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Weekly Commentary

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Inflation not following the script

Inflation appears to have gone off script. The play is supposed to go something like this: The Federal Reserve stations the fed funds rate at low levels when the U.S. economy has faltered, which encourages lending and borrowing, lowers mortgage rates and increases consumer and business confidence. As the economy grows, inflation usually rises. When it gets too hot, the central bank hikes rates. As econ textbooks tell us, this throws the above developments into reverse, causing inflation and activity to fall.

But the Consumer Price Index (CPI), is not acting its customary role. While it certainly has come down from the multi-decade highs of 2022, the report for January, released last week, showed that core CPI rose 0.4% in January, a tick higher than December's 0.3%. It grew at a 3.9% from a year ago, the same growth rate seen in December. Most economists and the markets had forecast the monthly to hold steady and the annualized number to slip. The difference between the expectations and reality might appear modest, but arresting the downward trajectory in any fashion is worrisome for the Fed.

But on the other hand, policymakers expected inflation would be tough to completely subdue. Their projections in December suggested they would not pivot to cut rates until the latter half of this year, and probably only a total of 75 basis points at that. It's the markets that must adjust. Once calling for upward of six quarter-point cuts starting in March, futures trading doesn't even predict one will come in the May policy-setting meeting, let alone March's. We still side with the Fed, and the longer rates are high, the more liquidity products stand to gain.

Views are as of the date above and are subject to change based on market conditions and other factors. These views should not be construed as a recommendation for any specific security or sector.

Consumer Price Index (CPI): A measure of inflation at the retail level.

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