Weekly market wrap

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‹ Weekly market wrap

Inflation runs hotter than expected

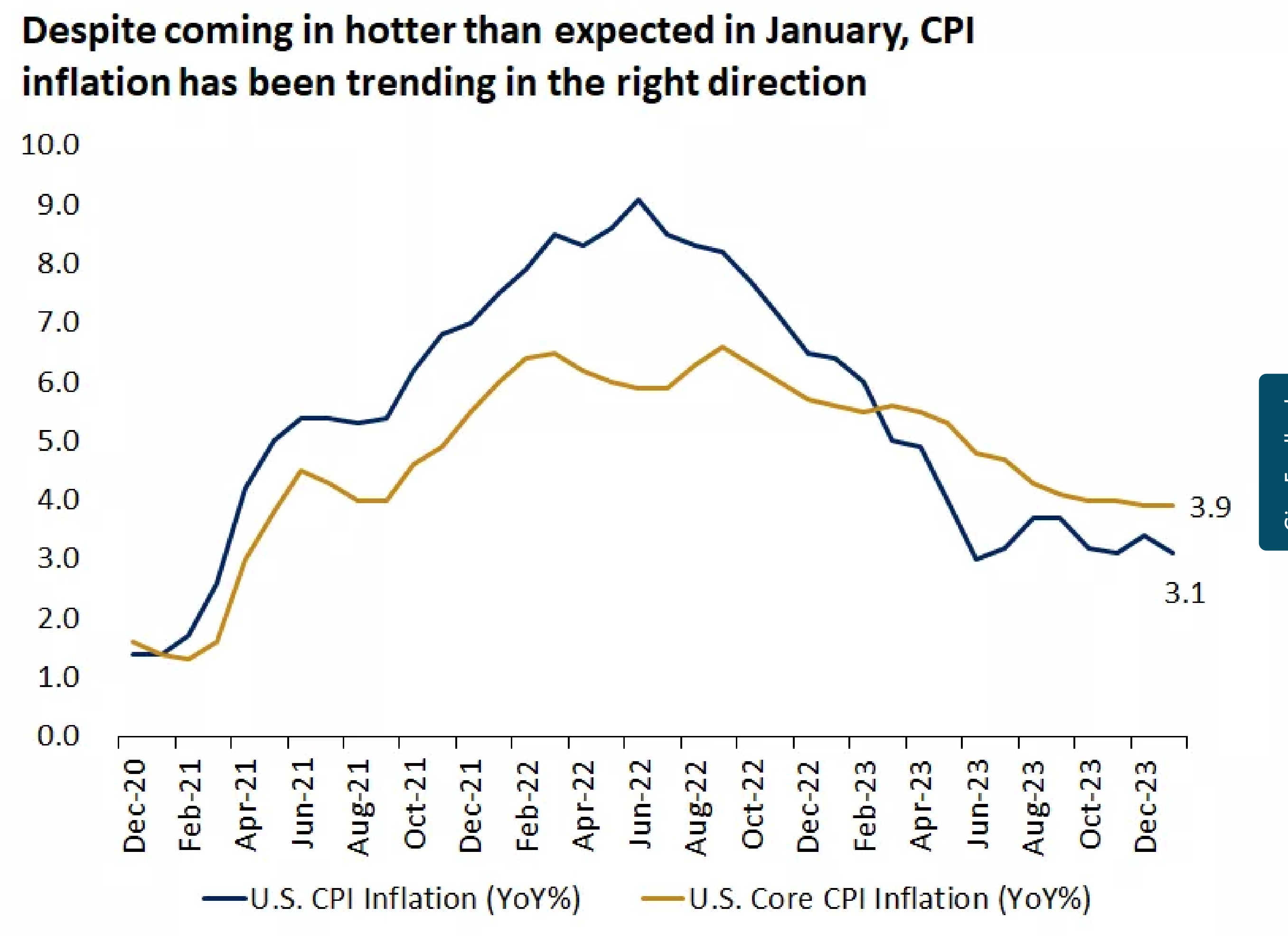
— will the trend persist?

