US Rates Viewpoint

10 FAQs ahead of Jan CPI print

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Asked & answered

In this note we go through 10 frequently asked questions around inflation, inflation markets, and oil as we look ahead to CPI. Our 3 main takeaways for markets: 1- composition of disinflation matters for Fed confidence, 2- front-end inflation continues to trade below where we think the monthly run-rate will settle, 3- market assumptions for seasonality make October issues look cheap in our view.

Composition matters for Fed and market

The Fed emphasized that it would need to see "greater confidence" in the inflation data to begin its cutting cycle. We think part of the confidence the Fed is looking for is in the composition of disinflation. The market is also going to care about the composition, both as it informs the Fed's decision on when to cut and the run rate of disinflation going forward. Specifically, the market will be focused on the pace of goods deflation, how much shelter disinflation is showing up, and how core services ex-shelter is evolving. We expect this divergence between goods and services to persist in Jan as we forecast core goods prices fell by 0.3% m/m, but core service increased by 0.5% m/m.

Seasonal revisions = modest good news for Fed

Despite the fanfare, last week's revisions to CPI were somewhat of a nonevent, consistent with our expectations. While the revisions to core CPI were modest in nature, underneath the hood there were shifts that are worth noting: 1- revisions resulted in more modest deflation in core goods to end the year, 2- core services inflation was revised slightly lower to close the year owing in part to downward revisions in rent, OER and medical services. We think this is marginally good news for the Fed as the disinflation seen towards the end of last year was less about goods deflation than originally thought. Market-implied TIPS seasonality is less volatile than what was observed in 2023 making October issues look cheap.

We question optimistic market path of disinflation

We continue to view the front end of the inflation curve as pricing a path of disinflation that is too optimistic and hold our 2y inflation swap long. We think that the largest difference between the market and our forecasts comes down to the speed and extent of rent disinflation but believe that upside risks are not adequately incorporated in pricing. Our commodities team flags rising risk of a crude oil or refined product supply shock alongside geopolitical tensions. Market assumptions through the end of the year imply a m/m SA run rate of less than 0.2%. We think this will be hard to maintain as goods deflation moderates, but a faster pace of shelter disinflation than we expect would be a headwind to this view.

UST= US Treasury

TIPS = Treasury Inflation Protected Security

OPEC = Organization of the Petroleum Exporting Countries

QT = quantitative tightening

QE = quantitative easing

MoM = month over month

CPI = Consumer Price Index

PCE = personal consumption expenditure

NSA = not seasonally adjusted

SA = seasonally adjusted

For a list of our open trades and those closed over the last 12 months, see the latest Global Rates Weekly

Pre-CPI FAQs

What do we expect from tomorrow's CPI print?

The January CPI report should show ongoing progress on inflation. We forecast headline and core CPI rose by 0.2% m/m (0.16% unrounded) and 0.3% (0.29% unrounded) respectively. This is in line with Bloomberg surveyed estimates (Exhibit 1). As a result, y/y headline inflation should print five-tenths lower at 2.9%, and core should print one-tenth lower at 3.8%. Additionally, our forecast implies a headline NSA index of 307.961 compared to 306.746 in December (see more details in: January CPI Preview). This is modestly above current market pricing of 307.930.

Exhibit 1: MoM SA CPI expectations
Expectations are generally aligned

	Headline	Core	NSA Index
BofA base	0.2	0.3	307.961
BBG consensus	0.2	0.3	308.014
Market pricing			307.930

Source: BofA Global Research, Bloomberg

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Exhibit 2: Market scenario analysis
Anticipate market to price greater conviction in May cut and lower trough if CPI disappoints but fewer cuts and flatter curve on a beat

Core CPI MoM	May pricing	10y impact	2s10s impact
0.2	20-25bps of cuts	-10bps	5bps steeper
0.3	15-20bps of cuts	within 5bps	within 5bps
0.4	<10bps of cuts	+10bps	5bps flatter

Source: BofA Global Research

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What will the Fed care most about?

