Blackshield Capital

12.02.24 – 18.02.24

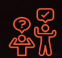
WEEKLY INSIGHTS

MARKET PLAYERS' OPTIMISM ABOUT RATE CUTS IS WEAKENING

Dynamics of key assets

Top charts of the week:

- the Fed's projected rate
- is the Goldilocks scenario possible
- risks for the Russell 2000



Have a question for the team? CONTACT US

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One of **the most important tasks of an investment firm is** to respond in a timely manner to the challenges of the economy and market conditions. While many risks of a geopolitical and financial nature cannot be predicted, it is worth staying informed to understand what is happening in a meaningful way.

Interest rates, the real estate market, employment and unemployment, inflation and corporate profits are just a few of the variety of factors affecting asset and security pricing.

Our goal is to provide a deeper and clearer understanding of what is happening in the markets with an emphasis on illustrations, charts and visuals.

Weekly Insights will provide a more detailed look at industry specifics, delve into the nuances of price mechanics, and provide a more detailed understanding of our strategic vision offered in our quarterly strategic reports.

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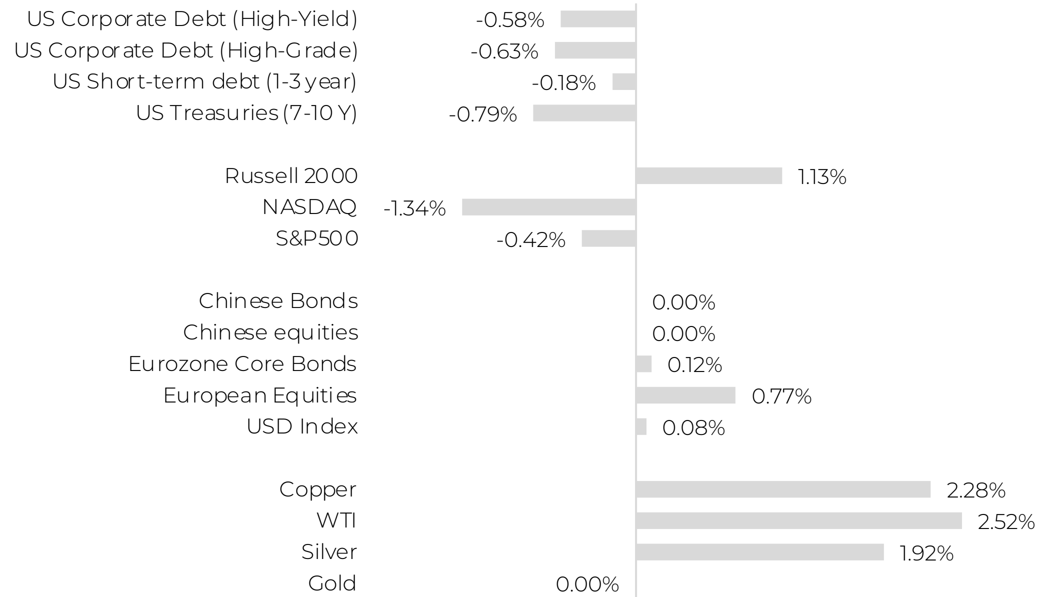
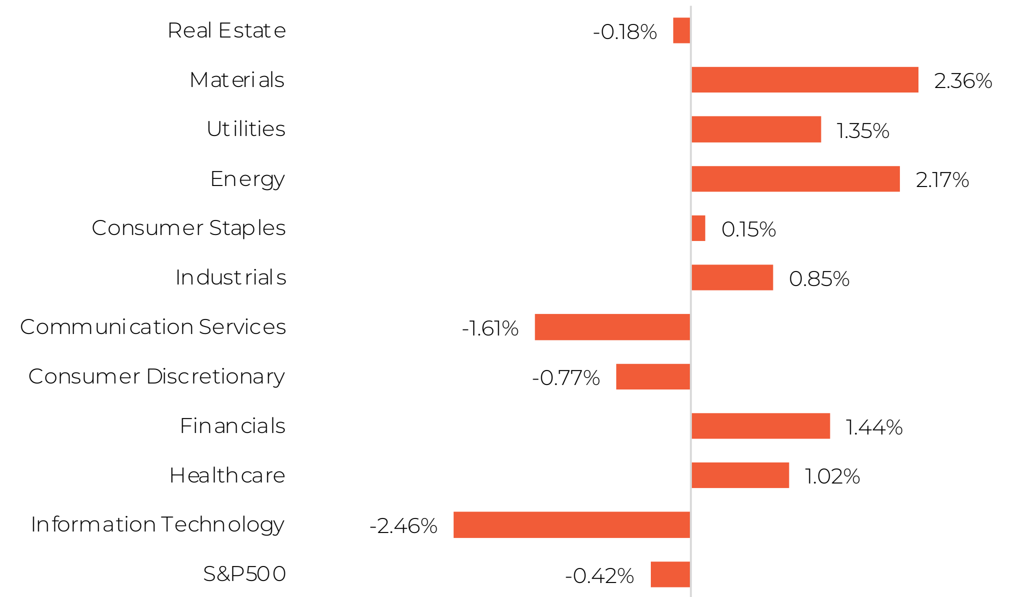
Dynamics of key assets

