John Dessauer Investments, Inc.

John Dessauer's market review and update as of Wednesday November 30, 2022

"Inflation has taken a big toll on the markets in 2022. Rising prices have emboldened the Federal Reserve to tighten monetary conditions at a historically fast pace, which has sapped demand for risk assets while also raising the cost of capital for individuals and businesses. It's made for a challenging year for investors.

Inflation has also meant higher costs for materials, inventory, and labor for corporations, which erodes the value of current and future earnings. Since stock prices are based on expectations of future earnings, it makes sense that sticky inflation is highly undesirable over the long term. When considering the trade-off between the short-term pain of tightening financial conditions and the long-term positive of having inflation under control, the latter should always be preferred.

It should make sense then that seeing inflation fall from high levels has generally been beneficial for equity markets. Since 1960, the consumer price index (which measures inflation) has gone above 6% on five occasions, in 1970, 1974, 1979, 1990, and 2022. In every instance before 2022 when CPI peaked and started falling, stocks staged relatively powerful rebounds. If we see more signs in the current cycle that inflation has peaked and started falling, I would expect a similar market outcome in 2023." (Mitch on the Markets, Zacks Investment Management)

The current inflation spike was caused by President Biden’s attack on U.S. fossil fuel production. That pushed up the price of oil, and all energy prices soon followed. As inflation rose economists thought that since the trigger was narrow, namely oil prices, that inflation could be brought under control without painful economic consequences. The idea was to encourage oil production. However, that takes time and is not a quick fix. In addition, President Biden did not reverse course for American energy producers. Instead, he begged Saudi Arabi and other OPEC countries to increase their production. Their response was to announce cuts in oil production. The result is that inflation is proving to be far stickier than expected. The reasons are that the rise in the oil price has affected global economies and has driven up costs for just about every business, including farmers.

What will it take to bring inflation down? The editors of the Economist magazine see three dimensions to the current inflation challenge.

“Begin with breadth. When the inflation surge started last year, it was confined in most countries to a small number of goods and services. In America it was second-hand cars. In Japan it was food. In Europe it was energy. This provided false comfort to pundits, many of whom assumed that once the prices of these few components stopped rising, overall inflation would fizzle out.

In fact, the inflation virus has spread. We analyzed the consumer baskets of 36 mostly rich countries. In June, 60% of prices in the median basket were rising by more than 4% year on year. Now 67% are. Even in Japan, the land of low inflation, the prices of a third of the basket are rising more than 4%. This broadening out is in part due to the exceptionally strong dollar, which raises inflation by making imports more expensive. But it is more to do with what is happening in domestic economies.

This is where the second dimension - wages - comes in. Pay is a guide to the future path of inflation: when companies' labor costs rise, they tend to pass them on to customers in the form of higher prices. Inflation optimists point to data from America where there is some evidence of a slowdown. Growth in Britain also seems to have peaked.

Elsewhere, though, there is not much evidence of restraint. New research suggests that nominal pay in Europe is rising by more than 5%. In Germany IG Metal, a big union for metals and engineering workers, is seeking a pay raise of up to 8%. In New Zealand, Norway and Sweden pay growth is still rising.

The third dimension is expectations. Survey-based measures of expectations provide no evidence of weakening inflation. Figures put together by the Cleveland Fed, Morning Consult, a data company, and Raphael Schoenle of Brandies University gauge the public's inflation expectations in various rich countries. According to the survey for October, in the median country the public reckons prices will rise by 5% over the next year, as it has in previous months. Another survey finds that American firms currently expect inflation of 7% over the next year.

Everyone can agree on one thing about the past year. It has demonstrated just how poorly economists understand inflation, including what causes it and what causes it to persist. It is likely, therefore, that economists will also struggle to predict when inflation will cool."

I find the three-dimensional approach to inflation to be helpful. Using that model will allow us to keep better track of the Fed's progress. There are indications, at least in the U.S., that the broad inflation base is shifting with parts showing a decline. For example, second-hand cars and housing are off their peaks. If November follows October with another decline in inflation, we will have more evidence that overall inflation has peaked. Then we will focus on the labor market and look for signs that the upward pressure on wages is softening. After that inflation expectations will come down and stocks will go up.

The mid-term election history says that the coming rise in stocks could take them to new highs.

I will have the next market review and update for you one week from today on Wednesday, December 7, 2022.

All the best,

John Dessauer