Weekly Market Flash

A Week of Mixed Signals

February 16, 2024

Spare a thought, if you will, for the poor bond market. The fixed income crowd lives and breathes for the certainty of where interest rates are headed, only to be forever buffeted by the crosswinds of conflicting economic data that tear apart the certitude of any directional trends. This week was particularly trying, and most of all for the masses tethered to the "6 in '24" narrative proclaiming six Fed funds rate cuts in 2024, a narrative which, outside the seemingly impenetrable insular bubble of bond traders and their media boosters, does not exist and has not existed. The culprits this week: two hotter-than-expected inflation reports on the one hand, and a colder-than-predicted number for retail sales on the other.

Inflation Surprise #1

A word about this week's Consumer Price Index (CPI) report before we delve into the details: the Fed gives more weight in its deliberations to the Personal Consumption Expenditures (PCE) index than to the CPI number, and as we reported a few weeks ago, the most recent PCE was quite cheery – the index showed a gain of 0.17 percent in December, translating to a 2.9 percent year-on-year growth rate and continuing a steady downward trend over the past half year or so. So that's good.

But the CPI also matters, and this week it showed some unwelcome trends both at the headline and the core (ex-food and energy) levels. Food prices were up by 0.4 percent in January, representing the highest monthly gain since June, shelter was up 0.6 percent, and services not related to energy (i.e., most of the services that make up our daily lives like visits to the hairdresser or the nail salon) were up 0.7 percent. To put that another way, many of the categories that make up typical household budgets saw price gains in January well above recent trends. That led to an overall year-on-year gain of 3.1 percent for headline CPI and 3.7 percent for core CPI. Once again, the bond market got a bracing dose of cold water thrown on its rate cut plans, as anything suggestive of higher inflation strenuously complicates any plans by the Fed for a near-term rate cut (and Powell had already signaled at last week's FOMC meeting that such a cut was very unlikely to be on the table when the Committee meets next in March).

Retail Sales: Bad News Is Good News

Then came the reprieve. A retail sales print on Thursday showed a sharp reversal in January that may be the first clear sign of a slowdown in consumer spending (although, to be fair, it may also have more to do with several severe weather incidents last month than with a more sustained directional movement). Retail sales in January declined by -0.8 percent. The so-called Control Group number, which strips out a few volatile categories and is the retail sales figure that flows into Gross Domestic Product calculations, was down a half percent when it was expected to gain a half percent – a one percent deviation from expectations. That's bad news if you want to see stronger growth, but it's good news if (like bond traders) the only thing in life that matters is the Fed cutting interest rates. Predictably, yields in Treasury securities came down and offset some of the rise from the Tuesday inflation report.

Inflation Surprise #2

Alas, the bond market's reprieve was but a passing moment. On Friday another inflation report came out, this time the Producer Price Index that measures changes in wholesale prices (i.e., stuff going on upstream from consumer-facing activity). Normally the PPI doesn't get anywhere near the attention the CPI and other consumer figures garner, but this time it was a dead weight on market sentiment. Core PPI in particular deviated significantly from expectations, with a month-on-month gain of 0.5 percent versus expectations of just 0.15 percent (and coming on the heels of the previous month when it actually fell by -0.1 percent. As a result, the 10-year Treasury is back at its highest level since last November (though still well shy of the 5.0 percent peak reached last October).

What to make of all this? Well, from our standpoint it goes along with the message we repeat to our clients on a regular basis: the short term is unknowable, so don't try to profit from outguessing where interest rates, or stock prices, or barrels of Brent crude oil, are going to be tomorrow or next week. We remain puzzled by why the bond market has consistently tried to outrun the Fed and make up its own bedtime stories about rate cut unicorns. But rather than thinking we know any better, we continue to move incrementally and deliberately in the context of the overall structural likelihood of peak rates and a gradual – subject to those many macroeconomic crosswinds – reduction towards the natural interest rate (which is not easy to pinpoint but is almost certainly lower than where rates are now). And we don't try to read too much one way or another into any single piece of information. One data point does not a trend make.

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