Up, Up and Away?

Once again Inflation exceeded consensus estimates, resulting in another WSJ banner headline on Thursday:

Inflation Hurtles to Highest Since ’81

A 9.1% price rise adds pressure on the Fed as more investors expect a bigger rate boost in July

BY GABRIEL T. RUBIN

U.S. consumer inflation accelerated to 9.1% last month, a pace not seen in more than four decades, adding pressure on the Federal Reserve to act more aggressively to slow rapid price increases throughout the economy.

The consumer-price index’s advance for the 12 months ended in June was the fastest pace since November 1981, the Labor Department said on Wednesday. A big jump in gasoline prices—up 11.2% from the previous month and nearly 60% from a year earlier— drove much of the increase, while shelter and food prices were also major contributors.

The June inflation reading exceeded May’s 8.6% rate, prompting investors and analysts to debate whether the Fed would consider a 1-percentage-point rate increase, rather than a 0.75-point rise, later this month. Slowing demand is key to the Fed’s goal of restoring price stability in an economy that is still struggling with supply issues, but raising interest rates also elevates the risk of a recession.

Core prices, which exclude volatile food and energy components, showed little sign they were moderating. While they increased by 5.9% in June from a year earlier, slightly less than May’s 6% gain, on a month-to-month basis they accelerated, with a 0.7% rise in June, a bit more than their 0.6% increase the prior month. ...

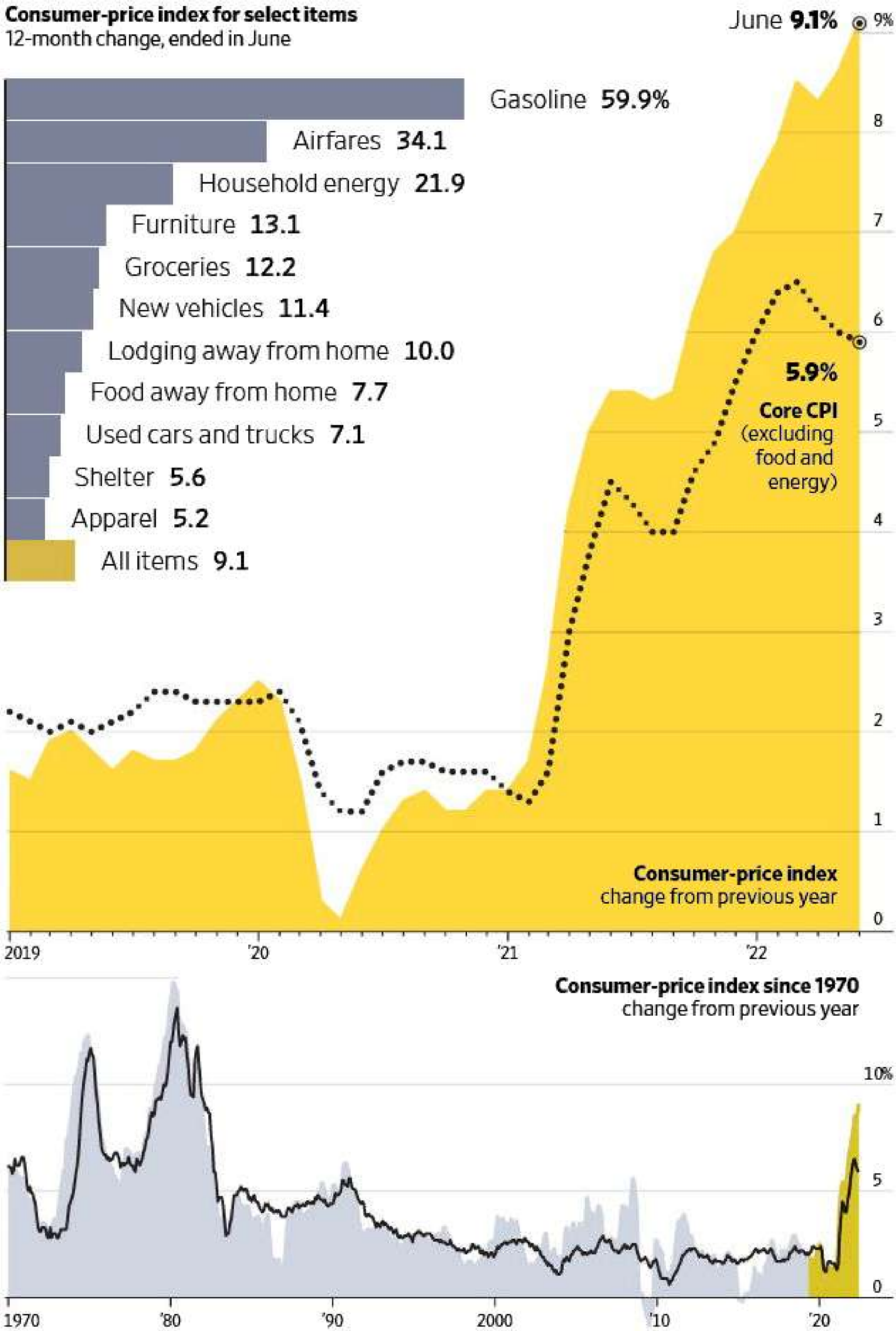
Despite June’s inflation reading, economists point to recent developments that could subdue price pressures in the coming months.

