

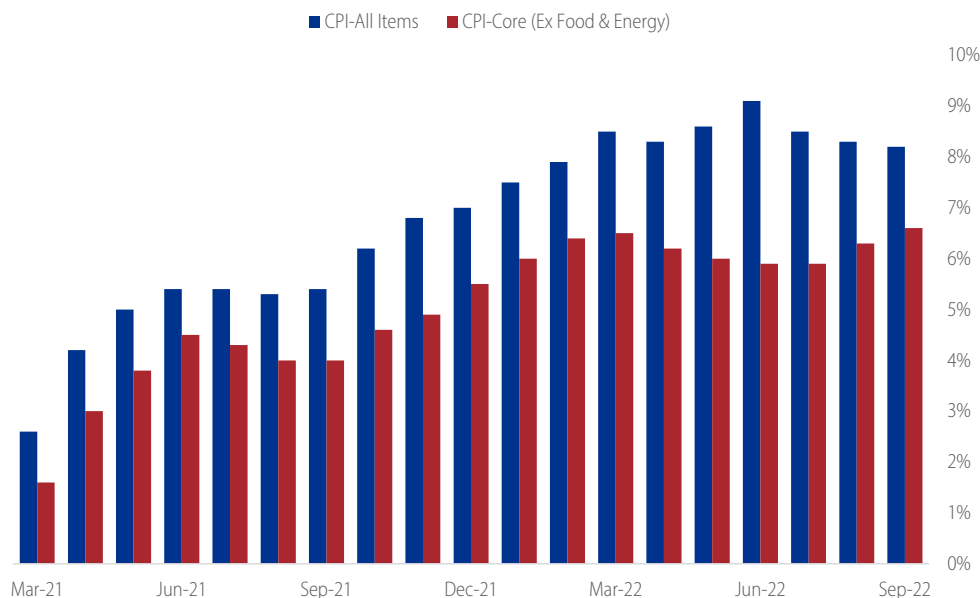
Markets Sag on Ugly Inflation Report

The September consumer price index (CPI) was expected to show an inflation rate still much too hot for Fed officials to consider anything other than dousing it with another big rate hike. This morning's release from the U.S. Bureau of Labor Statistics more than met that expectation with headline CPI rising +0.4% last month, *doubling* the +0.2% median forecast. The September increase follows a +0.1% rise in August and an *unchanged* reading in July.

On a year-over-year basis, overall CPI was up +8.2%, slightly above the +8.1% forecast. The annual rate peaked at +9.1% in June and has subsequently decreased in each of the past three months, *but at a maddeningly slow pace of decline*.

Spending on goods has given way in recent months to service spending, and the shift was evident in the September consumer inflation report. Core goods prices were unchanged in September while core services rose +0.8% with the cost for medical care (+1.0%), transportation services (+1.9%), food away from home (0.9%) and shelter (+0.7%) all rising sharply. Shelter costs, are notoriously sticky, and make up a third of overall CPI and about 40% of the core.

Consumer Price Index (Year-over-Year Percent Change)



Source: Bureau of Labor Statistics

Overall energy prices fell -2.1%, the third consecutive monthly drop. Driving the energy decline again last month was gasoline, which fell -4.9%. Unfortunately, falling pump prices can't be counted on for the October report. AAA reported an average gas price of \$3.91 this morning, up from \$3.71 a month earlier. Other notable decreases were found in used vehicles (-1.1%), lodging away from home (-1.0%) and apparel (-0.3%).

Scott McIntyre, CFA

HilltopSecurities Asset Management
Senior Portfolio Manager
Managing Director
512.481.2009
scott.mcintyre@hilltopsecurities.com

Greg Warner, CTP

HilltopSecurities Asset Management
Senior Portfolio Manager
Managing Director
512.481.2012
greg.warner@hilltopsecurities.com

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Core CPI, which excludes food and energy prices, climbed +0.6% for the second straight month, well above the median forecast of +0.3%. The core is now rising at a +6.6% annual rate, a new cycle high and the hottest reading since 1982. The shelter index climbed +0.7% for the second straight month, and is now rising at a +6.6% annual pace. Home prices are expected to fall in the coming months, locking out many prospective buyers and keeping steady pressure on rents.

The markets have grown impatient, but the Fed's tools are limited and take time to fully implement. With the November FOMC meeting now less than three weeks away, another 75 bp rate increase is now fully priced-in. This morning's ugly report isn't likely to alter Fed's immediate policy path, but it has increased the likelihood of additional rate hikes after November. Following a huge post-release sell-off in the bond market this morning, futures are indicating better than a 50% chance of yet another 75 bps increase at the December meeting. The implied funds rate peak has now risen to 4.91% in March, 60 bps higher than a month earlier.

Bond yields are at new cycle highs along much of the curve, with the 2-year Treasury note at 4.47%, the highest level since 2007, and the 10-year at +3.98% for the first time since 2008. The U.S. dollar is strengthening this morning with increased expectations for more aggressive future Fed policy, worsening the inflation battle overseas.

There is no positive spin for this report.

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Market Indications as of 9:22 A.M. Central Time

DOW	Down -209 to 29,001 (HIGH: 36,800)
NASDAQ	Down -181 to 10,236 (HIGH: 16,057)
S&P 500	Down -40 to 3,537 (HIGH: 4,797)
1-Yr T-bill	current yield 4.43%; opening yield 4.19%
2-Yr T-note	current yield 4.49%; opening yield 4.29%
3-Yr T-note	current yield 4.49%; opening yield 4.31%
5-Yr T-note	current yield 4.26%; opening yield 4.12%
10-Yr T-note	current yield 4.00%; opening yield 3.90%
30-Yr T-bond	current yield 3.94%; opening yield 3.88%

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