John Dessauer Investments, Inc.

John Dessauer's market review and update as of Wednesday February 8, 2023

Our Federal Reserve raised interest rates again, but this time by only 0.25%. When the Fed started raising rates, they raised rates by 0.75%, then the cut that back to 0.50% and now all the way down to 0.25%. By the way, the European Central Bank also just raised interest rates, but they stuck with a 0.50% rate hike. Does this mean that our Fed is clearly winning the battle against high inflation?

"Recent readings on wages and prices have markets increasingly optimistic inflation can be brought under control without a recession.

The Federal Reserve would love to agree, but it can't. Not yet anyway. In its quarter percentage point rate increase Wednesday, the accompanying statement, and Chair Jerome Powell's press conference, the central bank made it clear its views had not changed. Inflation is still too high and won't return to its 2% target without higher interest rates and a weaker labor market.

At the root of the divide between the markets and the Fed (and, increasingly, between Fed officials) are data that on the one hand show falling wage and price inflation and on the other, an economy, and labor market in particular with too little slack.

Mr. Powell acknowledged that recent data has been encouraging. Inflation excluding food and energy, as measured by the Fed's preferred index, fell from 5.4% last March to 4.4% in December, and was running at just 2.9%, annualized, in the last three months.

“We can now say for the first time the disinflationary process has started,” he said. In fact, he argued the Fed’s initial view that much of the rise in inflation would be transitory has been borne out, though it took more than a year longer than expected.

So why no victory lap? Because as Mr. Powell emphasized, even if most of the rise in inflation was transitory, some of it was not. Falling goods prices led the recent moderation in core inflation, the predicted result of supply chains becoming unsnarled and consumer demand rotating back to services. But just as the initial spike in goods prices was transitory, so will be this recent decline, Mr. Powell noted.

Once those factors wash out, Mr. Powell said “sustainable” inflation would be more like 4%--a discouragingly high number.

So what, then, does it take to return inflation all the way back to 2%? The markets seem convinced it will happen on its own accord, without a recession or higher unemployment. Some Fed officials agree - narrower profit margins and softer spending “could facilitate continued easing in the labor market and reduction in inflation without a significant loss of employment,” Fed vice chair Lael Brainard recently said.

Mr. Powell disagrees, which seems to reflect the greater weight he, and the Fed’s staff, put on economic slack and the Phillips curve—the inverse relationship between inflation and unemployment—as the main determinant of where prices are headed.

Mr. Powell’s preferred measure of underlying inflation is services excluding food, energy and shelter, and he said about 60% of that responds to slack in the economy, according to Fed research—in other words, how tight the labor market is.

To be sure, as Mr. Powell acknowledged, Tuesday's report on fourth-quarter employment costs showed private sector wage growth moderating notably during 2022. But, he said, it's too high to be consistent with 2% inflation. Harvard University economist Jason Furman estimates recent wage data was consistent with inflation falling to a 3.5% to 4% pace.

That's not surprising given that despite a dramatic tightening in monetary policy, unemployment has yet to rise from a half-century low, and in December, job vacancies actually rose, and are now back to roughly double the number of unemployed people. Inflation, Mr. Powell said, won't return to 2% without a better balance in the labor market."

Maybe the lagged effect of interest-rate increases to date will soon start to show up in the labor market. A report Wednesday by payroll processor ADP suggests payroll growth slowed sharply in January.

Absent such evidence, the Fed sees no reason to veer from the path of further interest rate increases it laid out in December. Markets seem to think that would be a mistake. Mr. Powell didn't dispute that possibility, but he said he would rather tighten too much than too little.

"It's very difficult to manage the risk of doing too little and finding out in six or twelve months we actually were close but didn't get the job done," he said." (The Wall Street Journal, Feb 2, 2023)

In my view inflation is an economy and stock market killer. Far better to tighten a little too much than not enough. After all, the Fed can always ease up if need be. In addition, raising interest rates 0.25% at a time is not exactly a major threat to the

economy or the stock market. Stocks are likely to remain moderately volatile until the evidence of lower inflation is clear.

I will have the next market review and update for you one week from today on Wednesday, February 15, 2022.

All the best,

John Dessauer