Investor expectations of slowing economic growth world-wide have led to a decline in commodity prices in recent weeks, including for oil, copper, wheat and corn, after those prices rose sharply following the Russian invasion of Ukraine. Retailers have warned of the need to discount goods, especially apparel and home goods, that are out of sync with customer preferences as spending shifts to services and consumers spend down elevated savings. ...

The Fed raised its interest-rate target last month by 0.75 percentage point, the largest increase since 1994. Besides tempering demand, the central bank is trying to prevent consumer expectations of higher inflation from becoming entrenched, as such expectations can be self-fulfilling. Fed Chairman Jerome Powell has said the central bank wants to see clear evidence that price pressures are diminishing before slowing or suspending rate increases....

Consumer inflation expectations have improved somewhat, according to a Federal Reserve Bank of New York survey this week. The bank said in its June Survey of Consumer Expectations that respondents see the annual inflation rate three years from now at 3.6%, down from their expectation in May of 3.9%.

Higher interest rates won’t have the same effect on all prices simultaneously, economists said. Costs such as mortgages and rents—a big part of household budgets—respond over time to the demand-sapping effects of



Source: Labor Department via the Federal Reserve Bank of St. Louis higher interest rates. Shelter costs rose by 0.6% in June over the prior month, the same rate as they did in May. The rent index rose 0.8% over the month, which was the largest monthly increase since April 1986.

Housing inflation represents around 40% of core CPI and around 17% of the Fed’s preferred inflation gauge. ...

With annual wage growth at 5.1%, average hourly earnings adjusted for inflation are declining at their fastest pace in four decades. After accounting for seasonal and inflation adjustments, average hourly earnings decreased 3.6% from June 2021 to June 2022.

Record home prices and higher mortgage rates are leading prospective buyers to drop out of the market for now. But with limited supply and continued demand, it might take months before housing prices see significant declines.

From Friday's Global Investment Strategy:

What If The TIPS Are Right?

US CPI Surprises to the Upside… Again

Investors hoping for some relief on the inflation front were disappointed once again this week. The US headline CPI rose 1.32% month-over-month in June, above the consensus of 1.1%. Core inflation increased to 0.71%, surpassing consensus estimates of 0.5%.

The key question is how much of June’s report is “water under the bridge” and how much is a harbinger of things to come.

Since the CPI data for June was collected, oil prices have dropped to below $100/ bbl. Nationwide gasoline prices have fallen for four straight weeks, with the futures market pointing to further declines in the months ahead. Agriculture and metals prices have swooned. Used car prices are heading south. Wage growth has slowed to about 4% from around 6.5% in the second half of last year. The rate of change in the Zillow rent index has rolled over, albeit from high levels (**Chart 1**). The Zumper National Rent index is sending a similar message as the Zillow data. All this suggests that inflation may be peaking.

The TIPS market certainly agrees. It is discounting a rapid decline in US inflation over the next few years. This week’s inflation report did little to change that fact (**Chart 2**).

