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Inflation

Both US Consumer Price Index and US Producer Price Index data for January were hotter than expected, but it was no cause for concern, in my opinion.

Economic slowdowns

The most recent gross domestic product prints for Japan and the UK show that both economies were technically in recession in the back half of 2023.

Volatility

Recent volatility among US small-cap stocks underscores market confusion and uncertainty about when the Fed will begin cutting rates and by how much.

Weekly Market Compass | February 20, 2024

Last week was a busy one for data and markets. Hotter-than-expected US inflation data roiled markets, signs of economic slowdown became clearer, and uncertainty about the path ahead for US Federal Reserve (Fed) rate cuts has had particular impact on small-cap stocks. Here are my key takeaways from what we learned last week.

Disinflation continues in Western developed economies, imperfectly.

Both US Consumer Price Index (CPI) and US Producer Price Index (PPI) for January were hotter than expected, but it was no cause for concern, in my opinion.

This CPI print in particular was a source of great market concern, as evidenced by the stock market sell-off that occurred that day. However, I think the reaction was not a reflection on the print itself, but on the state of confusion that exists around Fed policy (we saw outsized reactions all week to various economic data). The CPI reading was **not** hot — it just wasn't cool enough for expectations. I am not rattled by it. Progress may be slower than expected, but we are moving in the right direction.

In fact, virtually all US CPI components are moving in the right direction. And yes, the shelter component remains elevated — but it's easing. It's just that shelter represents 42% of the core CPI index¹, so it has a big impact on the overall core CPI reading. And don't get me started on how a large component of shelter inflation — Owner's Equivalent Rent — can inaccurately reflect housing costs. It's also important to point out that the Fed's inflation gauge of choice is Personal Consumption Expenditures (PCE), specifically core PCE, and that has been tamer and more strongly supports the disinflation narrative. (Even though some components of PPI filter into PCE, I don't think January's higher-than-expected PPI reading will have a significant impact on the next PCE reading.)

Another measure to look at is consumer inflation expectations. We got a reading last week from the University of Michigan Survey of Consumers that shows longer-term inflation expectations (five years ahead) remain very well anchored at 2.9%.²

On the other side of the pond, UK CPI was better than expected. Services inflation remains elevated, but that should be no surprise — we have seen goods inflation be a first mover, both up and down, followed by services inflation given the nature of consumer behavior during and after the pandemic. The CPI reading seemed to have soothed markets, as it came on the heels of higher-than-expected UK wage data, which along with US CPI had caused some market gyrations.

I think a good analogy for inflation is weight loss. The path of weight loss is usually bumpy, even for those who faithfully stick to their diets day after day. One week could bring a big drop while another week could bring no progress, or even an increase in pounds. But while weight loss

can be imperfect, if we stick with a long-term plan that's tailored to our needs, we likely will reach our goal. The only difference is that monetary policy operates with a long lag, so we will very likely remain on a trajectory, albeit an imperfect one, to reach our target long after the first rate cut.

Retail and industrial demand is cooling

The NFIB Small Business Optimism Index for January clocked in at 89.9, its lowest reading since May 2023.³ In particular, the sales expectations sub-index fell quite dramatically. This survey is volatile, but it could be foreshadowing economic weakness.

US retail sales and industrial production also came in below expectations. US retail sales not only showed a significant decline last month, but November and December retail sales were downwardly revised. Perhaps all the headlines about planned layoffs are creating a more subdued consumer. The Fed wants to see a slowing economy before it cuts interest rates, so this is arguably good news as it should get the Fed more comfortable with cutting sooner.

We have already seen economic slowdowns in other countries. The most recent gross domestic product prints for Japan and the UK show each economy technically was in recession in the back half of 2023.

Of course, we have to be vigilant that the slowdown does not become too severe. I'm a big believer in the mantra "everything in moderation." I'm prepared for a bumpier landing than most, but that does not mean a recession this year. I'm keeping my eyes out for cracks forming that might get too big.

I still expect the Fed to cut in the second quarter

Nothing I have seen in the data or heard in FedSpeak has changed my expectation that the Fed will begin cutting rates in the second quarter of this year. Yes, we have heard a lot of hawkish FedSpeak recently, but I continue to believe that Federal Open Market Committee (FOMC) members are using their voices as a tool to tamp down financial conditions and try to prevent markets from getting ahead of themselves.

I actually think it's more instructive to hear from a former member of the FOMC who is no longer charged with keeping a lid on financial conditions but can simply share his policy prescription — former St. Louis Fed President Jim Bullard was historically a good bellwether of what the Fed was really thinking and planning to do. Last week, Bullard spoke at the National Association of Business Economics Conference and he was very dovish, arguing that current conditions indicate that the start of rate cuts should be now. He explained, "I think they should get going. It's probably wiser to go sooner but slower...I'm worried that you're going to get into the third quarter and policy rate is going to be too high for that situation, so why not go now."⁴

US small caps have been hyper-volatile, confused by data and Fed speak.

