

A Good End to a Challenging Year

By: Nicholas Riley, CFA, Investment Manager and Strategy Analyst

The theme of 2022 has been inflation. Inflation impacts almost everything from interest rates, currency values, purchasing decisions by consumers and businesses, politics and, importantly, standards of living. It also has a profound impact on financial markets.

High inflation hurts both bonds and equities and it has flipped the correlation between bonds and equities from negative to positive. This resulted in simultaneous losses for both during the first nine months of this year having had two decades of negative correlation with bonds and equities being very complimentary in investment portfolios.

The interaction between pandemic distortions (supply chain stress, large shifts between goods versus services, demand, and labour market disruption), together with the significant monetary and fiscal stimulus, made for a complex inflation backdrop coming into 2022. The Russia-Ukraine war further compounded inflationary pressures as commodity prices climbed.

The headline US inflation rate peaked at a 40-year high of 9.1% in June. In the eurozone and UK, it is highly likely that inflation peaked in October, at 10.6% and 11.1% respectively. Inflation in Japan has remained relatively low in a global context but 3.7% is the country's highest reading since 1991.

China has bucked the global inflation trend. Instead, disinflationary impulses from consumer weakness and property market stress have been more of a challenge. In Emerging Markets, headline inflation is at last falling in most major countries but is proving stubborn in many small and medium sized economies.

Given the dominant role of the US dollar in global trade and invoicing, US interest rate policy has an outsized impact on global financial conditions, so the outlook for inflation in the US is crucial.

US CPI inflation cooled for a second consecutive month in November as the headline figure eased to 0.1% month-over-month (7.1% year-over-year), falling below consensus estimates. Core inflation was also softer-than-anticipated, moderating to 6.0% y/y from 6.3% y/y. This was the smallest monthly increase in over a year.

Core goods deflation picked up pace in November with prices falling by 0.5% m/m, driven by a 2.9% m/m drop in used vehicle prices. This had been widely expected as global supply chain pressures ease and demand for goods weakens. Services inflation has been more concerning, however there was some good news in November as services prices increased by a softer 0.4% m/m.

Furthermore, the softer print was broad-based and included a still elevated housing inflation component, which we know lags in the official data. Recent weakness in private sector rent measures will feed through to the official numbers next year. This is on top of lower energy prices - the oil price is back to where it started the year - and there are also signs that food price pressures will ease next year.



The easing in inflationary pressures has helped financial markets in the fourth quarter, but another important factor has been the pragmatism shown by central banks. After getting inflation badly wrong last year, a legitimate concern this year was that they risked making the opposite mistake (by not trusting forward looking indicators showing that inflationary pressure are easing) and would overtighten policy.

Back in May of this year, Jerome Powell said “truthfully, this is not a time for tremendously nuanced readings of inflation. We need to see inflation coming down in a convincing way.” However, this tone has changed meaningfully with recent speeches reminding us that they are aware of policy lags, the extent of cumulative tightening and focused on important nuance around and how official rent measure are captured.

With the Fed still of the mindset that “it will take substantially more evidence to have confidence that inflation is on a sustained downward”, inflation readings will remain in focus next year. Consensus is that the US will likely experience a mild recession, but pessimism has been tempered recently.

Soft data, such as surveys, has been weaker than actual economic data, so many forward-looking models of growth paint quite a bleak picture. However, softer inflation readings, the eurozone weathering the energy crisis better than expected, China abandoning its zero-Covid policy and a pragmatic approach from central banks is a good news combination to end a difficult year.

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