

# Two events this week will set the stage for 2023



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## Inflation

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## Interest rates

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Last week I wrote about how this could be a December to remember for the global economy. And for the US in particular, this is a critical week with two very important events happening that will help set the stage for 2023: the release of the latest US inflation figures, and another likely interest rate hike from the US Federal Reserve. Here are some thoughts on both of these anticipated events:

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#### 1. Inflation.

This week we'll get the US Consumer Price Index (CPI) reading for the month of November. This is important because it will tell us whether October's print was an aberration or the start of a trend toward inflation moderation. I believe it's far more likely to be the latter than the former, but there is certainly fear on the part of many that inflation could be higher than hoped, given the higher-than-expected US Producer Price Index print last week. One indicator that suggests inflation could be easing is the Citi US Inflation Surprise Index. After a dramatic climb in which inflation was repeatedly higher than expectations, this index has now fallen significantly, retracing much of the previous rise, as inflation has been lower than expectations. This was supported by the New York Fed's recently released readings of consumer inflation expectations.<sup>1</sup> Median one-year ahead inflation expectations fell to 5.2% from 5.9% the previous month – a significant drop. Median three-year ahead inflation expectations eased from 3.1% to 3%, also moving in the right direction. And median five-year ahead inflation expectations also dropped from 2.4% to 2.3%.

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#### 2. Interest rates.

The Federal Open Market Committee (FOMC) meets Dec. 13 and 14, and I expect a 50 basis point hike to be announced. However, I believe the FOMC's decision on how much to hike rates this month will be far less important than what it says about the future path of monetary policy, and we will hear about that in three ways:

- The "dot plot" – which illustrates where each FOMC participant projects the fed funds rate to be for the coming year – will give us a good sense of expectations for when the Fed could hit the "pause" button and what the terminal rate could be.
- And of course, the language in the FOMC announcement will also be important. In particular, the word "ongoing" in the sentence "the Committee anticipates that ongoing increases ..." is a loaded one, and suggests a Fed pause is not imminent. If the word "ongoing" is removed from the sentence, it could signal a pause soon, in early 2023.
- Finally, Fed Chair Jay Powell's press conference is likely to provide significant insight into what the Fed is thinking. While I expect Powell to attempt to sound hawkish, probing questions are likely to uncover the Fed's concerns about the lagged effect of its aggressive tightening, as well as some color on the criteria the Fed will look for in order to hit the "pause" button.

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Having said all that, there seems to be an overarching feeling of doom in markets. The S&P 500 fell nearly 3.5% last week<sup>2</sup> – it has been down in a downward slide thus far in December – as markets have expressed trepidation about the events this week; they are not convinced inflation is truly on the decline after having heard for too long that it is “transitory” and will soon dissipate. (It reminds me of the typical horror movie fake-out: every time it appears that the mass murderer in the hockey mask has been killed, he gets up again to wreak more havoc; at a certain point, the audience refuses to believe he can ever be killed. I call this “Jason Voorhees Won’t Die” Syndrome, and I think this can be applied to many market participants who just can’t believe high inflation will ever go away.)

However, I take more stock in what we are seeing in the bond and currency markets. I view them as more reliable market indicators, and what they’re suggesting is that inflation is easing and the Fed is likely to get less aggressive quickly: the US dollar is rolling over and the 10-year US Treasury yield has fallen significantly.

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### **The outlook**

And that leads me to our outlook for 2023. Not surprisingly, the outlook for 2023 is largely dependent on the path of monetary policy, which in turn is very reliant on the path of inflation. Our base case is that inflation will moderate, leading to a pause in central bank tightening in the first half of 2023. This should enable a recovery regime to unfold where global growth will be below trend but rising.

However, given an unemployment rate already near all-time lows, this is unlikely to represent the start of a new economic cycle. Instead, we expect rising global risk appetite to reflect a positive repricing of recession risks in terms of timing, duration, or magnitude, while we continue to assess the full impact of past monetary policy tightening, with its long and variable lags.

In this environment, we would prefer risky credit and investment-grade credit, shorter duration, value-oriented regions, and cyclical sectors. Currency preferences include the Australian dollar, Canadian dollar and Brazilian real as we expect the US dollar to continue to weaken.

**Alternate scenario: Persistent inflation.** However, there is the possibility (though we think it’s unlikely) that inflation remains stubbornly high. If that is the case, we assume central banks will continue tightening monetary policy for longer and would expect a longer contraction regime as a result. We would expect this to increase the probability of a global recession, resulting in worse growth and further pain in risk assets. In this environment, we would prefer to underweight equities relative to fixed income, and within equities we would favor defensives, quality, and low volatility. We would prefer government bonds and duration, and would favor the US dollar.

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### **Happy holidays**

Weekly Market Compass will be on hiatus for the next two weeks. We at Invesco wish you and your families a wonderful holiday season filled with many blessings.

With contributions from Brian Levitt and Alessio deLongis

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**Notes**

<sup>1</sup>Source: New York Fed Survey of Consumer Expectations, November 2022

<sup>2</sup>Source: Bloomberg, L.P., as of 12/9/22

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**Important information**

Past performance is not a guarantee of future results.

An investment cannot be made into an index.

This does not constitute a recommendation of any investment strategy or product for a particular investor. Investors should consult a financial professional before making any investment decisions.

All investing involves risk, including the risk of loss.

In general, stock values fluctuate, sometimes widely, in response to activities specific to the company as well as general market, economic and political conditions.

A value style of investing is subject to the risk that the valuations never improve or that the returns will trail other styles of investing or the overall stock markets.

Low volatility (in factor investing) describes investments that have consistently demonstrated lower volatility than other securities in the same asset class over time.

Quality (in factor investing) characterizes companies with strong measures of financial health, including a strong balance sheet and stable earnings growth.

Fixed-income investments are subject to credit risk of the issuer and the effects of changing interest rates. Interest rate risk refers to the risk that bond prices generally fall as interest rates rise and vice versa. An issuer may be unable to meet interest and/or principal payments, thereby causing its instruments to decrease in value and lowering the issuer's credit rating.

The values of junk bonds fluctuate more than those of high quality bonds and can decline significantly over short time periods.

Duration is a measure of the sensitivity of the price (the value of principal) of a fixed income investment to a change in interest rates. Duration is expressed as a number of years.

The Consumer Price Index (CPI) measures change in consumer prices as determined by the US Bureau of Labor Statistics. Core CPI excludes food and energy prices while headline CPI includes them.

The Producer Price Index is compiled by the US Bureau of Labor Statistics and measures the average change over time in the selling prices received by domestic producers for their output.

The S&P 500® Index is an unmanaged index considered representative of the US stock market.

The Citi US Inflation Surprise Index measures whether inflation data are, on average, coming in above or below consensus expectations.

The Federal Open Market Committee (FOMC) is a 12-member committee of the Federal Reserve Board that meets regularly to set monetary policy, including the interest rates that are charged to banks.

The terminal rate is the anticipated level that the federal funds rate will reach before the Federal Reserve stops its tightening policy. The federal funds rate is the rate at which banks lend balances to each other overnight.

The Federal Reserve's "dot plot" is a chart that the central bank uses to illustrate its outlook for the path of interest rates.

A basis point is one hundredth of a percentage point.

Tightening is a monetary policy used by central banks to normalize balance sheets.

The opinions referenced above are those of the author as of Dec. 12, 2022. These comments should not be construed as recommendations, but as an illustration of broader themes. Forward-looking statements are not guarantees of future results. They involve risks, uncertainties and assumptions; there can be no assurance that actual results will not differ materially from expectations.