Last week was marked by the release of macroeconomic data, which inherently became a negative trigger for the US market. At the same time, the commodities market improved amid rising inflation, particularly for copper and oil.



- The US stock and bond markets declined in their quotes as a result of the release of important macroeconomic data: CPI, PPI, and Retail Sales, which prompted a reassessment of expectations for Fed policy and overall economic forecasts.
- At the same time, commodity assets showed growth amid a general decline in markets. The reason for the rise in oil prices was the continuation of the conflict in the Red Sea, while copper grew due to improved forecasts for demand for this metal.
- It is worth noting that Chinese markets were closed for trading due to the Chinese New Year celebrations, so there were no quotes.



- In terms of sectors, we saw an increase in investor attention to defensive sectors, including Healthcare, some Consumer Staples and the rate-sensitive Financials industry.
- Last week's leaders: IT, Communication Services, and Consumer Discretionary recorded declines in their quotations amid changes in market expectations regarding Fed policy.

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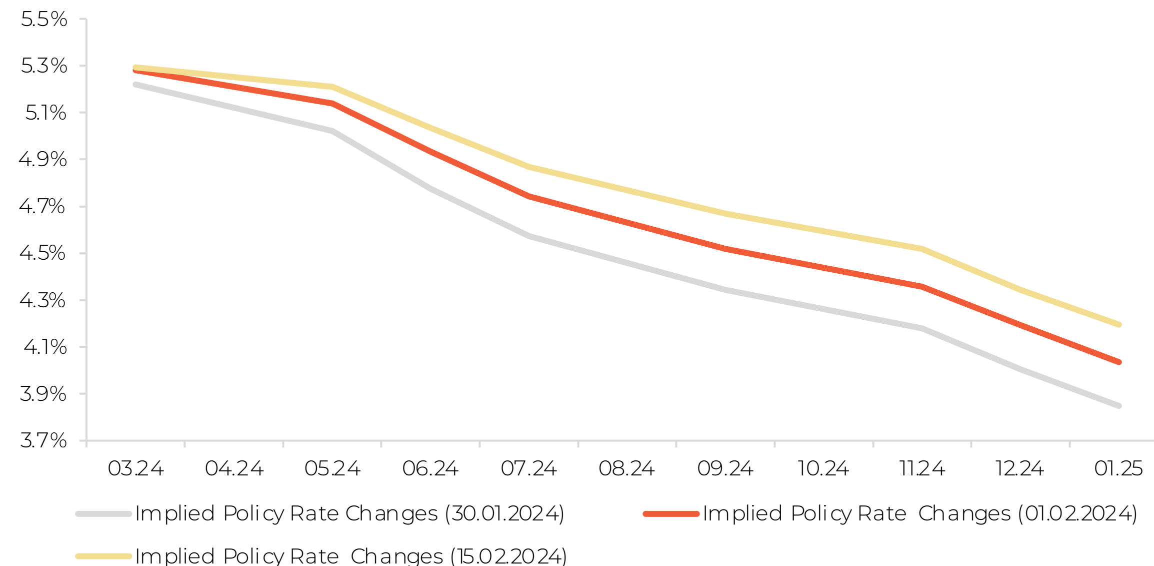
Top charts of the week – the Fed's projected rate

The beginning of the year was marked by high expectations for the pace of Fed rate cuts, which is now less likely based on published macro data for the first six months of 2024. Currently, instead of 6-7 rate cuts, the market expects only 3 rate cuts.