The Fed emphasized that it would need to see "greater confidence" in the inflation data to begin its cutting cycle. We think part of the confidence the Fed is looking for is in the composition of disinflation (see: January FOMC: March is no longer the base case). To date, disinflation has been driven by goods price deflation while services disinflation has been more stubborn. We expect this divergence to persist in January as we forecast core goods prices fell by 0.3% m/m, but core service increased by 0.5% m/m. That said, the Fed was likely somewhat encouraged by the revisions to CPI which resulted in faster disinflation in core services in 4Q and less deflation for core goods.

A report in line with our expectations would continue to build the Fed's confidence and support our expectation for the first cut to be in June. The details of our forecast suggest that January PCE inflation, the Fed's preferred measure, could come in softer than CPI again given the difference in weights for housing services. That said, strong PCE financial services inflation may bias the print higher in January. Nevertheless, this is just the first of five CPI reports the Fed will have on hand at its June meeting. Therefore, the outcome of the January report is unlikely to meaningfully shift our expectations for monetary policy.

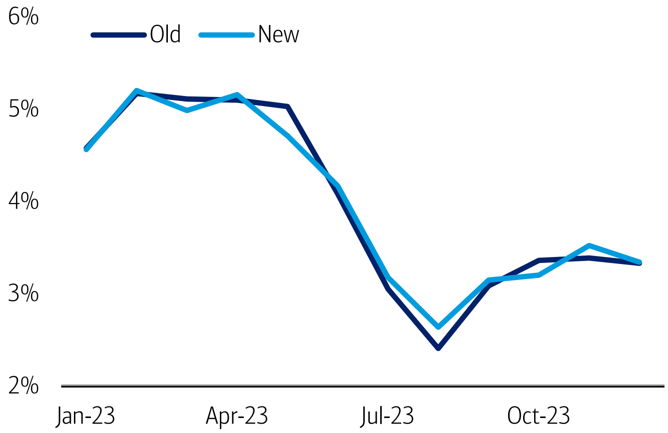
How will the market respond?

The market is also going to care about the composition, both as it informs the Fed's confidence to cut and the run rate of disinflation going forward. Specifically, the market will be focused on the pace of goods deflation, how much shelter disinflation is showing up, and how core services ex-shelter is evolving. Signs that core goods is less of a drag on the overall index may help push back on market pricing of disinflation that is faster than our forecasts. Stickier shelter may also challenge near-term disinflation optimism, but is likely to be viewed as still in the pipeline. Confidence on inflation being broad based will be in part judged by progress in core-services ex shelter. As discussed in Longs remain dominant but challenged position, we see long USTs as a dominant position in the market and so the larger price response may come on a beat vs a miss.

Did last week's CPI revisions change the story for the Fed?

Despite the fanfare, last week's revisions to CPI were somewhat of a nonevent, consistent with our expectations (See: CPI Inflation Watch: CPI revisions unlikely to impact Fed policy). The revisions became a focus for market participants after Governor Christopher Waller indicated he would be paying close attention to the revised data. The good news is that, unlike last year, this year's did not materially alter the path and progress seen on inflation was largely unchanged (Exhibit 3 and Exhibit 4). Indeed, the 3- and 6-month annualized rate for core CPI inflation in December was revised up by 1bp and 4bp, respectively.

Exhibit 3: Core CPI pre-and-post revisions (3-m annual % ch.)
This year's CPI revisions did not materially change the path of inflation



Source: Bureau of Labor Statistics, Haver Analytics
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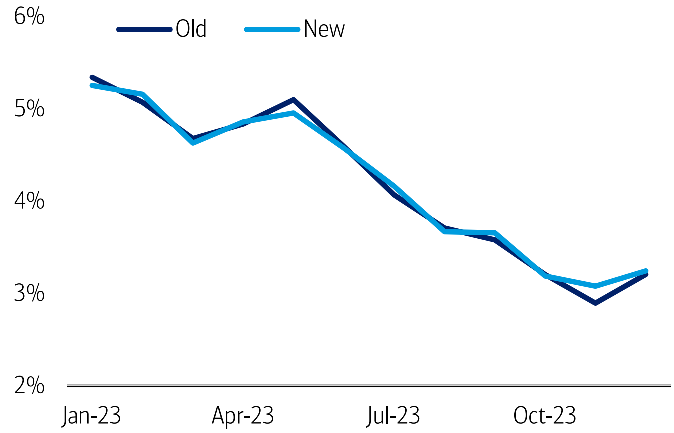
Exhibit 4: Core CPI pre-and-post revisions (6-m annual % ch.)
This year's CPI revisions did not materially change the path of inflation



