John Dessauer Investments, Inc.

John Dessauer's market review and update as of Wednesday January 11, 2023

I found the following editorial to be astounding. This is the best analysis of the current inflation situation that I have seen. It is written by Alan S. Blinder, professor of economics at Princeton and former vice chair of the federal Reserve. It was published in the Wall Street Journal on January 5.

"Maybe we should start the new year with some good news: Inflation has fallen dramatically.

No, that's not a prediction; it's a fact. With one month remaining in 2022 (in terms of available data), inflation in the second half of the year has run vastly lower than in the first half. In fact—and this is astonishing—it's almost back down to the Federal Reserve's 2% target. Even more astonishing, hardly anyone seems to have noticed.

Yes, there's a catch or two or three, to which I'll come back. But first the good news:

Over the past five months (June to November 2022), inflation has slowed to a crawl. Whether measured by the consumer-price index, or CPI, which most people watch, or the price index for personal consumption expenditures, or PCE, which the Federal Reserve prefers, the annualized inflation rate has been around 2.5% over these five months.

Yes, you read that right. Yet hardly anyone has noticed this stunning development because of the near-universal concentration on price changes measured over 12-month periods, which are still 7.1% for CPI inflation and 5.5% for PCE inflation.

Normally, focusing on 12-month inflation rates is the right thing to do, for two main reasons. First, it guards against hyperventilation over "blips" in the inflation data, whether up or down. Second, it obviates the need for seasonal adjustment, since, for example, you are comparing prices in November 2022 with those in November 2021.

But when the inflation rate changes abruptly, 12-month averages can leave you watching recent history rather than current events. Today is one of those times.

As mentioned, the CPI inflation rate over the past 12 months has been an alarming 7.1%. But the U.S. economy got there by averaging an appalling 10.6% annualized inflation rate over the first seven months and a mere 2.5% over the last five. The PCE price index tells a similar story, though a somewhat less dramatic one. The 5.5% inflation rate over the past 12 months came from a 7.8% rate over the first seven months followed by a 2.4% rate over the last five.

Lest you think I'm performing numerical sleight-of-hand, the same phenomenon can and does operate in the opposite direction: Inflation can surprise you by leaping upward. It happened in 2021.

Between February 2021 and June 2021, the 12-month CPI inflation rate showed a rise from 1.7% to 5.3%. Bad enough. But if you took that 5.3% number apart, you would have seen that it came from a 3.3% annualized rate between June 2020 and January 2021 (seven months) followed by an 8.2% annualized rate between January 2021 and June 2021 (five months). Thus in June 2021, when it looked as if we had a 5% inflation problem on our hands, we really had an 8% inflation problem. (And the 12-month rate eventually peaked at 9% in June 2022.)

So is today's true inflation rate a mere 2.5%, meaning that Jerome Powell and the Federal Reserve can relax? Not quite. Now for the catches I promised earlier.

First, we've had this wonderfully low inflation rate for only five months. That's longer than one or two months, which is why I'm writing this article. But it's still too short a time to declare victory.

Second, if you concentrate instead on "core" inflation, which excludes food and energy prices, annual inflation over the past five months has run higher: a 4.7% annual rate for the CPI and 3.7% for the PCE. So the Fed's fight against inflation isn't over.

That headline inflation has dropped more than core inflation tells you that lower food or energy inflation played a meaningful role. In this case, it was energy. As measured in the CPI, energy prices have dropped 11% over the past five months, whereas they rose 27% over the previous seven. And perhaps this constitutes a third catch. With the war in Ukraine still raging and Iran in turmoil, maybe we can't count on gasoline remaining at $3 a gallon.

Was the rest of the stunning drop in inflation in 2022 due to the Fed's interest-rate policy? Driving inflation down was certainly the central bank's intent. But it defies credulity to think that interest-rate hikes that started only in March could have cut inflation appreciably by July. There is an argument that monetary policy works faster now than it used to—but not that fast.

What did change dramatically was the supply bottlenecks. Major contributors to inflation in 2021 and the first half of 2022, they are now mostly behind us.

Peering ahead, the bottlenecks almost certainly won't return. Another energy shock can't be ruled out but looks unlikely. And the anti-inflationary effects of the Fed's monetary policy are yet to come.

Altogether, the inflation future does indeed look brighter than the inflation past. Happy New Year."

And now we have the December Supply Management's PMI report which fell sharply from November and is now at 49.6%, which is in contraction territory. With the service sector weakening, the case for lower inflation becomes stronger. And the case for a stock market recovery also becomes stronger.

I will have the next market review and update for you one week from today on Wednesday, January 18, 2022.

All the best,

John Dessauer