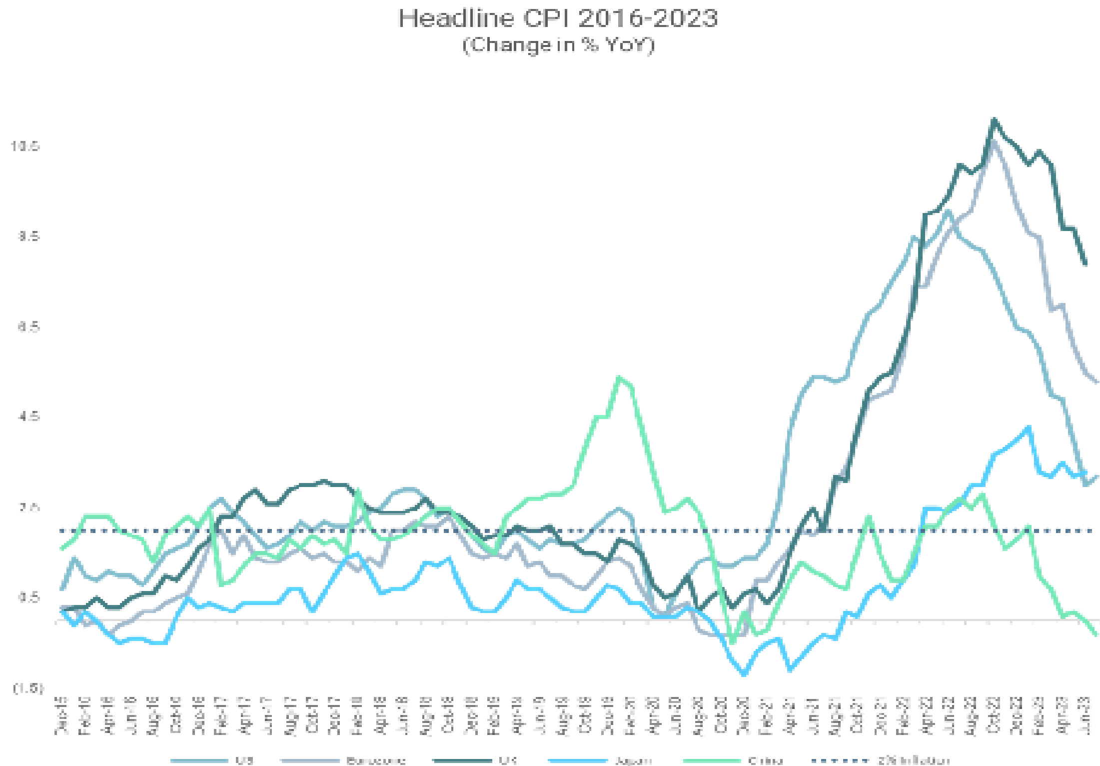
INFLATION UNSTICKING?

This week's data for US consumer price inflation were, in the words of former Obama Chief Economist Jason Furman, "unambiguously good" for the second month in a row. The good cheer was dented somewhat by a bigger than expected rise in producer prices, reported on Friday. But despite this, evidence is gathering that the inflationary surge that terrified markets a year ago is gradually fading away. And it is doing so without the much-feared recession and rise in unemployment that models of the past – and many present observers – thought would be inevitable. Worrisome data earlier this year suggested inflation would be "sticky" at uncomfortably high levels. That risk cannot be dismissed. But it looks smaller now than just a few months ago.

Investors remained cautious, with equities down again on the week. Caution is wise. Geopolitical tensions remain a risk. This week's executive order from the White House on outbound investment served as a reminder, even though the suggested curbs were narrowly focused on national security and private markets, with control in the hands of the US Treasury and a year for discussion (see below). And on the prospects for US markets, more data is needed to reassure central bankers that inflation is truly beaten. The Federal Reserve has another full month before its next meeting to decide whether to keep rates unchanged, as market pricing suggests, or to hike another 25 basis points.

