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Watching the paint dry

One of the key characteristics of financial markets is that they are forward-looking — assigning value to something today is highly dependent on the many factors that impact the anticipated prospects for the years to come.

A significant issue with that mindset, however, is that the future is unknowable in advance and the only way to determine if a forecast is ultimately correct is to wait and see. Moreover, progress tends to be slow-moving, and very rarely do things develop in a straight line — instead, there typically are ebbs and flows that complicate getting a clear read on actual trends in real time.

While this all would suggest that patience is necessary when it comes to making decisions — Nobel Memorial Prize-winning economist Paul Samuelson famously stated that *"investing should be dull, it shouldn't be exciting; investing should be more like watching paint dry or grass grow"* — markets tend to have knee-jerk reactions to noisy data-release headlines that often end up carrying little impact in terms of altering the outlook.

A good example of this has been the market response to the economic dataflow of late, especially stateside in recent months culminating with last week's consumer price index (CPI) report.

After seeing inflation fall sharply from its mid-2022 peaks, as the most significant supply-side impacts of the pandemic subsided, indicators of overall consumer prices perked up in response to energy prices late last summer, while the deceleration in "core" price growth (excluding food and energy) started to become less substantial — and while the 12-month core inflation rate did tick down (on an unrounded basis) in the US report for January (released earlier this month)[1] for the 10th consecutive month and 15th time in the last 16 months, it was a much smaller deceleration than anticipated.

Markets interpreted this as a sign that prices were proving to be stickier than they had assumed, which, combined with the continued signals of general resilience of overall economic activity in the US, would mean the US Federal Reserve (Fed) delaying the unwind of the aggressive tightening cycle that began in 2022 — the first rate cut that had been fully priced at the start of the year was for March but has now been kicked out to June, while the magnitude of cuts priced in by year-end has now been nearly cut in half.

The question, therefore, is: has anything materially changed since the start of the year that warrants a rethink of the outlook and any related investment thesis? In simple terms, the answer is: not yet.

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[1] U.S. Bureau of Labor Statistics, Bureau of Labor Statistics, Economic News Release, *Consumer Price Index Summary*, February 13, 2024, https://www.bls.gov/news.release/cpi.nr0.htm

For starters, we have long been in the camp that, while the deceleration in inflation had been significant, the fact is we have picked much of the low-hanging fruit and, combined with our expectations that macroeconomic momentum while moderating, was firmer than consensus, indicated that the road ahead would see comparably gradual, but still persistent, progress that saw inflation move within range of inflation targets in the second half of the year.

Accordingly, the aggressive repricing of rates late last year against increased expectations of imminent pro-active rate cuts by the Fed seemed misplaced from our view. The recent developments in the market appear to have just brought consensus more in line with our expectations.

Further, the "firm" January data does not alter these expectations.

Drilling down into the details, while the breadth of price gains was fairly wide, the verve in overall prices in the US last month was largely driven by surprising strength in the heavily weighted housing and shelter component, as well as a handful of categories that historically have been subject to meaningful beginning of the year price adjustments, with the likes of vehicle insurance, health insurance and health care, and child care punching well above their weights.

History suggests that the likelihood of the outsized gains in the latter components being repeated is minimal, while indicators of housing prices, mortgage rates and market rents suggest that further shelter cost disinflation should be in the cards for the months ahead. As well, signs of further disinflation in consumer and producer prices outside of the US (including Canada[2]) may well temper upside risks.

As the saying goes, one month does not a trend make. Despite all the noise, there is nothing here, yet, to suggest that underlying inflation is on the verge of making a break from the moderating trend that would appear to position central banks to begin unwinding policy in the second half of the year.

That said, the focus will remain on watching the paint dry to ensure the coat comes out as expected.

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[2] Statistics Canada, The Daily, *Consumer Price Index, January 2024*, February 20, 2024, https://www150.statcan.gc.ca/n1/daily-quotidien/240220/dq240220a-eng.htm?HPA=1

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