

WATCHING AND WAITING

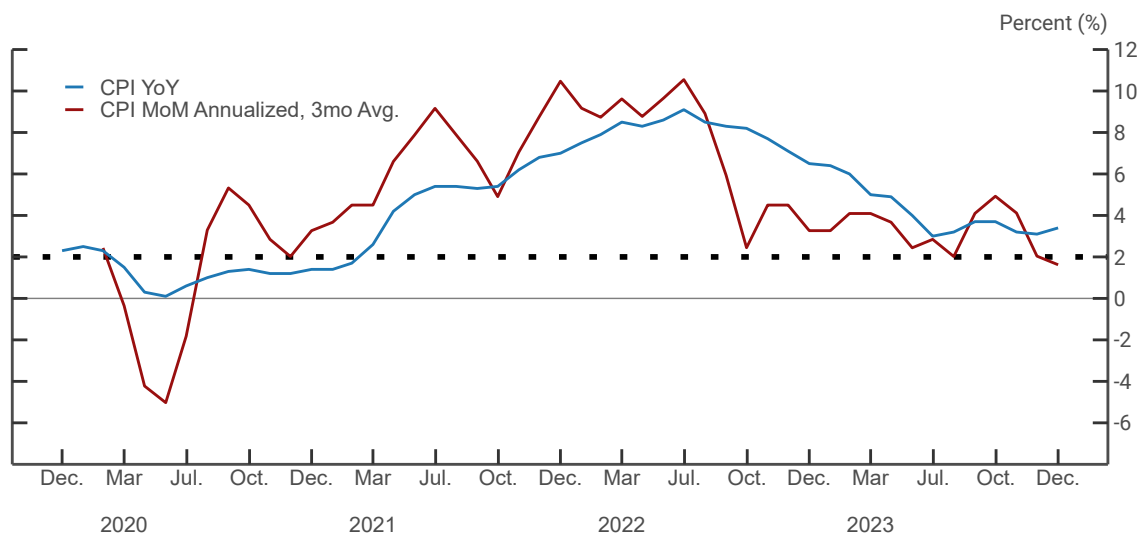
Markets celebrated already in December, anticipating early interest rate cuts from a more relaxed central bank. This month's data show why cuts may be more likely in the summer than in the spring.

First, we learned last week that the labor market stayed strong through the end of last year, calming fears that the economy might suddenly crack under the pressure of tight money. And now this week's consumer price inflation data – with headline and underlying prices rising in December by more than 3% on most measures – confirm that reaching the Federal Reserve's 2% price goal will still take time, despite impressive progress in 2023. Markets were essentially flat after Thursday's price release with the S&P 500 up 0.3% so far this year.

For investors, the year has started with confirmation that a hoped-for soft landing is clearly within sight, with a gradual slowdown in GDP growth more likely than the recession feared for much of last year. Indeed, the US economy is by many measures extraordinarily strong. Economists are puzzled as to why Americans, when polled, are so downbeat about their finances. The answer may lie outside the economy, in the extraordinary set of domestic and global tensions that look set to continue in 2024.

On the domestic front, a partial government shutdown later this month is already looming. A spending compromise between House and Senate leaders is under threat from hard-liners in the House who insist on lower spending

US CPI



Dotted line presents 2% inflation target.
Source: RockCreek, Bureau of Labor Statistics.

and a link to border security measures. As the US election primary season gets underway, divisions in the country are on stark display. The presumptive nominees of both major parties have now warned of a threat to democracy.

Internationally, conflicts in Europe and the Middle East have only intensified in January, with extensive Russian bombing of Ukrainian cities, continued Israeli fighting against Hamas in Gaza, and a rising threat to shipping lanes in the Red Sea from Iranian-backed Houthi rebels in Yemen. China-watchers note that a victory of the more independent-minded candidate in Taiwan's Presidential election this weekend is not expected to further unsettle the already tense relations between Taiwan and the mainland. But President Biden's decision to send a high-level albeit unofficial delegation to Taipei right after the election is likely to irritate China.

It is always difficult to price political risk. It may impact mood more than economic behavior. For that reason, the near-certainty of monetary policy easing across most major economies is likely to prove more important for investors, at least this year, although rate cuts may not begin until well past March. Lower US rates later this year could kick-start the housing market that has been near-frozen since the Fed began to tighten monetary policy.

EYES ON INFLATION - IS IT MORE DAMAGING THAN WE THINK?

The Fed signaled in December that it has begun to think about cutting rates. But the central bank will remain cautious. Chair Powell understands how pernicious inflation can be and how much people "hate it," as he commented last year. That dislike may be another factor in Americans' gloom about the economy.

