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Word of the year II

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If doing something two years in a row is sufficient to deem it a tradition, then this finance word of the year (WOTY) blog meets that criterion.

In my inaugural WOTY blog a year ago, "transitory" as it pertained to inflation stood out as the word that most dominated market discourse in 2021. But the job of an investment strategist is to anticipate where the world is going, not summarize where it's been. Thus, the real point of the blog was to predict the 2022 WOTY, and I proposed "soft-landing", or alternatively "hard-landing."

As 2022 WOTY candidates go, soft-landing is a solid option, but it doesn't jump out as the defining investment issue over the last 12 months. Concerns about a recession are certainly prevalent and inflation has been much higher than expected. But the driving force in financial markets this year has been the Fed aggressively hiking rates at a pace unseen since the early 1980s, and so any WOTY should be associated with this fact. "Tightening" and "hawkish" are fair descriptions of Fed policy, though neither captures the investment zeitgeist this year. Financial conditions arguably do, but that's a term not a word. Probably the best option is "pivot" in regard to Fed policy, but it's only really been prevalent in the past few months.

Turning to 2023, soft / hard-landing may be even better candidates for next year than this one as the economy gets closer to the precipice of a recession, and investors increasingly worry about slowing growth. Yet my money is on "disinflation." For one, disinflation is already happening, with CPI down from 9.1% in June to 7.1% in November, and it's likely to continue falling rapidly in the first part of 2023. That there will be disinflation is not really in dispute at this point, the debate is over how much disinflation there will actually be. Will inflation measures fall all the way back to 2% without more Fed rate hikes that are currently expected or will it hit a floor around 4%?

With investor concern shifting from high inflation to slowing growth, proposing disinflation as the 2023 WOTY may appear backward-looking. But the case for disinflation being the most dominant market issue is strong. First, the magnitude of disinflation matters for Fed policy—the more rampant and structural disinflation is, the sooner the Fed can stop hiking rates and start cutting. Second, as we've been reminded this year, Fed policy is arguably more important for markets than any other variable, so a Fed that goes from investor foe to friend is the inflection point to watch next year. Third, disinflation matters for the soft-landing debate because the more it happens without further Fed tightening, the more likely a recession is avoided, which makes a soft-landing more of a by-product of disinflation than the other way around. Fourth, the debate between a soft-landing and recession is almost more about semantics than actual economic distinctions as both could entail negative earnings growth, whereas there is a big macro difference between a lot versus a little disinflation. Finally, as a WOTY candidate, disinflation has the virtue of being a development that will likely last all year long.

To be clear, predicting that disinflation will be the most dominant market story next year is not a prediction for significant disinflation, with a return to 2% inflation by year-end. But just as the Fed tightening financial conditions is what drove performance across financial markets this year, potential disinflation could do the same in 2023. If that's not a recipe for a finance WOTY, then nothing is.

That's a debate we can all put on hold for the next two weeks. For now, I wish everyone a happy and healthy holiday season, and hopefully a better market environment in 2023.

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