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Destination Disinflation?

Fixed Income Macro View

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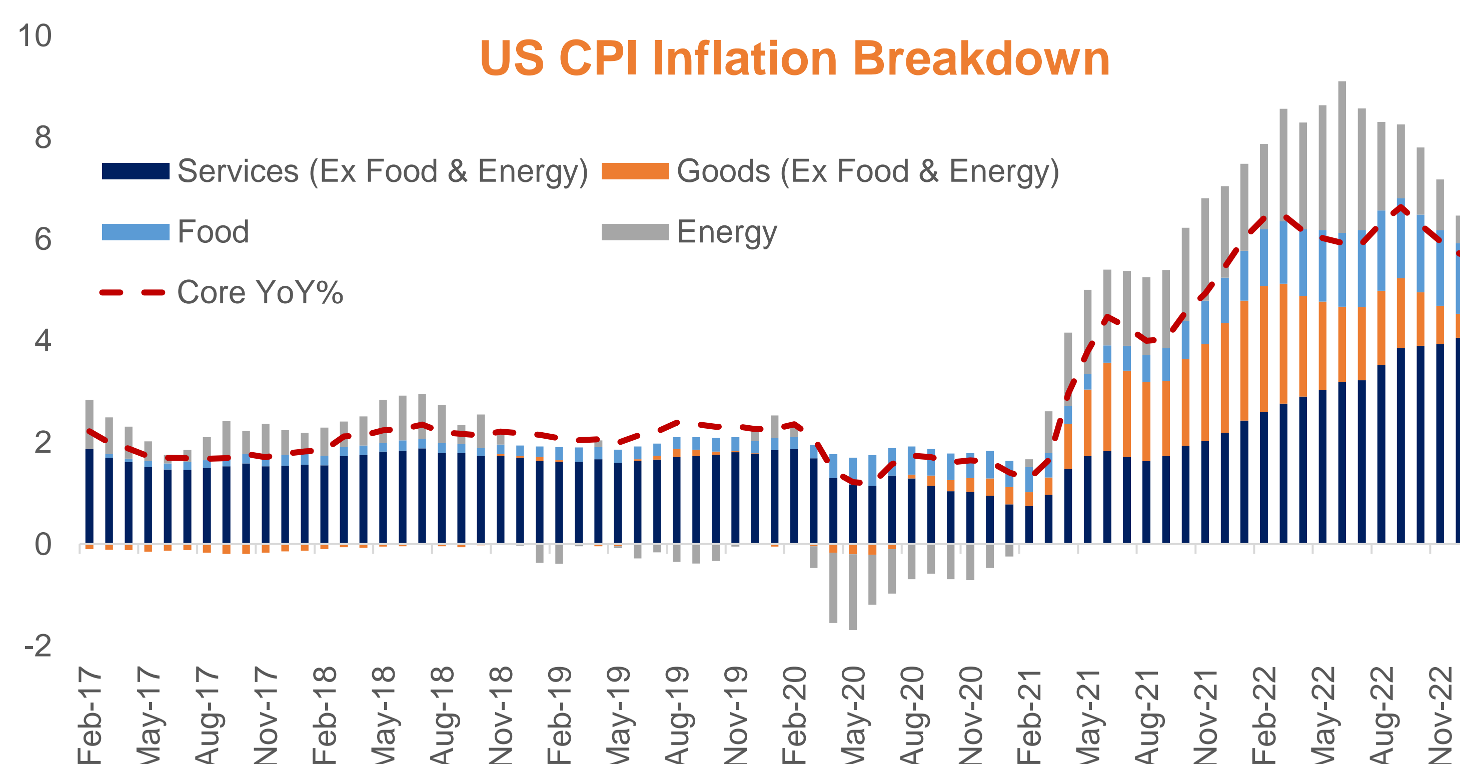
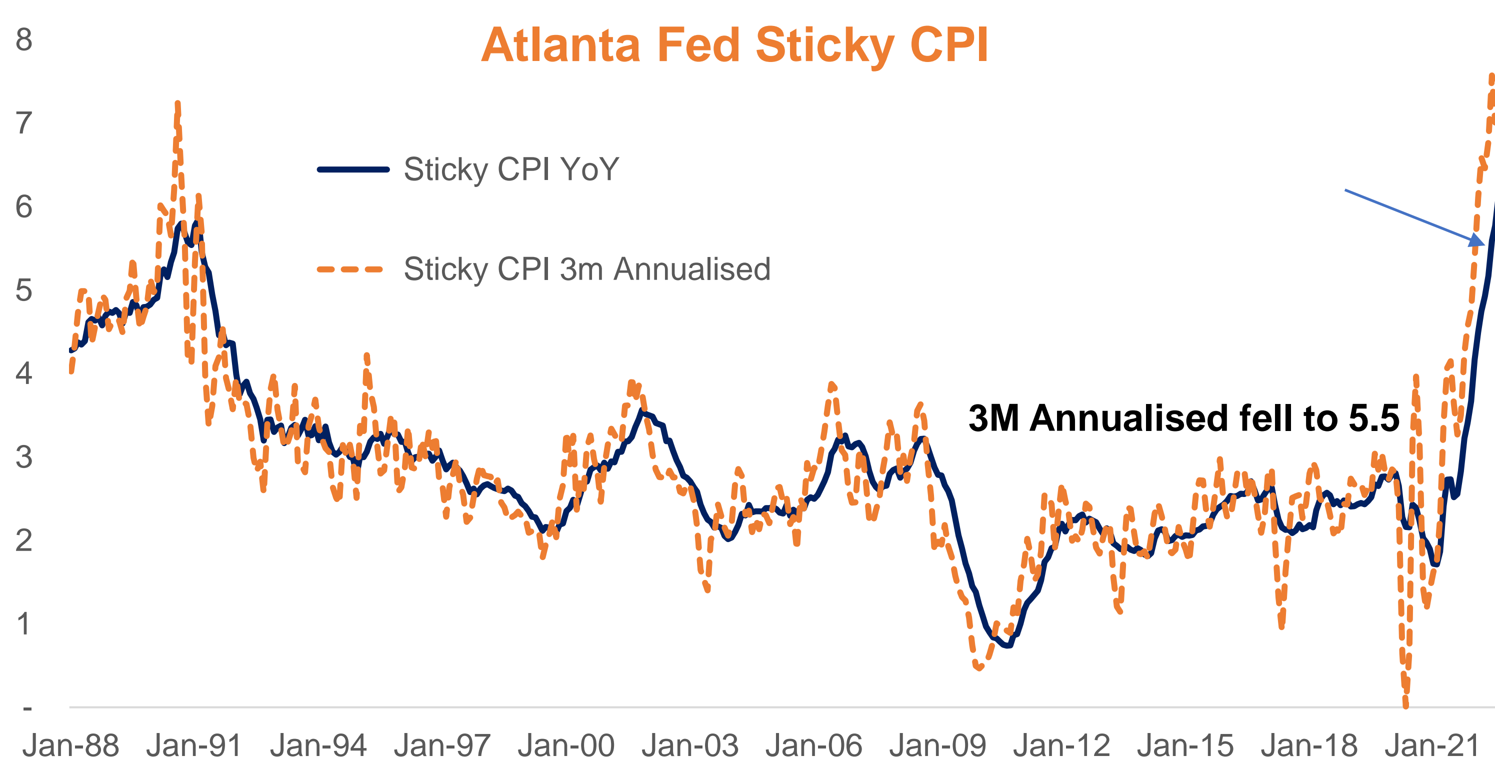
Disinflationary Respite

