CIO View

Americas CIO View

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Marketing material

The illusions and confusions of inflation: It's dangerous to let them linger

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IN A NUTSHELL

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October CPI declined more than expected, but the inflation fight is far from over

The holiday rally came early, sparked by lower inflation in October than expected, along with bullish narratives circulating about reliable post midterm election rallies, China reopening and Russia retreating. It's likely best to take this gift rally and leave the festivities early. As the inflation fight is far from over. And neither are the other concerns. Inflation off its highs is welcome, yet it already took longer than hoped, but the big fight will be getting it under 4%. It's important that the U.S. Federal Reserve (Fed) bring inflation closer to 3% by mid-2023, otherwise it risks the bond market demanding higher inflation risk premiums because of high inflation being a 2+ year experience. October consumer price index (CPI) showed headline and core at 7.8% and 6.3% y/y, compared to 8.2% and 6.7% y/y in September. Most of the Goods categories slowed in price y/y and m/m increases (some with big declines unlikely to persist), however, most of the Service categories still ran y/y and m/m changes over 5%. Thus, disinflation is narrow and yet high inflation is broader at services and thus labor. The CPI report has noise related to adjustments at health care, shelter, and is generally noisy m/m. We're focusing on unit labor costs, i.e. wages/productivity. Very poor trends here year-to-date (YTD) suggest it will take time and more hikes for inflation to normalize.

Markets, journalists and some FOMC members making the inflation fight harder

The next Federal Open Market Committee (FOMC) decision is on December 14th and the next CPI report for Nov is Dec 13th. We doubt there is enough new information in November inflation or jobs reports to alter the Fed's near-term decisions and 2023 projections. Markets and financial conditions likely greater factors. If S&P over 3800 and broad financial conditions loosen in Nov-Dec vs. Sept-Oct, we think Fed hikes 75bp in Dec. or 50bp with at least another 50bp in 1Q. Current conditions raise risk Chair Powell takes hawkish tone at Dec post FOMC press conference (like in 2018). Dots likely show 5.0-5.5% median terminal Fed Funds rate through 2023.

Mid-term elections: A clear disappointment for Republicans and the supply-side

Republicans make minor gains in House and not clear it will be a unified Representative majority. Small chance Reps take Senate with NV and then GA in the Dec 6th runoff, which extends midterm uncertainty into a period of budget and other lame duck session risks. History's strong S&P performance after midterms doesn't have a clear conceptual basis. Poor post-election performance in 2002 & 2018 shows that Fed policy and geopolitical issues can supersede. Russia-Ukraine war still ongoing. Asking Ukraine to concede territory to expedite a cease fire is odd given Russian invasion, atrocities and Ukraine resistance winning. We expect bipartisan tough-on-China and Ukraine support in new Congress.

Illusions and confusion of inflation: Beware measures of wages, sales and profits

Oil is in a lot of things, but labor is in everything. The best structural measure of inflation is unit labor costs (ULCs). If wages are rising 5% and productivity is rising 5%, that's prosperity. If wages are rising 5% but productivity is low/ negative and CPI is over 5%, that's misery for both employees and employers. If ULCs (hourly wages less hourly output) are above the Fed's target then inflation is structurally too high. ULCs are rising since 3Q21 and now 6.1% y/y in 3Q22. Meanwhile, productivity is weak and -1.4% y/y in 3Q22. Also, there is nothing good about retail sales or corporate sales and profits lagging inflation either. S&P real EPS growth is very negative, healthy real growth is 5%.

How does high inflation impact equities? It weighs on the economy, lowers fair PE

Although equities represent real assets and price-to-earnings (P/E) ratio is driven by the real cost of equity, broad-based inflation is negative for equity performance. Broad-based inflation if lasting for multiple years have negative impact on the economy, such as lower productivity, greater uncertainty with higher inflation risk premium and thus higher real interest rates, higher effective taxation and lower earnings quality from inadequate depreciation expense, etc. All of these lower the fair PE and the real return earned on the ownership of equities.

We see downside risk to S&P 500 into early 2023

S&P is trading at about 18x forward EPS on our estimates. We find this a very demanding valuation with what Treasury bills/ bonds, corporate and muni bonds are yielding. We think bonds are better for 2023. In our view the S&P is likely to test its 2022 lows around 3600 before yearend or 1Q23 as the inflation fight lingers. There are risks around the lame duck session, budget setting and ceiling, into yearend tax loss selling and continued risks with Russia/Ukraine for Europe and the world.

Glossary

The consumer price index (CPI) measures the price inflation as a percentage, year over year, of a basket of products and services that is based on the typical consumption of a private household.

Core inflation excludes items which can be susceptible to volatile price movements, e.g. food and energy.

Cost of equity (CoE) is the return (often expressed as a rate of return) a firm theoretically pays to its equity investors, to compensate for the risk they undertake by investing their capital.

In relation to currencies, depreciation refers to a loss of value against another currency over time.

Disinflation describes a slowing of the pace of price inflation.

Each dot represents where an FOMC member sees the federal funds rate at the end of each year.

The Federal Funds rate is the interest rate that banks charge each other to borrow or lend excess reserves overnight.

The Federal Open Market Committee (FOMC) is the committee that oversees the open-market operations (purchases and sales of securities that are intended to steer interest rates and market liquidity) of the U.S. Federal Reserve.

The United States House of Representatives is a legislative chamber consisting of 435 Representatives, as well as non-voting delegates from Washington, D.C. and U.S. territories. Representatives are elected for two-year terms and each state's representation is based on population as measured in the previous Census.

The price-to-earnings (P/E) ratio compares a company's current share price to its earnings per share.

Productivity measures how much economic output is produced for a given level of inputs (such as capital and labor).

The risk premium is the expected return on an investment minus the return that would be earned on a risk-free investment.

The S&P 500 is an index that includes 500 leading U.S. companies capturing approximately 80% coverage of available U.S. market capitalization.

The U.S. Federal Reserve, often referred to as "the Fed," is the central bank of the United States.

Unit labor costs (ULC) measure the average cost of labor per unit of output.

The United States Senate is a legislative chamber consisting of 100 Senators, with each state being represented by two Senators. Senators are elected for six years, overlapping terms in their respective state.

Important information – EMEA, APAC & LATAM

Important information – North America

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