Keeping pace with the Fed

Equity markets had a great start to the year. The S&P500 rose 1.7% in January, surpassing the all-time high of January 2022. This was largely in response to the confidence the Fed showed after its December meeting in its plans to lower rates in 2024. At that time, it emphasized the decline in inflation in recent months, the moderation of economic activity, and a labor market that, while still sustained, no longer had the exuberance of previous months. However, at the last meeting, he put a chill on expectations of seeing the first rate cuts in March, erasing half of the month's gain.

U.S. stocks rise for third consecutive month

S&P500 vs Nasdaq

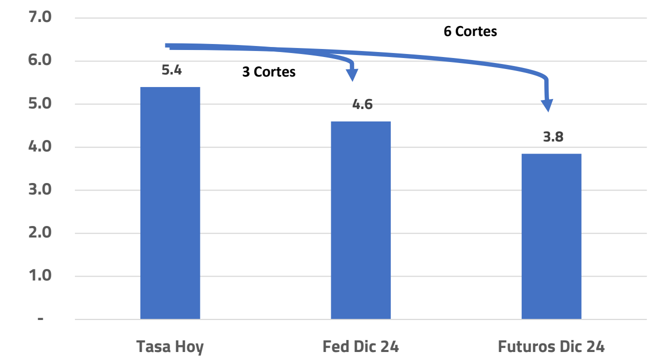
Source: Bloomberg

In the following months, the Fed will have to manage rates in such a way as not to keep them high for too long, causing a recession, nor lower them too fast, encouraging an inflationary rebound. For the time being, its chairman has ruled out a rate cut in March, as he is not confident that inflation has been definitively defeated. In fact, the labor market continues to be in good shape and economic activity remains firm.

The market is overly dependent on the Fed's actions, showing great volatility in the post-meeting periods. This is due to changes in tone from meeting to meeting and divergence of opinion with the market about its next steps. While the Fed continues to think about lowering rates during the year, that decision is conditional on inflation continuing to decline convincingly or a deterioration in the labor market. For now, it will not cut rates in March, and probably not in May either.

Big discrepancy between the Fed and the market

Expectations of Fed rates in December 2024 vs. current rates



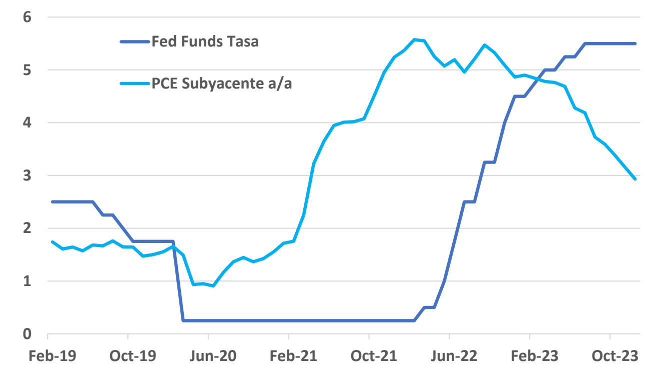
Source: Bloomberg

Moreover, its economic projections published in December showed that it expects only three 25 basis point cuts in 2024. Instead, the market thinks it should have already cut rates given the significant decline in inflation in recent months. In fact, even after the recent meeting, the futures market indicates that the benchmark rate will undergo 5-6 cuts.

The market reasons that benchmark interest rates at 5.25-5.50% are already well above both the 3.4% rate at which consumer prices grew in December and the 2.9% reported for core PCE, the Fed's favorite inflation measure. This implies that while the real (inflation-adjusted) short-term rate is above 2%, a level that some consider fair or low because of the large amount of debt the U.S. has to issue over the next few years, it is a historically high level. Moreover, some market analysts have pointed out that annualized core PCE inflation over the past 3 and 6 months is already below the 2% target. In the face of these questions, the Fed argues that to be more confident, it needs to see these inflation levels in year-over-year comparisons.