On the face of it, the gloom is misplaced. US Consumer spending is still robust, defying expectations. Unemployment has stayed below 4% for nearly two years. In December, businesses continued to add to payroll at a faster rate than pre-pandemic. Data this week show that January began with new unemployment insurance claims at a lower-than-expected 202,000. And the booming labor market has been accompanied by a continued deceleration in inflation, from its mid-2022 peak. Wage gains at an average of 4.1% in the year to December finally exceeded consumer price increases of 3.4% over the same period.

But, as [discussed in an interesting Brookings panel this week](#), the average American may dislike the uncertainty introduced by changing inflation rates – and relative price shifts – more than they welcome the real wage increases that come if wages rise by somewhat more than prices. Higher mortgage rates are also a damper on sentiment, with the US housing market near frozen since the well-publicized run-up in mortgage rates as the Fed tightened policy. Some of this will likely unwind this year. However, buyers waiting for a return to the low rates of the 2010s are likely to be disappointed.

CENTRAL BANKS SHIFT?

Inflation is moving in the "right" direction in Europe and Japan, as well as in the US. But central banks have differing perspectives.

Take Japan first: the Bank of Japan has been trying for more than a decade to reverse deflation. It has now succeeded in getting price inflation firmly positive. So far wage growth has not caught up. Corporations have boosted profit margins, with a dramatic response from the stock market, as described below. But consumers are unhappy and reluctant to spend. BOJ is reluctant to allow interest rates to rise

prematurely, and curb inflation, although a relaxation of yield curve control (YCC) is likely in 2024.

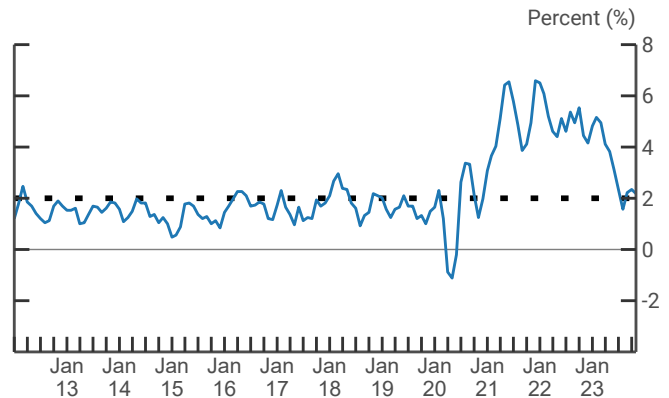
In both Europe and America, central banks remain concerned about inflation being too high rather than too low, although price increases have decelerated more rapidly than pessimists feared. In Europe, preliminary indications released this month show headline price increases dipping below 3% in December. The risk of over-tightening seems more imminent in Europe than in the US, given the marked weakness of the real economy. But look for a more cautious approach to easing from the European Central Bank (ECB) than the Fed. One possible game changer: if the German economy continues to weaken, the firm stance of Isabel Schnabel, the most hawkish member of the ECB Board, may soften.

RATES

At times when inflation is shifting, investors – and the Fed – look at a number of different measures, beyond the headline annual rate, to guide analysis and policy. Inflation expectations – while also tricky to measure with confidence – are also an important guide. While several inflation measures remain significantly above the 2% target, others, including producer prices which fell unexpectedly on Friday, may help to explain why markets seem more sanguine than the Fed, with an 80% probability that rate cuts will begin in March.

The three-month rolling average of annualized, MoM, Core PCE readings (a measure the Fed monitors closely) suggests that the war against inflation is essentially won. The five prior monthly readings of this measure have been 2.4% or less with one printing 1.6% and two more (including the most recent) registering 2.2%. While not yet down to the 2% target, it is hard

Core PCE MoM Annualized, 3mo rolling average



Dotted line presents 2% inflation target.
Source: RockCreek, Bureau of Labor Statistics.

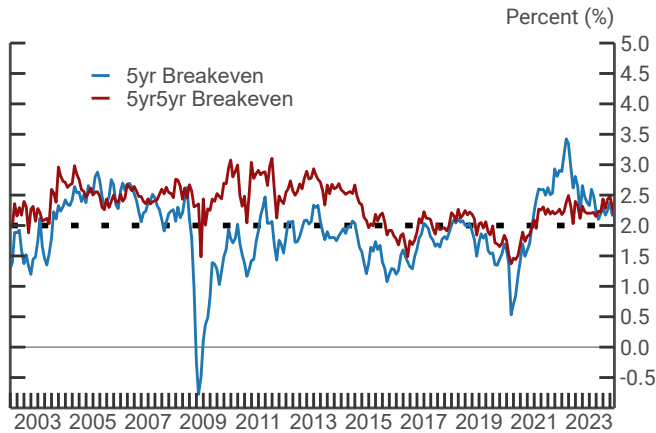
to see the Fed risking overtightening should this measure persist at around the 2.2% for a few more readings. This could explain why short-term interest rate markets are pricing more cuts, sooner, this year than the Fed's December dot plot suggests.

