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Weekly Commentary

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By Hubert Marleau

Believe It Or Not: The Inflation Rate Is Falling

Submitted October 15, 2022

Last week, I wrote: "The Fed may get an opening because the inflation rate and the employment growth is receding at a slow enough pace that a veritable Lazarus moment for the left-for-dead 'soft landing' story is therefore still alive." I added that a careful historical analysis suggested that the Fed had had a much more encouraging record than the media claims. In fact, it had managed to get reduced inflation without causing a deep recession in 6 out of 11 cases. Unfortunately, achieving this is no small feat. The Bureau Labour of Statistics (BLS) proved it. The CPI shows that inflation eased only moderately in September to a yearly increase of 8.2%, staying stubbornly high and more than expected. Really?

Why did the stock market, after some reflection, translate what appeared to be red-hot inflation numbers into a huge swing, which oscillated the S&P 500 by 194 points or 5% in a single day, posting a powerful key upside reversal in all the major indices? A key reversal is characterized by an open that's below the previous day's close, which then makes a new low but closes above the previous day's high. Why this happened is a mystery.

The off-the-cuff answer is: the unwinding of profitable short bets and hedges being too bulky: a watershed moment for chart watchers, as the 200-week average hovers around 3500, reflecting a trench war between bulls and bears. While this is technically true, it is an unsatisfactory explanation. Trading and positioning are not fundamental reasons in the midst of a bear market. Massive reversals don't come out of nowhere. They are usually the product of something more fundamental. That is why we need to look under the hood. What got me going on this one was the behaviour of the dollar. It did not make sense for it to fall 80bps in spite of a significant increase in the level of interest rates. It suggested that the Fed was not going to hike any more than the amount it had already telegraphed.

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For the 3-months ended September 2022, the annualized rate of inflation plunged to 2.01%, from 10.91% in Q1/2022. Most of that came from shelter costs, which accounted for a third of the overall consumer-spending basket. Excluding shelter, overall prices would have risen m/m a more muted 0.2% rather than the actual 0.4%. In this connection, the 3-month annualized rate would have been only 1.2%. Right now, renting costs are cooling. Data from Zillow show they rose by 0.3% in September from August, considerably less than the 0.8% reported by the BLS. Rent figures from Core Logic, Realpage, a property-management-software provider, and Apartment List, a rental marketplace, tell the same story. Meanwhile, import prices fell 1.2% and the NY Fed's Underlying Inflation Gauge (UIG), which captures sustained movements in inflation from information contained in a broad set of price, real activity and financial data, fell 0.1% as did producer prices. Yet worries over the cost of living are not going away, even though most inflation points are trending down. In fact, disinflation has shown up in core goods. Falling shipping costs, commodity prices and swelling inventories are offering hints that more month-on-month price declines are coming. When all is said and done, inflation is perhaps not as hot as officially reported.

The best way to monitor how successfully the Fed will strike a delicate balance between inflation and employment is with the Misery Index, which is the addition of inflation to the unemployment rate. The direction of this index is positive, but the cycle is taking time to play out because the economy has not come to a full stop. Actually, the economy is doing well. The Atlanta Fed's GDPNow tracking model's latest estimate is that real GDP rose at the annual rate of 2.9% during the September quarter. It looks as if the economy has been in some kind of a rolling recession since the start of the year, hitting different sectors at different times and, in turn, experiencing a soft landing.

Perhaps this explains why the University of Michigan showed that consumer inflation expectations moved back up in early October, which prevented Thursday's huge upside swing in stock prices from continuing. On Friday, the S&P 500 lost 86 points or 2.3%. Because it did not close above Thursday's close, however, the market did not confirm the reversal. This means that stock prices are not going straight up from here, but it's still a reliable indicator that the worst may be over. Barry Ritholtz, a brilliant market commentator, pointed out that because the market has given back 50% of the post-Covid rally, the upside feels potentially explosive. One mild CPI print or one bad employment report could do the trick.

Over the coming weeks, corporate earnings will be scrutinised. So far, they have beaten consensus. As of now, the market expects third-quarter earnings growth of 1.6%, which would be the lowest quarterly forecast in 2 years. But the bar is low. Here is what Yardeni Research has to say about this: "Recent downward revisions in the coming six quarters are reflected in analysts' 2022 and 2023 earnings estimates at $223.72 and $241.83. Forward earnings is the time-weighted average of the two and was $237.30 this week. It's

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converging toward the 2023 estimate at the end of this year, and will soon start giving weight to the 2024 estimate, which is currently $260.93, at the beginning of 2023." That translates into an attractive P/E multiple (13.5x). Unsurprisingly, people in the know are buying. The ratio of insiders sales to buys is 5-to-1. That is about as low as it gets. Readings under 12.0 are bullish.

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