The Panic Over The Print

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The financial markets have had a laser focus on inflation as it has such a huge impact on the prospects of Federal Reserve (Fed) tightening, interest rates and valuation metrics on the equity market. The markets have been constantly recalibrating expectations: easing inflation with the potential ending of the Fed's tightening cycle versus persistent inflation driving further rate hikes. Today's 4.3% decline is over the apparent disappointment that the latter scenario is likely. Just as the three-year inflation expectations in the New York Fed's Survey of Consumer Expectations fell to nearly a two-year low, the August inflation report came in hotter-than-expected and the fears of an aggressive for longer Fed were once again revived as the S&P 500 posted its worst day since March 2020. While market movements such as these are uncomfortable, here are some dynamics to consider:

The Shortcomings of the CPI Calculation

The Consumer Price Index captures more than its fair share of media attention, perhaps because it is heavily utilized as a benchmark for public policy and oftentimes is the first inflation reading released each month. Regardless, the methodology behind its calculation is flawed and many economists and market commentators (including ourselves and the Fed) do not believe it is a superior measure of inflation. In fact, in 2013, Federal Reserve Bank of St. Louis President James Bullard wrote about the many reasons why the Fed changed its preferred measure of inflation to the Personal Consumption Expenditures (PCE). In summary, the Consumer Price Index does not account for the substitution of goods (e.g., trading down), has less comprehensive coverage, and does not readily account for shifts in consumer behavior. As a result of these biases, CPI tends to overstate inflation. For example, over the time period of Bullard's study (January 1995 to May 2013), CPI was more than 7% higher than PCE.

One Print Doesn't Make a Pattern

"One print doesn't make a pattern." This is a phrase expressed by the Fed and we've repeated it as we've discussed the potential policy path over the past several weeks and months. Today, we will use it again as we explain why this singular CPI reading is not indicative of inflation's path moving forward—which we believe is still in a downward trajectory. Why? There are a number of real-time indicators that suggest inflationary pressures are easing. The average price of a gallon of gasoline has fallen for over 90 days—the longest streak since 2015. Oceanic freight rates posted their largest weekly decline on record (-14%) and are now down ~70% from their recent peak. Elevated inventories have led to an above-average proportion of apparel and footwear on markdown. The Manheim Used Vehicle Value Index has declined for six out of the last seven months. There are even more indicators that we could highlight (e.g., impact of the stronger dollar, falling supply chain bottle necks), but we believe the breadth of evidence supports our view that the pace of inflation will ease in the months ahead.

Asynchronous Easing of Pricing Pressures

In our Investment Strategy Webinar held this past Monday, we explained that many of the components that drove inflation higher are set to reverse in the coming months. We laid out a clear timeline of how we expected inflation pressures to decelerate. First, commodity prices such as oil, copper and lumber have already fallen 29%, 27%, and 67% from their respective peaks. Second, 'goods' prices like apparel and home furnishings are being discounted to reduce inventories to bring in holiday-oriented goods. Third, 'service' prices for things like travel are in the process of easing as we exit the travel-heavy summer travel period. Going forward, we believe food price increases are likely to fall during the fourth quarter. And while US inflation statistics point to still increasing prices, broader global food indices like the UN Food Price Index have declined for five consecutive months since its record high in March—supported by declines in wheat, corn, and soybean oil down 32%, 13%, 26% respectively.

This should translate into grocery bills and restaurant costs easing in the fourth quarter and the early part of 2023. Finally, rent (or shelter prices) increases should start to slow if not stall in 2023. It our belief that rents lag the health of the housing market so when the housing market is strong, rents tend to move higher and when the housing market stalls, rental increases stall or are lower. And from our vantage point, the housing market is struggling—especially as mortgage rates have risen. As a result, our economist believes that rents tend to lag the housing market by approximately one year, so as house price appreciation decelerates from approximately 20% year-over-year to the mid to low single digits over the next year, so will rental increases slow which will cause inflation to decelerate. And the good news is when you look at real time data from Zillow, it does look as if rents are already starting to decelerate from very elevated levels.

The bottom line is that inflation is going to have multiple pieces fall into place—falling commodity prices, falling goods prices, falling food prices and then decelerating rents as we go into next year—which should help inflationary pressures accelerate their downward trajectory going into next year.

Supportive Seasonal Shift

In addition to the fundamental components of inflation, the calendar effects will also help push inflation lower. As we transition into the fall, headline and core indices will 'roll off' two of the hotter monthly inflation prints seen in October and November of last year. At the headline CPI level, these prints were +0.9% and +0.7% for the two months, respectively. How does this impact the year-over-year pace? If the monthly pace of headline inflation remains consistent with this month's report (+0.1%), the year-over-year pace will fall from +8.4% to +6.5% by November. If this occurs, it would be the swiftest three-month deceleration in the year-over-year pace of headline CPI since 2009, exclusive of COVID-related impacts.

