

Producer Prices Fall Once Again, Dragging Bond Yields Lower

This morning, the December PPI report told a much different story than yesterday's CPI release as producer prices signaled *deflation* at the wholesale level for the third consecutive month. Whereas consumer prices had been warmer than expected in December, producer prices were much cooler. Headline PPI unexpectedly fell -0.1%, while the previously reported *unchanged* reading for November was revised downward to -0.1%. For all of 2023, overall PPI rose by just +1.0% compared to +6.4% in 2022. When food and energy are excluded, core PPI was up +0.2% for the month and +1.8% year-over-year.

PPI reflects the prices U.S. producers pay for goods and services, while CPI measures retail prices paid by consumers. As a result, PPI is considered to be a *leading indicator*, although the filter-down correlation with CPI isn't nearly as strong as implied. PPI has recently gained importance with the market's overall focus on inflation, but also because several of the PPI components feed into the Personal Consumption Expenditures (PCE) index, a preferred inflation measure of Fed officials. This morning's cooler PPI numbers hint at an improved December PCE report, which is scheduled for release just days before the FOMC announcement on February 1.

Immediately after this morning's release, the bond market accelerated a rally that began late yesterday afternoon, driving the 2- and 3-year Treasury yields down to their lowest levels *since last May*. Yesterday's rally reflected a nervous market, concerned that the conflict in Gaza may be escalating after a coalition force, led by the U.S., struck Houthi targets in Yemen in response to a series of attacks by the Iran-backed fighters on commercial ships in the Red Sea. Houthi rebels have been disrupting sea trade for months in support of Hamas, and defied an ultimatum issued earlier this week by coalition forces to end the attacks.

The longer term effect of the evolving geopolitical events on both the economy and the markets are far from clear. Escalating conflict in the Middle East should put upward pressure on energy prices, while shipping costs are already moving higher. Both of these increases suggest further progress in the inflation fight could stall, complicating policy decisions by the Fed and presumably delaying the first rate cut. At the same time, the prospect for war usually reduces appetite for market risk as investors seek the "safe harbor" of government bonds, maintaining downward pressure on yields.

Uncertainty has contributed to another volatile week for both stocks and bonds. Unfortunately, there is little reason to expect things to calm down in the coming weeks. The U.S. is once again facing a shutdown of all but essential federal government services. Although congressional leaders have agreed on a \$1.66 trillion budget compromise, there isn't enough time to enact legislation before the deadline a week from today. A continuing resolution to fund the government until a budget deal can be passed does not have the support of the GOP Freedom Caucus.

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Market Indications as of 1:52 P.M. Central Time

DOW	Down -148 to 37,563 (HIGH 37,715)
NASDAQ	Down -4 to 14,966 (HIGH: 15,188)
S&P 500	Up 0 to 4,780 (HIGH: 4,783)
1-Yr T-bill	current yield 4.65%; opening yield 4.74%
2-Yr T-note	current yield 4.14%; opening yield 4.24%
3-Yr T-note	current yield 3.92%; opening yield 4.00%
5-Yr T-note	current yield 3.83%; opening yield 3.87%
10-Yr T-note	current yield 3.95%; opening yield 3.96%
30-Yr T-bond	current yield 4.20%; opening yield 4.17%

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