Key Takeaways:

- *Last week, stocks were modestly lower and Treasury bond yields were higher as the U.S. consumer price index (CPI) and producer price index (PPI) inflation reports for January came in hotter than expected. Stocks recovered from a sharp drop after Tuesday's CPI inflation report, and the S&P 500 even approached new all-time highs last week. But investors may still be feeling anxious. Can inflation continue to moderate, as it has over the past year, even in the face of resilient economic growth, or is this a start of a trend in the wrong direction?*
- *We believe inflation can continue lower in the year ahead, albeit perhaps not consistently downward. The shelter and rent components of CPI inflation are set to play some catch-up to the downside, and the labor market may cool modestly from here, putting downward pressure on wage gains and services inflation as well.*
- *This past week's inflation readings also pushed out the expectations for Federal Reserve interest rate cuts, which markets now expect to begin in June. In our view, the expectation of about four rate cuts starting in June is better aligned with the Fed and our view of three to four cuts in 2024. In this backdrop of easing inflation and lower interest rates, we recommend using periods of volatility as opportunities to add to or diversify portfolios ahead of the start of a multiyear Fed rate-cutting cycle.*

Despite a disappointing January, inflation trend is still favorable

Overall, while last week's January CPI and PPI data was disappointing for investors, we don't believe it signals a sustainable trend of higher inflation. The headline CPI figure came in at 3.1% year over year, above expectations for 2.9% but, notably, still lower than December's 3.4%. Core inflation (excluding food and energy) remained stickier at 3.9% year over year, above expectations for 3.7% and in line with December's reading.



Source: Bloomberg.

Chart description

Similarly, PPI inflation, which measures the prices received by producers of domestic goods and services, came in above expectations on headline and core figures. In January, headline PPI was 0.9% year over year, above forecasts of 0.6% but below December's 1% reading.[1] Core PPI (excluding food and energy) was 2%, above expectations of 1.6% and above December's 1.8% reading.[1] Keep in mind, though, that PPI inflation has already fallen below the 2% target, coming down meaningfully from highs of nearly 12% in 2022.[1] In addition, markets and the Fed tend to put higher weight on the CPI inflation metric given its direct impact on household and consumers.

