CETERA® INVESTMENT MANAGEMENT

COMMENTARY

February 13, 2024

Inflation Report Surprises Higher

- Today’s CPI report was stronger than expected and pressured financial markets.
- We still expect disinflation and the Federal Reserve to cut interest rates.
- As volatility picks up, diversification and staying focused on your goals is even more important.

U.S. financial markets struggled today on the heels of a higher-than-expected inflation report. The consumer price index, a broad-based measure of the prices consumers face for goods and services across the economy, increased 0.3% for the month. On a 12-month basis, that figure came out at 3.1%. The strength of this report raised questions about whether the Federal Reserve (Fed) will delay expected rate cuts, which caused a drop in both U.S. equities and bonds.

Despite today’s inflation surprise, we expect the Fed to cut interest rates and navigate the economy into a so-called “soft landing” to avoid a recession. While today’s inflation report was strong on an acceleration in the owners’ equivalent rent component, the rest of the report showed plenty of disinflation in the economy. In fact, as we noted today, if you remove these shelter costs from CPI, this inflationary measure is only 1.5% on a 12-month basis as key goods prices such as clothing, medical care commodities, and used cars continue to decline. With inflation slowing and the fact that high interest rates weigh on economic growth, we anticipate that the Fed will still lower interest rates by the summer, though not likely as soon as markets had hoped.

While the threat of a 2024 recession rises, since the Fed might need to keep interest rates higher for longer than anticipated, we feel the economy is robust enough to handle it. For example, fourth quarter U.S. GDP was 3.3%, well above expectations, the job market remains very strong with the unemployment rate at 3.7%, and current sectors in recession, such as manufacturing and housing, are showing clear signs of stabilization, if not improvement. Taken together, the economy will feel some pressure if rates stay high too long, however, it is coming from a position of strength.

In our opinion, today’s market reaction was somewhat expected. The financial markets had been overly optimistic that the Fed would cut interest rates more than the Fed said they would in their last Summary of Economic Projections back in mid-December. This was seen in the increase in stock market valuations that saw the price-earnings ratio of the S&P 500 rise from about 17x forward 12-month earnings to over 20x 12-month earnings in the past three months. The surge in valuations reflected near flawless optimism that neither inflation nor the economy would experience any bumps, and we all know that the last mile is always the hardest.

Today’s volatility is an example of market fluctuations that we can expect as investors try to understand to what degree the Fed will cut rates. More importantly, as we have noted since the S&P 500 correction in late October, we expect markets will be volatile, but they can also present opportunities for long-term investors. We are extremely confident that inflation is slowing and the Fed will lower interest rates this year. Also, we are optimistic that the worst is behind us in terms of corporate earnings. In fact, according to Factset, the current earnings growth for 2024 is expected to rise to 10.9% from the current estimate of 1.2% for 2023. Since corporate earnings tend to lead stock prices, this is a strong positive.

Until we get more clarity on inflation, the Fed’s interest rate plans, and corporate earnings, we do expect market volatility to remain elevated. But again, market volatility is a normal part of investing. Case in point, as we noted last month, from 1980 – 2023, the S&P 500 has been positive in 36 of these years, yet the average intra-year drawdown was -14.2%. Market volatility is a normal part of investing. Diversification helps to protect against this volatility. Given the potential positives that we see on the horizon, markets can change abruptly and reverse course quickly. Your financial professional can help you stay focused on your personal financial goals. As always, please contact your financial professional with any questions about tailoring your portfolio to your personal situation.

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