While CIO expects the Fed to remain cautious in the near term, the deceleration in inflation has reinforced a constructive outlook for equities and quality bonds in 2025. (UBS)

Equities and bonds rally on easing inflation data

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US equities and bonds rallied on Thursday after slowing inflation in December bolstered hopes for a more dovish turn from the Federal Reserve in the months ahead.

The core consumer price index (CPI), which excludes volatile food and energy prices, decelerated for the first time in six months, easing to 0.2% from 0.3%in the prior month. On an annual basis, core inflation came in at 3.2%, down from 3.3% in November. Economists had expected the annual rate to hold steady. The headline rate of inflation accelerated to 0.4% from 0.3% in the prior month, with 40% of the advance due to energy prices.

The release appeared to come as a relief after stronger-than-expected employment data on Friday caused investors to further scale back their expectations over the pace of Fed interest rate cuts in 2025.

What do we expect?

The December inflation data was only fractionally lower than the consensus forecast. It also comes against a backdrop of a recent run of robust economic releases. The Atlanta Fed's GDPNow, which projects growth based on recent data, suggests the US economy expanded at a 2.7% pace in the fourth quarter—still strong by historical standards. Against this backdrop, we don't expect the latest inflation release to notably alter the Fed's monetary policy trajectory. We anticipate no further rate cuts before June.

But the softer inflation figures are a reassuring sign for markets, particularly after a period of elevated bond yields and retreating equity prices. Much of the elevated inflation is coming from shelter costs, which account for more than a third

of the CPI. Shelter prices rose 4.6% annually in December. However, this reflects previous strength in the housing market, since rental contracts are only typically renewed annually or every few years. The monthly rises in rents within the CPI were more moderate in November and December, adding to our confidence that annual shelter inflation will continue to slow. Excluding shelter, headline inflation was just 1.9%, while core inflation ex-shelter stood at 2.1%—consistent with the Fed's 2% target.

As a result, we believe that the market is now underpricing chances for further policy easing. The latest release reinforces our view that the Fed is on track to reduce rates by 50bps in 2025—though cuts may only resume closer to the middle of the year. Given the recent resilience of the data, including in the Beige Book published by the Fed on Wednesday, we see no reason for the Fed to move rates at its upcoming policy meeting, which concludes on 29 January. Looking ahead, we think retail sales and industrial production data out this week will be important in shaping expectations for the Fed.

How do we invest?

While volatility may persist, the latest CPI data suggests that inflation is beginning to cool after months of stickiness. While we expect the Fed to remain cautious in the near term, the deceleration in inflation has reinforced a constructive outlook for equities and quality bonds in 2025.

Put cash to work: We believe the moderation in December inflation data supports our view that the Fed will reduce rates gradually later this year, with the first cut anticipated in June. In a lower rate environment, returns on cash will decline further.

We see attractive opportunities in the 5-year part of the US curve and maintain our Attractive asset class recommendations on high grade and investment grade bonds. We forecast lower rates from here over the course of the year, and given the recent curve steepening, yield pickup is now generally available by switching out of cash.

More to go in stocks: The recent shift in the expected pace of Fed easing has presented a headwind for equities. However, while the speed of rate reductions is likely to be slower than expected prior to the December meeting, cuts are still on the way, in our view. Historically, stocks performed well in periods when the Fed cut rates while growth remained positive. In addition, the strength of the economy is highly correlated with earnings growth, which we think bodes well for equities at this level of rates. We therefore see equity pullbacks from growth-related rate increases as a buying opportunity.

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