Before we review our four themes, we will set the stage by briefly reviewing 2022.

GLOBAL MACROECONOMIC INVESTMENT COMMITTEE
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2022: The year most did not expect

Expectations coming into 2022 were for inflation to be transitory, growth to fall slightly, and the Federal Reserve to raise interest rates to a level below 1% by year-end.[1] This clearly did not playout as expected, as inflation remained elevated, and the Federal Reserve raised interest rates at a pace last observed over forty years ago.[2]

The resulting impact on most investors' portfolios was painful. Traditional diversification in public markets crumbled as stocks and bonds declined in near unison. Last year was the worst year for US stocks[3] since 2008 and the worst year for US bonds in the history of the Bloomberg Aggregate index.[4] International investments similarly provided little diversification benefit. Only a few asset classes, such as cash and commodities, provided some protection for investors in public markets.

1 Source: Federal Reserve FOMC as of December 2021.

2 Source: Federal Reserve FOMC as of February 2023. In November 2021 while testifying in front of the US Senate Banking Committee, Chairman Powell stated that calling inflation transitory may no longer be appropriate.

3 Source: Bloomberg as of December 2022. The Russell 3000 index declined 19%.

4 Source: Ibid. The Bloomberg Aggregate index declined 13%. The index was launched in 1986 with data backfilled to 1973.

Theme 1: US monetary policy and inflation

The Fed's aggressive policy response appears to be paying off as headline inflation, after peaking at over 9% in June, has drifted down to 6.4% year-over-year through January of 2023.[5] An easing of supply chain issues from the pandemic has also contributed to a drop in the rate of inflation. Driving the decline in headline inflation was a fall in energy prices from their highs, ending the year near where they started. Weakening food prices and improvements in the used car market have also contributed to falling inflation. Stripping out the more volatile food and energy components, core CPI has also declined from its peak (5.7% versus 6.6%).[6] This represented the biggest increase over a 12-month period since the early 1980s[7]

5 Source: Bureau of Labor Statistics (BLS) as of February 14, 2023.

6 Source: Ibid.

7 Source: Bureau of Labor Statistics. See also Chairman Powell's press conference comments on February 1, 2023.

One area of particular concern that the Fed is focused on is so called "stickier" inflation areas, such as services, where prices continue to rise. About one-third of the components of the CPI basket are considered flexible-price goods, like food and energy.[8] These flexible-price goods tend to respond quickly to changing market conditions.

8 Source:Cleveland Federal Reserve, Economic Commentary, M. Bryan et al., "Are Some Prices in the CPI More Forward Looking Than Others? We Think So," May 2010.

However, the remaining two-thirds of components of the CPI basket are thought to be less responsive to market changes, and these make up the sticky-price inflation index (see Figure 1).[9] Sticky price inflation rose 6.7% year-on-year in January 2023.[10] The major components of sticky-price inflation include medical services, education, recreation, food away from home, public transportation, and rental costs for primary residences.[11] For example, rents for primary residence, which represent approximately 6% of the sticky-price basket, rose 7.9% from the year before.[12]

9 Source:Cleveland Federal Reserve, Economic Commentary, M. Bryan et al., "Are Some Prices in the CPI More Forward Looking Than Others? We Think So," May 2010.

10 Source: Atlanta Federal Reserve as of February 14, 2023. Annualized sticky-price inflation rose 6.3%. Sticky-price index is based on BLS monthly CPI data.

