

# Government debt and inflation talk highlight a busy market week

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**Kristina Hooper**  
Chief Global Market Strategist

## Key takeaways



### Davos update

Discussions about government debt gained focus at the World Economic Forum and shone a light on the impact of higher interest rates.

### Trump term

Tariffs and immigration were big focuses in the first week of President Trump's new term, prompting concerns about inflation.

### Bank of Japan

After assessing the impact of its previous rate hike six months ago, the Bank of Japan enacted another hike at its January meeting.

Last week I got a case of information overload. In the course of just a few days, we saw the annual World Economic Forum meetings in Davos, the Bank of Japan meeting, and the inauguration of US President Donald Trump, which was immediately followed by a cavalcade of executive orders, policy pronouncements, and tariff threats. So much was happening all day, every day, that it was hard to keep track of every development. Here are the highlights:

### Debt talk in Davos puts interest rates in focus

For me, the most important discussions in Davos were about government debt. International Monetary Fund Deputy Chief Gita Gopinath argued that there has been an "optimism bias" that has made policymakers and investors less concerned about growing government debt than they should be. As I've said before, the problem is not just the size of government debt but the relatively high interest rates governments have recently been faced with (a product of aggressive tightening in the last several years). That's made it far more expensive to service the debt – which has contributed to fiscal deficits.

A case in point is the UK fiscal situation. It was revealed last week that the UK borrowed 17.8 billion pounds last month, which was far greater than the 14.6 billion pounds forecast by the UK Office for Budget Responsibility.<sup>1</sup> The difference was largely driven by higher borrowing costs. In fact, interest charged on UK government debt reached 8.3 billion pounds in December, which is a very high level relative to history. There is a similar situation in the US and many other countries, where higher rates are exacerbating a problem that has been many years in the making.

We're getting closer to the point where this must be resolved. An easy way to ease a lot of the pressure is, of course, lowering rates. And that happens to be one of the policies President Trump advocated for last week when he demanded immediate rate cuts from the Federal Reserve.

### New Trump term begins with a focus on immigration and tariffs

Beyond the demand for rate cuts, following are some headlines from the Trump administration's first few days in office:

- Trump signed an executive order to establish an External Revenue Service to collect tariffs and duties from foreign trade, and to suspend US participation in the Global Tax Deal
- Trump threatened to apply tariffs on Canada and Mexico by Feb. 1 if they don't comply with US immigration policies.
- The Trump administration immediately stepped up immigrant deportation activity, with a number of high-profile raids.
- The Trump administration rolled out Project Stargate, a private investment partnership that promises to invest \$500 billion over the next four years into artificial intelligence (AI) infrastructure. Despite reports that \$100 billion has already been put forward, questions remain over where this capital will be drawn from. Elon Musk registered skepticism about the project's funding, which may have helped dampen enthusiasm as the

market reaction was only modestly positive.

Also last week we got the final January edition of the University of Michigan Survey of Consumers. It showed inflation expectations have risen substantially — which is no surprise given the focus on tariffs and immigration policy. As I've said before, I'm far more concerned about the impact of an aggressive immigration policy on inflation than I am about tariffs. Rising food prices have been cited as a potential consequence of deportations, but other industries could be even more negatively impacted, notably construction and health care.

Take construction, for example, which is a critical industry given the housing supply/demand imbalance (and sticky shelter inflation). It's even more important in states that have been affected by natural disasters, such as the recent tragic California fires, where rebuilding will have a major impact on demand for construction labor. It's estimated that about 13.7% of construction workers are undocumented,<sup>2</sup> which means there's a risk that the construction labor force could shrink if mass deportations come to fruition. Rice University's Baker Institute for Public Policy has noted that demand for labor in the construction industry already outpaces supply, largely due to low immigration levels. It has advocated for a number of policy measures to correct that imbalance, including establishing legal pathways for migrants via a construction visa.<sup>3</sup>

At a high level, the supply of labor needs to expand faster than demand for the labor market to exert a disinflationary force. There is reason for heightened concern given that this seems unlikely in a number of industries that are dependent on immigration, including illegal immigrants.

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### **The Bank of Japan raises rates**

Also last week, the Bank of Japan (BOJ) decided to raise its policy interest rate from 0.25% to 0.50% at its monetary policy meeting, as was widely expected. This is its highest level in 17 years.