Number of rate cuts by the beginning of 2025

- The beginning of the year was more optimistic for the market than most players currently expect, so the expected pace of interest rate cuts in the economy is also declining. The reason for this is a change in key macroeconomic data: inflation remains steady, the Fed is changing its rhetoric to postpone rate cuts, and the first data on January retail sales did not satisfy the market either.
- At present, we believe that these changes are only the beginning of adjustments to market expectations for 2024. After all, as we pointed out in our previous reports, the market is now at a stage of strong disconnect from the real state of affairs in the economy, which creates conditions for correction.

Dynamics of rates reduction during 2024



- Not only the change in the pace of rate cuts, but also the final projected value of the key policy rate at the beginning of 2025 is indicative.
- Thus, at the end of the second week of February 2024, the expected rate is at 4.2%, which is already 0.4% higher compared to January 30 and 0.2% higher compared to February 5.
- Given this rapid pace of key policy rate revisions, we believe that the likely further macroeconomic conditions (stable inflation, a stable labor market, or neutral GDP growth) in the next few quarters could lead to a larger shift in market expectations.

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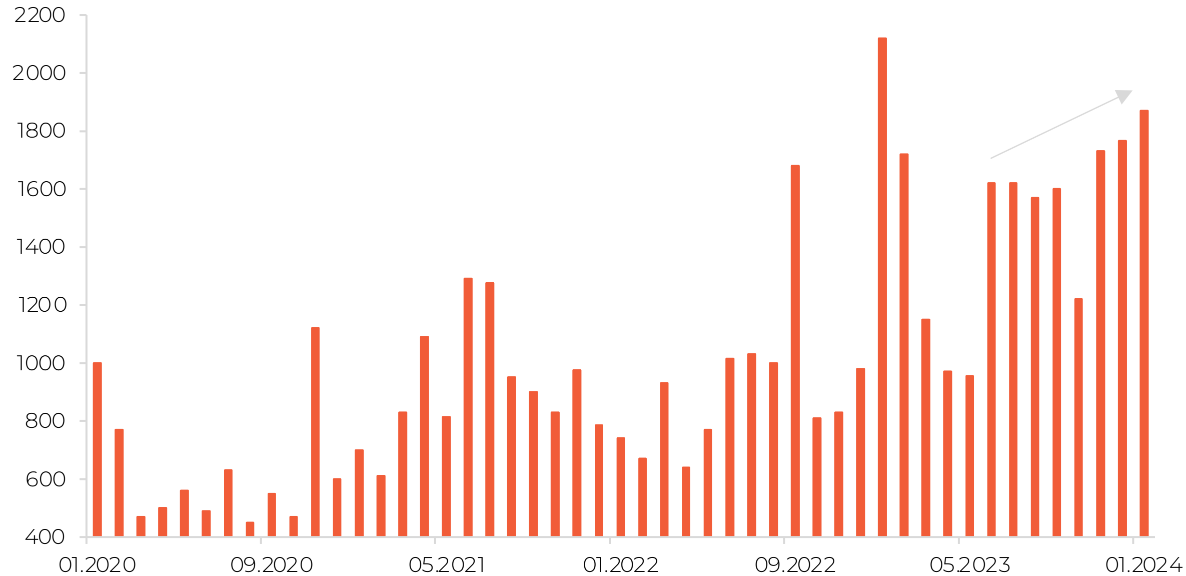
Top charts of the week – is the Goldilocks scenario possible

