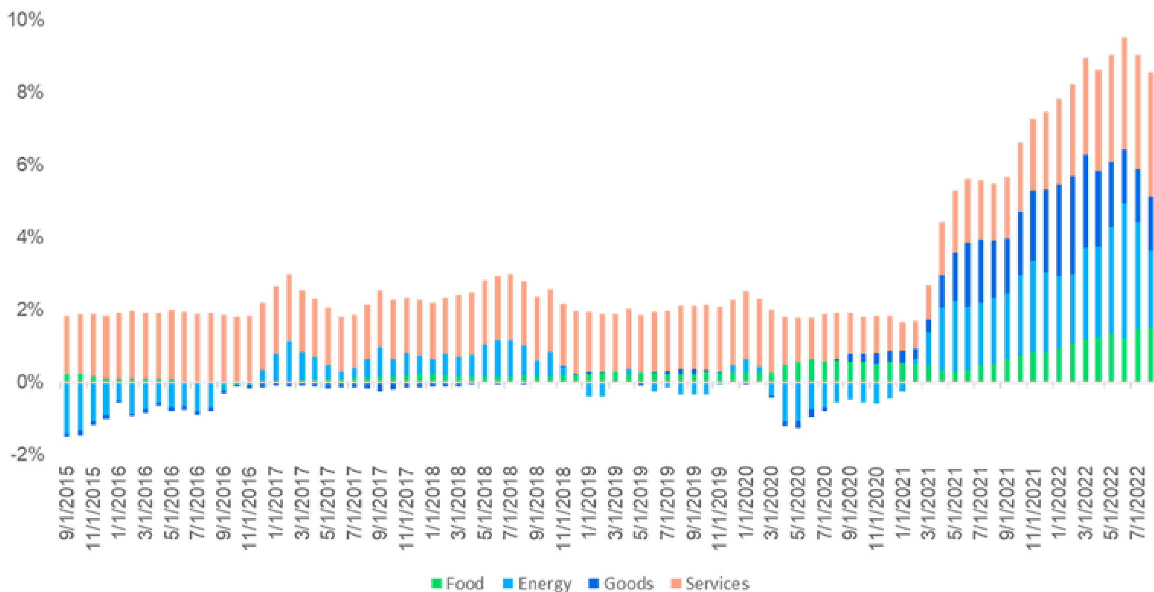
FRIDAY, SEPTEMBER 16, 2022

IT'S ALL ABOUT INFLATION

This week's August inflation report for the US was undoubtedly disappointing. But the take-away – that the Federal Reserve's tightening cycle has a lot further to run – should have come as no surprise. Another 75 basis point rise in rates at next week's Fed meeting was likely before the inflation news, as we said last week. Investors should now be watching to see how high the central bank expects rates to rise, and for how long. The quarterly update of the Fed's economic projections, and the "dot plot" of where the central bankers expect interest rates to go will be released next Wednesday, along with this month's rate decision.



Chair Powell and colleagues have repeatedly stressed their determination to keep fighting inflation, even if that hurts the economy. Markets seem to have been reluctant to get the message, rallying this summer at any sign of good news. On Tuesday, after the release of the consumer price index, equities plunged, undoing, in one day, much of the recent rally, which had been sparked in July by hopes that inflation had peaked – and that the Fed would pivot early next year, to ease. Bond markets resumed their sell off with the US 10yr yield 3bps away from setting a new high this year. Markets are now pricing a small probability of a full percentage point in the Fed Funds rate, with notable pundits calling for as much and increasing probability of a 75 bp increase in November.

As markets moved ahead of the Fed meeting, mortgage rates climbed above 6%, double the rate of a year ago. Bad news for home buyers – and would-be sellers – but that's how monetary policy feeds first into the economy to curb demand. According to data from the University of Michigan, consumer expectations for 1 year inflation fell slightly to 4.6% from 4.8% in the prior month. Longer term inflation expectations also fell slightly to 2.8% from 2.9%. While moving in the right direction, there is still some work to be done to re-anchor consumer inflation expectations.

When bad news is bad – inflation is still high

Sometimes, bad news is good. That's not how it worked out with the inflation data this week.

The news was bad – and the details of the consumer price index (CPI) release just made it worse. Yes, headline annual inflation may have peaked in June, when it topped 9% in the US. But the decline in the headline rate in July and August, to 8.3% last month, largely reflects a fall in gas prices.

Gas prices have fallen 24% from their summertime highs but are still 16% higher than a year ago. That will continue to put upward pressure on headline price measures when compared to a year ago, albeit to a lesser degree. OPEC has expressed a preference for oil prices slightly above current levels but are not necessarily looking to push up the price. What matters most is what happens to Russian oil. The US and Europe are in a difficult position. They don't want higher oil prices to continue to provide a windfall for Russia, helping to fund its military fight. But they do want Russian oil – or at least much of it – to stay in the global market. Hence the G7 plan for a price cap on Russian oil exports, which would hold down Russia's revenues while keeping the global economy supplied.

