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The Curious Case of Lower Inflation Being Bad For Rates

Markets and mortgage rates are currently trying to reconcile the big narratives that have accounted for most of the movement in 2022. In one corner we have inflation and the forces trying to fight it. In the other, we have the economic fallout from that fight.

Inflation was the main reason rates skyrocketed in the first half of the year. Inflation is **bad** for rates in and of itself, but even worse when it prompts the Fed to aggressively tighten monetary policy.

In other words, the Fed is one of those **forces** trying to fight inflation. It does this by raising short term rates directly and also by making policy changes that indirectly push longer-term rates higher.

It may seem like a **cruel punishment** for the Fed to push rates higher when inflation has already made things more expensive, but their rationale is that it's better than the alternative. Simply put, they want to get inflation under control no matter the cost.

The Fed is fully transparent in saying that the fight against inflation will take a toll on the economy. That's the idea, after all--to slow down the "**demand**" side of the economy so the "**supply**" side eventually lowers prices. Then when balance is restored, the Fed eases policy and consumers can go back to their normal economic business without the encumbrance of decades-high inflation.

All of the inflation and the anticipated impact from the Fed's inflation fighting efforts came to a head in June. Rates shot up to their highest levels since 2008. Markets expected such a restrictive environment to solidify **negative** economic momentum that was already showing up in some reports. Several reports in July did just that and before we knew it, mortgage rates were on the way back down.

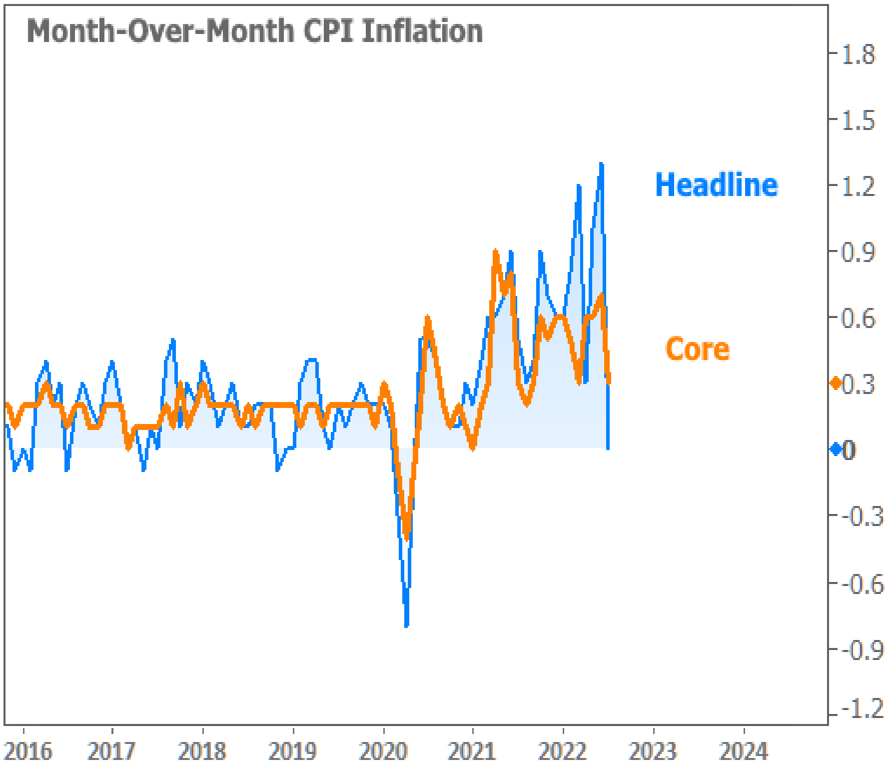
At the time, we expected rates to remain in a **sideways, volatile range** based on the expectation that the Fed would want to see several months of calmer inflation data before declaring victory and even beginning to discuss easing monetary policy. But in late July, economic data was downbeat enough that markets feared an overcorrection. "Recession" was an unavoidable word in news headlines.

What a difference the last two weeks have made! Troublingly **weak** economic data has generally been replaced with surprising **strength**. Last week's jobs report was a key player in that shift, but it hasn't been the only report suggesting economic resilience. Just today, August's preliminary reading of the Consumer Sentiment Survey beat forecasts by a wide margin--a notable shift considering the same report caused concern last month.

