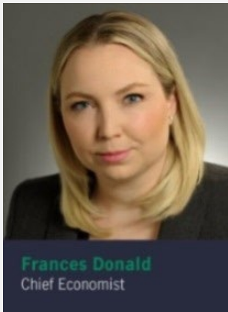


A higher-than-expected January inflation reading in the United States led some market participants to price in a full 50 basis points interest-rate increase in March, and a couple of major forecasters are now predicting as many as seven hikes this year.[1] Did the data justify the reaction? Frances Donald, Global Chief Economist and Head of Macroeconomic Strategy, believes that the market overreacted to January's inflation print for four reasons.

Did markets overreact to January's U.S. inflation data?

An unnecessary panic?

January's U.S. inflation data was painful: The Consumer Price Index (CPI) jumped 7.5% year over year (YoY), beating consensus expectations of 7.3% YoY. Core CPI, which strips out relatively more volatile items such as food and energy, was just as spicy, coming in at 6.0% YoY. Ouch. The inflation doves highlighted—correctly, in our view—that the bulk of the price pressures was still emanating from COVID-19-related distortions. The inflation hawks also rightly noted that the CPI reading itself was climbing higher and that services activity was also witnessing some price pressure.

Markets reacted swiftly—expectations for a 50 basis points (bps) hike in March jumped to 70% while two-year rates jumped as well. James Bullard, president of the Federal Reserve Bank of St. Louis, already a noted hawk, switched his position and advocated for a 100bps interest-rate hike to be "in the bag by July 1." Meanwhile, major investment banks ramped up their expectations to as many as seven interest-rate hikes this year.

Naturally, the yield curve continued to flatten aggressively and is, in the absence of a meaningful dovish U.S. Federal Reserve (Fed) pivot, on track to invert within six months—typically seen as a sign of impending recession. Judging by the market's response, you'd think we had been ambushed by significant *net new* information that required everyone to change their base case expectations.

Four reasons why we believe the market has overreacted

We concede that, yes, pressure is building for the Fed and the White House (and frankly speaking, their peers worldwide) to do *something*: Higher costs of living can have an important impact on average households. And, yes, a 7.5% YoY CPI print certainly gives hawkish Fed officials additional ammunition to bang their rate-hike drums even harder. But let's gently push back: We believe the market overreacted to January's inflation print for four reasons.

1. **The U.S. Bureau of Labor Statistics announced new CPI weightings for each inflation category 48 hours before releasing January's data.** It's an exercise that takes place every two years, undertaken to reflect shifts in the CPI market basket. On closer inspection, these revisions revealed a greater emphasis on goods (which have been the main contributors to inflation) and reduced importance on services (which have been weaker contributors to inflation*)*. These adjustments implied that we'd see some

[1]Bloomberg, as of 14 February 2022.

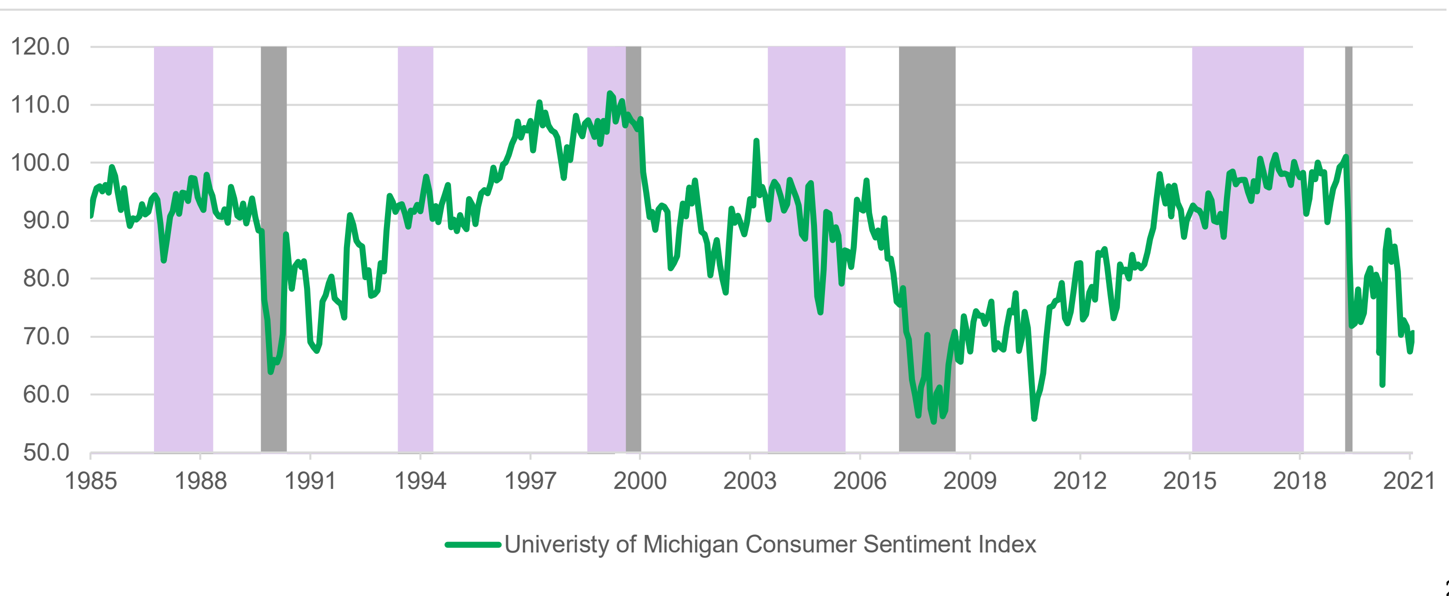
upside to January's forecasts; however, they also suggest we're likely to see *downside* pressure on inflation by year end as the price of goods experience disinflation/deflation while services inflation rises. As we say every month, CPI math isn't real life and parceling out bps as calculation adjustments risks turning noise into signal.

