EVERYTHING IS RELATIVE

January's inflation data for the U.S. disappointed markets, at least at first. Instead of dipping below 3%, the headline number for consumer prices came in just above at 3.1%. This followed a stronger than expected labor market report for January, with a seasonally adjusted jump in payrolls that was twice as big as predicted. Could an overheated economy stall progress on inflation and delay central bank cuts in interest rates?

By the end of the week, with a disappointing report on producer prices on Friday, markets were struggling for direction. Stocks and bonds recouped some of their losses from mid-week, but still finished down as markets pulled back from hopes of an early rate cut from the Federal Reserve.

The Fed was never likely to cut interest rates in March. The path to price stability is still too uncertain. In large part, that is because shifting relative prices make predictions harder than usual. After consideration, investors seem to have decided that the inflation reports were disappointing relative to expectations, rather than in themselves. Treasury Secretary Janet Yellen commented in Detroit mid-week that "the trend here is that inflation is moving decisively down". She called focus on "minor fluctuations" a "tremendous mistake".

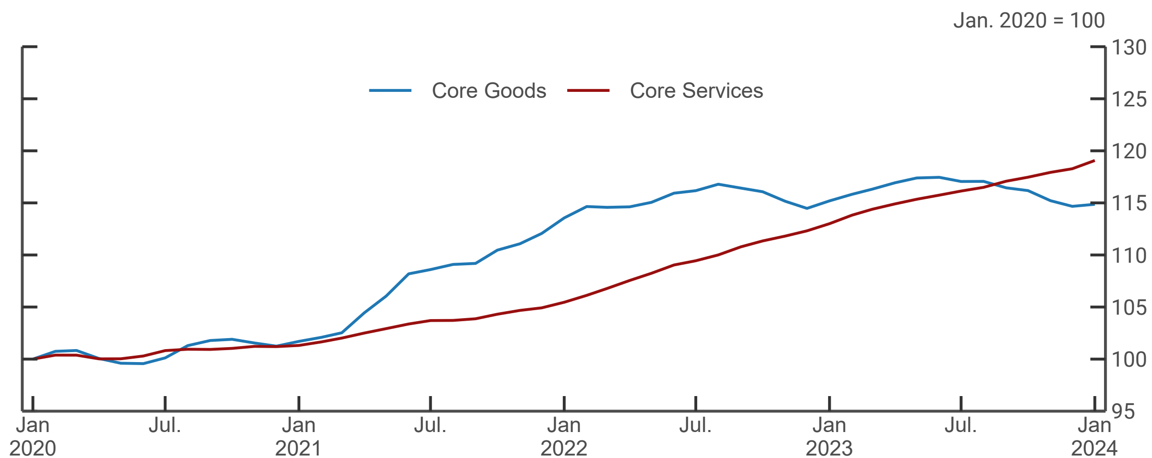
The rapidly changing mood in markets reflects the difficulty in this monetary cycle for investors and central bankers alike in gauging underlying inflation – and thus interest rates. The Federal Reserve has long made clear that it wants to return inflation to the 2% goal. But that number is an average, as always, of price changes across sectors in the economy. And during the pandemic lockdown and reopening, there have been enormous shifts in relative prices. This has complicated assessments of inflation trends and bedeviled predictions of when the Fed and other central banks will move interest rates.

THREE THEMES FOR INVESTORS

Timing of interest rate cuts is one of three themes that RockCreek has highlighted for 2024. Political and geopolitical developments and prospects for growth are also important for investors to watch. With debilitating and devastating wars in Europe and the Middle East, geopolitical tensions are as high as ever. Markets may seem strangely disconnected. One reason is that energy prices – often a marker of global concerns and a conduit to economic dislocations – have remained muted. With the U.S. now a major oil and gas producer and exporter, markets are less fearful of supply disruptions. Moreover, slowing global growth, including the spill over from China's muted recovery, is dampening demand for oil and other commodities.