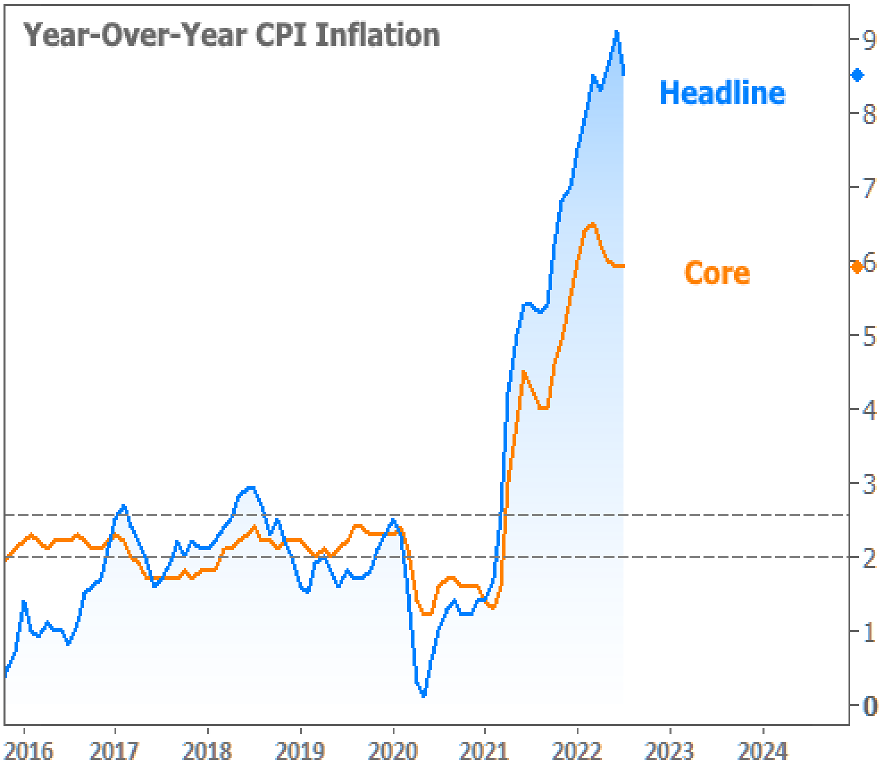
Economic data has had an impact to be sure--generally pushing rates higher--but the star of this week's show was always going to be Wednesday's Consumer Price Index (CPI). Or so we thought.

CPI is the earlier of two key inflation reports from the US government, and it has been at the center of some of the biggest swings in rates in 2022. This week's release showed a decisive drop for the first time all year--essentially playing the part of "**the drop we've been waiting for.**"

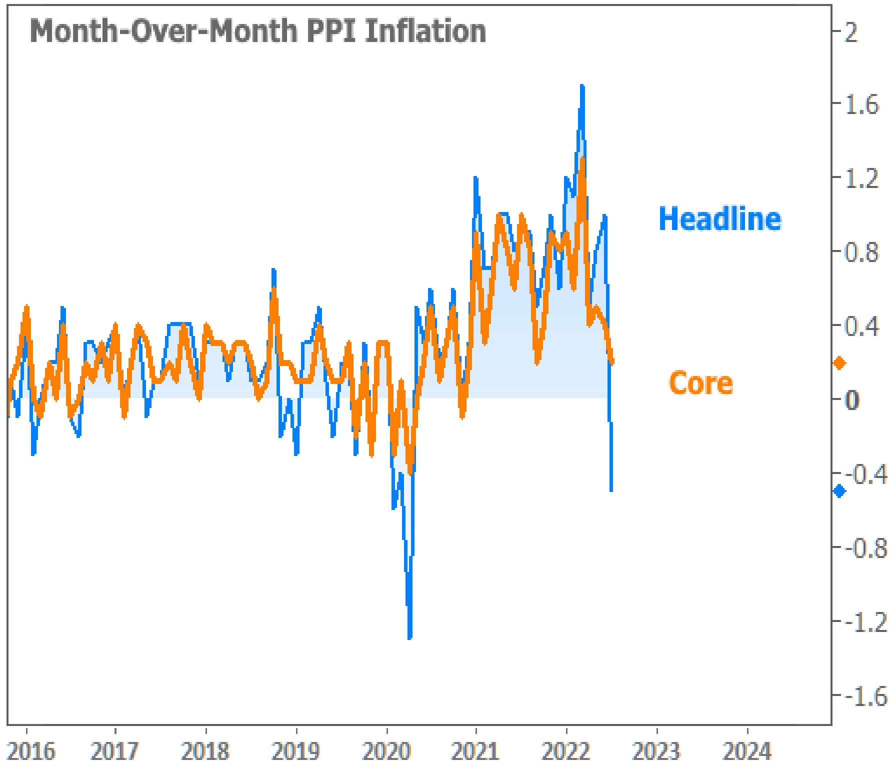
The drop was most visible in month-over-month "headline" CPI. This refers to all of the prices counted in the report whereas the "core" CPI excludes food and energy prices.



