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U.S. Inflation: Hotter March CPI Puts Fed in a "Sticky" Situation

Yet another higher-than-expected U.S. consumer price index report raises the risk for inflation to settle a higher rate, clouding prospects for rate cuts by the U.S. Federal Reserve. Here's what that could mean for investors.

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The monthly "surprises" regarding the pace of consumer inflation in the United States may be getting less surprising. A report issued by the U.S. Bureau of Labor Statistics on April 10, 2024, showed that U.S. consumer price index (CPI), prices rose at a higher-than-expected rate in March for the third month running, with both the headline and core (excluding food and energy prices) CPI up 0.4%. The core CPI has flattened out at 3.5%+ annualized rate over the three-, six-, and 12-month trailing periods.

With no downward trend evident, that's far too rapid a pace for the Federal Open Market Committee (FOMC), the policy-setting arm of the U.S. Federal Reserve (Fed), to cut interest rates and encourage even easier financial conditions.

Housing Brings the Heat to CPI

The March CPI report showed that "supercore" inflation–core services excluding rents–picked up sharply in the first quarter, hinting that rising wage costs are passing through into prices at an accelerated pace. While the PCE deflator[1] version of this measure won't be rising quite as fast, it may also be turning up at a more rapid rate when the March PCE data are released later this month.

Rents remain a driver of higher-than-anticipated core inflation. The largest component, owner-equivalent rent (OER), shows no sign of trending lower in recent months as a shortage of single-family homes for sale keeps upward pressure on the rental component of that market. OER makes up a third of the core CPI, and it is very difficult for core inflation to return to the pre-pandemic pace if it continues rising almost 2% faster (on an annualized basis).

There's a little more of a hint that rent inflation is trending lower in the much smaller tenant's rent component of the CPI report. But it's fair to say that housing inflation has proven much stickier than many thought it would be, as low vacancy rates and strong job growth preserve a sizable imbalance between demand and supply.

Core consumer goods prices dropped modestly in March as motor vehicle prices fell. But rising import prices suggest an inflection higher in coming months.

Policy and Investment Implications

With not a single month in over two and a half years in which the core CPI rose at a pace consistent with the Fed's 2% inflation target–and no hint of a downtrend in recent months–the chances of a rate cut in June and two more in the second half of 2023 are fading fast. Instead, the Fed is likely to hold rates steady to avoid adding fuel to a strong economy that is generating inflation that may become entrenched at a rate too far above the 2% marker.

For investors, we believe that positioning for a steeper yield curve makes sense for two reasons. First, we think the bar for a Fed rate hike is high, and policymakers are still biased towards a cut, as indicated by projections issued at the March Fed meeting. There are a lot of Fed speakers in the coming days so we will see if that is still the case after payrolls and inflation.

Second, we see the chance for yields on five- and 10-year U.S. Treasury notes to move higher, in what would represent a bear steepening,[2] as the terminal rate in the policy cycle (the rate at which the Fed stops cutting) rises in response to the prospect of inflation settling in at a higher rate.

As we noted in a podcast posted earlier this month, a late-cycle economic environment brings with it an unfavorable trade-off between growth and inflation. For investors, that suggests reducing duration exposure, collecting high-quality carry, and emphasizing stocks of high-quality companies with high secular growth and market positions that confer meaningful pricing power.

Important Information

[1]The U.S. Personal Consumption Expenditure price index (PCE), also referred to as the PCE deflator, is the U.S> Federal Reserve's favored measure of consumer-level inflation.

[2]Bear steepener describes the widening of the yield curve caused by long-term interest rates increasing at a faster rate than short-term rates. A bull steepener is when the curve widens because short-term yields have fallen more than long-term yields.

Unless otherwise noted, all discussions are based on U.S. markets and U.S. monetary and fiscal policies.

References to fund yields are for informational purposes only and are not meant to represent any specific Lord Abbett bond fund or portfolio.

Asset allocation or diversification does not guarantee a profit or protect against loss in declining markets.