UNDERSTANDING INFLATION

Since the inflationary surge began in 2021, analysts have sliced the data many different ways – sometimes excluding different items where price pressures seemed unusual and perhaps transitory, sometimes cross-checking against other measures such as wage and



Source: RockCreek, Bloomberg.

earnings growth, and sometimes comparing changes over just a month, with three- or six-month movements trying to extract a trend. Measures such as "super core" have been developed alongside the more traditional "core" inflation that excludes energy and food. At the same time, stripping out price changes in one or another item has seemed potentially misleading at a time of such varied changes.

Goods prices first shot up. Demand from consumers forced to stay home, with money to spend, overwhelmed global supply capacity. Russia's invasion of Ukraine exacerbated pressure on energy and food prices. More recently, prices of labor-intensive services, from travel to fast food, have rebounded while some goods prices have actually fallen. As prices continue to rebalance, it is not surprising that the Fed wants to hold off premature easing.

The Fed and other major central banks have been criticized for misunderstanding the inflationary pressures from the pandemic and related fiscal pressures. But as time has gone on, it has become clearer that few observers understood just how the extraordinary circumstances of the pandemic and global lockdown changed economic relationships.

The early debate between those, including the Fed, who viewed price pressures as supply driven and transitory and those who believed excess demand was driving prices seemed settled in favor of the latter. But more recently, as inflation has come down without a sharp compression in demand or rise in unemployment, opinion is swinging in the other direction. A new paper suggests that shifting relative prices give a clue. Excess demand would tend to push up prices across the board. Differential price changes across different items and sectors are a signal of supply shifts, the authors argue.

ECONOMIC PERFORMANCE IS RELATIVE TOO

After decades mired in deflation, Japan's economy has seemed to be shaking off malaise. Japanese equities surged in the past year as inflation turned positive, while the central bank delayed raising rates. In addition, fundamental changes have been attracting investors – arguably the most important of which is increased distributions to shareholders via dividends and share buybacks. Distribution of cash balances has been supported not only

by shareholders, but also by the local exchange in order to boost the myriad of companies trading below book value to achieve at least a 1x valuation. A further tailwind to equity prices could come via consolidation as there is excess capacity in the economy that could be resolved through M&A activity, which could also have the added benefit of reducing crossover shareholding.

This week showed the downside of the story. Japanese companies have been raising prices but not wages. That is good for profits, but has left consumers unwilling or unable to boost spending. Reflecting this, the economy slipped into recession at the end of last year, with a second negative quarter reported for GDP. With a weaker yen also weighing on measures of Japan's relative size, it has now slipped behind Germany. Although the German economy has also been hit by weak demand from China and higher food and energy prices, it is now the world's third largest economy, after the U.S. and China.

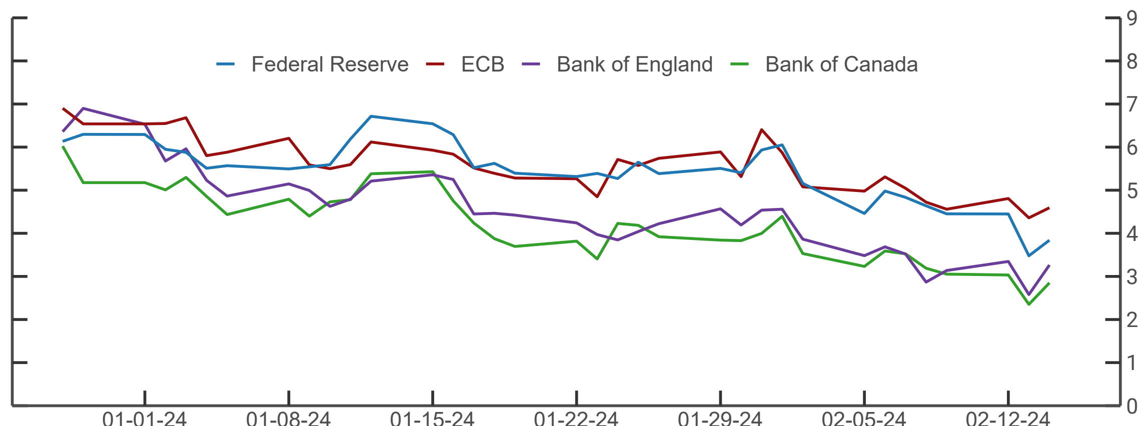
Germany's growth prospects are not good, however, according to the latest economic forecasts from the European Commission released this week. The EC has revised down last year's growth to 0.5% while reducing the projection for this year to 0.9% for the whole EU and just 0.8% in the euro area. This will add to concerns that the European Central Bank (ECB) is holding monetary policy too tight, amid an unexpectedly rapid deceleration in inflation in recent months. Markets do not expect the ECB to relent, however. Just as in the U.S., pricing has now adjusted with approximately four rate cuts expected during 2024 that would bring the ECB policy rate down to 2.75% - 3.0% by year end.

