INFLATION: AUGUST BLIP?

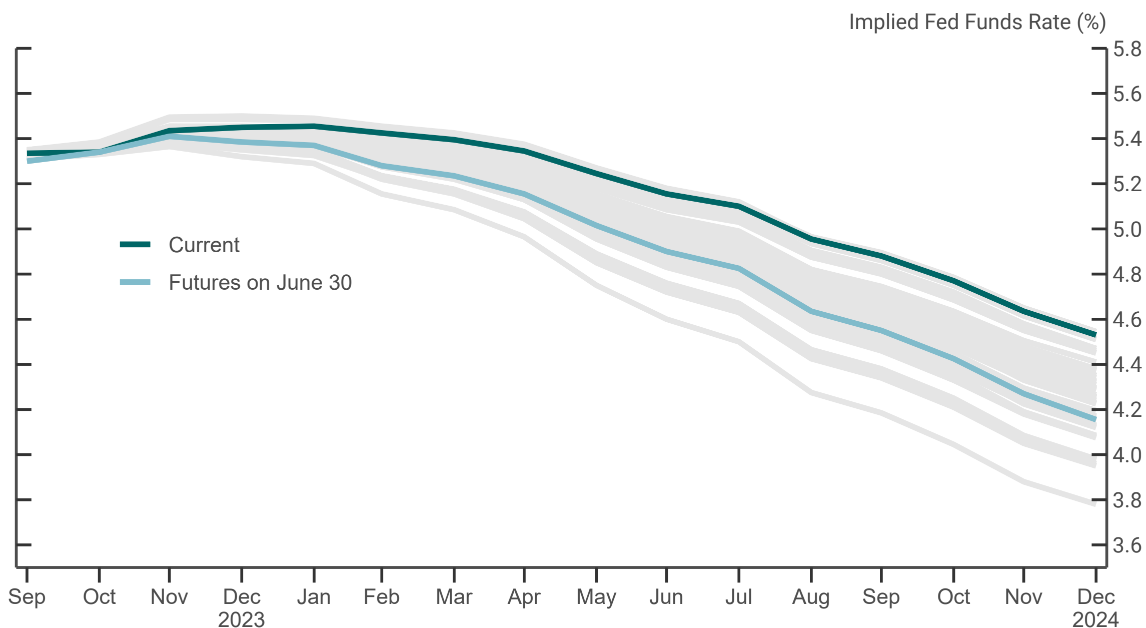
Hopes built over the summer that major central banks might be ready to stop hiking interest rates. This week showed those hopes were a little premature.

In Europe, the central bank decided on Thursday to raise its policy rate another 25 bps to a record-high 4%, despite the sluggish performance of the European economy. On this side of the Atlantic, August inflation reports for consumer and producer prices suggested that the Federal Reserve will opt to keep a further rate rise on the table when it meets next week.

Two risks to the US inflation outlook are uppermost: wage increases, brought into focus with this week's strike action by autoworkers (see below), and energy costs. Rising gasoline prices helped to push up headline consumer price inflation to 3.7% last month, while producer prices jumped by 1.6% in August in its second month of gains after declining earlier this summer.

Markets decided to look mostly on the bright side. Treasury yields continue to imply a September rate pause by the Fed, but adjusted away from likely cuts in 2024. Equities were mostly steady, though some volatility all but

Markets are buying the 'higher for longer' rhetoric



Note: Grey lines represent movements in market pricing from June 30, 2023 to September 14, 2023.
Source: RockCreek, Bloomberg.