Source: Bureau of Labor Statistics, Haver Analytics
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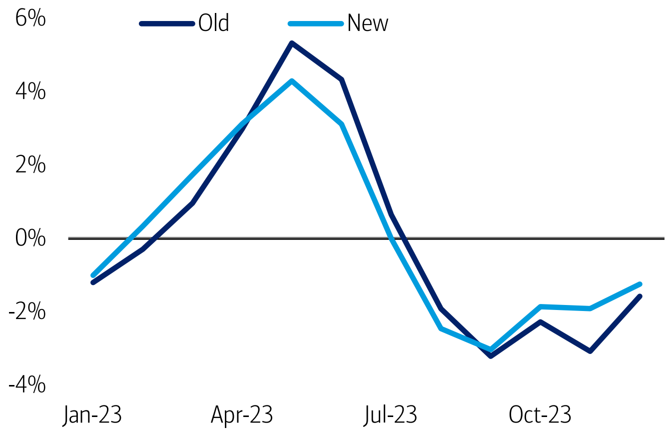
While the revisions to core CPI were modest in nature, underneath the hood there were shifts that are worth noting. First, the revisions resulted in more modest deflation in core goods to end the year (Exhibit 5). This appears to be due in part to upward revisions to used vehicle prices and apparel (Exhibit 7). Second, core services inflation was revised slightly lower to close the year owing in part to downward revisions in rent, OER and medical services (Exhibit 6). We think this is marginally good news for the Fed as the disinflation seen towards the end of last year was less about goods deflation than originally thought.

Exhibit 5: Core goods CPI pre-and-post revisions (3-m annual % ch.)
The revisions revised away some of the deflation at the end of the year



Source: Bureau of Labor Statistics, Haver Analytics
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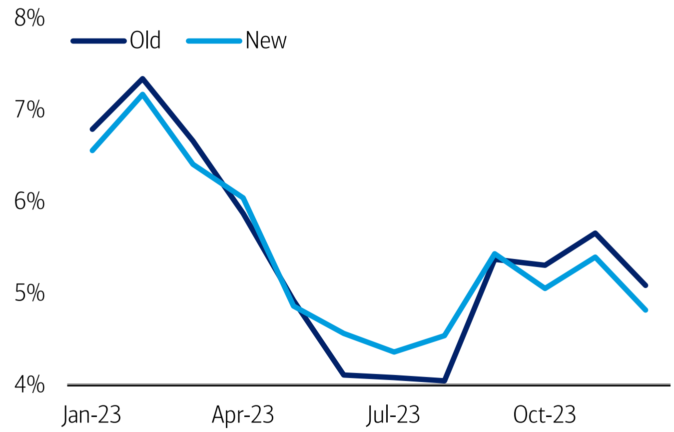
Exhibit 6: Core services CPI pre-and-post revisions (3-m annual % ch.)
The revisions revised down services inflation to end the year



Source: Bureau of Labor Statistics, Haver Analytics
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The revisions, however, are not all rosy for the inflation outlook. Looking at the monthly details, the new seasonal factors will be more of a boost to core inflation in four of the first six months of the year. Therefore, progress on inflation might be a little harder to come by in the first half of the year.

Exhibit 7: The change in the % m/m inflation rate for headline and various categories of CPI (bps)

Revisions to inflation were relatively modest to end the year but there were several components which saw large revisions throughout the year