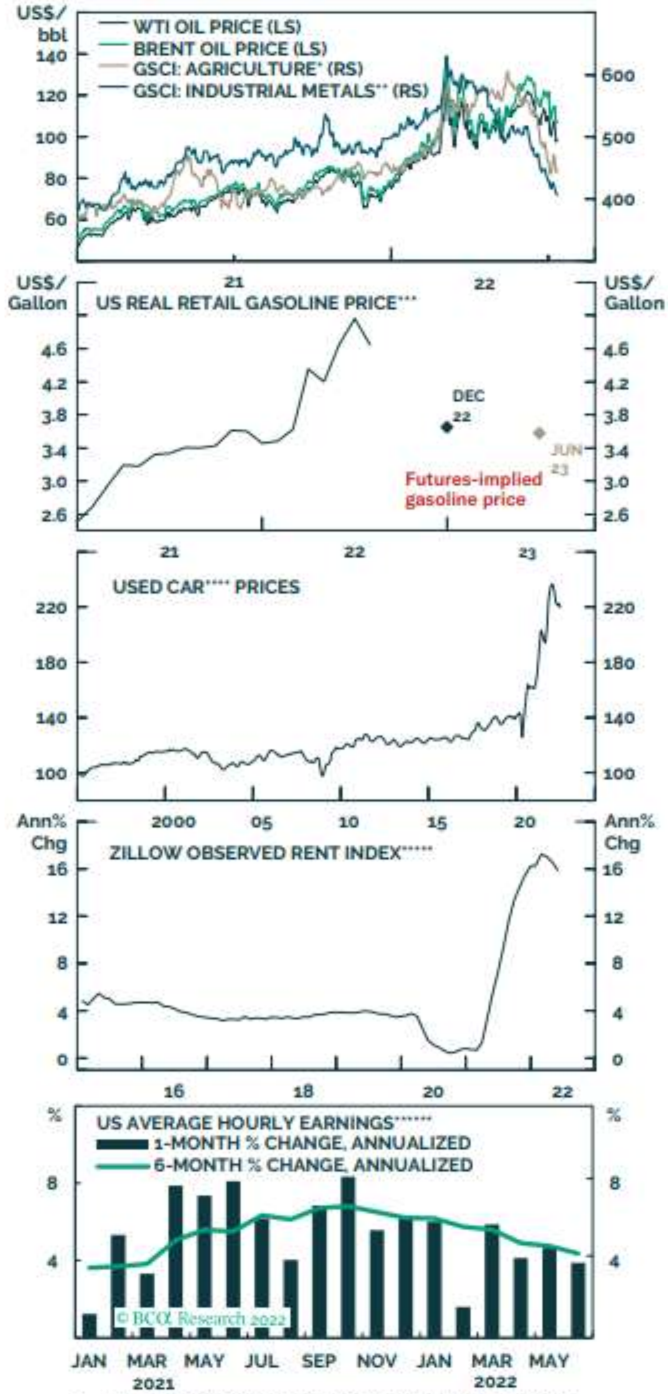
TIPS Still Siding with Team Transitory

If the TIPS market is right, this would have two important implications. First, the Fed would not need to raise rates more quickly over the next six months than the OIS curve is currently discounting (although it probably would not need to cut rates in 2023 either, given our higher-than-consensus view of where the US neutral rate lies).

The second implication is that real wages, which have declined over the past year, will start rising again as inflation heads lower.

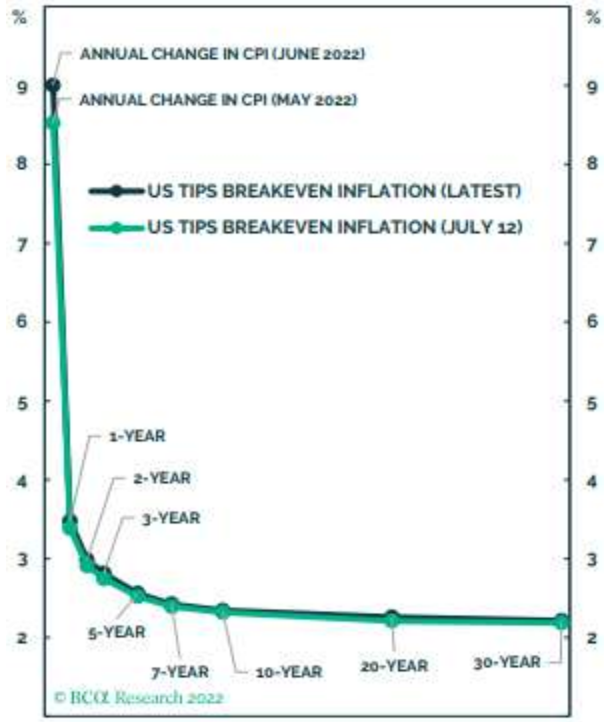
Falling real wages have sapped consumer confidence. As real wage growth turns positive, confidence will improve, helping to bolster consumer spending. To the extent that consumption accounts for nearly

