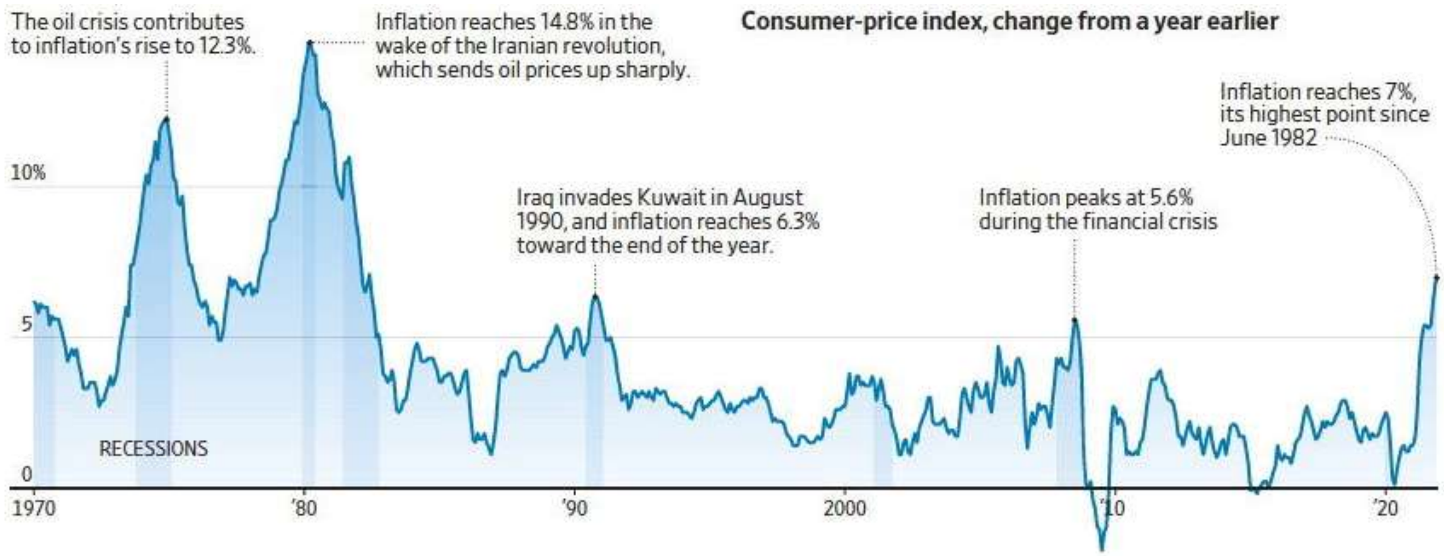
Inflation! Now what?

The banner headline from Thursday's WSJ:

Inflation Hits Fastest Clip Since ’82

Consumer prices rise by 7% as pandemic disruptions, consumer demand stay strong



BY GWYNN GUILFORD

U.S. inflation hit its fastest pace in nearly four decades last year as pandemic-related supply and demand imbalances, along with stimulus intended to shore up the economy, pushed prices up at a 7% annual rate.

The Labor Department said Wednesday the consumer-price index—which measures what consumers pay for goods and services—rose 7% in December from the same month a year earlier, up from 6.8% in November. That was the fastest since June 1982 and marked the third straight month in which inflation exceeded 6%.

The so-called core price index, which excludes the often-volatile categories of food and energy, climbed 5.5% in December from a year earlier.

That was a bigger increase than November’s 4.9% rise and the highest rate since 1991. ...

The circumstances were very different in June 1982, the last time consumer prices clocked in at such an annual increase. While inflation right now is rising, back then it was falling after peaking at 14.8% in 1980.

By then, new Federal Reserve Chairman Paul Volcker had set out to crush inflation by raising interest rates dramatically, causing a brief recession in 1980. As rates reached 19% in 1981, a much deeper recession began. By summer 1982, both inflation and rates were falling sharply.

Today, the Covid-19 pandemic has caused supply-chain disruptions, and a shortage of goods and materials—particularly autos—coupled with strong demand from consumers flush with the benefits of government stimulus are behind the inflation surge. ...

