The Weekly Market Update – 1/17/23: Fed is Likely Happy With Recent Inflation Trends

Major Indices (Price Returns)	Close	Last Week	Quarter-to-Date	Year-to-Date	Trailing 12-Months	All-Time High	% to High
S&P 500	3,999.09	2.67%	4.16%	4.16%	-16.09%	4,796.56	19.9%
Dow Jones Industrial Average	34,302.61	2.00%	3.49%	3.49%	-5.60%	36,799.65	7.3%
NASDAQ Composite	11,079.16	4.82%	5.85%	5.85%	-29.18%	16,057.44	44.9%
Russell 2000	1,887.03	5.26%	7.14%	7.14%	-15.96%	2,442.74	29.4%
MSCI EAFE (USD)	2,080.35	4.24%	7.02%	7.02%	-10.95%	2,398.71	15.3%
MSCI Emerging Markets (USD)	1,029.84	4.16%	7.68%	7.68%	-16.41%	1,444.93	40.3%
Bloomberg Commodity Index	111.58	3.21%	-1.09%	-1.09%	12.51%	237.95	113.3%
Barclays U.S. Aggregate Bond	91.27	0.91%	2.69%	2.69%	-12.85%	112.07	22.8%

Source: FactSet

Easing inflation data in December supports a less aggressive Federal Reserve Bank (Fed) in the months ahead. The consumer price index, or CPI (a widely followed measure of consumer inflation reported monthly by the Bureau of Labor Statistics, BLS), increased 6.5% in December 2022 year-over-year (Y/Y). This was the lowest monthly Y/Y inflation increase of 2022; since peaking at 9.1% in June 2022 compared to June 2021, the CPI Y/Y increase has trended lower for six consecutive months. In addition, compared to November 2022, the month-to-month (M/M) price change moved lower, dropping 0.1%. The inflation data was helped by lower gasoline prices, which dropped 1.5% Y/Y and 9.4% M/M; as well as prices for used cars and trucks, which declined 8.8% Y/Y and 2.5% M/M, respectively. The volatile food category continued to push prices higher, increasing 10.4% Y/Y and 0.3% M/M. “Core CPI,” which excludes the energy and food categories, increased 5.7% Y/Y in December and rose 0.3% M/M. The Y/Y core CPI increase has declined for three consecutive months since peaking at 6.6% in September 2022, but has not receded as rapidly as headline inflation due to elevated prices for services, which increased 7.0% Y/Y in December. The shelter component (includes rent and a rent equivalent of home ownership) of services increased 7.5% Y/Y and 0.8% M/M**.** With some evidence that home price increases are moderating (S&P CoreLogic Case-Shiller home price data), we expect inflation pressure from shelter to moderate in the months ahead. While several Federal Reserve Bank members (Chairman Powell, Bank Presidents Bostic, Bullard and George) have discussed the need for ongoing interest rate hikes from the Fed (the Fed sets the overnight bank lending fed funds interest rate target), we believe that the trend of lower inflation will allow the Fed to pause its rates hikes in the first half of 2023. There are two scheduled Federal Open Market Committee (FOMC) meetings in the first four months of 2023 (ending on 2/1/23 and 3/22/23). While we expect the committee to raise its fed funds target at both meetings, we also believe that the Fed could pause its rate hikes in the current cycle at that time. In 2022, the Fed raised the low end of its fed funds rate to 4.25% from 0%. We attribute equity market gains to begin 2023 (the widely followed S&P 500 index was up 4.2% through 1/13/23) to investors’ expectation that upward pressure on U.S. interest rates will subside, reducing the potential for surging rates to derail economic growth.

Earnings estimates for the fourth quarter (4Q22) have moderated as companies begin reporting financial results. According to FactSet, S&P 500 companies are estimated to report 4Q22 earnings that are down 4.5% Y/Y. This would be the first down Y/Y earnings quarter since 3Q20, and reflects challenges faced by many companies including the impact of inflation on materials costs and labor, moderating consumer spending and business investment, and global uncertainty. The FactSet consensus for revenue growth is +4%, indicating that margins are expected to remain pressured (when revenue growth exceeds earnings growth, that generally reflects lower margins). We also look for cautious commentary regarding the 2023 outlook and see some risk to the current 2023 FactSet consensus earnings estimate of +4.6%.

U.S. economic growth has trended positive in 4Q22 with second half trends contributing to full-year growth as well. Gross domestic product, or GDP (the value of goods and services produced reported by the Bureau of Economic Analysis), is estimated (FactSet) to have grown 1.2% in 4Q22, with the full-year 2022 GDP estimate at growth of 1.9%. Despite solid growth trends from reported data in October and November, GDP growth estimates are conservative for 1Q23, including a consensus estimate of -0.2%.

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