11 Source: Cleveland Federal Reserve, as of May 2010.

12 Source: Atlanta Federal Reserve as of February 14, 2023.

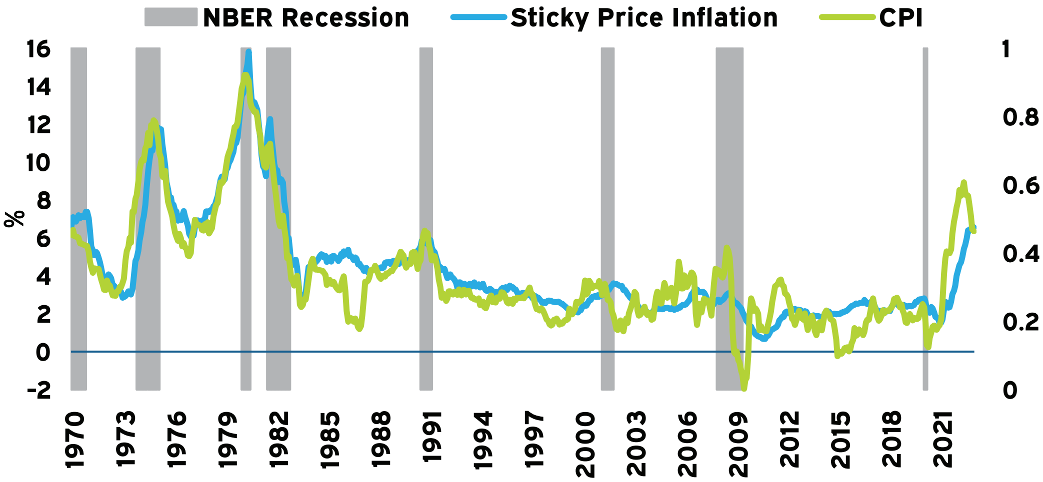

FIGURE 1

CPI and "Sticky" Price Inflation

Source: FRED as of February 15, 2023. The Atlanta Federal Reserve tracks Sticky-Price CPI as part of its real-time GDP estimator.

At the start of 2023, the difference in the Fed's guidance on future interest rates and what the market was pricing in had diverged significantly. The Fed expected a terminal rate (final and highest point in the rate hiking cycle) above 5% where the market coming into 2023 expected the terminal rate to be slightly under 5%. Given recent strong economic data, market expectations for the peak in rates have increased to over 5%.[13] One difference that remains for now between the Fed and market expectations is related to the path of rates after reaching their peak. The Fed expects to hold the rate at the terminal rate for some time.[14] They do not project cutting interest rates until 2024, at the earliest. At the start of 2023, the markets believed that the Fed would have to start cutting rates on slowing economic growth. But in February, the markets realigned their views to more closely match the Fed's more hawkish outlook.[15] In the coming months, if the US economy deteriorates into a recession with rising unemployment, the Fed (and the markets) may reconsider the current projected terminal interest rate target.

Recent market optimism based on expectations of an end to or even reversal of tightening policy has supported positive returns in US equity and bond markets. The fight against inflation may not be over, though, with levels still well above the Fed's 2% average target level. As shown in Figure 1, "sticky" price inflation – the prices that are most stubbornly resistant to higher interest rates – is well above the Fed's long-run average inflation target of 2%.[16] The strong labor market and hourly wages have so far defied the Fed's aggressive policy tightening and signal healthy consumer demand, which may keep prices rising, albeit at a slower rate than last year.

Theme 2: US recession risks and unemployment

One of the bright spots in the US has been the labor market (see Figure 2). The unemployment rate has returned to pre-pandemic levels, wages are up 5% year-over-year, and there are 1.7 jobs available for each person looking.[17] Although this is great for workers, an environment of low unemployment and high wages complicates the Fed's goal of bringing down inflation. At the February 1, 2023,

13 Source: Bloomberg Fed Fund Futures as of February 14, 2023.

14 Source: Bloomberg and Federal Reserve as of February 10, 2023. Interest rate futures did not align with the FOMC December 2022 interest rate outlook.

15 Source: Ibid.

16 Source: BLS and FRED. See Atlanta Federal Reserve https://www.atlantafed.org/research/inflationproject/stickyprice.

17 Source: BLS and FRED as of February 10, 2023.

press conference, Fed Chairman Jerome Powell recognized the need for higher interest rates and their potential costs:

> "Reducing inflation is likely to require a period of below-trend growth and some softening of labor market conditions. Restoring price stability is essential to set the stage for achieving maximum employment and stable prices over the longer run. The historical record cautions strongly against prematurely loosening policy. We will stay the course, until the job is done. To conclude, we understand that our actions affect communities, families, and businesses across the country."[18]

We have already started to see some layoffs, particularly in the technology sector.[19] This trend of layoffs will likely continue as companies prepare for one of the most anticipated recessions in the US in some time.

