

Advisory Blog

Timely insights on the issues that matter most to advisors and their clients

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Inflation May Be Peaking in the U.S. What about the Rest of the World?

By: Jim Caron | September 14, 2022

New York - Inflation is inching downward at the headline level, but remains stubbornly high at the core level (excluding food and energy). In fact, inflation data released on September 13 revealed that prices rose slightly in August. Still, inflation in the U.S. may be peaking, but it's more of a "rounding top" than a sharp decline from the highs, putting added pressure on the Fed to continue tightening.

The picture is cloudier in Europe and the UK, where inflation is still on the rise primarily due to severe energy shortages throughout the region, in part because of the war in Ukraine. But since the pandemic, the UK and European economic cycles have lagged the U.S. by about 3 months, meaning that if U.S. inflation is in fact peaking in 3Q — albeit slowly — then inflation may peak for the UK and Europe in 4Q. Following the Fed's lead, both the European Central Bank and the Bank of England have been aggressive with rate hikes to combat inflation.

In the Asian-Pacific (APAC) region, economic weakness in China is a drag, especially for Emerging Markets (EM). Central banks in Australia and New Zealand are still tightening but seem to be softening their pace. EM is more idiosyncratic and country specific, but the rate of change for increasing inflation is starting to slow and central bank policy across the region is likely to follow suit.

To date, 2022 has been mostly about rising inflation. Looking ahead, however, we should perhaps incorporate a view of peaking, then falling, inflation in 2023. That said, inflation risks remain: Inflation may in fact peak, then fall, but the question is will it fall enough — to target levels — **and will it then stay there?** Inflation could reverse a downward course based on changes in supply chains or labor shortages, keeping it higher than target levels, and for longer than expected.

In this scenario, central banks may need to restart a tightening cycle sometime late in 2023 — and this is a risk scenario that is not currently priced in the markets. Alternatively, if the economy slows more than expected, then inflation will likely be controlled, but for all the wrong reasons.

Given this backdrop, I am often asked "is it time to buy bonds?" Well, the short answer is yes *and* no, depending on my four Ws: **Where** geographically, **Which** bonds, **What** maturity and **When** to buy.

Where

U.S. as inflation has likely peaked and Fed may reach the terminal federal funds rate of 4% by end of the year. **UK & Europe** as inflation and policy lags the U.S. by three months. **Emerging Markets** may be a little early but idiosyncratic to country risk.

What

According to the "Three Bears," **long duration is "too hot"** — an attractive play for a recession but also riskier. **Short rates are "too cold"** as central banks become aggressive. So **3-4 years of duration looks "just right."**

Which

Investment Grade/High Quality offers yield, duration sensitivity and lower default risks but if we have a mild recession, then **High Yield** can offer more potential upside.

When

Timing is everything. U.S. policy rates are likely to peak and hold first. This plus a strong U.S. dollar gives **U.S. assets an edge over other markets.**

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