The U.S. is the outlier on the upside. After avoiding recession last year, the U.S. economy is still growing steadily and creating new jobs. That does not mean that Americans feel good. Consumer sentiment has moved up slightly, but the disconnect between standard macro measures of well-being and sentiment surveys that has puzzled economists continues – with inflation the likely missing link.

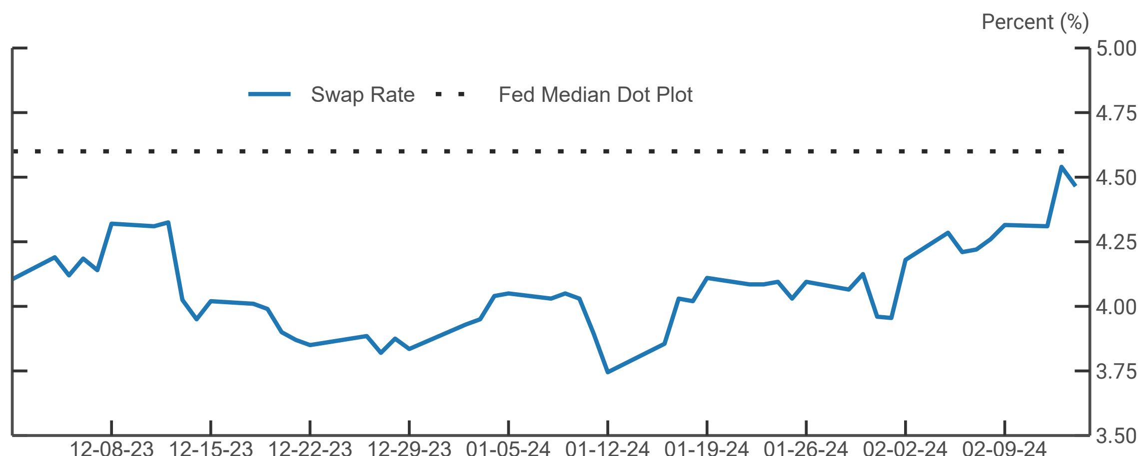
CHANGING EXPECTATIONS

In our last letter, *Watching and Waiting*, we highlighted the data-dependent nature of monetary policy and, as a result, asset prices.

Change in Total Expected Cuts



Source: RockCreek, Bloomberg.



Source: RockCreek, Bloomberg.

Since January 12, we have had a trove of significant economic data both domestically and internationally including interest rate decisions by all four major central banks, a U.S. non-farm payroll print, and multiple inflation readings. Interest rate markets have gyrated in the wake of several of these readings, none more prominent than this week's CPI print, as markets work to settle on the most likely path of Fed easing.

So far in 2024, interest rate markets have shifted from pricing approximately six cuts from the Fed to only expecting three. Europe and the UK have had a similar three-cut reduction, while Canada has dropped four cuts, from six to two. As a result, short-term interest rate market pricing has shifted much closer to the Fed's median projection for year-end 2024 policy rate levels. Expectations for the first cut have also shifted from March to June.

