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Global Markets Monthly Update

February 2023

KEY INSIGHTS

- Major equity markets were mixed in February, as investors weighed growth hopes against inflation concerns, while bond prices fell globally.
- Japanese inflation reached a 41-year high, driven by rising import prices.
- Rising tensions with the U.S. weighed on Chinese equities, due in part to the U.S. military's shoot-down of a suspected spy balloon.

HIGHLIGHTED REGIONS

- U.S.
- Europe
- Japan
- China
- Other Key Markets

U.S.

Stocks Give Up Some January Gains on Inflation Concerns

The major indexes pulled back in February, with the S&P 500 Index surrendering roughly half of its January gain, as investors reacted to some signs of reaccelerating inflation. Energy shares performed worst within the index, falling over 7% in total return (including dividends) terms, while information technology stocks managed a small positive return thanks to a solid rise in chipmaker NVIDIA and resilience in tech giants Apple and Microsoft (each of which accounts for roughly one-fifth of the index's market capitalization).

Inflation worries also weighed on the bond market, pushing the yield on the benchmark 10-year U.S. Treasury note from 3.52% to 3.92%. (Bond prices and yields move in opposite directions.) Corporate issues underperformed as equity prices fell and investors grew more averse to risk.

Job Gains Remain Robust as Unemployment Falls to 54-Year Low

The month brought several upside economic surprises, suggesting both that the U.S. might skirt a recession in 2023 and that the Federal Reserve had more to do in slowing growth to cool inflation. At the start of the month, the Labor Department reported that employers added 517,000 non-farm jobs in January, roughly triple consensus estimates and the biggest gain in six months. The unemployment rate slipped to 3.4%, its lowest level since 1969. A measure of services sector activity also jumped back into expansion territory after indicating the beginnings of a slowdown in December. Investors seemed to take the news in stride, despite Fed Chair Jerome Powell's repeated concerns about the tight job market's role in sustaining inflation pressures.

Stocks began a persistent downward slide at mid-month, however, as data suggested that the rebound in economic activity was resulting in a similar recoil in inflationary pressures. Stocks fell sharply on news that the producer price index rose 0.7% in January, its biggest gain since June, while core (less food and energy) producer prices rose 0.5%, the most since May. A rapid drop in producer price inflation had suggested that a further cooling was in the pipeline for consumers, which January's data seemed to throw into question.

Fed's Favored Inflation Gauge Records First Increase Since September

Asset prices continued lower to end the month on news that the Commerce Department's core personal consumption expenditures (PCE) price index had jumped 0.6% in January, its biggest rise since August. December's figure was also revised higher, pushing the year-over-year increase—widely considered to be the Federal Reserve's preferred inflation gauge—from 4.6% to 4.7%, the first pickup in pace since September.

Investors also appeared unsettled that personal spending rose a solid 1.8% in

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January, the biggest increase in nearly two years, while retail sales jumped 3.0%, the biggest increase in 10 months. In an interview with Yahoo! Finance, T. Rowe Price Chief U.S. Economist Blerina Uruçi highlighted the importance of the strength in goods spending given the widespread expectation that reducing services inflation (heavily driven by shelter costs) is the main challenge moving forward. Spending at department stores jumped 17.5% in January, which she acknowledges may have been due to consumers having waited for post-holiday sales.

Europe

In local currency terms, shares in Europe extended their winning streak into February on an improving economic outlook and China's economy reopening after the government relaxed policies designed to curb the spread of COVID-19. For a time, stocks received a lift on hopes that interest rates were peaking. However, strong signals from central banks that rates would stay higher for longer took some of the steam out of the rally. The MSCI Europe Index finished lower in U.S. dollar terms. Major indexes in Italy and the UK gained ground.

