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Investment Insight

Inflation Held Steady in December

Morningstar Investment Management LLC
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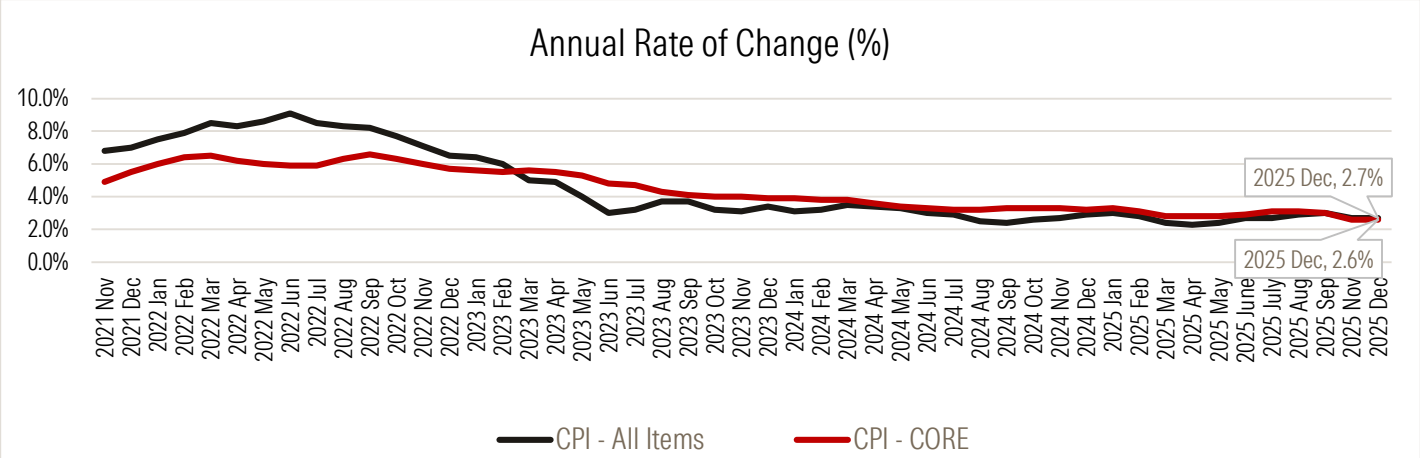
Key Takeaways

- December CPI was in line with expectations as headline inflation maintained an annual rate of 2.7%, following a 0.3% increase for the month. Core CPI rose at a 2.6% annual rate in December, below the expected 2.7% rate after rising by 0.2% for the month, also 0.1% below expectations.
- Equity markets are rallying, led by growth and small-cap stocks. Treasury bond yields are holding steady.
- Futures markets now project that the Fed will hold rates steady this month but show a 92% likelihood the Fed will cut rates at least once in 2026, and a 66% probability they will cut at least twice in 2026.

Summary

The December inflation report showed that the increase in consumer prices was inline or slightly below expectations. While today's inflation figures remain above the Fed's stated 2% target, their trends remain stable to slight declines despite the Fed lowering interest rates three times in late 2025. This allows the Fed to focus on weakening employment data, paving the way for additional interest rate cuts in 2026. Three of the last four monthly employment reports have been quite weak, partially as a result of backward-looking negative revisions to previous months' totals.

In today's release, we learned that Headline CPI increased by 0.3% in the month of December, which held the annual rate steady at 2.7%, both of which were exactly in line with expectations when including all items consumers buy. The current annual rate is below the 2.9% rate from the end of 2024 confirming inflation subsided a bit year-over-year despite the implementation of new tariffs and other restrictive trade policies. This is somewhat surprising as most economists expected the tariffs announced on "Liberation Day" in April to push consumer prices higher for the year, and while there was a temporary increase over 2024's level the impact has been far more subdued than anticipated. The Core CPI, which excludes food and energy prices due to their short-term volatility, rose less than expected in December, posting a monthly increase of 0.2% bringing the annual rate down to 2.6%, both of which were 0.1% below forecasts.



Source: Bureau of Labor Statistics as of 1/13/2026

The December report was important as there were concerns that the October and November inflation data was artificially skewed lowered as the government shutdown caused a slowdown in economic activity. That potential slowdown could have put downward pressure on prices, driven by a decrease in the demand side of the equation—seeing steady inflation data following the shutdown should help alleviate those concerns.

Beneath the Headline

The shelter category, one of the main drivers of inflation persistence, increased 0.4% for the month and rose 3.2% on an annual basis. Shelter has a large impact on the weighted average calculation of CPI and therefore has accounted for the largest contribution to the 2025's increase. Food prices, something consumers are very sensitive to as they face it daily, jumped 0.7% for the month. Energy prices rose less than the Broad Index, rising only 2.3% for the year. In a reversal of recent trends used cars and trucks showed deflation as their prices declined 1.1% for the month. New car prices were flat month-over-month also reversing trend from consistent increases over much of 2025.

Market Reaction

Equity markets are generally moving higher across the board continuing their positive tone to kick off 2026. Per the Morningstar Style Box breakdown, as of 8:45 AM CST, the equity rally is being led by growth and small-cap stocks, both of which are often buoyed by lower interest rates.



In the fixed-income market US Treasury yields are holding steady across the yield curve, with the 10-year US Treasury yield holding at 4.18%. The 30-Year Treasury yield, which is generally most sensitive to inflation, is lower by 0.01% to 4.83%

Looking Ahead

Equity markets have been strong to start the year despite a myriad of unexpected headlines around geopolitical events and rising domestic political tensions. The belief that the Fed has a clear path to lower interest rates further in 2026 is likely contributing to these. Although inflation remains stubbornly above target it is inching lower, but more importantly, not rising, which will allow the Fed to lower rates if their concerns around weakening labor markets persist. Morningstar's Economics team believes the Fed will cut rates two to three times in 2026. While the timing of any cuts can be debated, CME Fed futures show only a 5% probability of a rate cut at the Fed's next meeting in January. Longer term, expectations of a cut increase with futures showing a 92% probability of at least one cut in 2026 and a 66% probability of at least two cuts in 2026.

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