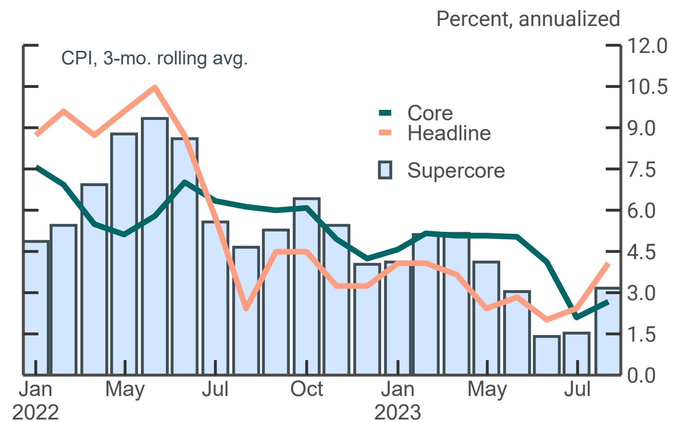
erased markets gains by Friday. The tick up in inflation came with strong retail sales and continued subdued unemployment claims. Much of the rise in spending reflected high gas prices at the pump. But, together with indications that jobs remain plentiful, the spending data supported the view that American consumers will keep the economy moving along, despite tight monetary policy.

SLICING AND DICING INFLATION

As inflation first soared 2021-22 and then began to retreat, the debate has been intense about how best to measure it. When inflation is low, most measures show the same or a very similar picture. But the measures – and their meaning – diverge when prices change more rapidly. In June and July, different measures of inflation all showed the same trend: a gradual deceleration or disinflation. This week, the first numbers for August were released. They showed an unexpected, but slight, uptick in monthly price changes, to 0.6%, as measured by the overall consumer price index (CPI). The annual inflation rate rose from 3.2% in July to 3.7% in August. As the White House explained, a jump of more than 10% in gas prices drove up the overall price index. But "core" inflation, which excludes energy and food prices, was also up a little more than expected, by 0.3% month on month, compared to increases of 0.2% in June and July. This does not mean that the summer hopes should be dashed. But it reinforces the view that it will take time and effort to squeeze excess inflation out of the economy.

Understanding the message from the inflation data is important for policymakers and investors. Monetary policy has been focused on the price stability part of the Federal Reserve's dual mandate since the post-pandemic surge in inflation in America and

**Hotter than hoped,
but not too hot for a Fed pause?**



Source: RockCreek, Burea of Economic Analysis.

most of the rest of the world. The failure of most models to predict this surge has pushed central banks to rely more on current data than on forecasts of the future to decide their monetary policy moves.

One issue in interpreting inflation data concerns which prices to measure and how to weight them in an overall average index. Options include all consumer prices, as monitored in stores (the CPI); a broader measure derived from personal consumption, as measured for GDP (PCE); or a subset of either index that excludes prices that are volatile, such as food and energy, or prices that have gone up or down particularly sharply that month, or prices that are hard to measure accurately (housing costs). Excluding volatile prices, such as energy and food, may give a better view of underlying, or core, inflation. But American households are naturally sensitive to the prices of everyday goods, such as gas and groceries. Ignoring those, especially when they are rising sharply, will not capture the pressures that may lead workers to press for higher wages and companies to grant them.

Another question is whether to look at price changes over just one month, which may not be sustained, or over a longer period, that does not illustrate recent trends so clearly. The traditional measure – a change in prices over a year earlier – will underweight the most recent developments. This week's data showed the core CPI rose by 4.3% from August 2022. But the price increases were larger in the early months of that twelve-month period. Over the last three months, core CPI was up by just 2.4% at an annual rate.

The Federal Reserve, the European Central Bank (ECB) and many other central banks have had a 2% inflation goal for some time. They believed that 2% was both a fair estimate of "price stability" and a level of inflation that allowed monetary policy to be effective, with room to move interest rates to bring the economy into balance, even in times of economic weakness. The Fed focused on a core measure of inflation that excluded volatile food and energy prices, and reflected overall consumer spending, or personal consumption expenditure (PCE).