ECB Signals March Rate Hike

The European Central Bank (ECB) raised its key deposit rate by half a percentage point to 2.5%—the highest level since 2008—and indicated that it expects a similar increase in March due to inflationary pressures. The ECB added that it "will then evaluate the subsequent path of its monetary policy," with "future decisions continuing to be data-dependent and following a meeting-by-meeting approach." Several policymakers periodically warned against complacency over the rest of the month, calling for more rate increases after March.

Slower Eurozone Headline Inflation Confirmed; Economy Unexpectedly Grows

Revised data showed eurozone inflation eased in January to an annual rate of 8.6%. This was only marginally higher than the initial estimate, even after delayed data showed that consumer price growth remained elevated in Germany. However, the core inflation rate—which excludes fuel and food prices—accelerated to 5.3% from the 5.2% registered in December. Separately, the economy unexpectedly grew 0.1% in the final quarter of 2022 and employment rose to a record high, which could exacerbate ECB worries about second-round effects on inflation.

BoE Hints Rates May Have Peaked; Inflation Slows for Third Month

Bank of England (BoE) policymakers voted 7 to 2 to raise the key interest rate by half a percentage point to 4%. Officials dropped a commitment to continue increasing rates "forcefully." The BoE said that "the risks to inflation are skewed significantly to the upside" and warned that "if there were to be evidence of more persistent pressures, then further tightening in monetary policy would be required."

The BoE also said a UK recession was likely to be "much shallower" than forecast in November, largely due to a drop in energy prices. But the International Monetary Fund projected that the UK economy would contract 0.5% this year.

UK Inflation Slows; Economy Dodges Recession

Official data showed annualized consumer price growth fell for a third consecutive month in January, hitting 10.1%. Easing services and fuel costs helped, although unemployment remained just off an all-time low of 3.7%, and pay, excluding bonuses, rose by 6.7% in the three months through December. The economy also avoided a recession at the end of last year. Despite a sharp drop in output in December, the overall gross domestic product (GDP) was flat for the final quarter.

Japan

Japanese equities generated a modest positive return in February, with the MSCI Japan Index up 0.73% in local currency terms. Speculation about the Bank of Japan's (BoJ's) future monetary policy trajectory continued as it was announced that surprise nominee Kazuo Ueda was set to become the next BoJ governor in April. On the economic data front, Japan's core consumer price inflation reached its highest level in over 41 years in January, while the economy rebounded by less than expected over the final quarter of 2022.

Against this backdrop, the yield on the 10-year Japanese government bond hovered around the 0.50% level at which the BoJ caps yields. The yen weakened to about JPY 136.15 against the U.S. dollar, from approximately JPY 130.10 at the end of January, mainly on expectations that there would be no change to the BoJ's ultraloose monetary policy stance in the short term.

Incoming BoJ Governor Indicates Policy Continuity Likely in Short Term

The government presented to parliament Kazuo Ueda, an economist and former member of the BoJ Board, as its nominee for Japan's central bank's next governor, and Ryozo Himino and Shinichi Uchida as deputy governors. Himino is a former commissioner of the Financial Services Agency and Uchida is an executive director at the BoJ.

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In a hearing in the lower house of parliament, Ueda adopted a largely dovish tone, emphasizing monetary policy continuity but also acknowledging that current policy had side effects. He said that it will take time for the BoJ to achieve its 2% target in a sustainable and stable manner and, given the current economic and price situation as well as the outlook, it is appropriate to continue with monetary easing. However, when the BoJ's inflation target is realized, the central bank will be able to take steps to normalize monetary policy. Without going into specifics, Ueda hinted at various possibilities for the future of the BoJ's yield curve control framework, while emphasizing that the outlook for underlying prices will determine whether it is reviewed in the direction of normalization.

Ueda asserted that the main reason for the rate of increase in consumer prices—Japan's core consumer price index rose 4.2% year-on-year in January, its biggest gain in over 41 years—is cost-driven inflation due to rising import prices and not due to strong demand. He emphasized the need to focus on a variety of factors, including wage growth, to determine underlying price trends.

