

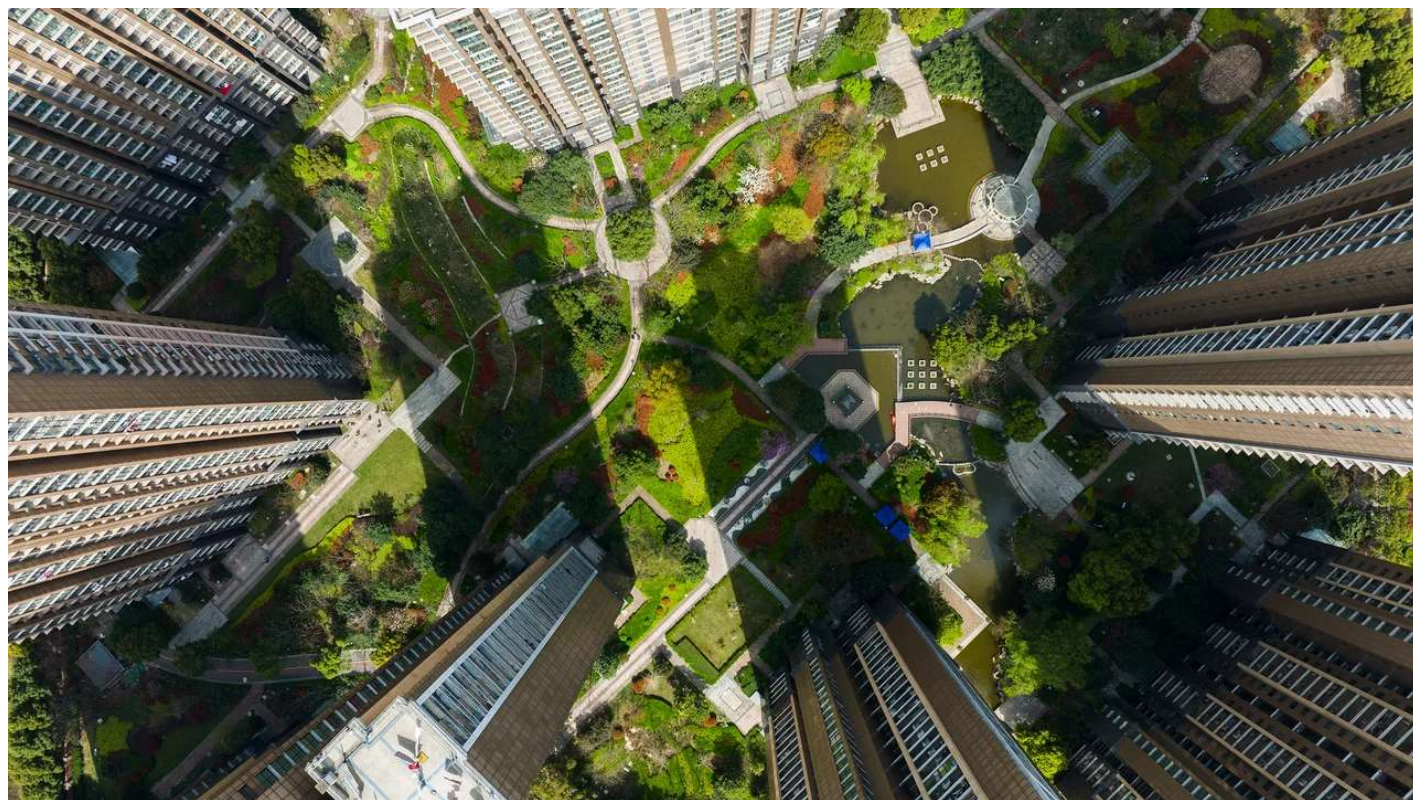
Global markets: What to watch in July

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Key takeaways

US inflation

Stubborn core inflation remains the key concern for the Federal Reserve. Unfortunately, relatively strong wage growth exacerbates that concern.