While headline inflation may have come in at 0.0% month-over-month, the Fed is looking for core year-over-year inflation in the 2 to 2.5% range. Let's just say we're not there yet.



Even so, the way the orange line is leveling off in the chart above is good news for rates. It was joined a day later by a similar drop in inflation at the wholesale level, seen in the Producer Price Index (PPI). In fact, headline prices actually moved lower in that report.

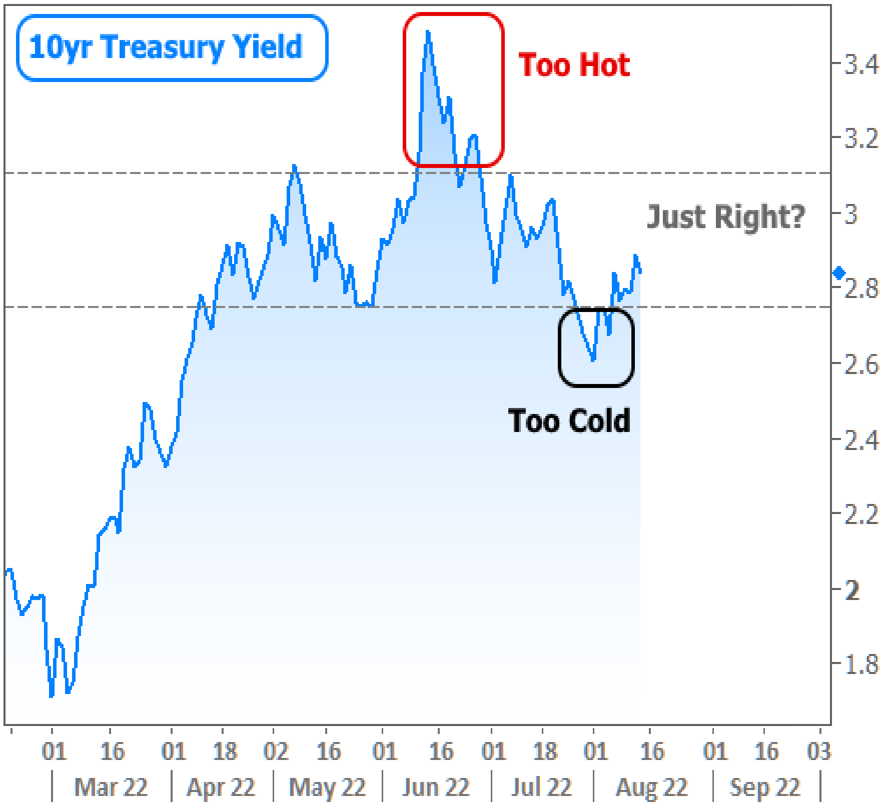


Again, lower inflation is supposed to be **good** for rates. Indeed, that math seemed to be valid on Wednesday morning. Bond yields fell sharply after CPI came out, but the improvement was short-lived. Rates then moved quickly to the highest levels of the week by Thursday afternoon.

The question is: why would **lower** inflation result in **higher** rates?