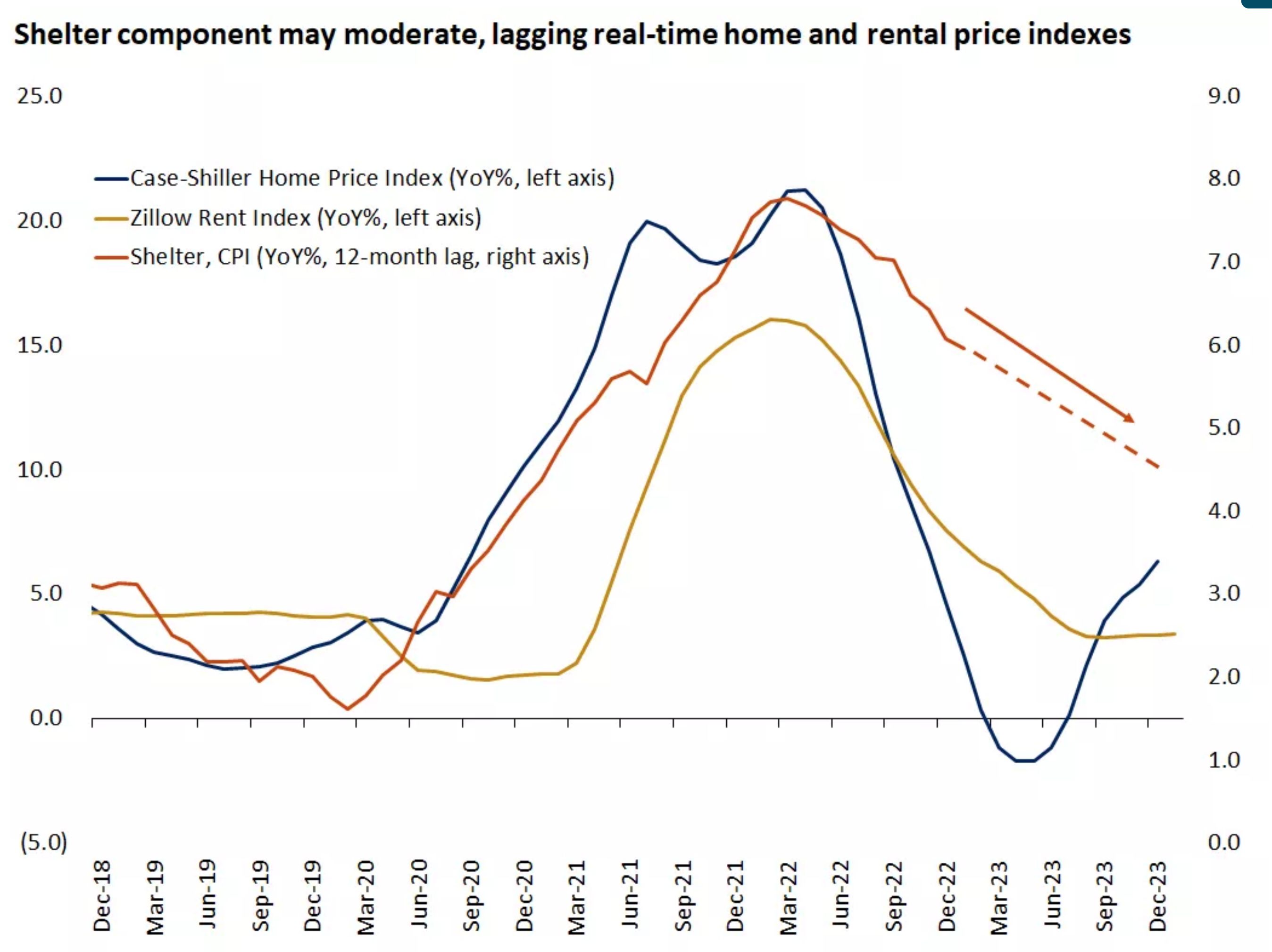
Shelter and rent are key to the CPI inflation story

Underneath the surface, we saw more nuanced trends in the CPI inflation report. CPI inflation did moderate in energy and energy services, commodities and used car and truck pricing. However, food and food away from home (e.g. restaurants), as well as motor vehicle insurance, climbed higher.[1]

Perhaps the most critical components moving higher were shelter and rent, which account for nearly one-third of the overall CPI basket. This figure was up 6% annually, above expectations and stickier than most investors had anticipated.

However, shelter and rent in the CPI basket often lag what is playing out in housing and rental markets across the country. Real-time data over the past year suggests these CPI components will cool in the months ahead. In fact, we see CPI falling to around 2.5% over the next year, which would provide support for consumers and give the Fed further confirmation to embark on a rate-cutting cycle.

Give Feedback



Source: FactSet.

Chart description

The January effect on prices

Perhaps another factor in play in the January CPI and PPI readings is what's known as the "January effect" for consumer and wholesale prices. Corporations tend to push through price increases at the beginning of the year, which can have an outsized impact on January inflation data. But it may be more of a one-off effect versus a persistent trend in the year ahead. If this is the case, we could continue to see more moderation, particularly in goods pricing, in the coming months.

Will the last mile to 2.0% prove too difficult?