It is a difficult task for the Fed to increase interest rates to a level to reduce inflation back toward their average 2% target, but not push the economy into a significant recession.[20] Complicating this is that their policy moves have a delayed impact. This leads to them having to anticipate how much they need to tighten policy and pause to see how it flows through to the economy. This creates the potential for a policy error in either direction. Experts disagree on the impact of the Fed's inflation fighting rate hikes. Some argue that the Fed will be able to contain inflation and the economy will avoid a recession. Others believe we will not be able to avoid a recession, with the 'soft-landing' and 'hard landing' camps disagreeing on the severity and length of the recession that could follow the Fed's aggressive policy tightening schedule.

It is likely the US economy will continue to slow this year and potentially enter a recession. Questions remain though about the length and depth of the slowdown. With unemployment at historic lows (3.4%)[21] and consumers in a relatively healthy spot, it is likely that if we have a recession, it will be shallow and short-lived given that personal consumption expenditures comprise around seventy percent of US GDP.[22] Recent data regarding the labor market and retail sales appear to indicate that the aggressive policy tightening has failed to significantly weigh on consumers.[23] A strong labor market may make it more difficult for the Fed to tame inflation without triggering a recession.

[18] Source: Federal Reserve transcript of Chairman Powell's statement at press conference February 1, 2023.

[19] Source: Wall Street Journal as of February 20, 2023. https://www.wsj.com/articles/the-companies-conducting-layoffs-in-2023-heres-the-list-11673288386.

[20] Source: Federal Reserve and Chairman Powell's press conference transcript as of February 1, 2023 and FOMC economic projections as of December 2022.

[21] Source: BLS as of February 10, 2023.

[22] Source: Federal Reserve FOMC economic projections as of December 2022. FOMC projects modest rise in unemployment and slowdown in economic growth in line with a mild recession. FRED as of February 22, 2023.

[23] Source: BEA and BLS. Retail sales accelerated in January of 2023 related to higher gasoline prices. Initial jobless claims remained low.

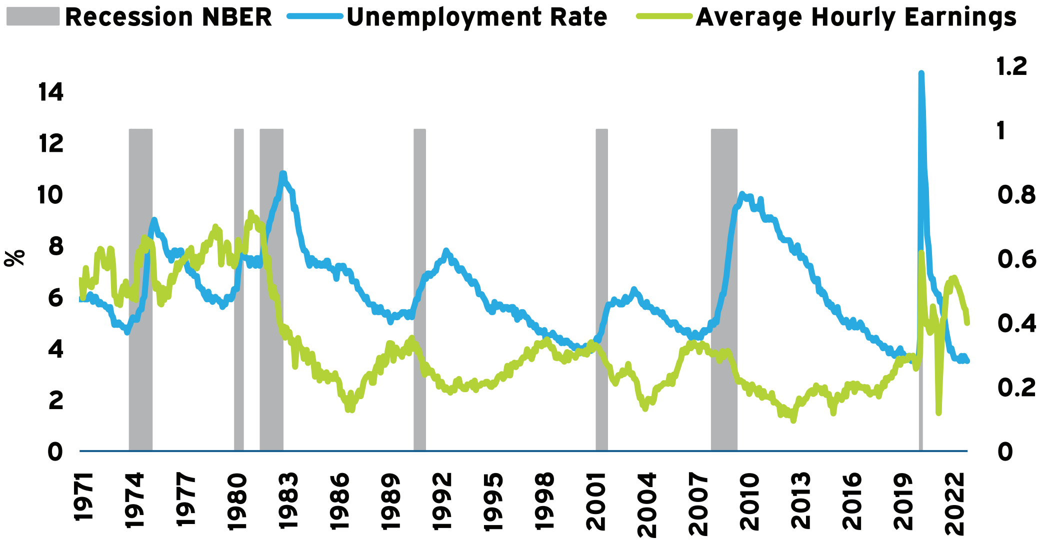

FIGURE 2

US Unemployment & Average Hourly Earnings (1971 – 2022)

Source: FRED data as of January 24, 2023. Average Hourly Earnings are non-seasonally adjusted wages of non-supervisory workers in the private sector.

Theme 3: The impacts of China reopening

China's COVID-zero policy and isolationism weighed heavily on domestic demand and production in 2022. Yet in a quick and unexpected turnabout, the Chinese Communist Party ("CCP") abruptly exited its zero-COVID policies in December. After several years of promoting self-sufficiency and nationalism, the CCP leadership seems anxious to attract foreign capital and unleash domestic demand to achieve 5% growth in 2023.