CHART 1
Some Signs That Inflation Has Peaked



* WHEAT, CORN, SOYBEANS, COTTON, SUGAR, COFFEE AND COCOA.
** ALUMINUM, COPPER, LEAD, NICKEL, AND ZINC.
*** SHOWN IN JUNE 2022 DOLLARS. DIAMONDS REPRESENT ESTIMATES FOR DECEMBER 2022 AND JUNE 2023 REAL GASOLINE PRICES USING GASOLINE FUTURES AND BLOOMBERG CONSENSUS CPI ESTIMATES.
**** SOURCE: MANHEIM.
***** SOURCE: ZILLOW.
****** AVERAGE HOURLY AND WEEKLY EARNINGS OF ALL EMPLOYEES ON PRIVATE NONFARM PAYROLLS.

CHART 2
Investors Expect Inflation To Fall Rapidly Over The Next Few Years



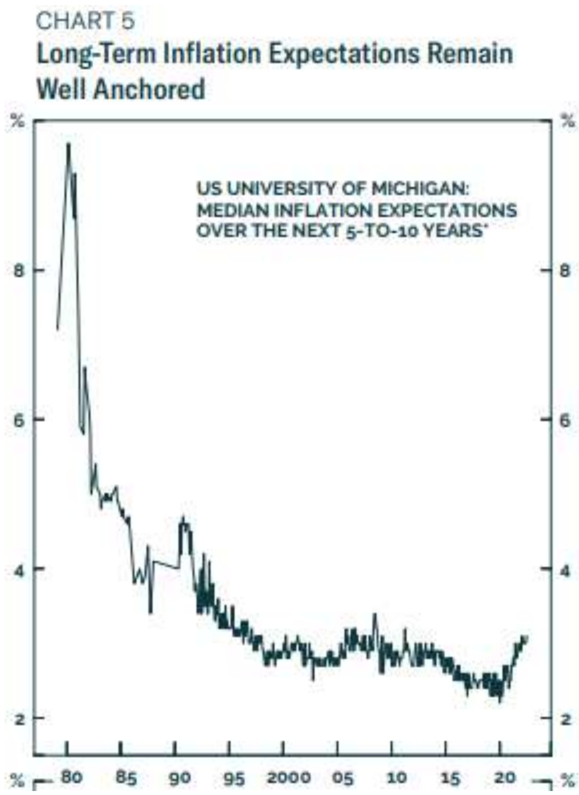
70% of the US economy – and other components of GDP such as investment generally take their cues from consumer spending – this would significantly raise the odds of a soft landing. Of course, the TIPS market could be wrong. Bond traders do not set prices and wages. Businesses and workers, interacting with each other, ultimately determine the direction of inflation.