Economy Rebounded by Less Than Expected in the Final Quarter of 2022

GDP expanded 0.6% quarter-on-quarter on an annualized basis in the three months to the end of December 2022, below consensus expectations and following a contraction in the third quarter. Private consumption was the main driver of growth, primarily due to the lifting of tough border controls in October, while accelerating government spending and positive net trade also provided a boost. Business investment contracted, serving as a drag on growth.

China

Chinese equities retreated in February after a three-month rally as rising geopolitical tensions and concerns about the strength of the country's recovery dampened sentiment. The MSCI China Index plummeted 10.4%, while the China A Onshore Index fell 4% in U.S. dollar terms. The yuan declined 2.6% versus the U.S. dollar after the Federal Reserve's preferred inflation gauges unexpectedly picked up in January, raising expectations that the Fed would keep raising interest rates for longer.

Deteriorating U.S.-China relations—a key factor driving currency swings—also weighed on the currency. Tensions with the U.S. rose after the U.S. military shot down a suspected Chinese spy balloon in U.S. airspace in early February, raising the prospect of further sanctions after the Biden administration announced a sweeping ban on U.S. companies selling advanced semiconductors and certain chip manufacturing equipment to China last October. U.S.-China relations will be a key market-moving policy catalyst in 2023, and the risks are skewed to the downside, believes T. Rowe Price's Washington/regulatory research analyst Michael Pinkerton. Possible U.S. measures targeting China in the next two years include outbound investment screening for Chinese investments and further export controls, according to Pinkerton.

In monetary policy developments, the People's Bank of China (PBOC) left its benchmark one-year and five-year loan prime rates unchanged for the sixth consecutive month, as expected. Many analysts expect that the PBOC will continue its accommodative stance to support the economy amid a sluggish property market, tumbling exports, and fragile consumer confidence.

In regulatory news, China's securities regulator published new rules to revive offshore initial product offerings following a regulatory freeze that began in July 2021. The rules grant oversight of variable interest entities, or shell companies commonly used by Chinese tech companies to bypass the government's restrictions on foreign investment in sensitive sectors, such as the internet industry. The new rules go into effect on March 31 and come as foreign investors are revisiting Chinese assets after Beijing dropped its zero-COVID stance in December.

Economic Data Point to Growth

China's consumer price index picked up 2.1% in January from a year ago, in line with estimates, while producer prices fell more than expected due to lower commodity costs. The inflation data showed that China isn't likely to experience heightened inflation similar to the U.S. and Europe and raised expectations that monetary policy would remain supportive.

The official manufacturing Purchasing Managers' Index (PMI) rose to 50.1 in January from December's 47.0 and marked a return to growth for the first time since September as domestic activity picked up. The nonmanufacturing PMI rose to a better-than-expected 54.4 from 41.6, reaching its highest reading since June.

Other Key Markets

Turkish Equities Climb Despite Tragedy of Earthquakes

Turkish stocks, as measured by MSCI, returned 5.76% for the month versus -6.48% for the MSCI Emerging Markets Index.

A massive earthquake with a magnitude of 7.8 on the Richter scale struck in the

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early morning hours of February 6, near the border between Turkey and Syria. The quake was followed by a number of aftershocks, as well as another powerful quake measuring 7.5 on the Richter scale.

As losses in terms of human life—more than 50,000 in both Turkey and Syria as of the end of the month—mounted, and as the extent of infrastructure damage became clearer, President Recep Tayyip Erdogan announced a week of mourning and requested international assistance. He also declared a three-month emergency in 10 provinces, and the stock market suspended trading for several days following a steep sell-off.

While the immediate economic effect is likely to be relatively limited in terms of economic growth, the widespread impact on human life and infrastructure will likely require large and extended logistical operations. Initial estimates suggest that the fiscal effect on government finances could see the budget deficit widening to 3% of GDP (from a 12-month rolling fiscal deficit of 1.2% of GDP currently) due to reconstruction-related expenditures.

