UNITED STATES: DISINFLATION HAS STARTED

The US consumer price data for October have reinforced the view that disinflation -the narrowing of the gap between observed inflation and the central bank's inflation target- has started. That conclusion seems clear as far as headline inflation is concerned -it has peaked in June- but we need confirmation that the decline in core inflation from the September peak is not a one-off. Core goods inflation has been moving down but core services inflation remains stubbornly high on the back of transportation services and shelter. What matters now for the economy and financial markets is the speed of disinflation because this will influence Fed policy, the level of the terminal rate and how long the federal funds rate will stay there. All this influences the perceived downside risks to growth.

When you have been desperately waiting for good news, the reaction can be euphoric when at long last it arrives. This was perfectly illustrated by the behaviour of financial markets last week following the positive surprise of the US consumer price inflation data: headline and core inflation were lower than expected by the consensus..

The charts that follow show the market evolution on an intraday basis on 10 November, before and after the publication of the inflation numbers.

US Treasury yields (*chart 1*) recorded a big drop -close to 20 basis points for the 10-year yield, slightly more for the 2-year yield-, reflecting an expectation that the Federal Reserve would tighten less than expected previously. The federal funds futures curve (*chart 2*), which reflects market expectations of the future policy rate, moved significantly down. Investors now expect the terminal rate to be 20 basis points lower. This caused a strengthening of the euro versus the dollar (*chart 3*). Global bond yields are highly correlated so unsurprisingly, Bund yields also recorded a huge drop (*chart 4*). Equity markets (*chart 5*) rallied in Europe and Wall Street opened significantly higher compared to the previous day's close. This reflects the usual discount rate effect -the decline in government bond yields raises the net present value of future dividends- but also a reduced concern about downside risks to growth from ever higher policy rates. Finally, the price of gold increased as well (*chart 6*). This may look counterintuitive -after all, inflation eased more than expected, which should weigh on gold as an inflation hedge- but reflects the belief that real interest rates will rise less than expected previously.

The market reaction to positive economic data surprises has much in common with watching fireworks: waiting impatiently until the fuses are lit, watching full of admiration when the arrows light the night sky, soon to be followed by the question of what happens next.

The good news is that it looks that disinflation -the narrowing of the gap between observed inflation and the central bank's inflation target- has started in the US.

Headline inflation is on a clear downward trend after peaking in June (*chart 7*). Inflation excluding food and energy has peaked in September, so we need confirmation that the decline in October was not a one-off, keeping in mind that core inflation had been moving down for four months in a row after a peak in March. Core goods inflation -commodities excluding food and energy- has seen a downward shift as of July whereas core services inflation -which excludes energy services- remains stubbornly high on the back of transportation services and shelter. The latter rose 0.8% m/m in October -the largest increase since August 1990- and contributed over half of the monthly increase in headline inflation. Over the past 12 months, it accounted for over 40 percent of the total increase in core inflation. With the correction in the housing market and the prospect of a weakening of the labour market, shelter inflation will eventually decline but this may take time.

What matters now for the economy and financial markets is the speed of disinflation because this will influence Fed policy, the level of the terminal rate and how long the federal funds rate will stay there. All this influences the perceived downside risks to growth. Financial markets worry sequentially. When fears of further significant rate hikes will have eased, recession concerns will take over as dominant topic.

William De Vijlder

US TREASURY YIELDS

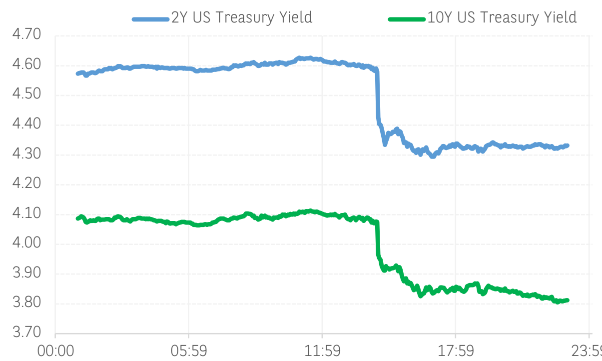

CHART 1

SOURCE: BLOOMBERG, BNP PARIBAS

Financial markets worry sequentially. When fears of further significant rate hikes will have eased, recession concerns will take over as dominant topic.

FEDERAL FUNDS FUTURES CURVE

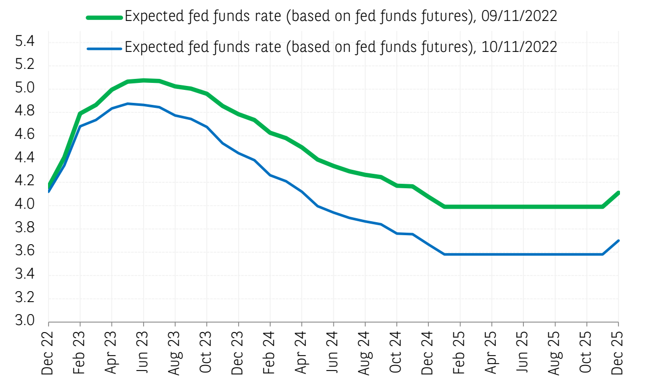

CHART 2 SOURCE: REFINITIV, BNP PARIBAS

EUR IN USD

CHART 3 SOURCE: BLOOMBERG, BNP PARIBAS

10-YEAR BUND YIELD

CHART 4 SOURCE: BLOOMBERG, BNP PARIBAS

EQUITY MARKETS

CHART 5 SOURCE: BLOOMBERG, BNP PARIBAS

GOLD IN USD

CHART 6 SOURCE: BLOOMBERG, BNP PARIBAS

US INFLATION (Y/Y IN %)

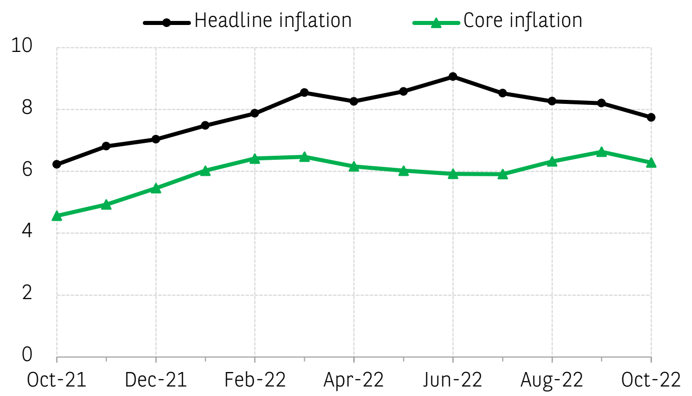

CHART 7 SOURCE: BLOOMBERG, BNP PARIBAS