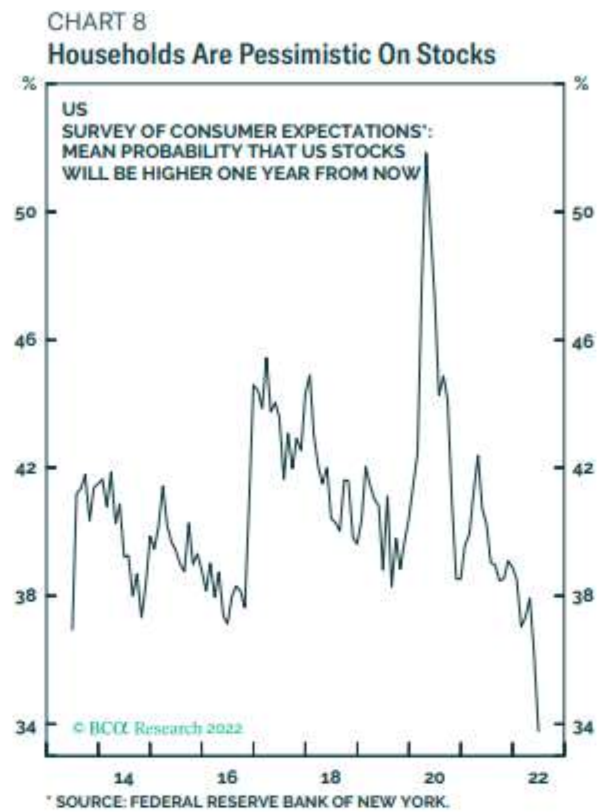
Yet, the view of the TIPS market is broadly in sync with the view of most households and businesses. Expected inflation 5-to10 years out in the University of Michigan survey has risen since the pandemic began, but at about 3%, it is close to where it was for most of the period between 1995 and 2015 (**Chart 5**).

Investors Now See Recession as the Base Case

Our relatively sanguine view of the US economy leaves us in the minority camp. According to recent polling, more than 70% of US adults expect the economy to be in recession by year-end. Within the investment community, nearly half of retail traders and three-quarters of high-level asset allocators expect a recession within the next 12 months.

Reflecting the downbeat mood among investors, bears exceeded bulls by 20 points in the most recent weekly poll by the American Association of Individual Investors. A record low percentage of respondents in the New York Fed's Survey of Consumer Expectations believes stocks will rise over the next year (**Chart 8**).





Resilient Earnings Estimates

Admittedly, while sentiment on the economy and the stock market has soured, analyst earnings estimates have yet to decline significantly. In fact, in both the US and the euro area, EPS estimates for 2022 and 2023 are higher today than they were at the start of the year.

What's going on? Part of the explanation reflects the sectoral composition of earnings. In the US, earnings estimates for 2022 are up 2.4% so far this year. Outside of the energy sector, however, 2022 earnings estimates are down 2.2% year-to-date and down 2.9% from their peak in February (**Chart 10**).

Another explanation centers on the fact that earnings estimates are expressed in nominal terms while GDP growth is usually expressed in real terms. When inflation is elevated, the difference between real and nominal variables can be important. For example, while US real GDP contracted by 1.6% in Q1, nominal GDP rose by 6.6%. ...

How Much Bad News Has Been Discounted?

