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A Weekly Comprehensive Macroeconomic Overview

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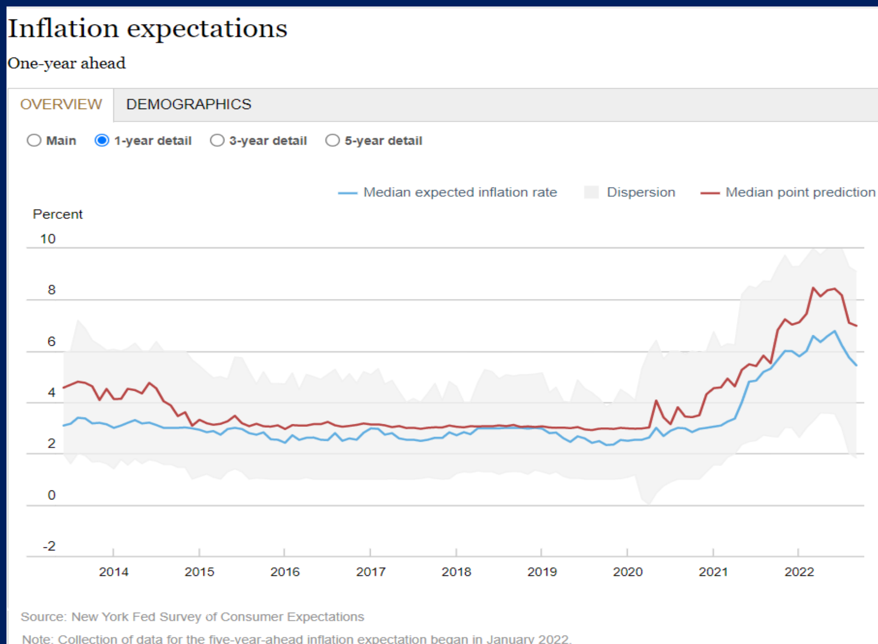
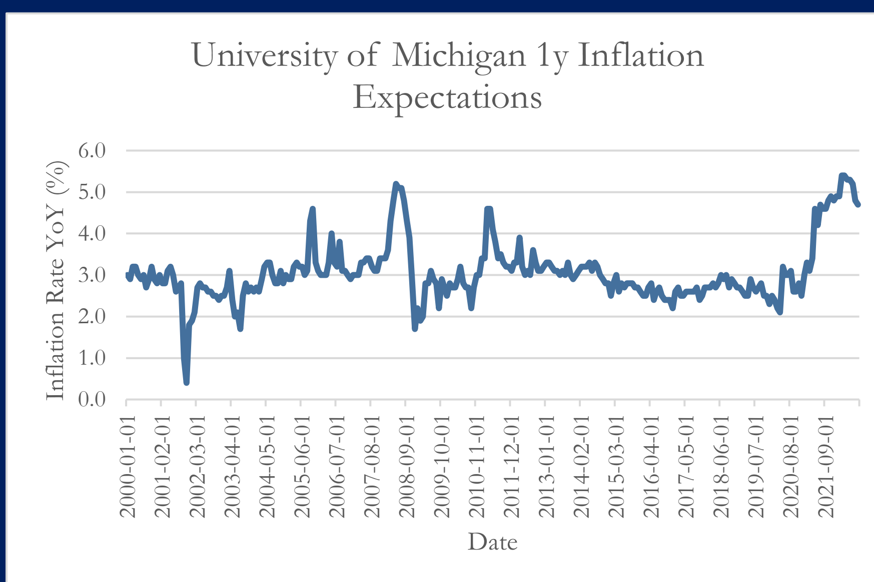
On Inflation

Inflation has been the economic topic of 2022. US consumer price inflation prints excite markets and, as a result, investors react disproportionately to higher and lower-than-expected readings. Zooming out from monthly CPI reports, in this section we will try to understand which inflation measure drives markets and how misestimates could radically change returns.

Investors and businesses have been assuming a continuity of low and stable inflation in their business models. A high and unstable inflation regime comes as a surprise, and they are currently learning the analytical tools to deal with it. This partially explains why agents were so slow to react to the sudden increase in inflation, including central banks. Once they reacted, market started pricing in these new assumptions. In other words, it is inflation expectations what drives markets, not actual inflation. Below you can find two different measures of inflation expectations, one provided by the University of Michigan and the other by the Federal Reserve of NY.