Like other countries who enjoyed a re-opening consumer boom, global markets anticipate that China's exit from zero-COVID lockdowns will experience a similar boost in growth and consumer spending, as evidenced by the rebound in Chinese markets since November (see Figure 3). However, it remains uncertain how China's reopening will impact global growth and inflation. The reopening could prove inflationary due to the potential to push up global prices for food, energy, and goods. Alternatively, China's reopening could prove disinflationary as the curtailment of lockdowns allows for increased industrial production and easing of supply chain pressures.

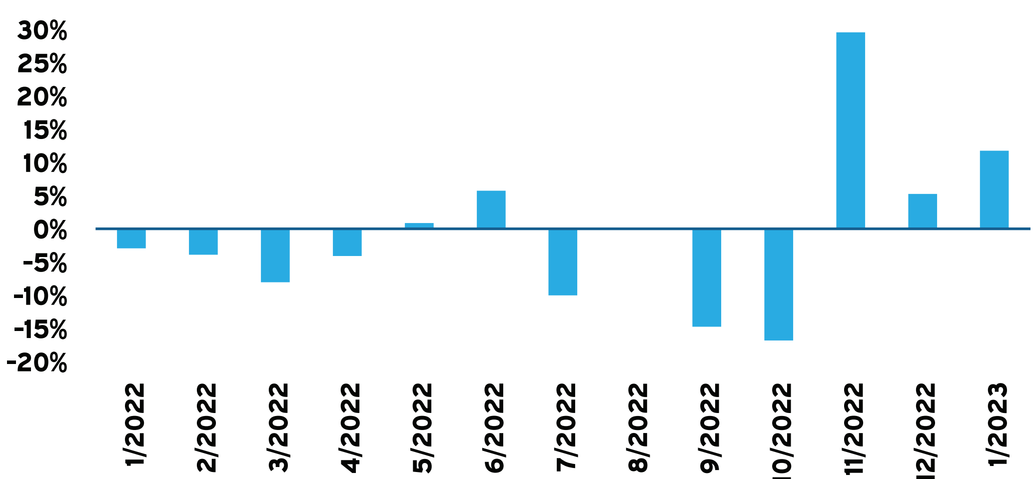

FIGURE 3

Monthly Returns for the MSCI China Index

Source: Bloomberg as of January 2023. The MSCI China index includes on-shore and off-shore listed Chinese stocks.

China's economic reacceleration should help support global growth in 2023. The degree to which China's re-opening benefits countries outside of China will depend on the orientation of the recovery as either internally or externally focused. If it is geared toward goods and services that are produced in China, the incremental global growth will largely accrue to China, whereas a recovery focused on external travel and consumption could have a supportive impact on foreign economies.

Theme 4: The potential for policy divergence and implications for the US dollar

Tight monetary policy has not been exclusive to the US, as inflationary pressures have been global. Major central banks like the European Central Bank ("ECB"), the Bank of England, and the Bank of Canada, have all been raising rates to bring down inflation. Some central banks have also been reducing their balance sheets, which grew substantially during the pandemic, to further tighten financial conditions.

Although many central banks have been tightening, the pace of tightening has varied significantly, with the US taking one of the most aggressive approaches. Last year the Fed increased rates eight times, including four consecutive 75 basis point hikes with rates ending the year at a range of 4.50%-4.75%.[24] The Federal Reserve has also started to reduce its balance sheet, which is having the equivalent tightening effect of the Fed Funds Rate being an additional 1% higher by some estimates.[25] Outside the US, many central banks have been less aggressive than the US. The ECB started raising rates later than the US and is at a lower rate level now, while the Bank of Japan has not changed rates despite recent hints that higher rates may be forthcoming. The Bank of China has focused on supporting growth, bank lending, and injecting liquidity into the troubled real estate sector via lower borrowing costs and capital adequacy ratios for banks and expanded credit allocation schemes.

These differences in monetary policy have implications for the US dollar. Demand for the dollar is driven by many things, including safe-haven flows, trade, perceived investment opportunities in the US, and, importantly, interest rates. If interest rates are higher in the US compared to other countries, investors will often sell their domestic bonds to fund the purchase of US bonds that are perceived to be at least as safe and that offer a higher yield. The greater demand for interest-bearing US assets increases the value of the US dollar.