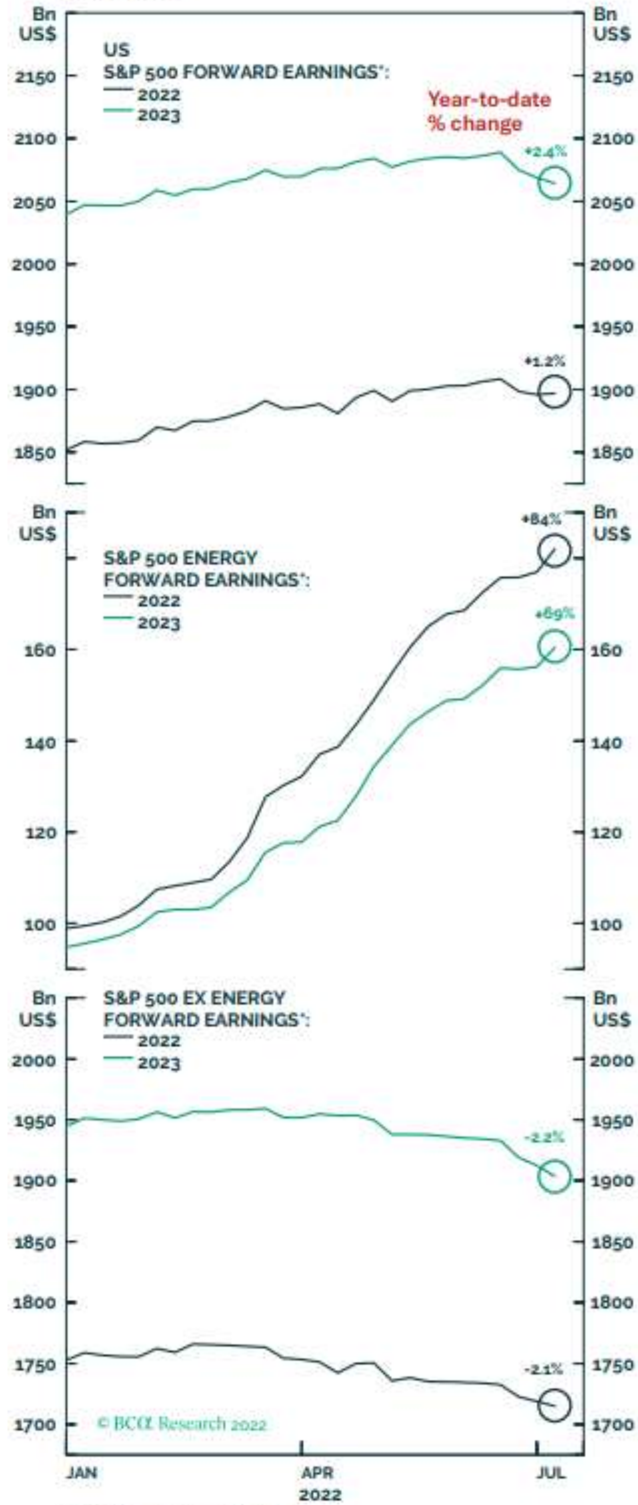
Historically, stocks have peaked at approximately the same time as forward earnings estimates have reached their apex. This time around, stocks have swooned well in advance of any cut to earnings estimates (**Chart 11**). At the time of writing, the S&P 500 was down 25% in real terms from its peak on January 3.

This suggests that investors have already discounted some earnings cuts, even if analysts have yet to pencil them in. Consistent with this observation, two-thirds of investors in a recent Bloomberg poll agreed that analysts were "behind the curve" in responding to the deteriorating macro backdrop.

Nevertheless, it is likely that stocks would fall further if the economy were to enter a recession. Even in mild recessions, operating profits have fallen by about 15%-to-20%. That is probably a more severe outcome than the market is currently discounting.

Subjectively, we would expect the S&P 500 to drop to 3,500 over the next 12 months in a mild recession scenario where growth falls into negative territory for a few quarters (30% odds) and to 2,900 in a deep recession scenario where the unemployment rate rises by more than four percentage points from current levels (10% odds). On the flipside, we would expect the S&P 500 to rebound to 4,500 in a scenario where a recession is completely averted (60% odds). ...

CHART 10
Soaring Energy Prices Have Boosted Earnings Estimates



* SOURCE: REFINITIV / IBES.

What's the Right Framework for Thinking About a European Recession?

Whereas we would assign 40% odds to a recession in the US over the next 12 months, we would put the odds of a recession in Europe at around 60%.

With a recession in Europe looking increasingly probable, a key question is what the nature of this recession would be. The pandemic may provide a useful framework for answering that question. Just as the pandemic represented an external shock to the global economy, the disruption to energy supplies, stemming from Russia's invasion of Ukraine, represents an external shock to the European economy.

