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Investment Institute

Market Commentary

Weekly perspective on current market sentiment **December 11, 2024**

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Last week's S&P 500 Index: +1.0%

Inflation reality check

Key takeaways

- Our guidance reflects a higher-for-longer inflation scenario where the Federal Reserve cuts rates twice between now and the end of next year.
- We seek to lock in long-term yields while minimizing the near-term price volatility.

You may have noticed that the financial media have seemed to put the topic of sticky "core" inflation on the back burner of late. Recall that the Federal Reserve (Fed) likes to look at inflation measures excluding the effects of food and energy; that's core. The theory is that Fed monetary policy has little effect on the price of food or energy. Food and energy are often thought of as markets that are at the whim of weather patterns (for example, droughts and hurricanes in the gulf that affect energy production).

Now let's try to take this a step further without getting too far down into the weeds. The Fed's favorite inflation gauge is core Personal Consumption Expenditures (PCE). The news media and general public tend to pay more attention to the core Consumer Price Index (CPI). Trying to sound like an economist, the main differences between the two are the way that housing and health care are tallied. Another important difference is that PCE takes into account a "substitution effect." In other words, when certain goods a consumer wants to buy are perceived as too expensive, that consumer will substitute with different goods that cost less. CPI assumes you buy the same goods no matter the price.

As of the latest readings, core PCE shows a 2.8% increase over the 12 months through October while core CPI shows a 3.3% increase. As most of our regular readers know, the Fed is targeting a 2% inflation level, on average, over the longer term. Clearly, the latest readings on both of these measures are well above where our central bankers would like to see them. On top of that, both inflation measures have ticked a tenth or two higher since midsummer. That's not what the Fed wants to see.

Our guidance reflects a higher-for-longer inflation scenario where the Fed cuts rates twice more between now and the end of next year. Considering this outlook for lower short-term rates, we suggest that investors with a long-term focus rebalance portfolios to a position that locks in long-term rates. That involves moving funds from short-term instruments into a laddered fixed-income strategy. Laddering starts by reallocating first into favored (overweight) intermediate maturities in the three-to-seven-year range.

For another ladder rung, we would add cash to long-term fixed income, but in line with strategic allocations. We expect longer-term yields to move up and down sharply in 2025, and moves higher would push down the prices more for longer-maturity bonds than for more intermediate maturities. The comparatively lower sensitivity of intermediate maturities to a given change in yield is a main reason why we're overweighting intermediate maturities. Nevertheless, we expect price volatility to fade, which is why we would add some cash to long-term bonds, although for now not as much as to the intermediate maturities. Where we seek to lock in long-term yields, while minimizing the near-term price volatility, we favor adding longer-term maturities patiently, waiting to put cash to work as yields rise and prices fall.

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