While economists and the Federal Reserve expect inflation to ease this year, the Omicron variant of Covid-19 has renewed uncertainty about the economic outlook. ...

Fed Chairman Jerome Powell in congressional testimony Tuesday said he was optimistic supply-chain issues would ease this year. However, he noted that a smaller U.S. labor force "can be an issue going forward for inflation, probably more so than these supply-chain issues," Mr. Powell said. ...

The December employment report signaled continued tightening of the job market, with the unemployment rate dropping to 3.9% from 4.2% in November, the Labor Department said, giving workers additional leverage on pay.

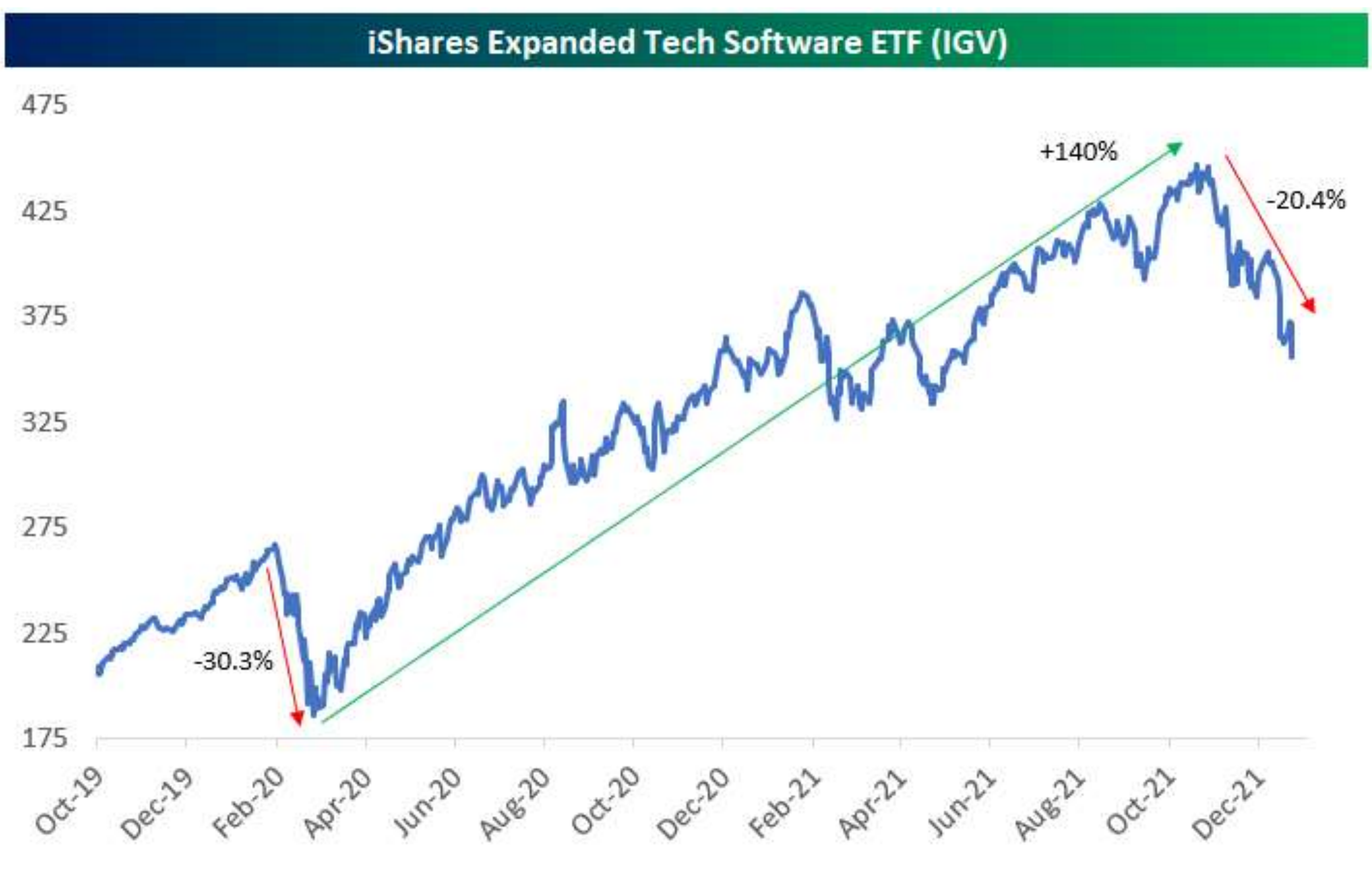
While wages advanced last year at a faster pace than before the pandemic, they didn't increase enough to keep up with inflation, with average hourly wages rising 4.7% in December from a year earlier.