Chinese stimulus

We would not be surprised to see more monetary stimulus and some targeted fiscal stimulus in China, which could be a positive catalyst for Chinese equities.

European economy

With more rate hikes expected from the European Central Bank, we will want to see how resilient the eurozone economy can remain.

The second quarter has ended, and what a momentous period it was.

Bond yields rose in many countries, including in the US. US equities posted substantial gains as stress in regional banks eased. A relatively small cohort of technology stocks powered the US stock market rally despite rising yields, helped by excitement over artificial intelligence. Japanese equities also had a strong showing, fueled by optimism over the economy as well as very supportive monetary policy from the Bank of Japan. Canadian and European stocks posted relatively modest gains for the quarter, while Chinese markets lagged on disappointment over the strength of the re-opening.¹

But the question becomes: Where do we go from here? Following are a few things to watch in coming weeks that can help us navigate markets.

Will US inflation remain stubbornly high?

Consumer Price Index (CPI) data comes out in the US this week, and all eyes will be on core CPI (which excludes food and energy prices). Stubborn core inflation remains the key concern for the Federal Reserve (Fed). Unfortunately, relatively strong wage growth exacerbates that concern.

Markets will place outsized importance on the CPI given its proximity to the next Fed meeting, and it could send stocks higher or lower depending on whether it exceeds expectations. However, I think we need to take a step back and look at the bigger picture. While the most recent US employment situation report showed higher-than-expected average hourly earnings in June, wage growth has moderated in the past year and is likely to ease further given the cooling of job creation. In addition, other data is showing indications that services inflationary pressure is moderating. The ISM Survey for June showed that, within the Services Purchasing Managers' Index, the Prices Paid sub-index fell further to 54.1, from 56.2 in May.² Core inflation has eased in the past year, and I believe will substantially moderate further.

As I have said before, the disinflationary process will be imperfect and sometimes disappointing -- but it is definitely underway. Unfortunately, that reality may not be enough to keep the Fed on pause in July. We will have to see.

Will the Fed hike rates or hold tight in July?

All eyes are on the Federal Open Market Committee (FOMC) and what it will do on July 26, with most assuming there will be a rate hike. I continue to hold out hope that the Fed will be more measured and cautious and sit on its hands at the July meeting, especially given that the most recent surveys of consumers (both from the University of Michigan and the New York Fed) show that near-term inflation expectations have fallen significantly, and longer-term inflation expectations are well-anchored. In addition, the minutes from the June FOMC meeting showed that most FOMC members said that leaving

the rate unchanged would allow them more time to assess the economy's progress toward the committee's goals of maximum employment and price stability. I hope they will still hold that perspective at the July meeting given that there hasn't been much data to assess in between the two meetings.

However, I must admit I was alarmed by statements made by Dallas Fed President Lorie Logan last week. She said that "Some people say a lot of further cooling is in store from lagged consequences of the rate increases the FOMC has already made over the past year and a half" but that she is "skeptical about the potential for large additional effects from this channel."³

I respectfully disagree. There is a significant lag between monetary policy decisions and their impact on the real economy, and I believe that today, much of the impact on the US economy has not yet appeared. I can only hope that few FOMC members share Ms. Logan's view and that they proceed cautiously, knowing that more economic damage will appear from tightening that has already occurred.

How might the European economy react to further rate hikes?

Last week's PMI surveys showed a continued deceleration in the eurozone economy. Composite PMI fell to 49.9 in June from 52.8 in May. Manufacturing PMI was 43.4, a 37-month low. Services PMI was 52.0 — still in expansion territory, but a significant drop from 55.1 in May.⁴ With more rate hikes expected from the European Central Bank — ECB President Christine Lagarde continued last week with her mantra that there is more work to be done — we will want to see how resilient the eurozone economy can remain.