Rates are already in restrictive territory

Core PCE inflation vs. Fed rates



Source: Bloomberg

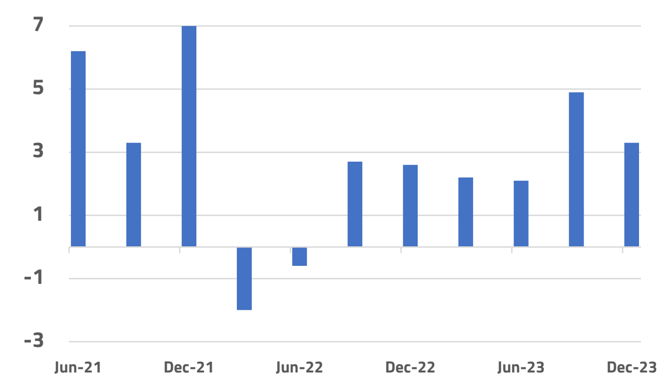
Also in favor of the market's stance, there are factors that should contribute to a drop in inflation in the coming months. Among them are the stability in goods prices, the moderate growth in services prices, and above all the much anticipated drop in the housing component in the indexes due to methodological issues.

If this market view is correct, it would be a great time to buy bonds, as rates around 4% (2 percentage points above inflation) for 10-year treasuries look attractive.

At first glance, the Fed would appear to be erring on the side of conservatism. However, its prudent action is based on both economic and political reasons. The first factor is economic growth. The consensus of analysts expects the U.S. economy to grow by only 1.5% in 2024, down from 2.5% in 2023. However, growth in recent quarters has been robust, with 4.9% annualized q/q in Q3 and 3.1% annualized q/q in Q4. In addition, the first quarter growth estimate for the Atlanta Now, an index that forecasts economic growth in real time, has just risen to 4.2% from 3.1%. On the other hand, some of the purchasing managers' indexes have moved into expansionary territory after several months of showing contraction. This data may have contributed to the recent rally in stocks and a transitory rebound in rates.

Strong growth of the U.S. economy

U.S. GDP growth (% annualized t/t)

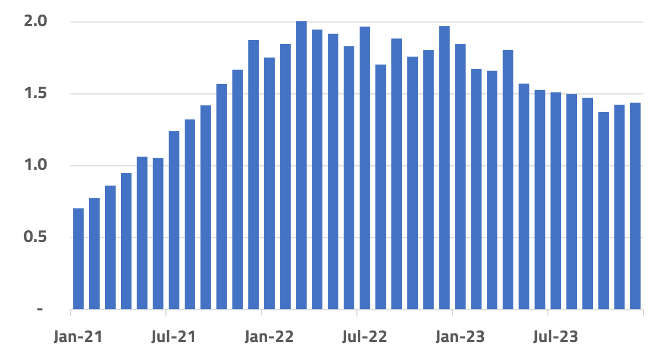


Source: Bloomberg

On the other hand, the buoyant labor market is one of the Fed's main impediments to moving forward with a rate cut process. While job creation has been slowing, unemployment remains below 4%, while labor demand remains at very high levels, with 1.5 job openings for every unemployed person. In addition, while wages are growing at a slower rate than a few months ago, they continue to grow at 4-5% per year, well above inflation.

Labor market remains robust

Job offers / unemployed persons



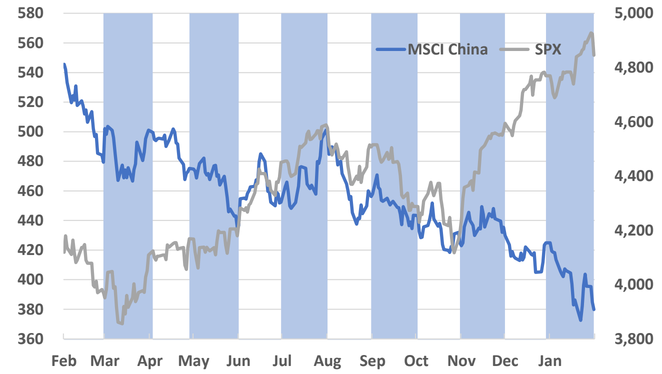
Source: Bloomberg

Finally, the Fed's prudent action would be an attempt to show independence from political forces in an election year. Any unsubstantiated rate cut could be used by an opposing presidential candidate to blame the Fed for playing favorites with the incumbent president's candidate.

The Fed's decision to keep rates unchanged is not an isolated event. During January, the Canadian and British central banks kept rates at previous levels, also citing the need for greater confidence in the disinflationary process. The European Central Bank made the same decision, but its discourse was different. Its argument was that economic weakness would lead it to implement rate cuts earlier than expected. Economic weakness was reflected in a slowdown in inflation to 2.8% YoY and zero economic growth in the last quarter of the year.

