U.S. FIXED INCOME STRATEGIES

Need to Know

May 15, 2024 | CPI Report Card for April

INFLATION GRADE

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After a series of upside inflation surprises this year, inflation simply meeting expectations—though still-lofty ones—was enough to allow markets to breathe a sigh of relief

Key April Release Dates:

Producer Price Index (PPI)
May 14

Consumer Price Index (CPI)
May 15

Import Price Index (IPI)
May 16

Personal Consumption Expenditures (PCE, the Fed's preferred inflation gauge)
May 31

RBC WM Inflation Report Card
May 31

Fixed Income Strategies

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Key Stats: Headline inflation advanced +0.30% in April, easing from the +0.40% increases in February and March, which took the annual inflation rate down to 3.4% from 3.5% previously. Core inflation, excluding food & energy, was +0.3% and in line with expectations, taking the annual inflation rate down to 3.6% from 3.8% previously, notably marking the slowest pace of inflation since April 2021. As we discuss in more detail on the following page, housing costs and auto insurance rates alone continue to drive the bulk of inflationary pressures. Goods prices like cars, household furnishings, recreation, and education continue to fall year-over-year, leaving the service sector as the sole source of inflation. On that front, there was some good news as well with airfares falling and vehicle maintenance costs flat.

Impact on the Fed: Policymakers at the Fed had already signaled that recent disappointments on the inflation front were likely to delay any rate cut plans. However, Fed Chair Powell—as recently as yesterday—has been keen to drive home the idea that the likelihood of further rate hikes remains remote. This inflation report was certainly Fed-friendly and should support the idea that—though delayed—modest rate cuts are still more likely than not. At the March meeting, policymakers were already split between two and three rate cuts this year. Though we suspect that bias has shifted towards two in the months since, today's report shouldn't have much impact on the Fed's thinking and Fed communications—this was a small step in the right direction and policymakers should ultimately remain patient and data dependent in judging the next steps, in our view.

Market Reaction: Markets—and the Fed—have long-known that the path back to price stability would be a bumpy one. Throughout the global inflation wave of the past two years, markets have at times been more sensitive to inflation *surprises* rather than inflation itself. That has certainly been the case this year as Treasury yields have risen sharply after recent CPI reports which have missed expectations. Today's market reaction to largely-as-expected report reflects that idea. Markets hate surprises, so while inflation does remain elevated, the idea that economists still have a grip on the underlying dynamics appears good enough, sparking a rally in both risk assets and bond prices.

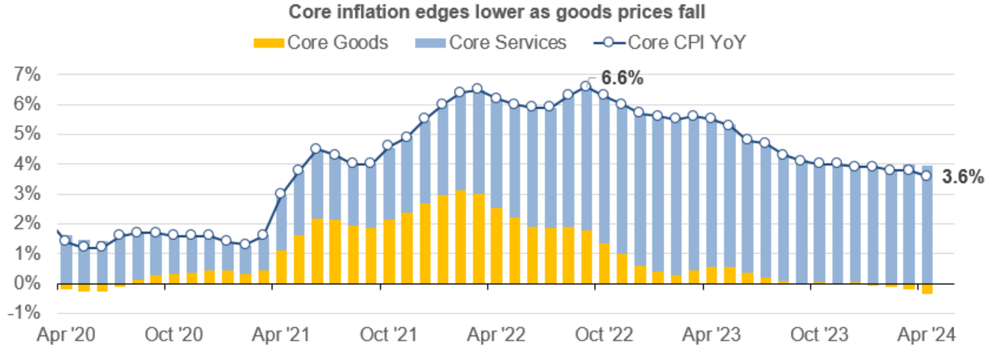
And nowhere is that more evident than in equity markets, where the S&P 500 broke out this morning to a fresh record high of ~5,290 and is now up nearly 12% year-to-date.

