

Is the third time the charm? The financial markets understandably greeted this week's report of slowing consumer prices with a good deal of optimism. For one, it solidifies perceptions that inflation has peaked and the Fed can ease up on its aggressive rate-hiking campaign. Indeed, the financial markets are more convinced now than a few weeks ago that the central bank will be cutting rates sometime later this year. For another, it also raises hopes that the Fed can accomplish its goal of taming inflation without sending the economy into a recession, bringing about the elusive "soft landing". That, in turn, would have positive implications for workers, businesses and investors as it enhances job security, strengthens earnings prospects and supports asset prices.

But even as the markets cheered the latest inflation reading, the Fed is not uncorking the champagne. After all, this is the third time during this frightful inflation cycle that the pace of price increases has slowed. The previous two, during the summer and early fall of both 2022 and 2021, didn't last as inflation reaccelerated and moved to successively higher highs, peaking at 9.1 percent last summer. No doubt, the Fed is confident that the current slowdown is more durable; it has, in fact, already lasted longer, with the consumer price index notching lower annual increases for six consecutive months. Following December's 0.1 percent decline from November, the annual rate slipped to 6.5 percent, the lowest since October 2021. The core CPI that strips out volatile food and energy prices – over which the Fed has no control – has followed a somewhat different trajectory, increasing more in December (0.3 percent) than in November (0.2 percent) but still declining to a twelve-month low of 5.7 percent at an annual rate. The steeper retreat in the headline CPI – registering the first outright decline since May 2020 – was driven by a 9.4 percent plunge in gasoline prices.

Where the markets and the Fed depart is in their assessments of how fast the inflation rate will reach pre-pandemic levels of roundly 2 percent, and what is required to get it there. The markets think that one more rate increase of a quarter-point would do the job, leaving the Fed's policy rate at 4.75 percent. Based on market pricing, traders expect inflation to slip to just over 2 percent within the next two years and the steep fall in the 2-year Treasury yield – which is highly sensitive to expected policy changes – over the past two weeks reflects expectations the Fed will cut rates sooner rather than later. The 2-year yield has returned to the level that prevailed before the last two rate hikes totaling 1.25 percentage points. But the Fed is not on the same page as traders – at least not yet. Recent comments from policy makers indicate that the Fed has not budged from its December projection of two more rate hikes that would lift the federal funds rate to 5.1 percent and leave it there for the remainder of the year.

At best, the stepdown in inflation will nudge the Fed to dial back the next rate increase to a quarter-point from the half-point hike taken in December and the three-quarter percentage point increases implemented in each of the four previous FOMC meetings. That would lift the fed funds rate to 4.75 percent following the February 1 meeting, leaving it one or two increases short of the terminal level it expects to hit in coming months. However, it remains to be seen if it actually follows through with those increases. Much depends on future inflation readings and the state of the economy, most notably the health of the job market where wages are rising too quickly for the Fed's comfort. Importantly, while the headline consumer price index is pointing to rapid improvement, the Fed is looking under the hood for more concrete evidence of a sustained slowdown in inflation.

On this score, the details present a mixed picture. Both the overall and core CPI have dropped comfortably below their nearby peaks, thanks mainly to falling goods prices and, particularly last month, steep declines in energy prices. The disinflation in goods prices is expected to continue, reflecting healing supply chains

and reduced demand, as consumers shift their purchases from goods to services. In some cases, the price declines are shaping up to be dramatic; used car prices, for example, are falling like a stone, turning one of the biggest inflation influences during the height of the pandemic into the biggest drag on inflation. Used car prices fell in nine out of the last eleven months and are almost 9 percent lower than a year ago. But the service side of the inflation ledger is less accommodating.

Excluding energy, core service prices accelerated in December, rising 0.5 percent compared to 0.4 percent in November. The stubbornly rapid increase in housing costs is having the biggest influence, with shelter prices rising by a robust 0.8 percent, underpinned by higher rents. But here too there are encouraging omens. The shelter component, which accounts for an outsized 40 percent of the core CPI, overstates current inflationary conditions in the housing market because it includes rents under signed leases made as long as six months ago. According to virtually all industry sources, new lease signings are generating much smaller rent increases, which will gradually pull down the increase in housing costs over time. Aiding this process, a record supply of new rental units is poised to hit the market this year.

