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The US economy remains in good shape, and investors shouldn't let Goldilocks data be the enemy of good data when evaluating the outlook. (UBS)

Look for market "North Stars" amid data noise

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A mixed bag of data out of the US has increased uncertainty about the economic and market outlook. The consumer price index for January came out stronger than expected, while retail sales for the same period turned out weaker than had been generally assumed.

While the S&P 500 finished last week only 0.4% lower—a minor decline after logging gains in 14 out of the last 15 weeks—investors were left unsure what exactly the data are signaling about the economy.

However, rather than overemphasizing a few data points, investors should rely on several core assumptions about the economy, the Federal Reserve, and investor positioning for investing guidance. All of which, in our view, remain positive.

The combination of trend-level growth and further disinflation should be supportive for risk assets. The specific level of economic growth and the pace of disinflation matter for absolute investment returns, but financial markets should have a modest tailwind as long as these attributes generally hold. While confidence in the disinflation narrative took a hit last week, it appears that a one-time "January effect" of annual price increases for specific services inflated the CPI data, as did owners' equivalent rent. What's more reassuring to us is the continual moderation of wage growth, with the employment cost index and the Atlanta Fed wage tracker at their lowest levels since the end of 2022. Overall, the US economy remains in good shape, and investors shouldn't let Goldilocks data be the enemy of good data when evaluating the outlook.

Fed rate cuts remain on the table. Market pricing for the number of Fed rate cuts this year has gone from nearly seven at the start of this year, to about 3.5 now. But it is important to note markets are also trading on the expectation that the central bank will step in if growth data weakens sufficiently. This is evident in how the relative performance of small-caps versus the Nasdaq 100 has closely tracked market pricing for fed funds rates—the sooner the market expects the

Fed to start cutting, the better small-caps have done on a relative basis. We continue to believe it's less important if the start of rate cuts may be months away or that there may be only three this year. For the market outlook, it's sufficient that the Fed is biased toward rate cuts.

Investor positioning is elevated but not stretched. There is fear of a positioning-led pullback as the S&P 500 has risen 21.5% since the end of October. While that is certainly possible, we think there's plenty of dry powder for investors in aggregate to buy a 5–10% dip. Discretionary institutional investors have been buying call options to get upside exposure while also selling volatility, but they have not been aggressively chasing the rally by adding to existing allocations. Retail investors, meanwhile, have added over USD 120bn to money market funds this year, versus slightly negative net flows into US equity funds.

So, even if the magnitude of returns will depend on the specific details for growth, inflation, and rate cuts, we see a fairly healthy US macro environment that is directionally positive for financial markets. For investor positioning, we continue to like quality and small-cap stocks.

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