While US stocks in general have experienced significant volatility recently, US small-cap stocks have been even more volatile. Every trading day of the last week saw the Russell 2000 Index move at least 1% in either direction.⁵ The biggest move came last Tuesday, when the Russell 2000 Index fell almost 4%, following the release of January CPI

data.⁵ Last week also saw a big move higher for the Russell 2000 Index — up nearly 2.5% on Thursday, helped by weak US retail sales.⁵

In recent months, US small-cap stocks have largely been driven by expectations about Fed policy; they have been more sensitive to economic data and Fedspeak — the factors that impact rate expectations — because they have historically been more driven by the economic cycle. The volatility experienced in recent days underscores market confusion and uncertainty about when the Fed will begin cutting rates and by how much. However, it also could represent opportunity for very significant mis-pricings depending on one's economic outlook.

Changing monetary policy is a waiting game

In conclusion, last week was a reminder that monetary policy is still a critical driver of markets, which means we are all waiting for the Fed and other central banks to decide when to cut rates. While we wait, we can seek to take advantage of a more robust income environment by ensuring there are some components of our portfolio that offer adequate yield potential. That includes investment-grade corporate bonds, high yield bonds, municipal bonds, and of course dividend-paying stocks.

Dates to watch

Date	Report	What it tells us
Feb. 20	Bank of England Governor Bailey Speaks	Gives insight into the central bank's decision-making process.
	Canada CPI	Tracks the path of inflation.
	Australia Wage Price Index	Measures changes in the price of labor.
Feb. 21	FOMC Meeting Minutes	Gives insight into the central bank's decision-making process.
Feb. 22	Germany PMIs	Indicates the economic health of the manufacturing and services sectors.
	Eurozone PMIs	Indicates the economic health of the manufacturing and services sectors.
	Eurozone CPI	Tracks the path of inflation.
	Canada Retail Sales	Measures consumer demand.
	US S&P Global PMIs	Indicates the economic health of the manufacturing and services sectors.
	US Existing Home Sales	Indicates the health of the housing sector.
	UK Consumer Confidence	Tracks UK consumers' views of their finances and the economy.
Feb. 23	German GDP	Measures a region's economic activity.
	Germany Ifo Business Climate Index	Assesses the current German business climate and measures expectations for the next six months.

Notes

¹Sources: US Bureau of Labor Statistics, "Measuring Price Change in the CPI: Rent and Rental Equivalence," Feb. 9, 2024. Federal Reserve Bank of Boston, "Forecasting CPI Shelter under Falling Market-Rent Growth."

²Source: University of Michigan Survey of Consumers, Feb. 16, 2024

³Source: NFIB Small Business Optimism Index, Feb. 13, 2024

⁴Source: The Wall Street Journal, "Former St. Louis Fed President James Bullard Says March Rate Cut Would Be Wise," Feb. 17, 2024

⁵Source: Bloomberg, L.P., as of Feb. 16, 2024

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.

Should this contain any forward looking statements, understand they 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.

Diversification does not guarantee a profit or eliminate the risk of loss.

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

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.

Municipal securities are subject to the risk that legislative or economic conditions could affect an issuer's ability to make payments of principal and/or interest.

High yield bonds involve a greater risk of default or price changes due to changes in the issuer's credit quality. The values of high yield bonds fluctuate more than those of high quality bonds and can decline significantly over short time periods.

Stocks of small and mid-sized companies tend to be more vulnerable to adverse developments, may be more volatile, and may be illiquid or restricted as to resale.

The risks of investing in securities of foreign issuers, including emerging market issuers, can include fluctuations in foreign currencies, political and economic instability, and foreign taxation issues.

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

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

The Consumer Price Index (CPI) measures change in consumer prices as determined by the US Bureau of Labor Statistics. Core CPI excludes food and energy prices while headline CPI includes them.

The UK Consumer Price Index (CPI) measures change in consumer prices as determined by the UK Office for National Statistics.

Personal consumption expenditures (PCE), or the PCE Index, measures price changes in consumer goods and services. Expenditures included in the index are actual U.S. household expenditures.

The Core Personal Consumption Expenditures Price Index measures the price changes of consumer goods and services, excluding food and energy prices. It is reported by the US Department of Commerce's Bureau of Economic Analysis.

Dovish refers to an economic outlook which generally supports low interest rates as a means of encouraging growth within the economy.

Hawkish is to favor relatively higher interest rates if they are needed to keep inflation in check.

The Federal Open Market Committee (FOMC) is a 12-member committee of the Federal Reserve Board that meets regularly to set monetary policy, including the interest rates that are charged to banks.

Fedspeak is one of the US Federal Reserve's techniques for managing investor and public expectations regarding the current and future monetary policy.

The University of Michigan's Consumer Sentiment Index is published monthly, based on a telephone survey designed to assess US consumer expectations for the economy and their personal spending.

Yield is the income return on an investment.

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

The Producer Price Index (PPI) is compiled by the US Bureau of Labor Statistics and measures the average change over time in the selling prices received by domestic producers for their output.

The Russell 2000® Index, a trademark/service mark of the Frank Russell Co.®, is an unmanaged index considered representative of small-cap stocks.

The National Federation of Independent Business (NFIB) Small Business Optimism Index is a composite of ten seasonally adjusted components. It provides an indication of the health of small businesses in the US.

The opinions referenced above are those of the author as of **Feb. 20, 2024**. 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.