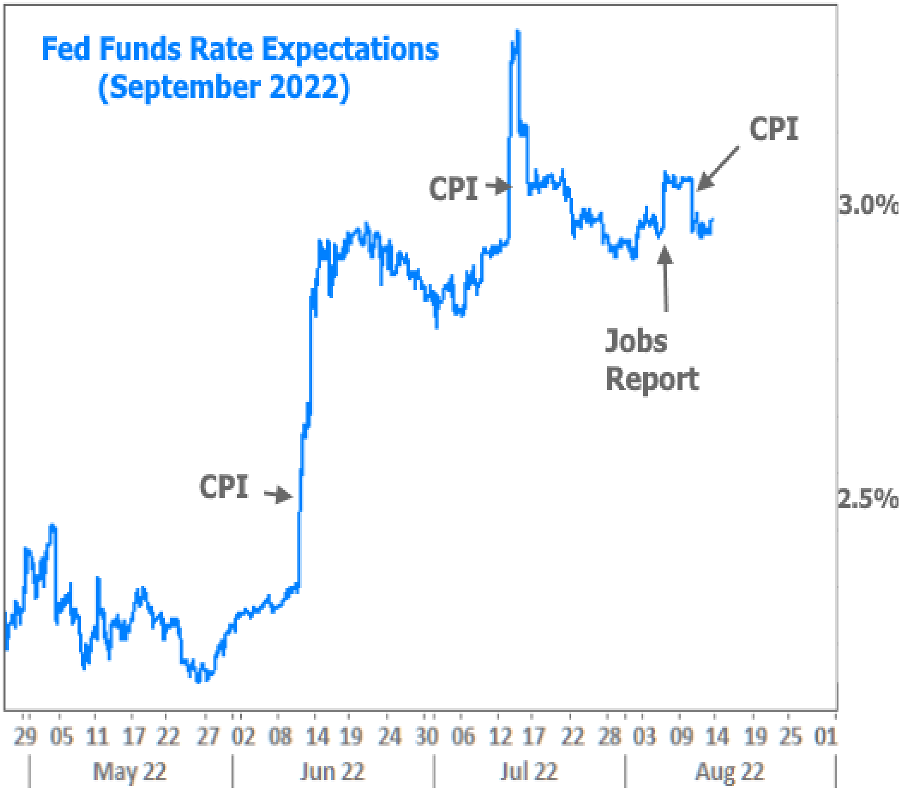
That's a very **tricky** question, because lower inflation was sort of in the wrong place at the wrong time. Remember that "sideways volatile range" expected to take hold after rates spiked in the first half of 2022? It turns out to have been a pretty good call according to several Fed speakers in the past two weeks. They've been unified in reminding the market not to get ahead of itself in expecting friendlier Fed policy and that we need to see a lot more improvement in inflation before we would even begin to consider such things.

At the same time Fed speakers were delivering their sobering messages, bond traders were already feeling like the peak-to-trough move in rates was a bit too much, too soon. 10yr yields show the psychology with the horizontal lines roughly outlining the sideways range.

