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## Why Markets Are Shrugging Off Sticky Inflation

COLLIN MARTIN: I'm Collin Martin

LIZ ANN SONDEERS: And I'm Liz Ann Sonders.

COLLIN: And this is *On Investing*, an original podcast from Charles Schwab. Every week we analyze what's happening in the markets and discuss how it might affect your investments.

LIZ ANN: Well, hi, Collin, plenty to discuss here this week, and ironically, even though you and I are doing this in our own rooms on our own laptops, we are at the same conference. And we've literally just got off stage, so I know what's top-of-mind, because we just discussed it with a number of retirement clients of the company's, and that is inflation, given the time of the week it is, and it continues to be in focus. We got recently the Consumer Price Index, or CPI, that was up 3.8% in April in year-over-year terms. Core CPI, which is ex-food and energy, was also up a 0.4 month-over-month. That might not sound like a lot in one month, but that's the largest one-month increase since January of 2025.

And then we got the Producer Price Index as we're recording this today, and that was really on the hot side, headline PPI 6% year-over-year and even core 5.2% year-over-year. Now, culprit obviously in these higher prices is energy costs, and certainly as it relates to gasoline, which, one of the things we discussed on stage today, was just how visceral that is as an indicator of inflation for the average consumer. And the rub is that the Fed, as someone that has inflation as part of its dual mandate, they really can't do anything directly to bring gasoline prices down. So talk about the inflation data in the context of where we sit with Fed policy.

COLLIN: Yeah, we hit the nail on the head before, Liz Ann, with it. It's just still too hot. And whether it's the CPI or the PPI, they're above the Fed's 2% target. There's no shortage of inflation indicators that are out there. And I won't say all, because maybe there's some that are magically low, but most that we track are at or above

2%. They've generally been there for five years now and counting. And we were hopeful that they would continue to move closer to 2%, but that has reversed since the war with Iran began, the rise in energy prices. And that should change the trajectory, and has changed the potential trajectory, for Fed policy, where at a minimum, this should allow the Fed to hold rates steady for an extended period of time. The extended period, to be determined. The way we've been framing it, Liz Ann, is that we think they'll be on hold for several meetings.

A lot of it does come down to clarity around the Middle East. And if there were to be good news, that could bring the price of oil down, which over time could bring the price of gas down. Maybe that opens the door for a Fed rate cut. But the longer it goes on, the longer the conflict goes on, the idea of a cut really shouldn't be in our vocabulary. And I think that's ... that we've certainly, and I've shifted a little bit, where we shouldn't even be talking about cuts right now, given when you look at the Fed's dual mandate, when you're seeing inflation at, you know, 3% or more by a number of indicators, why would the Fed be cutting rates in that situation?

So we expect them to do nothing. They're doing their jobs, of course. They're going to evaluate the data, but from a policy standpoint, we don't expect them to make any tweaks. The change or question now is are rate hikes more likely, and that's a question that I've been getting a lot. I'm sure you get asked all the time, Liz Ann. I'd say, well, it comes down to a number of things, but I can break it down into two things that I think are important. The first would be a continued meaningful increase in core inflation, because as you mentioned, the Fed can't bring gas prices down. It can't open up the strait. But it can influence our demand of other products and services.

And if core inflation, which excludes volatile food and energy prices, were to meaningfully and continue to increase, or if we saw inflation expectations get unanchored and start to rise, because then that could make inflation some sort of a self-fulfilling prophecy, that's something that could maybe result in a rate hike. Too early to tell right now. And then I think another thing that could allow them to hike, if we look at the other side of the mandate, is the labor market. The labor market has been very stable for a number of months now. The unemployment rate has been between 4% and 4.5% for close to two years now. The most recent reading was 4.3%. I think a continued stabilization probably doesn't move the needle for the Fed. But if we saw an improving labor market, and we've gotten some good reports over the past two months or so, and if we were to see that unemployment rate start to decline again, that might move the needle a little bit where you have a strong labor market and rising inflation. Way too early to tell there also, but I think those are the things that the Fed would be looking at to pivot from what was an easing bias, and probably is not an easing bias anymore based on the dissents from the last meeting.

But that's what it would take to get, I think, more committee members to actually start thinking about a hike.

Now we also have other Fed news this week. We're recording this in the middle of the week. Kevin Warsh has been confirmed as a governor, but now he still needs to be confirmed as the chair. We expect that to happen by the end of the week. What are your thoughts on that? There's a lot of moving parts there. He has potential changes. We've talked about them on this podcast. But one thing that he's focused on is inflation, how we look at inflation and the PCE, or the Personal Consumption Expenditures, as the main inflation gauge that the Fed looks at. What are his thoughts there, his perspectives, and what are you watching for in the coming weeks once Warsh gets fully approved?