Arguably more important than what inflation has done, are market expectations for inflation. The NY Fed's survey of inflation expectations for December indicates that expectations for 1yr and 3yrs ahead are 3% and 2.6%, respectively. Both measures were 2.5% in December 2019, indicating a slight amount of uncertainty one year ahead (the peak one-year survey number was 6.8% in June 2022), but largely normal inflation in three years' time. A few market-based measures of medium to longer-term inflation have all converged to levels consistent with periods of historically calm volatility. 5yr and 5yr5yr breakeven inflation in the US have both settled in at 2.2%. These are in line with their expectations during normal periods of inflation and in from their 2022 peaks.

Logically, then, 10yr breakeven inflation is also centered around 2.2% as well, falling from a high of nearly 3% in April of 2022. Aggressive policy action from the Fed drove real 10yr rates

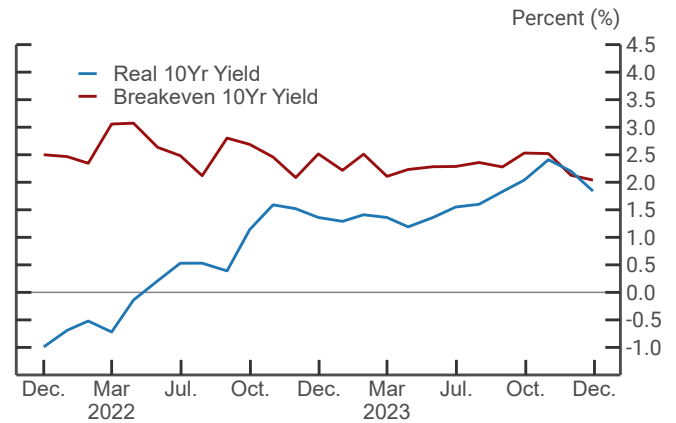


Breakeven inflation



Dotted line presents 2% inflation target.
Source: RockCreek, Bloomberg.

US 10Yr Real Rates and Breakeven Inflation



Source: RockCreek, Bloomberg.

higher over that period. Thus, the combination of rising real yields and falling breakeven inflation put downward pressure on risk assets which was easily observable in 2022. Since the end of 2022, breakeven inflation has been largely range-bound and stable, leaving moves in real yields to drive risk asset direction from a macro perspective. This was most apparent in the risk-on stock rally into year-end 2023 as real rates reversed all of their increase since early August.

EQUITIES

So far in 2024, the equity market narrative has largely been driven by a partial reversal of the year-end rally. Small caps have underperformed the S&P 500 by approximately four percentage points, after outpacing the large-cap index by more than ten percentage points in December. Most major equity indices are in the red so far in 2024 including Europe and Emerging Markets. While the S&P 500 has managed to eke out a modest gain of 0.3%, led by a 1.4% increase by the Magnificent 7, the standout winner so far in 2024 has been Japan. With the Topix rising nearly 5% in local terms (1.3% in USD).

In fact, Japanese equities have reached a 34-year high, but have yet to eclipse their high watermark set at the end of December 1989. Equities continued to be supported by investor optimism, and perhaps necessity, as the economy continues to climb out of a decades-long bout with deflation. The BOJ is the only major central bank actively keeping rates accommodative and thus domestic savers are looking for more returns, while international investors find the low real yields attractive for equities.

Despite their significant gains in December, small-caps still look attractively valued – and it's not just a US phenomenon. Interestingly, the MSCI World Small Cap index now trades at a forward PE of 12.3x, a discount to the broader index's 17.3x, and its own longer-term average of 15.9x. Perhaps most interestingly here is that not only are small caps cheap on their own valuations, but their cheapness to the broader index has not been the historical norm, with smaller caps throughout history exhibiting a premium to large caps.

BITCOIN

On Wednesday, January 11th, the US SEC approved ETFs to track Bitcoin. The regulator approved 11 applications including ones from BlackRock, Ark Investments & 21Shares, Fidelity, Invesco, and VanEck. In their first day of trading the iShares tracking ETF traded over \$1 billion while Grayscale Bitcoin Trust traded \$2 billion in value. Despite this initial enthusiasm it remains to be seen if this watershed moment will provide enough comfort for institutions to fully embrace the asset class.