	Headline	Core	Core goods	Apparel	New Vehicles	Used vehicles	Alcoholic beverages	Core Services	Shelter	Rent	OER	Medical care services	Transportation services
Jan	0.0	1.5	3.0	-39.6	-0.3	59.7	8.5	1.7	-1.5	-3.0	-1.2	24.3	2.3
Feb	1.4	1.6	14.6	-21.0	3.4	134.7	10.5	-0.7	-3.7	1.0	-1.5	19.9	-7.3
Mar	2.5	-6.0	1.5	-3.6	-6.8	29.4	-2.5	-7.0	-3.2	0.0	1.8	-0.6	-49.4
Apr	5.9	5.9	-12.7	-0.6	7.5	-121.6	-5.5	11.7	6.2	2.1	2.4	7.9	69.3
May	-1.4	-7.4	-13.5	-9.2	3.5	-122.8	-5.5	-6.1	-1.7	3.1	0.6	0.1	-57.7
Jun	3.0	3.7	-3.2	-16.6	-1.5	-14.9	4.7	5.4	4.9	1.9	2.0	-3.2	31.0
Jul	3.9	6.8	0.5	16.2	4.7	-12.9	8.4	7.4	3.8	5.4	1.1	8.3	48.0
Aug	-11.9	-4.8	-11.1	-5.0	-5.5	-62.9	-1.0	-1.0	6.1	-0.1	4.5	-10.0	-34.6
Sep	-3.6	-0.4	15.3	41.0	-5.3	73.6	-21.2	-5.0	-7.7	-3.0	-5.9	-7.2	3.6
Oct	3.4	1.4	6.4	-8.9	2.5	39.4	14.4	-0.1	0.7	-3.0	0.9	-11.6	6.0
Nov	6.3	2.3	8.1	65.4	4.7	-21.1	5.8	-1.2	-0.2	-3.7	-1.2	-10.6	-3.8
Dec	-7.0	-3.4	-6.1	-10.5	-8.9	10.7	-17.8	-5.1	-4.9	-2.5	-4.8	-20.8	-2.3

Source: Bureau of Labor Statistics, Haver Analytics

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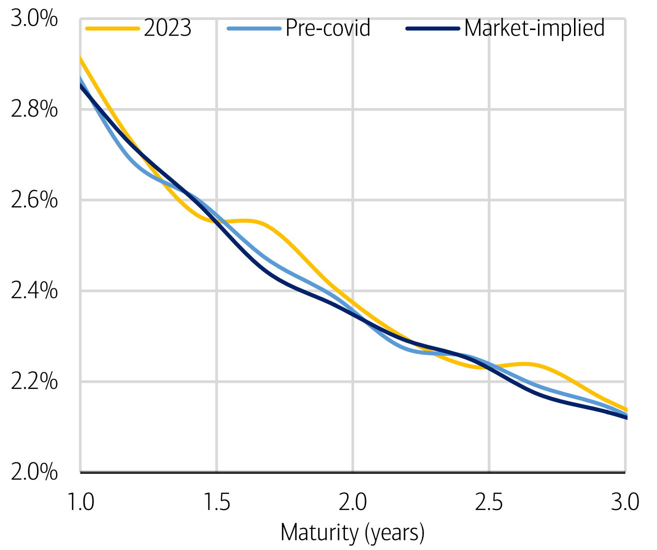
How did the market respond to SA revisions?

Consistent with our expectations, last week's revisions did not meaningfully impact market pricing of inflation (see: CPI Inflation Watch). For inflation markets, what matters is NSA headline CPI, the index that TIPS and inflation swaps reference. Many forecasters, including BofA economics, forecast in NSA terms. Therefore, seasonal factor revisions have a larger impact on SA inflation expectations than NSA inflation expectations. Indeed, inflation swaps and breakevens were little changed Friday on net.

How is the inflation market pricing seasonality?

We can back out what the market is implying for seasonality and see how it compares to what has been observed historically. In Exhibit 8, we show SA real yields under three seasonality assumptions: 1- 2023 historical, 2- pre-covid historical (2013-2019), 3- implied seasonality from far-forward CPI swaps. The assumption that smooths through TIPS seasonality the best is implied from CPI swaps. As shown in Exhibit 9, market-implied seasonality is less volatile than what was observed in 2023 and pre-covid. This suggests that seasonality may realize stronger vs what is reflected in market pricing.

