Sharply Lower Inflation Brings Fed Rate Cuts Into Focus

Justin Grable
President of Mortgage Lending, ABLE Mortgage
www.ABLEMortgage.com
P: (951) 899-0009
M: (951) 899-0010
justin@ablemortgage.com
41923 Second St.
Temecula CA 92592
NMLS 246763
CA DRE 01411989

There was a lot riding on this week's economic data and it delivered in a big way. The Consumer Price Index (CPI) has had the biggest influence on interest rates of any of the scheduled monthly economic reports, and for good reason. It is one of the two biggest and most detailed inflation reports on any given month, and it comes out about 2 weeks before the other one.

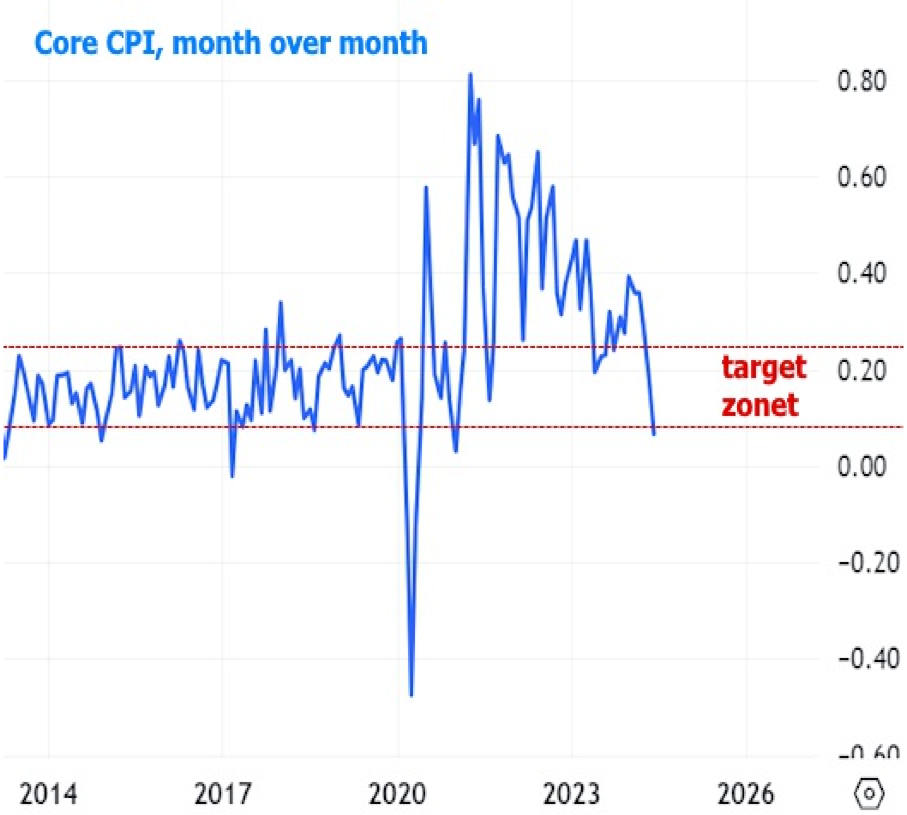
That's incredibly important at this moment in economic history which has seen the first major battle against hyperinflation in more than 40 years. CPI had been an inconsequential report in the decade leading up to the post-pandemic inflation explosion, but ever since then, it's a bellwether for a potential shift.

Winds of change have seemingly picked up speed a few times over the past year, but the first few months of 2024 brought the most recent reality check. In other words, inflation looked to be dropping in late 2023, but then bounced noticeably in early 2024. It's only been in the last few months that the data has grown more favorable and really since the CPI report in early June that the market could begin to ask the question: is inflation finally turning a corner?

With that in mind, this week's CPI report was in a unique position to speak to the corner turning question. The answer ended up being great for rates.