The G7 is hoping that India, China and other nations still buying from Russia will work with them to support the price cap, when Europe's measures to choke off its imports of Russia's oil come into effect, scheduled for early December President Putin in turn has vowed to cut off all supplies to global markets if Europe goes ahead and a price cap is agreed. He may be bluffing. But for the US, even without another energy price shock pushing pump prices back up, "core" inflation faced by other consumers is likely to continue to increase at an uncomfortably rapid rate.

The CPI release demonstrated this, and showed why there is no interest rate relief in sight. In August, "core" prices excluding fuel and food rose at an annual rate of 7%, far above the Federal Reserve's 2% target. Another inflation measure compiled by the Cleveland Fed, the median CPI, strips out extreme price changes on either the high or low side. And in August, this measure rose at an annual rate of 9.2%, the worst monthly rate since the series began nearly 30 years ago.

These data do not mean that inflation will persist at close to double digits – at least not in the US. Easing supply chains are already slowing producer prices. The strong dollar led to a drop in import prices last month. And a slowing economy, as interest rates climb and choke off some demand, will also contribute to bringing down the CPI in coming months. But without further tightening, it will not reach the Fed's 2% target.

What is still up for debate is how much pain the economy will need to suffer – how much of an increase in unemployment – before the Fed is "confident," in Chair Powell's language, of reaching price stability.

When good news is bad – the economy is still showing some strength

In the whipsaw pattern of the post-pandemic economy, this week also showed some signs that while the economy is slowing, it is not yet in recession. But with concerns focused on the inflationary risks from the tight labor market and continued demand side pressures, good news can be bad. August retail sales showed consumers are still increasing spending, with sales up by more than inflation in August. Unemployment claims, meanwhile, slipped in early September to their lowest level since late May, further evidence of the continued strength of labor markets.

Worker shortages push up wages and costs. One puzzle post-pandemic has been the continued lower labor participation rate, which has contributed to constrained labor supply. Lingering effects of Covid 19 may be partly to blame. Workers who need to take a week off work to recover from Covid are 7% more likely to be out of the labor force a year later, amounting to a loss of 500,000 workers, according to new research by Gopi Shah Goda and Evan Soltas published by NBER.

The pandemic has changed the economy in many ways that we are only beginning to understand. Another shift has been a revival of interest in unions. The tentative resolution of a threatened freight rail strike is good news. Economists had warned that the supply shock if the strike had gone ahead could have been even worse than from the pandemic lockdowns. But the 14 % immediate pay rise, while good for railroad workers, is bad for industry costs.

When bad news meets more bad news – markets tumble

Equity markets absorbed two major blows of bad news last week. Tuesday's disappointing CPI data promptly sent the US market tumbling more than 4%. Then, after investors had just had a chance to digest how entrenched inflation appears to be in the economy and the promise of more Fed tightening than earlier anticipated, FedEx issued a brutal profit warning after the market's close Thursday, sending equities further down on Friday. FedEx's report of worsening macroeconomic trends and lower shipment volumes in the US and overseas over the past few weeks amplified fears that a recession, while not inevitable, could be ahead. FedEx stock plummeted 21.4%, falling to its lowest price level since mid-2020 during the height of the Covid pandemic. The S&P 500 and Nasdaq Composite ended the week 4.7% and 5.5% lower, respectively. Europe and Japan followed suit with the STOXX Europe 600 giving up -3.3% and Japan's TOPIX losing 1.7% for the week.

Even before this double whammy, investor sentiment was extremely low as portrayed in Bank of America's latest Global Fund Manager Survey. Average cash levels have soared to the highest levels seen since the aftermath of September 11 and equities remain at a record underweight across portfolios. 72% of fund managers expect a weaker economy next year.

Ordinarily, such pessimism might be a sign of markets bottoming or at least hope for a relief rally, however, as we have noted in previous commentary, valuations remain full with corporate earnings on a downward trend. The S&P 500 is trading at approximately a 17x multiple of 12-month forward earnings even as analysts have cut their estimates for Q3 earnings growth by 5.5% since the end of June, according to FactSet. That marks the biggest cut since Q2 2020 when the pandemic brought the economy to a standstill.

Company management teams appear to be losing confidence as well with nearly half of S&P 500 companies bringing up the topic of recession during last quarter's conference calls. Declining earnings are not just a US phenomenon. Profit warnings have come out of Europe from such companies as Associated British Foods and Electrolux in recent days.