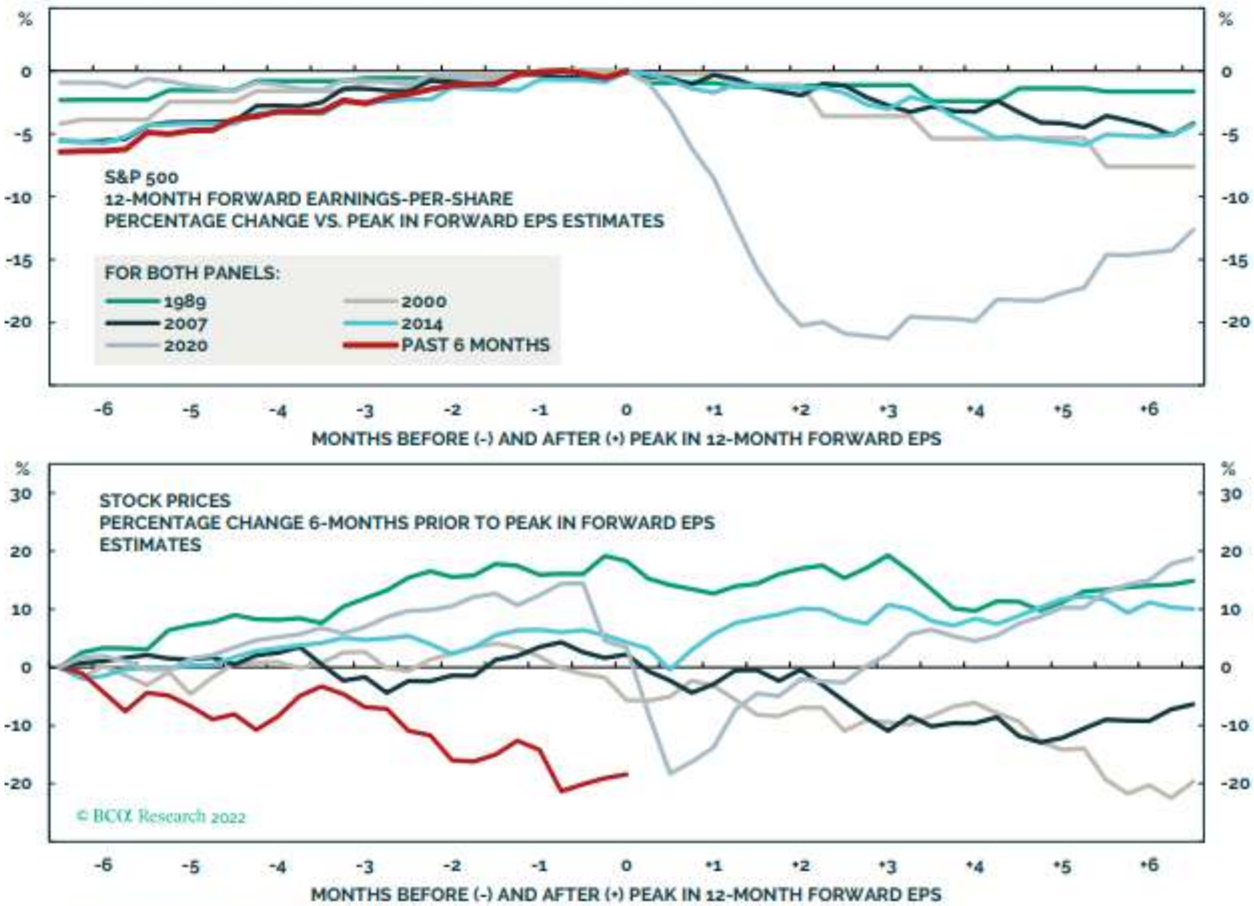
In the initial phase of the pandemic, economic activity in developed economies collapsed as millions of workers were forced to isolate at home. Over the following months, however, the proliferation of work-from-home practices, the easing of lockdown measures, and ample fiscal support permitted growth to recover. Eventually, vaccines became available, which allowed for a further shift to normal life.

Just as it took about two years for vaccines to become widely deployed, it will take time for Europe to wean itself off its dependence on Russian natural gas. Earlier this year, the IEA reckoned that the EU could displace more than a third of Russian gas imports within a year. The more ambitious REPowerEU plan foresees two-thirds of Russian gas being displaced by the end of 2022. ...

During the pandemic, governments wasted little time in passing legislation to ease the burden on households and businesses. The European energy crunch will elicit a similar response. ...

CHART 11

Unlike In Past Cycles, Stocks Peaked Well Before Earnings



SOURCE: REFINITIV / IBES, BCA CALCULATIONS.

The ECB’s soon-to-be-launched “anti-fragmentation” program will allow the central bank to buy the government debt of Italy and other at-risk sovereign borrowers without the need for a formal European Stability Mechanism (ESM) program, provided that the long-term debt profile of the borrowers remains sustainable.

All this suggests that Europe could see a fairly brisk rebound after the energy crunch abates. If the euro area recovers quickly, the euro – which is now about as undervalued against the dollar as anytime in its history – will soar. ...