The 1 year ahead expected inflation measure is at 5.4% and 4.7% respectively. Investors assume the inflation peak is over and that inflation will continue to fall in the long-term to levels similar to the last decade. This assessment will determine if we have a period of beta drought – a sideways market – driven by an increasing price of risk and a higher expected returns on assets (Treasury rate + Equity Risk Premium) or if we continue trending higher in 5 years. Could a wage-price spiral happen? Has inflation become structural in our economy? Has it impacted the investors and consumer psyches?





If inflation settles at around central bank target levels of 2% or less or we stay at levels of 3-4%, we will face a very different long-term game. Inflation has key effects that directly impact valuations and sector preferences:

1. Interest and exchange rates
2. Risk premium required and capital withdrawals from the riskiest segments of the economy.
3. Consumer psychology: lower savings levels, leveraged household balance sheets…

American Markets

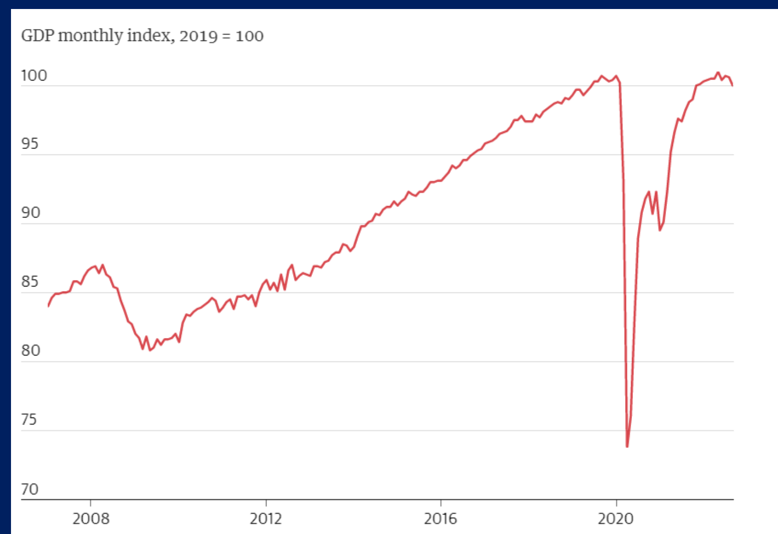
Lower inflation opens the door to Fed slowdown. As mentioned, US consumer prices increased less than anticipated, with the annual consumer price index climbing 7.7%, the smallest increase since January. CPI rose 0.4% in October versus expectations of 0.6%.

A lighter inflation print may allow the Fed to cut back on its massive rate hikes if the downward trend continues. Traders are now starting to price in a 50 bps raise in the December meeting. Fed officials also voiced support for the potential slowing of rate rises. According to Bloomberg News, San Francisco Fed President Mary Daly said the report was "good news" while Dallas Fed President Lorie Logan said it "may soon be appropriate to slow the pace of rate increases," though such a move "should not be taken to represent easier policy." The suggestion of a slowdown was also supported by a weakening in the labour market as weekly initial jobless claims rose by 7,000 to 225,000.

In addition to this, data gathered by Zillow shows that the average American now has to work about 8 hours longer a month in order to pay increased rent prices. Inflation has caused many staple goods to increase in price compared to wages which have not yet been adjusted for these increases. However, the rise in rents has now come down to 7.5% from 18% at the beginning of 2022. Therefore, this trend shift is positive in the eyes of the Fed who is doing everything they can to taper the high inflation situation. Increasing wages for workers to sustain the higher prices would make the inflation issue more sustained and sticker, which could mean the Fed would have to run with higher rates for longer. This would make borrowing more expensive, therefore, firms would need to deal with both costs of higher wages as well as higher interest payments on debt, cutting down profit margins further for longer. Thus, monitoring the US CPI and labour data will be crucial going forward as it will guide how the hiking cycle will continue.

Inflation's effects on the UK

The ONS announced that the UK's GDP contracted by 0.2% in Q3 of this year following the BoE's warnings that we face an 8-quarter long recession. The development is in sharp contrast to news coming from the US that CPI came in at 7.7% in October, which was lower than what markets had anticipated. Britain being the only G7 member whose GDP has not returned to pre-Covid levels begs the question, why?



Source: ONS (Office of National Statistics)

A lack of economic activity has made it harder for companies to grow. Despite demand for labour, the supply is not there, with the number of people in work also not returning to pre-Covid levels. 9 million working age people are economically inactive and this has been creditted to a signficant rise in long-term sickness, mainly due to the strain the NHS is under by their large backlog of patients.

Looking forward, we should pay attention to Jeremy Hunt's Autumn Statement. The BoE's prediction of an 8 quarter recession did not factor in anticipated tax rises and spending cuts that will worsen markets in the short term but help with inflation.