When good news is really good – child poverty and the uninsured down

This week did bring some unalloyed good news. First, and most important: new research showed an unprecedented decline in measures of child poverty in the quarter century that ended in 2019. Over this period, the rate of child poverty dropped from one in four children to one in ten, a decline of more than half. The authors note that declines in child poverty both improves wellbeing for children and families and provides important benefits for society, with less crime, lower health care costs and higher taxes paid. The gains came across the board – for different racial and ethnic groups, for both immigrant and non-immigrant families, and across all regions in the US. Two factors were key: a strong economy and public policies that expanded the social safety net, notably the earned income tax credit and housing subsidies.

Other good news this week came from data on health insurance reported by the American Community Survey, confirming evidence from an earlier survey that the uninsured rate fell between 2019 and 2021. The ACS showed a 0.5 percentage point decline, to 8.6%, in the percentage of Americans without health insurance.

Merged Ether

On Thursday, the Ethereum blockchain completed The Merge as part of its vision to become more scalable, secure, and sustainable. This was the long-awaited switch from a proof-of-work consensus mechanism to proof-of-stake, a much less energy intensive method for securing the network. Since December 2020, the Beacon Chain (the proof-of-stake consensus layer) had been running in parallel to Ethereum's Mainnet, going through extensive testing before being merged with Mainnet as Ethereum's main engine of block production.

Besides reducing its energy intensity by 99.95%, the change to proof-of-stake also paves the way for scalability upgrades that were not previously possible. The deployment of sharding is the next landmark upgrade for the Ethereum community and could be deployed sometime next year. The development would allow for exponential growth in the network's capacity by working with layer 2 blockchains to more efficiently "rollup" hundreds of transactions into a single transaction on the layer 1 blockchain (i.e., Ethereum). This would lower gas fees associated with transacting on Ethereum and expand the potential use cases while maintaining its security characteristics.

Emerging Markets

This week's disappointing inflation print in the US did not spare emerging markets assets either. Investors chose to de-risk first and ask questions later. It might be tempting to dismiss this latest market downturn as a knee jerk reaction to unexpected news, but emerging markets have experienced net outflows for months now, particularly in fixed income. Investors are nervous about the prospects for EM going into 2023 – presenting opportunities for those long-term EM investors with dry powder.

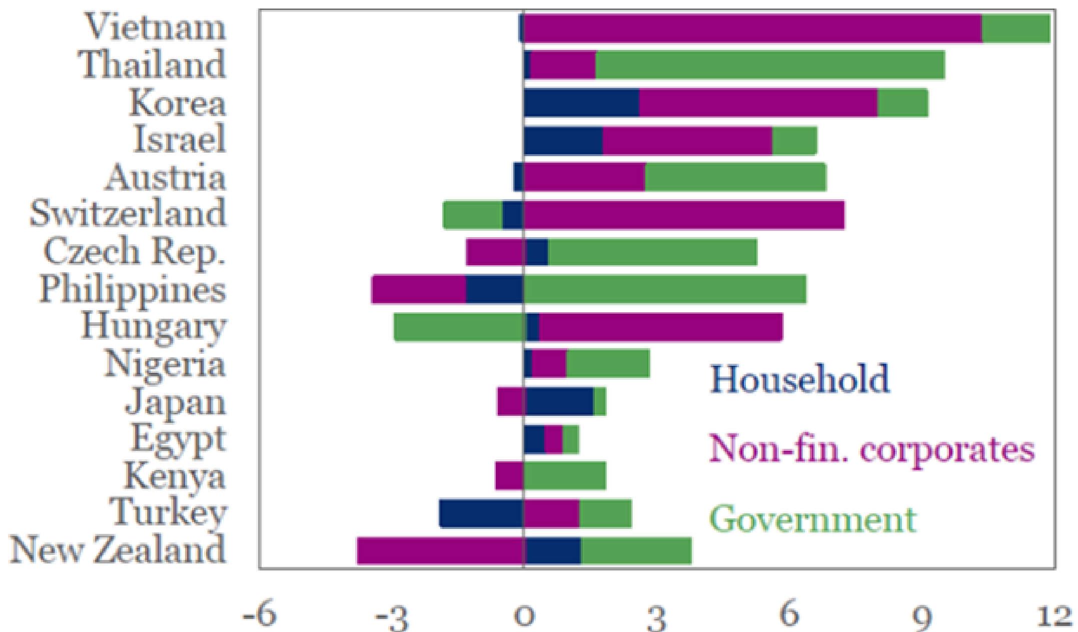
Investors Running for the Exit

Fund Flows	Asset	8w flows (8w ago → current)	This wk	YTD
	EM Bonds and Equities		-5.2	-45.1
	EM Bonds		-1.4	-59.6
	Hard Ccy		-0.9	-29.1
	Local Ccy^		-0.5	-30.5
	o.w. EM ex-China		-0.5	-13.3
	o.w. China		0.0	-15.8
	EM Equities		-3.8	14.4
	US HG		1.0	-61.8
	US HY		-1.7	-42.9
	Global Equities		-11.3	95.4