Wage increases are contributing increasingly to high inflation because they support higher spending, but also because they raise costs for businesses. In December, some 49% of small businesses said they planned to raise prices in the next three months, on net, according to the National Federation of Independent Business, a trade association.

Omicron's spread has worsened the labor shortage by driving up workplace absences. ...

While the Nasdaq's resulting 2.5% decline on Thursday has it again approaching correction territory, Software, for example, is already in a Bear Market. From Bespoke on Thursday:

High-growth Tech stocks continued to take a beating today with the Software group as proxied by the iShares

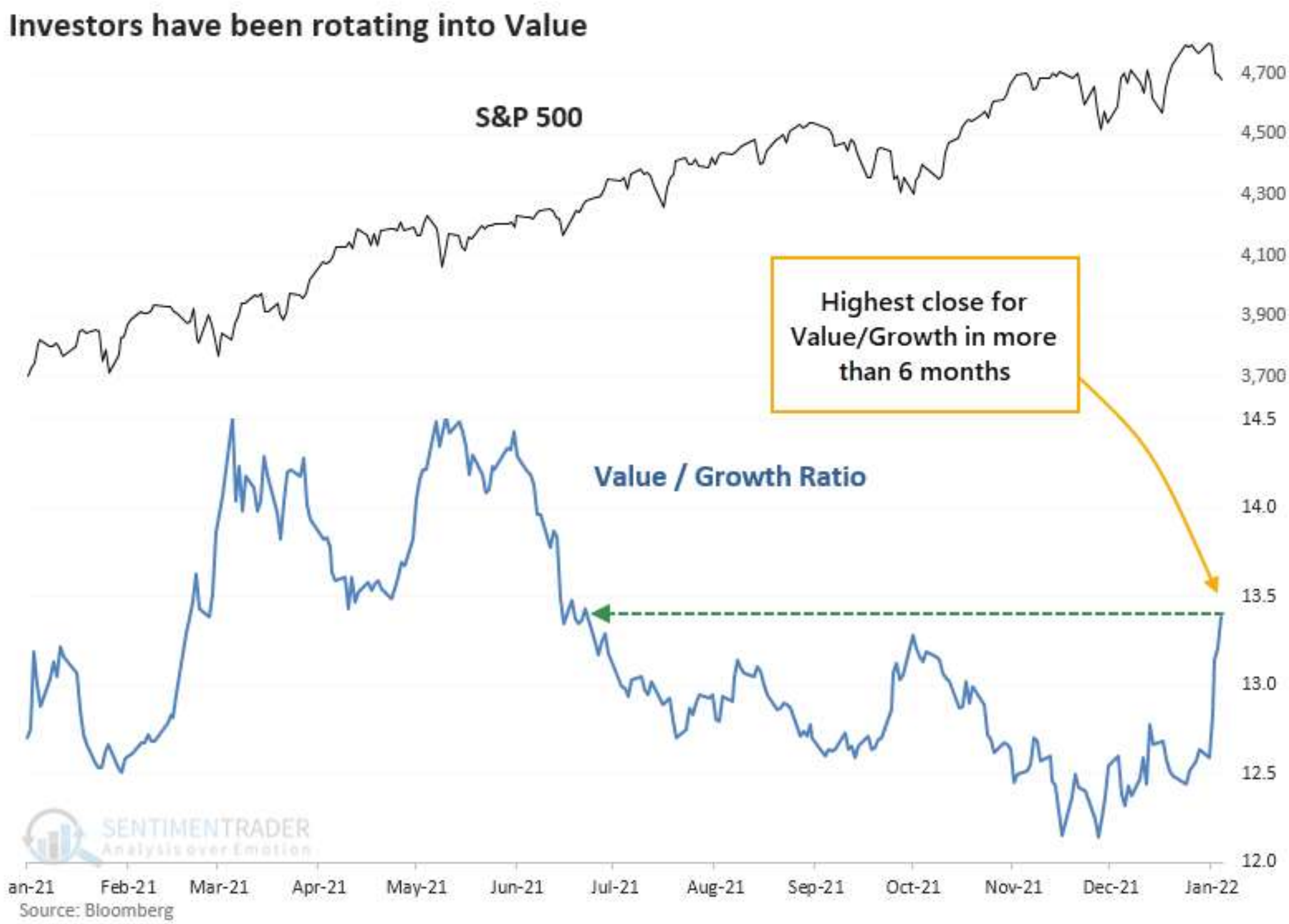


Expanded Tech Software ETF (IGV) entering bear market territory. After a 30% decline during the COVID Crash, IGV rallied 140% to its recent peak. It's now in a 20.4% drawdown and back to levels it was trading at around a year ago.

With the Fed having made clear that it will be responding to the surge in inflation with at least three rate hikes beginning in March, value is now outperforming growth. From Tuesday's SentimenTrader:

Value has been surging relative to Growth

One of the most vicious reversals of the new year has been the rotation out of Growth and into Value. After plunging to nearly a 20-year low late last year, the [ratio between Value and Growth factors has soared](). On Monday, it reached a 6-month high, surpassing its peak from October.



While the odds favor the above trends continuing, it is important to note that market corrections in and of themselves are not predictive. From Thursday's MarketWatch:

Opinion: Nasdaq near a 10% correction isn't the sell signal you probably think it is

