Rates Recover After Tame Inflation Data

Last week's big to-do was the jobs report, which sent rates sharply higher. This week's inflation data had a chance to add fuel to that fire or put it out.

The inflation report in question was the Consumer Price Index (CPI). In addition to being one of the two most important monthly economic reports, it also turned out to be quite the little firefighter this time around.

The following chart shows stock market movement since last Friday along with the 10yr Treasury yield (a proxy for longer-term interest rates like mortgages).

The impact on stocks may be counterintuitive at first. After all, conventional wisdom suggests stocks should improve when the job market is strong, as shown by last Friday's jobs report. In the current market environment, however, stocks are more concerned with the data's impact on rates.

In other words, data that makes Fed rate cuts less likely (like the jobs report), sends rates higher and stocks lower. Data that does the opposite does the opposite. Wednesday's CPI was a good example, as seen in the chart above.

CPI helped rates and stocks because it came in slightly lower than expected. The following chart shows the change in core CPI each month. Notice the most recent drop (reported this week) helped keep the trend toward target levels intact.

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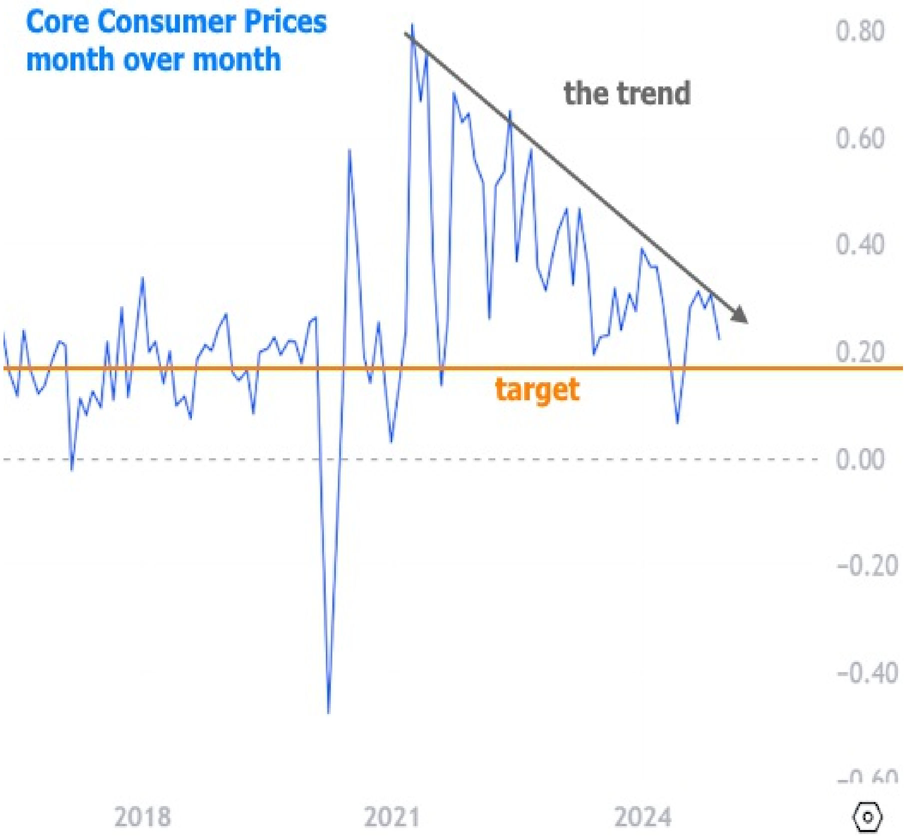
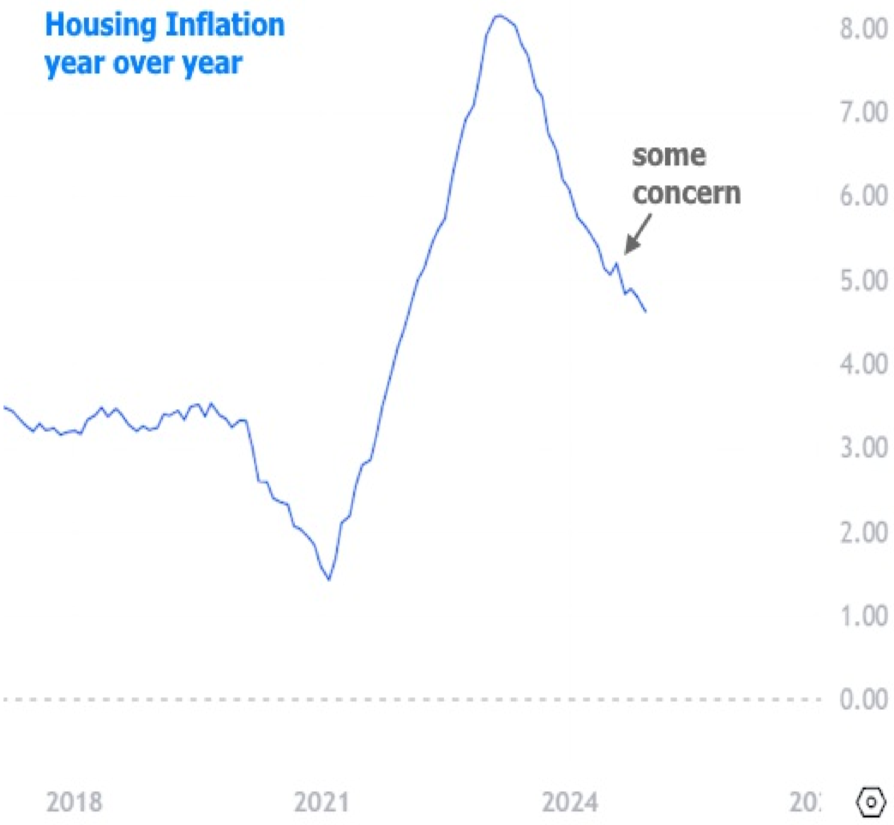
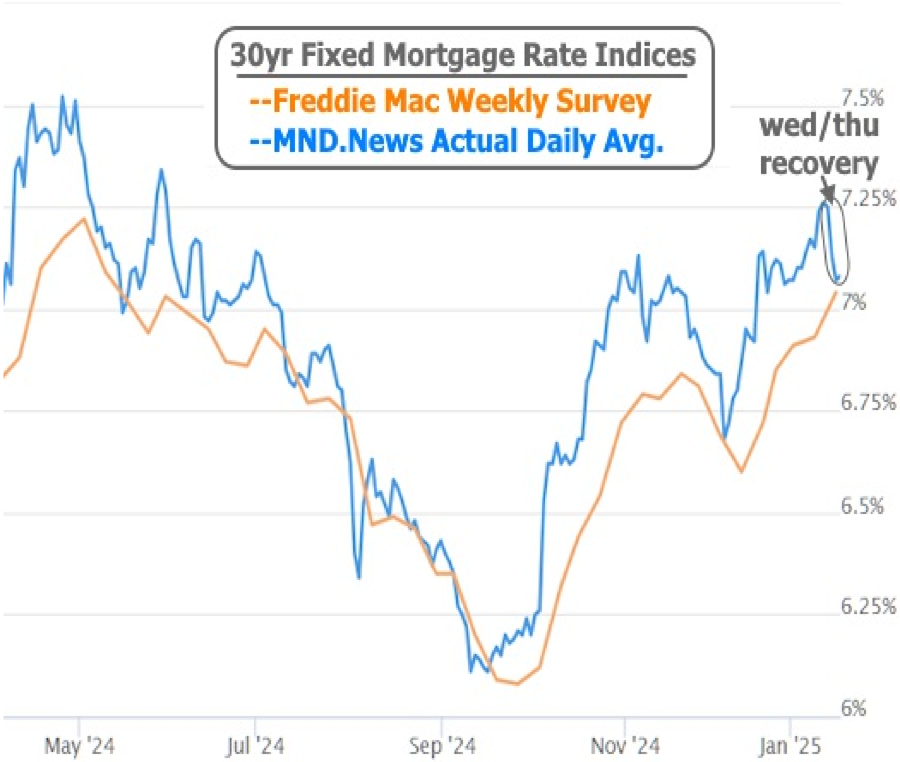


