BEHIND THE HEADLINES

with **Ronald Temple**, Chief Market Strategist

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The Week Behind

1. **A lower-than-expected US core Consumer Price Index (CPI) report invigorated markets.**

   The December US inflation report was modestly better than expected on a core basis but in line with headline expectations. Headline CPI increased by 0.4% month-on-month (m-o-m) and 2.9% year-on-year (y-o-y). Core CPI increased by 0.2% m-o-m and 3.2% y-o-y with both metrics 10 basis points (bps) below expectations.

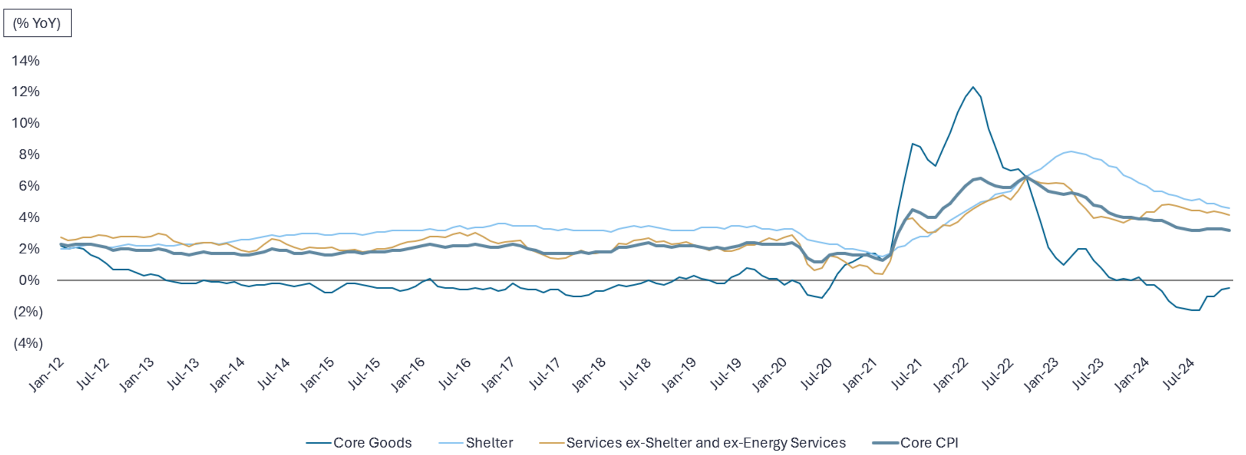
   Digging deeper, shelter inflation remained at a lower run rate than observed through much of last year. The m-o-m increase of 0.3% for rent of a primary residence and owners' equivalent rent (OER) of a primary residence was encouraging as the data now aligns better with metrics such as the Zillow Observed Rent Index which has shown rent inflation below 3.6% y-o-y for 18 months.

   At the same time, inflation for services excluding shelter only increased 0.2% m-o-m. If shelter inflation were to persist at 0.3% per month with services ex-shelter at 0.2%, core CPI from these two components alone would imply core CPI of ~2.5% per annum.

   From 1999 to 2019, core goods price inflation was zero, as globalization lowered consumer prices at the expense of blue-collar workers in developed economies. If that paradigm were to be repeated, the Federal Reserve (Fed) could declare victory, as core CPI tends to run about 50 bps above core Personal Consumption Expenditure (PCE) inflation which is the Fed's primary inflation metric. However, I believe strongly that core goods inflation will not return to a zero-inflation level given the likely implementation of tariffs by the incoming Trump administration and ongoing corporate efforts to de-risk supply chains by moving production away from China to other locations that in many cases are more expensive but viewed as more resilient. In fact, even before the inauguration next week, in three of the last four months, US core goods prices have increased after being flat or down most of the prior 18 months, suggesting that even without tariffs, there could be increasing upward pressure on goods prices. The graph below shows the y-o-y change in each major category in the core CPI while the table below summarizes the key moving parts in December.

Shelter and Services Inflation Are Slowly Subsiding, but Core Goods Inflation Is Accelerating

US Consumer Price Index Inflation for Key Categories



Source: Bureau of Labor Statistics, Haver Analytics
Note: As of December 2024
Core goods represent ~23% of core CPI, shelter represents ~46%, and other services ex-shelter and ex-energy services represent ~31%.