IS THE ECONOMY DOING WELL OR POORLY – THE US VS EUROPE

Inflation is not the only economic phenomenon that is tricky to assess. On some metrics, the US economy is performing well. Unemployment is still close to record lows, and workers have come off the sidelines to join the labor force and ease supply pressures. Spending and overall GDP have been resilient so far this year, despite the sharp rise in interest rates over the past 18 months. And, as noted above, inflation is down considerably from the 9% peak reached in June 2022. But most Americans still express concern. New data for real incomes – measuring spending power after taking account of inflation – showed that the average (median) American household saw a 2.3% decline in 2022 as inflation ate into income gains. At the same time, the child poverty rate doubled, reflecting the ending of a set of tax measures, notably including an extension of child tax credits, as pandemic relief expired. More recent wage gains, together with the slowdown in inflation, have led to rising real incomes in 2023. And higher employment has boosted the number of Americans with health insurance.

In Europe, both the European commission and the ECB have this week updated their economic forecasts, recognizing the worsening economic outlook – with little or no growth in the first half of 2023 – and still sticky inflation.

BATTLE WITH THE AUTO GIANTS

The United Auto Workers are among those fighting for higher wages to offset the rising cost of living. The union has been in heated negotiations with the Detroit Three – General Motors, Ford Motors, and Stellantis – over key economic issues, including pay increases, pension benefits, and job security. With no agreement reached at the Thursday deadline, UAW workers staged their first-ever coordinated strike on Friday with 12,500 workers walking out on all three automakers.

The broader economic implications are not yet clear. Much will depend on how long and how widespread the strike becomes. The last strike against GM in 2019 lasted 40 days and cost the company $3.6 billion. But in 2023, with tighter labor markets and a recent string of other unionized victories emboldening workers, this time might be different. According to the Bureau of Labor Statistics, the US auto sector employs nearly 1 million people. A prolonged shutdown could cost the automakers up to $5.6 billion in lost output, according to

Anderson Economic Group, and lead to supply chain disruptions across the Midwest. And a shortage of new cars could push prices up at a time when all Americans are hoping for relief from high inflation.

WHERE DO EQUITIES GO FROM HERE?

This week's inflation data certainly had some worrying signs but was good enough for investors to maintain some optimism about a Fed pause and a soft landing scenario. But the lull in equities broke with Friday's $4 trillion "triple witching" event. This quarterly affair is often associated with a spike in volatility as expirations in options contracts and futures coincide with a rebalancing of benchmark indexes. Tech stocks also led equities lower after news broke that TSM had asked suppliers to delay shipment of some high-end equipment. The S&P 500 and Nasdaq both reversed gains from earlier in the week to end 1.2% and 1.8% down, respectively.

One of the larger factors permeating the market is higher oil prices. Energy stocks have led the way this month while energy-consuming industries like transportation and heavy industrials have lagged significantly. Airlines are having to increase prices to compensate for higher fuel costs, but at the same time consumers are starting to balk at significantly higher prices and be more discerning about purchase decisions. We expect to see meaningful dispersion between companies that are well-positioned to benefit or at least protect from higher input prices and those that are more hampered.

The IPO market has been in the doldrums over the past year and a half, so the successful debut of Arm Holdings to the Nasdaq gained much notice from investors on Thursday. It was the largest IPO since Rivian came to market in November 2021 and the listing opened 10% higher than its IPO price and proceeded to end the day almost 25% higher. The hope is that this signals a heating up of the IPO market and augments more activity, but it is important to keep in mind that Arm, as a designer of circuit chips that go into semiconductor chips, had favorable AI momentum trends at its back. Also, the IPO was well-priced and Thursday's price surge only brought it in line with the $64 billion valuation implied by Softbank's recent purchase of a 25% stake held by its Vision Fund. The upcoming IPOs of grocery delivery provider Instacart and marketing automation company Klaviyo next week will be interesting to watch.

CLEARING THE AIR

It was a big week for climate policy as California's state legislature passed two landmark bills that address growing climate concerns and risks to the financial system. The first requires large companies who generate more than $1 billion in revenue via operations in the state to disclose their greenhouse gas (GHG) emissions, while the second bill will require those with more than $500 billion in revenue to report climate-related risks on an annual basis. If these bills do become law, they would be the first of their kind in the US to tackle transparency issues around measuring the climate impacts of both private and public companies.

