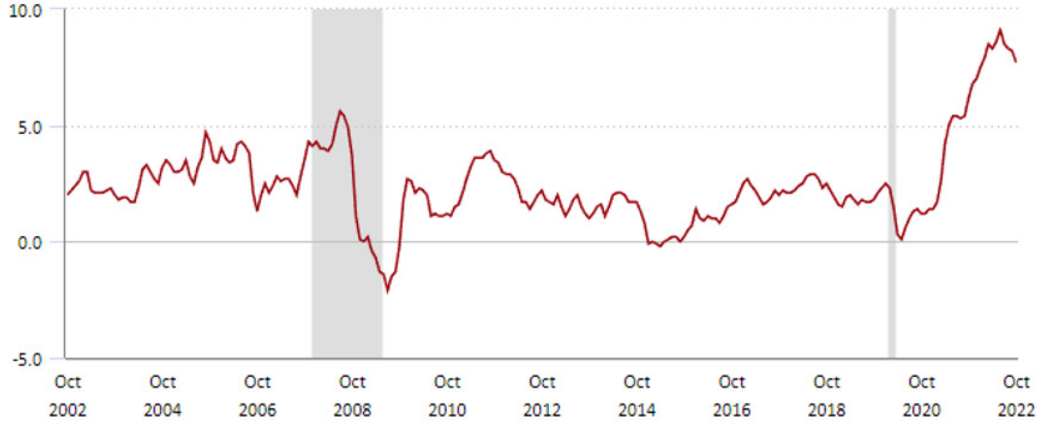
Week in Review

Friday, November 18, 2022

Markets Celebrate a Slowdown in Inflation

Last week the markets responded very positively to the release of the Consumer Price Index. The index increased 7.7% for the 12 months ended October which was the smallest 12-month increase since the period ending January 2022, preceding the outbreak of the Ukrainian war.

12-Month Change in Consumer Price Index



Hover over chart to view data.
Note: Shaded area represents recession, as determined by the National Bureau of Economic Research.
Source: U.S. Bureau of Labor Statistics.

Following the 8.2% increase from the previous month, the 7.7% annual pace in October was a welcome slowdown and was well below expectations of 8.0%. Financial markets responded very favorably with the stock market seeing some of the strongest gains since March 2020.

The positive response by the financial markets was driven by the expectation that lower inflation will give the Federal Reserve scope to slow down interest rate increases. Lower interest rates deliver both positive valuation support and increase hope for a softer slowdown for the economy.

This week further reassuring inflation data was released with the Labor Department's U.S. producer price index for the 12 months ending in October coming in at 8.0% versus 8.3% expected and down from 8.5% in the preceding month. Once again, the market rallied on the data, although to a lesser degree than in the prior week.

However, before getting too excited, the positive inflation data is just for one month and the absolute level remains very high. The data suggest inflation has likely peaked and is set to come down, but the Federal Reserve Board is unlikely to change the expected trajectory for another 50-basis point increase to the Federal funds rate in December and bias for keeping the rate higher for longer. Federal Reserve officials have stressed they want to see several months of decelerating price gains to be convinced they have made progress in fighting inflation.

Another growing dampener on market sentiment is the rising probability of an economic recession in 2023. Following the release of inflation data, yield curves have become more inverted and expectations for negatively revised earnings forecasts for 2023 have risen. To offset the potential of lower corporate earnings in 2023, stabilization of interest rates may not be good enough to support markets as the belief that rates will actually be cut may be needed.

The next release of inflation data will come on lucky December 13th with the final Federal Reserve meeting for the year occurring the following day. The cadence for the markets into the final weeks of 2022 will likely be driven by the outcomes on those days. Until then, financial markets have at least been given a respite from the heavy weight of inflation.