RockCreek

INFLATION VS INNOVATION: WHAT MATTERS MOST?

This week's poor inflation data were not surprising. We already knew that January was not a great month. Reports for consumer and producer prices released earlier showed inflation ticked up at the beginning of the year. Thursday's release of the PCE – the Federal Reserve's preferred measure of inflation – served as confirmation.

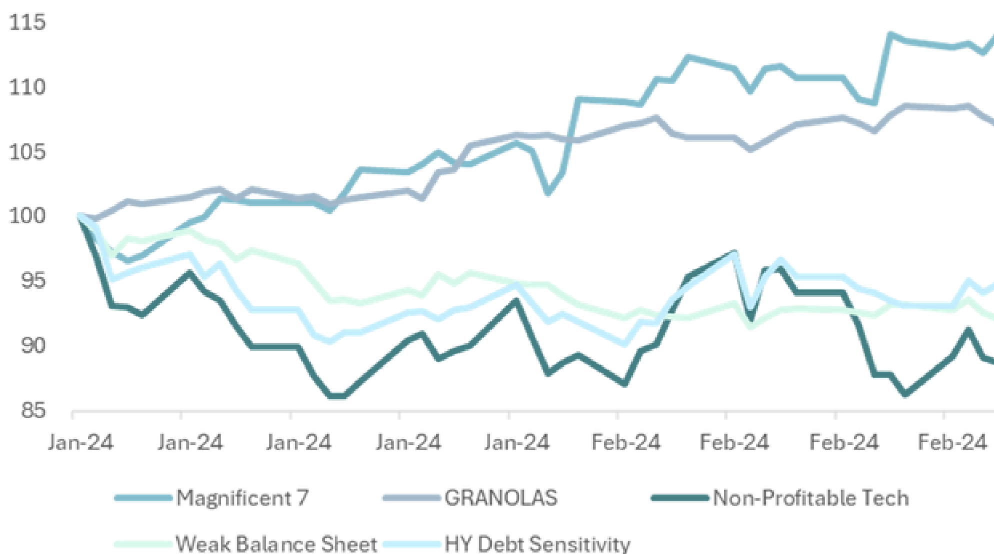
Equity investors seemed unbothered, focusing instead on the good news. The US economy remains strong, but not too strong. And AI innovation holds such great promise that high interest rates may no longer be an automatic damper on the tech stocks that have powered US markets. Indeed, the tech-heavy NASDAQ closed February at a new record high, despite dwindling hopes during the month of early Fed rate cuts. By Friday, markets had closed February 5.2% higher, and climbed nearly 1% in the first day of March trading.

Markets had softened earlier in the week, with concerns that continued strong US growth and sticky inflation could lead the Fed to delay cutting interest rates. Remarks from a number of Fed speakers confirmed their caution. Voting FOMC member Lisa Cook emphasized the counterproductive nature of excessive easing in a speech for a conference at Princeton University late last week. But investor spirits remain high – at least in the US – as Nvidia's apparently unstoppable growth continued to underpin equities. The stock has now climbed 21.7% since Q4 earnings were announced on February 21st.

At RockCreek, we have pointed to three themes for investors to watch:

- Geopolitical tensions and political spillovers
- Monetary easing: timing of rate cuts
- US and global growth

Select Thematic Equity Index Performance



Source: RockCreek, GoldmanSachs, Bloomberg GRANOLAS = GSK, Roche, ASML, Nestle, Novartis, Novo Nordisk, L'Oreal, LVMH, Astrazeneca, SAP, and Sanofi

It is hard to position for political disruption. But investors should remain alert to potential spillovers, and long-term consequences. As 2024 goes on, it is becoming clearer that the all-important US election in November will pit President Biden against former President Trump. Sharp divisions between them are mirrored in the US electorate and, increasingly, in Congress. But all is not dysfunction. The threat of a government shutdown was postponed this week, albeit briefly, with Democrats and Republicans voting on a stop-gap bill. And hopes remain that funding for Ukraine can be agreed. The untimely death in prison of Russian opposition leader Alexei Navalny has served to remind of the ruthlessness of Russian President Putin. The devastating war in the Middle East continues to divide Americans, and the international community.

WHY DID MARKETS GET AHEAD OF THEMSELVES AND THE FED?

It is interesting to consider why markets became so convinced two months ago that interest rate cuts would come early and often this year. The expectation took hold just after the Fed first signaled clearly, in its December projections, that it expected its next move to be a rate cut. The Fed expected three cuts totalling 75 basis points during 2024. Markets quickly priced in twice as many. In Canada, markets now anticipate three rate cuts, but in late 2023 the figure was five.

To some, including at RockCreek, the disconnect was puzzling. Taking the Fed at its word about the focus on reaching price stability, and considering the strength in the US economy, we have looked for the first cut to come only around mid-year. Bond markets in the US – and other advanced economies – have now moved to reflect the later, slower pace of interest rate cuts that central banks had foreshadowed.