December 2024 Core CPI Details	Weight in Core CPI	Contribution/ Detraction (bps)
Key Categories:		
Shelter (OER, rent of primary residence, other accommodation)	45.8%	11.9
Services ex-Shelter	31.2%	8.5
Core goods	22.9%	1.2
Total Core CPI (from sum of key categories)		21.6
All Items Ex-Food and Energy (reported)		22.5
Contributors:		
Owners' equivalent rent of a primary residence	33.9%	10.5
Rent of Primary Residence	9.7%	3.0
Airline fares (Services ex-shelter)	1.0%	4.0
Used cars and trucks (Core goods)	2.4%	2.9
New cars (Core goods)	4.5%	2.1
Medical Care Services (Services ex-shelter)	8.2%	1.5
Detractors:		
Other lodging away from home including hotels and motels	1.4%	(1.9)
Source: Lazard, Bureau of Labor Statistics		
As of December 2024		

Overall, the December report was positive, but not materially enough to drive the equity and bond market rally that immediately ensued. Fed rate hikes in 2025 were not likely before the CPI report, in my opinion, and that remains the case. However, the argument for meaningful rate cuts has not changed either. I expect the policy decisions emanating from the new US presidential administration related to trade and immigration to largely determine Fed policy in 2025, as these policies could materially affect the trajectory of inflation and growth which then directly impact both legs of the Fed's dual mandate to maximize employment while maintaining price stability.

I expect the new administration to announce tighter immigration policies and higher tariffs relatively quickly after the inauguration. The tariff announcements could be instructive as we will gain a better sense of the potential negotiating strategy and the magnitude, scope, pace, and nuance with which tariffs might be imposed. I am confident the Fed will be watching as keenly as investors.

2. **US retail sales were mixed with headline sales below expectations and core sales above.**

Total sales were below expectations despite strong sales at gasoline stations in large part due to weaker-than-expected auto sales growth. The control group which excludes a number of volatile categories beat expectations with strength from miscellaneous stores, sporting, hobbies, and books stores, and clothing and accessories stores.

The initial reading on retail sales is subject to sizable revisions as the sample for the second reading is triple the size of the first. Hence, one should not overestimate the importance of this report.

December US Retail Sales	Consensus	Actual	Prior Month	Revised
Retail Sales m-o-m	0.6%	0.4%	0.7%	0.8%
Retail Sales ex-Auto m-o-m	0.5%	0.4%	0.2%	
Retail Sales ex-Auto and Gas m-o-m	0.4%	0.3%	0.2%	
Retail Sales Control Group	0.4%	0.7%	0.4%	

Source: Bloomberg, U.S. Census Bureau

3. **China's trade surplus reached a new record high, likely further elevating the case for tariffs with the incoming US administration.**

China's trade surplus reached a new record of $104.8bn in the month of December and fell just shy of reaching $1trn for the full year. China's export volumes (in USD terms) beat expectations with growth of 10.7% y-o-y versus the consensus expectation for a 7.5% increase and the November gain of 6.7%. Exports to the United States rose 15.6% y-o-y in December versus an 8.8% increase in exports to the European Union suggesting front-leading to avoid tariffs. Imports were much less impressive rising 1.0% y-o-y versus the consensus expectation for a decline of 1.0% and the November decline of 3.9%.

4. **China reported 5.0% real GDP growth for 2024, in line with the government target.**

   Unsurprisingly, China reported real GDP growth for 2024 in line with the government's 5% target. Results benefited from an upturn in activity in Q4-24 growth to an unannualized 1.6% quarter-on-quarter (q-o-q) rate and Q3-24 in which the figures were revised upward to 1.3% q-o-q from 0.9% q-o-q. The upturn in activity in Q4-24 was to be expected given the magnitude of stimulus measures (primarily monetary policy) since 23 September. We also have seen signs of a potential bottom in real estate prices and activity which should bode well for 2025. However, one should be careful of getting too excited about the 5% figure as there are reasons to believe that while growth accelerated versus 2023, the level of growth might still be materially below reported levels.

   As importantly, nominal GDP in 2024 was only 4.2% y-o-y, in line with the level of 2023, as the GDP deflator remained negative for the seventh consecutive quarter. Nominal growth is important given the level of corporate indebtedness and the degree of excess manufacturing capacity. Given the risk of US tariffs in 2025, nominal growth should be a focal point for investors.