December's much anticipated CPI print arrived pretty much in line with expectations. What is clear from the data is that the pace of goods inflation has dropped significantly, as expected, from the early post-Covid highs. The bond market, which had seemingly already priced in the slow down in inflation and Fed hikes went on something of a tear with yields falling across the curve. Ironically the forecasts for Fed rate movements over the next 18 months did not alter materially, a clear indication that additional technical factors are at play on top of the improvement in sentiment. We would highlight the following in this regard: Strong US treasury market auctions buoyed by a re-emergence of foreign buyers, coupled with improved sentiment in both the Gilt and European bond markets. Regarding the latter, the UK was helped by a less negative fiscal outlook (lower than expected energy price caps) while in Europe, increased German openness to European climate linked bond issuance was a positive catalyst. As is always the case in thinly traded January markets, a little bullishness goes an awfully long way. However even at that the moves so far in 2023 have been fairly remarkable.



Source: Bloomberg as at 12/01/2023

Headline Services remain sticky with Shelter CPI hitting the highest level since 1982. However as this component operates with a lag to house prices, the market is increasingly looking through the current highs to an expected cooling down the line.

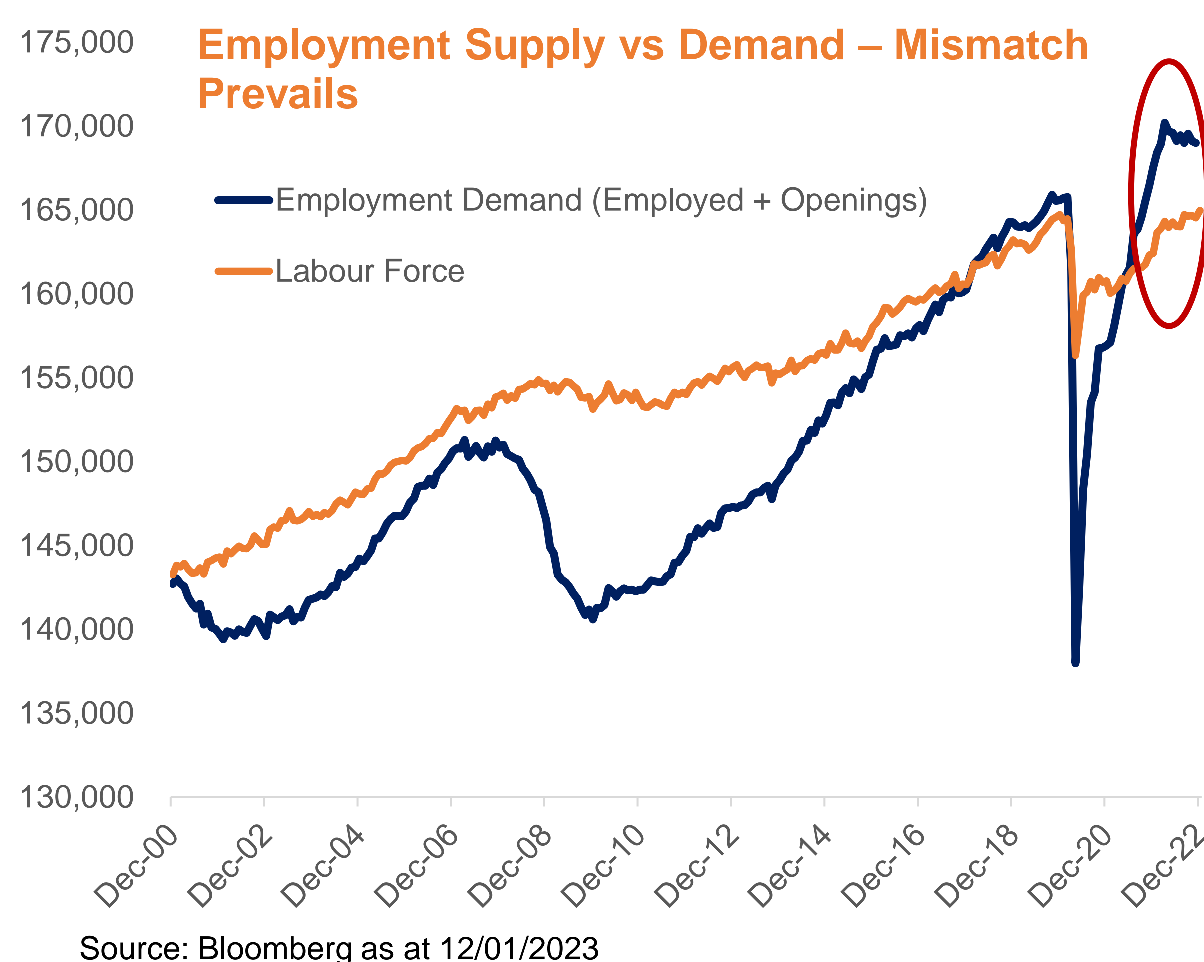


Source: Bloomberg as at 12/01/2023

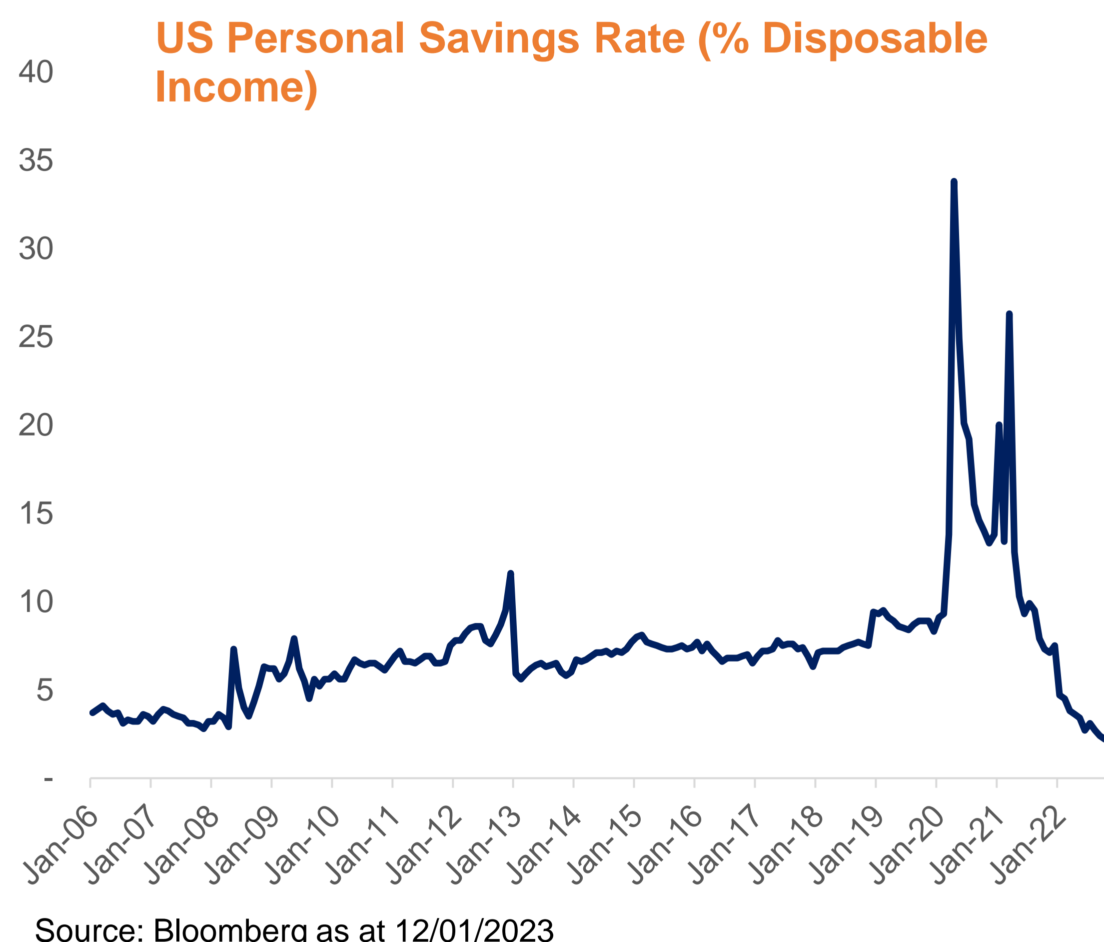
While the sticky components of CPI as measured by the Atlanta Fed remain stubbornly high (as also reflected in Services above), the 3 month measure reflects recent disinflationary momentum.

A More Balanced View

