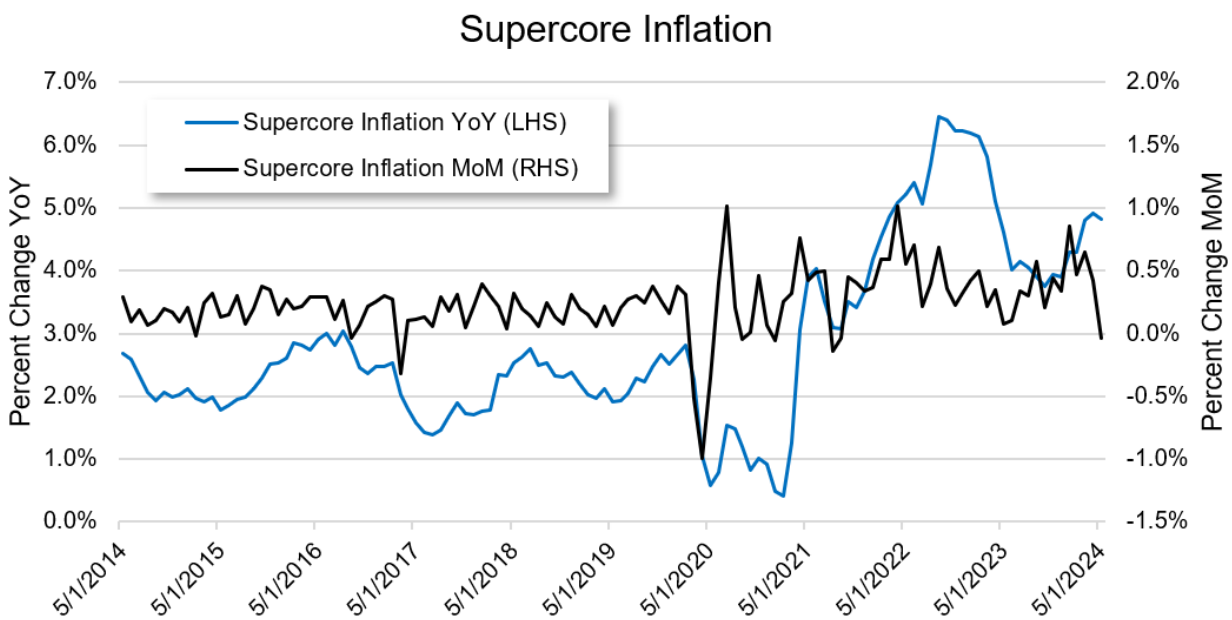
SMITH CAPITAL INVESTORS

Data Improves, Fed Demands More on Inflation: The Balancing Act Continues

Markets were set up for volatility this week as key inflation data coincided with the June FOMC meeting. Wednesday included the May CPI data in the morning, followed by the Fed's rate decision, updated Summary of Economic Projections (SEP), and Powell's press conference in the afternoon. Thursday morning brought PPI data to round out a busy 24 hours for the macro calendar. In the interest of timely transparency, we thought it to be prudent to provide a quick recap of the data released and an update on our views.