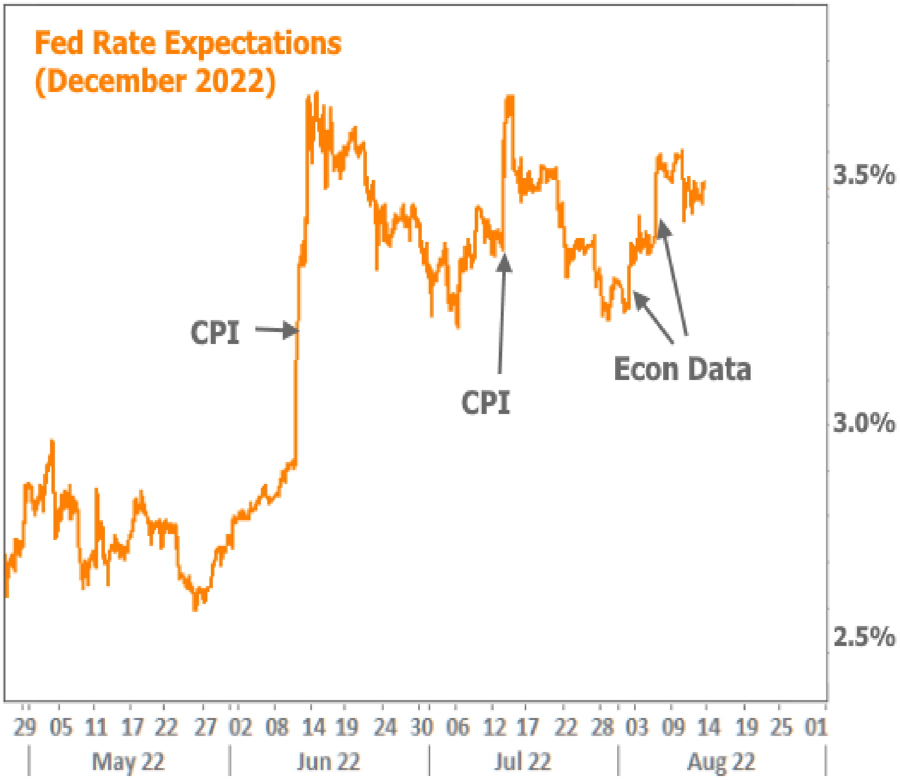


The Fed's comments also reminded markets that there was a **high bar** to change the rate hike outlook in the short term. We can see the market agreeing with the Fed based on traders' who bet on the Fed Funds Rate in the futures market. The following three charts show rate hike expectations for next month, December 2022, and next June.

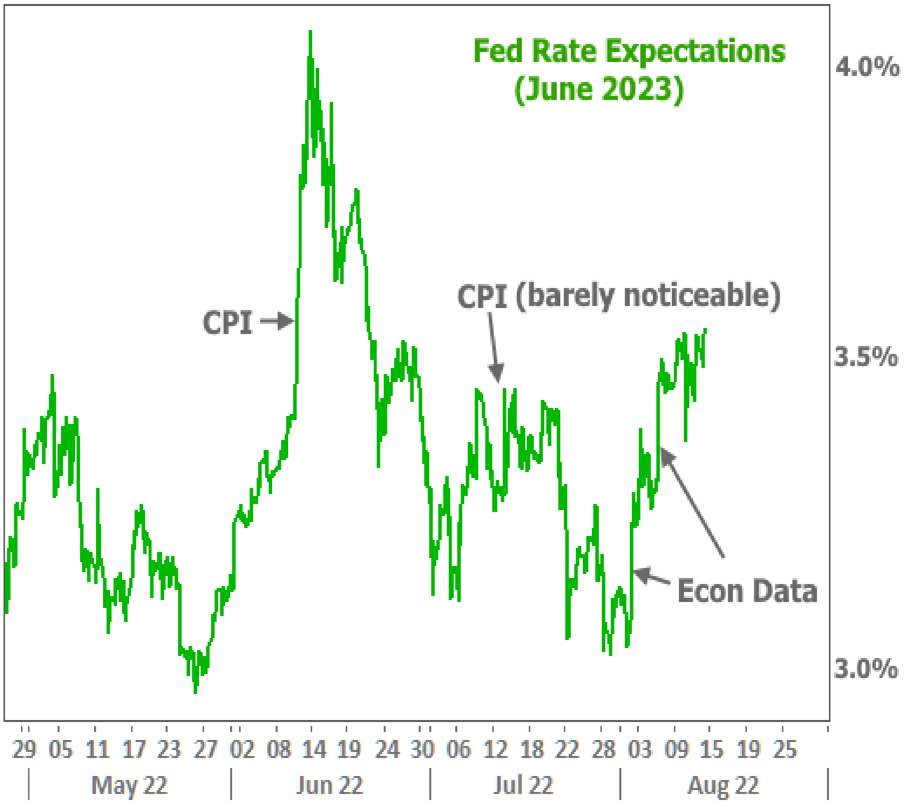
September rate hike expectations spiked in June and July after CPI data showed higher inflation. Things calmed down in late July due to weaker economic data. They then spiked only modestly after last week's jobs report and moved lower by an equal amount after this week's CPI.



