Flash Update: US Rate Markets – Wednesday 5/15/2024

- **April CPI prints lower than forecast; Core CPI cools for the first time in six month**
- **Rate cuts back on the table for 2024 – Odds for a 25 bp rate cut in September are now ~80%**
- **Retail Sales cools-off in April, signaling the US consumer may finally be feeling the pinch from high rates**
- **SOFR swap rates drop on better than expected inflation data; SOFR swap rates currently down ~6-8 bps**
- **Rate markets will continue to be data dependent and will pay close attention to Fed-Speak in the near-term**

The April CPI and Retail Sales data released this morning both missed expectations. CPI printed slightly lower than expected and Core CPI cooled for the first time in six months, providing some relief for the Fed on the inflation front. Retail Sales stagnated in April after revised gains in the prior two months, indicating high borrowing costs and mounting debt are encouraging greater restraint among US consumers.

The market reaction was swift and decisive after the data printed at 8:30 AM. US Treasury yields and SOFR swap rates initially dropped about 10 basis points immediately following the data releases, then stabilized and are currently trading ~6-8 bps lower than last night's close. Traders took the weaker than expected Retail Sales data and cooler inflation data as an encouraging signal that the Fed will definitely need to cut rates this year, likely beginning in September. Odds for a 25 basis point rate cut in September are now sitting at ~80%. Those odds are up considerably from just a few days ago. The current market sentiment can be summed up as follows: rate cuts are back on!

However, it is apparent that the market does not want to get too carried away with rate cut euphoria. Maret participants already fell into that trap and paid dearly for it as rate cut after rate cut were unwound from the swap curve in the face of strong economic data, a robust consumer and an uptick in inflation. As we mentioned in yesterday's update, market sentiment can and will change frequently. Recently, we have seen weaker growth and employment data, weaker retails sales (and downward revisions) and stable inflation. A few weeks ago it looked like we might not get any rate cuts this year. Now, it seems that the two 25 bp rate cuts priced into the forward curve are the likely outcome.

Powell's comments yesterday will also stop the market from overreacting to recent data. Powell once again reiterated that the Fed has not seen the progress on inflation they want to see before cutting rates. He also said that the labor market, although showing some signs of cooling, is still strong and would not merit a rate cut anytime soon. The numbers this morning validate the Fed's current approach: they will be patient on rate cuts for the near-term, but they are on the horizon for 2024. The market is likely to remain data dependent and sensitive to Fed-Speak. The data today simply pushed the needle closer to the potential first rate cut.

Keep in mind that today's CPI data was only slightly lower than expected – yesterday's PPI was hotter-than expected. Even with some slight cooling in the labor market, unemployment still sits at 3.8%. Although growth has cooled, GDP is expected to remain positive for the rest of the year. From my perspective, the data released so far this week validate the Fed's wait and see approach, and keep two 25 bp rate cuts on the table for later this year. The market's primary focus will continue to be economic and inflation data, with Fed-Speak also in the mix.

CHART 1: ***US RATES SNAPSHOT: 11:30 AM Eastern***

UST YIELDS	SWAP SPREADS	SOFR SWAP RATES

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2Y	4.747	-0.068	-8.5200	-0.2000	4.6630	-0.0700
3Y	4.528	-0.081	-13.5019	-0.0719	4.3955	-0.0830
4Y	4.432	-0.083	-21.5825	+0.0375	4.2328	-0.0851
5Y	4.366	-0.089	-23.2209	+0.3970	4.1355	-0.0838
7Y	4.359	-0.084	-31.6017	+0.3583	4.0440	-0.0800
10Y	4.361	-0.078	-36.2505	+0.4718	3.9995	-0.0737
20Y	4.617	-0.072	-65.1573	+0.9677	3.9672	-0.0610
30Y	4.521	-0.065	-74.2498	+1.0002	3.7793	-0.0548

