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PALOS

Macro View

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By Hubert Marleau

The Inflation Question: Encouraging

Perception of inflation is as important for investors as actual inflation, especially when both collaborate. A survey for the New York Fed showed that consumer expectation for 12-month inflation is currently 3.6%, down from 3.7%, while 5-year expectation fell to 2.7%. As a matter of fact, the swap market for bonds is presently suggesting that inflation in the month of November, 2024 will run at an annual rate of 2.1%, averaging 2.4% over the next 5 years. The market mood, meanwhile, was generally positive on Tuesday morning ahead of the Bureau of Labor Statistics inflation report, a sentiment confirmed by better than expected numbers. The October headline CPI rose 0.1% m/m with a y/y increase of 3.2%, while its core, which excludes food and energy, rose 0.3% for a y/y increase of 4.0%. Both gauges were lower than consensus. The latest Truflation number, which provides on a daily basis an accurate real-time inflation calculation, is 2.94%. Without shelter costs, inflation is right on target at 2.0%.

Accordingly, there is a good reason to believe that the Fed may start cutting rates sooner than generally expected by the media, with the CME FedWatch Tool showing that traders pricing in the first cut in the 2nd quarter of 2024. With falling inflation rates and the high cost of money, real rates are rising fast while productivity is eating wage rate increases, making previous interest rate hikes more severe. The Fed is bound to take this under serious consideration. The big money-market banks certainly are doing so. Morgan Stanley, UBS and Goldman Sachs are all projecting rate cuts in 2024, and so am I. UBS is forecasting one as early as March.

This report on inflation may end-up being a game-changer. The entire yield curve has changed dramatically over the past month, suggesting that 5% yields were indeed the cap. Yields on 2-year treasury notes, which are highly sensitive to monetary policy, fell 41 bps to 4.81%, while the yield on 5-year Treasury bonds, which is a reliable estimate of the neutral rate, decreased 53 bps to 4.44%, and the return on 10-year Treasuries, which reflects inflation expectations, declined 57 bps to 4.43%. The S&P 500 rose 86 points on Tuesday or 2.1%.

Huber Marleau's Macro View

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