The S&P 500 rose 0.9% and the Nasdaq gained 1.5% after US producer price inflation eased to 8% year-over-year in October, lower than consensus forecasts and down from 8.4% the previous month. (ddp)

Stocks and bonds rally on easing inflation concerns

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Equities and bonds rallied on Tuesday as softer-than-expected US producer prices data supported hopes that the Federal Reserve will slow the pace of rate hikes at its December policy meeting.

The S&P 500 rose 0.9% and the Nasdaq gained 1.5% after US producer price inflation eased to 8% year-over-year in October, lower than consensus forecasts and down from 8.4% the previous month. September's data was also revised lower. The PPI data helped support the risk-on sentiment in markets evident since last week's weaker US CPI data.

Better-than-expected earnings from retailer Walmart offered reassurance on consumer demand. The most recent Fed speakers also adopted a less hawkish tone. Federal Reserve Bank of Philadelphia President Patrick Harker on Tuesday said he expects the Fed to slow the pace of interest-rate increases, and Vice Chair Lael Brainard made similar comments on Monday. Yields on 10-year US Treasuries fell 7 basis points and the 2-year equivalent dipped by 4bps. Fed funds futures markets moved to price in a slightly lower terminal rate of 4.88% next June (down 4bps).

But the extent of the equity rally—which had at one stage taken the S&P 500 1.8% higher for the day—was trimmed by reports that a purported "Russian-made" missile had struck NATO-member Poland's territory.

What do we expect?

In our view, the market's reaction to a modest improvement in producer price inflation reflects a fear of missing out (FOMO) on a year-end rally on the part of faster-moving institutional investors, who have reduced their risk exposure significantly this year.

For example, last Thursday's 5.5% gain in the S&P 500 in the wake of the CPI data was the 16th largest one-day gain in 30 years. Even more striking is that the VIX volatility index ended the day at 23.5, its lowest closing level on all days since 1990 when the S&P was up over 5.5%. The median VIX level on those other days: 58. In other words, the S&P has only

rallied that much during periods of market stress and after large sell-offs, with policy intervention or something equivalent immediately changing the outlook. The October CPI data released Thursday morning before the US open was good news, but not on par with the Fed announcing market support tools during the March 2020 pandemic sell-off.

While less extreme, Tuesday's rally is in a similar vein and suggests that in the near term, asset prices are likely to rise more on good news than they'll fall on disappointing news. That has been the story for the S&P 500 thus far in the fourth quarter: On average, it is 2.07% higher on up days and 1.1% lower on down days.

With the Fed expected to shift to a 50bps rate hike in December, which will be preceded by November employment and inflation reports that are both likely to show further moderation, it is hard for momentum investors to be short equities and bonds, and long the USD—common trades for many months—going into these events.

In our view, there is a distinction between a technical tailwind for the market into the end of the year and a change in the macroeconomic outlook sufficient to drive a sustainable rally. The CPI and PPI data are not game changers for the outlook. While there has been gradual improvement on inflation and labor market overheating in recent months, there is still a way to go before the Fed can comfortably expect inflation to return close to the 2% target.

And as equities and bonds rise, this leads to an easing of financial conditions once again, increasing the risk that the Fed pushes back more strongly against the rally, as Chair Jerome Powell did at Jackson Hole in August.

Additional monetary tightening and the cumulative impact of this year's rate hikes suggest recession risks still remain elevated. Tighter lending standards, likely further declines in the ISM Manufacturing index, and the Fed's expectation that the unemployment rate will rise suggest that earnings per share will fall next year. Our estimate calls for a 4% decline, which could be optimistic.

Meanwhile, news that a missile had hit Poland was a reminder that geopolitical risks remain elevated, with the potential to lead to bouts of volatility.

How do we invest?

Overall, we continue to believe that the macroeconomic pre-conditions for a sustainable rally—that interest rate cuts and a trough in growth and corporate earnings are on the horizon—are not yet in place. As a result, notwithstanding the recent rally, we think the risk-reward for markets remains unfavorable over the next three to six months.

Market volatility is likely to remain elevated, and we favor strategies that add downside protection while retaining upside exposure. Against this backdrop, we favor defensive sectors—including healthcare and consumer staples stocks—income opportunities, "safe-havens," and alternatives.

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