STRONGER ECONOMY AND MORE INFLATION

The shift could be another instance where historical patterns, disrupted by pandemic upheaval, proved misleading to many. In previous monetary cycles, once easing begins it has often moved more quickly than the Fed anticipated. In those cases, the turn in policy has come too late to stop an accelerating decline in economic activity, rising unemployment and, sometimes, financial stresses.

That was not the pattern this year. Instead, employment and GDP growth have remained strong, albeit with a dip in real consumer spending in January. Revised data for GDP growth this week showed Q4 growth only marginally lower than originally estimated, at 3.1%. That is well above what most believe is the underlying potential growth rate for the US. The “nowcast” produced by one of the Federal Reserve regional banks suggests on the basis of Q1 data so far that growth has remained positive.

At the same time, inflation has come down – but the path to price stability is not smooth. The Fed’s preferred measure, core PCE, was up by just 2.8% in the year to January. But in the month from December, inflation on this measure was running at an annualized rate of almost twice as much. The truth is somewhere in between.

That is much better than many would have looked for a year ago. But it is a reminder that the Fed is wise to pace itself as it turns to easing. The US economy is still powering ahead. Jobs remain plentiful and the prices of services, which fell relative to goods prices during the pandemic, are now going up at a rapid rate. Average wages are growing at a pace consistent with price inflation of closer to 3% or 4% rather than the 2% Fed goal for price stability.

The same caution may not be warranted in Europe. Inflation there has also come down more quickly than expected, notwithstanding disappointing data this week. But the biggest economy, Germany, is in recession and growth in the region was barely positive last year and remains sub-par. Higher interest rates have hurt consumers and businesses more than in the US. The shock from Russia's invasion of Ukraine and consequent energy price increases also fell more heavily on Europe. New research shows that whereas the recent inflation in the US was caused by both supply shortages and demand pressures, for Europe the balance was different. Supply shocks – which are not amenable to monetary tightening, and have now eased – accounted for the bulk of the inflationary surge in the euro area. That supports the case for earlier monetary easing by the European Central Bank (ECB) than in the US. Comments this week by ECB President Christine Lagarde suggest, however, that the bank is likely to wait.

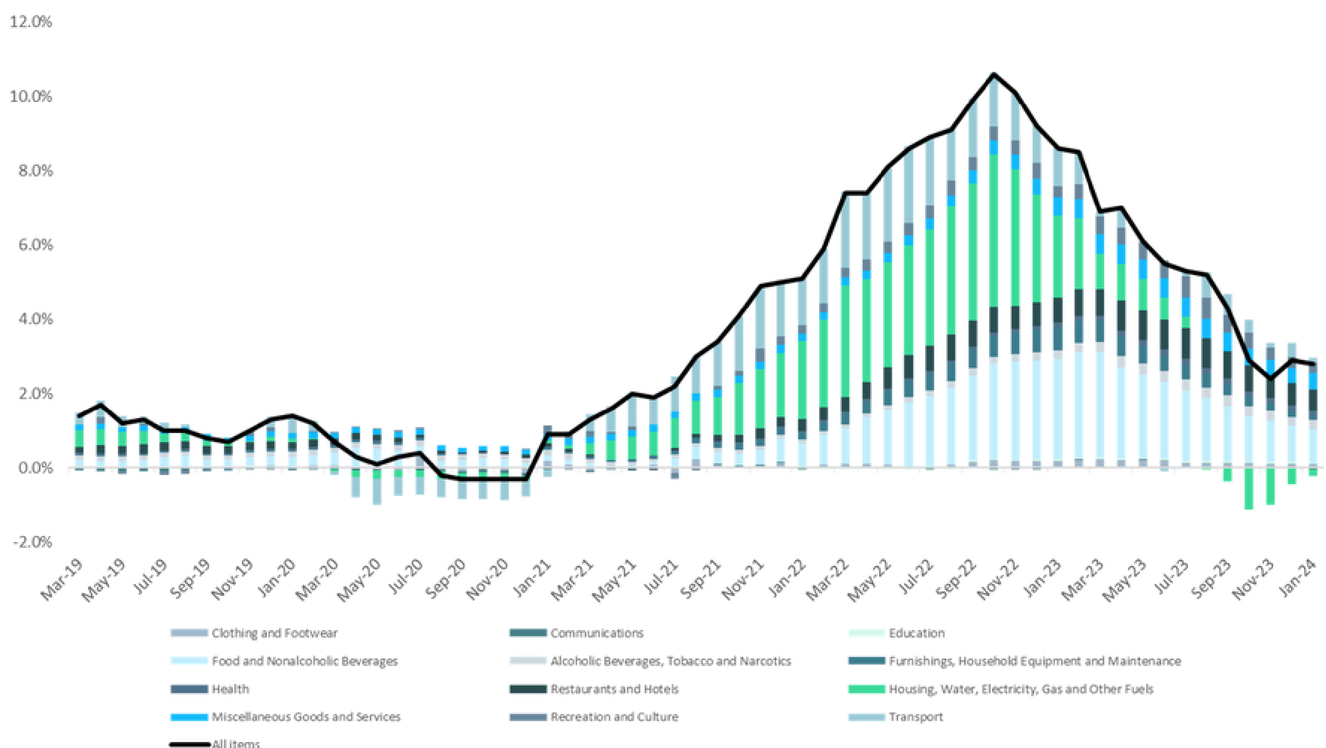
MEASURING INFLATION IS TRICKY

Consumer sentiment is not quite as bad in 2024 as last year, but it is no secret that most Americans are disappointed with the economy. Inflation is the main reason. A new paper with authors including former Treasury Secretary Larry Summers may help to explain why. They measure the cost of credit – think auto loans, credit card debt – and include this in estimates of the cost of living. Higher interest rates that do not feed through to other measures of inflation, except indirectly through housing and rent costs, eat into living standards just as rising prices for groceries or travel.