Exhibit 8: SA real yield under different assumptions
Market-implied real yields from inflation swaps are the best fit



Source: BofA Global Research, Bloomberg; Note: pre-covid is average seasonality from '13-'19
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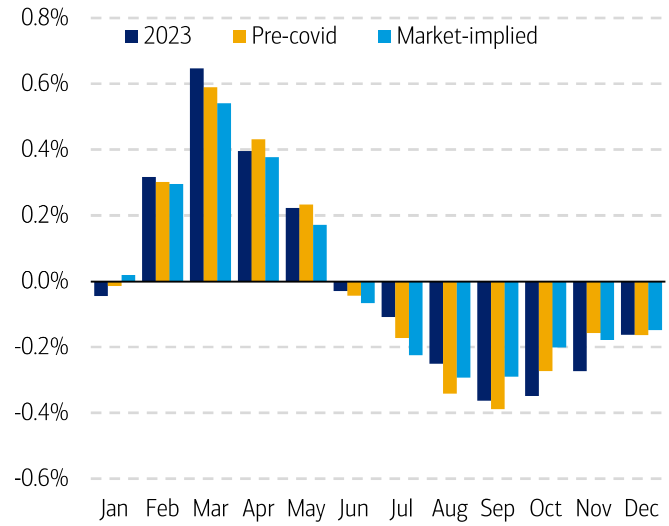
Exhibit 9: Seasonal adjustment assumptions by month (NSA/ SA)
Market-implied seasonality is lower than '23 and pre-covid



Source: BofA Global Research, Bloomberg; Note: pre-covid is average seasonality from '13-'19, lagged to align with inflation market, positive number = seasonally stronger NSA vs SA index
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If the 2023 seasonal pattern persists beyond the next year or two, rather than quickly mean-reverting to long-term market pricing (that looks more similar to pre-covid), then short-dated October issues look cheap. In Exhibit 10, we show this comparison using October '25 vs April '26 TIPS. Market implied seasonality suggests a -15bps spread vs a -24bps spread using '23 seasonality and -20bps using pre-covid seasonality. There is room for this spread to narrow by 5-10bps if seasonality comes in closer to what has historically been realized. While these are relatively low differentials, clients interested in buying short-dated TIPS, either outright or as part of long breakeven trades should prefer October vs April issues.

Exhibit 10: Oct '25 / April '26 spread using different SA assumptions
Market-implied SA spread has room to widen vs pre-covid and '23 assumptions

	NSA	SA 2023	SA pre-covid	SA market-implied
10/15/2025	2.11%	2.54%	2.47%	2.44%
4/15/2026	2.26%	2.30%	2.28%	2.29%
Spread	0.15%	-0.24%	-0.20%	-0.15%

Source: BofA Global Research, Bloomberg
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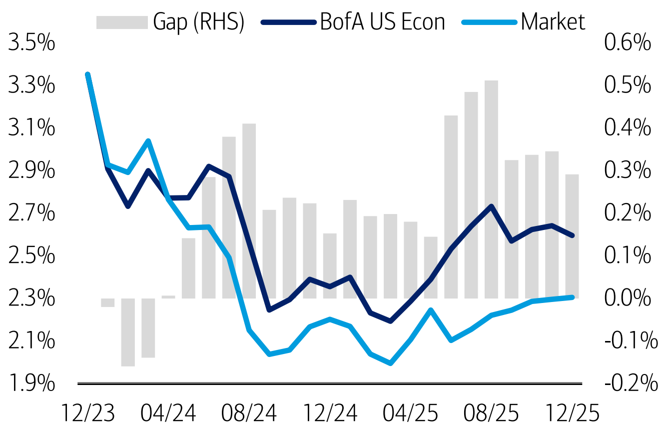
Favorite trades?

We hold our long 2y inflation swap position (see: Risks to market's downhill CPI path) and 5s10s real yield steepener (see: Cloudy with a chance of landing).

We continue to view the front end of the inflation curve as pricing a path of disinflation that is too optimistic. We think that the largest difference between the market and our forecasts (Exhibit 11) comes down to the speed and extent of rent disinflation but believe that upside risks are not adequately incorporated in pricing. We recommend expressing this through being long 2y inflation swap: current level = 2.25% (initiation 2.20%), target = 2.60%, stop = 1.90%. The risk to the trade is a downside growth and/ or commodity shock.

