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Market View
A tale of two inflation releases

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At a glance

- A strong market start faltered in April due to unexpected March CPI data, causing the S&P 500 to drop 4.2% and 10-year Treasury yields to rise to 4.7%.

- Achieving the 2% inflation target remains difficult, but May's moderate 3.4% reading has led to increased confidence, with expectations of two Federal Reserve rate cuts by year-end.
- Despite significant rental inflation impacts, moderating wage growth and slowing rent increases have helped markets recover.

Markets had a strong start to the year as it appeared likely a soft landing would be achieved. Although investors pared back the number of expected rate cuts this year, this came as a result of a more resilient global economy. Furthermore, it seemed as though central banks had successfully muted inflationary pressures with their series of rapid interest rate hikes.

Reassessment

The release of the March Core Consumer Price Index (CPI) data showed a year-on-year increase of 3.8%, which was higher than anticipated, prompting a meaningful reassessment.[1] Investors questioned whether the resilience of the US economy would keep growth high and inflation sticky, resulting in interest rates being higher than previously thought. This caused a material repricing of equity and bond markets in April, with volatility escalating further due to ongoing tensions in the Middle East. The S&P 500 fell 4.2% last month while 10-year Treasury yields rose to the highest level since November last year, reaching 4.7% towards the end of April.

Final push is the hardest

Many economists have predicted that the final push to bring inflation to the target 2% rate will prove the most challenging. We are witnessing this scenario play out, as US resilience is keeping price pressures elevated. Consequently, some investors are questioning whether we are about to enter a period of structurally higher inflation.

However, softer economic data combined with a moderate inflation reading of 3.4% in May has given investors' confidence that inflation is still on a downward trajectory.[2] Last month, markets were only pricing in one interest rate cut from the Federal Reserve (Fed) by year-end. This has now increased to two.

Rental inflation lags

We have mentioned in previous Brief articles about the lagged effects of rental inflation. Excluding food, energy and shelter, inflation has been hovering around 2% for quite some time. Taking a closer look at the underlying components that make up the inflation basket, we note that motor vehicle insurance represents 2.9% of the overall CPI basket.[3] Motor vehicle insurance has increased 22.6% over the past year, meaning that such a small component accounts for 0.66% of the CPI's 3.4% rise year-on-year, or close to 20%.[4]

The shelter component makes up 36.2% of the CPI basket and accounts for 2% of the 3.4% figure (59%).[5] Wage growth has shown signs of moderating, indicating households are less able to absorb higher rents. The more timely Zillow rent index meanwhile shows rents are slowing down, rising only 0.3% in April down from 0.4% the prior month.

While motor insurance has jumped significantly, new vehicle and used car sale prices have come down, helping deflationary forces. Used car sales have dropped 7% year-on-year after experiencing a surge during the pandemic.[6]

While the inflation picture may have upset the apple cart in April, sentiment was quick to recover. This topsy turvy nature of markets is reminiscent of one of Charles Dickens's more famous quotes: "It was the best of times, it was the worst of times." Recent data, including retail sales, show despite all the volatility, the soft-landing scenario remains the base case. This optimism has pushed markets higher, with 10-year Treasury yields falling back to 4.36%, and the S&P 500 continuing to surpass all-time highs in May. In times like this, it is worth remembering investing is a marathon and not a sprint.

[1] Bureau of Labor Statistics

[2] Bureau of Labor Statistics

[3] Bloomberg

[4] Bloomberg

[5] Bloomberg

[6] Bloomberg