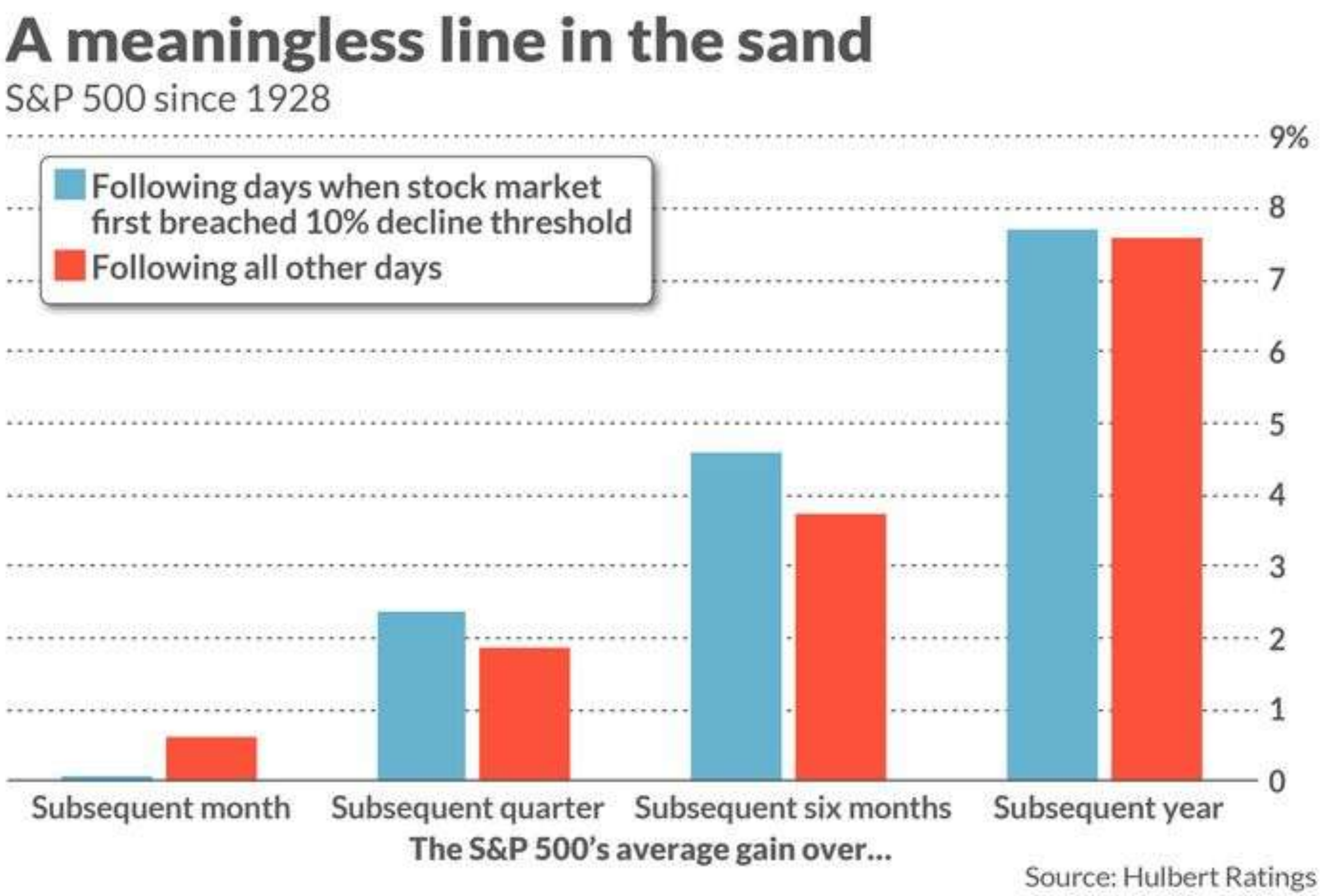
By Mark Hulbert

The odds that stocks will rise are no different after a 10% decline than they are before

There's nothing magical about a stock index hitting the 10% decline that constitutes what Wall Street considers to be a correction. So we need to stop treating this 10% mark as meaningful. It isn't.

The odds that stocks will rise are no different after a 10% decline than they are before. This is important to keep in mind now that the Nasdaq Composite Index is losing ground quickly, down 2.5% on Jan. 13 alone and off 7.8% from its closing high on Nov. 19, 2021.