Exhibit 11: Market pricing of YoY headline CPI vs BofA Economist forecast
We are expecting slower disinflation vs market



Source: BofA Global Research
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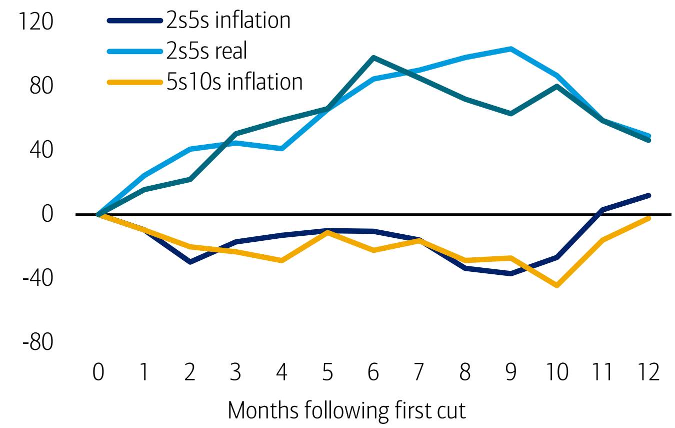
Exhibit 12: Real & inflation curves after first cut in 2007 (BPS)
Real yield curves initially steepened while inflation curves flattened 12mo after first cut



Source: BofA Global Research, Bloomberg, Note: TIPS and UST curves used
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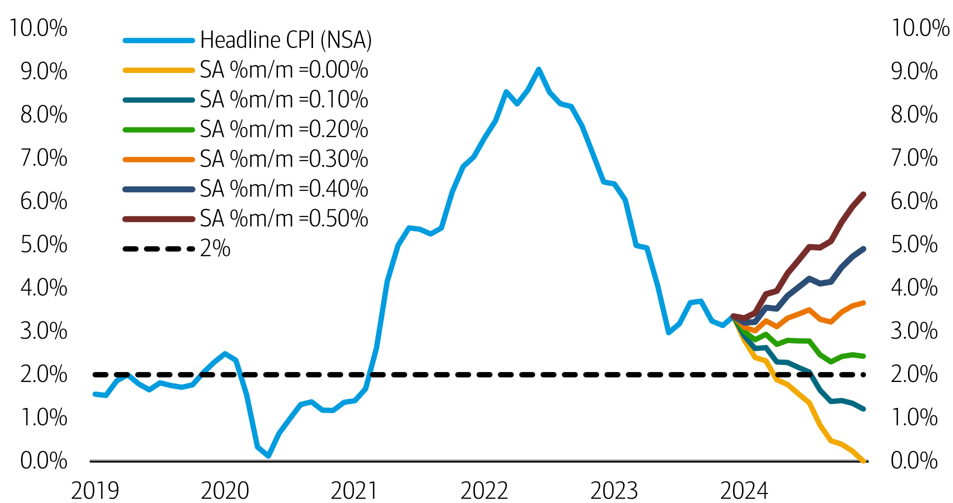
We also continue to favor 5s10s real rate steepeners. While the real yield curve has room to steepen, we are wary of the dis-inversion already observed in inflation swap and breakeven curves. We think real yield steepeners can perform in softer landing outcomes and led the steepening as the Fed delivered cuts in 2007 (Exhibit 12). Current level = 1bp (initiation = -6bps), target = 50bps, stop = -40bps. Risk to the trade is a flight to quality event that sees energy prices decline sharply and market illiquidity rise.

What would it take for the market to be correct on the pace of disinflation?

The market is pricing in a faster pace of disinflation this year than we expect. Indeed, the market expects headline CPI inflation to reach 2.2% by yearend compared to our forecasts for 2.4% y/y. In Exhibit 13, we perform a simple exercise to see what different monthly run rates of CPI imply for YoY headline.

Exhibit 13: Headline CPI implied from different monthly run rates of monthly SA CPI
A constant run rate of 0.2% would get YoY CPI down to 2.4% by December



Source: BofA Global Research, Haver
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We assume different rates for the seasonally adjusted % m/m prints for headline CPI ranging from 0% to 0.5%. Using these we simulate a path for the seasonally adjusted headline CPI index. Since the market prices contracts in not-seasonally adjusted terms, we then back into the not-seasonally adjusted number for each index by assuming the implied seasonal factor from 2023 holds in 2024. Based on this exercise, we think the market is assuming a run rate of 0.15% to 0.20% m/m for seasonally adjusted headline CPI. We think a sub 0.2% run rate will be hard to maintain as goods deflation moderates, but a faster pace of shelter disinflation than we expect would be a headwind to this view.

