Although yield volatility is likely to remain high in the near term, CIO retains a most preferred rating for quality bonds in our global portfolios. (UBS)

Cooling core CPI supports the case for a soft landing

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US headline inflation has not followed a consistent downward path, yet lower goods inflation in December helped the consumer price index (CPI) move toward the Federal Reserve's 2% target.

Following the US CPI release, equities and fixed income markets remained little changed as investors priced in 145 basis points of Fed rate cuts in 2024. By Thursday's US equity market close, the S&P 500 declined 0.1% to 4,780 while the US 10-year Treasury yield dipped six basis points to 3.98%.

The December report showed headline CPI rose 3.3% year-over-year from last month's 3.1%, while core CPI (ex-food and energy) declined to 3.9% from November's 4%, its lowest reading since May 2021. Core goods inflation was unchanged from the prior month, while core services, particularly shelter costs, contributed the most to core CPI. On a monthly basis, headline CPI and core CPI rose 0.3%.

But, there are signs that US inflation is continuing to cool, in line with our base case soft-landing scenario, although the market's current pricing of close to a 70% chance of a first rate cut in March may be too optimistic.

Core CPI continues to recede. Core CPI has declined from its peak of 6.6% in 2022 to 3.9% currently. While core goods prices have been fairly stable, much of the core inflation has come from higher services costs. We suspect this relationship may change in the coming months, as the trend in goods prices may be less favorable and shelter costs may slow. Shelter inflation, which rose 6.2% year-over-year in December, accounts for nearly 70% of core services inflation. Data on new rental agreements suggest that shelter inflation, which lags new rental agreements by around 12 months, will continue to slow in the months ahead.

Elevated US wage inflation is on a downward trajectory, but still too high. During December's Federal Open Market Committee's (FOMC) policy meeting press conference, Fed Chair Jerome Powell highlighted the FOMC is monitoring elevated wage growth pressures. This week's Atlanta Fed wage tracker for December was unchanged at 5.2% year-over year. While the pace of wage growth has subsided from July 2022's 6.7%, it is still too high to be compatible with the Fed's 2% inflation goal. In our view, the labor, inflation, and economic growth data are too strong for the Fed to rush into rate cuts despite signs of a gradual cooling in the labor market. Since job creation remains robust, US unemployment is still close to multi-decade lows, and household balance sheets are strong, we expect a soft economic landing will only bring a gradual slowdown in consumer spending for 2024.

Inflation is likely to fall at a more gradual pace. The falling trend in inflation has become well-established. But it is likely that the improvement will slow in the first half of 2024, as year-over-year price comparisons become less favorable. Due to this fading of favorable base effects, it is possible that upcoming headline inflation could lead to some disappointment among investors. In our view, inflation prints are likely to approach the Fed's target only in the second half of this year. In light of this, and with growth continuing to surprise to the upside, the Fed may prefer to wait for further softening before cutting rates.

So, our base case scenario is for four 25-basis-point rate cuts this year starting in May. We reiterate the need for investors to manage liquidity by limiting cash balances and locking in yields. Although yield volatility is likely to remain high in the near term, we retain a most preferred rating for quality bonds in our global portfolios. We also continue to see quality stocks as a core holding for investors.

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