BULL & BEAR BULLETIN

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Inflation Hawks are sticking around, but will they overstay their welcome?

Inflation, the broad rise in the level of prices for a sustained period, has hampered consumers and producers for over a year. We are experiencing this through our grocery, utility and gas bills; however, in recent months, inflation has risen at a slower pace in part due to the Federal Reserve's tightening measures as well as slower economic output.

With both October and November inflation data releases surprisingly to the downside, we have begun to see a deceleration in prices more notably from the highs of 9.1% year-over-year we experienced for the month of June 2022. As noted in a previous publication, there is a lag between the Federal Reserve's rate hikes and the tightening effect it has on the economy. Given the start of rate hikes in March 2022, we are already starting to see softening in many leading edges of the economy, while at the same time labor market resilience prevents a full-fledged downturn.

The Consumer Price Index (CPI) for November came in at 7.1% year-over-year and 0.1% month-over-month. Core CPI, which excludes the two most volatile components, food and energy, came in at 6% year-over-year and 0.2% month-over-month. Both these numbers beat expectations to the downside and generally moved lower over the last two months. This is a good directional trend, though policymakers likely want to observe lower absolute levels before they halt the tightening cycle. Energy costs and used cars were the main drivers of cooling inflation month-over-month, as seen in the tree map below. On the other hand, shelter and food items were the main drivers of the monthly increase in inflation. More broadly on a year-over-year basis, services inflation remained persistent while goods inflation dropped again.

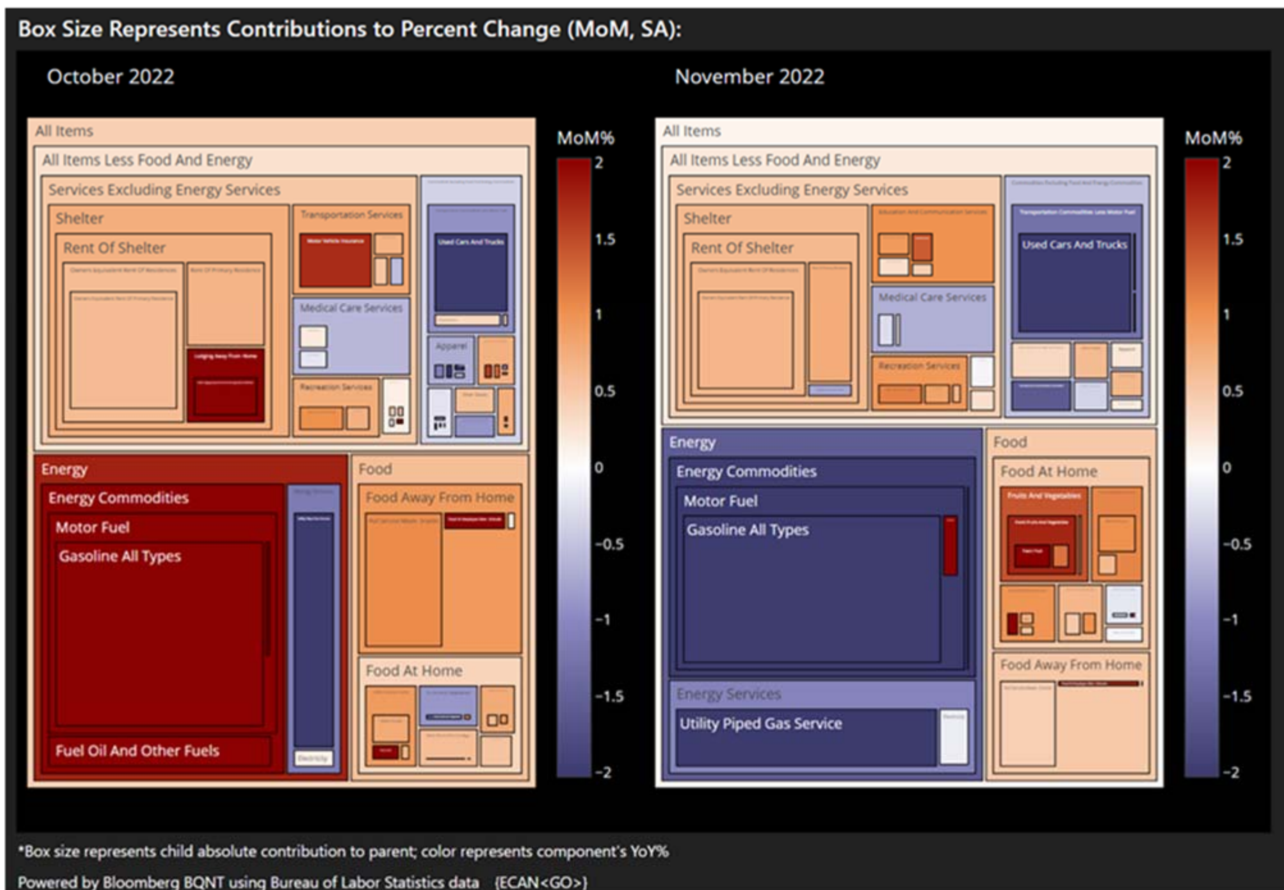
Shelter makes up about one-third of the CPI and consists of total spending on rented and owned housing. Housing prices have already begun to fall month-over-month starting in July, as seen in the S&P/Case-Shiller Home Price Indices. A softening of rents could follow. A deepening disinflation trend in 2023 could lead to the Federal Reserve pausing their tightening in order to assess the effects of the tighter policy. In this type of environment, if investors see a contractionary economy just around the corner, longer duration bonds of high quality and less cyclically sensitive areas of the stock market could be more favorable in investor portfolios.

Alternatively, a stubborn inflationary dynamic could emerge. The "long and variable lag" phrase is often being heard in the financial press and from policymakers. This is an attempt to describe how the effect of monetary policy transmits through to the economy. Some economists and investors believe that the extraordinarily large monetary and fiscal stimulus seen in 2020 and 2021 will require a longer restrictive policy period in order to withdraw excesses from the system.

Any potential resilient inflationary condition would likely be further exacerbated by factors such as supply chain constraints, deglobalization trends and the reopening of China's economy, which could all keep price instability from subsiding. In this type of environment, investors could look towards sectors like energy, commodities, materials and industrials and seek out companies whose profits are able to remain resilient due to a continued pricing power.

This most recent Federal Reserve meeting demonstrated that policymakers are continuing to signal that the greater threat to individuals, businesses and general economic well-being would be persistent inflation. This is to say that their prevailing desire is to prioritize a suppression of inflationary pressures over simply preserving the economic growth cycle.

The Fed's hawkish posture likely increases the probability that they will be successful in the inflation fight and that this will ultimately catch up to the business cycle in the form of a growth slowdown and possibly an outright economic contraction. It is the "long and variable lag" to policy which by definition makes the timing of a cycle downturn difficult to foresee. It will be important going into next year to monitor very closely the trends in savings, consumption and coincident economic indicators in order to detect any potential incoming weakness.



Source: Bloomberg

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