China's stocks continue to free fall

MSCI China vs S&P500



Source: Bloomberg

Europe's poor economic performance is related to China's sluggish economy. China is suffering from a lack of confidence on the part of local consumers and foreign investors about its ability to find an early way out of the real estate crisis. Inflation was negative for the third consecutive month in December, something that has not happened since 2009. Despite the strong growth data reported, the market remains skeptical about the recovery and is dissatisfied with the measures taken by the government. Stocks fell nearly 10% in the month and the 12-month performance disparity between the Japanese and U.S. markets is at historically high levels. However, until there is a positive catalyst that signals the end of the real estate crisis, it will be difficult to see the long-awaited rebound.

American Stocks	1M	YTD
DJIA	1.3%	1.3%
Nasdaq Composite	1.0%	1.0%
S&P 500	1.7%	1.7%
Russell 2000	-3.9%	-3.9%
Russell1000 Value	0.1%	0.1%
Russell 1000 Growth	2.5%	2.5%
Russell 1000	1.4%	1.4%

January was a good month for U.S. stocks. Growth and technology stocks, driven by an increasing probability of rate cuts, outperformed value stocks. Small cap stocks continued to lag large cap stocks, as they have a lower weighting in the technology sector indexes.

Developed Markets (USD)	1M	YTD
MSCI ACWI	0.6%	0.6%
MSCI ACWI ex-US	-1.0%	-1.0%
MSCI World	1.2%	1.2%
MSCI World ex-US	0.4%	0.4%
Japan: Nikkei 225	4.1%	4.1%
Stoxx Europe 600	-0.2%	-0.2%
Germany: DAX	-1.1%	-1.1%

Developed market equities had a weak start to the year, with the United States leading the way. The strong dollar had a negative effect on returns measured in dollars.

Emerging Markets (USD)	1M	YTD
MSCI EM	-4.6%	-4.6%
China: Shanghai Comp.	-7.2%	-7.2%
Hong Kong: Hang Seng	-9.2%	-9.2%
India: S&P BSE Sensex	-0.4%	-0.4%
Brazil: Bovespa	-6.7%	-6.7%
MSCI: México	-1.4%	-1.4%
Argentina: Merval	2.9%	2.9%
Chile: Santiago IPSA	-8.6%	-8.6%

Emerging markets disappointed, mainly influenced by the strong dollar. The MSCI Emerging Markets was dragged down by the poor performance of Chinese stocks, which account for 25% of the index.

US Treasury Bonds	1M	YTD
US Treasury 2 Yr	(4)	(4)
US Treasury 5 Yr	(1)	(1)
US Treasury 10 Yr	3	3
US Treasury 30 Yr	14	14

U.S. Treasury yields fell slightly in January at the short end of the curve on the back of good economic data.

Fixed Income Indices (USD)	1M	YTD
US HY	0.1%	0.1%
US IG	-0.7%	-0.7%
US GLOBAL	-0.7%	-0.7%
GLOBAL HY	0.0%	0.0%
GLOBAL IG	-2.0%	-2.0%
EM HY	-0.3%	-0.3%
EM IG	-1.2%	-1.2%
EM Global	-0.9%	-0.9%

The rise in long-term rates in January negatively influenced fixed income returns. Lower credit quality bond indices, which have shorter durations and higher carry, continued the trend of 2023, with better returns than those of good quality.

Currencies	1M	YTD
DXY	2.2%	2.2%
Euro	-2.0%	-2.0%
Yen	-4.0%	-4.0%
Libra	-0.3%	-0.3%
Yuan	-1.0%	-1.0%
Real	-2.0%	-2.0%
MSCI Emerging Mkts Currency	-0.9%	-0.9%

The growth data, together with the drop in the probability of rate cuts in the United States at the end of the month, boosted the dollar. Expectations of rate cuts in Europe and weak economic data in China led to a depreciation of their currencies.

Commodities	1M	YTD
BBG Commodity Index	0.4%	0.4%
BBG Agriculture Index	-1.5%	-1.5%
Oil	6.1%	6.1%
Gas	-16.5%	-16.5%
Oro	-1.1%	-1.1%
Plata	-3.5%	-3.5%
Cobre	0.4%	0.4%
Soja	-5.5%	-5.5%
Trigo	-5.2%	-5.2%
Maíz	-4.9%	-4.9%
Algodón	5.1%	5.1%
Ganado	2.1%	2.1%

The strong dollar led to a drop in returns for most commodities. However, geopolitical tensions boosted oil prices.

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