Markets are fully priced for a first rate cut in September, while seeing a 97% chance that a second rate cut could follow this year, likely at the Fed's December meeting. Treasury yields are lower across the curve with the benchmark 10-year Treasury note yield down 7 basis points to 4.35%, well below the 2024 peak level of 4.70% on April 25.

Inflation Outlook: More good news could be on the horizon. As we discuss on the following page, the fewest small businesses in about a year are planning to raise prices in the months ahead. Energy prices have been rising since last December, with oil moving from $69 to a peak of $87 in April. However, over the past month oil prices are down 10% and gas prices are down about 10 cents which should show up in the May inflation data. The Cleveland Fed's inflation tracking model currently suggests May headline inflation will be just +0.10% m/m, down from +0.30% reported today for April.

The Fed, and markets, will get the next CPI report just ahead of its key June 11-12 meeting. While policymakers almost certainly won't have gained the 'greater confidence' needed that inflation remains on the road back to 2% by then, they could have a pair of encouraging inflation reports in hand as they potentially begin to lay the groundwork for modest policy rate recalibration plans later this year.

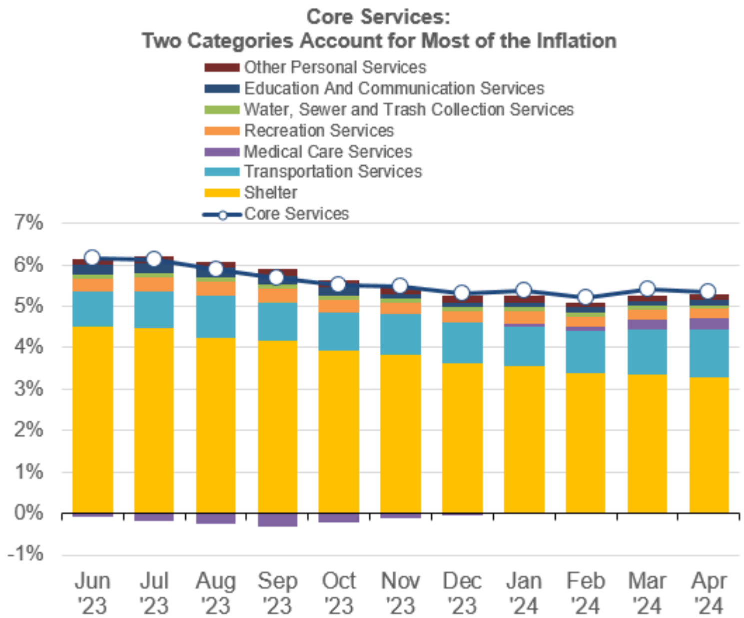
Core inflation edges lower as goods prices fall