These moves in front-end interest rates have also pushed longer dated rates higher: most notably, 10yr real interest rates are back above 2% for the first time since early December of 2023, after that month's FOMC meeting was received by markets as particularly dovish. This move higher in longer-term real interest rates has put pressure on equities, in particular the most interest rate sensitive names.

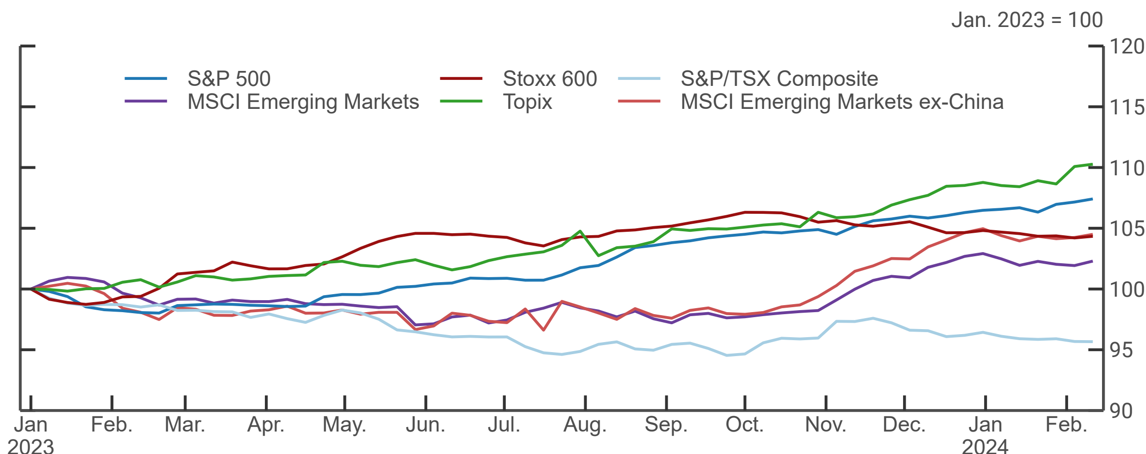
Rising rates have most negatively impacted duration sensitive equities including small-caps, high growth companies, and emerging market equities. One notable exception globally has been Japan. So far in 2024, Japanese equities are outpacing the S&P 500 and remain an investor favorite, despite tipping into a technical recession at the end of 2023, as discussed above.

EMERGING MARKETS: CAN VALUE FINALLY BE REALIZED?

Despite emerging markets wobbles to start the year, these equities, especially when excluding China, remain attractive. Relative performance for emerging market equities vs. the S&P 500 are at multi-year lows, but on a forward earnings basis, EM ex-China revisions have kept pace with the U.S. and Japan, outpacing other global markets.

Within that cohort, Mexico and Brazil look particularly attractive. The markets are cheap, real interest rates are high enough to allow for

12-month Forward EPS Estimates



Source: RockCreek, Bloomberg.

local easing to simulate the markets, and, in the case of Mexico, the economy is poised to benefit from nearshoring and U.S. economic strength. Interestingly, imports to the U.S. from Mexico recently surpassed those from China for the first in 20 years. India continues to be attractive as a secular growth story as well.

U.S. LARGE CAP: MAGNIFICENT SEVEN TO FAB FOUR?

The Magnificent Seven's (Mag 7) run in 2023 was nothing short of astonishing. Those seven names accounted for approximately 60% of the S&P 500's total return last year, with three of those names rising more than 100% during the year. However, that performance has narrowed in 2024, with only Microsoft, Amazon, Nvidia, and Meta outperforming the S&P 500 so far this year. Google has just lagged, while Apple is down 5.4% and Tesla has lost 19.6% compared to the index's positive 5.1% return. The narrowing of outperformance adds speculation as to whether or not the whole trend is bound to reverse. From a valuation perspective, the Mag 7 contribute heavily to the S&P 500's expensive valuation. The average trailing P/E for the Mag 7 is >40x. Given their large weight in the index this is enough to drag the overall index up to >24x. With those names stripped out the index is actually trading below its five-year average of ~22x. Time will tell, but for now surveys suggest investors are willing to let it ride.