There are four main reasons behind this rate hike:

1. Current Japanese economic conditions called for a rate hike. The BOJ has been clear that if the economy was on track to meet growth and price expectations, it would continue to raise policy interest rates accordingly. In its latest outlook report published last week, the BOJ's forecasts for real gross domestic product growth and inflation were largely maintained from its October 2024 report. Notably, the BOJ's forecasts for the core-core CPI (consumer price index excluding fresh food and energy) for fiscal years 2025 and 2026 were both set at 2.1%, with the forecast for fiscal 2025 slightly revised upward from 1.9%.<sup>4</sup> The intention of some major companies to significantly raise wages ahead of the Shunto spring labor negotiations also contributed to reducing uncertainty about the economic outlook. Given that the economy is on track and that the policy interest rate is significantly lower than the nominal neutral interest rate, which is considered to be in the range of 1.0%-2.5%, the BOJ decide to hike last week.
2. Following Trump's November victory in the US presidential election, the US dollar had strengthened against other major currencies. However, since the start of 2025, the yen has generally strengthened against major currencies such as the dollar, euro, and pound, primarily due to market expectations of a rate hike at the BOJ's January meeting. If the BOJ had not raised rates at this meeting as expected, the yen could have depreciated to a large degree, which could negatively impact private consumption.

3. Six months had passed since the last rate hike in July, which was an adequate amount of time to assess the impact of that hike. Keep in mind that for more than 30 years, the BOJ had never raised rates by more than 0.5% cumulatively, and so hiking after the July hike required careful review and thoughtfulness.

4. There was no financial market turmoil last week despite all the policies announced by the Trump administration since taking office. If Trump's policies, such as additional tariffs, had led to a global stock market decline, the BOJ would have found it difficult to raise rates. However, such a situation did not materialize, allowing the BOJ to proceed with the rate hike.

Even though the rate hike was widely expected, the BOJ's upward revision to its inflation outlook seemed to have increased the market's concern over a more hawkish BOJ policy stance. The yen appreciated and the yield rose on 10-year Japanese government bonds.

Looking ahead, the BOJ will remain data dependent, with the timing of future rate hikes guided by the outlook for the economy, inflation, and the yen exchange rate. We think the Japanese economy is likely to continue to expand gradually, driven by domestic demand. After taking enough time to assess the effects of this rate hike – probably around 3 to 6 months – we expect the environment will be conducive to further rate hikes. However, with Upper House elections scheduled for this summer, the actual timing of the next rate hike is expected to be in the fall of 2025. The BOJ is expected to conduct one additional rate hike in 2025, but depending on the wage increases in the spring labor negotiations and the future economic and inflation outlook, two additional rate hikes could also be an option.

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### **Manufacturing and services data from China**

We also got official Purchasing Managers' Index (PMI) data for China. Both manufacturing and services PMIs fell from December to January. It seems this slowdown is very temporary, coming off a strong fourth quarter. I expect growth will likely re-accelerate in coming months as policy support continues to be stepped up.

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### **This week starts with a 'Deep Scare' for AI-related stocks**

As if last week's events weren't enough to digest, we kicked off this week with news that a Chinese AI company, DeepSeek, has found a way to create an AI model that does not require the kind of sophisticated chips that thus far were believed to be necessary. It was reported that the model demonstrated performance comparable to some of the best AI models on the market today, though there are some notable weaknesses (such as in code generation). Skeptics have highlighted that the training data used in producing the model benefited from prior work done by other AI companies. Nevertheless, DeepSeek's announcement sent US AI-related stocks plummeting on Monday, Jan. 27.

This illustrates the dangers of high valuations. When priced for perfection or near perfection, a stock is more vulnerable to a significant sell-off – even based on news flow with little in the way of details. I must underscore that this is not a time for knee-jerk reactions since we know so little at this juncture. We'll need to learn a lot more about this before we can decide whether this is a serious threat to US AI companies – and whether it could present a significant opportunity to make AI more accessible at a far lower

cost. We do think it could prompt more scrutiny on companies' AI investment spending.