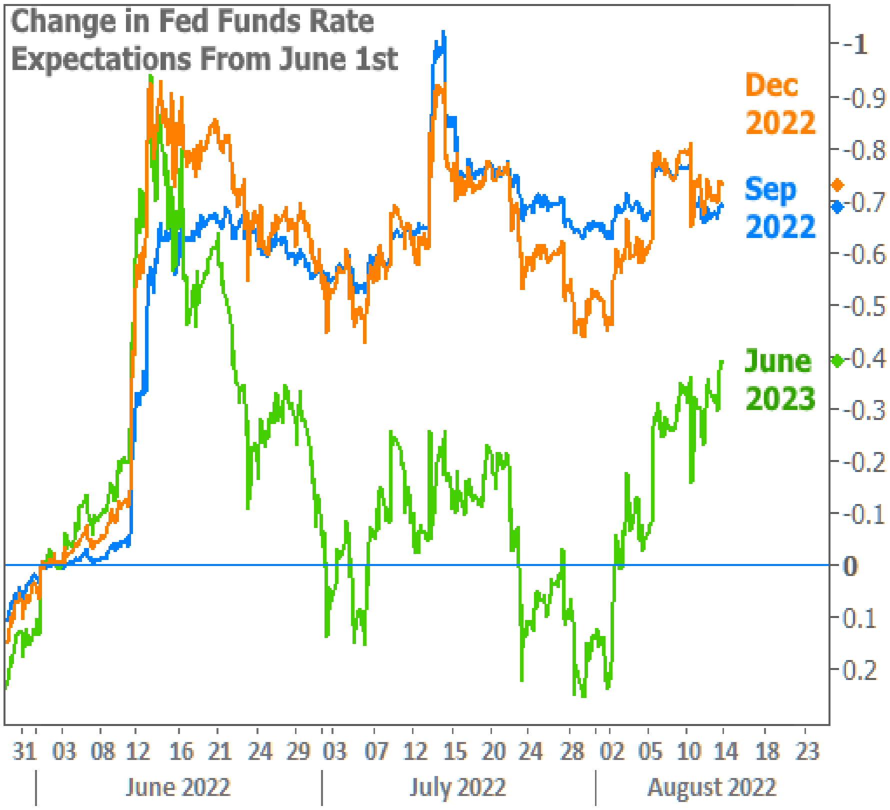
The takeaway from the chart above is that the market was only very surprised about the extent that inflation continued moving **HIGHER** in June and July. The eventual shift (seen in this week's data) was expected, but the improvements in economic data were less certain. With the near term rate outlook being more locked-in, the market has instead relied on economic data to shape the longer-term rate outlook.



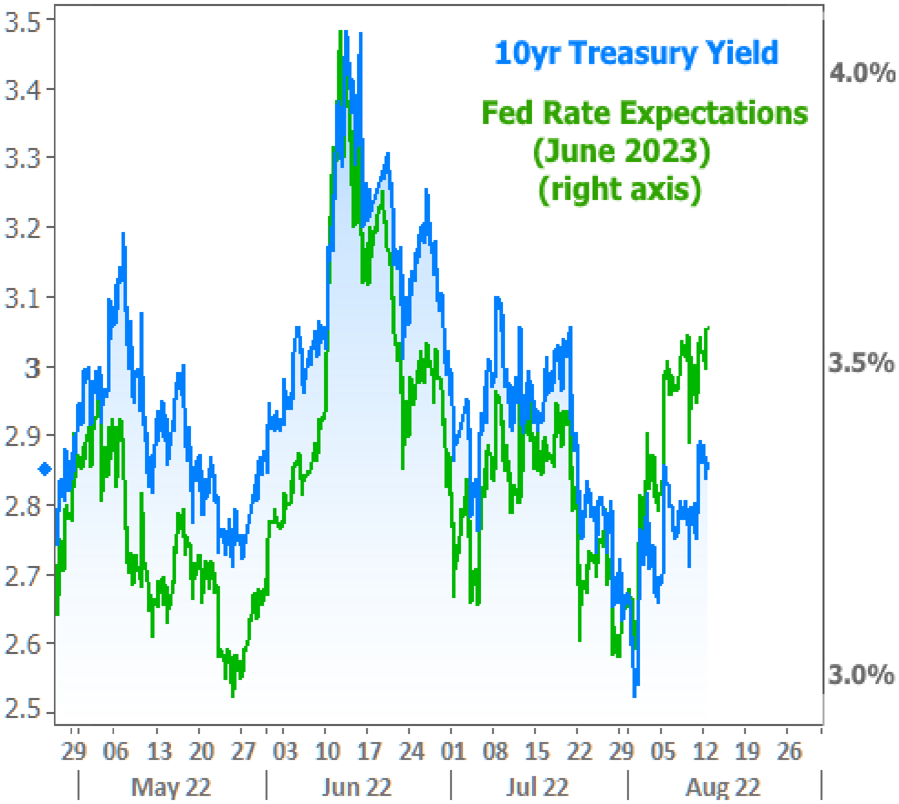
By the time we move out to expectations for the June 2023 meeting, we can see CPI has fallen by the wayside, its importance fully replaced by economic data.



