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Weekly Commentary

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Macro View

By Hubert Marleau

The May Inflation Print Was an Unwelcome Surprise

Submitted June 10, 2022

The market has been choppy, boring and illiquid, obscuring the direction of the S&P 500. Over the past two weeks, the broad market has vacillated within a 100-point range, worrying about the course of inflation. Currently, investment banks are carrying fewer stocks in their risk asset portfolios because they are less eager to trade as specialists. Slower growth and soaring prices for necessities like shelter, food and energy, combined with the prospects for higher interest rates makes them uneasy. Traders were in a holding pattern until the Bureau of Labor released its June CPI report, which showed that inflation is running rampant, as are inflation expectations. Headline inflation shot up to a yearly increase of 8.6%, above consensus, with one-year inflation expectation rising to 5.4%. Nor were the May numbers on inflation fluky. The idea that peak inflation might not have arrived yet, and that the upward trajectory was still alive, was perceived as bad news. The inflation rate needs to turn down firmly for the stock market to perform bullishly: in the week ended June 10, the S&P 500 dropped 208 points, or 5.1%, to 3901.

Nevertheless, what really matters to investors is core inflation, over which the Fed has some control and where demand is price-elastic. It needs to come down fast soon, if only to head off a wage-price spiral. Economic history is not amicable when core inflation runs above 4.5% for long periods of time. Consensus saw a year-over-year increase of 5.9% for May. The actual increase was 6.0%, compared to 6.2% in April and more modest than the gains registered in the prior 3 months. We actually got an unambiguous sign that core inflation remains elevated and is not slowing down fast enough. Moreover, the change has to be sequential, broad-based and sustained if an inflationary bust or a stagflation episode is to be averted: two big things that all major central banks want to avoid.

A survey that was conducted by Robert Armstrong, a FT columnist, showed that about ⅔ of the respondents felt that either one of these two things is likely. The other third has bet on a soft-landing or an inflationary boom. That is why the outlook is so puzzling. We think that there is a 60% chance that we are either going to

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stay in either a stagflation episode or inflationary boom that should last for a while longer, with a 18% chance that we will end up in an inflationary bust and 22% a soft landing.

The expectation that rising energy and food prices, combined with higher interest and exchange rates will ease the supply chain has started to play out. Inventories are building up. Thus the ongoing reduction in monetary growth should create the necessary deflationary pressure to bring back inflation eventually to an acceptable rate. Over the past 3 months, the money supply rose at the annual rate of 1.6%.

Stanley Druckenmiller, George Soros's money manager, is inactive. He said: "I've lived through enough bear markets that if you get aggressive in a bear market on the short side, you can get your head ripped off in rallies." A sudden turn for the better for the inflation front rate could be disastrous for both short and rip sellers. Jim Paulsen wrote in a note to his clients: "The good news about inflation spikes is how the stock market performed once the inflation rate topped out. Regardless of how fast inflation moderated from its peak, and whether or not a recession developed, most often, the stock market rose in the coming year." On average, among 17 inflationary episodes shown, the S&P 500 gained 13.2% in the 12 months following the inflation peak. Interestingly, I spotted in Market Watch that David Rosenberg, who has been pessimistic on markets for some time, is becoming a bit more positive, suggesting that the combination of euphoric sentiment, stretched positioning and excessive valuations is being unwound. While he expects the drawdown in stocks to continue for a bit longer, his equity model has improved to a level suggesting above-average returns of 13.8% over the next 12 months. Yet, from hereon investment should be oriented to companies with strong balance sheets, whose primary task will be to defend their profit margins and protect cash flows because growth is going to be dicey. The Fed Atlanta's GDP Now forecast for Q2 is 0.9%.

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