The previous chart showed monthly changes. The following chart is the same underlying data, but expressed in year-over-year change. For the fight against inflation to be a success, this is the line that needs to hit 2.0%. There had been quite a bit of concern over the stall. Reports like this week's help build a case for the stall being a temporary pause as opposed to a sign of a reversal.

In addition to the broad inflation metrics, some individual sectors have been closely watched. Housing is at the top of this list because it has a big effect on the overall number in addition to being problematically elevated in recent years. There was a stall in the housing inflation metrics as well, but it was a bigger concern because it was out of character for a line that normally trends more smoothly. Here too, the most recent installment helps reinforce the friendly trend.



Some disclaimers: inflation is different than outright prices. The charts above do not mean prices are coming down. They mean prices are rising at a slower pace, which is what the Fed needs to see in order to justify additional rate cuts. Moreover, the market will digest these reports one month at a time. If it looks like things are stalling out again, it will be bad for rates. This report happened to be good, but that was ultimately only worth a decent pull-back from the highest mortgage rates since May 2024.



Next week is shorter than normal due to the Martin Luther King Jr. holiday. Bonds will reopen on Tuesday and markets may be responding to political developments in light of Monday's inauguration day. Everything that can already be known about the new administration is currently reflected in rates, but that's always a bit of a moving target. If the initial salvo of executive orders has implications for financial markets that differ from expectations, Tuesday could be a volatile day.

All that having been said, the bigger-picture, longer-term fate of rates lies with the outcome of the next several months of economic data in addition to fiscal policies that may take even longer to materialize.