Stocks rally in hopes the inflation fight is over

- Thanks to October's surprisingly soft U.S. Consumer Price Index report released last Thursday, stocks and bonds staged one of their sharpest single-day rallies on record. For the week, the S&P 500 rose 5.9%, while the 10-year U.S. Treasury yield plunged from 4.17% to 3.82%.[1](The bond market was closed on Friday in observance of Veterans Day.)
- The U.S. dollar also fell broadly in sympathy with the drop in U.S. inflation expectations and interest rates, losing 3.5% on a trade-weighted basis, according to Bloomberg's weighted index.[2]
- With the Democrats securing control of the Senate over the weekend, all eyes now turn to the 20 seats up for grabs in in the House of Representatives. We believe the margin will remain quite narrow, but if Republicans gain a majority in the "lower chamber," passage of any major legislation during the next two years of President Biden's administration will be difficult.
- This week will provide October retail sales data in both the U.S. and China, where consumer narratives have diverged recently. U.S. consumers remains well-supported by excess savings and low unemployment. Meanwhile, in China, concerns about ongoing Covid lockdowns – which showed signs of easing – have fueled higher saving rates as households hoard cash.

Each week, we present our featured topics in the context of major themes from Nuveen's most recent global investment outlook:

- **U.S. economy**: A deep or prolonged recession is unlikely, but expect inflation to come down slowly.
- **Global economy**: Countries with lower personal income levels and greater energy dependence are more vulnerable to harsher downturns.
- **Policy watch**: Central banks worldwide remain firmly in tightening mode.
- **Fixed income**: Still too early to extend duration, but yields across segments of the bond market look attractive.
- **Equities:** Favor U.S. stocks (especially large caps) over non-U.S. developed and emerging market shares. Keep expectations in check.
- **Asset allocation**: Diversification benefits remain elusive, but fixed income is valued more attractively than equities for the first time in years.

Quote of the week: "The foundation of every government is some principle or passion in the minds of the people." – John Adams

The midterm elections are almost in the books. What's next?

While their margin of victory will likely be narrower than expected, we believe Republicans will gain a majority in the House of Representatives when the 118th Congress convenes in January. Democrats secured control of the Senate over the weekend and will look to extend their lead with Georgia's December 6 runoff on tap.

Divided government is, of course, not a new development, but that's of little solace to President Biden. History tells us that under such circumstances, few, if any, major pieces of legislation will arrive on his desk during the second half of his term. In place of lawmaking, we anticipate plenty of partisan gridlock punctuated by tense brinksmanship. These roadblocks have become especially troublesome when Congress is tasked with raising the U.S. debt ceiling.

Most notably, in August 2011, S&P downgraded the credit rating on U.S. debt from AAA (the highest rating) to AA+ (the second highest). That historic move occurred several days after the U.S. Treasury narrowly avoided a default — which would have sent shockwaves through global markets — as President Obama and Congress initially couldn't agree on a spending deal that included an increase in the debt ceiling. (The debt ceiling prevents the Treasury from borrowing above a certain amount to fund spending, even if that spending has already been approved by Congress and the president.)

Although that impasse was resolved, its proximity to the Great Recession spooked investors for the rest of the year. A similar spending showdown may be forthcoming. Some Democrats favor raising the debt ceiling by year-end during Congress' "lame duck" session. To their dismay, they're unlikely to garner enough support to do so. A 2023 budget battle seems inevitable.

Also on our radar screen next year will be the federal government's response, if any, to a severe recession. While such an economic contraction is not our base case, experience gained from the Covid pandemic suggests that a fast injection of stimulus can stabilize an economy, alleviate the effects of higher unemployment, and help set the stage for a faster recovery. But it's not clear to us that a divided Congress would approve even a substantially smaller stimulus package compared

Hold the presses! An encouraging inflation report.

Could the end of "sticker shock" be on the horizon? October's Consumer Price Index (CPI) report, released last Thursday, gave consumers (and investors) hope.

Year-over-year, headline CPI fell from 8.2% in September to 7.7%, its lowest rate since January, thanks to a broad decline in good prices. Core CPI, which strips out food and energy costs, edged down to 6.3% versus 6.6% in September. On a monthly basis, headline (+0.4%) and core inflation (+0.3%) both undershot consensus forecasts.[3]

The news wasn't all positive, however. The year-over-year results remained elevated by historical standards and well above the Fed's 2% target. Moreover, some of the deceleration in October's data was driven by an annual update for calculating health insurance that isn't likely to lower costs for consumers. On a "line item" basis for the CPI print, we homed in on two figures:

- Rent costs (+7.5% year over year), one of CPI's larger components, are still running hot and will take some time to cool down.[4] One optimistic sidebar: national rent websites such as Zillow are showing rent increases beginning to slow.

- Used car prices fell 2.4% but have only just started to reverse their 51% cumulative increase in 2020 and 2021.[5] New car prices continued to rise moderately.

As we've often said, one month of data is rarely, if ever, dispositive. Nonetheless, markets reacted as if inflation were on a path to normalcy, which would give the Federal Reserve breathing room to ease up on its aggressive rate hikes and boost the likelihood of an economic "soft landing."

In the wake of the CPI release on Thursday, fed fund futures, used by traders to bet on the direction of interest rates, priced in around 100 basis points (bps) of tightening over the next three Fed meetings. This compares to about 120 bps just after the November 2 Fed meeting, leading to a potentially lower ending point —or terminal rate — for this hiking cycle. Indeed, some Fed officials have already thrown their support behind slowing the pace of rate hikes.

Meanwhile, U.S. equities and U.S. Treasuries rallied hard. The S&P 500 Index jumped 5.5% and the yield on the bellwether note plunged 28 basis points, its biggest one-day dive since 2020.[6]

But investors have experienced false dawns before, most recently in July, when cooler CPI prints fueled a 9.2% gain in the S&P 500 Index, and the 10-year yield dropped 44 basis points in less than two weeks.[7] Those moves quickly reversed course, though, when inflation reheated. The bottom line: we'll need more data to confirm that the welcome details in this report are becoming durable trends.

SOURCES:
1.Marketwatch, Federal Reserve via Haver
2.Bloomberg
3.Bureau of Labor Statistics (BLS): BLS via Haver
4.BLS
5.BLS
6. Bloomberg, Marketwatch
7.Factset, Federal Reserve via Haver

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