Source: RBC WM, Bloomberg, BLS; Shows contribution to annual inflation

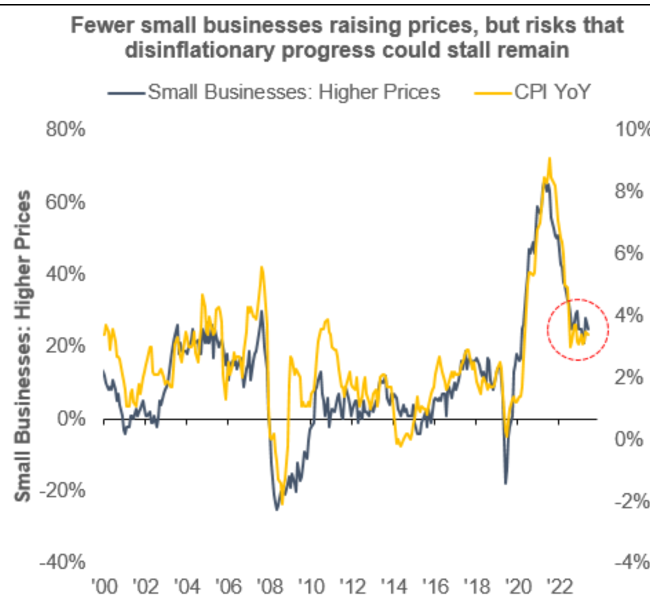
Charting the Data

- With goods prices not only low, but negative year-over-year, the focus—and particularly so for the Fed—remains on service sector prices.
- Core services prices are still rising north of 5% y/y, but as has been well-covered, the bulk of that is coming from just two categories: shelter costs (rent) and transportation services (largely vehicle insurance & maintenance). Those two sectors alone account for 4.4% of the 5.3% annual increase in service prices.
- As we have discussed in past publications, both are lagging indicators of inflation, and should trend lower from here. On rents, CPI calculation largely reflects rates from previously signed leases. Real time data, like from Zillow, Inc, show that rent growth rates have slowed sharply. We continue to expect that to gradually feed through to official data this year, pulling inflation lower.
- The Fed can do almost nothing about car insurance rates: new (and used) car prices rose sharply during the pandemic, but are now falling y/y. While more expensive cars with more expensive technology to fix likely won't mean an outright decline is forthcoming, we expect the pace to slow, or even flatline, ahead.



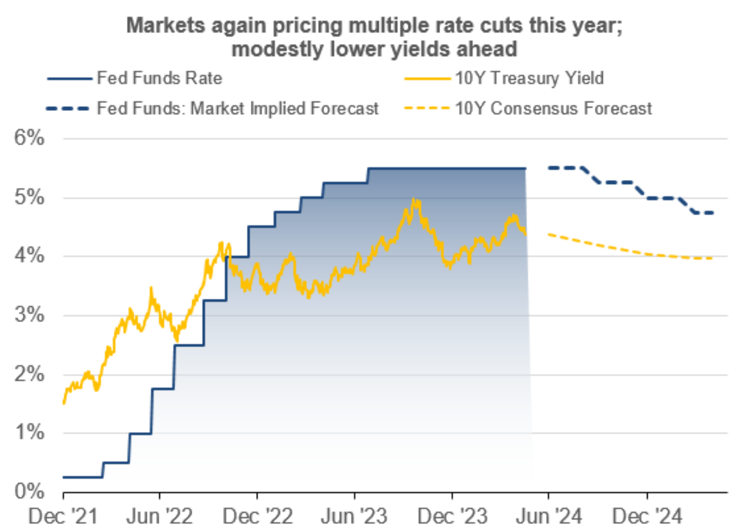
Source: RBC WM, Bloomberg, shows contribution to annual changes

- Prior to the CPI release, the NFIB's Small Businesses Survey for April, released on May 14, confirmed some positive pricing trends of late, and ahead.
- As the chart shows, the percentage of firms raising—or lowering prices—has correlated strongly with official inflation data (90% correlation).
- In April, 25% of small businesses reported raising prices, down from 28% in March. Additionally, just 26% of companies planned to raise prices over the next three months, the lowest percentage in a year.
- That said, a quarter of companies still raising prices remains both historically elevated and relatively unchanged over the past nine months. But it remains a key index to watch if inflation is to take the next leg lower toward the Fed's 2% annual target.



Source: RBC WM, Bloomberg, National Federation of Independent Business

- Markets remain volatile and highly sensitive to Fed rate cut expectations. Back in January, markets were looking for nearly seven rate cuts this year. At one point in April, markets were pricing a chance of no rate cuts this year.
- Having gone from one extreme to another, markets have now settled on two rate cuts this year to a target range of 4.75-5.00%, a view that we believe seems reasonably under most scenarios.
- The 10-year Treasury yield—a greater factor for consumers as it more-directly influences lending rates for mortgages, auto loans, credit cards, etc—peaked at 5.0% in 2023 and at 4.7% this April.
- We have tentatively viewed the 4.7% level as likely to prove to be the high-water mark for 2024, and recent economic data on inflation and the labor market only adds to our confidence. Trading at 4.35% in the aftermath of this week's CPI report, consensus has it trending lower and toward 4.0% by year-end.



Source: RBC WM, Bloomberg survey for April, Fed Funds Futures data