WATCHING WAGES

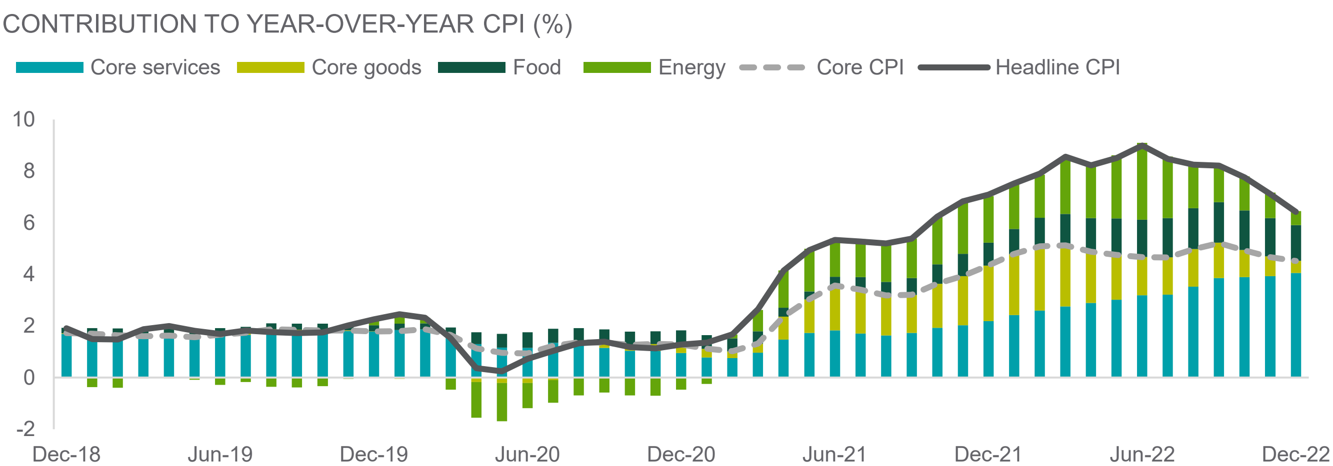
As inflation continues to moderate, attention has shifted to a narrower aspect of the price story – non-shelter services inflation. This component represents the aspect of inflation most closely tied to wage growth, and is proving the most resistant to central bank (particularly the Federal Reserve) taming. The labor market remains tight, with the most recent employment report in the U.S. displaying continued strength in hiring and a lower unemployment rate. Importantly, wage growth slowed and the prior month was revised lower – but remains elevated. We believe inflation will continue to decline over the course of 2023, but that labor market dynamics could prevent inflation from falling to levels that represent a declaration of victory for the Fed, representing a risk to financial market expectations. In the meantime, it should be expected that the Fed will continue to lean hawkishly to maintain credibility and keep long-term inflation expectations in check.

Internationally, the economic outlook appears incrementally better than the recent trajectory, reflecting a warmer winter bringing down energy costs in Europe and China ending its zero-Covid policy. We still see a recession as likely in Europe and higher than 50/50 odds in the U.S. as economies feel the full weight of central bank tightening to date. The forward-looking nature of the market suggests weakening economies in developed markets will be weighed against the sentiment benefits of declining inflation and pauses in monetary tightening likely in the first half of 2023. We agree with the market's pricing of a roughly 5% terminal rate for the Fed, while we see the European Central Bank (ECB) raising rates somewhat less than suggested in their surprisingly hawkish statement last month. China's economic reopening will very likely experience unevenness and setbacks, and secular headwinds remain considerable, but a 2023 recovery could move some long-term investor concerns to the back burner this year.

We reduced the size of our underweight to emerging market equities this month to reflect the upside economic opportunity associated with the winding down of China's zero-Covid policy. With our expectation that the weaker economic picture in the developed world will be balanced against improving sentiment, we are neutral developed market equities.

A NARROWED FOCUS

With many inflationary elements calming, the Fed and investors are now focused on core services.



Source: Northern Trust Asset Management, Bloomberg. Core excludes food and energy. Consumer Price Index (CPI) data from 12/31/2018 through 12/31/2022.

BASE CASE EXPECTATIONS

Fundamental Downside, Sentiment Upside

Developed markets will see weaker economic growth in 2023 from cumulative central bank tightening, but sentiment should start to shift more favorably on a “plateau” in policy rates and lower inflation. Outside of the U.S., China reopening and less elevated energy prices help the balance of risks.

Watching Inflation

Central banks have communicated a slowing in rate increases to a plateau in 1H23, preferring to hold a sufficiently tight policy rate as opposed to continuing to hike. This reduces the risk of a policy mistake, and recenters attention more specifically on the path of inflation to determine the duration of restrictive policy.

RISK CASE SCENARIOS

Labor Market Durability

More persistent tightness in the labor market leads to more stubborn core inflation, necessitating an unexpected monetary policy response that is negative for financial markets.

Eastern Threats

Ukraine war produces knock-on effects (food/energy shortages) that disrupt the global economy; China struggles to deal with (in order of importance) pandemic pressures, bad debt contagion and Taiwan tensions.

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