Weekly Market Commentary

November 14, 2022

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Politics and inflation took center stage this week. While Wall Street abhors surprises and uncertainty, both were on full display, injecting more turbulence into the markets than seen in some time. In fact, some Treasury yields underwent the biggest one day drop in more than a decade on Thursday, while stock prices whipsawed violently on Wednesday and Thursday, when they staged the strongest daily gain since early 2020. Things calmed down on Friday, as the bond market closed for the Veterans Day holiday. Stocks extended Thursday's rally, however, ending the week a solid 5.9 percent higher and leaving Wednesday's 3.2 percent plunge in the S&P 500 in the dust.

The tumult got its spark from the mid-term elections on Tuesday, which featured a better-than-expected outcome for the Democrats (the surprise) and, more importantly, left investors pondering which party would be in control on Capitol Hill (the uncertainty). It looks like the chambers will have different majorities, although races in both the House and Senate were still unresolved as of this writing on Friday. With a split verdict likely, the prospect of legislative gridlock looms large, something that may or may not be favorable for the financial markets. It does, however, set the stage for acrimonious battles over raising the debt ceiling, tax and spending legislation, a possible government shutdown, the administration's climate agenda and funding for Ukraine, not to mention non-fiscal matters, such as investigations that would hardly provide a calming backdrop for the markets.

But as headline-grabbing as the midterm elections are, they were overshadowed by Thursday's key inflation report, which ignited the astonishing rally in stock and bond prices that day. Economists are fond of slicing and dicing important economic reports to come up with nuggets that confirm various viewpoints. But there was little to dispute over the consumer price report for October, which unequivocally revealed a slower pace of price gains. The headline CPI increased 7.7 percent from a year ago, a dramatic slowdown from the 8.2 percent increase in September. The annual core inflation rate, that strips out volatile food and energy prices, fell to 6.3 percent from 6.6 percent. The month-to-month readings were just as encouraging; the overall CPI increased 0.4 percent in October, the same as the previous month but well under expectations, while the core CPI downshifted to a 0.3 percent increase from 0.6 percent in September.

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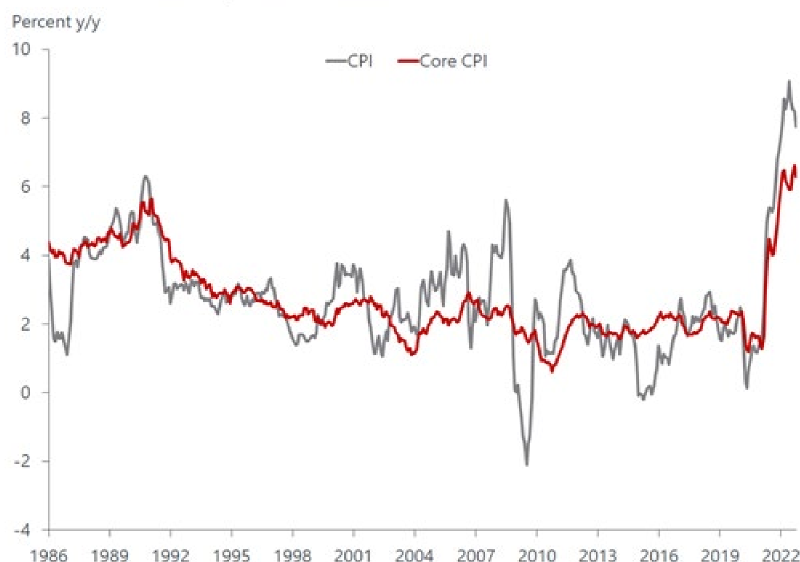