LIZ ANN: Well, Collin, specific to inflation, I know that he referred to that preferred measure of core PCE that the Fed has fairly consistently used as a "rough swag" to estimate underlying inflation. And his argument is that there's more modern data and that we need to account for some big swings that can sometimes happen in individual components, and his preference is for what's called trimmed gauges of inflation. So the Dallas Fed has a trimmed mean PCE. The Cleveland Fed has a median CPI/PCE. And they basically just eliminate some of the statistical outliers or extreme price moves up or down regardless of whether it's in those typical core, ex-core areas like energy and food. So it could be in eggs. It could be in housing. Whether that sort of, for lack of a better descriptor, catches on, we'll have to see.

You know, the other interesting thing, and you and I talked about this on stage today, the other changes that he has talked about is possibly doing away with the so-called dots plot, which is the ... every other meeting the Fed and its members update their summary of economic projections. It's what they project individually, where they project the economy to be more broadly, the unemployment rate, the inflation rate, and they also project where they think the fed funds rate will be at year-end points over the next couple of years. So it'll be interesting to see if they do away with that because that's something that the market anchors to.

He also is maybe not in favor of as many vocal members of the Fed. I've often joked that maybe the Federal Open Market Committee, the M should be changed to "mouth," and we're really dealing with the "Federal Open Mouth Committee," and I don't say that in a derogatory way. I think for the most part a more vocal collection of folks on the Fed reinforces the idea, number one, that it's an independent body and number two that the chair wields some power but is not the end all be all and doesn't have the final say, that every decision is made by a majority of 12 members. And I think that's important. So those are some of the potential changes that we all should watch out for.

But the other thing I wanted to say broadly about inflation, and it helps put some other economic data in some context, and that is that you and I have already sat here and talked about PPI and CPI and PCE and headline readings versus core readings and trimmed mean versions of those readings. And it's in the context of sometimes discussion about things like the tariff impact on inflation being, well, it really isn't going to cause ongoing rate of change inflation. It's just a one-time change in prices.

And the problem with that argument is that, again, you and I live in the weeds of this inflation data, but the man on the street, and the woman on the street, particularly if they're in their car and they're going to buy gasoline, they don't think in core-versus-headline and trimmed mean. They think, "This is more expensive than it was a year ago or two years ago or three years ago," whether it's price of gasoline, whether it's the price of food.

So that helps to explain why the psyche has been so dented by what we're seeing here and has picked up in consumer sentiment measures like the monthly one that comes out of University of Michigan that shows consumer sentiment at a record low in the many-decade history of this data, because of how the consumer feels inflation in their day-to-day lives. So I think that distinction is important, especially because discussions around tariffs are not fully in the rearview mirror.

COLLIN: Well, let me follow up on that. And this is something that I've been thinking about a lot. If we think about, we have the higher gas prices and what that's meaning for inflation. There's two ways it impacts us as consumers. One, if we're spending more on gas, that's less money we can spend elsewhere. And then in this week's CPI, Consumer Price Index, report, with that, we can look at what aggregate income looks like. And we got real consumer incomes, and they were negative on a year-over-year basis. At some point that you'd think that that would be a negative if we're spending money elsewhere, or we're losing our purchasing power. But here we are with a very elevated stock market. Yes, sentiment indicators are down, but we're seeing the hard data. You know, we had the discussion between hard and soft data. The hard data and the economy continues to grow. GDP is close to 2%. Personal consumption maybe slowed a little bit last quarter, but still positive. Are we ever going to see that flow through to our habits or the aggregate consumer?

LIZ ANN: Well, we have seen a little bit of a waning in the consumption driver of gross domestic product, of GDP. What has been picking up the slack has been capital spending, business capital spending. That was a very significant positive driver to what was still a decent most recent GDP report.

The only rub there is there's a bit of concentration. So it's pretty much all AI-related capital spending, not just large language models, the hyperscalers, but more broadly, including AI-related spending on data centers and power generation. But it's still very much an AI story. Ex-anything AI-related, business capital spending is in negative territory. So that is something that bears are watching. There's a lot of hope and certainly embedded optimism associated with the earnings outlook, which continues to just be on fire for anything AI related. But that also elevates the bar a bit in terms of continuing to be able to beat those expectations. So doesn't look to be a near-term problem, but that is something that is on my radar.

COLLIN: It flows into the bond market, too, because to fund this AI data-center expansion, they're using corporate bonds. And that's been a big story for the past, call it year or so, which I would argue that there are risks to that, but you don't see it in the actual corporate bond market. When risks rise or perceived risks rise, the textbook would tell you that you'd see credit spreads, the yield advantage that corporates offer above Treasuries, you'd expect to see them rise. And there's been hiccups here and there, but today in early to mid-May, they're very, very low. Markets are not concerned.