The key challenge for the ECB and for investors will be to figure out how to handle a lopsided economy with a strong services sector but a weakening manufacturing sector. Europe's big economies — especially Germany, but also Italy and France — are major goods exporters. Their growth is that much more exposed to global goods demand, including in China, than the US or UK, for example. On balance, we continue to think the ECB will continue with hawkish hikes and that services will continue to buoy up the eurozone economy for the time being.

What about the UK?

While the both the US and eurozone are experiencing slowing growth, elevated inflation and tight labor markets, the UK may be the most perplexing story among major Western economies. Most everyone has been bearish on UK growth for a long time, yet growth and inflation are both proving much stronger than could have reasonably been expected.

The UK seems to have extremely strong labor demand like the US, shortages in labor supply especially for the tourism/leisure/hospitality sectors (probably due to Brexit), as well as strong food inflation and core inflation. The Bank of England probably has far more work to do than other major central banks. This is likely to be more positive for sterling than UK gilts or other fixed income or equities. The UK example makes the case for paying more attention to country macro stories and becoming more selective in asset allocation across different countries, as their macro stories and cycles become quite differentiated.

Could additional Chinese stimulus help boost stocks?

China's private Caixin PMI Survey for June showed Manufacturing PMI at 50.5 and Services PMI at 53.9, down from 57.1 in May.⁵ While both are technically in expansion territory, growth has clearly moderated. Plus, inflation is very low, with some indications even of deflationary pressure. We would not be surprised to see more monetary stimulus from the People's Bank of China as well as some targeted fiscal stimulus. This could be a positive catalyst for Chinese equities, which have been under pressure in recent months.

How much longer can the Bank of Japan keep rates steady?

Japanese equities have been strong performers this year, helped by a very accommodative central bank. The question becomes how much longer this can last. I suspect it can continue to hold off on rate increases given that medium-term inflation expectations remain well-anchored. However, the Bank of Japan (BOJ) meets in late July, which will provide us with more insight into what it plans to do under the new leadership of Kazuo Ueda, who took the helm only months ago as the bank's first new governor in 10 years. While inflation has clearly been rising, along with wages, there's still a good chance that the BOJ will remain the most dovish of the major central banks as it seeks to ensure that this is not yet another false dawn of inflation in Japan.

What will earnings season tell us?

The second quarter earnings cycle begins late this week as banks start to report. Many tech companies report later in July. Consensus is for an earnings decline of 7.2% for S&P 500 earnings per share for the quarter; as of March 31, earnings were only expected to decline 4.7% for the second quarter.⁶ We are likely to see a compression in margins this quarter.

European forecasts have fallen in recent months but are anticipating a smaller earnings contraction than in the US. As always, my focus will be on the earnings calls and the forward guidance provided for the back half of this year.

What is important to keep in mind is that earnings typically decline at this point in the cycle, but the countervailing force supporting stocks is lower yields, which typically drive price-to-earnings multiple expansion.

What could individual investor sentiment mean for stocks?

The AAI Investor Sentiment Survey, which is typically viewed as a contrarian indicator, shows bullish sentiment at 46.39%, its highest level since November 2021.⁷ Typically peaks and troughs in bullish sentiment have closely coincided with market troughs and peaks. For example, bullish sentiment hit 19.22% in March — a low for the calendar year — coincided with the start of a strong rally.⁸ The current high bullish sentiment suggests that tactical investors may consider being cautious in the near term given sentiment is becoming frothy.

Conclusion

I liken the current environment for Western developed economies to an anemic, job-full slowdown — not dissimilar to the anemic, jobless recovery after the global financial crisis. There will likely be twists and turns as inflation moderates and growth slows, and we will want to pay close attention to developments.

We favor remaining well-diversified across equities, fixed income and alternatives, as well as being well-diversified across geographies as economic cycles become more differentiated.

With contributions from Arnab Das

ⓧ **Footnotes**

1 Source: MSCI, based on the MSCI USA Index, MSCI Europe Index, MSCI Canada Index, MSCI China Index, MSCI Japan Index, and MSCI United Kingdom Index as of June 30, 2023.