[24] Source: Federal Reserve FOMC as of December 2022.

[25] Source: https://www.frbsf.org/economic-research/publications/economic-letter/2022/november/monetary-policy-stance-is-tighter-than-federal-funds-rate/

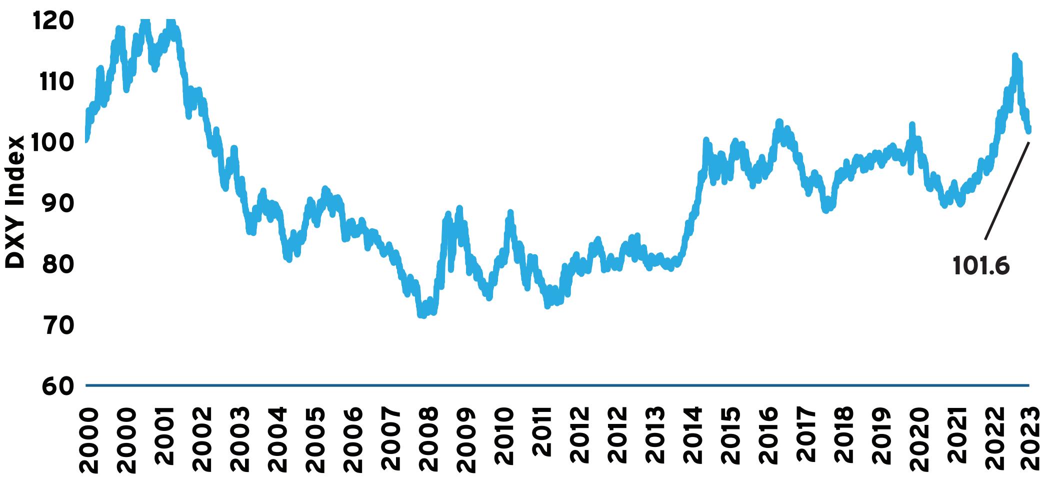

FIGURE 4

Bloomberg Trade-Weighted US Dollar Index

Source: Bloomberg as of February 14, 2023.

As shown in Figure 4, the US dollar had a very strong 2022, increasing by close to 28% from the start of the year to the peak in late September.[26] Obviously, the aggressive pace of policy tightening in the US contributed to demand for US bonds and the strength of the dollar in 2022. More recently, though, the dollar has weakened. Declining inflation in the US and corresponding expectations for the pace of policy tightening to slow and eventually end around the middle of this year have been key drivers of the weakness. If the Federal Reserve does continue to slow the pace of policy tightening and eventually stops while other central banks continue to tighten, there could be additional downward pressure on the US dollar. Outside the impact on foreign investments denominated in local currencies, a weaker dollar would also influence trade and add to inflationary pressures.

[26] Source: Bloomberg. The DYX index compares the dollar to a broad basket of foreign currencies.

Conclusion

As we move through 2023, we will be watching our four themes for clues on how global assets may respond. Central banks, particularly the US, have embarked on one of the most aggressive policy tightening campaigns in a long time to fight inflation. The impacts of monetary policy changes are lagged, making it challenging to manage a so-called “soft landing”. The Fed’s actions may be the largest determinant of whether one of the most anticipated US recessions materializes, and if so, how deep it will be. Despite the Fed’s aggressive policy tightening, labor markets and consumer demand domestically appear to be minimally affected thus far. The continued strength in the labor market and consumer demand will create challenges for the Fed in bringing down inflation.

Outside the US, China’s re-opening is thought to be a boon for the global economy, but experts warn that the benefit may be smaller than many investors hope. The recent weakness in the US dollar, after a very strong 2022, could continue if rates peak soon and growth slows here in the US, but stubbornly persistent inflation and an aggressive Fed could create continued support for the dollar. Outside these issues, lingering impacts of the pandemic and the war in Ukraine could persist into 2023, with unexpected outcomes for asset prices and portfolio returns. Overall, we expect 2023 to provide some clarity on key questions around the course of monetary policy, the path of inflation, and the track of economic growth.

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