I see two risks, though, with the build out, whether that comes to fruition in terms of performance, we'll have to see, but the first is just supply and demand. I mean, we're talking about huge dollar amounts. I mean, the numbers that we're hearing are staggering. And if there's not a potential buyer there, and so far there has been, but if there's not, and demand doesn't pick up, does that mean those spreads rise to kind of attract the new buyer? And then the second risk is, you know, what's the ultimate return on this investment? And it's probably going to be a while before we know what that looks like. But that's a risk knowing that a lot of these bonds are long term.

There's been an interesting trend. I'm not sure if you've seen it, but we're seeing some of these companies, and this goes to the supply-demand dynamic start to issue—these are, you know, U.S.-based companies—issue in other currencies, or there is a company issued in Swiss francs or the euro. So they're trying to test out other markets to see if there's demand there. It's going to be an interesting trend to follow. I mean, I don't know if it's a signal that there's not demand here, because I would say there appears to be a lot. But the fact that they're diversifying their currency and potential buyer base is certainly interesting.

LIZ ANN: Yeah, it's important to mention that because in the early stages of the creation and development of AI, a lot of the capital spending was financed out of very strong cash flows. So a couple of years ago, if you're going to use the

Magnificent 7 group of stocks as a proxy for AI, you had free cash flow growth, on a year-over-year percentage change basis, running at north of 60%.

And for that cohort, it's now in negative, slight negative territory year-over-year. So that is why there's more financing being done with debt. And you're right to point out that we're not seeing any kind of blowout in spreads. So far it looks like a fairly benign backdrop, but we're often asked, you know, "What are you keeping an eye on? What are potential risks down the road?" And that's just a change in the financing vehicle for this AI build-out.

COLLIN: What about just the level or direction of interest rates right now? Is that a risk? Because we've talked about what our evolving Fed outlook is. We've seen Treasury yields rise. And I'm trying to think if that will play a role, if you're a company, a CFO, a treasurer, did you assume that maybe interest rates would be falling over the next handful of months? And instead, we're seeing the opposite. Is that going to play a role into either corporate bonds or the overall equity market?

LIZ ANN: Well, the yield that is most relevant to the equity market from a correlation standpoint is the 10-year. And you do ebb and flow, and we have been ebbing and flowing in terms of whether the 10-year yield and the stock market are positively correlated or negatively correlated. I look at rolling one-year correlations, which are around flat right now, but the rolling 30-day correlation between the 10-year yield and the S&P has moved back into comfortably negative territory, and the way it tends to work is when the 10-year yield is fluctuating based on the inflation backdrop, that tends to lead to a negative correlation, so higher yields because of higher inflation, all else equal, bad for the equity market.

When yields are in an environment where they're keying more off of growth, that's when you tend to see a positive correlation between bond yields and stock prices, because in that kind of backdrop, like frankly, like much of what we saw in the so-called Great Moderation era that went from the mid-to-late '90s up until maybe two years into the pandemic. And that was an environment where yields were moving more based on the growth backdrop, not inflation, because we had a very benign inflation backdrop then. So higher yields meant higher growth without the attendant concern about inflation. That's sort of nirvana for equities.

Now we're back in this negative correlation mode. And I don't know that we're entering into a secular period like that, but for what it's worth, the period that preceded the Great Moderation, what we've been calling the temperamental era that went from the mid-'60s to the mid-'90s, of course, included the high inflation era of the 1970s. But it was an era of much more inflation volatility. For almost that entire 30-year period of time, bond yields and stock prices were negatively correlated.

We're back there now, at least on a rolling 30-day basis, but that's something that I have very much on my radar. And that's the direct tie-in that happens between your world in bonds and my world in stocks.

COLLIN: Well, that is perfect. So full disclosure, I had an ulterior motive when I asked that question. I said, "I really just hope she mentions the 10-year," because selfishly I want to talk about the 10-year right now. So that worked, and thank you for that transition because, as, as we're recording this, 10-year Treasury yield is just shy of 4.5%. I think on an intraday level, middle of this week, it touched maybe 4.49%, but it's at its highest level since July 2025, I believe. And you made a lot of interesting points that I wanted to bring up. There's a lot of things that tie into and can direct what the 10-year Treasury yield is doing, the expectations about Fed policy, the rate of inflation, but there's a very wonky thing that I look at called the term premium.