   Looking beyond GDP, industrial production and retail sales beat expectations. Export growth helped lift industrial production as US customers tried to front-run potential tariffs. Auto output growth was strong with a gain of 15.2% y-o-y in December (in line with November) while output growth of crude steel and steel products accelerated to 11.8% y-o-y in December from 7.1% in November. The contraction in cement output also improved to -2.0% y-o-y from -10.7% the prior month.

   Retail sales comparisons in December normalized after distortions in October and November related to the earlier-than-usual start to the Singles' Day Shopping Festival which extends several weeks around the date itself. Singles' Day is always on 11 November – 11.11 – but retailers in 2024 chose to begin the promotions a full week earlier than usual on 14 October. This decision pulled demand into October from November and hence inflated the October 2024 retail sales gains while weakening the y-o-y comparisons for November 2024. The December figures are "cleaner" as these distortions were no longer relevant. Reflecting this changing Singles' Day effect, online sales in December improved y-o-y after showing weakness in November while in-store and restaurant sales showed less strength than in November.

   Importantly, the effectiveness of consumer trade-in subsidies was on full display in the home appliance sales figures where growth in December was an impressive 39.3% y-o-y versus 22.2% in November. Investors expect expansion and extension of these subsidies to be announced at the Two Sessions in March. However, it is important to remember that trade-in subsidies likely pull forward demand rather than delivering a higher sustainable domestic demand run rate.

One final note of caution is in order. To the extent Chinese authorities interpret this week's data as signaling that prior stimulus measures are working, it could lead them to deliver less fiscal stimulus than investors expect at the upcoming Two Sessions meeting in March. Put simply, good economic news could be bad market news relative to expectations for fiscal stimulus as well as the more enduring structural measures that are needed to sustainably lift long-term growth.

December China Economic Data		Consensus	Actual	Prior	Revised
GDP for Q4-24	y-o-y	5.0%	5.4%	4.6%	
	YTD y-o-y	4.9%	5.0%	4.8%	
	q-o-q	1.7%	1.6%	0.9%	1.3%
Industrial Production	y-o-y	5.4%	6.2%	5.4%	
	YTD y-o-y	5.7%	5.8%	5.8%	
Retail Sales	y-o-y	3.5%	3.7%	3.0%	
	YTD y-o-y	3.5%	3.5%	3.5%	
Fixed Asset Investment	YTD y-o-y	3.3%	3.2%	3.3%	
Property Investment	YTD y-o-y	-10.4%	-10.6%	-10.4%	
Residential Property Sales	YTD y-o-y	*	-17.6%	-20.0%	
New Home Prices	m-o-m	*	-0.08%	-0.20%	
Used Home Prices	m-o-m	*	-0.31%	-0.35%	

Source: Bloomberg, National Bureau of Statistics
* No consensus estimate available on Bloomberg.

5. **The European Central Bank (ECB) released its December monetary policy meeting accounts.**

The December ECB meeting leaned in a dovish direction with some members of the Governing Council indicating that they would have liked "more consideration being given to a 50-bps cut" and the Council acknowledging that inflation is likely to return to the 2% target earlier than previously expected. Partially contributing to the decision to ease by 25 bps was a concern that a larger reduction could be interpreted as a signal of a weaker economic outlook than is expected by the ECB.

Interestingly, but unsurprisingly, the ECB discussed the risk of US tariffs and the negative effects on Eurozone growth as well as the risk that US protectionism could lead to more exports from China to the Eurozone at even lower prices. Ultimately, the discussion concluded that a trade conflict would be negative for Eurozone growth but the effect on inflation was inconclusive.

While the ECB debate is enlightening, I expect it to shift in a more dovish direction in 2025 with 125-to-150 bps of rate cuts versus the current market expectation for ~100 bps of easing.

6. **UK inflation surprised on the downside providing more space for the Bank of England (BoE) easing.**

   The UK headline, core, and services CPI metrics all were better than expected. Headline CPI rose 0.3% m-o-m and 2.5% y-o-y versus the expectations for increases of 0.4% and 2.6%, respectively. Core CPI rose 3.2% y-o-y versus consensus of a 3.4% rise. Services inflation was most encouraging with an increase of 4.4% y-o-y versus the consensus expectation for a rise of 4.8%.

   A significant driver of the downside inflation surprise was driven by volatile airline fares. It is also notable that energy-intensive service prices fell in December and could easily recover given recent price rises for Brent crude. Non-energy intensive service prices rose solidly in the month.