On Thursday, the government reported a headline increase in consumer prices of 3.2% in the year to July. That was a tick up from June. But underlying or "core" inflation for the months of both June and July was running at an annual rate of just under 2%. The more volatile producer price index rose by more than expected but stayed below 3% from a year ago. At the same time, US unemployment dipped in July to 3.5% and has stayed in a range of 3.4% to 3.7% for 17 months. For once, the question facing policymakers and investors is "what went right?"



HOW DID INFLATION DECLINE?

Sharply tighter monetary policy in the US and around the world was surely one element in the – so far – successful fight against inflation. The Federal Reserve was slow to begin raising rates but acted swiftly once it started to hike in 2022. And, against the advice of some, Fed Chair Jerome Powell was firm in declaring that 2% remained the central bank's definition of price stability and the target that it intended to reach. That has helped to anchor market expectations, even while inflation reached close to double digits last summer. At 5.25-5.5%, policy rates are now restrictive.

The other factor supporting disinflation is time – and the reversal of some of the extraordinary events that caused the surge in prices in 2021-22. The sudden rise in inflation that took central bankers in developed markets unawares was, at least in part, a result of large but one-off changes in the global economy. Existing models were no match for the impact of the pandemic and post-pandemic period, including the outbreak of war in Ukraine. As the global economy returns to some version of normal, goods that were in short supply are now moving, workers that were staying on the sidelines are rejoining the labor force, and prices that soared in the face of shortages of energy and food – post-Russia's invasion – have come down.

It also seems that employers who learned post-pandemic that they had laid off workers too quickly are now cutting hours rather than implementing widespread layoffs. That is keeping traditional measures of the labor market, notably unemployment, looking stronger than otherwise. It is also likely that when faced with sudden labor shortages – as lockdowns lifted and demand for services surged – businesses surged hiring and pushed up vacancy numbers. Perhaps the jobs market was never as tight as it seemed last summer, although wage increases have certainly risen.

An arithmetic breakdown of how inflation has come down is nicely laid out on X (formerly Twitter) by Furman. There are myriad inflation measures – CPI, PCE, headline, core, supercore. Each can be looked at over different periods – annual, 3-month, 1-month, 6-month annualized.

Abstracting from the noise, there seems to be a relatively straightforward story. The rapid rise in prices in 2021-22 has not sparked a sharp wage-price, or price-price, spiral as feared. Instead, prices that had shot up because of pandemic factors and the war have since come down sharply. And the improvement has been broadly passed through to consumers. In addition, tight money may have been working to curb inflation even without the expected cost in terms of lost jobs.

The numbers show that inflation faced by American households has come down by almost 6 percentage points from a year ago, from nearly 9% to just over 3%. Most of that decline – some 4 percentage points – has come from volatile prices, particularly energy but also food. These prices are excluded from measures of “core” or underlying inflation because historically they do not have much predictive power for where inflation is headed. But of course, they matter enormously for the consumers that need to buy food to feed themselves and their families, put gas in their cars, and heat their homes. A renewed rise in such prices is one risk to inflation in the months to come.

About a further 1 percentage point of the drop in inflation in the past year can be accounted for by an unwinding of transitory pandemic-related factors. That leaves about 0.5 to 1 percentage point “unexplained” – or at least, not explained by any rise in unemployment. Critical going forward will be whether this disinflation continues, or gets sticky again with wage increases running above what is consistent with price stability.

WHAT MAY GO WRONG?

Looking ahead, opinion is divided on whether the summer hopes of a soft US landing will

fade in the fall. Credit agencies have drawn attention this month to two underlying weaknesses. The Fitch downgrade of US government debt was a reminder of political difficulties in managing US finances, although markets are right to shrug off concerns of creditworthiness. Potentially more serious was Moody's downgrade this month of regional and mid-size banks. As discussed below, financial fragility in such banks has been seen as a risk to the economy since the sudden collapse of Silicon Valley Bank and others in March. So far, the risk has not materialized. But as restrictive monetary policy is maintained, strains in the financial system could grow. In particular, the challenges facing real estate, hurt by high interest rates and empty office space, present potential risks to the financial system, in particular to regional banks whose portfolios are closely linked to the local economy and to developers and builders.