The proposed rules have been met with varying degrees of enthusiasm. Though hundreds of companies already voluntarily report their direct emissions in California, the rift over the new measures largely centers around the reporting of scope 3 emissions. These are emissions that a company does not directly control but has exposure to

through its borrowers or supply chains. For banks, research published earlier this year by the Federal Reserve showed that scope 3 comprises the majority of their emissions and are very rarely reported. And banks argue that a lack of standard methodology - which the emissions bill does not address - and dearth of quality data has made it too onerous to report these emissions.

The new bills add to the ongoing and contentious debate around standards setting. The International Sustainability Standards Board (ISSB) and SEC have faced pushback this year from companies who worry that a hodgepodge of standards will create investor confusion and increase costs that would undermine efforts to reduce emissions. But for all the negative rhetoric espoused recently, these new corporate sustainability disclosures reflect the growing interests in both consumers and investors alike for more transparency on climate impacts and risks. California has long been the trendsetter when it comes to environmental rules, and these bills are shaping up to be some of the biggest pieces of climate policy to come out of the US this year.

BETTER NEWS FROM EMERGING MARKETS

Emerging markets were up approximately 30 bps this week, with most major markets showing positive returns. Growth names outperformed value, reversing what has decidedly been a year in favor of cyclical and defensive names. Markets were buoyed by data coming out of China that showed stronger than expected August retail sales and manufacturing data. In addition, China's central bank cut the reserve requirement ratio by 25 bps and lowered the rate of 14-day repo agreements by 20 bps. Still, we believe the road to recovery remains fraught with risks and will in part depend on the real estate sector finding footing. In the meantime, investors are still waiting for a strong policy signal or bold reform plan from Beijing to restore confidence. We are mindful of the possibility that markets may begin to price in a recovery in the coming months given low valuations, but we remain equally vigilant of another leg down.

Outside of China, the notable news this week was the US-Vietnam summit in Hanoi where President Biden announced an upgrade to Vietnam's diplomatic status. There was also plenty of business dealing on the sidelines, as senior executives from Google, Intel, Microsoft, Honeywell, Boeing, and others met with Vietnamese counterparts to deepen economic ties around strategic sectors such as cloud computing, semiconductors, and artificial intelligence. Microsoft announced plans to introduce a generative AI-based solution tailored to Vietnam and emerging markets while Boeing announced a large purchase of 737 Max airplanes from Vietnam Airlines. Honeywell also announced plans to launch a pilot program to develop Vietnam's first battery energy storage system. Vietnam's status as a supplier of rare earth minerals was also underscored with the country boasting the world's second largest estimated deposits of rare earths, which are used in the manufacturing of electric vehicles and wind turbines.

THE LONG AND WINDING ROAD

One of the most expansive announcements from this week's G20 Summit was the India-Middle East-Europe Economic Corridor (IMEC). "It's got the right idea, which is to build an economic corridor connecting India all the way into Europe, through the Middle East," new World Bank President Ajay Banga said in an in-depth interview from New Delhi. "This is the

right kind of thing to do."

The IMEC is also seen as a western counterpoint to China's decade-old Belt and Road Initiative (BRI), connecting China to Europe through Central Asia. As a player in both endeavors, the World Bank serves as a geopolitical barometer of the effort to re-imagine old trade routes for the 21st century. At the first Belt and Road Forum in Beijing in 2017, then-World Bank President Jim Yong Kim said that the World Bank Group "proudly supports the Government of China's ambitious, unprecedented effort" to build and improve trade on a trans-continental scale." While the Bank is still involved, Banga said this week, "The World Bank has a very low role to play at BRI," and he did not plan to attend the upcoming BRI summit.

Even with strong support from Western nations, the IMEC has a long way to go from the current memorandum of understanding to the planned railways, pipelines, and cables connecting countries that account for around 40% of the global population and half of the world's economy. Turkish President Recep Tayyip Erdoğan is among those unhappy with the plan, not only for G20 (and NATO) member Turkey's exclusion, but the possible inclusion of Israel on transit routes. The next few years will show whether economic ambition is enough to overcome geopolitics to make old trade routes new again.