2. **What matters to the Fed is how far inflation falls, not where it peaks**. When we look at data, we're automatically searching for *new* information, specifically developments that have what has yet to be reflected in the price. Most of us had expected January CPI to come in *above* 7% (and potentially higher in February due to developments in the energy space). In our view, this should point to a rate hike in March, but the number of interest-rate raises we'll see throughout 2022 will be a function of how quickly inflation eases, not how high it peaks. The Fed has been clear that it's looking for sequential declines in month-over-month inflation after February. If we change our Fed call (and indeed, if the Fed doves who favor a slower path of hikes change their view), it will be because our expectation for future inflation is too low. Indeed, President of the Federal Reserve Bank of Kansas City Esther George noted that "the print was not a surprise."

3. **We maintain that the bulk of the inflation we're experiencing now isn't Fed-responsive.** We've noted before that the primary sources of inflation in the United States (i.e., cars and energy) are interest-rate sensitive. Perhaps more importantly, we expect most of the inflationary pressure within this particular segment to dissipate without any policy intervention. Conversely, the segment that *is* interest-rate sensitive (broader services and housing) typically responds to hikes after a one- or two-year lag. An intermeeting rate hike (which nobody on the Fed has suggested or validated) or even a 50bps rate hike at the March 16 meeting would, in our view, be more of a *show* than a necessary or successful way to cool Q2 inflation prints.

4. **January's inflation data lands against a backdrop characterized by recession-level consumer confidence**. The University of Michigan's Index of Consumer Sentiment has fallen to levels that are more consistent with recessions, not overheating economies. Interestingly, the Fed has never begun a hiking cycle with consumer confidence looking so weak, or within an environment

The Fed rarely starts a rate-hiking cycle while consumer sentiment remained weak



Source: Bloomberg, Macrobond, University of Michigan, Manulife Investment Management, as of February 14, 2021. Fed refers to the U.S. Federal Reserve. The grey areas represent U.S recessions. The purple areas represent the Fed's rate-hiking cycles.

where economic momentum is *slowing*. Going into the March 16 FOMC meeting, we believe the Fed will be facing declining Purchasing Managers' Indexes, weak consumer confidence, and declining small business confidence even as it faces a sizable headwind as a result of fiscal tightening. While it's intuitive to predict Fed decisions on the back of a single data point, the Fed looks at the economy holistically. Yes, normalization is necessary, but it'll require a gentle hand.

Implications of an extremely hawkish Fed

In a nutshell, our base case expectation didn't change as a result of a 20bps upside surprise to January's inflation data. This number which, in our view, mathematically speaking at least, doesn't provide an accurate reflection of inflationary pressures. We continue to believe that the Fed will want to hike rates on March 16, and that the bank would like to wrap up quantitative easing quickly and begin quantitative tightening). But as upcoming growth data deteriorates over Q1 and Q2—likely PMI declines, a weakened consumer, the impact of fiscal tightening, and the lagged effects of global monetary tightening—we believe the Fed will pivot sometime in the second quarter. We expect the Fed to place an emphasis on the need for a gentle normalization process that's consistent with another one to two hikes in 2022 and continued gentle hiking in 2023. This should also lead to a re-steepening of the yield curve and an extension of the cycle—an outcome that should augur well for equities and risk assets in general.

We hope we're correct, because if the Fed does feel compelled to hike at every meeting and engage in aggressive quantitative tightening, then it's likely that a yield curve inversion will materialize, thereby boosting the chances of a recession in 2023 and a more problematic macro outlook for risk markets.

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