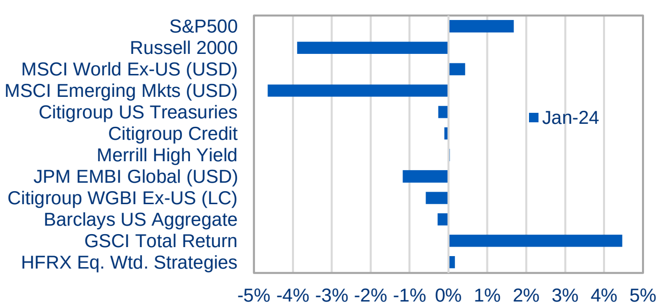
Global Market Review

In their latest policy-setting meetings, the Fed, the ECB, and the Bank of England kept their respective policy rates on hold and sought to dampen market expectations for imminent rate cuts. Their notes of caution reflect a determination to avoid a resurgence in price pressure arising from a premature pivot to easier policies. Although the U.S. equity market was disheartened by the Fed's cautious tone, and lost ground immediately following the meeting, it ended January with a healthy gain, adding to the strong returns of the fourth quarter of last year. Other advanced economy bourses also rose, albeit much more modestly. Emerging equity markets, in contrast, fell sharply in January dragged down by a further steep decline in Chinese equities. Global sovereign bond and credit markets also lost ground in January. The U.S. dollar rose against most major currencies. Commodity prices spiked, largely reflecting a sharp increase in oil prices induced by intensifying geopolitical concerns.

Performance of Major Market Indices

Sources: S&P, MSCI, FTSE Russell, Barclays, Citigroup, Bank of America Merrill Lynch, J.P. Morgan, HFR, Bloomberg.



U.S. equity market extends gains. Oil prices surge higher.

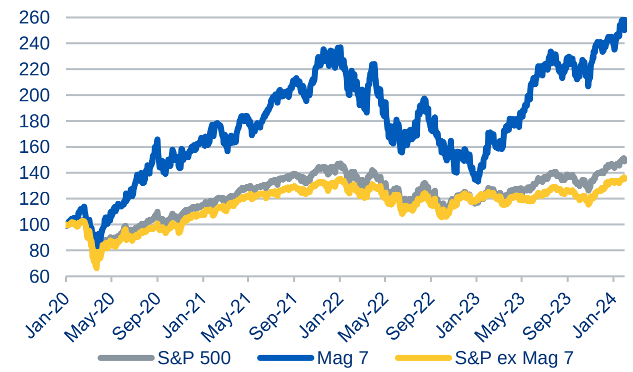
Fed Caution Does Little to Temper Exuberance

While the FOMC's decision to keep rates on hold at its January 31 meeting was widely discounted in the market, its attempt to dampen expectations for a rapid pace of rate cuts beginning in March was not, resulting in a sell off on the last trading day of the month. Despite this decline, U.S. equities rose in January, extending the strong gains of the fourth quarter of last year.

The market gain in January remained lopsided, driven primarily by the Magnificent 7 (Alphabet, Amazon, Apple, Meta Platforms, Microsoft, NVIDIA, and Tesla). The share prices of these firms continue to benefit from speculation surrounding the potentially transformative impact of AI on profits and productivity. The S&P 500 rose 1.7% in January compared to a 2.5% gain of the Magnificent 7. Excluding the Magnificent 7, the index was up 1.2% (Exhibit 1).

Exhibit 1. U.S. Equity Market Gains Remain Lopsided

Source: Bloomberg. Index January 1, 2020 = 100.



Reflecting the dominance of the Magnificent 7, growth stocks outperformed value in January, gaining 2.2% versus value's decline of 0.2%. This dynamic also buoyed large cap stocks, up 1.4% versus the 3.9% decline in small cap.

The travails of New York Community Bancorp, which plunged 38% on the last day of the month, reminded markets of the risks to the banking sector arising from the combination of high leverage and falling asset valuations. Although this episode, like the more serious banking mini-crisis in March of last year, remains well contained, U.S. office properties face $117 billion in debt that will need to be repaid or refinanced this year in an environment of higher debt costs and much lower valuations.

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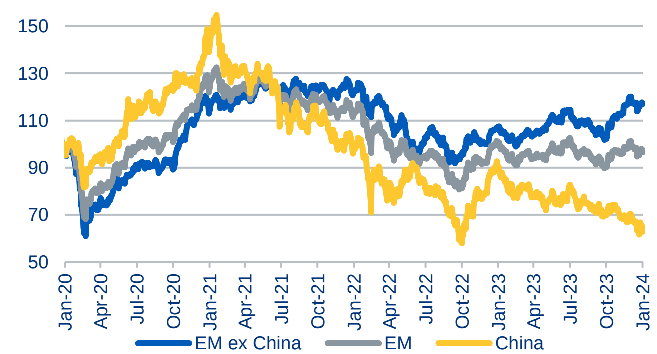
Chinese Equity Market Slides Further

Chinese equity markets have lagged others by a wide margin over the past two years. Although the causes of the poor performance of Chinese equites are many – heavy-handed and erratic regulation, geopolitical concerns, deflationary forces, high debt levels, a declining workforce, diminishing returns to new capital expenditure, and a fragile financial system – the over-built and over-leveraged property market has been a primary factor. Two years after its default, this month's bankruptcy of Evergrande, China's biggest real estate firm, epitomizes the danger that distress in the property sector could have far reaching implications for the financial system, local government finances, and the broader economy.