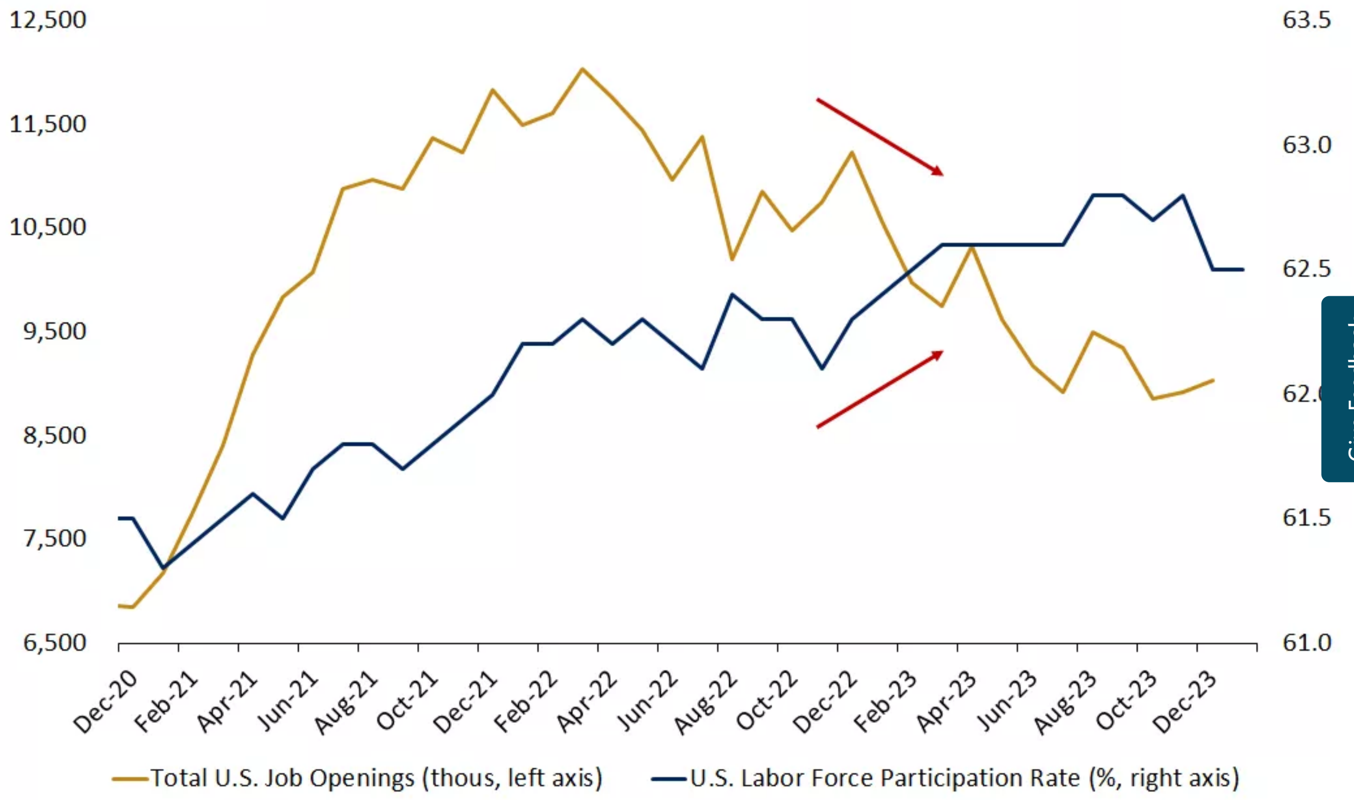
Those who believe inflation may be persistent in the months ahead often point to the strong economy and resilient consumer as sources of inflationary pressures. It's true that over the past four quarters, the U.S. economy has grown at an average 3.1% annualized pace, well above trend growth of 1.5% to 2%, driven by strong household consumption.[1]

Coming out of the COVID-19 pandemic, consumers have clearly shifted their consumption patterns, from buying goods online to buying services and experiences, including travel, leisure, hospitality and dining. This has also shown up in higher services inflation and softer goods inflation in both the CPI and PPI baskets.

But can the U.S. consumer continue to spend at a robust pace? There may be some early indications that consumers may be slowing down a bit. This past week, the monthly U.S. retail sales figure for January came in well below expectations, with retail sales falling 0.8% month over month.[1] This was more than the expected 0.15% decline and below December's 0.4% gain.[1] This is a trend worth watching, as monthly retail sales figures can be volatile. They also tend to track goods consumption versus services consumption, which we know has been lagging.