And the term premium is, it's a theoretical kind of model-based factor of the 10-year Treasury, but it's meant to compensate investors. We look at it as compensation that the path of short-term rates kind of don't follow expectations, or it's meant to be compensation for an uncertain outlook. And it had been depressed for a number of years, really starting after the financial crisis.

And I think there's a few things that played into that. One was quantitative easing (QE) by the Federal Reserve that maybe artificially brought it down, even brought it into negative territory. We were also in this very, very low inflationary environment that you just mentioned. And if we're now in a higher inflationary environment with a lot of uncertainty, and with the Fed not actively participating in a quantitative easing process, in fact, likely incoming Fed chair, Kevin Warsh, doesn't want to use the Fed's balance sheet. So the idea of QE coming into place is pretty low. I think that's something to keep an eye on as we look at the 10-year Treasury yield, because right now that term premium is around 70 basis points. But if we go to the pre-financial crisis period, it spent most of its time above a full percentage point, above 100 basis points, more like 1.5%.

And that's something, if we are in an uncertain and higher inflationary period, without the Fed using its balance sheet, maybe that pulls yields up a little bit higher in the form of a higher term premium. So a little bit wonky there, but something that I've certainly been paying attention to.

So Liz Ann, what's on your radar for the next week?

LIZ ANN: Well, between now and when this airs, we will get retail sales. So that will be important. We'll, I'm sure, be posting on our X feeds about that, but as a proxy for

consumer spending. We get industrial production, going to pay close attention to that. We get some housing market data, including the NAHB, which is National Association of Home Builders, their overall housing market index. It's kind of a sentiment index of home builders, a whole bunch of other housing-related stuff, pending home sales, building permits, housing starts.

We get S&P Global's version of the Purchasing Managers' Indexes. ISM version is still maybe a little more widely followed, but S&P Global is gaining some traction. And then I mentioned University of Michigan's consumer sentiment. We get the final read on that, and that comes at the end of next week. So that's on my radar. How about you?

COLLIN: There's two things that I'm paying attention to next week. The first is a release we get on Monday. It's the Treasury International Capital, or TIC for short. It's a report we get each month that the Treasury releases about really who's owning Treasury securities, actually a number of securities, but we tend to focus on Treasuries to see what flows look like. Are foreign investors still buying? Are they selling? And there's always a lag. So the release we're getting next week is for March. And I think March is going to be interesting because it's going to capture the first month after we launched the attack.

And I say that because we saw outflows of April of 2025, after the tariffs were announced, and I'm just trying to think if there's a relationship, or if foreign investors are viewing our securities differently in these big, sort of large-scale things that our government does that impacts countries across the globe. So that's something we're going to pay attention to. And it's important right now. I mean, Liz Ann, we've been talking about, we were at a conference now, and the first question I got was about foreign central bank ownership of Treasuries. So we're going to see, are they still buying? Are they selling? Are they holding? And if they're holding steady, who else is buying our Treasuries? Because our issuance just continues to increase.

So we're looking at that next week. Also, we get the minutes of the most recent Federal Open Market Committee meeting. That gives us a deeper look into the conversations that the committee had. We already have, I think, some color because after the Fed has its meeting and they come out of their quiet period, a lot of the officials give speeches and provide interviews. So we have a pretty good idea. But we'll be looking to see how robust of a discussion there was around maybe those three dissenters who didn't want the easing bias in there.

We already heard from Susan Collins from Boston that she would have agreed with them about removing that easing bias. So we're going to see if there's more officials,

when we get details there about what that conversation was. And then that'll be important for us to kind of see what that potential Fed trajectory looks like and how much support there may or may not be for hikes going forward.

So as always, thanks for listening. As a reminder, you can always keep up with us in real time on social media. I'm @CollinMartinCS on both X and LinkedIn. That's Collin with two L's, and CS is for Charles Schwab.

LIZ ANN: And I'm @LizAnnSonders on X and LinkedIn. I've had some really weird imposters lately. One that figured out a handle that was "Assistant to Liz Ann Sonders." That's not me. It's not my assistant. So make sure you're following the real me.

COLLIN: Hey, Liz Ann, I don't have imposters yet.

LIZ ANN: Oh, you'll get them.

COLLIN: But I think I had my first imposter reply with someone trying to, you know, pitch some sort of crypto thing. So maybe that's step one.

LIZ ANN: Yeah, that is step one. Enjoy that. And of course, we all write reports as well. And you can find all of those, and they typically include lots of charts and graphs for those visually minded out there, and those are on [schwab.com/learn](https://www.schwab.com/learn). And if you've enjoyed the show, please consider leaving us a review on Apple Podcasts, a rating on Spotify, or feedback wherever you listen. And please tell a friend, or lots of friends, about the show, and we will be back with a new episode next week.

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