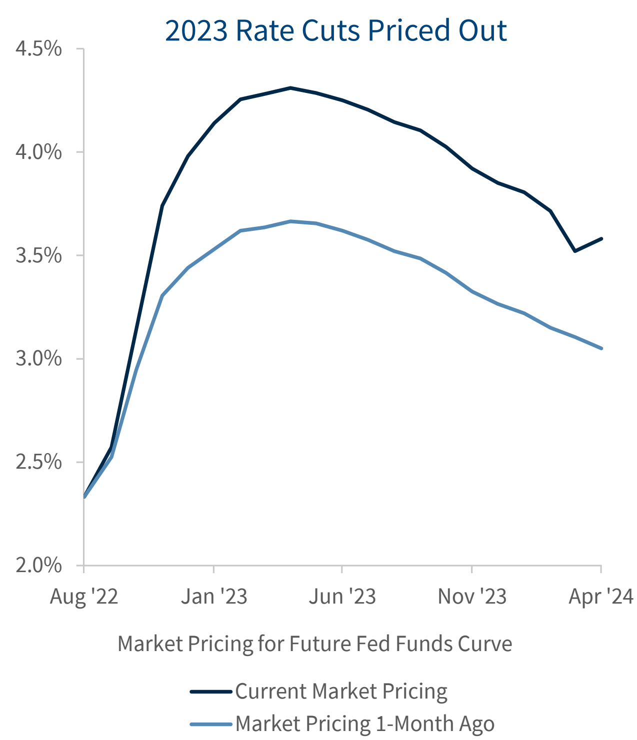
Bottom Line: The Market Impact

The equity market traded significantly lower following the inflation report, as the S&P 500 posted its largest drawdown of the year. However, to put this move into perspective, and following the 5% rally that we've seen over the last week, the market is back to its post-Labor Day weekend level.

The market selloff is indicative of fears that the hotter inflation print will inevitably push the Fed further into restrictive territory. In fact, the futures market has now fully priced in a 75 basis point hike at next week's September FOMC Meeting with which we now agree. As for the peak policy rate, the futures market is now expecting a terminal rate of 4.3% in April 2023, translating to 180 basis points of additional tightening from current levels. This is a significant adjustment considering the peak rate was 3.7% just one month ago. In contrast, we see the fed funds rate peaking at or below 4%. Tomorrow's Producer Price Index release could place additional pressure on the Fed's decision, as it could follow CPI's trend or it could confirm the broader picture that we've been seeing.

Ultimately, we believe this sharp upward adjustment in the terminal rate expectations is likely overdone, as the deceleration in the future pace of inflation, combined with a slowdown in economic growth in early 2023 (due to the lagged effects of tightening monetary policy) should allow the Fed to ease its stance by the end of the year.

Source: FactSet, as of 9/13/2022.

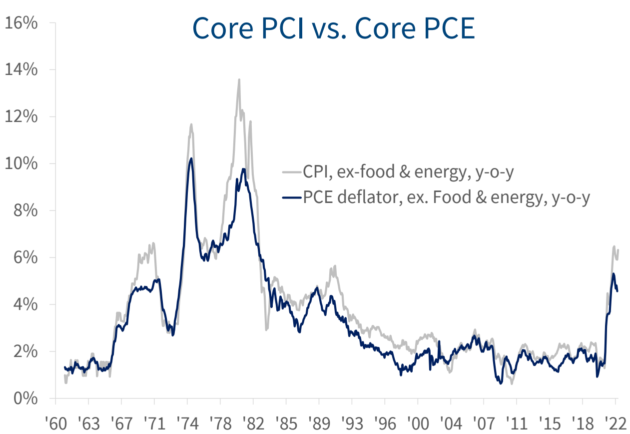


Source: FactSet, as of 9/13/2022.

Eugenio J. Alemán, Ph.D., SVP, Chief Economist

Markets love a roller-coaster, going up or down on a whim. That is the nature of markets. But it is not the nature of economics. The Federal Reserve's (Fed) inflation target of 2% for the personal consumption expenditure price deflator that doesn't mean that it expects the PCE deflator to be at 2.0% always. It only means that, on average, and over time, it is targeting a 2.0% PCE deflator, even if it never gets a 2.0% PCE deflator, ever. The PCE deflator could be higher or lower than 2.0% but over time, the Fed targets it to be at an 'average' of 2.0%.

The August consumer price index report (CPI) showing higher top line inflation but, fundamentally, higher core CPI (excluding food and energy prices) was not good news for markets and certainly not good news for the Fed. However, we would say that we must take August's CPI report with a grain of salt. Recall that the Fed does not target core CPI, it targets PCE, so we would like to wait a bit, until the end of September, to really know what is happening to core prices. In July, the core CPI was up 0.3% but core PCE was up only 0.08%, two very different rates. With few exceptions over history, core CPI typically runs higher than core PCE and this time is no different, even though we will not know the August core PCE until late in September.



