PALOS

Weekly Commentary

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Macro View

By Hubert Marleau

September Morn: Inflation Is not Transitory or Structural but Cyclical

Submitted October 17, 2021

A Snapshot of the Market for the Week Ended October 15, 2021:

Wednesday's consumer price inflation printed a year-over-year increase of 5.4% in September with core number, which strips out food and energy costs, holding at 4.0%. The situation is not getting worse or better. The market looked right through this as if nothing new happened, dogging the stickiness of inflation. Maybe it's assessment was correct, inflation has been sticky at the annual rate of 5.0% for five consecutive months.

The yield on the 10-year Treasury dipped 7 bps to 1.51%, while the 2-year yield popped to 0.36%, giving a calming message to the equity market. Perhaps, the print should have weighed more on the stock market than it did. Instead, the stock market took solace in the fact that the Fed is taking inflation more seriously than it has so far, the start of an upbeat earnings season has lightened spirits, the public approval for more spending and taxes is rapidly declining and many reopening-sensitive prices were either down or rising more slowly. Looking under the hood, the market probably saw that the 3-month annualized headline and underlying CPI has slowed to 4.9% and 2.4% respectively, down from highs of 9.6% and 10.5% in June.

The stock market was in a rally mode, ending the week with an exclamation mark. Of the 35 companies on the S&P 500 that had reported earnings through Friday, 85% had beaten analysts' forecasts. So far, actual third quarter earnings are coming in at 15% above expectations. The S&P 500 rose 80 points or 1.8% to 4471 and only 1.5 % off its all-time high. The broad index is now trading above its 50-day moving average, a key technical level, which illustrates the potential for a large and broad uptrend. Barron's "Big Money" poll of institutional investors, which founded that 50% of respondents are bullish about the prospects for equities in the next 12 months while 38% is neutral and only 12% is bearish.

Macro View cont.

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There is a pattern here. Speculators buy the dips, the traders sell the highs, the retailers rotate their portfolios, while the seasoned investors watch. THE LATER ARE NOT STUPID. They know that the track record of the stock market is just too good to avoid. Ben Carlson, author of "Wealth of Common Sense" showed (1926 to 2021) that over a 20 year period the U.S. stock market had positive returns 100.0% of the time, 99.8% for 15 years, 94.9% for 10 years, 94.9 for seven years, 88.1% for 5 years, 84,2% for 3 years, 75.7% for 1 year and 63.1% for 1 month.

Although the extreme effects seem to be fading away, there is still evidence that what was believed to be entirely transitory is more persistent and broader than originally thought. On a month-by-month basis, the pandemic effect appears to be over. In fact, price pressure now appears to be cyclical. Looking at the last two year inflation, a calculation which should eliminate some of the acyclical effects of the pandemic, the annual rate would be about 3.25%. Further price increases are now expected to last for a longer period and be broader but mainly concentrated in essential items, which are highly sensitive to the whims of economic activity. The indexes for food and energy contributed for more than half of the 0.4% monthly increase. These two indices rose 0.9% and 1.3% respectively, which grossed up to a yearly increase of 7.3%. Meanwhile, ex-food and energy, the producer price index rose only 0.2% m/m in September versus 0.5% overall. Energy played the starring role, rising 2.8%.

Many companies are passing on higher labour, logistic and material costs to retailers. In September, some 46% of small businesses said they planned to raise prices in the next three months, according to the National Federation of Independent Business, the most since records began in 1986. Meanwhile, the latest installment of the NY Fed's consumer expectations survey showed one and three year inflation expectations hit new highs of 5.3% and 4.2% respectively, marking the third consecutive monthly increase.

Thus, it's becoming very hard to spin narratives that price increases are solely transitory. Morgan Stanley, Goldman Sachs, Bank of America and JPM said that inflation isn't temporary. They want higher rates for obvious reasons. Given that the economy They have way too much cash as their loan-to-deposit ratio is extremely low.

Three central bankers now believe that the inflation has reached the point where the Fed should begin to withdraw some of its monetary support. Interestingly, the Fed has signaled it could dial back the bond buying program as soon as November and finish it by next July, even though there are still 4.3 million jobs missing. Let alone that Congress has not completely resolved the debt ceiling issue, the Treasury has not yet normalized its cash balances and Biden's social spending scheme is losing political appeal with startling speed.

Macro View cont.

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The inflationary content of the Misery Index, which is the addition of the unemployment and inflation rates and the Palos Monetary Policy Index, which is the inflation rate divided by the unemployment rate less employment growth, are near record highs. It's a reality check. History and conventional theory show that under such conditions, the monetary stance needs to tighten if persistent inflation is to be avoided. The monetary authorities are aware that a big part of the recent surge in inflation is as much cyclical as it is acyclical. I'm of the opinion that the inflation base is about 2.0%, the acyclical is around 2.0% and the cyclical is roughly 1.5%.

The supply constraints are not destroying demand. They are merely delaying economic transactions from occcuring. The demand-pull scenario is about. The postponement of production and delivery of goods and services, which is caused by bottlenecks in the supply chain and labour shortage, is what is really transitory. The push-up in prices is spurring supply chain fixes while workers are learning to live with the virus. US labour force participation usually increases when wage rates start to rise to compensate for the ravage of inflation. Real average hourly earnings are down 0.8% y/y.

The cyclical rise in food and energy prices is what is holding back the economy. It's entirely possible that the price for essentials have risen enough to change the terms of trade and act as a drag on the consumption function. The Atlanta Fed's GDPNow Casting model is forecasting a 1.2% increase in real economic activity in Q3. Despite the disappointment of that number, which many forecasters view as being overly pessimistic, it remains that the economy is rolling on with hardly any chance of an imminent recession. Last week, initial jobless claims fell to 293,000, the least since the onset of the pandemic. And, there is a reason to believe that employment will keep on rising. Job openings are high and vacancies abound as the quit rate is setting records. Additionally, third quarter earnings of big money banks are telling us that activity is brisk as the economy is back on its feet and borrowers have improving credit. They reported that consumers are spending with their credit and debit cards and businesses are raising money to invest and making deals to raise efficiency. Indeed the economy is resilient. Retail sales jumped 0.7% in September and 0.8% ex-autos, handily beating consensus's expectations. This situation will probably continue because the banks have an extraordinarily low loan-to-deposit ratio and, therefore, capable to finance the remaining expansion of this business cycle.

In a tweet, Olivier Blanchard, former IMF's head economist, said: "I feel the use of stagflation is wrong. We are not seeing anything like stagflation. What we are seeing instead is very strong growth, fueled by private and public demand, hitting supply constraints, and leading to some sharp price increases. Nothing to do with stagflation".

Macro View cont.

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Predicting what the post-pandemic economic scenario will look like, is really a mug's game. My best guess is that the economy is probably heading back to what it was before the pandemic hit. The current level of real economic activity is just a tiny bit higher than it was in Q4 of 2019. At that time, the R-GDP and CPI inflation were both running at the annual rate of 3.3% and 2.3% respectively. But, assuming that cyclical forces will keep the inflation at the current annual rate of 5.5% over the next year, the five-year breakeven inflation, which is presently 2.7%, is telling us that the rate of inflation will return on average to 2.3% for the period of 2023 to 2027.

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