While goods inflation has collapsed remarkably quickly (second hand cars were not going to stay more expensive than new cars forever) service based inflation continued to increase - ‘sticky’ inflation is falling at a slower rate. The service based inflation has always been more closely related to the jobs market. On this note, at the same time the US CPI data was released, Initial Jobless Claims also came out and showed few signs of a weakening labour market. While wage growth has slowed somewhat from the impressive 6 percent plus rate, it remains at over 4%. With 10 million Jolts jobs remaining unfilled the Fed will still have concerns over the tightness of the labour market.



Source: Bloomberg as at 12/01/2023



Source: Bloomberg as at 12/01/2023

While recent survey data has been weak (not unusual for this time of year) there are suggestions of some greens shoots - Europe's negativity about the energy crisis is subsiding, China is not attempting to re-open under a cloud of Covid they are also putting forward significantly more positive economic policies re property and trade relations (Aus, US). While the impact of these may ultimately be short-lived, on the margin they are encouraging and enough to move the needle on sentiment. In addition, financial conditions have eased significantly over the last couple of months. Bond yields have fallen from the highs and credit spreads have once again tightened. In fact throughout the last year and half neither equities nor credit have ever really priced in any outcome other than a soft landing. Today the markets are not only pricing in a lower terminal rate but faster rate cuts (they don't and never believed the Fed's commitment to holding rates higher for longer). A pause in rates is clearly being taken as a ‘pivot’ by the markets. Looking ahead perhaps the biggest headwind relates to consumer spending as excess savings have collapsed - however a stubbornly strong jobs market, wage growth, lower energy prices and easing mortgage rates (certainly from peaks of last year) may just balance things out over the near term.