   Markets interpreted the good inflation news (and weak economic data discussed in #7 below) as opening the door for earlier policy easing from the BoE with the probability of a 25-bp rate reduction at the 6 February meeting rising from 64% the day before the release to 92% by the end of the week.

7. **UK retail sales fell well short of expectations in December and for the fourth quarter.**

   December retail sales were weaker than expected, and October's and November's figures were revised lower. In total, Q4-24 retail sales fell by 0.8% compared to the prior quarter and rose 1.9% versus the Q4-23 result. The figures added to a series of data suggesting economic weakness in the United Kingdom including the monthly GDP figures that showed stagnation in the fourth quarter.

   December sales fell for food stores and non-store retailing (online merchants) while sales increased for clothing and footwear stores, gas stations, and department stores.

December UK Retail Sales	Consensus	Actual	Prior Month
Retail Sales including Auto Fuel m-o-m	0.4%	-0.3%	0.2%
Retail Sales including Auto Fuel y-o-y	4.9%	3.6%	0.5%
Retail Sales excluding Auto Fuel m-o-m	3.0%	-0.6%	0.3%
Retail Sales excluding Auto Fuel y-o-y	4.0%	2.9%	0.1%

Source: Bloomberg, UK Office for National Statistics

The Week Ahead

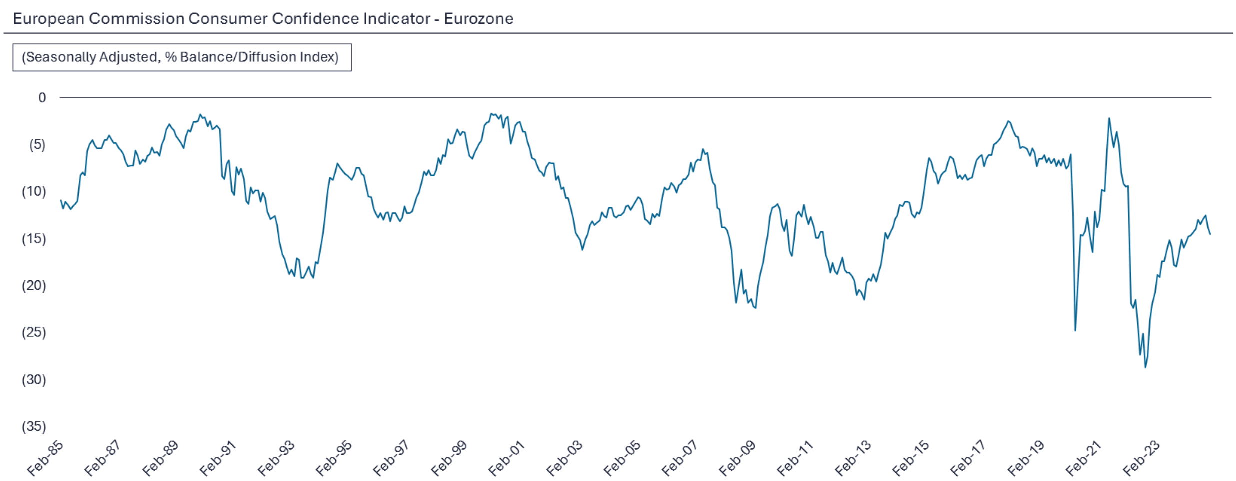
1. **Purchasing Managers' Index (PMI) data for the Eurozone, France, Germany, Japan, United Kingdom, and United States will be reported on 23 and 24 January.**

   Most developed economies continue to report Manufacturing PMIs that are in contractionary territory (below 50) with stronger Services PMIs (well above 50 in some cases). I will be watching for any nascent signs of manufacturing recovery. In services, I will be watching for sustained strength in the United States and signs of improvement in the Eurozone.

2. **Eurozone consumer confidence is expected to recover marginally in January.**

   Consumer confidence in the Eurozone had been improving steadily until November when the US election results appear to have introduced more uncertainty. In January, confidence is expected to improve marginally. Absent a trade conflict with the United States, the Eurozone should enjoy better economic conditions in 2025 given the benefits of lower interest rates, higher real wages, and (hopefully) resolution of political uncertainties in key economies.

