Market Strategy
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Market Strategy Weekly

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Strategas Head of Fixed Income Research Tom Tzitzouris gives us his instant reaction to the hotter-than-expected September inflation data, how it might impact interest rates over the near-term, and what indicators he's watching most closely going forward.

Tom Tzitzouris, Strategas
Managing Director, Head of Fixed Income Research

Ross Mayfield, Baird PWM Research
Investment Strategy Analyst

INFLATION TOO HOT | RATES RISING | WATCHING WAGES, HOUSING, MANUFACTURING

ROSS MAYFIELD: We're chatting just after the September CPI report was released – what's your big takeaway?

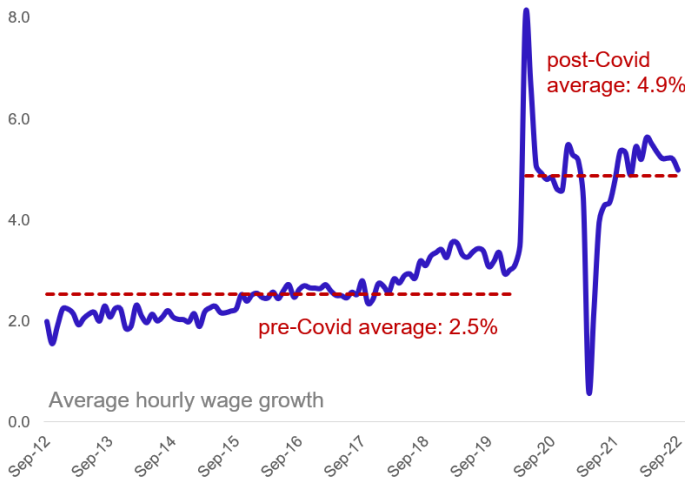
TOM TZITZOURIS: I have to be honest with you, it's a very concerning report. Headline inflation of 8.2%, core inflation of 6.6%. Both of those higher than expected. I'd say the more troubling item is that core consumer inflation is rising at a faster clip than most expected, and it is not rolling over. That's concerning because core and headline inflation are probably going to converge by the end of the year, but expectations for that convergence point have had to gradually rise from 4% to 5% to now 6-6.5%. That tells us that the tightening that the Fed has done and plans to do is probably still not enough to bring core inflation down to levels that are considered healthy. That's a problem.

ROSS: What is the impact of a report like this (and higher inflation more broadly) on Treasury yields?

TOM: When you're looking at 10-year Treasury yields, you have to balance two forces. One is high inflation and the idea that this means higher yields across the curve because the Fed has to tighten more and for longer. But you have to balance that with the reality that the US economy is facing a recession in the next six months, and that there's going to be some flight to quality as a result. That means longer-term bonds will look attractive and yields are likely to fall as a result (price and yield are inversely related; i.e., more people buying bonds pushes yields down). Should equity markets continue to see weakness, much of that selling activity is going find its way back into the US Treasury market and you'll see long bond yields dip lower. So, the question for investors becomes: when will the Treasury market – particularly 10-year Treasuries – have sold off enough to make stabilization likely? We expect that level will be somewhere around a 4.0% yield on the 10-year, and we do think we're getting close to a point where equity market investors are capitulating and we'll see a flight back into Treasuries.

ROSS: With this report now behind us, what are a few things you'll be watching most closely going forward?

TOM: Jobs numbers are always the most important in my opinion, and particularly average hourly earnings, because that gives you a guide as to where core inflation might be heading. But more broadly, we just got core consumer inflation, core and headline producer inflation, and wages all within the last week or so. And all of those data points are indicating to us that core inflation will be around 6% or higher for the remainder of this year and into early next year. Looking forward, we want to keep an eye on the housing market, and particularly things like housing starts (a measure of new residential construction). That is a good leading indicator. In manufacturing, things like supplier delivery times (a measure of supply chain stress) and new orders. If those start to contract, that tells us we're looking at a slowdown in output. Combined with tightening financial and monetary conditions, that's almost the definition of a recession. So, we'll be watching those very closely in the coming months.



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