Against the backdrop of these significant cyclical and structural challenges, Chinese equities plunged 10.5% in January following an 11.2% drop in 2023. Weighed down by the Chinese market, the EM index fell 4.6% in January, following the index return of 9.8% last year (Exhibit 2).

Exhibit 2. China Deepens its Decline

Source: Bloomberg. Index January 1, 2020 = 100.



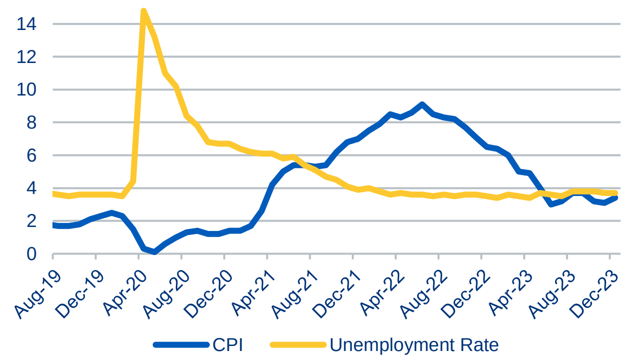
Advanced equity markets managed a small gain for the month, although the size of these returns to U.S. dollar-based investors was reduced by the dollar's appreciation. The MSCI World ex-U.S. index of advanced equity markets rose just 0.4% in January, following its gain of 17.9% last year. European bourses saw marginally negative returns in January, while the Japanese market rose 4.6%, adding to last year's 20.3% gain.

Falling Inflation, Resilient Economy, Cautious Fed

Widely vacillating views on the paths of inflation, economic growth, and monetary policy dominated broad U.S. equity market movements last year. Hopes that the Fed would soon declare victory over inflation and begin easing policies precipitated a strong equity and bond market rally in the fourth quarter. January's FOMC meeting sought to dampen the most optimistic of these expectations. As expected, the Fed kept rates unchanged and removed its tightening bias, indicating that "the risks to achieving its employment and inflation goals are moving into better balance" (Exhibit 3). The Fed cautioned, however, that the timing and pace of rate cuts would not be as soon or as rapid as the market hopes, and would need to await "until it has gained greater confidence that inflation is moving sustainably below 2%." Although inflation has fallen sharply from its mid-2022 peak of 9.1%, the Fed is well aware of the dangers of allowing price pressures to be rekindled by premature easing. This concern and the low level of unemployment, which is at its lowest point in over 50 years, support the Fed's cautious approach.

Exhibit 3. Falling Inflation Low Unemployment

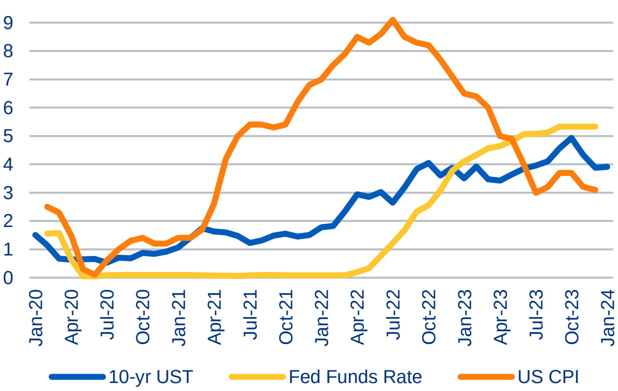
Source: Bloomberg. YoY inflation and unemployment rate in percent.



With the decline in inflation, the Fed funds rate and the yield on 10-year U.S. Treasury notes are well above the current inflation rate (Exhibit 4). This tightening of rates in real terms is likely to work its way through the economy and contribute to bringing inflation sustainably below the Fed's 2% target. Although markets widely expect that this disinflation can be achieved without a contraction in growth and employment, whether the Fed can achieve this rare feat remains an open question.

Exhibit 4. Real Fed Funds Rate and Treasury Yields Rise

Source: Bloomberg. Yields and inflation in percent.



Performance of Major Market Indices through 01-31-2024

Sources: MSCI, FTSE, Barclays, Citigroup, Bank of America Merrill Lynch, J.P. Morgan, S&P GSCI, HFR, Bloomberg.

	1-Month	QTD	YTD	1-Year	3-Year	5-Year
S&P500	1.7%	1.7%	1.7%	20.8%	11.0%	14.3%
Russell 2000	-3.9%	-3.9%	-3.9%	2.4%	-0.8%	6.8%
MSCI World Ex-US (USD)	0.4%	0.4%	0.4%	9.5%	4.9%	7.1%
MSCI Emerging Mkts (USD)	-4.6%	-4.6%	-4.6%	-2.9%	-7.5%	1.0%
Citigroup US Treasuries	-0.3%	-0.3%	-0.3%	1.2%	-3.5%	0.4%
Citigroup Credit	-0.1%	-0.1%	-0.1%	4.2%	-2.9%	2.1%
Merrill High Yield	0.0%	0.0%	0.0%	9.2%	1.9%	4.3%
JPM EMBI Global (USD)	-1.2%	-1.2%	-1.2%	5.9%	-3.1%	0.8%
Citigroup WGBI Ex-US (LC)	-0.6%	-0.6%	-0.6%	2.8%	-4.5%	-1.2%
Barclays US Aggregate	-0.3%	-0.3%	-0.3%	2.1%	-3.2%	0.8%
GSCI Total Return	4.5%	4.5%	4.5%	0.1%	19.0%	7.8%
HFRX Eq. Wtd. Strategies	0.2%	0.2%	0.2%	2.7%	0.8%	2.4%