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US inflation edges higher, but Fed easing still on track

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US stocks were relatively muted on Thursday after stronger inflation data raised doubts about how fast the Fed will cut rates. But while the speed of rate cuts is uncertain, the direction of travel is not. In this context, we continue to advise investors to prepare for lower rates.

Higher-than-expected US inflation data released on Thursday added to recent concerns that the Federal Reserve may be more hesitant in cutting rates. The core consumer price index for September, which excludes volatile food and energy prices, rose by 0.3% for the second consecutive month, slightly above consensus estimates of 0.2%, bringing year-over-year core inflation to 3.3%, up from 3.2% in August.

Stronger-than-expected employment data had already led markets to scale back the likelihood of another bold 50-basis-point cut, and today's CPI data has confirmed this shift in expectations. The latest CME FedWatch data now show a 0% probability of such a large move, down from over 35% just a week ago. Markets now imply around a 13% chance that no cut will occur at the upcoming policy meeting, up from 0% last week.

Inflation should stay under control. While inflation was slightly higher than expected, there were also some positive developments. Headline inflation eased to 2.4%, marking the lowest rate since 2021. Furthermore, in September, the index for shelter, which includes rents and owners' equivalent rent, rose by just 0.2%, cooling from the 0.5% recorded in August and 0.4% in July. Notably, even prior to today's shelter figures, data on actual rents had pointed to only modest increases over the past 18 months, reinforcing our view that inflation is unlikely to stand in the way of further Fed rate cuts. Additionally, CPI was also disappointing in August, but personal consumption expenditure data, the Fed's preferred measure of inflation, showed annual inflation slowing to the lowest level since February 2021, signaling a broader disinflation trend.

Fed minutes suggest more cuts ahead. In discussing the outlook for monetary policy, Fed officials anticipated a "move toward a more neutral stance of policy over time" if economic data continue to come in about as expected, according to the minutes released Wednesday. While policymakers may not see the urgency to move as quickly as they did in September, as some "would have preferred a 25-basis-point reduction," they acknowledged the restrictiveness of monetary policy. In addition, the minutes noted that the overall path of policy normalization would be more important in determining the degree of policy restriction, rather than the specific amount of easing.

Fed officials indicate a bias for additional cuts. Fed officials continue to stress the importance of economic data in their considerations, but they have also supported further rate cuts even after the strong payrolls report. Governor Adriana Kugler said she would consider further reductions if inflation continues to ease as she expects, Boston Fed President Susan Collins said further adjustments of policy will likely be needed, and St. Louis Fed President Alberto Musalem said he supports more cuts as the economy moves forward on a healthy path. Dallas Fed President Lorie Logan highlighted "still real" upside risks to inflation and "meaningful uncertainties" over the economic outlook, but said she supports a more gradual path back to a normal policy stance.

So, we continue to recommend investors position for a lower-rate environment, deploying excess cash, money market holdings, and expiring fixed-term deposits into assets that can offer more durable income. These would include bond ladders, medium-duration investment grade bonds, diversified fixed income strategies, and equity income strategies. We also believe lower rates make a favorable backdrop for equities, and favor AI beneficiaries and quality stocks.

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