The Day Ahead: CPI Puts a Floor Under Recent Rate Rally

Unrounded core CPI came in at 0.335, which nearly rounds to 0.4% versus an expectations of 0.2%. This is a big surprise when it comes to inflation data, and it matters more at the moment given the rapidly evolving Fed rate hike outlook. Recent Fed speeches caused a significant pull-back in rate hike expectations. Today's inflation data undoes most of that progress. It may not cause rates to break into new highs, but it makes a strong case for this week's lows being the floor until further notice.

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Confused about the market reaction? Let's talk more.

For those wondering why forecasters didn't expect more inflation, the first thing to check is that you're not confusing the concept of "higher price" with "inflation." Two different things... We all know prices are up. The question is about the pace.

Assuming we're on the same page there, the next thing to understand is that there isn't even the slightest possibility that an individual person's anecdotal observations about prices could ever hope to accurately inform the reality of the CPI data set. They're looking at a lot more prices than we individuals could ever see--let alone mentally process.

80-100 professional forecasters are evaluating the entire data set (although, some take this more seriously than others) and submitting forecasts each month. By the day of the release, the median forecast is the entire market's best guess as to where the data comes in. If the data comes in hotter than expected (which today's did... and significantly so), bonds sell off in proportion to the significance of the report in question.

If you're wondering why today's reaction was so big despite core CPI being 0.3 vs 0.2, we can break that down too. First off, you're right that we've seen far smaller responses to similar data. But today's report was critically important to the Fed rate outlook (which has been very volatile recently).

Fed rate expectations fell sharply at the end of September and then have been in a holding pattern as traders waited to see if today's data would validate that sharp fall or reverse it. Core CPI of 0.335% and supercore at 0.423% is more than enough to throw lots of cold water on recently dovish Fed speakers who've called additional hikes into question.

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