

October 2023

Vanguard Inflation Market Commentary

Recap:

The combination of cheap valuations, rising geopolitical risks and a shift in Fed's reaction function was enough to arrest the real yield selloff last month and supported the inflation market into the end of the month. Real yields hit multi-decade highs at the beginning of the month, with 5yr real yields briefly touching 2.70%. Geopolitical developments in the Middle East introduced upside risks to energy prices, and new guidance from Fed officials suggesting caution around tightening of FCI and the broader selloff in longer dated yields supported a significant relief rally in real rates and subsequent rally in breakevens. Front to belly real yields lead the rally into month end, with the curve bull steepening. Breakevens also were well bid across the curve and broke out of its sleepy range, with 5yr BEIs wider by 20bps off the lows and 5yr5yr forward reaching the highs of the year at 2.78%. The TIPS index posted a smaller negative return of -1% for the month, bringing year-to-date returns on the year at -2.45%

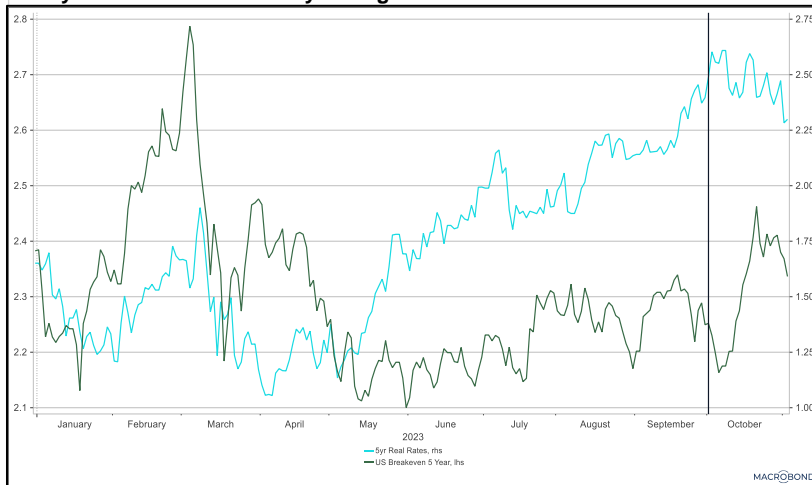
September's CPI beat consensus expectations, with the headline CPI advancing 0.40% m/m compared to 0.30% consensus, while the core segment came in line at 0.32% m/m. Headline inflation was again led by energy prices which rose 2.5% for the month while food prices rose 0.23%. For the core component, most of the upside surprise was explained by a firmer increase in shelter prices (lodging away from home in particular), but airfares / hotels, healthcare and services ex-shelter all registered their strongest print in 6 months. Powell's closely watched gauge 'core services ex-shelter', ticked up from 0.37% in August to 0.61% in September. The 3m and 6m trend is 4.78% and 3.04% suggesting signs of reacceleration for the path of core inflation. Looking ahead to next month, lower energy prices (retail gas prices -10% off highs) should push headline inflation lower. On the other hand, core inflation pressures remains quite sticky and with the expected reversal of healthcare insurance inflation occurring in October, the path of further disinflation on core inflation metrics might prove to be lengthier.

For Fed policy, the most significant shift from the Nov FOMC meeting has been the uniform cautiousness around the tightening of financial conditions and the sharp selloff in long end rates. Fed officials have communicated that persistent tightening of financial conditions warrants attention, and they are proceeding carefully in terms of future action and is comfortable waiting and accessing data as they come in. Financial markets have essentially taken down the probability of another hike post the meeting, with current market pricing only showing 20% of another hike over the next two meetings.

Strategy/Outlook:

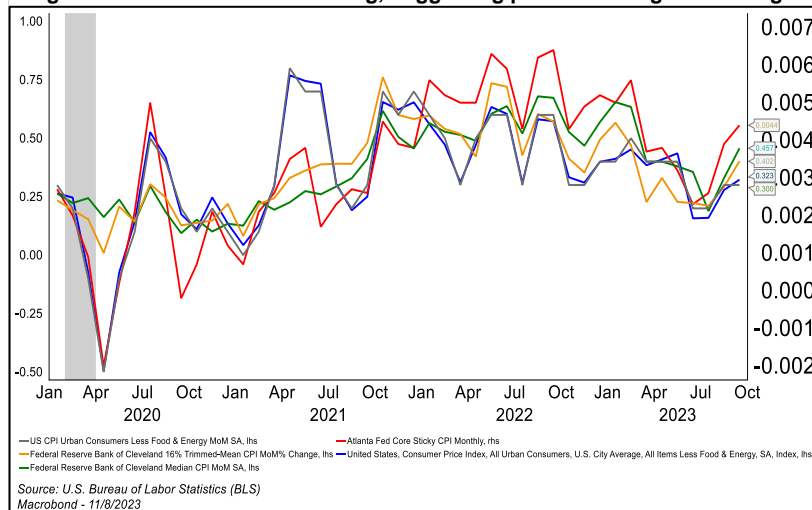
Valuations looks less compelling from a tactical perspective here with the rally in both real yields and breakevens over the course of the last month. Fundamentally, a more dovish reaction function from the Fed considering the concerns around tightening of FCI despite elevated realized inflation >3.5% should support real yields. However, offsetting negative technicals with the turn lower in inflation carry profile over the next two months and a continuation of the outflow cycle in industry will continue to weigh on market sentiment and technical dynamics. We are being patient and opportunistic on looking for more attractive valuations to re-engage in broader duration / curve and BEI strategies, while in the meanwhile leaning on more relative value / systematic opportunities around supply events.

Real yields lead the relief rally during the month as BEIs increased



Source: Bloomberg

Progress on core inflation reversing, suggesting path to 2% might take longer



Source: U.S. Bureau of Labor Statistics (BLS)
Macrobond - 11/8/2023

Lower energy prices should feed into more benign picture for headline inflation



Source: Bloomberg

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