What are geopolitical risks to non-core components?

An important input in thinking about the path of headline inflation is risks around the commodity outlook. Since the start of the year the petroleum complex was jostled by geopolitical events that were mostly bullish for prices. Escalating Middle East tensions and attacks on ships in the Red Sea increased the risk premium in crude oil and refined product prices. Furthermore, the rerouting of trade away from the Red Sea continues to lengthen the petroleum (and global trade) supply chain, pushing up shipping costs and tying up more crude oil and refined products in transit. These dynamics widened regional fuel spreads and added a layer of 'demand' for oil. Oil's risk premium was nearly erased in early February on reports that Israel and Hamas made progress on negotiations, but it has since reflated as global conflicts continued to escalate.

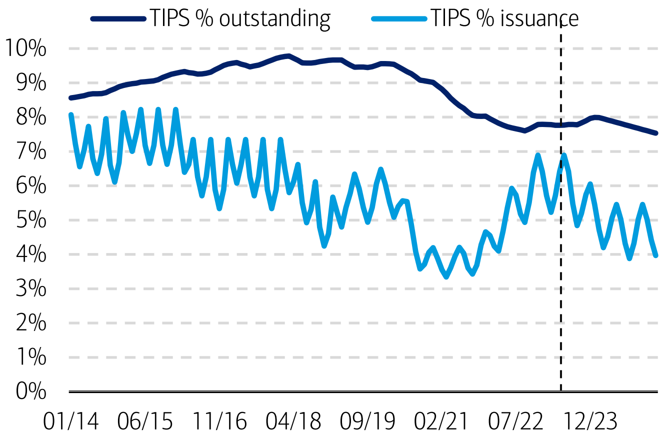
Middle East conflict has overshadowed the Ukraine war in its ability to influence oil prices recently, but a shift in Ukrainian strategy – targeting more energy infrastructure – has created significant upside risk for oil and energy prices broadly. Notably, numerous Russian refineries and processing facilities have been targeted by drone strikes in the past month. Outages have thus far been minor, but we think the risk of a material disruption in Russia is rising. Across the Atlantic, Venezuela is reportedly amassing troops along its border with Guyana in a dispute over the Essequibo region and associated territorial waters, which are currently under Guyanese control. Conflict in the region could threaten Guyana's meteoric oil production growth, an essential source of new oil supply in the medium term (see Non-OPEC supply low cost but not low risk), and lead to the re-imposition of sanctions on Venezuela, both bullish developments. We think that new refining capacity and increased crude oil supply outside OPEC+ should keep oil balances in check, but the risk of a crude oil or refined product supply shock is rising.

How has TIPS demand been evolving alongside growing supply?

In the latest refunding, UST delivered what we expect will be the last increase in TIPS auction sizes through the rest of the calendar year (see: Refunding recap). TIPS auction sizes have been increasing to keep up with coupon supply but will shift lower as a share of issuance in coming months given the outsized growth in nominal coupons (Exhibit 14).

Exhibit 14: TIPS as % of issuance and outstanding debt

TIPS as % of issuance is still lower than TIPS as % of outstanding and may diverge over time



Source: BofA Global Research, Bloomberg, US Treasury, Federal Reserve, Note: levels exclude inflation accrual, values after dashed line are projected from BofA supply forecasts

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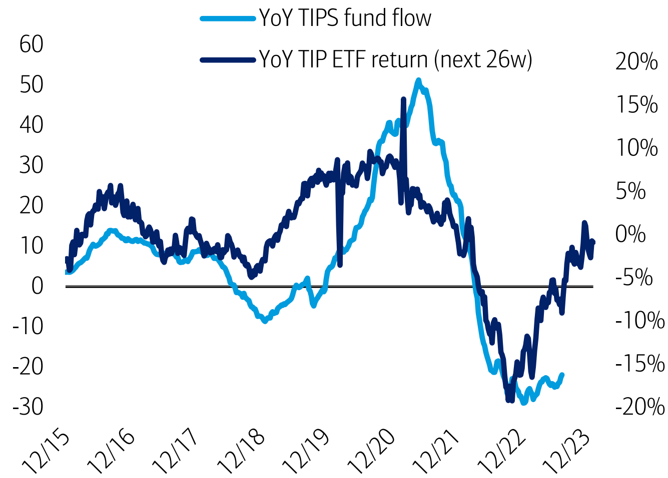
Exhibit 15: Fund flows and ETF returns

