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Multi-Asset Solutions
Weekly Commentary
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Highland Associates

Stocks: Upward Bias Ahead of Fed Speakers, Potentially Market-Moving Economic Data; The Calm Before The 'Storm?'

Domestic indices spent much of last week mired in a relatively narrow trading range as a combination of oversold conditions and increasingly bearish sentiment buoyed domestic equities amid a flurry of economic data. Ultimately, the S&P 500 and small-cap Russell 2000 index turned out weekly gains of 1.9% and 2%, respectively, after rallying into the close on Thursday and again on Friday. Last week's relative calm could be setting the broader market up for a sizable move in either direction over the near-term with potential upcoming catalysts for a breakout or breakdown including this Friday's February nonfarm payrolls report, next week's release of the February Consumer Price Index (CPI), and the upcoming FOMC meeting on March 21-22 which will include a potentially market moving update to the Committee's Summary of Economic Projections, or dot plot. Market participants might not have to wait too much longer for a meaningful move, but in which direction remains dependent upon the market's interpretation of the FOMC's likely response to forthcoming data on the inflation and labor fronts.

- The MSCI Emerging Markets (EM) index gained 1.6% on the week after a strong China Manufacturing PMI reading for February drove inflows into Chinese equities, propelling the MSCI China index to a 5.7% weekly gain. Notably, country indices tied to India, Mexico, South Korea, and Taiwan all turned out gains of 2.5% or more on the week, highlighting the broad-based nature of the rally.
- France, Germany, and Spain each posted 'hot' inflation readings for February early last week which ultimately translated into an upside surprise for the Eurozone Consumer Price Index (CPI) last Thursday. Year over year, headline Eurozone CPI rose 8.5% in February, besting the 8.2% estimate, but what is likely more worrisome for central bankers in the euro area is the record core CPI reading of 5.6% year over year which also topped the 5.3% estimate. Surprisingly, on the heels of the CPI release, euro area equities held up well on the week. 'Hotter' inflation data highlights the need for the European Central Bank (ECB) to remain vigilant and hike key policy rates more aggressively to loftier levels over coming months, but with euro area stocks rallying despite last week's 'hot' CPI release, there appear to be doubts surrounding the ECB's resolve to squash inflation after some mixed messages from some of the more vocal ECB policymakers of late.

Uncertainty on this front could continue to prop up the U.S. dollar relative to the euro over coming months, presenting a potential hurdle for U.S. equity prices while providing a boost for euro-area stocks on a relative basis.

- China's Manufacturing Purchasing Managers Index (PMI) for February was released last Wednesday and surprised to the upside with a reading of 52.6 vs. the expectation of 50.7, with a reading above 50 indicating that economic activity in the manufacturing segment of the economy was generally expanding. The 'hot' manufacturing PMI reading boosted Chinese equities with the Hang Seng in Hong Kong rising 4.2% on the day while putting upward pressure on prices of copper and steel, among other commodities, as market participants interpreted the PMI data as evidence that China's reopening was picking up steam and likely to increase demand for various commodities. While a boon for copper and steel prices, interestingly, China's reopening has so far failed to boost crude oil prices in a material way but last week's rally in West Texas Intermediate (WTI) and Brent crude oil could be the wake-up call needed for the commodity after weekly gains of 4.4% and 3.8, respectively.

On the topic of energy prices, we are entering into what has historically been a positive seasonal period for crude oil demand and prices of the underlying commodity as refiners require more product to prepare for an uptick in gasoline demand into the spring and summer months. WTI closed at $79.68 per barrel last Friday, above its 50-day MA of $77.60 while remaining entrenched in its YTD trading range between $73 and $81; however, a break above $81 could target the mid-$80's relatively quickly, a likely boon for energy-related equities tied more heavily to crude oil relative to natural gas.

Bonds: Global Lift in Yields Continues; ECB's Hand Likely Forced by Upside Surprises to Eurozone Inflation Data

Domestically, a weaker Manufacturing ISM report for February and a higher prices paid component prompted a lift in U.S. Treasury yields mid-week, but most of that yield move was reversed on Friday as the February Services ISM showed prices paid falling, a most welcome data point for bond investors concerned that the FOMC would need to be more aggressive in tightening monetary policy over the near-term in response to rising labor costs. After the 2-year Treasury yield touched 4.95% last Wednesday, a level last seen in June of 2007, it ended the week higher by 5 basis points at 4.83%. The 10-year Treasury yield closed above 4% for the first time since

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November on Wednesday but ended the week lower by just 5 basis points at 3.90% after investors stepped in to buy long bonds on the heels of the February Services ISM release. Corporate credit performed well on the week as the investment-grade Bloomberg Corporate index turned out a 0.4% gain while the Bloomberg U.S. High Yield index did a bit better, generating a 0.7% weekly return as investor risk appetite improved into the weekend.

- Short-term inflation break-even rates soared again last week with the 2-year inflation break-even rising to 3.32%, a level not seen since June of 2022 and a data point unlikely to be viewed positively by central bankers in the U.S. The bond market remains prone to overreaction in both directions over coming weeks as inflation and labor market data rolls in, but in our view current yields on long-term Treasury bonds are only now nearing fair value and could trend higher still.
- Last week's data releases forced Fed funds futures to push expected rate cuts out into 2024, catching up to where we believe they should have been all along, but whether the peak terminal rate is priced in remains to be seen as 'higher for longer' could evolve into 'much higher for much longer' if inflation data fails to cooperate.
- The February Services ISM reading of 55.1 on Friday topped the estimate of 54.5, pointing toward continued strong demand for services/labor. However, the more closely watched prices paid component garnered headlines as it fell to 65.6 from 67.8 in January, throwing cold water on the stagflation narrative making the rounds and forcing Treasury yields lower into the weekend.
- Global inflation trends dominated headlines this week with France, Germany, and Spain all registering inflation for February above expectations, setting the stage for Eurozone CPI coming in at 8.5% besting estimates of 8.3%. Core CPI accelerated year-over-year to 5.6% again topping expectations of 5.4% believed to provide cover for an increasingly hawkish European Central Bank (ECB). Market-based measures now anticipate two 50-basis point increases in the coming months with the ECB's key policy rate exceeding 4% by the end of 2023. The path taken by both the euro and U.S. dollar appears tethered to which regime can 'win' and styme inflation first, but with widely dispersed inflation expectations across EU bloc countries ranging from 5% to 15% we believe rumors of the U.S. dollar's demise and a resurgence of the euro are, for the moment, greatly exaggerated.

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What We're Watching:

- The Bureau of Labor Statistics releases the January Job Openings and Labor Turnover Survey (JOLTS) on Wednesday which is expected to show 10.7 million jobs open at month-end versus just north of 11 million in December.
- The U.S. Treasury is scheduled to auction $32 billion of 10-year Treasury notes on Wednesday and we will be monitoring demand from indirect bidders - primarily foreign central banks - and the percentage of the offering that dealers are forced to take down for any signs that demand for long-term Treasuries may be waning.
- Friday brings with it the release of February Nonfarm Payrolls expected to show 207,500 jobs were created during the month, down from 517,000 in the prior month, but a level still indicative of a healthy/tight labor market. The unemployment rate is expected to remain static month over month at 3.4% while average hourly earnings are expected to tick higher by 0.40% during February, up from a 0.30% increase the prior month.

Our most recent publication shares Highland's thoughts on the current economic environment and our in-house view on asset allocation.

Respectfully,

Highland Associates

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