



Progress in battle to cool inflation

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December consumer price data confirms the Fed has made significant progress in its battle to cool inflation. Overall, the Consumer Price Index (CPI) hit a 41 year high of 9.1% last June driven by energy prices, which began to spiral upward as we emerged from the pandemic lockdown in 2020 and spiked following Russia's invasion of Ukraine last February. Gasoline, which topped out above \$5 a gallon in June, has fallen to a national average of \$3.27 according to the AAA, an important reason CPI inflation is now down to 6.5%. Prices of durable goods, particularly new autos in scarce supply due to parts shortages, shot up as locked-down consumers went on a buying spree. Demand for durables has since softened as the public, learning to live with the receding virus, has shifted demand to scarce or previously unavailable services. Used car prices have been falling since July and new car prices, including EVs, dropped in December and have fallen further in January as price competition has intensified. These declines have helped push core CPI, which excludes volatile food and energy, down to 5.7% in December from 6.6% in September. The pandemic and near zero interest rates fueled a boom in housing. Demand for larger houses and residences in locations outside of congested areas soared just as builders struggled with shortages of land, materials and workers. These factors are now moderating; home prices are falling, and new rents are rising much more slowly.

In retrospect, rising energy, auto and housing prices were driven by combination of concentrated demand and restricted supply, the root causes of which were our excessively stimulative domestic monetary and fiscal policies which led to too much money chasing too few goods, mandated lockdowns in response to a once in-a-century pandemic, and the Russian invasion of Ukraine. When some buyers are willing to pay almost anything for something they want, prices will rise. When European governments pay up to stockpile natural gas, rental car companies, desperate for used cars to rebuild their depleted fleets, are aggressive buyers and migrants from US coastal cities are willing to pay elevated prices for houses in interior markets, inflation will surge.

Importantly, we believe the December headline CPI report showing the first month-to-month decline in 2 1/2 years and the smallest gain in core CPI since December 2021, will likely give the Fed cover to raise its reference rate 25bp at its February 1 policy meeting, downshifting the pace of tightening from 50bp in December. A growing number of Fed officials have recently provided support for slowing the pace of tightening but clearer signs of weakening in the labor market will be needed before the FOMC will feel comfortable putting further rate increases on hold. Fed officials have repeatedly emphasized the link between the labor market and core services inflation and that the pace of jobs growth and labor costs will be an important determinant of future inflation and Fed policy.

Recent readings of the jobs market paint a mixed picture. The unemployment rate was a very low 3.5% in December and job growth remained robust. But the pace of job growth has slowed lately and recent declines in temporary help employment could be a leading indicator for some further weakening in the broader labor market. Nevertheless, initial jobless claims remain historically low suggesting a low level of

layoffs and good prospects for finding a new job following a layoff. Overall, the labor market remains tight and out of balance.

Inflation *expectations* can also impact inflation. They are likely to be an important factor in how aggressive FOMC policy makers believe they need to be in bringing inflation down to their 2% target. In their view, the longer inflation remains elevated the greater the risk inflation expectations will move higher, an outcome they are trying to avoid. To date, we have seen no clear upward shift in inflation expectations. In fact, the most recent University of Michigan consumer survey continued its recent downward trend, falling another 0.4 percentage point in January. While the latest reading of this measure is higher than pre-pandemic levels, it is well below many of the figures reported in the late 1970s and early 1980s when inflation was last out of control.

Still, there are other factors that can influence inflation apart from the labor market. For example, the US dollar has fallen recently, following a long period of relative strength, putting some upward pressure on import prices. December import price data showed a 0.4% increase, the first monthly gain since last April, and the dollar has continued to depreciate this month. Further dollar weakness and, more generally, any easing in financial conditions stemming from a sharp rise in the equity markets could hamper the Fed's efforts to slow the economy and bring down inflation.

In summary then, looking at recent inflation and employment trends, it's evident the Fed's belated push since last March to constrain the economy and in the process curb inflation is just beginning to have an impact. Inflation remains well above the Fed's 2% target. Much of the progress we have seen in the past few months has come from volatile categories such as falling energy prices, which could reverse. Inflation has now migrated from the goods sector into labor intensive services where workers have leverage on wages. Progress with service sector inflation, made possible by the eventual easing in labor market conditions, will be necessary before the Fed puts an end to its tightening cycle.

Housing

The housing sector was a major and early beneficiary of the Fed's zero interest rate policy of 2020-21 and the government's effort to prop up the pandemic-stricken economy, spending \$7+ trillion to cushion the blow for unemployed workers and their beleaguered employers. But once the Fed started tightening, housing was hard hit, becoming a casualty of the current interest rate cycle. Housing's current decline is not expected to be a repeat of the 2006-11 bust but it will drag on until at least late this year or early 2024 by which time interest rates are forecast to begin coming down. Home sales and prices are expected to drag in 2023, particularly in the existing home market.