At RockCreek, we nevertheless think that the Federal Reserve and counterparts in Europe have the wherewithal to balance the risks of such strains with the risks of a re-acceleration of inflation.

The three main economic themes for investors remain: when and at what level will interest rates peak; is inflation really vanquished; and can we continue to avoid recession?

For the US, the outlook is positive. For China, the world's second largest economy, the disappointing performance in the first half of this year is set to continue. This is due, at least in part, to broader geopolitical forces. In Europe, data has been mixed. Initial estimates for Q2 GDP showed growth of 1.1% on an annualized basis. There have also been some signs of inflation slowdown, holding out hope for a pause in rate rises when the European Central Bank (ECB) meets in September. But this week's data for Germany suggest that Europe's economic powerhouse may be sliding into recession. Industrial production dropped by 1.5% at an annual rate in June and survey data for July show further weakness.

HOT AUGUST NIGHT

Equities appeared to be under the weight of August's summer doldrums this week. After having ridden mega-cap shares higher over the first half of the year, hedge funds and other institutional investors have broadly reduced exposures over the past couple months. That has left a lot of capital on the sidelines during this heavy vacation month. There was little to be excited about early in the week when Moody's cut the ratings of 10 mid-sized US banks (more below). On Thursday morning, the market rallied on the back of July's CPI print, but the steam let out quickly and indices

returned close to where they started the day. The S&P 500 ended the week down 0.3%, while the Nasdaq was down 1.9%, depressed also by the news about China and the US.

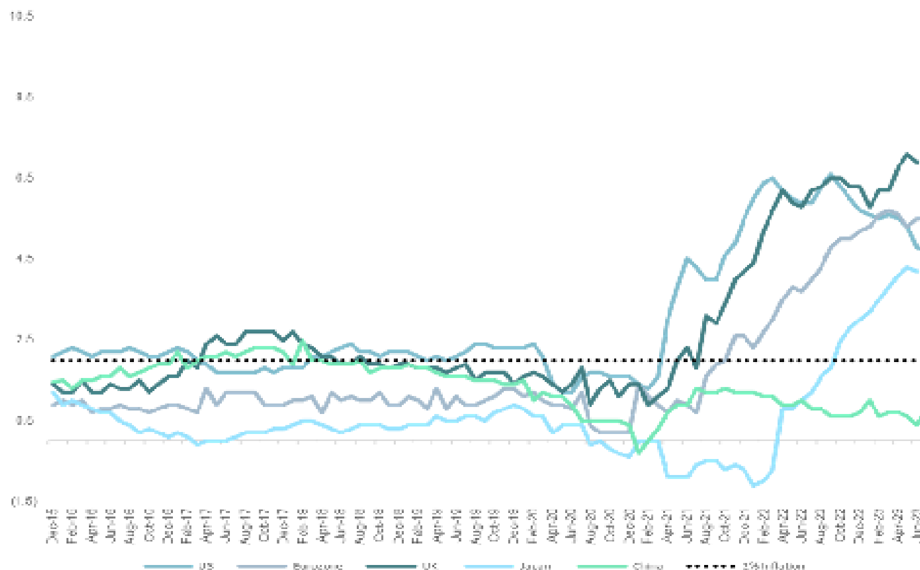
The STOXX Europe 600 ended the week down 0.8%. China's lifting of a ban on group tours to more than 70 countries, including the US and UK, helped spur hopes of a rebound in consumer spending and vacation travel. Shares of luxury goods, travel and leisure companies were lifted by the news. In addition, Coach owner Tapestry's announcement that it was acquiring Versace owner Capri Holdings for about $8.5 billion further propelled the luxury consumer sector.

Japan is also being seen as a beneficiary of China's lifting of its travel ban and Japan's Nikkei 225 rose 0.9% for the week. The energy sector also performed well on the back of higher crude oil prices. Economic data released on August 8th was mixed with a smaller-than-expected decline in real wages and improvement in real disposable income offsetting a disappointing reading in real spending.

JUST WHEN THINGS STARTED LOOKING UP FOR REGIONAL BANKS...

