The "hot" inflation data do not change their base case for a soft landing of slower growth, falling inflation, and 100bps of Fed rate cuts this year, likely starting in the second quarter. (UBS)

Stocks and bonds fall as US inflation disappoints

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Equities and bond markets fell in tandem, while the US dollar strengthened Tuesday after a disappointing US consumer price index (CPI) release. The stronger-than-expected data, particularly for core services, added to investor concerns that the Federal Reserve may need to wait longer before it begins to cut rates in 2024.

What do we expect?

Stocks have rallied in recent months on hopes of faster Fed cuts. At one point in January, as much as 170 basis points of easing were priced in for this year, starting as early as March. Our base case remains that the Fed will lower rates by 100 basis points by the end of 2024, with the first cut occurring in the second quarter. So, a move higher in yields and a consolidation in stocks on firmer inflation data (which also followed a strong labor market report) is not a surprise to us. In our view, it is unlikely that prices for core services will continue to rise at such a rapid pace, and we still expect inflation to slow in the months ahead. In the January data, the strength largely reflected start-of-year price increases for labor-reliant categories such as medical services, car insurance and repair, and daycare. We expect inflation in these categories is likely to be lower in February and March. Also, while owners' equivalent rent was at a nine-month high of 0.56%, the rent category was up only 0.36%—the largest gap between the two since 1995.

So, the "hot" inflation data do not change our base case for a soft landing of slower growth, falling inflation, and 100bps of Fed rate cuts this year, likely starting in the second quarter. But we are continuing to monitor the incoming data and the start of rate cuts could be delayed should the economic prints remain strong.

There will be a number of economic releases before the next two Federal Open Market Committee (FOMC) meetings (19–20 March and 30 April–1 May), but rate cuts are not likely until the FOMC, in its own words, has "gained greater

confidence" that inflation is moving sustainably toward its 2% goal. The next two CPI reports, 12 March and 10 April, will need to show further progress to justify a cut in May.

How do we invest?

Despite Tuesday's pullback, the S&P 500 has rallied strongly since October and remains close to our end-2024 target. Selectivity is therefore important. We prefer quality stocks, which should continue to perform as growth slows and which, in the US, also offer exposure to the structural AI growth trend. We continue to recommend small-caps as a complement to quality. Although small-caps performed poorly on Tuesday, they are likely to recover if rates are cut later in the year as we expect, given the high proportion of floating-rate debt they hold.

We also recommend investors look for quality in fixed income. We still expect yields to finish the year lower; our December 10-year US Treasury forecast is 3.5%. The prospect of lower yields means that investors still face reinvestment risk on cash holdings and should look to lock in yields to manage this exposure.

Tuesday's pullback also demonstrates that stocks can go down as well as up, and investors should consider capital preservation strategies to lock in gains, while retaining upside exposure. Finally, uncertainty about policy rates is increasing FX volatility, but key currency pairs are still trading in established ranges, which offers the opportunity for yield pickup by trading the ranges.

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