

# MARKET SIGHT LINES



## Shaping Our 2023 Outlook: Cooling consumer inflation and a Federal Reserve rate hike in line with expectations

By Michael O'Keefe, *Chief Investment Officer*



Last week, we discussed where we've been focused as [we prepared for the Federal Reserve's \(Fed's\) December 2022 meeting](#), going deeper into inflation and potential Fed policy actions. Since then, we learned the details of the consumer price index (CPI) report for November, as well as the Fed's latest policy action and Summary of Economic Projections (SEP). In this week's Sight|Lines, we review these results and how they will influence our outlook for 2023.

### **THE TAKEAWAY: CPI COOLS, AND THE FED WILL SLOW HIKES BUT CONTINUE ITS FIGHT**

We learned about the November consumer price index (CPI) and the results of the final Fed meeting of 2022, as well as the Fed's expected policy path for 2023 and beyond:

- The monthly CPI and core CPI cooled in November, coming in at 0.1% and 0.2%, respectively.
- The Fed hiked its benchmark rate 0.50% to a range of 4.25%-4.50%, in line with expectations.
- The Fed statement was otherwise unchanged, reiterating its commitment to more rate hikes to rein in inflation while considering the lag effect of cumulative rate hikes to date and incoming data.
- The SEP showed Fed officials expect a higher funds rate by year-end 2023, signaling hikes totaling 0.75%, higher unemployment, and more muted economic growth over that time.
- In his post-meeting press conference, Chairman Jerome Powell said the softer CPI reports were a "welcome reduction," but "substantially more evidence" that inflation cooling is needed. He acknowledged that goods inflation is improving as a result of improved supply chains, housing services are likely to improve by the middle of next year, and non-housing related core services remain problematic, which is largely a function of a very strong labor market.

### **IN-DEPTH: INFLATION COOLED MORE THAN EXPECTED, THE FED RAISED RATES 0.5% AS EXPECTED, BUT FED FORECASTS SHOW HIGHER-FOR-LONGER RATES NEXT YEAR**

As we look back to 2022, we're reminded that higher inflation and the Fed's hawkish policy shift have been key drivers of market volatility and weakness. So naturally, our judgment about inflation and Fed policy in 2023 is key to our outlook for the economy and markets. As has been our practice, we're processing data right to year end in this effort. And this week, we've had the opportunity to dig into the November CPI report and the results of the Fed's final meeting in 2022. Going deeper:

- The monthly CPI and core CPI cooled in November, coming in at 0.1% and 0.2%, respectively, compared to consensus expectations of 0.3% for each:
  - Prices for gasoline, electricity, and utility gas services declined over the month.
  - But the cost of food rose 0.5%, with shelter prices increasing 0.6%.
- The Fed hiked its benchmark rate 0.50% to a range of 4.25%-4.50%:
  - Just prior to the meeting, Fed futures indicated an 80% probability of a 0.50% hike.
- The Fed statement was otherwise unchanged, reiterating its commitment to rein in inflation while being data-dependent. Some quotes from the statement:
  - *The Committee anticipates that ongoing increases...will be appropriate in order to attain a stance of monetary policy that is sufficiently restrictive to return inflation to 2% over time.*
  - *In assessing the appropriate stance of monetary policy, the Committee will continue to monitor the implications of incoming information for the economic outlook.*
- The SEP projected a higher funds rate, higher unemployment, and more muted economic growth in 2023:
  - The projected 2023 fed funds rate is now 5.1%, compared to the 4.6% projection in September.
  - The 2023 unemployment increased to 4.6% versus 4.4%, the economic growth forecast fell from 1.2% to 0.5%, and the inflation projection rose to 3.5% from 3.1%.
- In his post-meeting press conference, Powell commented on three distinct segments of inflation:
  - Inflation on goods like household furnishings and cars is cooling given improved supply chains.
  - Housing services inflation will be higher as the pipeline of existing lease renewals is processed, but it is expected to come down by the middle of next year.
  - Inflation from non-housing related core services is the most problematic and tied to supply and demand imbalances in the labor market. There are still 1.7 job openings for every unemployed person, and despite some slowing in economic activity, Chair Powell said companies are reluctant to lay off employees. This is, in part, tied to a structural labor shortage. There are an estimated 4 million fewer workers today than prior to COVID.

## CONCLUSION

Interestingly, while the good results from the November CPI report were better than expected, in some ways, the results of the Fed meeting were mixed to negative, yet should have been expected. Chair Powell has been signaling for weeks to expect a projection of higher rates from this SEP. Fed watchers and investors alike were curious to see just how far the Fed would go. The Fed could have softened its inflation-fighting message, given the CPI report. But instead, Powell reinforced and even strengthened the message that rates will go higher and will stay higher for longer as the Fed is seeking strong evidence that inflation will get back to its 2% target. The Fed's continued commitment will inform our outlook for 2023.

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