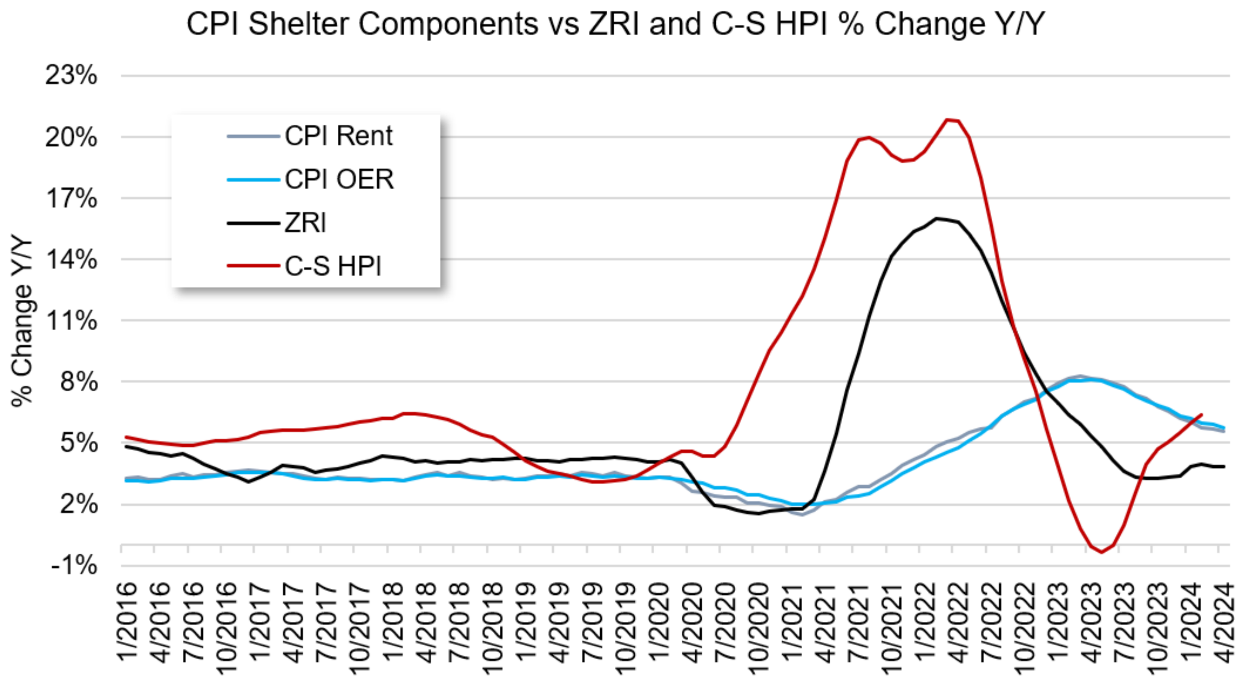
Inflation data continues to be the center of focus for markets as a primary driver of forward Fed policy. Wednesday's CPI data was anticipated to show some relief after a series of hotter prints to start the year but came in even softer than expected and triggered a relief rally in rates. Both headline and core CPI came in 10bps softer than expected at 0% and 0.2% MoM, respectively. The headline print was driven lower by a drop in energy components such as gasoline, with core CPI softness attributed to declines in car insurance and airline fares. Another key metric that the Fed pays close attention to is known as supercore inflation, which is core services after stripping out housing. This metric posted a surprising negative MoM print for the first time since 2021 after a series of sticky prints to start the year, aiding market optimism of a return to the disinflationary narrative that appeared to have stalled at the beginning of the year.



Source: Smith Capital Investors, Bloomberg (6/12/2024)

While several components showed indications of pricing pressure relief, the thorn in the side of CPI continues to be the housing components that we have been attentive to, which actually accelerated slightly in May. Shelter remained sticky at 0.4% MoM when rounded and seasonally adjusted (SA), with OER (owner equivalent rent) and Rent of Primary Residence increasing by 0.43% and 0.39% respectively. These components continue to prop up CPI with shelter still elevated at 5.4% YoY and the OER piece at 5.7% YoY. While the lag effect in May did not occur to the extent we anticipated, we believe the overall prints in CPI shelter inflation will continue to trend downward to catch up with market rents, though the transmission lag may be longer than originally anticipated.

Percent change YoY in CPI Shelter offset by 12 months vs the Zillow Rent Index (ZRI) and Case-Shiller Home Price Index (C-S HPI):

