PALOS

Macro View

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By Hubert Marleau

The Regime of High Inflation is Over: It's Cooling

The US economy, like all others, is permanently uncertain, and forecasters who make subjective predictions about future inflation and growth are usually wrong. When they hit it right, they are just lucky. That is why I look for tea leaves in the bond markets, where the smart traders are. They place real money bets on where they see collectively where inflation and growth is heading.

Presently, the swap market is predicting that headline inflation will be running at the annual rate of 1.8% by next September. I don't know for sure what will happen next with inflation, but nonetheless I'm going along with what the bond traders are predicting.

My analysis of what has occurred lately in the economy is telling me to believe what the bond market thinks will happen. The money supply has fallen, with corresponding weakness in many economic prints that are inflation-related. Inflation was front and centre on Wednesday, when the BLS reported that headline inflation surged 3.7% y/y, while the core fell sharply to 4.3%. Weeding through the noise of the media surrounding the announcement, I've discerned that lower inflation is still the most likely outcome of the near-term future. Excluding shelter from both indices - Headline and Core - shows inflation rates of only 1.9% and 2.2% y/y. During the summer of 2022, these were 11.0% and 7.5% apiece. Moreover, headline inflation was boosted by a 10.6% jump in gasoline prices, which also contributed to core inflation via a 4.9% increase in airline fares. Without consideration for shelter cost and fuel prices, there would have been little inflation worth talking about. The question here is what will happen from hereon. In my judgement, soaring shelter and energy costs look to be in the rearview mirror.

First, the inflation rate for new rental leases has already come down significantly since the start of the year. The Zillow Observed Rent Index is up 3.1% y/y versus 7.7% and 8.0% respectively for Owners' Equivalent Rent and Rent of Primary Residence. That big gap is bound to narrow because CPI's rent inflation components are starting to reflect this development, since they include rents in existing leases as well as new ones.
Second, oil prices have accelerated since last June, up $30 a barrel to $92. Put the blame on OPEC. The formidable Saudi-Russian alliance's desire to push the price toward $100 had a huge immediate impact on inflation, and it explains a big chunk of the increase. In this connection, however, supply shortages might be rectified by December

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as momentum could fade. Simple mathematics pegs the marginal cost of oil production around $70 per barrel. Moreover, the energy bill is now 3.5% of the N-GDP, closing in on 3.75%, a threshold where oil prices have in the past caused disinflationary reactions on retail sales ex-energy. Retail sales were up in August, beating expectations. However, this was mostly due to higher gas sales.

The blessing is that this anticipated substitution effect may have already started in June. A recent consumer survey by the NY Fed showed that consumers were more concerned about credit than inflation. Most people have few alternatives to driving, so gas demand is relatively price-inelastic. That said, increased spending on gas will likely be funded, at least in part, by cuts to households' discretionary items, especially when one takes into consideration the cash drain from the restart of student loan repayments, and the dwindling pile of excess savings accumulated during Covid. In fact, the August upside surprise in retail sales was entirely offset by downward revisions in prior months. Once all the revisions were made, total sales increased by 2.5% from a year ago, extending a marked deceleration in year-over-year growth from 6.4% last January. The spending momentum numbers published by Visa and zero growth in online sales tell a similar story. Perhaps consumers are feeling the pain of energy prices.

The Adobe Digital Price Index, which is modelled after the Consumer Price Index published by the BLS, fell to a 40-month low, down 3.2% in August. Moreover, Friday's CPI Truflation rate was 2.62% y/y, Truflation being a hub with 10 million data economic points that are updated daily independently, including price indexes. This rate offers a more reliable view of inflation than outdated government metrics. If one were to account for the impact of inflation, retail sales are not as strong as they appear on the surface. The St. Louis Fed's real retail sales, which is constructed from the nominal release deflated by the CPI, showed a marginal 0.07% decline in August. This was the first monthly decrease since March.

Setting aside monthly volatility, the new narrative is that we have exited the regime of high inflation. I understand that continuous increases in the price of oil could raise inflation expectations and be a pass-through to core inflation, but this risk is not concrete yet and may not emerge. And as I mentioned earlier, the momentum seems to be fading. There is talk that OPEC+ might be satisfied with market conditions by the end of the year, eliminating the heightened risk of a second wave of inflation. Interestingly, the Michigan consumer sentiment survey reported that there was a serious downshift in inflation expectations toward normalisation in September. A drop in 5-to-10-year inflation expectations to 2.7% from 3.0% in August was registered. - a 2-year low.

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Monetary Policy and the Stock Market:

Currently, markets are expecting the Fed to stay put, with probabilities of a pause in September at 97%, according to the CME FedWatch Tool. This anticipated pause is definitely helping the stock market and is well documented. Amid rising oil prices, weak Chinese growth and the Fed's hawkish talk, the S&P 500 shed only 7 points on the week to close at 4450. Had it not been for Friday's volatility, which was caused by the expiration of stock options, stock index futures, and stock index options, the stock market would have probably ended the week on a very high note. Why? Unpredictability and anxiety in the bond market has stopped. Merrill Lynch's Option

Volatility Estimate fell from 200.00 last Marsh to 97.11 on Thursday. The bond market is buying the "immaculate disinflation" narrative: lower growth and lower inflation without a recession. Indeed, the New York Staff Nowcast stands at 2.3% GDP growth for Q3 and 2.4% for Q4. This is happening because the fall in the rate of inflation is the product of expanding supply and not crushing demand. Hence the immaculate disinflation, plus a possible explanation for the wide gap between the gross GDP and GDI.

Betting against the bearish sentiment of the street is a risky business. The Bank of America's global fund manager survey (FMS) for September - a broad measure of sentiment, based on cash position, equity allocation, economic growth and general expectations - shows that international investors are close to being extreme bears. From a contrarian perspective, it presents a buying opportunity. That is why I'm still modelling an 8% gain for the S&P 500 from today's 4450 over the next 6 to 12 months. Given stagflation in Europe and a disinflationary downturn in China, a lot of money would plough into any weakness in U.S. equities. I take comfort that I'm not the only one who is bullish. For example, Manish Kabra, head of U.S. equity strategy at Société General, is predicting the S&P 500 will reach 4750 by the end of the year versus a prior 4300.

Market Watch came up with 4 other reasons worthy of consideration as to why the market has legs:

- The benchmark has moved back above its 50-day moving average, which is a supportive level.
- The ECB delivered a dovish interest rate hike, which bodes well for the Fed to signal that it's done with tightening.
- Earnings forecasts have been improving over recent months. An increase is expected in Q3.

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- Investors have a lot of dry powder. According to the Bank of America, as much as $5.625 trillion is held in money market funds - a fresh record that is $800 billion above the pre-pandemic high of $4.8 trillion.

Huber Marleau's 'Macro View'

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