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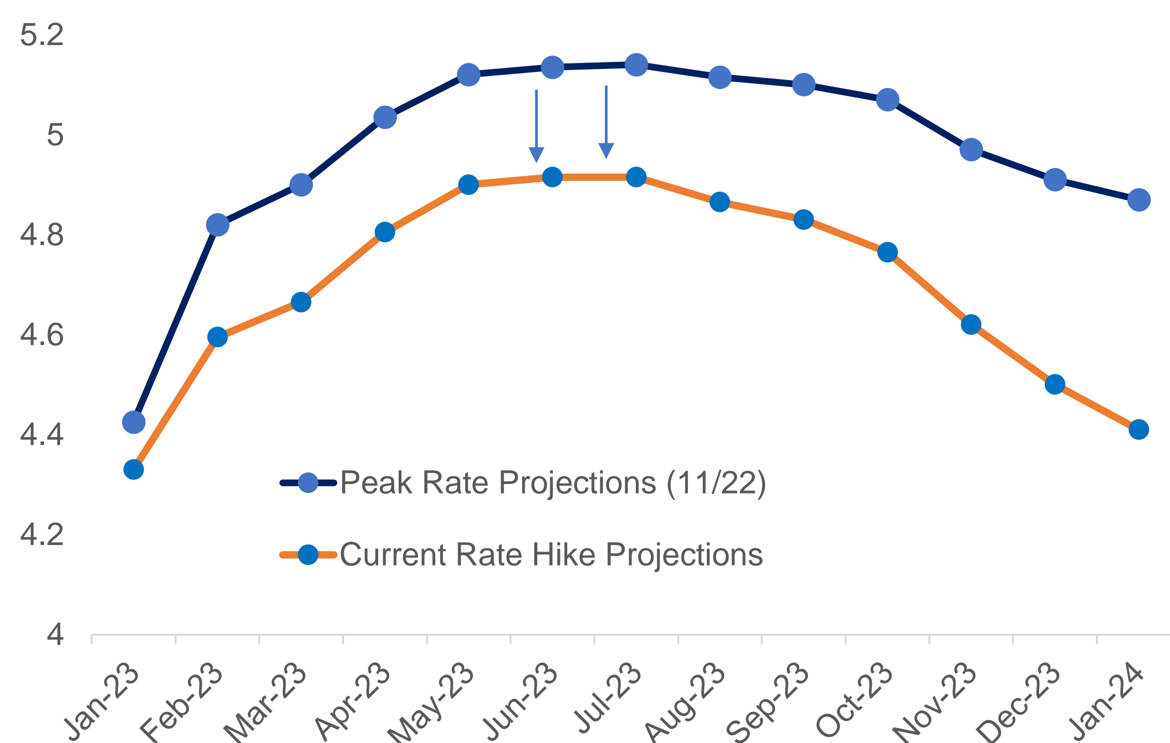
Bottom Line

There remains enough uncertainty in the economic outlook to keep the Fed from being too dovish in the short term. In our view we won't see a true pivot until the data genuinely warrants, and not in a Goldilocks way. Despite all of the conflicting information the global economy is projecting, it is clear that the market is pricing in a near perfect outcome - Inflation gone, growth stable, earnings solid, reduced geopolitical tension, stable climate outcome, strong labour market with benign wage growth and a Fed pivot. While some of these may indeed come to pass, all will certainly not (downside moves can happen as quickly as upside moves as we have seen over the last couple of years). As we felt at the beginning of the year, the higher running yields we have locked in (given the excessively inverted yield curve) represent the best path to generating returns in the face of another potentially volatile year. We are currently at an interesting point where the excesses of the Covid cycle are unwound and we move slowly into the new and structurally different market trends.

Source: Bloomberg as at 12/01/2023



Source: Bloomberg as at 12/01/2023

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