What's Hot: Higher for Longer

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US inflation data in July 2023 provided mixed signals. While Consumer Price Index (CPI) is moving in the right direction, producer price inflation suggest pipeline pressures are picking up. Core CPI, which excludes often-volatile food and energy costs, rose only 0.2% for a second month in a row . However, US producer prices picked up in July, owing to increases in certain service categories. This likely buys more time for the Federal Reserve (Fed) to deliberate on the future path of monetary policy.

The flows into bond exchange traded funds (ETFs) have been volatile. Over the past year, investors were starting to embrace duration. Investors were positioned for recession, inflation crash, and Fed cuts - evident from $31.7bn inflows to Treasury bond ETFs on pace for a record year2. However, investors are starting to pull out of the biggest bond ETFs devoted to Treasuries. More than $1.8 billion came out of the $39 billion iShares 20+ Year Treasury Bond ETF last week, the most since March 20203. Sentiment toward long-dated Treasuries has soured over the past month amid growing conviction that the Fed will keep interest rates at elevated levels for an extended period. We expect rates to remain higher for longer and are unlikely to see the Fed cut rates until the Q1 of next year amidst a stronger US economy.

Don’t celebrate on disinflation just yet

Overall, the US economy continues to show extraordinary resilience despite monetary constraints and credit tightening. While inflation has shown encouraging signs of decline, we caution that the level remains high. Strong July retail sales raise the risk of a re-acceleration in inflation. The four biggest categories of the ex-auto’s component saw outsized gains: non-store retailers, restaurants & bars, groceries, and general merchandise. Amidst a tight US labour market, with unemployment at historic lows and wages continuing to rise, the downward pricing momentum in the service sector is likely to be at a slower rate. Commodity prices are also beginning to rebound from the weakness seen in Q2 2023. Energy prices have been rising on the back of Organisation of Petroleum Exporting Countries and its allies (OPEC+) production cuts. If commodity prices extend their recent momentum, it could pose upside risks to inflation.

Fed Officials remain divided

Messaging on a somewhat mixed inflation outlook from the Fed Officials remains a mixed bag. One faction remains of the view that rates hikes over the past year and a half has done its job while another group contends that pausing too soon could risk inflation re-accelerating. Fed governor’s Michelle Bowman and Christopher Waller remain in the hawkish camp, hinting at more rate increases being needed to get inflation on a path down to the 2% target.

Futures markets are assigning about a 11% chance of a 25-basis-point rate hike when the Fed next meets on 19 and 20 September4. Additionally, rate cuts have now been completely taken off the table until perhaps later in the Q1 2024. The latest Fed minutes reveal commentary from officials, including the hawks, such as Neel Kashkari, suggest a willingness to pause again in September, but to leave the door open for further hikes at the upcoming meetings5.

Source: Bloomberg, WisdomTree as of 17 August 2023. Forecasts are not an indicator of future performance and any investments are subject to risks and uncertainties.

Source: Factset, WisdomTree as of 17 August 2023. Historical performance is not an indication of future performance and any investments may go down in value

The weakness in eurozone growth alongside resilient US activity (particularly consumption and the labour market) has helped the performance of the US dollar versus the EUR. Despite sticky core inflation in the eurozone, the European Central Bank sounded more dovish at the recent meeting, acknowledging the effect rates were having on broad demand. In comparison, the Fed appears likely to stay on hold for an extended period of time. These factors are likely to pressure the EUR further versus the US dollar and could benefit a EUR based investor invested in WisdomTree USD Floating Rate Treasury Bond UCITS ETF.

Source: Bloomberg, WisdomTree as of 17 August 2023. Historical performance is not an indication of future performance and any investments may go down in value

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1 Bureau of Labour Statistics as of 10 July 2023

2 BofA ETF Research, Bloomberg as of 9 August 2022 - 9 August 2023

3 Bloomberg as of 14 August 2023

4 Bloomberg as of 17 August 2023

5 www.federalreserve.gov as of 16 August 2023

6 Difference in yields 1.89% between WisdomTree USD Floating Rate Treasury Bond UCITS ETF (5.44%) and Bloomberg Euro Treasury Index (3.55%) as of 18 August 2023

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