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Mixed data point to uneven path to soft landing

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Weaker-than-expected US retail sales on Thursday painted a different picture of the US economy from the elevated inflation readings released during the week. But the overall trend continues to show an economic backdrop in line with our soft landing base case. We like quality bonds, quality equities, and small-cap stocks, and see several ways investors can hedge market risks.

US equities had a volatile week, with market sentiment swayed by stronger-than-expected US inflation data, softer retail sales, and dovish comments from Chicago Fed President Austan Goolsbee. Following a 1.4% drop on Tuesday, the S&P 500 climbed nearly 1% on Wednesday. By Thursday's close, the benchmark index was up another 0.6% to claim a new record high, yet it declined 0.5% on Friday to end the week at just above 5,000. The benchmark index is up 4.9% year-to-date.

A key focus for investors remains how soon and how swiftly the Federal Reserve will cut rates, leading to a heightened sensitivity to both positive and negative data surprises. But while investors should brace for further volatility, we continue to see an economic backdrop in line with our base case scenario of a soft landing.

Consumer spending is likely to remain healthy amid a solid US labor market. The most recent data showed US retail sales fell more than expected in January, pulled down by declines in receipts at auto dealerships and gasoline service stations amid cold weather. The month-over-month decline of 0.8% for January marked the sharpest drop in 10 months, but it followed a strong performance over the holiday season. Despite a likely slowing in momentum this year, we believe consumer spending should stay healthy given the strength of the labor market. Initial jobless claims fell for a second week last week, while the growth in nonfarm payrolls for January exceeded market expectations. Looking past the headline numbers, we see job creation on a moderate falling trend, with still-low unemployment supporting household consumption.

Inflation is still expected to slow in the months ahead. Both the consumer price index (CPI) and producer price index (PPI) for January came in hotter than expected. But the strength in the CPI largely reflected start-of-year price increases for labor-reliant categories such as medical services, car insurance and repair, and daycare; and we expect inflation in these categories to be lower in February and March. Also, owners' equivalent rent was at a nine-month high of 0.56%, but the rent category was up only 0.36%—the largest gap between the two since 1995.

Fed rate cuts are likely still not far off, despite mixed comments from top officials. Atlanta Fed President Raphael Bostic said on Thursday that he's not yet ready to call for interest rate cuts, the latest Fed official to push back against immediate easing. However, he said that the central bank has made "substantial and gratifying progress" in slowing the pace of inflation, and that he expected inflation will continue to decline. Chicago Fed President Goolsbee earlier in the week said that slightly higher inflation data for a few months would still be consistent with a path back to the Fed's 2% target, and that it's important not to judge the inflation trend from one month's number. We continue to see a likely first cut in the second quarter of this year.

So, while we do not expect the path toward lower inflation and lower rates to be smooth, we maintain the view that a soft landing for the US economy favors quality bonds and equities. We also see opportunities in small-cap stocks, which benefit more from lower rates. For investors looking to hedge market risks, we recommend defensive structured strategies, oil, gold, and hedge funds.

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