Toward the end of the month, the Turkish central bank decided to reduce its key interest rate—the one-week repo auction rate—from 9.00% to 8.50%. In their post-meeting statement, central bank officials noted that the "impact of the earthquake on production, consumption, employment, and expectations is being extensively evaluated," but they anticipate that "it will not have a permanent impact on performance of the Turkish economy in the medium term."

Nevertheless, policymakers concluded that it has become "even more important to keep financial conditions supportive to preserve the growth momentum in industrial production and the positive trend in employment after the earthquake." They considered their 50-basis-point rate cut to be a "measured reduction" in interest rates and deemed it as being "adequate to support the necessary recovery in the aftermath of the earthquake." T. Rowe Price sovereign analyst Peter Botoucharov believes that macroeconomic policymaking, based on highly stimulative monetary policy, is unlikely to change ahead of the elections, which are still expected to take place in May or June.

Central Eastern European Markets Mixed

Major central eastern European markets were mixed in February but outperformed the broader MSCI Emerging Markets Index. As measured by MSCI, stocks in the Czech Republic gained 10.39% in U.S. dollar terms, while shares in Hungary returned -0.35%. Equities in Poland and Romania returned -4.39% and -2.10%, respectively.

According to T. Rowe Price credit analyst Ivan Morozov, the Czech Republic and Hungary are now in a technical recession defined by having two consecutive negative quarter-over-quarter GDP readings. On the other hand, growth in Poland turned negative in the fourth quarter after experiencing a strong third-quarter economic rebound, while Romania maintained a relatively solid positive growth rate.

Overall, Morozov believes that recent data confirm that the region is in a period of stagnation at best. The data are even more striking given recent upside surprises to economic growth in the eurozone. The key explanation, in his opinion, is a more aggressive degree of monetary tightening in central eastern Europe versus the eurozone. Recent GDP readings indicate that monetary policy tightening in central eastern Europe has been effective in slowing growth.

Morozov expects regional economies to remain weak until at least the second half of 2023, with perhaps only a marginal pickup in growth. More meaningful growth in the region will likely require monetary easing, which he believes central banks will eventually deliver—but not in the near term, as inflation remains elevated. In fact, year-over-year inflation in the Czech Republic (17.5%) and Hungary (25.7%) recently surprised to the upside, but inflation in Romania (15.1%) and Poland (17.2%) surprised to the downside while remaining high.

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Major Index Returns

Total returns unless noted

As of 2/28/2023 Figures shown in U.S. dollars	**Month**	**Year-to-Date**
U.S. Equity Indexes		
S&P 500	-2.44%	3.69%
Dow Jones Industrial Average	-3.94	-1.13
Nasdaq Composite (Principal Return)	-1.11	9.45
Russell Midcap	-2.43	5.68
Russell 2000	-1.69	7.89
Global/International Equity Indexes		
MSCI Europe	-0.61	8.03
MSCI Japan	-3.83	2.14
MSCI China	-10.37	0.18
MSCI Emerging Markets	-6.48	0.92
MSCI All Country World	-2.83	4.16
Bond Indexes		
Bloomberg U.S. Aggregate Bond	-2.59	0.41
Bloomberg Global Aggregate Ex-USD	-3.99	-0.65
Credit Suisse High Yield	-1.13	2.52
J.P. Morgan Emerging Markets Bond Global	-2.20	0.84

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Note: Returns are for the periods ended February 28, 2023. The returns include dividends and interest income based on data supplied by third-party provider RIMES and compiled by T. Rowe Price, except for the Nasdaq Composite Index, whose return is principal only.

Sources: Standard & Poor's, LSE Group, Bloomberg Index Services Limited, MSCI, Credit Suisse, Dow Jones, and J.P. Morgan (see Additional Disclosures).

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