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## Looking ahead

Despite all that happened last week, stocks rose and volatility fell. And interestingly, while it is just late January, we have seen European equities outperform US equities so far this year.<sup>5</sup> I suspect that will continue given the potential for significant European Central Bank easing this year. This week, we'll get earnings reports from some tech giants including Microsoft, Tesla, Apple, and Meta, which means there is likely to be a lot more in the way of discussions around AI. I should note that we are unlikely to get all the details we'd like on DeepSeek given that the Lunar New Year is about to begin. (Happy Year of the Snake to all who celebrate!) We'll also get the Fed meeting this week, where I expect rates to remain unchanged and the Fed to remain cautious about when it expects to cut rates again.

*With contributions from Tomo Kinoshita, Ashley Oerth and Emma McHugh*

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## Dates to watch

Date	Report	What it tells us
Jan. 27	US New Home Sales	Indicates the health of the housing market.
Jan. 28	US Durable Goods Orders	Measures current industrial activity.
	US Conference Board Consumer Confidence	Details consumer attitudes and expectations for inflation, stock prices, and interest rates.
	US S&P/Case Shiller Home Price Index	Indicates the health of the housing market.
	Bank of Japan Monetary Policy Meeting Minutes	Gives further insight into the central bank's decision-making process.
	Australia Consumer Price Index	Tracks the path of inflation.
Jan. 29	Bank of Canada Monetary Policy Decision	Reveals the latest decision on the path of interest rates.
	Federal Open Market Committee Decision	Reveals the latest decision on the path of interest rates.
Jan. 30	Germany Gross Domestic Product	Measures a region's economic activity
	Eurozone Gross Domestic Product	Measures a region's economic activity
	Eurozone Unemployment	Indicates the health of the job market.
	European Central Bank Monetary Policy Decision	Reveals the latest decision on the path of interest rates.
	US Gross Domestic Product	Measures a region's economic activity
	Japan Industrial Production	Indicates the economic health of the industrial sector.

## Dates to watch

Date	Report	What it tells us
Jan. 31	Germany Consumer Price Index	Tracks the path of inflation.
	US Personal Consumption Expenditures	Tracks the path of inflation.
	US Employment Cost Index	Indicates the health of the job market.

## Notes

<sup>1</sup>Source: UK Office for National Statistics, Jan. 22, 2025

<sup>2</sup>Source: American Immigration Council, 2024

<sup>3</sup>Source: Rice University's Baker Institute for Public Policy, "Boost US Construction Workforce by Employing More Immigrant Labor, Oct. 10, 2024

<sup>4</sup>Source: Bank of Japan Outlook for Economic Activity and Prices, Jan. 24, 2025

<sup>5</sup>Source: MSCI, as of Jan. 24, 2025. Based on the year-to-date performance of the MSCI Europe ex-UK Index (7.0%) versus the MSCI USA Index (4.0%).

## Important information

All investing involves risk, including the risk of loss.

Past performance does not guarantee future results.

Investments cannot be made directly in an index.

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.

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

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.

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.

The Consumer Price Index (CPI) measures the change in consumer prices and is a commonly cited measure of inflation.

Disinflation, a slowing in the rate of price inflation, describes instances when the inflation rate has reduced marginally over the short term.

Monetary easing refers to the lowering of interest rates and deposit ratios by central banks.

Gross domestic product (GDP) is a broad indicator of a region's economic activity, measuring the monetary value of all the finished goods and services produced in that region over a specified period of time.

The health care industry is subject to risks relating to government regulation, obsolescence caused by scientific advances, and technological innovations.

Inflation is the rate at which the general price level for goods and services is increasing.

The International Monetary Fund is a global organization that supports economic policies that promote financial stability and monetary cooperation.

Purchasing Managers' Indexes (PMI) are based on monthly surveys of companies worldwide and gauge business conditions within the manufacturing and services sectors.

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

The MSCI Europe ex UK Index captures large and mid-cap representation across developed markets countries in Europe, excluding the UK.

Shunto refers to the annual wage negotiations between unions and employers in Japan.

The Survey of Consumers is a monthly telephone survey conducted by the University of Michigan that provides indexes of consumer sentiment and inflation expectations.

Tightening monetary policy includes actions by a central bank to curb inflation.

The opinions referenced above are those of the author as of **Jan. 27, 2025**. 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.