While CPI was higher than consensus estimates, inflation continues to trend lower overall, and CIO still expect it to ease further in the coming months. (UBS)

The broader inflation trend remains downward despite near-term volatility

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US inflation rose more than expected in January, adding uncertainty to the timing of Federal Reserve rate cuts. The consumer price index (CPI) increased 3.0% on an annual basis, with core CPI—excluding food and energy —rising 3.3%.

On a monthly basis, headline CPI jumped 0.5%, marking the fastest pace since August 2023, while core CPI climbed over 0.4%, and nearly rounded up to 0.5%, the highest since April 2023. Price increases in food, gasoline, and transportation services contributed to the upside surprise, offsetting declines in categories like clothing and furniture.

While CPI was higher than consensus estimates, inflation continues to trend lower overall, and we still expect it to ease further in the coming months.

Shelter inflation remains a key driver, but is expected to moderate. Owner's equivalent rent (OER) rose 0.3%, in line with December's pace, and 4.4% annually, the smallest 12-month increase since January 2022. This was one of the more encouraging aspects of the report, as OER is a key driver of core inflation, and a sustained slowdown would help ease price pressures. Since CPI lags real-time rent measures, it will take time for this disinflation to be fully reflected in the official data, but rising housing supply and moderating rent growth should gradually push shelter inflation lower in the months ahead.

The broader inflation trend remains downward despite near-term volatility. Despite the stronger-than-expected monthly increase, overall inflation has declined sharply from its 2022 peak above 9%. Some of the latest price increases, including a 15.2% surge in egg prices due to supply disruptions and a 1.8% rise in gasoline, were driven by temporary factors rather than underlying demand pressures. As these shocks fade, inflation should continue its downward trajectory, supporting the Fed's patient stance on policy easing.

The labor market remains strong, but is no longer fueling inflation. Fed Chair Powell on Tuesday described the labor market as "broadly in balance" and "not a source of significant inflationary pressures," signaling that while job growth has moderated, it remains solid enough to support consumer spending without reigniting inflation concerns. With hiring cooling in a controlled manner and wage gains stabilizing, the labor market continues to support economic expansion while allowing inflation to decline.

So, considering the Fed still views its monetary policy as restrictive—implying rate cuts will be needed at some point—we continue to expect easing in the second half of 2025 as inflation moderates over time. In this context, we see an attractive backdrop for risk assets, supported by economic resilience, artificial intelligence (AI) advancement, and a gradual decline in yields. Although volatility may persist, our year-end S&P 500 target remains 6,600. In fixed income, our base case is for the 10-year yield to fall to 4% by the end of the year. We favor investment grade corporate bonds, and five-year Treasuries as a good way to lock in attractive yields, while not taking on too much duration risk.

Original report: **US inflation higher than expected in January, 13 February 2025.**

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