OBSERVATIONS: *Markets whipsawed by hot inflation data and retail sales underwhelm.*

- Markets were volatile last week—they fell sharply after last Tuesday's inflation data but then rebounded later in the week. The S&P 500 finished nearly flat last week -0.4%, while small caps (Russell 2000 Index) gained +1.2% and the yield on a 10-year Treasury rose 10 basis points to 4.28%.[1]
- The latest Consumer Price Index (CPI) data shows that inflation is remaining stubborn and the path to the Fed's target of 2% inflation is likely to be bumpy. January's headline CPI fell to 3.1% year-over-year (YoY) from December's 3.4% YoY figure. But core-CPI—which removes volatile food and energy prices—did not budge from December and remained 3.9% YoY in January—both core-CPI and headline CPI came in above expectations.[1]
- Similarly, producer prices came in higher than expected, with the PPI Index rising +0.3% month-over-month (MoM), versus expectations for only a +0.1% MoM gain.[1]
- Retail sales in January came in below expectations across the board. Headline retail sales decreased -0.8% MoM, while retail sales excluding autos and gas fell -0.5% MoM.[1]
- Industrial production also underwhelmed in January, with the Industrial Production Index declining -0.1% MoM and capacity utilization falling to 75.5% from December's 75.8% figure.[1]
- New housing starts fell to 1.331 million (annualized rate) in January down -14.8% from December, while new housing permits fell to 1.470 million (annualized rate) in January down -1.5% from December.[1]

EXPECTATIONS: *Rate cut expectations fall, a year of operational efficiency, and earnings inch up*

- In the aftermath of last week's inflation numbers, the market significantly repriced the odds of rate cuts this year. At the end of January, markets had priced in nearly six -25 basis point cuts by the Fed with the first cut coming in March, but after the latest Fed meeting—which all but ruled out a cut in March—and the recent inflation reports, the market is now pricing in less than 4 cuts with the first occurring in June.[1]
- 2024 looks to be a year where corporations are focused on improving margins. This earnings reporting season has seen mentions of the words 'operational efficiency' reach the highest level in history (nearly 100 S&P 500 companies) as firms aim to protect and grow profit margins.[2]
- With nearly 80% of the S&P 500 having reported, Q4 earnings are set to have risen by +3.2% YoY and the number of companies reporting a positive earnings surprise is 75%, which is below the 5-year average (77%), but above the 10-year average (74%).[3]

ONE MORE THOUGHT: *How Scary Is Our National Debt?*

As Congress continues to wrangle over the budget—the latest stop gap measure extends government funding until early March—we receive a steady stream of questions related to the size and the trajectory of the US government debt. The two most common—and difficult questions—are will the current level of debt hurt the US economy and second could the US be heading for a debt crisis? There is, unfortunately, not an easy answer to either question. There is some economic research that found countries with debt levels over 100% of GDP tended to experience lower real GDP growth than countries with levels of debt under that threshold. However, these findings have been challenged in recent years and even the IMF has concluded that there is no "simple relationship between debt and growth." However, there is more evidence of two other impacts related to high levels of public debt. The first is

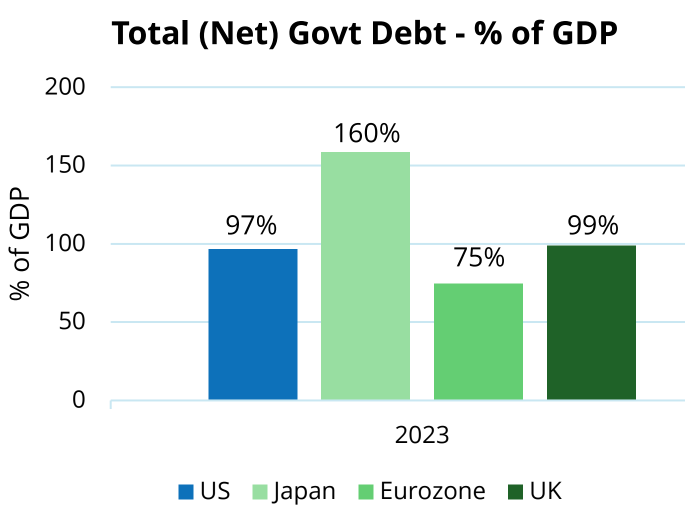
[1] *Bloomberg LP*

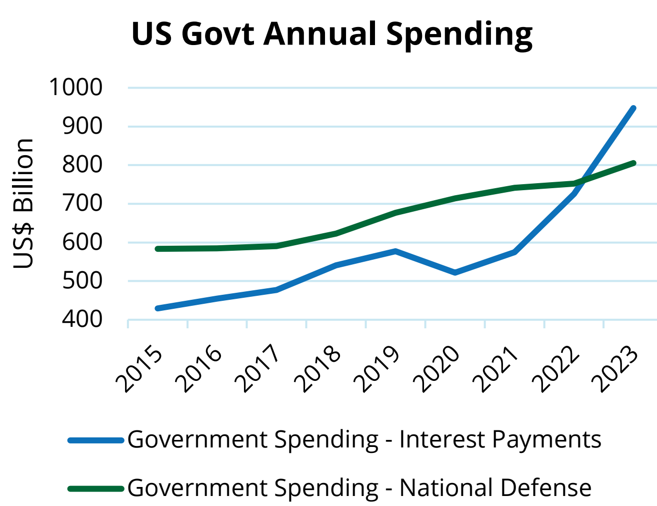
[2] *Bloomberg LP, Morgan Stanley, Alphasense*

[3] *FactSet Earnings Insight 2/16/2024*

that high levels of public debt can impede the ability of a government to boost fiscal spending when hit with a negative economic shock. A study of COVID-period fiscal policy shows that countries with less debt had the fiscal space to boost spending and help their economies recover faster from the pandemic than more indebted countries that spent less and recovered slower. Second, high levels of debt can crowd out other government spending plans as interest payments rise. We have seen this firsthand in the US as interest payments on the US national debt rose last year to over $900 billion and is now greater than what we spend annually on national defense. As interest payments rise it becomes harder and harder for any legislature to agree on how to spend what is left. As to the question of how much debt is too much. Could a debt crisis be looming for the US? The inconvenient answer is there is little solid research to make a confident judgement. On the positive side, the US dollar is the world's reserve currency and despite the efforts of a few countries—principally, Russia, Iran, and China—to diversify away from dollars, as the world becomes richer the demand for US dollars structurally rises and ultimately contributes to additional incremental demand for US Treasuries. On the negative side, the dysfunction in Washington DC and the inability of our elected officials to chart a credible path towards a more balanced budget is a cause for concern. The US bond market can be thought of as a decentralized system—with many millions of individual actors making independent decisions—and these systems can often be unpredictable, frequently feature multiple equilibria, and can "tip" towards extreme outcomes with little warning. All this should underlie the importance and value to US bond holders of a credible plan to eventually bring America's revenues and expenditures into better balance.

CHART OF THE WEEK





Source: Clearstead, IMF, Bloomberg as of 12/31/2023

Aneet Deshpande, CFA
Chief Investment Officer
Clearstead

Dan Meges
Chief Economist & Head of Global Equity
Clearstead