Source: Bloomberg, LLP | 11:30 AM NY Rates Snapshot

***Note:* First column is the current market level, second column is the change on the day**

CHART 2A & 2B: ***April CPI Recap***

Core CPI cooled in April for just the first time in six months, indicating price pressures are abating only gradually and supporting the Federal Reserve's intent to keep interest rates higher for longer. Core CPI, which excludes food and energy costs, increased 0.3% from March and advanced 3.6% from a year ago. Economists generally see the core gauge as a better indicator of underlying inflation than the overall CPI number. Headline CPI climbed 0.3% from the prior month and 3.4% from a year ago. Shelter and gasoline prices accounted for over 70% of the annual increase to Headline CPI. Overall, today's CPI calmed markets and left traders confident we would see at least two 25 basis point rate cuts this year.

Yesterday, FOMC Chair Jerome Powell affirmed the central bank's plans to hold interest rates at the highest level in more than two decades as it awaits evidence that a slowdown in inflation will resume after setbacks this year. Powell said he expected inflation to continue heading lower but that he was less confident than he had previously been about that outlook, leaving the Fed unable to say whether or when they might be able to lower interest rates. "We're just going to have to see where the inflation data falls out," he said yesterday. Fed officials began 2024 optimistic that they would be able to lower rates from their highest level in two decades. After a series of cooler inflation readings in late 2023, it seemed possible that a rate cut was just around the corner. Then came three successive disappointing inflation reports, leading Powell and his colleagues to effectively hit the reset button. "We did not expect this to be a smooth road, but these were higher than I think anybody expected," Powell said. He repeated his view that interest rates "by many, many measures" are high enough to slow demand, meaning "we'll need to be patient and let restrictive policy do its work." (Note, Chairman Powell had seen April PPI before making his speech yesterday.) The Fed will definitely still be in a heavily data dependent mode for the foreseeable future, and nothing is yet guaranteed in terms of rate cuts.

Chart 2A: APRIL CPI RECAP

Metric	Actual	Estimate
CPI MoM	+0.3%	+0.4%
Core CPI MoM	+0.3%	+0.3%
CPI YoY	+3.4%	+3.4%
Core CPI YoY	+3.6%	+3.6%

Source: Bloomberg, LLP | APRIL CPI RECAP

Chart 2B: HISTORICAL CPI

Source: Bloomberg, LLP | HISTORICAL CPI DATA

CHART 3A & 3B: ***April Retail Sales Recap***

April Retail Sales stagnated in April, and the prior two month's results were revised lower, indicating high borrowing costs and mounting debt are encouraging greater restraint among consumers. MoM Retail Sales were little changed from a month earlier after a downwardly revised 0.6% March increase. Much of the retail spending during April was on necessities, such as food and gasoline. The median forecast called for a MoM rise of 0.4%. Core Retail Sales (excludes cars and gasoline), *dropped* 0.1% in April, below expectations calling for an increase of 0.2%.