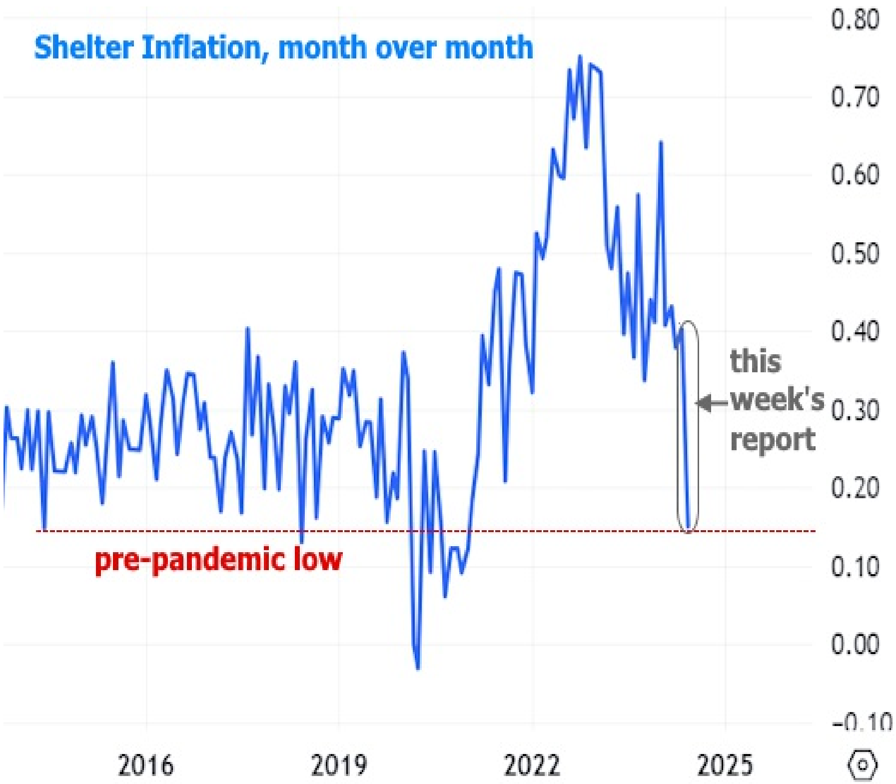
CPI is a complex report, but the most important line item is "Core" CPI which excludes more volatile food and energy prices. The Federal Reserve targets a core inflation rate of 2% in year over year terms (or 0.168% in month over month terms). That's one more reason the early June report was exciting: monthly core CPI hit 0.163.

How'd we do this time around? Was 0.163 a fluke or a sign of a shift? While we can't know what the next report will look like, at 0.065, we can definitely say it's moving in the right direction.



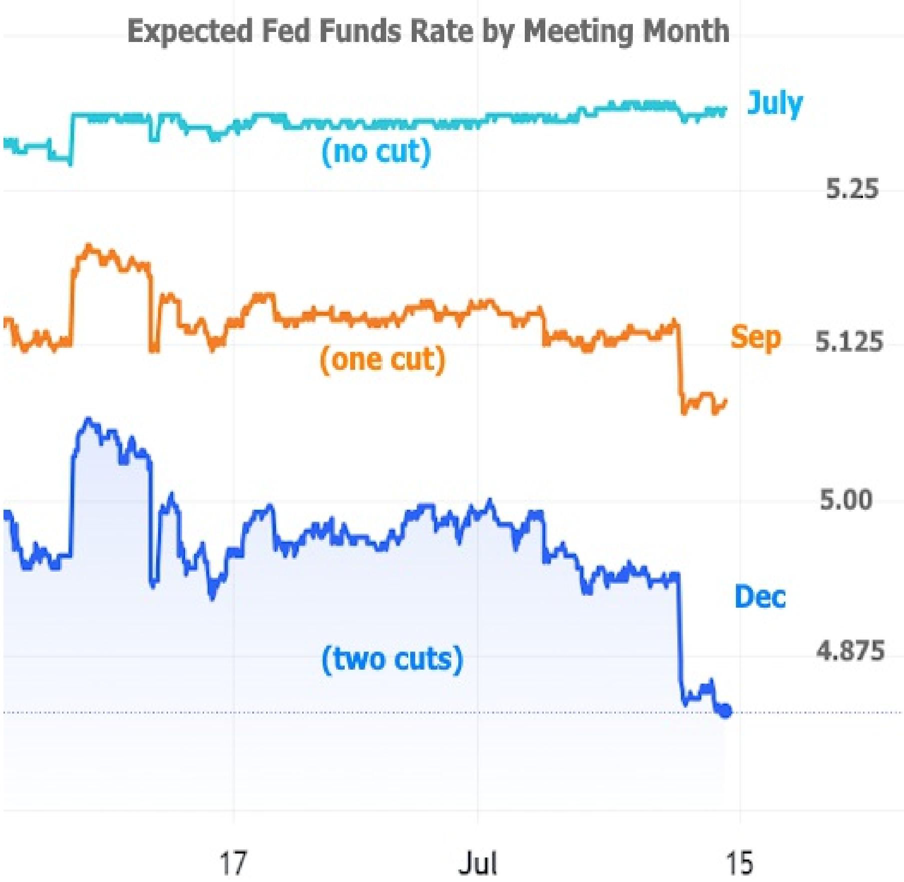
As the chart suggests, we can also say that monthly core inflation is not only the lowest it's been since topping out in 2021, but it's also in line with the lowest levels seen in more than a decade, initial covid lockdown months notwithstanding.

