OBSERVATIONS: *Markets rebound, largest merger of the year, China fights deflation.*

- US equity markets largely traded higher last week, with the S&P 500 gaining +1.7% and the tech-heavy NASDAQ gaining +1.4%, in part due to the continued strength of AI-oriented stocks such as NVIDIA which beat earnings expectations and gained +8.5% for the week. Meanwhile US small caps (Russell 2000 Index) traded slightly lower, falling -0.8% and the yield on a 10-year US Treasury fell 3 basis points to 4.25%.[1]
- The Conference Board's Leading Indicator Index fell by -0.4% month-over-month (MoM) in January. The index is still signaling economic headwinds overall, but, for the first time in the past two years, six of the ten indicators have turned either slightly positive or improved to at least flat.[1]
- Initial unemployment claims came in below expectations registering only 201k last week and continue to indicate strength in the US labor market.[1]
- Total existing home sales rose in January +3.1% MoM to 4.0 million (annualized rate) from December, but January's 4.0 million home sales were down -1.7% year-over-year (YoY) from total home sales in Jan-2023.[1]
- Capital One agreed to buy Discover Financial last week in what stands as the largest announced merger of 2024 with the deal valued at $45 billion. If the deal closes, the combination would create the largest US credit card company by loan volume.[1]
- Despite the recent intermediate trends of inflation rising at a slower rate, it is the level not the rate of change of inflation that matters for most Americans. According to recent data, following a 5-year stretch (2019-2023) during which food prices rose by a cumulative 25%, US consumers now spend 11.3% of disposable income on food, matching the rate last seen in the 1980s. Americans in the lowest income quintile spent over 30% of disposable income on food.[2]
- China reduces key rate. China's central bank cut its five-year prime rate—a benchmark interest rate for home loans— to 3.95% from 4.2% in a bid to stabilize its housing market. The mid-week move came on the heels of additional easing measures by the central bank as China battles deflation with both consumer and producer prices falling outright in most recent data—in contrast to inflation trends in the western world.[1]

EXPECTATIONS: *Fed minutes are hawkish, while Congress returns to work.*

- The minutes from the most recent Fed meeting (30-31 Jan) were largely hawkish in their tone with most participants noting the "risks of moving too quickly to ease" monetary policy; the minutes underscore the recent comments of several Fed speakers that signal the Fed is in no hurry to begin cutting rates.[1]
- Congress is back in session this week and the House needs to pass appropriations bills covering about 20% of the Federal government by Friday, March 1st or a partial government shutdown will begin. At this point, it looks as though the House is likely to pass a stop-gap spending resolution that moves the deadline to March 8th which is the deadline to pass a budget for the other 80% of the Federal government. The risk of a full or partial government shutdown remains possible.[3]

