



Markets Absorb Inflation Noise as Rotation Broadens

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Markets pushed to new highs again last week as investors looked past headline inflation noise and focused on improving breadth beneath the surface. Earnings season is just getting underway, but what has already been notable is the rotation—away from the largest growth names and toward smaller-cap and value-oriented stocks—suggesting a healthier and more durable market advance rather than a narrow handful of mega-cap leaders.

On the inflation front, the CPI and PPI reports were broadly in line, and certainly not alarming. The nuance, however, lies beneath the surface. The PPI did see upward revisions to prior months, and some careful dissections suggest that the December PCE deflator—the Fed’s preferred measure—could print closer to four-tenths of a percent. That is not ideal, but it is also not destabilizing. The most encouraging aspect of the CPI was that it held steady despite shelter costs rising four-tenths. We know from private rental data that housing inflation has been flat for more than two years, so there is every reason to believe shelter inflation will decelerate meaningfully in upcoming reports. Our own measure of core CPI subbing in more real time rents for the BLS shelter series shows Core inflation of only 1.6% instead of 2.6%. Even with that lagged distortion, inflation data remain consistent with gradual disinflation, not a reacceleration.

Growth data remain strong but uncertain in magnitude. The Atlanta Fed is still tracking fourth-quarter GDP above 5%, but that estimate is heavily influenced by trade flows—particularly gold imports—which can materially distort GDP accounting. Once that noise is stripped out, I expect growth to settle lower, but still impressively resilient given the government shutdown and tighter conditions of the past year. Importantly, nothing in the growth data points to an imminent downturn.

The labor market continues to confirm that view. Initial jobless claims fell to 199,000—still signaling no meaningful deterioration. There may be minor seasonal adjustment issues lingering from the turn of the year, but even if claims drift modestly above 200,000, they remain far from levels associated with recession. This is one of the most timely indicators we have, and it shows no stress.

There was also considerable noise this week around speculation of legal action involving the Fed and Chair Powell. I view this as largely silly political theater. Powell’s term will expire well before any hypothetical legal process could have real impact, and it is historically unprecedented for a Fed chair to remain on the Board after stepping down.

Markets briefly reacted to the headlines, but the episode does not alter monetary policy or the Fed’s trajectory. More importantly, the Fed has now entered its pre-meeting quiet period, which all but guarantees no rate hike at the upcoming January meeting. That is effectively a settled question. March remains the earliest plausible window for a cut, contingent—as always—on incoming inflation and labor data.

What has been far more consequential for markets is the rotation now underway. Large-cap growth stocks have pulled back roughly 10% to 12% relative to value, and while we have seen reversals of this magnitude before—most notably during tariff-related volatility last spring—this one appears more durable. Small-cap stocks, in particular, have real momentum behind them. Valuations are compelling, earnings expectations are improving, and investors are reassessing concentration risk after years of dominance by a narrow group of AI-linked names. Questions around competition and innovation in artificial intelligence have not derailed the long-term story, but they have capped near-term multiple expansion and encouraged diversification.

Crucially, this rotation is occurring even without a dramatic shift in rate-cut expectations. What we are seeing instead is a decline in mortgage and term premia, helped by reduced long-bond volatility and the possibility—still speculative—that policy support for mortgage-backed securities could narrow spreads further. Mortgage rates are now at multi-year lows. I

continue to believe the neutral Fed funds rate is closer to the low 3% range, and while March is the earliest plausible cut, the direction of policy is clear over the course of this year, to the benefit of small stocks..

As earnings season unfolds, results will ultimately determine how far this rotation can run. But small-cap stocks do not require heroic earnings growth to perform well from today's valuation levels. If earnings merely stabilize and the Fed continues its gradual pivot toward easing, the case for broader market leadership remains strong. This is the kind of environment where diversification finally pays off.

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