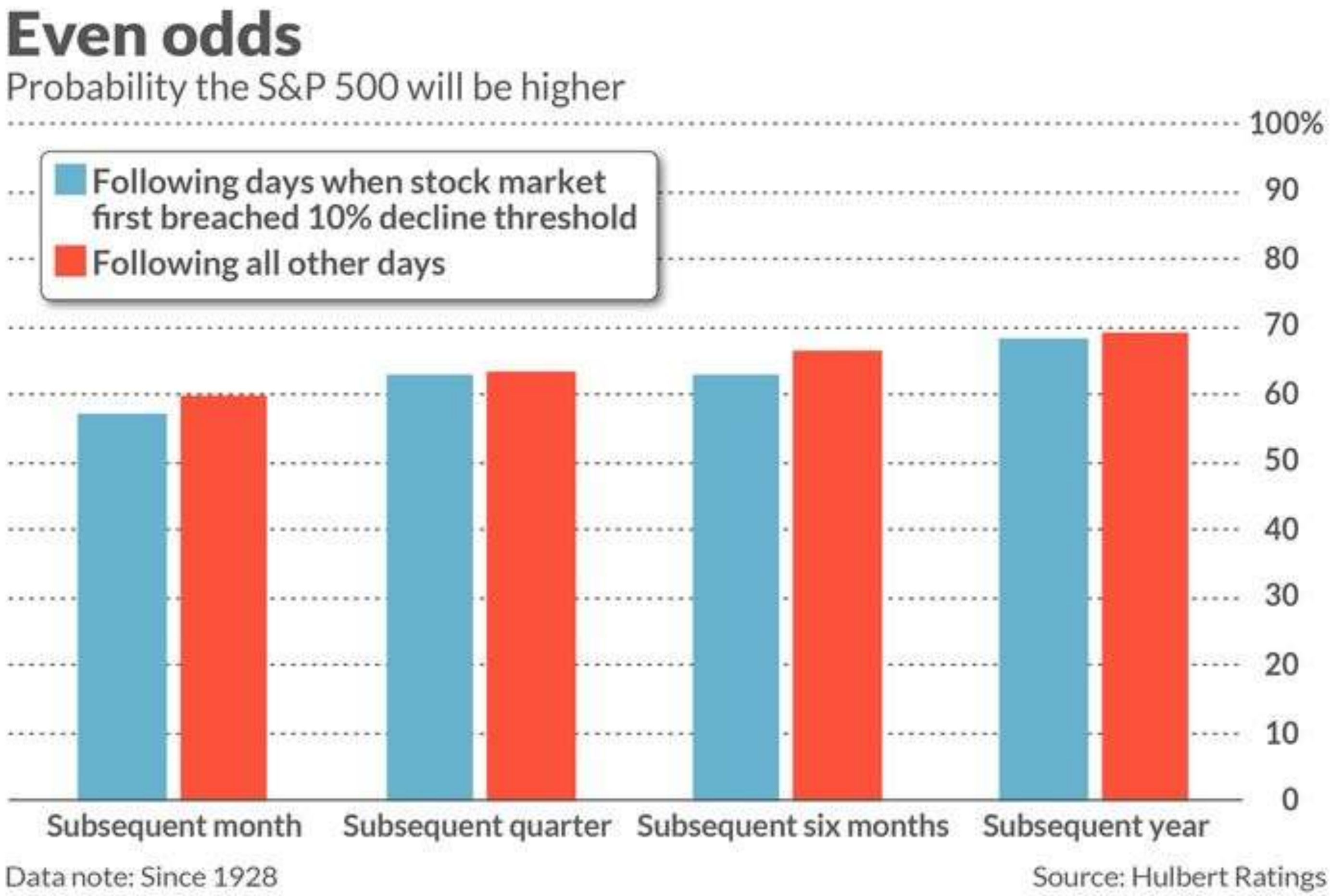
To show that this 10% correction threshold has no significance, I analyzed all occasions since 1928 in which the S&P 500 (or its predecessor index) dropped at least 10% from a prior high. In some of these cases, the market continued to decline and entered into bear-market territory by dropping at least 20% from a market high. In other cases, the market almost immediately turned around and rose again.



To calculate the market's overall odds across all such occasions, I focused on the exact days on which the S&P 500 first breached the 10% threshold. On such days there would have been no way of knowing whether the market's decline was almost over or the start of something far worse. The chart above reports the S&P 500's average gain in the weeks and months following these particular days.

None of the differences plotted in this chart is significant at the 95% confidence level that statisticians often use when determining if a pattern is genuine. In any case, notice that the stock market's average return is often greater following days on which the stock market first steps over the 10% decline line in the sand.

It could be that these results are being skewed by a few outliers. To test for that possibility, I calculated the market's odds in a different way: The percentage of time the market was higher over the subsequent month-, quarter-, six months and 12 months. The chart below reports the odds calculated in this second way. Again, none of the differences is statistically significant.



What explains these results?

You may be surprised by the data in these charts, but you shouldn't be. The stock market is forward-looking. The market's level at any given time already reflects all currently known information. That includes how the market has performed up until that time.

For purposes of illustration, let's imagine that breaching the 10% decline threshold really did indicate that the market's prospects had suddenly deteriorated. In that case, investors would immediately sell stocks upon such a breach, pushing prices down even further until the market hit equilibrium. This is how market efficiency works. The net effect would be that the threshold stopped being meaningful.

What does all this mean for the next time the market does breach this 10% threshold? If you're backward looking, you can bemoan a 10% decline. But as an investor, looking forward is what you want to do.