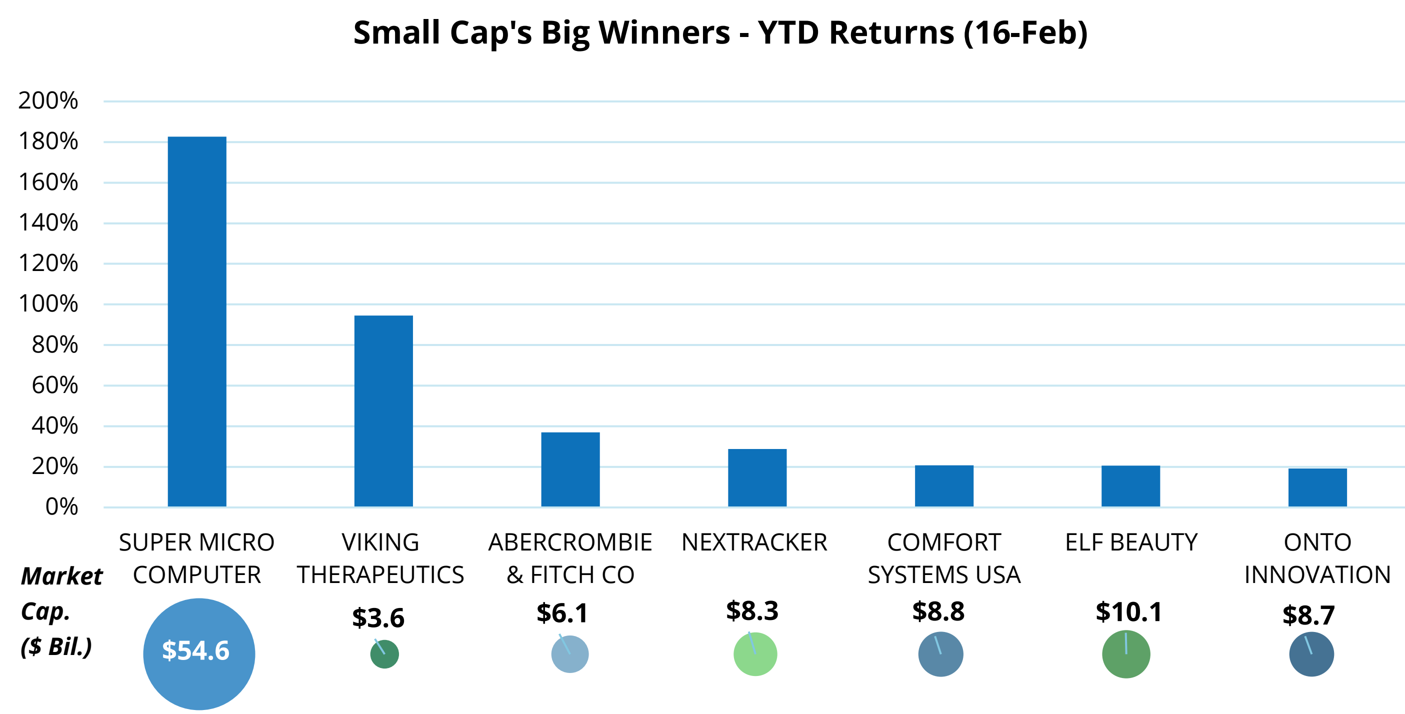
ONE MORE THOUGHT: *Small cap gets its own version of the magnificent seven.[1]*

Small caps are off to a slow start. Through the first eight weeks of the year (16-Feb), the Russell 2000 Index was up only +40 basis points. However, with over 60% of the index having negative returns year-to-date (YTD) and the median small cap stock returning -2.9% YTD, the gains in the index are being driven—similar to what we have seen

[1] *Bloomberg LP*
[2] *https://www.ers.usda.gov/data-products/ag-and-food-statistics-charting-the-essentials/food-prices-and-spending/*
[3] *https://rollcall.com/2024/02/21/tall-order-for-lawmakers-to-finish-spending-bills-next-week/*

in the US large cap space—by a small number of stocks. Despite the Russell 2000 Index being comprised of nearly 2000 individual stocks, seven stocks—which represent only 2.4% of the total index weight—have produced over 25% of the total gains for the index YTD. The largest small-cap gainer YTD has been Super Micro Computer (SMCI), an IT firm whose specialty servers are the go-to-choice for AI applications, whose share price has surged over +182% YTD. The AI frenzy of the past year has caused SMCI shares to surge so much that it has gone from a firm with a $5 billion market capitalization in early 2023 to over a $50 billion firm at present. When the Russell 2000 index rebalances in mid-2024, SMCI will likely go from being classified as a small to a large cap and entirely leapfrog over the mid-cap category. Other big gainers for small caps this year include Elf Beauty, NextTracker, and Abercrombie & Fitch (See Chart of the Week). While the concentration of returns in the Russell 2000 Index YTD are not as concentrated as we experienced last year among US large caps, it underscores the notion that earnings growth is not spread evenly throughout the US equity landscape.

**CHART OF THE WEEK**




*Source: Clearstead, Bloomberg 2/22/2024*

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