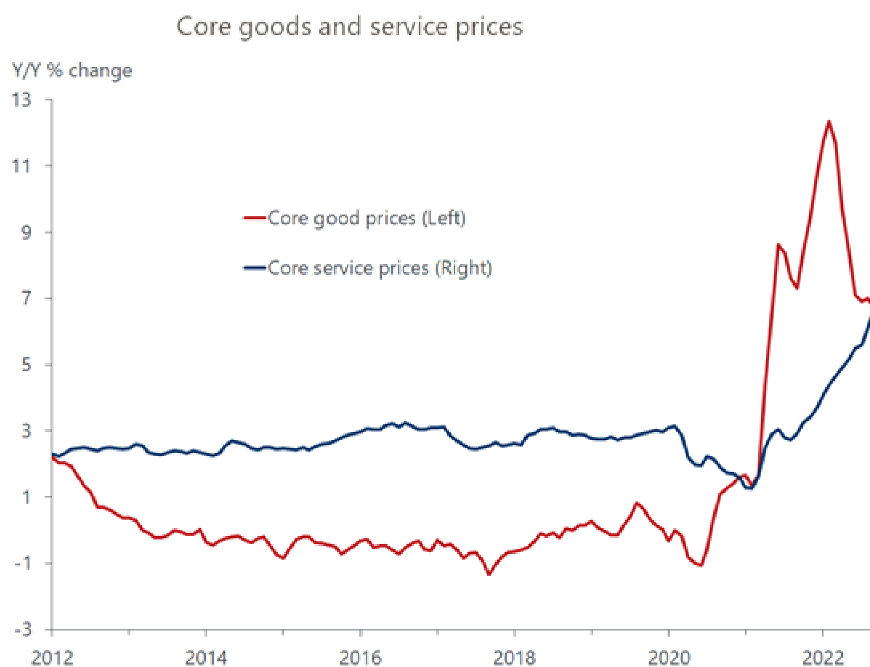
What a difference a month makes. The CPI report for September also shocked the markets, only in the opposite direction as it conveyed hotter inflation readings than expected. That month, the core CPI accelerated to a 6.6 percent year-over-year increase from 6.3 percent which sparked a market reaction that was the mirror image of what happened this week. Importantly, that report was arguably the proximate catalyst for the Fed's increasingly hawkish sentiment at the following FOMC meeting, which produced the fourth consecutive 0.75 percentage point rate hike and heightened perceptions among traders that a like-sized increase would be forthcoming at the December meeting. The discussion swiftly turned to how high rates would eventually go to curb inflation, with the consensus expecting it to exceed the 4.6 percent terminal rate that the Fed had projected. Some were convinced that the federal funds rate would have to surpass the five percent threshold before the end of 2023.

Fast forward to this week, and morale has been turned on its head – from deeply pessimistic to highly sanguine. For one, the markets have abruptly dialed down expectations of what the Fed will do at the December meeting, pricing in a 50-basis point hike in the federal funds rate instead of 75 basis points. For another, expectations that the terminal rate will need to climb to five percent or higher have been watered down, with the markets betting that the Fed can throttle back its rate-hiking campaign well before the end of the year. The odds that it will actually start cutting rates sooner rather than later have also increased markedly. Simply put, the widespread expectation following the latest CPI report is that the peak in inflation is behind us and pressure on the Fed to hike rates has lessened. A less aggressive Fed tightening, in turn, reduces the risk of an imminent recession – or at least a less severe one – spurring optimism among stock traders that profits would not be crushed.

While we agree that the inflation peak is probably in, we caution against reading too much into the latest consumer price report. For its part, the Fed is not convinced that a one-month slowing is enough evidence of an entrenched trend. We have seen false dawns during this inflation cycle before, including the head-fake last summer when price gains slowed but soon returned with a vengeance. Fed officials are very averse to declaring victory prematurely and then forced to resume tightening even more aggressively when their assessment turns out to be wrong.

That was the case in the 1970s when sporadic pauses in the inflation cycle produced stop-and-go policy shifts that ultimately failed to prevent inflation from gaining traction. That, in turn, resulted in the growth-crushing rate hikes that ushered in two deep recessions in the early 1980s.