Fund inflows ($bn, LHS) tend to follow returns (RHS)



Source: BofA Global Research, Bloomberg, EPFR

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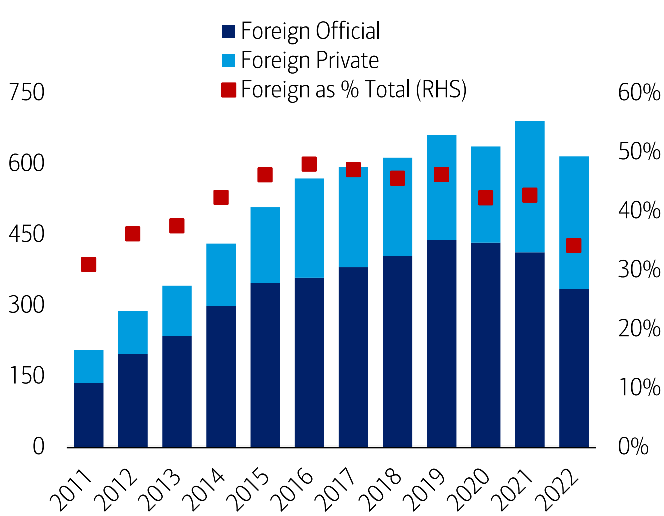
In recent years the largest flows in the TIPS market have been driven by inflation funds and the Fed. Fund inflows were historically large in 2020-2022, pivoted to outflows since, and now appear to be showing early signs of bottoming (Exhibit 15). A bottoming of these outflows can help support valuations at the belly of the curve where fund flows have been most prominent. While we believe that the Fed eventually reinvesting maturing MBS into the UST market after QT ends can be particularly supportive for TIPS (see: 10 FAQs ahead of CPI), we now anticipate QT will likely continue through the rest of the year (see: January FOMC recap).

Foreign buying of TIPS is challenging to monitor given limited data, but as of June 2022 TIC showed that the share of TIPS held by foreign investors has been on the decline (Exhibit 16). Foreign investors have consistently been taking down less than 25% of auctions (Exhibit 17). Strong investment fund demand is likely stemming from inflation hedge funds strategies and index funds which have both grown in prominence.

Exhibit 16: Foreign holdings of TIPS ($bn)

Foreign holdings of TIPS have been declining



Source: BofA Global Research, US Treasury

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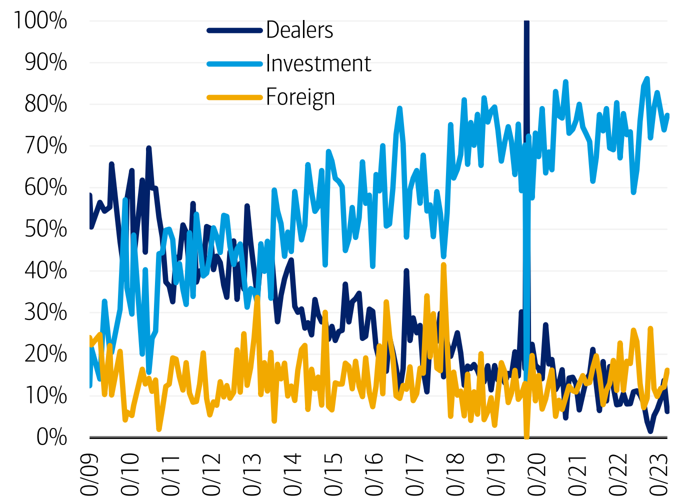
Exhibit 17: TIPS auction allotments

Investment funds have been taking down largest share at auctions while foreign investors remain less than 25%



Source: BofA Global Research, US Treasury

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