The bad news continued this week for credit ratings after Moody's took action against 27 small- to mid-sized banks on Monday, citing concerns around higher funding costs, asset quality risks, and weaker profitability. The

Core CPI 2016-2023
(Change in % YoY)



KBW Regional Bank Index fell by nearly 4% at the open on Tuesday morning after the news broke, but the index pared some losses to end the week down 2.0%.

The report comes on the heels of regional banks' second-quarter earnings results, which revealed growing profitability pressures despite the boost from higher rates. Citizens Financial, Capital One, and PNC were among the 11 lenders assigned a "negative" outlook, though Moody's warned that several of the 6 firms placed on review – namely, BNY Mellon, US Bancorp, State Street, and Truist – were also on the chopping block. Another 10 banks received negative downgrades. The credit agency had previously downgraded 11 regional banks in April, highlighting the growing instability in the sector following the recent spate of bank failures.

Banks depend on good credit ratings to access wholesale funding that supports lending activity. Both have come under pressure amid higher interest rates and the recent run on deposits. Banks seem to have stopped the deposit bleed, but there's still the issue of rates. The rising rate environment has generally been a boon for banks. Now that looks to be coming to an end as more than a year of tightening feeds into higher funding costs and further erodes the value of bank assets, especially in commercial real estate (CRE), where borrowers may struggle with higher refinancing rates and the post-pandemic realities of remote work (see below). Banks with higher exposure to these loans and/or carrying significant unrealized losses on securities will be particularly vulnerable to asset quality and profitability risks as higher rates persist.

Moody's Dimmer Outlook for Regional Banks

Downgrade	Review for Downgrade	Negative Outlook
Amarillo National	BNY Mellon	Ally Financial
Associated Banc-Corp	Cullen/Frost	Bank OZK
BOK Financial	Northern Trust	Cadence Bank
Commerce Bancshares	State Street	Capital One
Fulton Financial	Truist	Citizens Financial
M&T Bank	U.S. Bancorp	F.N.B. Corp.
Old National		Fifth Third
Pinnacle Financial		Huntington Bancshares
Prosperity Bancshares		PNC
Webster Financial		Regions Financial
		Simmons First National

The report did highlight one positive for large regional banks' outlook, namely the new regulatory proposal issued last month that seeks to shore up capital requirements for banks with over $100 billion in assets. A recent discussion on supervisory reform at PIIE notes that the ability to prevent more bank failures will come not only from these regulatory reforms, but also in addressing shortcomings in banks' internal governance and risk management. Moody's likewise notes that the proposal fails to address some of the more complicated interest-rate risks, such as the value of fixed-rate mortgages. As we mentioned in a previous letter, the proposed regulatory changes would be introduced gradually, and plenty can change between now and 2025 when they are expected to be phased in.

WFH VS. RTO: THE IRONIC CHAPTER

In the ongoing struggle between CEOs (who want people back in the office) and workers (who want flexibility), Zoom announced it was bringing workers back to the office two days a week. Coming from a company whose name became synonymous with remote work during the pandemic, the announcement garnered headlines. One Quartz story quipped that if the announcement had been fictional, "critics would certainly call its satire a touch heavy-handed."

But Zoom's plan shouldn't be surprising. Nearly three-quarters of US companies have return-to-office mandates, according to recent surveys, spanning from firms like Blackrock and JPMorgan requiring 4-plus days in the office, to companies like Airbnb, which allows employees to live and work anywhere. Most are somewhere in the middle: ongoing research from a consortium at ITAM, Stanford, and the University of Chicago found that employer work-from-home plans are trending around 2.2 remote days per week.

Office attendance has solidified accordingly. The Kastle Back to Work Barometer shows just under 50% average office occupancy across 10 major US cities. What does that portend for commercial real estate? A new report from the McKinsey Global Institute examines the new hybrid reality in nine "superstar cities" with a disproportionate share of global urban GDP and GDP growth: Beijing, Houston, London, New York, Paris, Munich, San Francisco, Shanghai, and Tokyo. Office attendance has stabilized at 30% below rates before the pandemic, and foot traffic in urban cores has dropped 10-20% below pre-pandemic levels.

