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Weekly Commentary

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By Hubert Marleau

Inflation Watch

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The path of inflation will influence looming decisions by the monetary authorities about how high to lift interest rates. The year-over-year increase in the CPI eased to 8.3% in August from 9.1% in June and 8.5% in July, but not as much as economists had expected. They were banking on 8.1%. Put simply, broadening price pressures caused disappointment as the cost for rent, health care and restaurant meals accelerated. Another 75 basis point increase in the policy rate is therefore in the bag. The monetary authorities will not back off until they reach satisfaction. Indeed, why would they? The economy is still expanding. The NYT's Ben Casselman and Lauren Leatherby evaluated 14 key economic indicators and found that most pointed to a good economy, weakness seemingly concentrated only in the residential and auto sectors.

Meanwhile, the latest Business Roundtable (BRT) survey of the chief executives of the world's largest companies may not be as exuberant as it once was, but still have healthy expectations for sales, hiring plans and investment. Accordingly, the odds have risen that the estimated interest rate peak is now expected to arrive early next year, about 3 months later than I originally expected, and should rise to 4.25%, around 50 bps higher than previously predicted. This is not a certainty, but it elevates the risk.

In this connection, markets strongly reacted to the downside as the bulls stared into the abyss, registering the worst week in months. The S&P 500 decreased 194 points or 4.8%, with losses erasing all gains from the previous sessions and more. The market had hoped for a better CPI inflation print as another Fed meeting looms and concerns over global macroeconomic conditions rise.

Yet the notion that the annual rate of inflation will abate remains sound. The world is in the midst of a synchronous period of monetary and fiscal policy tightening to fight inflation. "Global growth is expected to slow to 0.5% in 2023" says the World Bank. Disinflationary flags are everywhere, except in the CPI report from freight costs to auction prices for used cars and from normalization of supply woes to clearance of

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bloated inventory. Producer and import prices just registered a back-to-back drop in August. The former weakened by 0.1% to slow the year-over-year rate to 8.7% from 9.8% while the latter fell 1.0%, slowing to a yearly increase of 7.8%. Both prints suggest moderation in consumer prices is on the way.

If consideration had been given to changing spending habits, discount programs, inventory clearing and substitutions, the annual rate of inflation would have been much lower than reported. Over the past few weeks prints and surveys have shown that inflationary dynamics are improving and moving in the right direction. Costco's CEO Craig Jelinek said on the Jim Cramer Show that stubbornly high inflation is not going to be permanent - a promising prediction - based on what is currently happening with fuel prices, distribution and container costs. Michael Medline, CEO of Sobeys -Canada's second largest grocer -collaborated, saying that food prices are stabilizing and may have peaked.

The headline CPI rose 0.1%, perhaps worse than anticipated, but the mild increase brought the 3-month annualized rate down to 5.7% compared to 11.3% in Q1. Andrew Lees of MacroStrategy Partnership made the astute observation that looking forward to September, with the last two monthly changes of 0.0% and 0.1%, 0.4% or less would trim the 3-month annualized rate to the 2.0% target. That looks pretty normal to me. Anatole Kaletsky, the chairman and chief economist of Gavekal - a premier research organization, calculates that inflation would still be 4.3% in December if price increases came to a complete halt. Yes, but the 6-month annualized rate would still only be 0.2%.

This could be the reason why consumer inflation expectations fell sharply in August for the second month in a row. The N.Y. Fed's closely watched survey showed median 3-year-ahead expectations dropped to 2.8%. Inflation expectations have remained well anchored because the Fed still has not lost any institutional credibility. There is another reason, the Fed is facing general inflation which is broadly based, unlike Europe where inflation is specifically a major energy shock. Adam Tooze points: "What good will interest rate increases do in slowing down surge in gas prices caused by the uneven Covid recovery, Putin's war in Ukraine and the lack of integration in the global gas market?"

Contrary to the ECB, it is appropriate for the Fed to respond conventionally and solely with higher interest rates. Fortunately, the Fed has a helping hand - the viability and strength of the greenback. That is encouraging. The U.S.dollar is the envy of central banks. The DXY is almost 20% higher than it was a year ago - a form of guarantee that the Fed has not lost its institutional and international credibility, which may ease its task to convince business and labour to lessen the incorporation of higher inflation into their economic decisions. The bottom line: inflation will moderate but stay above 2.0%. The new target is 3.0% to 3.25%.

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What is important to know is that the stock market does well when inflation falls. Interestingly, Barron's Statistics showed Insider Transactions Ratio as bullish.

P.S.1 The Dollar Is Dead. Long Live the Dollar. But why Is it so Strong?

There is an argument that boldly states that the euro-dollar lock on international commerce, finance and investment is long overdue for an overthrow in the new multipolarity of power, trade and economic activity. Yet the dollar, in particular, remains the leading global and premier reserve currency. The DXY dollar index (110) is in a long-term secular upward trend, which started in 2011. The last two bull run peaks were 165 in 1985 and 122 in 2001. Many would attribute the resilience of the dollar system to 1) America's colossal economy, enormous military power, political stability, geographical security including energy independence and 2) the Fed's global leadership in cyclical change in monetary policy.

While the above factors are worthy of consideration, the real reason is that the world is bullish on America. The greenback is having a once-in-a-generation surge of supremacy over the world, registering a 40% gain on a real trade-weighted basis since 2011. What is remarkable is that this does not seem to be related solely to the aforementioned causes, but to the dynamic application of technology and business innovation. According to Marvin Barth, a former U.S. Treasury economist, the U.S.dollar had two previous megacycles: one in the '70s and early 80s with computerization, and another in the 1990s with the internet. Now it is in the midst of another megacycle with cloud applications and artificial intelligence. In each of the three cases, the U.S. was at the forefront of these thematic events. Jens Nordvig, CEO of Exante Data, which specializes in how macroeconomic developments play out in currency markets, thinks that the
U.S. is in for a banner year that may be bigger that the move in 2002 and even beat the 1980s performance. He sees nothing -China, Russia, etc-that points to any challenge to the U.S. dollar. This may be the reason why money is gravitating to North America.

P.S.2 Corporate Profits:

Invariably lost in the shadow of the ISM reports, the August Empire State Manufacturing index supports the Levy-Kalesky equation that corporate earnings may surprise the street to the upside. The August survey showed that prices paid by businesses for inputs have fallen much faster than price received, suggesting profit margin maintenance. The Philadelphia survey was equally constructive.

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