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Market forecasts and projections are based on current market conditions and are subject to change without notice.

Projections should not be considered a guarantee.

Equity Investing Risks

The value of investments in equity securities will fluctuate in response to general economic conditions and to changes in the prospects of particular companies and/or sectors in the economy. While growth stocks are subject to the daily ups and downs of the stock market, their long-term potential as well as their volatility can be substantial. Value investing involves the risk that the market may not recognize that securities are undervalued, and they may not appreciate as anticipated. Smaller companies tend to be more volatile and less liquid than larger companies. Small cap companies may also have more limited product lines, markets, or financial resources and typically experience a higher risk of failure than large cap companies.

Fixed-Income Investing Risks

The value of investments in fixed-income securities will change as interest rates fluctuate and in response to market movements. Generally, when interest rates rise, the prices of debt securities fall, and when interest rates fall, prices generally rise. High yield securities, sometimes called junk bonds, carry increased risks of price volatility, illiquidity, and the possibility of default in the timely payment of interest and principal. Bonds may also be subject to other types of risk, such as call, credit, liquidity, and general market risks. Longer-term debt securities are usually more sensitive to interest-rate changes; the longer the maturity of a security, the greater the effect a change in interest rates is likely to have on its price.

The credit quality of fixed-income securities in a portfolio is assigned by a nationally recognized statistical rating organization (NRSRO), such as Standard & Poor's, Moody's, or Fitch, as an indication of an issuer's creditworthiness. Ratings range from 'AAA' (highest) to 'D' (lowest). Bonds rated 'BBB' or above are considered investment grade. Credit ratings 'BB' and below are lower-rated securities (junk bonds). High-yielding, non-investment-grade bonds (junk bonds) involve higher risks than investment-grade bonds. Adverse conditions may affect the issuer's ability to pay interest and principal on these securities.

Glossary & Index Definitions

Carry is the difference between the yield on a longer-maturity bond and the cost of borrowing.

Duration is a measure of the sensitivity of the price (the value of principal) of a fixed income investment to a change in interest rates.

Fiscal policy is the use of government spending and taxation to influence the economy. Governments typically use fiscal policy to promote strong and sustainable growth and reduce poverty.

The **Federal Reserve (Fed)** is the central bank of the United States. The **federal funds (fed funds) rate** is the target interest rate set by the Fed at which commercial banks borrow and lend their excess reserves to each other overnight.

The federal funds rate is the interest rate at which depository institutions lend reserve balances to other depository institutions overnight on an uncollateralized basis.

The **U.S. Consumer Price Index (CPI)** is a measure that examines the weighted average of prices of a basket of consumer goods and services, such as transportation, food, and medical care. It is calculated by taking price changes for each item in the predetermined basket of goods and averaging them.

The **U.S. Personal Consumption Expenditure price index (PCE),** also referred to as the PCE deflator, is a United States-wide indicator of the average increase in prices for all domestic personal consumption. It is benchmarked to a base of 2009 = 100. Using a variety of data including U.S. Consumer Price Index and Producer Price Index prices, it is derived from personal consumption expenditures, the largest component of U.S. gross domestic product in the U.S. Bureau of Economic Analysis' National Income and Product Accounts report.

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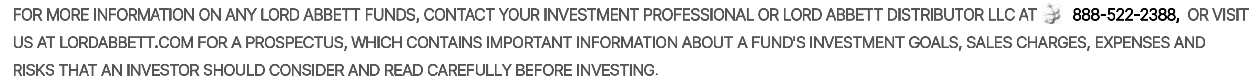

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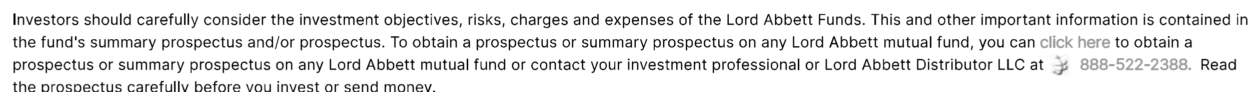

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