McKinsey modeled several future scenarios for in-person work in superstar cities and the effect on commercial real estate. In the moderate scenario, demand for office space is 13% lower in 2030 than it was in 2019; in the

severe scenario, office space demand drops by 38% in the most heavily affected city. Across all nine cities, roughly $800 billion of real estate is at stake. In the moderate scenario, on average, the total value of office space declines by 26% from 2019 to 2030, while in the severe scenario, office space values decline by 42%. Regardless of scenario, real estate investors are paying close attention to return-to-work plans, ironic or not.

BEACH TIME?

As we noted last week, nasty surprises have happened in August. Sadly, even a tropical paradise is not immune. The week ended with news of horrific wildfires, fueled by a dry summer and strong winds from a passing hurricane, that ripped across Maui, killing at least 55. “Climate change is here,” Governor Josh Green said and called the fires the largest natural disaster in Hawaii’s history.

The devastation punctuates a summer of unrelenting weather across much of the northern hemisphere. The National Oceanic and Atmospheric Administration (NOAA) cataloged more than 5,000 heat and rainfall records broken or tied across the US and more than 10,000 records set globally by the end of July. Phoenix baked under 31 consecutive days above 110 degrees Fahrenheit (trouncing the old record of 18 straight days in 1974), while a heat dome smashed records from Texas to Florida. Some economic ramifications are clear, such as major insurance companies pulling out of California and Florida because of rising costs of covering damage related to climate change.

August surprises seem unlikely on the economic front this year. But as investors take some time out in the last weeks of summer, it is worth thinking about the longer term. Just as the pandemic has led to permanent changes in the balance between work and home, it may have either led to, or accelerated, long-term changes in the relationship between spending, savings, and investment. A return to a low-inflation, low-interest-rate world may be unlikely, raising new questions for investors.

EMERGING MARKETS

After a strong June and even stronger July, it was perhaps only natural to see a correction in emerging markets equities. Most major markets are down anywhere from 1% to 9% month-to-date, most likely reflecting a combination of profit taking and negative reaction to this week’s news on China.

The Biden administration added to an already lengthy list of restrictions, effectively

prohibiting new US investment in sensitive technologies like computer chips and requiring government notification in other technology sectors. The long-awaited order authorizes the US Treasury Secretary to prohibit or restrict US investments in Chinese entities in three sectors: semiconductors and microelectronics, quantum information technologies, and certain artificial intelligence systems. Much will hinge on how Treasury Secretary Janet Yellen and Commerce Secretary Gina Raimondo define national security technologies.

The central aim of these new restrictions is to prevent the leaking of intangibles via investments. Drawing the line on what types of investments would provide know-how transfer and how such investments would provide transfer is not an enviable task. Perhaps this is why the Biden administration has also planned a 45-day period of consultation, seeking input from domestic stakeholders and allied countries to refine and clarify the rules to fulfill the objectives of the order.

We expect the economic impact of these new restrictions to be limited in scope. US-China FDI and private capital flows have been dwindling for some time. According to the Rhodium Group, an analysis that looked at transactions greater than $1 million puts the total of US FDI and private capital flowing into China from the US at less than $10 billion in 2022, compared to the $32 billion in 2018, which was the highest year for combined US FDI and VC/PE investment in recent years. Considering this latest executive order targets only new investments, the outcome of the ban will be a small fraction of an already dwindling pie of US investments. Importantly, the new restrictions do not extend to investments in Chinese public markets, nor do restrictions in this area appear imminent. Nevertheless, China equity markets sold off markedly for the week, forcing a cautious approach going forward.

Outside of China, the other juggernaut in emerging markets, India, was able to eke out a positive weekly performance despite the Reserve Bank of India delivering a hawkish note on inflation. While financials and consumer stocks took a beating, the rest of the market was able to support market indices. Unlike other central banks in emerging markets (i.e., Chile and Brazil) that have already started cutting rates, the RBI has plenty of dry powder it can use to boost consumption which it will not be shy to use once short-term inflation concerns abate.