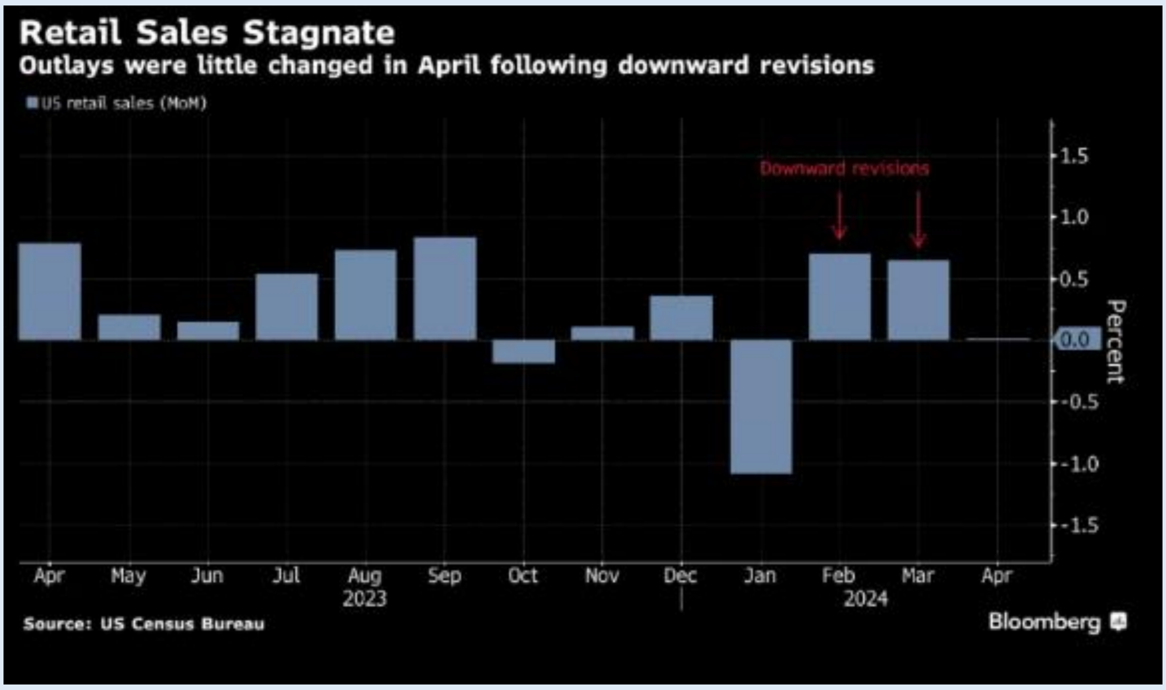
The Retail Sales figures indicate a softening in otherwise resilient consumer demand that has been bolstering the economy. While a still-healthy labor market is providing the wherewithal to spend, elevated prices and interest rates risk further squeezing household finances and limiting discretionary purchases. Continued consumer spending restraint could have negative implications on GDP and may also help to create lower inflation. Both of those developments would favor rate cuts.

Chart 3A: APRIL RETAIL SALES RECAP

Metric	Actual	Estimate
Retail sales (MoM)	0.0%	+0.4%
Sales ex. autos, gas (MoM)	-0.1%	+0.2%
'Control group' sales (MoM)	-0.3%	+0.1%

Source: Bloomberg, LLP | APRIL RETAILS SALES RECAP

Chart 3B: HISTORICAL RETAIL SALES



Source: Bloomberg, LLP | RETAIL SALES HISTORICAL INFORMATION

CHART 4A & 4B: ***SOFR Swap Market Reaction to CPI & Retail Sales Data***

Chart 4A shows the market reaction to this morning's data. You can see the initial drop in swap rates right after the number, which quickly stabilized and settled-in down ~6-8 bps. Prior to today's data releases, SOFR swap rates were stuck in a relatively narrow range. The rate markets breathed a sigh of relief this morning, but make no mistake, the market will continue to be data dependent, at least until the next FOMC meeting. Chart 4B details forward pricing – after the numbers this morning forward pricing implied 50 basis points of rate cuts this year, or two 25 bp cuts. You can see that just a few days ago ~40 bps of easing was priced into the curve – traders were beginning to doubt if the Fed would be able to cut rates at all this year, particularly given the recent uptick in the inflation data.

Given the tone and results of the recent economic data, rates are likely to trade in a new, slightly lower range as traders wait for more data supporting rate cuts. The next "big" number we will see will be PCE on 5/31 at 8:30 AM. Fed officials will be all over the tape in the coming days, so the market will be keen to hear their take on today's numbers and yesterday's PPI data.

Chart 4A: SOFR SWAP MARKET REACTION TO DATA - 2Y SOFR SWAP, PRIOR 3 TRADING SESSIONS

Source: Bloomberg, LLP | SOFR Swap Market Reaction To Inflation, 2Y SOFR Swap 3-Day Chart

Chart 4B: TRADERS RAMP UP RATE CUT BETS AFTER CPI, RETAIL SALES DATA

Source: Bloomberg, LLP | SOFR Swap Market Reaction To Inflation, Retails Sales Data

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