# After a positive inflation surprise, markets are at a crossroads

**Weekly Market Compass | November 14, 2022**

**Kristina Hooper**
Chief Global Market Strategist

### A positive surprise

Markets were clearly enthusiastic about the recent lower-than-expected US inflation numbers.

### Has inflation peaked?

However, we don't yet know for sure whether the US inflation peak is behind us or still lies ahead.

### Two scenarios

This week, I present the case for moderating inflation as well as the case for stubbornly high inflation.

Last week, markets got what they've been hoping for — a lower-than-expected inflation report in the US. But what comes next? Will inflation continue to ease in the coming months? Or will it remain persistently high? The former scenario would presumably mean that a pause in rate hikes is nearing, while the latter suggests the Federal Reserve (Fed) would have to remain aggressive for longer.

Clearly markets believe inflation has peaked in the US and will continue to moderate, and that the Fed will soon be pausing rate hikes — or at least markets believed that last week. Bond yields fell substantially on the inflation news, as did the US dollar, and stocks rallied rather dramatically. I couldn't help but feel the market overreacted. Yes, the news was good, but it was just one month of data. We won't know for several months whether inflation truly is trending down. As with so many market and economic indicators, we won't know the inflection point with certainty until it's in the rearview mirror.

## The case for moderating inflation

There are many arguments for the scenario that inflation has peaked and is moderating in the US. Goods prices have fallen materially; the reversal of fortune for used cars is emblematic of the changing environment. That makes sense given that financial conditions have tightened. In fact, the October 2022 Senior Loan Officer Opinion Survey indicates a material tightening of lending standards for businesses and households.[1] In addition, the Global Supply Chain Pressure Index has eased meaningfully since its peak of 4.2 in November 2021.[2] Its October reading of 1.0 is nearing a range that would be viewed as normal relative to history.[2] And the real estate market is clearly reacting to much higher mortgage rates, which are likely to result in significant downward pressure on shelter inflation.

## The case for stubbornly high inflation

However, there are several arguments for inflation remaining stubbornly high. One is the exceptionally tight labor market. Some argue that will mean it will be harder to tame wage growth. I agree that's likely to a certain extent, especially in certain industries. However, that doesn't mean overall inflation can't moderate in coming months. What is of far greater concern to me is inflation expectations.

As I mentioned in last week's blog, some believe inflation expectations play a major role in dictating future inflation. And as I've mentioned before, Fed Chair Jay Powell seems to be one of those people, as he appears to care a lot about longer-term inflation expectations. In fact, he suggested that the decision to hike rates by 75 basis points in June (after the Fed communicated it would be hiking by 50 basis points) was largely driven by two data points released a few days before that hike: the Consumer Price Index (CPI) and the University of Michigan consumer inflation expectations, both of which were higher than the Fed expected.

Last Friday, the preliminary Survey of Consumers for November was released by the University of Michigan; it showed that five-year ahead inflation expectations had risen slightly, from 2.9% to 3%.[3] This has become an unwanted trend, given that just a few months ago, five-year ahead inflation expectations were at 2.7%.[3] We saw similar results in the Survey of Consumer Expectations from the New York Fed. Median three-year ahead consumer inflation expectations experienced a material jump in one month, from 2.8% to 3.1%.[4] It seems consumer inflation expectations have been moving in the wrong direction as of late. Now it's only a few data points – and it does coincide with an upswing in prices at the gas pump – so I don't believe it's going to deter the Fed from downshifting to a 50 basis point hike in December. However, I do believe it will be cause for greater scrutiny by Federal Open Market Committee (FOMC) members.

Inflation expectations are certainly on the minds of some FOMC members already. For example, last week, in a speech in Zurich, New York Fed President John Williams seemed to go out of his way to convey the view that he was very happy with longer-term consumer inflation expectations in the US. In a speech titled "A Steady Anchor in a Stormy Sea," Williams explained, "Against the backdrop of the stormy seas of the global inflation of the past year and a half, a steady anchor is more critical than ever...The news is mostly good — longer-run inflation expectations in the United States have remained remarkably stable at levels broadly consistent with the FOMC's longer-run goal."[5] He did, however, focus on the issue of inflation uncertainty, noting that it has increased. He shared the extreme divergence in views about the future of inflation in the next five years: About 25% of respondents to the September NY Fed survey expect deflation, while nearly that many expect inflation to be higher than 4%.[5] He didn't raise alarm bells about this divergence, but other members of the FOMC might be more concerned with this "inflation confusion." All the more reason to be following measures of longer-term inflation expectations closely.

## My take on the path ahead for inflation

In terms of the two options, I lean toward the first scenario – that inflation has peaked. But I'm cautiously optimistic, especially since there is a tail risk that could materialize: An ebulliently positive market reaction to expectations of an imminent Fed pause could have the opposite effect, forcing the Fed to tighten more than it otherwise would. For example, Goldman Sachs reported its Financial Conditions Index eased by over 50 basis points on Thursday following the rally, which represented the third-largest single-day decline on record.[6] If markets get ahead of themselves, it could force the Fed's hand. As Fed Governor Chris Waller said last week about the October CPI print and the market reaction, "The market seems to get way out in front ... I just cannot stress this is one data point."[7] Now I think this is very unlikely – but I thought I would articulate it in case we have more days of positive overreaction.

It's important to note that even though I believe inflation has probably peaked and the Fed is likely to hike rates by 50 basis points in December, we still don't have enough visibility on when the Fed is likely to hit the pause button. It could be that the Fed starts to hike in bite-size pieces (25 basis points) but doesn't pause any time soon. While my base case is a pause by the end of the first quarter, we just don't know yet. I suspect the Fed doesn't know yet, given its data dependency. However, I have a sneaking suspicion that the direction of longer-term consumer inflation expectations may play a role in the Fed's path forward.

**Notes**

[1]Source: Board of Governors of the Federal Reserve System, Nov. 7, 2022

[2]Source: Federal Reserve Bank of New York, Nov. 4, 2022

[3]Source: University of Michigan, Survey of Consumers, Nov. 11, 2022

[4]Source: New York Fed Survey of Consumer Expectations, Nov. 14, 2022

[5]Source: Federal Reserve Bank of New York, Nov. 9, 2022

[6]Source: Nick Timiraos, New York Times, on Twitter, Nov. 10, 2022

[7]Source: MarketWatch, "Fed's Waller says market has overreacted to consumer inflation data: 'We've got a long, long way to go,'" Nov. 9, 2022



The Survey of Consumers is a monthly telephone survey conducted by the University of Michigan that provides indexes of consumer sentiment and inflation expectations.

The New York Fed's Survey of Consumer Expectations is a nationally representative, Internet-based survey of a rotating panel of approximately 1,300 household heads.

The Senior Loan Officers Survey is conducted by the US Federal Reserve to provide qualitative and limited quantitative information on bank credit availability and loan demand, as well as on evolving developments and lending practices in the US loan markets.

The New York Fed's Global Supply Chain Pressure Index (GSCPI) integrates a number of commonly used metrics with an aim to provide a more comprehensive summary of potential disruptions affecting global supply chains.

The Goldman Sachs Financial Conditions Index is defined as a weighted average of riskless interest rates, the exchange rate, equity valuations, and credit spreads, with weights that correspond to the direct impact of each variable on gross domestic product.

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 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.

A basis point is one hundredth of a percentage point.

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