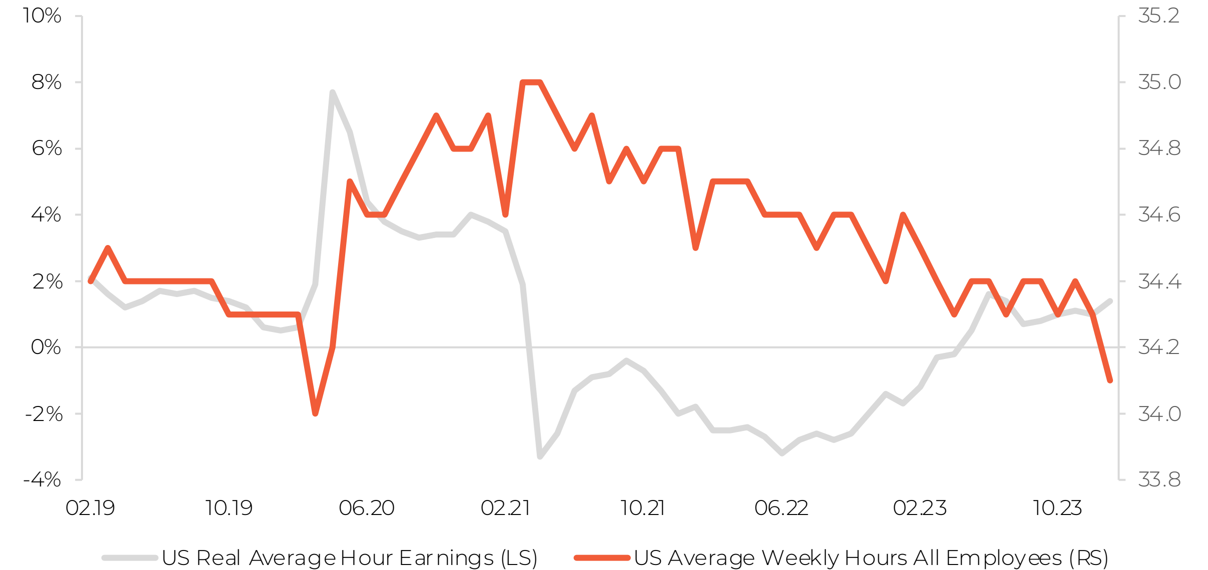
As we noted earlier, indicators of business activity, early changes in inflation and the unemployment rate point out that the real state of affairs is worse than the optimistic scenario that the market is seeing. This sentiment is driving the major indices higher, but the sustainability of these conditions remains a big question.

Number of mentions of the word "Goldilocks" during conversations with companies



- According to our observations, companies in their conversations with analysts are increasingly talking about the possibility of the so-called Goldilocks scenario - an ideal state of the economy: full employment, stable GDP growth and controlled inflation.
- At the same time, we observe that market sentiment is at a fairly high level, which is reflected in the current quotes of the main indices - S&P 500 and NASDAQ.
- Currently, these indices are updating their historical values, which indicates that positive expectations are being laid down to achieve the Goldilocks scenario.

Growth dynamics of real wages and average hours worked



- However, when we talk about the possibility of a Goldilocks scenario, we try to operate with earlier indicators of the main variables - inflation and unemployment.
- As for inflation, the latest data came out above market expectations, which are actually more likely to be explained by the stability of service price growth, particularly in the real estate market. At the same time, wage growth continues, which indicates the preconditions for further sustainability of the inflation rate.
- The labor market remains strong (the unemployment rate is almost the lowest in history), but such an early indicator as the number of hours spent working in the US is declining, suggesting a decrease in labor demand and early shifts towards an increase in the unemployment rate.

