The inflation data was a disappointment after a recent string of positive releases. However, beyond a fractionally higher monthly core figure, the details of the report were less concerning. (UBS)

Data highlight the importance of avoiding overreacting to short-term volatility

12 September 2024, 2:38 pm CEST, written by UBS Editorial Team

It was a volatile day for US equities on Wednesday. The S&P 500 initially fell as much as 1.5% after faster-than-expected inflation fueled concerns that the Federal Reserve may be less willing to cut rates rapidly to protect the US economy.

Markets were also digesting the implications of the debate between Vice President Kamala Harris and former president Donald Trump. Investor sentiment recovered through the day, and the index ended up just over 1.1% by market close. The tech-heavy Nasdaq 100 index was up 2.2%, led by an 8.2% gain in AI chipmaker NVIDIA.

Investors initially appeared unnerved by the release of August inflation data. This showed the core consumer price index —which excludes food and energy costs—rising 0.3% from July, the largest increase in four months. The three-month annualized rate climbed from 1.6% in July to 2.1%.

The release comes a week ahead of the Fed’s policy meeting, at which it is widely expected to start its rate-cutting cycle. Investors have recently scaled back the chances of a 50-basis point reduction. The yield on the two-year Treasury bond, which is highly sensitive to Fed moves, edged higher.

What do we expect?

The inflation data was a disappointment after a recent string of positive releases. However, beyond a fractionally higher monthly core figure, the details of the report were less concerning. While the outcome makes a 50-basis-point cut next week less likely, we don't believe the outcome will stop the Fed from easing by around 100 basis points by the end of the year.

First, the bulk of the increase was due to shelter costs—dominated by owners' equivalent rent. This does not measure actual transactions and is instead an estimate of the sum homeowners would pay to rent their own properties. More current data on rents have pointed to just modest increases over the past 18 months. If shelter is removed, the annual core rate of inflation in August falls from 3.2% to 1.7%. In addition, the Fed's favorite measure of inflation, the personal consumption expenditures index (released later this month), places much less emphasis on shelter.

Second, evidence has been mounting that the US economy is slowing, reducing the risks that inflation gets stuck above the Fed's 2% target. Data last week showed the US generated a net 142,000 jobs over the month, below consensus forecasts of 162,000, while downward revisions subtracted 86,000 jobs from the prior two months. This took the three-month moving average of jobs growth to 116,000, the lowest level since mid-2020. The Fed's Beige Book, in which Fed officials gather opinions from business leaders and economists across the country, also pointed to cooling demand.

Among the next key releases for investors will be next week's retail sales data for August, released a day ahead of the Fed's meeting. Given the importance of resilient consumer spending in supporting US growth, the outcome could also help determine the pace of monetary easing. But overall, recent data—including the latest inflation release—is consistent with our view that the US is headed for a soft landing.

Regarding the race for the White House, our general takeaway is that Harris turned in a stronger performance, especially relative to expectations. Online prediction market PredictIt showed that the gap between Harris and Trump widened post-debate, with the odds for a Harris win rising to 56% from 52%. But the outcome remains finely balanced. While we view a Harris presidency with a divided Congress as the most likely scenario—at around 40%—national opinion polls ahead of the debate were essentially a statistical dead heat, with very narrow margins in the critical swing states. That would argue against making large portfolio shifts—either in terms of asset class or sector—based on election predictions.

How do we invest?

The rebound in the S&P 500 from an intraday loss of as much as 1.5% to a daily gain of just over 1.0% underlined the importance of investors avoiding overreacting to short-term volatility.

In recent months, investors have been weighing a range of concerns from the risk of a US recession and the possibility that AI would fail to live up to investor enthusiasm to a potential escalation of the conflict in the Middle East. While we are monitoring these risks, our base case is that fundamentals will continue to support equities. We expect a soft landing for the US economy, supported by a steady pace of rate cuts from the Fed. We see no signs of a let up in capital spending on AI by the top tech firms, with progress toward monetizing those investments. Finally, while geopolitical risks have increased, our base case is that a significant deterioration can be avoided.

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Original report - **US inflation spurs renewed volatility, 12 September 2024.**