Forbes

INFLATION OUTLOOK FOR 2023

By: Coryanne Hicks - November 29, 2022

The return of inflation was one of the biggest stories of 2022. American consumers were coping with price increases the likes of which they hadn't seen since bell bottoms were all the rage. So it's only natural for people to be nervous about what's in store on the inflation front in 2023.

After decades of relative quiescence, prices surged to levels last seen during "the Great Inflation" of the late 1970s and early 1980s. The consumer price index (CPI) peaked in June 2022 above 9%, although the key measure of U.S. inflation has slowly drifted lower since then.

While CPI remained relatively elevated in October—up 7.7% year over year—observers have dared to hope that the downward trend could remain in place as we enter the new year. A few have even argued that we've reached peak inflation, thanks in part to the Federal Reserve's campaign of interest rate hikes.

The Fed has raised interest rates six times in 2022, and it's poised to do so again at its December confab. After two modest rate increases in March and April, the Fed implemented four massive 75 basis point (bps) rate hikes in the second half of the year.

The federal funds rate may have gone from zero at the start of 2022 to nearly 5% by year's end, but experts expect the Fed to pivot on policy—with major implications for inflation in 2023.

When Will the Fed Declare Victory?

Most market participants expect the Fed to keep raising interest rates incrementally in early 2023 and then pause at some point. The hope is that inflation will continue to slide lower, giving the central bank scope to pivot away from tightening.

When the inflation fever finally breaks, the Fed won't be in a hurry to cut rates—unless a recession deprives the U.S. economy of the desired "soft landing."

Currently, markets are projecting a rate hike of at least 50 bps at the Fed's final 2022 meeting in December, if not another 75 bps hike.

A soft landing for the economy would allow the bond market to recover and equity multiples to expand. Some experts say that could potentially form the beginning of a new bull market.

Asset prices could stabilize and possibly recover late next year even if the economy continues to slow because the market tends to anticipate the impact of monetary policies.

But the recovery may be slower than the last two recessions if the Fed sticks to its "hike-and-hold plan."

"This feels more like the 2001 to 2003 period than 2009 or even 2020, when the Fed used both rate cuts and quantitative easing (QE) to stimulate the economy and the market," says Carl Ludwigson, managing director at Bel Air Investment Advisors. "Without aggressive rate cuts and the return of quantitative easing, I would not expect a V-shaped recovery."

Personal Consumer Expenditures (PCE) Forecast

The Fed's preferred measure of U.S. inflation is core personal consumption expenditures (PCE). This measure has been above the central bank's 2% target since April 2021.

Measures of core inflation are less volatile than headline data because they strip out food and energy prices. Prices measured by core PCE rose 5.1% in September, down from 7% in June and just over 6% in July and August.

But even if core PCE inflation kept declining gently, the data would remain some ways from the Fed's 2% target rate.

"Inflation will be far stickier than most anticipate, as the economy continues to absorb the massive surge in the M2 measure of money the Fed injected into the system in 2020 and 2021," says Daniel Milan, managing partner and investment advisor representative at Cornerstone Financial Services.

The labor market remains tight. Structural issues like early retirees leaving the workforce, a lack of immigration and the pandemic's impact on labor participation will keep it that way into 2023, says Nanette Abuhoff Jacobson, global investment strategist at Hartford Funds.

Jacobson expects core PCE to be closer to 3% by the end of 2023, which would align with the Fed's predictions.

Economists at the central bank expect core PCE to fall to about 3.1% next year—although getting closer to the 2% target could take until 2025, according to a September 2022 SEP report.

If the Fed were to push too aggressively toward its target, it could tip the U.S. economy into recession.

"The Fed typically tries to navigate toward a soft landing, even if they never achieve this desired outcome in practice," says Mychal Campos, head of investing for Betterment. "I can see the Fed being comfortable with inflation coming down significantly from where it has been over the past year but remaining above the target inflation rate of 2% for some time," he adds.

Investors seem to agree with market-based measures of longer-term inflation expectations, such as the 10-year breakeven inflation rate also remaining slightly above 2%.

Supply Constraints Are in the Rearview Mirror

Supply chain disruptions were a big part of the inflation narrative in 2021 and 2022, thanks to the impact of the global Covid-19 pandemic.

Many of these constraints have resolved themselves as the global economy slowly, by fits and starts, got back on track in 2022, says Shawn Snyder, head of investment strategy at Citi U.S. Wealth Management.

Investment bank Goldman Sachs expects a "significant" decline in U.S. inflation next year due, in part, to an easing in supply chain constraints, coupled with a slowdown in rental prices and wage growth.

The Federal Reserve Bank of New York reports on a similarly optimistic state of affairs. Year-to-date movements of the Global Supply Chain Pressure Index (GSCPI), which increased only moderately in October after five consecutive months of easing, indicate that global supply chain pressures are falling back in line with historical levels.

Snyder says this can be illustrated with used car and truck prices. At the beginning of 2022, used cars and truck prices were nearly 41% higher year-over-year. Since then, they've dropped to a scant 2% higher year-over-year in October, according to the CPI data.

Improving global supply chains will help stabilize inflationary pressure in 2023 and potentially even lower them, says John Graves, founder and managing partner of G&H Financial.

The Impact of the Strong Dollar

The current strength of the U.S. dollar, buoyed by Fed rate hikes and the better economic conditions in the U.S. relative to other nations, may also help reduce inflation in 2023.

A stronger dollar makes imports cheaper, although it also reduces profits for U.S. companies with major overseas operations.

"Both impacts will have a downward pull on inflation, as domestic goods compete with cheaper foreign goods, thus lowering prices, which is compounded by higher unemployment rates resulting in fewer dollars seeking those same goods," Graves says.

U.S. efforts to tame inflation are essentially shipping that inflation to the rest of the world.

"As a result, foreign central banks will respond by raising their interest rates, boosting their currencies, and stemming their own rates of inflation," says Graves. "The scary thing is if it gets too much traction, over corrections could result in a global recession that hits the U.S."

Food, Energy and Consumer Durables Inflation

The Russo-Ukraine war has put considerable pressure on food and energy prices. Ukraine is a major exporter of wheat, corn and sunflower oil. The Russian invasion disrupted exports, causing a rise in global food prices.

"We've seen energy prices significantly increase as well, especially in Europe where there has been high dependence on Russia for gas," Campos says. However, signs point to this dependence coming to an end.

Snyder expects energy prices to remain volatile into winter 2023.

"As we move past February 2023, the initial impact of the conflict, when crude oil prices surged, will start to fade from the economic data," he says.

Snyder points to AAA's retail national gasoline price measure, which rose from $3.73 per gallon in March 2022 to more than $5 per gallon in June. As of Nov. 28, that price has fallen back to $3.54 per gallon.

Here's the big inflation takeaway for investors: Global and U.S. financial markets have a lot of inertia.

"It takes a long time and a gargantuan amount of effort to get this gigantic financial ship turning in a new direction, even after you spin the rutter and crank the throttle," Graves says.

But when it starts to move, it takes an equal amount of time or effort to get it to stop where everyone wants it.

"Despite the belief that managing an economy has turned into a science, there will be a lot of trial and error here to dial in that perfect Goldilocks balance of forces to get it just right," he says.

John Graves, founder of G&H Financial Group, specializes in retirement planning and working with clients pre- and post-retirement who desire to preserve their money for when they need it most. John prides himself on building and maintaining long-lasting relationships with clients and their families.
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