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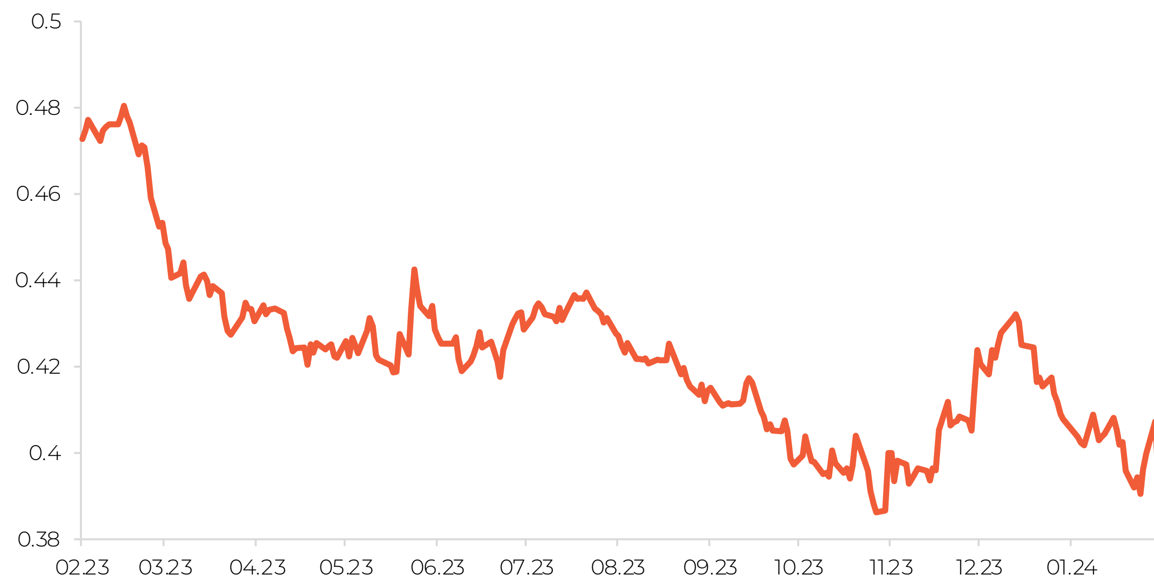
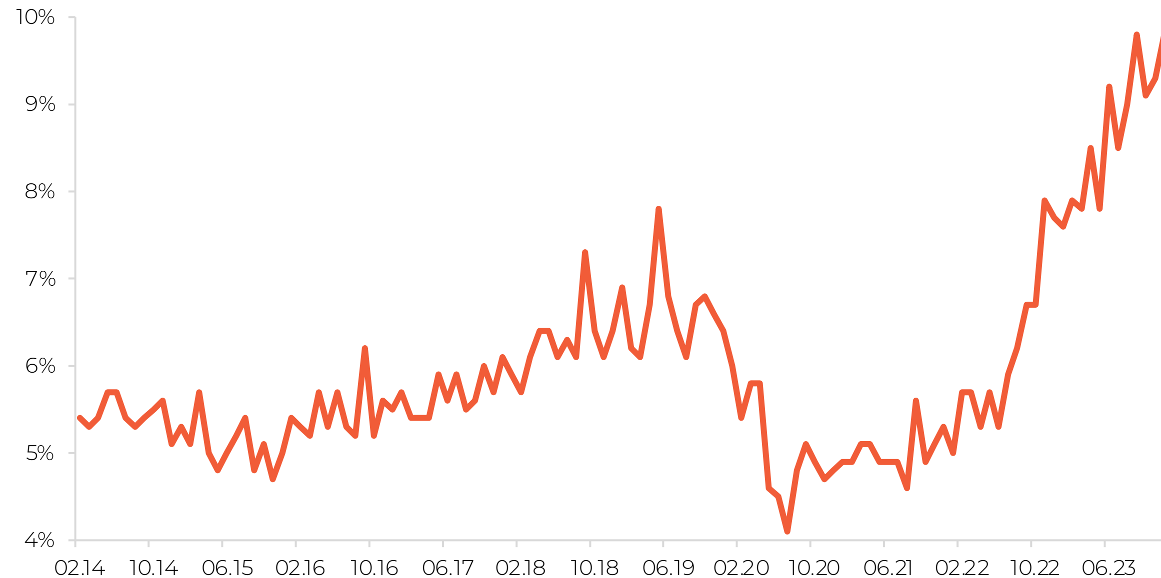
Top charts of the week – risks for the Russell 2000

Russell 2000, as a separate category, is always in demand among investors when the market is growing. However, we are not seeing this picture at the moment, because despite the market growth, interest rates in the economy are at a fairly high level, which does not allow small businesses to develop at the pace they used to.



- Despite the fact that the Fed has stopped the process of raising rates, the stock prices of small companies remain under pressure.
- The Fed's soft rhetoric in the fall of 2023 had a positive impact on stock prices and created the so-called autumn rally, in which the Russell 2000 and other interest rate-sensitive assets significantly outperformed the growth of major indices.
- Currently, we are seeing the opposite: a new lag in the growth of small-cap stocks compared to the overall growth of the stock market (Russell 2000 / S&P 500).



- The main reason for this lag is high interest rates in the economy, particularly for small businesses.
- Compared to 10 years of observations, interest rates are currently at their highest levels, which clearly has a negative impact on the ability of businesses to expand, create new jobs, and maintain current profitability.
- Small companies are more sensitive to changes in interest rates than medium and large ones. They are less stable in their development and profitability and have less access to equity capital. That is why, in the current environment, we do not see the category of small-cap stocks as attractive to buy compared to other types of stocks.

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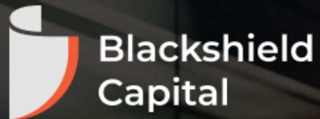

LET US HELP YOU TO FOCUS **ON WHAT MATTERS MOST**

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