One of the persistent "yeah buts" that has held investors back from believing in the sustainability of low inflation readings has been elevated housing inflation. CPI measures this under the "shelter" category, which had fizzled sideways at levels that were too high for the Fed's liking for months and months. This week's data not only marked the first big break below that "fizzle" range, but it also showed shelter inflation back at the lower end of the pre-pandemic range. Even if it drops no further from here. this is fertile soil for Fed rate cuts.



So why isn't the Fed cutting already? Part of the reason is that they want to be absolutely sure inflation is going to go all the way back to 2%. Again, that's an annual target, and while the last two CPIs imply a much lower annual number, the last 12 CPIs are definitely not quite there yet.

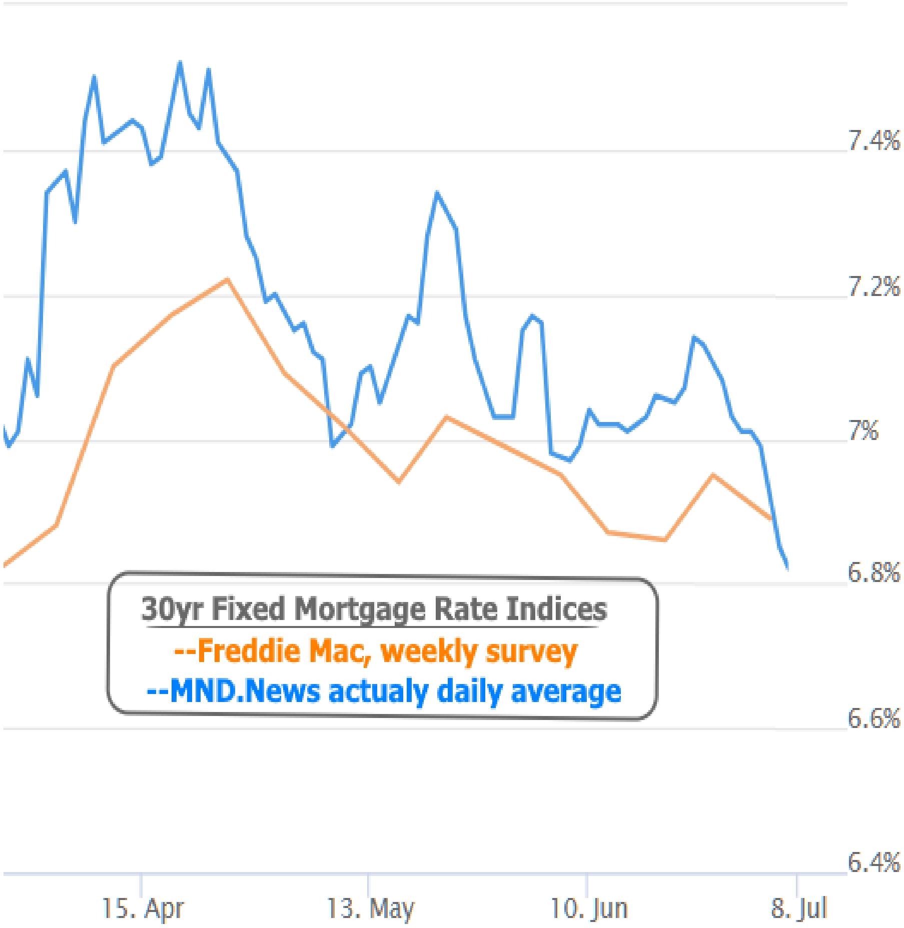
To be fair, the Fed won't wait until this line actually hits 2%. They just want to see one of two things: either another CPI report like this week's, or some weakness elsewhere in the economy that threatens the labor market and cools wage growth. The market is already re-ramping rate cut bets for 2024, with the first seen in September and the 2nd in December.



As for the more tangible reaction for consumer rates in the short term, CPI's impact is easily seen in terms of 10yr Treasury yields.

In the bigger picture, this victory actually goes a long way toward reinforcing the existing trend leading toward gradually lower rates. The CPI-driven drop helped yields make a new low--one of the things needed to establish and maintain such trends.

Mortgage rates benefited as well. Weekly survey numbers have yet to capture the impact, largely because CPI day is not part of the survey methodology. But the shift is easy to see in daily rate tracking.



The next week and a half will be relatively less exciting in terms of scheduled economic data. The key exception would be the Retail Sales report on Tuesday. Otherwise, the next big ticket doesn't arrive until Friday, July 26th. At that point, the stakes will be getting high yet again with the following weeks bringing a Fed announcement, the jobs report, and ultimately, the next CPI report.