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The Palos Perspective

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Inflation Got a Body Check in January

The Bureau of Labor Statistics reported a 3.1% headline CPI year-over-year increase in January, which was was down from 3.4% in December, but higher than the 2.9% the Cleveland Fed's inflation NowCasting model has been predicting. This inflation reading was a nasty surprise, which pushed back market expectations of imminent interest rate cuts, while the swap market raised its prediction that inflation would be 3.3% in one year's time, having been 2.0% at the beginning of the year.

This was totally caused by a blistering 0.9% m/m increase in "supercore" inflation, as a result of which the readjustment in bond yields not only pushed out the collective forecast for interest rate cuts in 2024, but brought back rate-hike murmurs on the trading floors and discussions in the press. The bond market's worst fears about inflation pretty much came to pass on Tuesday.

While the body-check from stubborn pricing pressure should not be ignored, there are nonetheless plenty of reasons to anticipate a re-establishment of the disinflation narrative. A single report does not kick the economy off the disinflationary path. Indeed, the January print looks more like a blip than the start of a new inflationary wave. The bottom line is that the monetary risk is skewed toward a prolonged pause as the last disinflationary mile might be choppy.

Digging deeper, however, there are signs that the January numbers were funky - more noise than signal - accounting for all of the miss. Firstly, many businesses involved in medical services, personal care and daycare made start-of-the-year price adjustments, passing on the unusually large input costs which took place last year. Secondly, the 0.6% m/m increase in the rent of primary residences looks suspicious. Rents reset infrequently because of the slow way the BLS reports shelter costs. Indeed, so far, the dramatic cooling in housing statistics that have occurred since 2022 has not been officially reflected. High frequency data produced by Zillow has shown U.S. rents down on a y/y basis for 8 consecutive months. Eventually, rental inflation will converge on newly signed leases.

Overall, we hardly have a back drop that should make investors hit the panic bottom. Excluding shelter and seasonal January price effects of businesses, where the numbers are funky, the headline and core CPI were up just 1.6% and 2.2% y/y through January, with a 3-month annualized rate of 1.1%. As a matter of fact, inflation expectations, which is the most important input to realized inflation, are not only well anchored but falling. According to a consumer survey conducted by the NY Fed, 3-year-ahead expectations are 2.4%. Austan Goolsbee, the Chicago Fed President, told the

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Council of Foreign Relations that inflation doesn't necessarily need to be as low as it was during the last 6 months of 2023 for the Fed to have confidence that it is returning to its 2% goal. Meanwhile a pair of economic prints on retail sales and industrial production were both weaker than expected as they contracted in January. The releases gave relief to the markets as Fed swaps fully priced an interest rate cut in June.

The Market Outlook:

Nonetheless, Wall Street was caught off-guard by the hotter-than-expected U.S. consumer and producer inflation readings, giving speculators reasons to take some trading profits in the form of a tactical correction. The CBOE Skew Index, a measure of the perceived tail risk, shot up to 171 from 150.

Fortunately, this index is far better at revealing what the traders are doing now than predicting negative outcomes. In fact, this is a healthy development for the sustainability of the bull run; and my hunch is that the broad market might fall, short term, to test 4850, where it's likely to find support. In this connection, bottom-pickers should consider buying dips in stocks that they like. Why? I maintain the view that the S&P 500 will nudge toward 5400 in 2024 and further along to 5900 in 2025. Take note that all-time highs are usually followed by more all-time highs and that it doesn't take much to positively change the mood in the stock market like we witnessed in the last few days.

Despite all the unsettling January increases in inflation, the y/y trend in both consumer and producer price indices remain downward and the sharp fall in retail sales and construction of new homes, the Atlanta Fed's NowCasting model is still predicting a 2.9% annual rate of increase in the GDP for Q1.It perhaps explain why the S&P 500 hovered around the 5000 mark all week, except on Tuesday.

P.S. 1 According to SocGen's Manish Kabra, if one were to apply the math prevailing at the peak of the " dot.com" bubble - that irrational exuberance of the late 1990s - it could even drive the S&P 500 to 6250.

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Chart 1: Palos Domestic Funds versus Benchmarks (Total Returns) [1]	**FundServ**	**NAVPS**	**YTD Returns**
Palos Income Fund L.P.	PAL100	$8.36	1.64%
Palos Equity Income Fund - RRSP	PAL101	$6.84	1.56%
Palos WP Growth Fund - RRSP	PAL213	$9.28	-2.40%
Palos-Mitchell Alpha Fund [3]	PAL300	$10.02	-1.88%
S&P TSX Composite (Total Return with dividends reinvested)			1.57%
S&P 500 (Total Return with dividends reinvested)			4.52%
S&P TSX Venture (Total Return with dividends reinvested)			-0.21%
Chart 2: Market Data [1]			**Value**
US Government 10-Year			4.28%
Canadian Government 10-Year			3.51%
Crude Oil Spot			US $78.18
Gold Spot			US $2,027.50
US Gov't10-Year/Moody BAA Corp. Spread			155 bps
USD/CAD Exchange Rate Spot			US $0.7395

[1] *Period ending February 20th, 2023. Data extracted from Bloomberg*

[2] *Fund is priced annually*

[3] *Fund is priced weekly on Tuesdays*

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