2 Source: Institute for Supply Management, as of July 6, 2023

3 Source: Dallas Fed, speech transcript, July 6, 2023

4 Source: S&P Global HCOB PMI Survey, as of July 3, 2023, and July 5, 2023

5 Source: Caixin Global, as of July 5, 2023

6 Source: FactSet Earnings Insight, as of July 7, 2023

7 Source: American Association of Individual Investors, as of July 5, 2023

8 Source: Bloomberg. The S&P 500 Index rose from 3891 for the week of March 16 to 4446 the week of Jul 6.

 Collapse

Important information

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Header image: Hildegard / Getty

Some references are US centric and may not apply to Canada.

Past performance is not a guarantee of future results.

This does not constitute a recommendation of any investment strategy or product for a particular investor. Investors should consult a financial professional before making any investment decisions.

All investing involves risk, including the risk of loss.

Diversification does not guarantee a profit or eliminate the risk of loss.

In general, stock values fluctuate, sometimes widely, in response to activities specific to the company as well as general market, economic and political conditions.

The risks of investing in securities of foreign issuers, including emerging market issuers, can include fluctuations in foreign currencies, political and economic instability, and foreign taxation issues.

Investments in companies located or operating in Greater China are subject to the following risks: nationalization, expropriation, or confiscation of property, difficulty in obtaining and/or enforcing judgments, alteration or discontinuation of economic reforms, military conflicts, and China's dependency on the economies of other Asian countries, many of which are developing countries.

Many products and services offered in technology-related industries are subject to rapid obsolescence, which may lower the value of the issuers.

Fixed-income investments are subject to credit risk of the issuer and the effects of changing interest rates. Interest rate risk refers to the risk that bond prices generally fall as interest rates rise and vice versa. An issuer may be unable to meet interest and/or principal payments, thereby causing its instruments to decrease in value and lowering the issuer's credit rating.

Alternative products typically hold more non-traditional investments and employ more complex trading strategies, including hedging and leveraging through derivatives, short selling and opportunistic strategies that change with

market conditions. Investors considering alternatives should be aware of their unique characteristics and additional risks from the strategies they use. Like all investments, performance will fluctuate. You can lose money.

The American Association of Individual Investor's AAI Sentiment Survey offers insight into the opinions of individual investors by asking them their thoughts on where the market is heading in the next six months.

The Consumer Price Index (CPI) measures change in consumer prices as determined by the US Bureau of Labor Statistics.

Purchasing Managers' Indexes are based on monthly surveys of companies worldwide, and gauge business conditions within the manufacturing and services sectors. The Prices Paid sub-index of the ISM Services PMI tracks changes in the prices paid by services industries for various raw materials and goods.

The Federal Open Market Committee (FOMC) is a 12-member committee of the Federal Reserve Board that meets regularly to set monetary policy, including the interest rates that are charged to banks.

The MSCI Canada Index measures the performance of the large- and mid-cap segments of the Canadian market.

The MSCI China Index captures large- and mid-cap representation across China H shares, B shares, Red chips, P chips and foreign listings (e.g. ADRs).

The MSCI Europe Index captures large and mid-cap representation across 15 developed markets countries in Europe.

The MSCI Japan Index measures the performance of the large- and mid-cap segments of the Japanese market.

The MSCI United Kingdom Index is designed to measure the performance of the large- and mid-cap segments of the UK market.

The MSCI USA Index measures the performance of the large- and mid-cap segments of the US market.

An investment cannot be made directly in an index.

UK gilts are bonds issued by the British government.

The opinions referenced above are those of the author as of July 10, 2023. These comments should not be construed as recommendations, but as an illustration of broader themes. Forward-looking statements are not guarantees of future results. They involve risks, uncertainties and assumptions; there can be no assurance that actual results will not differ materially from expectations.

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