However, it will take at least six months for lower rents to have a major impact on the consumer price index. What's more, the Fed is fully aware of the prospective unwinding of price pressures in the housing market. What concerns it more is the sliver of service prices unrelated to housing that refuses to slow. This hardcore component, service prices excluding energy and housing costs, has barely moved. In December, it increased 6.3 percent from a year ago, the same as in November and only a tad slower than the 6.6 percent peak reached three months ago. Over the past three months, these prices have cooled markedly, rising at an annual rate of 2.7 percent. But they tend to be highly volatile over short periods – the three month average increases have bounced back and forth between 0 and 10 percent over the past year—and the Fed views them as being closely tied to labor costs, which are rising far too strongly to be consistent with its 2 percent inflation target.

If the Fed is now focusing primarily on this hardcore component of prices – stripping out commodities, energy, food and shelter – it would be shaping policy decisions on the behavior of less than 30 percent of the CPI. This runs the risk of taming the tail until it kills the dog. We doubt that the Fed will go overboard based on this small sliver of price action but it does strengthen the case to closely monitor wage trends, which is a key influence in pricing decisions in the service sector. While the latest jobs report does depict a slowing trend in average hourly earnings, lower-paid workers are outpacing the pack. According to the Atlanta Fed's wage tracker, workers in leisure and hospitality and trade and transportation are getting raises of 7 percent or more, compared to still robust increases of 6.3 percent for all workers. The tracker covers the twelve months through December.

From our lens, the ongoing strength in the job market and sturdy wage increases together with healthy overall household balance sheets that nourishes consumer spending will keep the Fed in a hawkish mode. Prior to this week's consumer price report, the odds it would raise rates by a quarter or a half-point at the conclusion of the February 1 policy meeting were 50-50. Following the benign CPI report, the odds of only a quarter-point increase have moved closer to 100 percent, a bet that is fully priced into the financial markets. However, the strong inflation underpinnings – job and wage growth and sturdy consumer spending – together with sticky service prices also heightens the odds the Fed will raise rates again in March, lifting the federal funds rate above the 5 percent threshold.

Importantly, the Fed is not only striving to lean against the inflation tailwinds. It is also in a tug of war with the financial markets that refuse to believe the Fed will go that far. That, in turn, has led to sharp yield declines and buoyant stock prices, an easing of financial conditions that undermines the Fed's efforts to cool off the economy. The longer this tug of war prevails, the greater are the odds the Fed will step more firmly than necessary on the monetary brakes, heightening the risk of a recession. Ironically, the markets could well be fostering a self-fulfilling prophecy.

FINANCIAL INDICATORS

INTEREST RATES	Jan 13	Week Ago	Month Ago	Year Ago
3-month Treasury bill	4.61	4.62	4.30	0.13
6-month Treasury bill	4.79	4.84	4.70	0.29
3-month LIBOR	4.83	4.81	4.74	0.24
2-year Treasury note	4.22	4.28	4.20	0.96
5-year Treasury note	3.54	3.91	3.63	1.56
10-year Treasury note	3.51	3.56	3.49	1.79
30-year Treasury bond	3.61	3.69	3.55	2.13
30-year fixed mortgage rate	6.33	6.48	6.31	3.45
15-year fixed mortgage rate	5.52	5.73	5.54	2.62

STOCK MARKET				
Dow Jones Industrial Index	34,302.61	33,630.61	32,920.46	35,911.81
S&P 500	3,999.09	3,895.08	3,852.36	4,662.85
NASDAQ	11,079.16	10,569.29	10,705.41	14,893.75

COMMODITIES				
Gold (\$ per troy ounce)	1,923.00	1,871.00	1,803.00	1,816.30
Oil (\$ per barrel) - Crude Futures (WTI)	80.06	73.76	74.50	84.39

ECONOMIC INDICATOR	Latest Month/Quarter	Previous Month/Quarter	Two-Months/Quarters Ago	Average-Past Six Months or Quarters
Consumer Price Index (December) - % change	-0.1	0.1	0.4	0.2
Core CPI (December) - % change	0.3	0.2	0.3	0.4
Consumer Credit (November) - \$blns	28.0	29.1	25.3	29.2

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