From May 2020 until June 2022, both the national Case-Shiller price index and the FHFA price index rose more than 40%. But, since June 2022, Case-Shiller is down 2.4% and the FHFA is 1.1% lower. The largest declines to date have occurred in the West — San Francisco, Seattle, Las Vegas and Phoenix. However, every major metropolitan area, without exception, has experienced a decline in the past three months. Looking back, prices reached unsustainable levels relative to rents and should fall further to reflect better rental values. Housing market analysts expect a peak-to-trough decline in the 5-10% range, nothing like the 25% drop in 2006-11. Experts believe existing home prices are already close to fair value when measured against construction costs, limiting the downside for prices. In addition, there is no massive excess inventory of homes, unlike during prior busts. And, unlike during the sub-prime era, the vast majority of homeowners have mortgages locked-in at extremely low rates, which means they will be

extremely reluctant to sell.

The real effect of the rise in interest rates is evident in the existing home market where sales hit a 6.65 million annual rate in January 2021, the fastest pace since 2006. But by November 2022 sales had declined to a 4.09 million annual rate, a 38.5% fall from the peak. Existing home buyers have two major problems to contend with. First, much higher mortgage rates which translates into higher monthly payments. Assuming a 20% down payment, the rise in mortgage rates and home prices since December 2021 amounts to a 52% increase in monthly payments on a new 30-year mortgage for the median existing home. Meanwhile, it's hard to convince a current homeowner with a low fixed-rate mortgage to sell. In other words, sellers should now want more for their homes, while buyers want to pay significantly less. This will not soon change, leading to weaker sales in 2023 than last year.

New home sales are also down substantially since the pre-COVID peak but should soon find a bottom. The key to new home prices is the contractor with deep pockets. Also, housing has been underbuilt in the past 10 years falling short of potential demand. While the average price of a new home will likely fall, demand for new construction will eventually emerge as interest rates ease and new households continue to be formed.

Outlook

The Fed has raised its target policy rate by more than four percentage points in the last year. We are just now entering the period where the effects of these rate hikes will become evident, showing up in the data. Because of the lags involved, policy makers will face a difficult decision in coming months about when to stop their rate increases or reverse course. FOMC members will need to dial back before inflation is completely solved or risk tipping the economy into recession. Minutes of the most recent Fed policy meeting in December showed central bankers struggling with the risks. Indeed, our firm's proprietary [Economic Model](#), designed to signal a change in the direction of the economy 6 to 9 months ahead of an inflection point, has for months been signaling the possibility of a recession this year. Interestingly, historical data shows that, on average, as interest rates rise overall economic output begins to slow about six months after the commencement of a policy change such as we saw last March, and the unemployment rate starts to rise about five months following an initial rate increase. The Fed began raising rates last March, accelerating the pace of its rate hikes in June. If history repeats itself, we should soon see a further slowdown in economic activity and a rise in unemployment. Whether the slowdown will lead to a recession will depend upon how much higher and at what pace the Fed tightens. Time and the direction of monetary policy will tell.

Adding weight to the questionable outlook, both the *ISM Manufacturing and Non-Manufacturing Indices*, reliable leading indicators, have fallen below 50, signaling contraction ahead. The Manufacturing index declined to 48.4 in December from 49 in November while the Non-Manufacturing index dropped to 49.6. The major measures of activity of both indices were lower and new orders fell. In a good sign from both indices, supplier delivery times fell indicating a continuation of the easing in supply-chain bottlenecks.

So, at this point, considering the data we have seen recently, the outlook continues to be quite uncertain, heavily dependent upon decisions the Fed will make over the next few months. As we see it, a brief downturn is likely but not a certainty. Most economists believe a mild recession is probably in the cards. Nevertheless, there remains the possibility the Fed may find a path that allows the economy to narrowly skirt a downturn, achieving the elusive "soft landing" it hopes for. But be aware previous Fed efforts to thread the needle have led to disappointment.

Equity investment policy

The S&P Index closed December 2022 19.95% below its all-time closing high on 01/03/22. The S&P MidCap400 and S&P SmallCap600 Indices stood at 16.50% and 21.04% respectively below their record closing highs as of 12/30/22. The tech heavy NASDAQ lost over 33% of its value in 2022. Last year turned out to be the worst year for the S&P500 since 2008. However, just five trading sessions accounted for more than 95% of the losses in the S&P Index in 2022. For comparative purposes, an investor who missed the best five trading days of the year would have achieved a total return that was 13.11% lower than one who stayed invested in the S&P500 for the entire time; yet another indication, in our view, that trying to time the market remains a fruitless endeavor.