Source: JPMorgan, as of September 9th, 2022

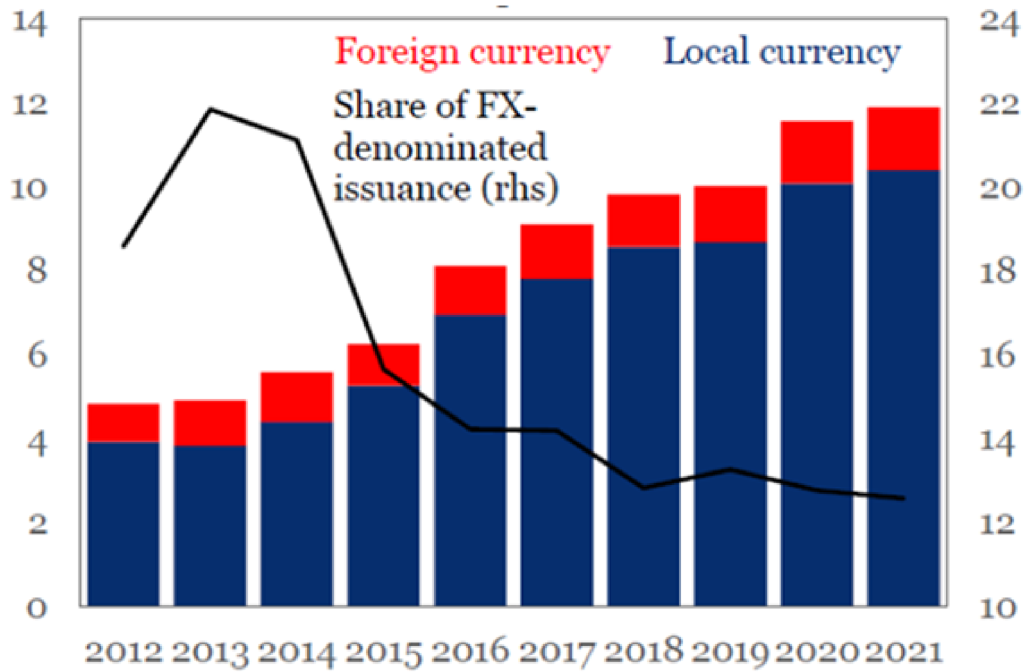
Although debt-to-GDP ratios have deteriorated markedly during the pandemic as governments raced to support their local economies and populations, much of the new debt issuance was in local currencies. There is less reliance on US Dollar-based borrowing (with a few notable exceptions) and EM currencies as a group have garnered more credibility as central banks have proven adept at dealing with inflation. Rising rates and a stronger US Dollar are not the bogeyman of the past.

% Change in debt/GDP ratios in 2021



Source: IIF, IMF, World Bank, Haver

$ Trillion EM Loan Issuance (Corp & Sov)



Source: Bloomberg, IIF

We continue to see plenty of opportunities in certain regions including ASEAN and India and across sectors such as industrials, healthcare, and transport but being selective will be key. Forward earnings expansion is not uniform but those companies with healthy balance sheets, smart allocation of capital, and strong management execution are beginning to emerge from the pack – and steadily gaining market share.

RockCreek Update

Squawk on the Street

In the wake of Tuesday's stunning CPI print, Afsaneh Beschloss joined CNBC's Leslie Picker and Carl Quintanilla to discuss the ramifications on markets. We can avoid a recession, Afsaneh argued, and if we end up with slightly higher wages and slightly lower earnings, it might not be good for markets but might be good for growth scenarios. Watch the clip here and the full interview here.

Development and the Power of Capital Markets

Over the past seven decades, using its AAA credit rating, the World Bank has used just $19 billion of paid-in capital to mobilize more than $800 billion in cumulative lending for middle-income countries. But the needs of developing countries, already in the trillions, were exacerbated by the pandemic, which unraveled decades of development achievements and pushed at least 100 million people back into extreme poverty.

Afsaneh Beschloss and other leaders in the public, private, and multilateral sectors, gathered to discuss new G20 recommendations to increase lending by multilateral development banks by re-examining their capital adequacy frameworks. More lending and greater private capital mobilization are possible, Afsaneh argued, but only if the institutions recommit to innovations to drive new development gains. Watch the entire discussion here.

With more to come,

Team RockCreek

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