Source: FactSet, as of 9/13/2022.

The main difference between these two measures, other than the fact that the PCE deflator is released almost two weeks after the CPI, is that the PCE deflator allows for substitution. That is, while the CPI measures prices of a fixed basket of goods, the PCE deflator measures all goods and services consumed by Americans, not just some specific, and fixed, basket. That is, if a price in the CPI basket goes higher, that higher price gets measured for the CPI report. However, if Americans substitute out of that good into an alternative good that is not in the fixed CPI basket, that substitution is not taken into consideration even though the consumer was able to avoid the increase in price by changing consumption behavior.

As we have argued before, markets are not patient, and the Fed has been pushed to not be very patient and allow for the increase in interest rates to do its work. Furthermore, the biggest issue with the August CPI report is that if food and energy prices happen to increase because of external factors, i.e., war, droughts, etc., then the probability of inflation declining comes down considerably. Thus, the Fed needs to see inflation coming down, but especially core inflation, that is, core PCE coming down considerably.

However, the PCE deflator report will come in after the Fed FOMC meeting and interest rate decision, so we are increasing our estimate of federal fund rate increases to 75 basis points (bps) for September, 25 bps for November, and 50 bps for December. This will take the federal funds rate at the end of 2022 to 3.75% to 4.00%, at which time the Fed is going to pause and stay there for the whole of 2023.

Joey Madere, CFA, Senior Portfolio Analyst, Equity Portfolio & Technical Strategy

We don't enjoy the phrase 'data-dependent' any more than you do, but it is the environment we are in right now. Investors have been conditioned for years to take 'bad news as good news' because inflation was low and the Federal Reserve (Fed) could come to the rescue. We do not have that luxury right now with inflation so high (and the jobs market still solid). Because of this, inflationary data will be highly influential on the Fed's path ahead—and in turn, market movements. Good news over the past week—i.e., ISM prices paid showing lower price pressures and August wage growth moderating—contributed to equities bouncing out of a weak trend. Then, today's stickier-than-expected August CPI reading has equities giving back those gains.

Overall, we expect inflation to moderate over the next year due to lower commodity prices, an improved supply/demand imbalance, and lower wage pressures. However, the path is unlikely to be quick or smooth. We still favor the worst of this bear market likely being behind us, but it will also be difficult for equities to show sustainable upside with inflation so high and the Fed intent on bringing it down to a more reasonable level. Technically, we are monitoring support at 3,900, but today's weakness raises the odds that this level does not hold. Below 3,900, we see support at ~3,800, ~3,742, and then the June lows. The result is a bear market that likely takes time to digest the inflationary data flow with back-and-forth trading over the coming weeks and months. With this in mind, we recommend not chasing the rallies and using the pullback periods as opportunities to accumulate favored stocks for the next bull market.

Tracey Manzi, CFA, Senior Investment Strategist

The surprise uptick in core inflation caught the market off guard, sending yields across the curve sharply higher. The 2-year Treasury, which is most sensitive to changes in policy rates, soared to 3.75%, its highest rate since 2007. The upward pressure on rates pushed the 10-year Treasury higher to 3.43%, with the 2-year/10-year Treasury curve further inverting. Market expectations for the peak fed funds rate rose to 4.3% in early 2023, which sent the US dollar soaring again.

While the hotter-than-expected inflation release represents a setback for the markets and the Federal Reserve (Fed), we still think that inflation pressures will continue to moderate over time. This is reflected in declining breakeven inflation rates (i.e., the difference between real and nominal Treasury yields), which are down more than 100 basis points from their prior peak. And with the Fed still aggressively tightening, further downward pressure on economic growth is expected. Although the Fed remains concerned that persistent inflation will unanchor inflation expectations, there hasn't been any evidence of that. Just this week, the NY Fed's own survey of common inflation expectations showed they remain well anchored with the median 3-year ahead expectations dropping to 2.8% and the 5-year ahead expectations falling to a mere 2.0%. With the Fed hyperreactive to current inflation data, there is a real risk that it tightens more than it needs to during this cycle. This would only reinforce curve inversion and lower long-term yields.

Today's inflation report raises the risk that the Fed delivers its third consecutive 75 basis point rate hike at its September meeting. What is concerning is that policymakers have been vocal with their higher for longer messaging in advance of a meeting where a new set of Summary of Economic Projections will be released. This has the potential for another upside surprise for the markets in that policymakers could project a higher peak federal funds rate which would put more near-term upward pressure on bond yields and be negative for risk assets.

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Personal Consumption Expenditure Price Index | The PCE is a measure of the prices that people living in the United States, or those buying on their behalf, pay for goods and services.

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