Beyond the broader indices, hundreds of small cap tech stocks without earnings or positive cash flows, former darlings of retail investors during the 2021 speculative bubble, fell sharply, declining as much as 75%+ from their October 2021 highs. Special Purpose Acquisition Companies (SPACS), so-called *meme* stocks and crypto currencies crashed. Many of these have disappeared from the listings. Beyond the shares of companies benefitting from rising energy prices, which now account for only about 5% of the S&P500, few stocks were spared the carnage. In short, very slow growth in inflation-adjusted profits, rapidly rising interest rates and recession fears combined to wash-out the speculative excesses that characterized the later stages of the 2020-21 bull market.

Near term, we believe equities are likely to remain volatile, particularly around the release of key inflation data, Fed decisions and Fed speak, absent greater clarity regarding future Fed policy. Several prominent market timers, worried that 2023 earnings estimates are too high given the recession risks, are predicting the S&P 500 will either revisit its 2022 lows or undercut them, before stocks finally bottom, setting the stage for a sustainable advance. Others, long-term investors including our firm, will stay-the-course, avoiding the temptation to time the market. Surprising to some market mavens, the stock market has begun this year on a more positive note. Since year-end, the S&P500 has risen 4.16% and the NASDAQ has bounced 5.85% as investors have apparently put some money to work anticipating a pivot in Fed tightening sooner than previously expected. Obviously, if it becomes apparent the Fed is succeeding in engineering its desired soft landing, stocks should rally substantially, recouping in short order much of the ground they gave up last year.

Looking a bit further out, we believe we are rapidly approaching the peak in the Fed's tightening cycle, reducing pressure on equity valuations and setting the stage for the next economic advance and a new bull market. Absent another exogenous shock, we expect the coming expansion to be strong and prolonged, supported by sound fundamentals including falling interest rates and easing credit conditions, sticky but gradually receding inflation, strong consumer and corporate balance sheets, and a well-reserved US banking system. In addition, while there is currently no near-term end in sight to the fighting in Ukraine, the war will eventually wind down and, as was the case following the end of WWII, an enormous investment will be required to rebuild Ukraine's infrastructure, creating new jobs and stimulating global growth in general. And the coming end to China's zero COVID tolerance policy will further underpin the nascent expansion.

Equity portfolios under our supervision remain broadly diversified between *growth* and *value* investments, still tilted toward *value* which outperformed growth last year by 24 percentage points. As the pressure of rising interest rates abates, we expect investors to rotate back toward growth shares as their valuations generally have become more reasonable relative to their long-term earnings growth prospects. Our investment platform also includes modest investments in both *developed* and *emerging*

markets abroad as well as allocations to domestic small cap stocks.

Fixed income

As Fed tightening and expectations for rising interest rates mounted last year, bonds with duration were badly bruised. The aggregate fixed income indices suffered unprecedented declines of as much as 13%. In our view, the rise in rates made bonds investable once again. Accordingly, we have modestly extended bond durations in clients' laddered bond portfolios using the proceeds of maturing holdings yielding less than 1% to add selectively to corporate obligations yielding near 5% which come due in about two years. We have also been active in managing cash equivalents for many clients by replacing lower yielding money market funds with riskless higher yielding US Treasury obligations maturing later this year, yielding close to 5%.

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Indexes are unmanaged, do not include fees or expenses and are not available for direct investment. Definitions:

Personal Consumption Expenditures Index (PCE): A measure of the prices that people living in the United States, or those buying on their behalf, pay for goods and services. The PCE price index is known for capturing inflation (or deflation) across a wide range of consumer expenses and reflecting changes in consumer behavior.

Conference Board's Confidence Index: The Consumer Confidence Survey® reflects prevailing business conditions and likely developments for the months ahead. **ISM Manufacturing Index:** The ISM manufacturing index or purchasing managers' index is considered a key indicator of the state of the U.S. economy. It indicates the level of demand for products by measuring the amount of ordering activity at the nation's factories. **ISM**

Non-Manufacturing Index: The Institute of Supply Management (ISM) Non-Manufacturing Index is an economic index based on surveys of more than 400 non-manufacturing (or services) firms' purchasing and supply executives. **S&P500 Index:** The S&P 500 Index, or Standard & Poor's 500 Index, is a market-capitalization-weighted index of 500 leading publicly traded companies in the U.S. **S&P500 Growth Index:** The S&P 500

Growth Index is a stock index administered by Standard & Poor's-Dow Jones Indices. As its name suggests, the purpose of the index is to serve as a proxy for growth companies included in the S&P 500. **S&P500 Value Index:** The S&P 500 Pure Value Index refers to a score-weighted index developed by Standard and Poor's (S&P). The index uses what it calls a "style-attractiveness-weighting scheme" and only consists of stocks within the S&P 500 Index that exhibit strong value characteristics.

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