EQUITY MARKETS KEEP CHUGGING

Innovation, particularly enthusiasm for AI, has powered US markets higher. The S&P 500 is up 7.6% YTD, while the Nasdaq closed February at a record high.

Eurozone Inflation Constituents



Source: RockCreek, Bloomberg

As in 2023, the S&P has been heavily driven up by a handful of stocks. This year, performance has become even more concentrated as the Magnificent Seven have transformed into the Fabulous Four (Fab 4). Nvidia, Amazon, Meta, and Microsoft contributed more than half of the index's return so far, a similar proportion to the contribution last year of the seven (which includes Apple, Alphabet and Tesla) The four high performers are also largely responsible for the index's expensive valuation. The S&P trades on a 24 P/E, while the Fab 4 have an average P/E of nearly 48.

It may seem surprising that such high multiple growth stocks are performing so well amid a repricing of longer-dated real rates. However, the Fab 4 – and Nvidia in particular – have been exceptional in growing their earnings at a faster pace than the market. Nvidia quarterly earnings have grown 500% in the last four quarters, while those for the S&P 500 have risen a mere 8%. Amazon, Meta, and Microsoft have risen 230%, 150%, and 20% respectively. In addition, Meta's dividend and buyback policy has helped drive a significant improvement in investor sentiment. A similar dynamic is playing out on the other side of the Atlantic where a group of high quality, large-cap equities known as the GRANOLAS (GSK, Roche, ASML, Nestle, Novartis, Novo Nordisk, L'Oreal, LVMH, Astrazeneca, SAP, and Sanofi) are leading performance. This group of stocks is up 8.0% YTD, more than twice as much as the Stoxx 600, which is up 3.9% on the year.

Outside of this elite group, higher rates have had the expected impact on less profitable growth stocks. A basket of unprofitable US growth stocks constructed by Goldman Sachs has fallen 9.9% YTD. There is another group of stocks that have been particularly hard hit on both sides of the pond by the repricing of interest rates: those with high exposure to debt. Two more baskets – High Yield Debt Sensitivity in the US and Weak Balance Sheets in Europe – have fallen 4.0% and 5.2%, respectively, in 2024.

All of this dispersion creates a strong opportunity for active management. Small caps remain attractively valued, but having the right stock picker is important given the weak balance sheet and profitability issues cited above. In addition, M&A activity is likely to pick up this year. The patent cliff faced by large pharma companies coupled with distressed valuations for smaller operators creates a rich environment for acquisitions in the Healthcare sector. The prospect of new M&A extends across various sectors, encouraged by cash-rich balance sheets in certain sectors and a stabilized financing outlook more broadly.

ANOTHER ALL-TIME HIGH

While media outlets ran headlines emphasizing the long two years the Nasdaq took to set a new high, a rather longer streak was broken last month. The Japanese Nikkei set a new high on February 22nd for the first time since 12/29/1989 – nearly thirty-five years ago. The record high is emblematic of international and domestic investor enthusiasm for the asset class. Japanese equities continue to benefit from supportive monetary policy and shareholder-focused reforms, which RockCreek has highlighted in the past. Bank of Japan Governor Ueda's comments late this week, that it was too early to determine whether or not inflation was sustainably at target, provided further support for those hoping that monetary policy will remain accommodative for some time.

Elsewhere in Asia, India's GDP numbers released this week were higher than expected, with the country registering an 8.4% annualized growth rate in the fourth quarter of 2023. Growth was robust across the board with manufacturing, investment, services, and consumption rising 11.6%, 10.6%, 6.7%, and 3.5% respectively on an annualized basis. Strong growth in the country has been mirrored by strong equity performance with MSCI India rising 5.2% YTD, landing it as a top performer in the emerging markets index and ahead of several developed markets. India has been a long-time favorite of RockCreek.

INTEREST RATES FINDING LEVEL?

After significant dramatic moves higher in the first half of February, interest rates seem to have stabilized around current levels. Longer dated real and nominal yields have gyrated some, but they ended the period marginally lower (about 8-10 bps) in the for the 10yr maturity. After weathering the latest PCE reading, markets wait until the FOMC meeting on March 20th for the next big move in rates. But, barring surprises from the upcoming data for February payrolls and consumer prices, it is likely that the Fed's new projections for the economy and the path of policy rates may not change much from December.