While there aren't many notable cracks in consumption — and the U.S. consumer is notoriously difficult to bet against — we may see some cooling in the labor market going forward. This could put downward pressure on wage gains and services inflation broadly. The Fed's own estimates show the U.S. unemployment rate rising to 4.1% from its current 3.7%, and we have seen leading indicators such as job openings and quits rates move lower.[2] While we wouldn't expect a deep or prolonged labor market slump in the U.S., better supply and demand balance may spur some easing in wage gains and softer consumption, which can support the last mile lower in inflation.

Better balance in U.S. labor market: Lower job openings, gradually higher participation



Source: FactSet.

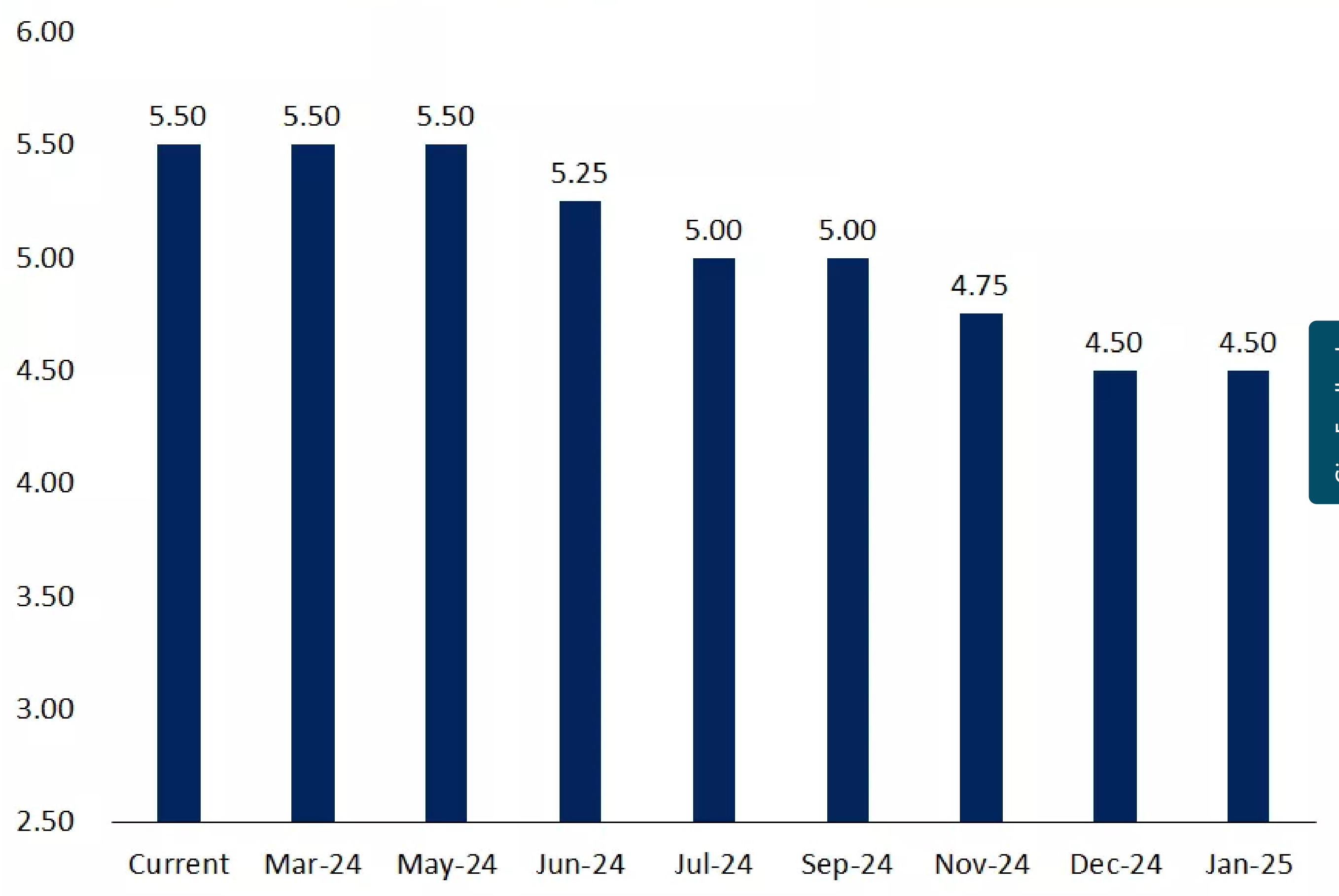
Chart description

What does this mean for the Fed and the markets?

