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Slowing US inflation calms market worries over the Fed

Weekly Global

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Deeper Dive

US equities and bonds rallied last week after slowing inflation in December bolstered hopes for a more dovish turn from the Federal Reserve in the months ahead. The US fourth-quarter earnings season also got off to a solid start, with strong results from US financials.

The core consumer price index (CPI), which excludes volatile food and energy prices, decelerated for the first time in six months, easing to 0.2% month-over-month from 0.3%. On an annual basis, core inflation came in at 3.2%, down from 3.3% in November. Economists had expected the annual rate to hold steady. The headline rate of inflation accelerated to 0.4% from 0.3% in the prior month, with 40% of the advance due to energy prices.

The release appeared to come as a relief after stronger-than-expected US employment data released earlier in the month caused investors to scale back their expectations over the pace of Fed interest rate cuts in 2025. The S&P 500 rose 2.9% last week, its best weekly performance since November, after a 1.9% decline the previous week. Bonds also rallied last week: The 10-year US Treasury yield fell 13 basis points to 4.63%.

What do we expect?

The December inflation data was only fractionally lower than the consensus forecast. It also comes against a backdrop of a recent run of robust economic releases. The Atlanta Fed’s GDPNow, which projects growth based on recent data, suggests the US economy expanded at a 3.0% pace in the fourth quarter—still strong by historical standards. Against this backdrop, we don’t expect the latest inflation release to notably alter the Fed’s monetary policy trajectory. We anticipate no further rate cuts before June.

But the softer inflation figures are a reassuring sign for markets, particularly after a period of elevated bond yields and retreating equity prices. Much of the elevated inflation is coming from shelter costs, which account for more than a third of the CPI. Shelter prices rose 4.6% annually in December. However, this reflects previous strength in the housing market, since rental contracts are only typically renewed annually or every few years. The monthly rises in rents within the CPI were more moderate in November and December, adding to our confidence that annual shelter inflation will continue to slow.

Questions for the week ahead

Will Trump's first policy moves unsettle markets? Donald Trump returns to the White House this week as the 47th US President and investors will be on high alert for his opening policy moves. We will be especially looking for early policy pronouncements on raising trade tariffs, which have the potential to concern investors.

Can the US earnings season stay solid amid anticipated market volatility? The market focus looks set to shift from economic data to earnings this week. After a strong start to the fourth-quarter reporting season from top banks, will profit growth from top US companies support the recent equity rebound?

Will the Bank of Japan resume its hiking cycle? As the global rate-cutting cycle continues in most of the world, Japan—which escaped the post-pandemic inflation surge that afflicted most nations—is moving in the opposite direction. Markets are expecting the Bank of Japan to raise rates by 25 basis points to 0.5% this week, which would be the first time since last July.

Excluding shelter, headline inflation was just 1.9%, while core inflation ex-shelter stood at 2.1%—consistent with the Fed's 2% target.

As a result, we believe that the market is now underpricing the chances of further policy easing. The latest release reinforces our view that the Fed is on track to reduce rates by 50bps in 2025—though cuts may only resume closer to the middle of the year. Given the recent resilience of the data, including in the Beige Book published by the Fed last Wednesday, we see no reason for the Fed to move rates at its upcoming policy meeting, which concludes on 29 January.

In fixed income, we expect further declines in Treasury yields as inflation eases and economic growth moderates. We forecast the 10-year Treasury yield at 4% by mid-2025.

In equities, we believe the easing inflation backdrop reinforces the case for further gains for the S&P 500 in 2025; we anticipate the index reaching 6,600 by December. A solid US economy, healthy corporate earnings growth, and further advancements in AI should support the rally, in our view.

How do we invest?
While volatility may persist, the latest CPI data suggests that inflation is beginning to cool after months of stickiness. While we expect the Fed to remain cautious in the near term, the deceleration in inflation has reinforced a constructive outlook for equities and quality bonds in 2025.

Put cash to work: We believe the moderation in December inflation data supports our view that the Fed will reduce rates gradually later this year, with the first cut anticipated in June. In a lower rate environment, returns on cash will decline further.

We see attractive opportunities in the 5-year part of the US Treasury curve and maintain our Attractive asset class recommendations on high grade and investment grade bonds. We forecast lower rates from here over the course of the year, and given the recent curve steepening, yield pickup is now generally available by switching out of cash.

More to go in stocks: Equities have been volatile amid recent shifts in the expected pace of Fed easing. However, while the speed of rate reductions is likely to be slower than expected prior to the December Fed meeting, cuts are still on the way, in our view. Historically, stocks have performed well in periods when the Fed cut rates while growth remained positive. In addition, the strength of the US economy is highly correlated with earnings growth, which we think bodes well for equities at this level of rates. We therefore see equity pullbacks from growth-related rate increases as a buying opportunity.