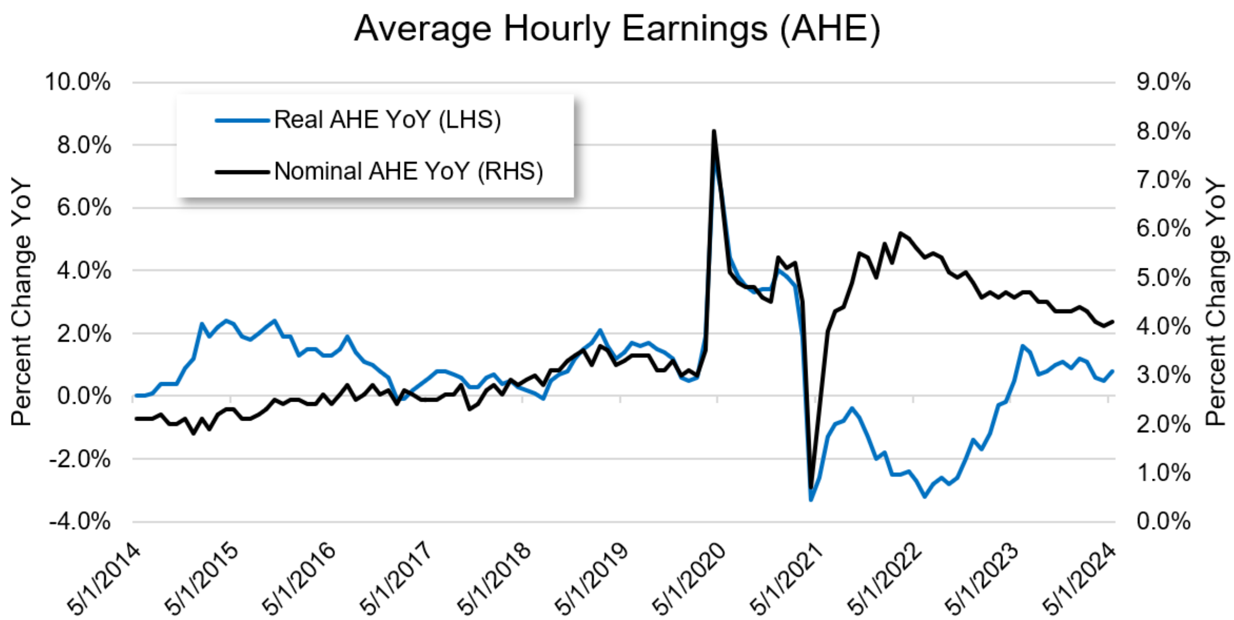


Source: Smith Capital Investors, Bloomberg (6/12/2024)

The Fed had access to the CPI data prior to the release of the SEP, which made the shift from three cuts projected in 2024 to one from the March to the June releases seem hawkish considering the better than anticipated inflation data. This was slightly muted, however, by an increase in rate cut expectations in 2025 to 100bps to bring the total to 125bps in cuts through the end of next year, which was in line with the overall anticipated trajectory.

The PPI release the following morning exhibited similar disinflationary trends, with all four stages of intermediate demand showing declines. The headline index for final demand declined by 20bps vs expectations of a 10bp increase, driven by final demand goods which printed an 80bp decline due to primarily to lower gasoline prices. Final demand services remained flat MoM, which includes airfares and portfolio management services that feed directly into PCE numbers. Both of these components posted moderate declines MoM, which read positive for continued progress in the Fed's preferred inflation gauge released in late June. Overall, the May inflation data indicate an encouraging narrative shift back to a downward path, but one month of positive data will not be enough to instill the confidence needed by the Fed to begin cutting rates.

Powell's commentary did not shift much from the prior meeting, though he did acknowledge an encouraging inflation print from the May CPI data and reiterated the need to see a continuation of that data to gain the confidence needed in disinflation before contemplating rate cuts. The labor market continues to come into better balance driven by supply-side gains from increased labor force participation and immigration flows. Job openings per unemployed worker have returned to pre-pandemic levels, but wage inflation remains above a normal run-rate and could contribute to additional pockets of stickiness in inflation.



Source: Smith Capital Investors, Bloomberg (6/12/2024)

After the recent volatility, markets are pricing in 49bps of cuts through the end of 2024 vs the updated 25bp median as forecasted by the SEP. Based on the ongoing strong economic data, particularly labor and consumption, and the ongoing elevated components of inflation we do not see the reason for the Fed to start a cutting campaign. But we acknowledge the Fed is in a position to ease rates if needed. **We believe, the "Fed Put" is back in play and will serve to keep fixed income investors on their toes. Aiding this hands-off approach are the transmission mechanisms of lower rates and higher equities leading to looser financial conditions, essentially the markets creating looser conditions for the Fed without them having to take discrete action if the data continues to be positive.**

SCI00469

Let’s keep talking!

Smith Capital Investors

Our mailing address is:
Smith Capital Investors
1430 Blake Street
Denver, CO 80202
303-597-5555
833-577-6484
info@smithcapitalinvestors.com

www.smithcapitalinvestors.com

The opinions and views expressed are as of the date published and are subject to change without notice. Information presented herein is for discussion and illustrative purposes only and should not be used or construed as financial, legal, or tax advice, and is not a recommendation or an offer or solicitation to buy, sell, or hold any security, investment strategy, or market sector. No forecasts can be guaranteed. Any investment or management recommendation in this document is not meant to be impartial investment advice or advice in a fiduciary capacity and is not tailored to the investment needs of any specific individual or category of individuals. Opinions and examples are meant as an illustration of broader themes, are not an indication of trading intent, and are subject to change at any time due to changes in the market or economic conditions. There is no guarantee that the information supplied is accurate, complete, or timely, nor are there any warranties concerning the results obtained from its use. It is not intended to indicate or imply that any illustration/example mentioned is now or was ever held in any portfolio.

Past performance is no guarantee of future results. Investing in a bond market is subject to risks, including market, interest rate, issuer, credit, inflation, default, and liquidity risk. The bond market is volatile. The value of most bonds and bond strategies are impacted by changes in interest rates. The return of principal is not guaranteed, and prices may decline if an issuer fails to make timely payments or its credit strength weakens. High yield or “junk” bonds involve a greater risk of default and price volatility and can experience sudden and sharp price swings.

Please consider the charges, risks, expenses, and investment objectives carefully before investing. Please see a prospectus, or, if available, a summary prospectus containing this and other information. Read it carefully before you invest or send money. Investing involves risk, including the possible loss of principal and fluctuation of value.

Smith Capital Investors, LLC is a registered investment adviser.