Capital Markets Strategy
Essential inCights for the C-Suite

MUFG

Policy Note

The outlook for inflation and Fed policy will be an important driver of markets in the 1H 2023. Please see below for our latest thoughts.

We have also re-attached our comprehensive 2023 outlook publication, ***The New Macro Supercycle,*** released a few days ago.

Expectations for the Fed in 2023

1. Nearly 85% of CBs tightened in 2022. Given that monetary policy operates with a 12-18 month lag, much of the impact will be felt in mid-2023.
2. As inflation and rate risk concerns give way to growth and earnings risk, the Fed may matter less for markets than in 2022. Larger, more important trends are transforming the global economy.
3. The Fed is much closer to policy normalization than its big 4 counterparts (ECB, BOE & BOJ).
4. We expect the Fed to downshift to a 25 bps pace in February, though a "hawkish" 25. Dampening financial conditions remains critical to the mission.
5. Fed Chair Powell's "favorite" inflation metric, core services ex shelter, remains uncomfortably high and just below peak.
6. For markets, how high the Fed goes (i.e., 4.75% or 5.25%) may be less meaningful than what they do next. The consistent Fed chorus has been "hold" for longer, but markets are pricing a "pivot."
7. With 10 year UST yields trading well below Fed Funds, the markets have effectively been questioning the Fed's ability to stay "higher for longer".
8. Thus far, the Fed has emphasized 3% inflation is not the new 2%, but rather, 2% is 2%.
9. Historically, Fed tightening cycles end when Fed Funds is greater than inflation. Since 1990, the Fed has averaged 300-400 bps of rate cuts in the 1-2 years after recession begins.
10. 7-8 G10 CBs are likely to undertake QT in 2023, increasing disruption and liquidity risk for markets. MUFG estimates that G4 CB balance sheets will decline nearly $4 tn, or 16%, in 2023.

Expectations for Inflation in 2023

1. This is not the 1970s. Global and US inflation peaked in the 2H 2022 and should rapidly decline in 2023.
2. Prepare for a long ride. The path to 2% will take years (i.e., 2024-25), not months. It will be much easier to go from peak 9% inflation to 4%, than from 4% to 2%.
3. Prepare for a bumpy ride. The disinflation path is unlikely to be smooth and linear.
4. Markets in 2023 will shift from "peak" inflation concerns to "sticky" persistent inflation.
5. The focus in 2023 will shift from goods and energy inflation to services (i.e., wages) and food. Services inflation, in particular, remains uncomfortably high.
6. Goods inflation tends to be more volatile, services more persistent. In 2023, we expect more rapid goods disinflation in the 1H, services disinflation in the 2H.
7. As the year progresses, concerns should then pivot from inflation and rate risk to growth and earnings risk.
8. The COVID-induced supply-side dislocations are closer to normalizing, as evidenced by sharply lower transportation and input costs throughout the entire supply chain.
9. Several "structural" dynamics (not cyclical) driving higher LT inflation: aging demographics, labor shortages and under-supplied housing markets.
10. Numerous pervasive "megatrends" driving higher LT inflation: energy transition, commodities supercycle, de-globalization, supply chain restructuring and US-China decoupling.

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