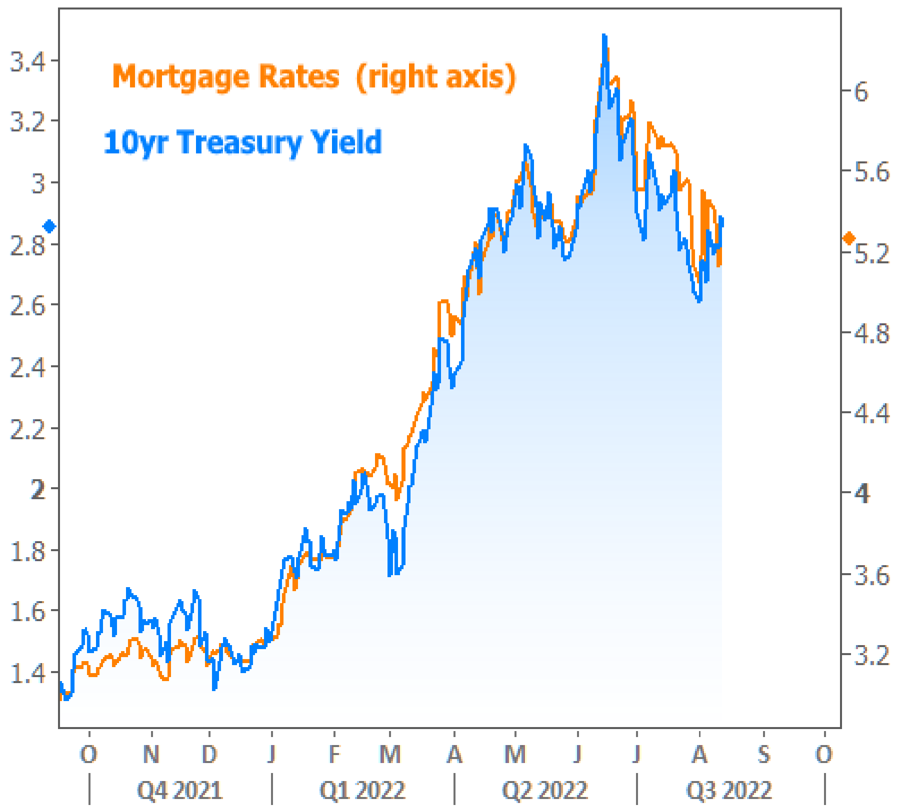
It's hard to tell in 3 separate charts that the June 2023 expectations are much more volatile. The following chart sets the previous 3 on the same axis to show the comparison. Think of the low point for the green line in late July as the market saying "we think the economy is going to slow down so much that the Fed is going to have to start cutting rates by the middle of next year." This makes the data-driven bounce back all the more logical in early August.



What does all of the above have to do with counter-intuitive movement in mortgage rates? Simply put, longer-term rates like 10yr yields and mortgages have more in common with those longer-term Fed rate expectations.



The chart above has an hourly interval in order to show the correlation between Treasuries and Fed rate hike expectations. The following chart is daily in order to show the correlation between mortgage rates and Treasuries.



At a time when economic data is taking the reins from inflation data when it comes to shaping rate momentum, next week will be even more informative. Retail Sales on Wednesday is the most important report, but there is other data (much of it housing-specific) on every other day but Friday.