European Consumer Confidence Is Likely to Continue Improving in 2025 Absent a Trade War



LAZARD Source: Bloomberg, European Commission
Note: As of December 2024

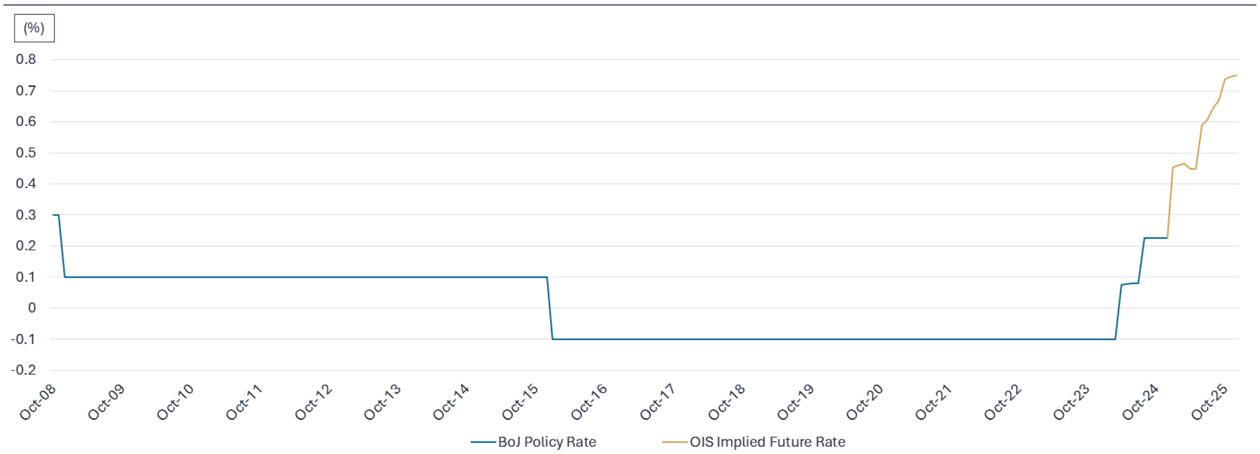
3. **The Bank of Japan (BoJ) is expected to hike rates by 25 bps on 24 January.**

   Markets have priced a 95% probability of a 25-bp increase in interest rates at this week's BoJ Monetary Policy Meeting with the next hike unlikely before the 31 July meeting where the likelihood of an additional 25-bp hike is ~50%. Interestingly, market expectations of a January hike have increased substantially since the December BoJ meeting when Governor Kazuo Ueda indicated that he wanted more evidence of ongoing wage growth and more clarity related to the policies and implications thereof of the new US admnistration before further adjusting monetary policy. While the BoJ has gained some insight into the wage demands made by workers' unions, it has not learned materially more about the likely outcome of the spring *shunto* negotiations or US policy intentions. In a speech this week, BoJ Deputy Governor Ryozo Himino indicated that the conditions for further hikes have not changed but that the BoJ has gotten positive feedback from surveys related to wage trends and from its branch managers' meeting, suggesting that confidence in the appropriateness of a rate increase has increased.

I expect the hike next week, if it occurs, to be the last of the year. Markets, on the other hand, are expecting two 25-bp cuts by year-end. My basis for a more dovish view is that despite Japan's large, sustained trade surplus, Japanese companies are significant investors in the United States, mitigating the desire of US officials to aggressively address trade imbalances. That said, these capital inflows are unlikely to fully eliminate the tariff risk to Japan under the new administration given that it is one of the five largest bilateral trade deficits the United States has globally.

Markets Suggest ~52 bps of Additional BoJ Rate Hikes in 2025*

Implied Eurozone Deposit Rate through December 2025



LAZARD

Source: Bloomberg
Note: As of 17 January 2025
* Markets currently imply a 90% chance of a 25-bp hike at the January meeting and a 95% chance of one 25-bp hike through March.

4. **Japan will report December CPI with headline and core metrics expected to increase from November levels while core-core inflation (ex-fresh food and energy) remains stable.**

   The headline and core (ex-fresh food) CPI figures are expected to increase as the expiration of the government's electricity and gas price controls increased energy prices in December. Core-core inflation is likely to reflect ongoing strength in rice and private sector services prices offset fully by weaker durable goods and hotel/accommodation prices.

Japan December CPI	Consensus	Prior Reading
Headline y-o-y	3.4%	2.9%
CPI y-o-y ex-fresh food (core)	3.0%	2.6%
CPI y-o-y ex-fresh food and energy (core-core)	2.4%	2.4%

Source: Bloomberg, Japan Ministry of Internal Affairs and Communications

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