What the latest inflation data means for markets, the Fed, and investors' portfolios

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Sam Grobart: Inflation came in a little higher than expected this week, so what does that mean for the Fed's next move? This is The Markets.

Hi, I'm Sam Grobart. Today, I am joined by Alexandra Wilson-Elizondo, co-chief investment officer of multi-asset solutions in Goldman Sachs Asset Management. Alexandra, thanks so much for joining us today.

Alexandra Wilson-Elizondo: Thank you so much for having me, Sam.

Sam Grobart: Alexandra, we got the December Consumer Price Index Report this week. It came in a little bit higher than estimates at 3.4%. What are your takeaways from that data?

Alexandra Wilson-Elizondo: So coming into today, there was a very heavy burden on the print itself because the market psychology had so strongly moved towards soft landing narrative, and the rate market had started to price pretty aggressively cuts starting in the first quarter. Now, today's print I would say is higher than expectations. And when you look at headline, core was pretty much in line. But the real theme is contained, that inflation is progressing. Some of this, when you look at real-time data is adjusting, so we had higher than expected OER. But when you look at Zillow data, it's contradictory to that when you look real time.

And so from our perspective, what it really has done is challenged the market's pricing of rate cuts starting in the first quarter. But it also does give Powell max optionality. So at this point, you could see he could go in either direction, but we really do look towards wage data. And you saw claims come down in this print. And we believe that starting in the middle of the year is when you'll actually start to see the Fed cut rates.

Sam Grobart: And there had been earlier estimates as early as maybe March. That now seems to perhaps be far less likely given this new data.

Alexandra Wilson-Elizondo: Yes, exactly. And that's in combination with some of the wage data that we saw in the latest payroll report, which just showed that average hourly earnings were ticking up a little bit. So I think bring that all together in totality, it will lead central banks, in particular in the Fed in this case, to just lean a little bit more on the hawkish side in line with actually what some of the minutes released showed.

Sam Grobart: Taking a longer view, more than just what's been happening today/this week, but what is your view on the Fed for this year? Are you looking for substantial cuts in 2024?

Alexandra Wilson-Elizondo: We do see that policy has peaked. Remarkable progress in disinflation and the rate of labor market, in particular as it relates to rebalancing. Quits rates have come back down to September 2020 levels. And that's really significant because the labor market has been a large source of the heat.

So from our perspective, we think the reaction function for the Fed will normalize and will be more balanced as it relates to growth and inflation. We do expect cuts this year, like I mentioned, to start in the middle of the year, but we do push back on that market pricing in terms of it being in Q1. And those key points for our argument are A) the December FOMC minutes show that there's more of a hawkish tone there and a sense of caution. And it would take some time for them to begin to communicate that there were cuts in sight. Still just a bit too early from our view.

And then there is the potential for a cyclical rebound, just given some of the loosening in financial conditions we've seen. In particular, mortgage rates, what that could mean for housing. And then we've seen some geopolitical consequences on supply chains, whether that's what's happened in the Red Sea, the Suez Canal, or even some of the drought impacts that you have seen in the Panama Canal. We just think it's just a little bit too early to view the rate cuts to be at the forefront right now.

Sam Grobart: Given all of this, what do you think this means for portfolios? Our colleagues in Goldman Sachs

Research say that the risk for 60/40 portfolios is coming down because inflation risk is coming down. So could we see bonds again serve as portfolio hedges?

Alexandra Wilson-Elizondo: We feel very strongly that this economic backdrop will give a strong tailwind to both stocks and bonds. And while we expect both to do well, we are expecting an increase in volatility.

Sam Grobart: And what would be some of the key drivers of that volatility?

Alexandra Wilson-Elizondo: Some of those would be the mega election cycle that's happening globally, with a key emphasis in outcomes in the UK, Taiwan, and the US. Some concerns around fiscal deficit and government spending. And last but certainly not least, the geopolitical tensions.

Sam Grobart: Alexandra, how are you thinking about valuations right now? It was a monster year for stocks in 2023, and there still remain a lot of questions about whether equities are overvalued. What's your take on that?

Alexandra Wilson-Elizondo: Yeah, in the US, we acknowledge fullheartedly that the equity market is expensive. When you look at historical valuations, we're now above the 90th percentile. To your point, we saw extraordinary performance from the Magnificent Seven meeting the top seven tech stocks, effectively up 76%, and equal weighted index only up 12%.

But let me share a few stats that really put that magnificence in context. When you look at the market cap of Microsoft, it's equal to the entire market capitalization of the Canadian equity market.

Sam Grobart: Really?

Alexandra Wilson-Elizondo: Similarly -- yes.

Sam Grobart: Wow.

Alexandra Wilson-Elizondo: Apple is the same size approximately as the UK equity market. So that really should shed some light into how magnificent those moves were. But in our minds, the high valuations are supported by the fundamentals. So whether you're looking at EPS trajectory, balance sheet strength, high profit margins, and the potential for the continued AI productivity boost, it makes sense to us to be invested.

And in the same vein, election years are typically pretty strong for equity markets, and some historical figures show that it's plus or minus 7% number. So that gives us some confidence that, despite the valuations being somewhat elevated, if you can be thoughtful about some of that volatility and entering the market at times where the market's just trading on fear rather than fundamentals, you can get your portfolios into that longer position that you would want aligned with our expectations for the soft landing outcome.

Sam Grobart: And Alexandra, our typical last: what is on your radar for next week?

Alexandra Wilson-Elizondo: Earnings, earnings, and some more earnings.

Sam Grobart: Some big bank earnings coming through, right?

Alexandra Wilson-Elizondo: Yes, absolutely. In particular, we're very much so looking forward to seeing margin development. Was Q4 really the trough? To what extent have rising interest costs and wage growth impacted net profit margins? Corporate guidance, has that shifted post the Fed pivot? So should we see less of a draconian outlook from corporate America? And lastly, from the bank front, what are we seeing in terms of trends in loan provisioning, in particular as it relates to the consumer and commercial real estate?

Sam Grobart: Alexandra, thank you so much.

Alexandra Wilson-Elizondo: Thank you very much for having me.

Sam Grobart: That does it for another episode of The Markets. Be sure to find us on Spotify, Apple Podcasts, or wherever you get your streaming audio. I'm Sam Grobart. Thanks so much for listening.

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