November 11, 2022

MARKET SIGHT LINES

Elections and Inflation: Uncertainty Persists Along the Road to Balance

By Michael O’Keeffe, *Chief Investment Officer*

A couple of weeks ago, we wrote about finding balance in several areas. Then last week, we discussed how the Federal Reserve’s (Fed’s) latest policy decision makes discerning the timing of a Fed rate hike pause still elusive.

In this week’s Sight|Lines, we provide a brief update on finding balance through the rest of the year and into 2023.

THE TAKEAWAY: IMBALANCES CONTINUE, BUT RESOLUTION IS ON THE HORIZON

Some imbalances continue, fueling uncertainty and the prospect for continued volatility, but resolution is on the horizon:

- Control of Congress is not yet known, with the Senate likely not decided until December, but a divided government appears likely.
- October consumer price index (CPI) was better than expected, a step in the right direction; however, the pace of inflation remains above the Fed’s 2% target.
- Futures now signal a 4.85% fed funds rate peak in 2023, with a 14% chance of a 0.75% December hike.
- The aggregate earnings growth rate for the fourth quarter of 2022 versus a year ago has turned negative.
- These imbalances may contribute to near-term market volatility, but a clearer picture in the coming weeks may calm markets and improve investor sentiment.

IN-DEPTH: POLITICAL UNCERTAINTY CONTINUES AND INFLATION IS COOLING

This week we received the preliminary results of the U.S. midterm elections and learned more about inflation, a shift in consensus views on Fed policy, eroding earnings growth estimates

- *Midterm Elections*: The anticipated “red wave” did not materialize, and control of Congress is not yet fully known. A divided government and gridlock in D.C. seem likely.
    - For the Senate, the current count is 48 Democrats, 49 Republicans, and a strong possibility that control will ultimately be determined by a December 6 runoff election in Georgia.
    - For the House, the current count is 208 Republicans and 185 Democrats, with 42 seats remaining to determine which party will reach the majority of 218 or more. Republicans are expected to gain a slight House majority, leading to a divided government at least through 2022.

- Congress is expected to focus on a spending bill, the annual National Defense Authorization Act, and the SAFE Banking Act in the "lame duck" session through the balance of the year, but not much is expected to get done.
- The new Congress in 2023 may well focus on a handful of topics of mutual interest to both parties, including new regulations for tech companies and cryptocurrencies.
- Former President Trump may well announce a 2024 presidential run, but a strong showing by Ron DeSantis winning reelection as governor of Florida signals a potential leadership shift in the Republican Party. On the other hand, a strong midterm showing by Democrats, as compared to expectations, may strengthen President Biden's confidence for a 2024 reelection run.

- *Inflation*: This week we learned about the October CPI results. Headline CPI is up 7.7% over the last year, and the month-over-month figure came in at 0.4%, which annualizes to 4.9%. Core CPI, which excludes things like food and energy, rose 6.3% over the last year, with month-over-month figure posted at 0.3%, reflecting an annualized rate of 3.7%. These better-than-expected results are a step in the right direction and provide some of the evidence the Fed is seeking for cooling inflation.
- *Fed Policy*: During his post-meeting press conference last week, Fed Chair Jerome Powell said that "the ultimate level of interest rates will be higher than previously expected," signaling that the peak rate in 2023 will likely be higher than the 4.6% projected 2023 peak reported in the Fed's September meeting. Market participants responded, and the peak rate implied by fed futures contracts rose to 5.08% after the meeting. And, as another indicator, the probability of another 0.75% hike in December rose to 48% after the meeting. Following the October CPI report, which is one input the Fed considers when setting future policy, the probability for a 0.75% hike fell to 14%
- *Earnings Growth*: Earnings growth estimates continue to recede. For example, the aggregate year-over-year earnings growth rate for fourth quarter 2022 moved into negative territory at -1.0%, down from almost 9% at the beginning of the year. The 2023 forecasted growth rate also declined to 5.9% versus 9.6% as of June 30, 2022.
- *Market Volatility*: Investors are seeking relief, and this week's inflation report and preliminary election results led to a boost in investor sentiment. Questions remain, however, around inflation, Fed policy, the economy, and earnings growth, which suggests volatility will likely remain in the near term.

CONCLUSION

We anticipate finding balance in several areas in the weeks and months ahead with volatility along the way but see the prospect of calmer and more positive markets as we head into 2023.

Michael P. O'Keeffe, CFA
Chief Investment Officer
michael.okeeffe@stifel.com
www.stifelinsights.com