A key outcome of this past week's hotter-than-expected inflation data was a repricing of market expectations for Fed rate cuts. Prior to last week, markets had been forecasting around five rate cuts, starting at the May Fed meeting.[3] Now the expectation is for around four rate cuts, perhaps starting at the June meeting.

In our view, this may be a healthy adjustment of market expectations. It's likely more aligned to the Fed's view as well as our view of three to four rate cuts beginning in mid-2024. We believe the Fed would like to be patient on cuts and will likely now wait and see on inflation trends for the next few months.

Markets now expect rate cuts to start in June 2024



Source: CME FedWatch Tool.

Chart description

Keep in mind that one of the Fed's preferred metrics of inflation, personal consumption expenditure (PCE) inflation, tends to be lower than CPI inflation. It's already at 2.6% for headline and 2.9% for core inflation, much closer to the Fed's 2.0% target range.[1] This is in part because the shelter component in PCE inflation is only about 15% of the basket versus about 33% in the CPI basket. The next reading for PCE inflation will come on Feb. 29, and the expectation is for a moderation in both headline and core PCE inflation annually.

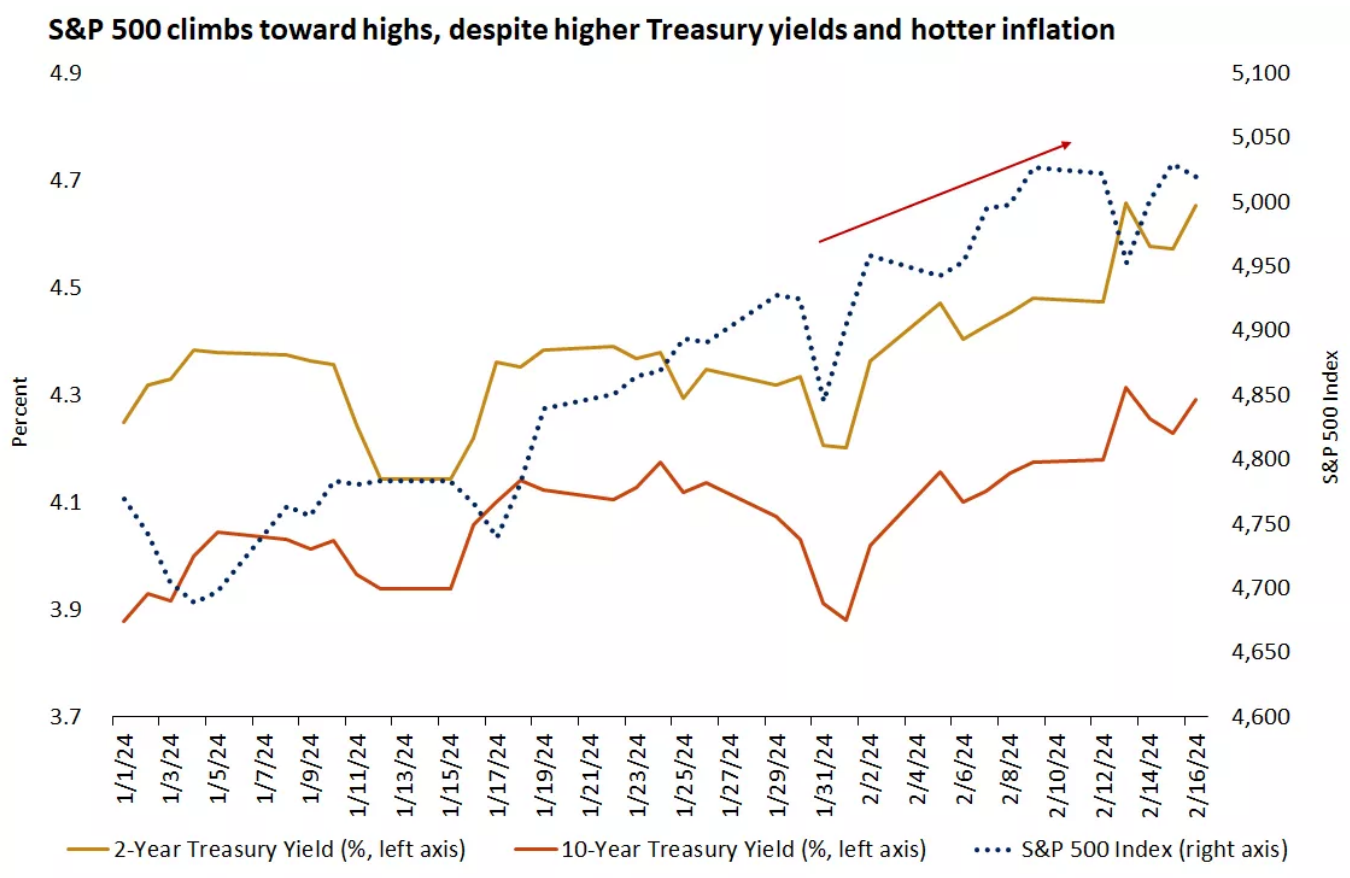
Overall, while yields did move higher and stocks did move sharply lower after the CPI inflation data, we have seen some stability (particularly in equity markets) since then. Yields have shifted higher from recent lows, in part reflecting the adjustment in Fed rate cuts this year, yet stocks continue to move toward highs. Markets may be endorsing a view that we could over time get the trifecta of fundamental outcomes we've been watching for:

1. Lower inflation
2. Fed rate cuts

3. Economic growth that cools but remains positive

As we've noted, we expect inflation to moderate, although likely not in a straight line lower. This may mean stock markets may encounter volatility along their path this year. But for investors, this could also mean opportunities, especially for those who weren't able to fully participate in the rapid rally that began late last year.

While pullbacks are likely and even expected in any given year, we do not see the scope for these pullbacks turning into more nefarious bear markets, given the fundamental backdrop. We recommend using market volatility to add to and diversify portfolios, especially ahead of a potentially multiyear Fed rate-cutting cycle that will likely begin late this year.



Source: Bloomberg.

Chart description

Mona Mahajan
Investment Strategist

Sources: 1. FactSet 2. FOMC December SEP 3. CME FedWatch Tool

Weekly market stats

INDEX	CLOSE	WEEK	YTD
Dow Jones Industrial Average	38,628	-0.1%	2.5%
S&P 500 Index	5,006	-0.4%	4.9%
NASDAQ	15,776	-1.3%	5.1%
MSCI EAFE*	2,238	0.6%	0.1%
10-yr Treasury Yield	4.28%	0.1%	0.4%
Oil ($/bbl)	$78.25	1.8%	9.2%
Bonds	$97.10	-0.5%	-1.6%

*Source: FactSet, 2/16/2024. Bonds represented by the iShares Core U.S. Aggregate Bond ETF. Past performance does not guarantee future results. *4-day performance ending on Thursday.*

Give Feedback

The week ahead

Important economic data being released this week includes the January FOMC minutes and S&P Global PMI data.

Review last week's weekly market update.

Mona Mahajan

Mona Mahajan is responsible for developing and communicating the firm's macroeconomic and financial market views. Her background includes equity and fixed income analysis, global investment strategy and portfolio management.

She regularly appears on CNBC and Bloomberg TV, and in The Wall Street Journal and Barron’s.

Mona has a master’s in business administration from Harvard Business School and bachelor's degrees in finance and computer science from the Wharton School and the

School of Engineering at the University of Pennsylvania.

Read Full Bio

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Market Data

DJIA 38,627.99 ↓ (-145.13)

S&P 500 5,005.57 ↓ (-24.16)

NASDAQ 15,775.65 (0.00)

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