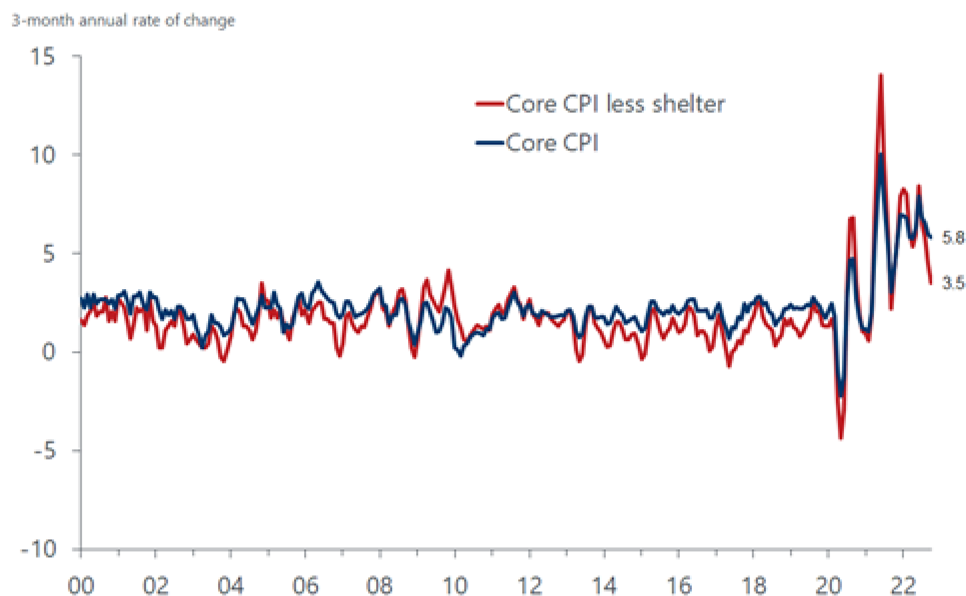
The good news is that there are compelling signs the inflation slowdown can continue. For one, the supply-side bottlenecks that underpinned much of the upward price pressures last year and early this year are easing; most notably, the computer chip shortage that propelled car prices sharply higher has all but disappeared, and the response has been dramatic. Prices of used cars and trucks have fallen in each of the past four months, including a sizeable 2.4 percent drop in October. For another, the distortions in consumer buying patterns caused by the pandemic are unwinding, as households are resuming normal purchasing habits, spending more on services and less on goods, easing pressures on goods prices. For the first time in two years, core goods prices are rising at a slower year-over-year rate than core service prices.



The bad news is that service prices, which are bigger drivers of inflation, are more resistant to a slowdown. One reason is that service providers are more labor intensive than goods producers and prices of services are more closely linked to labor costs. With the job market still running hot, though cooling somewhat, and worker shortages particularly acute in the services sector, employers are forced to pay higher wages and strive to pass on the increased costs to customers whenever possible. Their ability to make price increases stick reflects, in good part, the willingness of consumers to accept them. That, in turn, is a signal to the Fed that more rate increases are needed to cool off demand.

For another, the largest component of the consumer price index – accounting for 40 percent of the core CPI – is housing, where prices continue to climb at an elevated pace. Overall shelter prices rose 0.8 percent in October, the biggest monthly increase since August 1990. Take out shelter and the cooling of inflation looks much more dramatic.

On an annualized basis, the increase in the core CPI over the past three months slowed to 5.8 percent from a nearby peak of 7.9 percent. Excluding shelter costs, that slowdown is far more pronounced, falling to 3.5 percent from 8.4 percent over the same period. Still, while housing costs, primarily rents, are more resistant to change than most other prices, they are poised to slow as well.



Simply put, the latest consumer price report is an encouraging omen for inflation doves but is far from enough to prompt the Fed to take its foot off the brakes anytime soon. To be sure, some Fed officials have hinted even before the price report was released that a slower pace of rate hikes might be appropriate. The CPI report probably pushed up the timing of this prospect to next month, pointing to a smaller half-point rate hike at the December meeting. Importantly, however, the next CPI report will be released the day before the FOMC meeting concludes on December 15, which could muddy the waters. Keep in mind, too, that the Fed will have another jobs report before the meeting, and any upside surprises – on job growth or wages – could muddy the waters as well. Finally, the Fed is probably not overly happy about the robust market reaction to this week's CPI report. The torrid 5.5 percent increase in the S&P 500 on Thursday alone boosted household wealth by about $1.5 trillion, a potential lift to purchasing power that is at odds with the Fed's attempt to cool off demand – and curb inflation.