Following the CPI figures for August, it appears the Fed's easing cycle will start with a 25bp cut (UBS).

Inflation suggests that a 25bp cut next week is likely

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The Consumer Price Index (CPI) for August registered a 0.2% month-over-month increase in August, in line median market expectations. Several of the main disinflationary trends continue to unfold, with favorable behavior in goods prices and services excluding shelter. Yet core inflation came in at 0.3% m/m in August, a tad above market expectations of 0.2% m/m, owing largely to housing inflation.

What happened with housing?
Once again, Owner’s Equivalent Rent (OER) surprised to the upside in August, recording a 50bp monthly increase—its strongest print since January. Relative to market expectations, the bulk of the higher-than-expected result in core inflation was related to this component.

Overall, inflation dynamics were supportive of the disinflation process, but OER’s behavior has a significant impact, since that item alone comprises roughly 27% of the total CPI.

Policymakers have repeatedly raised concerns about the protracted disinflation process of housing, even when real time rent metrics suggest that shelter price pressures should be assuaging by now.

Our initial conclusion
The CPI result provided greater clarity on the Fed's potential first move than last week's non-farm payrolls numbers. With this info at hand, the FOMC seems more likely to gradually initiate the easing cycle, while keeping options open if data shows unexpected weakness in the labor market and domestic demand. In this context, we stand by our call that the Fed will likely reduce the policy rate by 100bps this year, but expect the first cut next week to likely be of 25bps.

Bottom line

We believe the current environment of disinflation, falling interest rates, and moderate economic growth is constructive for both equities and bonds. Even for those concerned about potential stronger-than-expected macro weakness, we remind them that the benefit of the current rates level is that the Fed has considerable room to add stimulus if conditions warrant it.

We therefore reiterate the importance of positioning for lower rates. Looser financial conditions should erode the appeal of short-term liquidity positions. We therefore recommend redeploying excess cash or money market funds into high-quality bonds, such as investment grade corporate bonds and agency MBS.

Please see the comments from CIO's US Senior Economist, Brian Rose: Shelter inflation remains sticky

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