Key Messages

Cooling US inflation reinforces hopes for Fed easing this year

The S&P 500 gained 2.9% last week, its best performance since November, and the yield on the 10-year US Treasury fell 13 basis points. The renewed optimism came following data suggesting the trend toward slower US inflation is back on track, which calmed worries that the Fed may struggle to justify rate cuts in 2025. Of course, investors should expect further swings ahead. Markets will be on the alert for policies from the incoming Trump administration that could make it harder for the Fed to hit its 2% inflation goal, including higher trade tariffs, fiscal easing, and tighter immigration controls.

But our view remains that further Fed rate cuts will take place later this year. Although the December consumer price index was only fractionally slower, with the monthly ex-food and energy measure down from 0.3% to 0.2%, this was the first decline in six months. Core inflation also slowed on an annual basis to 3.2% from 3.3% in December.

It is also worth noting that much of the current inflation is coming from shelter costs, which account for more than a third of headline CPI, and which we expect to slow further in the coming months. Excluding shelter, headline inflation was just 1.9%, while core inflation ex-shelter stood at 2.1%, consistent with the Fed's 2% target. As a result, we believe that the market pricing for only around 38 basis points of Fed easing in 2025 is too cautious, and we still expect 50 basis points of cuts.

Takeaway: Although the pace of Fed easing looks set to be slower than anticipated prior to the hawkish December meeting, US rates are still coming down. That will further erode returns on deposits and money market funds, increasing the importance of putting cash to work in fixed income and equity markets.

US fourth-quarter earnings: resilience amid challenges

With last week's start to the fourth-quarter earnings season, investors are likely to shift some attention from macroeconomic data to micro trends, especially with the S&P 500 index again just 1.5% away from December's all-time high. Earnings are forecast to increase by 7-9% year over year, driven by robust economic growth and significant contributions from major tech firms, which are expected to report earnings growth exceeding 25% due to progress in monetizing AI.

But with market sentiment remaining fragile as investors await the first policy steps from the Trump administration, we see several keys to navigating the results season.

Despite the generally favorable backdrop, the stronger US dollar could crimp first-quarter guidance for US multinational companies. We estimate this could cut first-quarter earnings growth by about 1.5 percentage points. Potential tariffs from the incoming Trump administration could also be a source of uncertainty. Strong results in certain industries could reflect pre-buying ahead of potential tariffs, while others may delay business plans until there is further clarity. However, we believe that part of the strong dollar risks have already been priced in and that the tariff impact is unlikely to be strong enough to derail healthy earnings growth.

The rise in Treasury yields since September, notwithstanding last week's retreat, has been linked to solid economic performance rather than inflation fears, indicating that stocks can weather these higher yields. Although the S&P 500's forward price-to-earnings ratio stands at a historically high 21.5 times, the current macroeconomic conditions justify these elevated valuations, in our view. We project 9% earnings growth for 2025 as a whole, with the S&P 500 potentially reaching 6,600 by year-end.

Takeaway: While further volatility is likely, we continue to view US equities as Attractive. We expect large caps to outperform small- and mid-caps given their greater AI exposure, better earnings trends, and less dependence on Fed rate cuts. Sector-wise, we like information technology, financials, utilities, communication services, and consumer discretionary.

Oil gains for a fourth week despite the Middle East ceasefire

The price of Brent crude reached a five-month high, gaining ground for a fourth consecutive week. The gains came despite news of a ceasefire between Israel and Hamas, which has the potential to lower tensions in the Middle East and hence the threat of a disruption to oil supplies.

But the positive news in the Middle East has been outweighed by other factors that look set to constrain supplies. Part of the recent upward pressure on oil prices has come from news earlier in the month that the outgoing Biden administration was imposing additional sanctions on the Russian oil industry. While there is still a winddown period to import Russian barrels, Indian and Chinese refineries have already started to look for alternative sources based on media reports, and freight rates have moved higher.

We think it is unlikely that these measures will be immediately repealed by the incoming Trump administration. Comments by officials in the incoming Trump administration regarding their desire to reintroduce a "maximum pressure campaign" on Iran have also added to supply concerns, while OPEC + producers have demonstrated solid compliance levels to their quotas. These developments come alongside data showing global oil inventories falling along with rising demand for heating oil due to a cold winter in Europe and the US.

Takeaway: Our base case is for Brent to trade around USD 80 a barrel through 2025. But given recent developments, oil could trade higher in the near term. Hence, we like to sell risk of falling Brent crude oil prices.

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