Situation analysis September 13, 2022

Q & A with AMG and U.S. Bank Economics Team on Tuesday's hotter-than-expected consumer price inflation

Key takeaways

- Higher-than-expected consumer prices maintain pressure on the Federal Reserve (Fed) to aggressively raise interest rates to slow the economy and combat elevated inflation.
- Investors are pricing in at least a 0.75% rate hike at next week's regularly scheduled Federal Open Market Committee (FOMC) meeting.
- Equity and bond prices fell (yields rose) as sticky consumer prices set a high bar for any reprieve from restrictive monetary policies.

Stock prices declined sharply on Tuesday while bond prices also fell (yields rose), reflecting heightened investor concerns following the release of a higher-than-expected gauge of consumer prices. The Consumer Price Index (CPI) rose 0.1% for the month and 8.3% versus year-ago levels, both higher than analysts' consensus expectations. The report showed that while gasoline prices dropped sharply and inflation has decelerated from a peak of 9.0% in June, price pressures remain sticky among a broad number of goods and services. Elevated inflation keeps intense pressure on the Federal Reserve (Fed) to tighten monetary policy via ongoing aggressive rate hikes, a key catalyst for today's stock price weakness and rise in Treasury yields.

The U.S. Bank Asset Management Group (AMG) and Economics Group contributed answers to investors' key questions about Tuesday's surprisingly strong inflation reading, contextualizing the capital market response, and concluding with considerations for investment portfolios:

Why was the CPI higher than expected?

Analysts forecasted a slight deceleration in headline CPI from July, but food prices climbed higher last month, as falling agricultural commodity prices (such as wheat) have yet to reach consumers. Food prices were up 0.8% month-over-month in August, after rising by 1% or more in the prior three months.

Core CPI (which excludes the more volatile energy and food components) rose a much-more-than-expected 0.6% in August, compared with the consensus forecast of 0.3% and about twice July's pace. Core goods prices accelerated on higher clothing and new car prices. Likewise, higher housing and rent prices drove a strong increase in core services inflation. August housing and rent prices combined were above the 25-year highs seen in May and June.

How are capital markets responding?

Economically sensitive equity prices are falling, especially technology stocks, as high inflation keeps pressure on the Fed to continue aggressively hiking interest rates, increasing borrowing costs in order to slow the economy and bringing inflation back to their target rate of two percent.

The S&P 500, representing the broad U.S. large-cap equity market, fell 4.3% today and is now 3.1% below the August 26th close, when equity prices fell sharply after Fed Chair Jerome Powell's Jackson Hole speech emphasized the Fed's intent to raise interest rates to combat rampant and pervasive inflation. The technology-oriented NASDAQ Composite fell 5.2% today and is now 4.2% below the August 26 level. Traditionally defensive sectors such as Utilities and Consumer Staples are outperforming growth sectors such as Technology, reflecting concerns that the Fed (and other central banks) are tightening financial conditions into a slowing economic environment.

Bond prices also fell (yields rose), particularly shorter-term maturities, reflecting investors' higher interest rate expectations for 2022 and 2023, with the 2-year U.S. Treasury yield rising to 3.74% and the 10-year yield near 3.41%.

Why is inflation so sticky?

We're currently in the 'easy' phase, moving off the 40-year highs of 8%-9% year-over-year headline CPI inflation, mostly due to swings in gas prices. But the 'hard' part is still to come, going from a 5%-6% underlying inflation rate in the economy closer to the Fed's 2% objective. Rents, recreation, restaurant food and rapid wage growth contribute to the challenges of returning to 2% inflation.

Explanations for higher inflation pressures include supply shocks, such as a shift in spending from services to goods due to the pandemic, the emergence of the Delta/Omicron variants of COVID-19, and the Russian invasion of Ukraine, each putting added stress on the availability and cost of materials.

More recently, however, the labor market has moved visibly out of balance, with demand for workers substantially exceeding supply. This has put persistent, upward pressure on labor costs, and while not our base case risks forming a wage-price spiral, which describes a damaging cycle whereby businesses raise their prices to accommodate the increase in labor costs, workers demand wage increases to make up for the expected loss of purchasing power, business further raise prices, and the cycle continues.

Finally, a housing shortage powered double-digit growth in rents. Close to one-third of the Consumer Price Index links to housing costs, which look to be source of rising inflation pressures for some time to come.

Will this damage consumer spending?

U.S. consumer fundamentals are mixed. Inflation is still near a 40-year high. Stock prices represented by the S&P 500 Index have fallen 18% from January's all-time high through Tuesday's close. And interest rates have risen rapidly, making mortgages and auto loans less affordable.

However, the labor market remains robust, with job growth showing little-to-no sign of faltering, still almost twice as many job openings as unemployed workers, and unemployment holding low and stable below 4%. Household balance sheets are in some of the best shape they've been in in decades, as many consumers have locked in previously record-low interest rates through refinancing and nearly all the excess savings accumulated during the pandemic remain in readily accessible liquid bank deposit accounts. Finally, credit remains readily available for many, based on Senior Loan

Officer surveys from the Fed. Taken together, the average household appears fairly well-positioned to weather the inflationary storm, keeping real consumer spending at least stable.

What does this mean for next week's Fed meeting?

Tuesday's hotter-than-expected Consumer Price Index cemented market expectations for at least a 0.75% rate hike at the Fed's regularly scheduled meeting next week, consistent with 0.75% increases in June and July, with potential for an even larger 1.0% hike. Investors will focus on the Fed's Summary of Economic Projections, or SEP also known as the "dot plot," which reflects the median of committee members' policy rate expectations for coming years. While the surprise inflation reading led investors to revise interest rate expectations closer to the Fed's, investors may not yet fully grasp the Fed's commitment to defeating inflation if next week's updated 2023 and 2024 "dots" indicate expectations for a persistent period near 4.0%.

How does this change our (or market) expectations for when and how high rates will peak?

Until recently, market prices reflected a series of quick rate hikes in 2022 followed by significant rate cuts in 2023, essentially anticipating a "soft landing" for the economy. Chair Powell and the Federal Reserve set a high bar for changing the more restrictive stance communicated during the Jackson Hole speech, which emphasized the importance of slowing inflation rather than a focus on economic growth. The new inflation insights, combined with other recent economic data releases, should keep pressure on the Fed to continue raising rates for now. Investors now anticipate the Fed's policy rate will peak around 4.25% in the first half of next year from the current 2.33%.

What does this mean for the rest of the world (tightening financial conditions, weak local currencies adding to local inflation pressures)?

Aggressive Fed policy keeps upward pressure on the U.S. dollar relative to other currencies, as global investors take advantage of higher real (inflation-adjusted) interest rates. A stronger U.S. dollar, in turn, raises borrowing costs for non-US borrowers and makes cost increases more concerning for consumers and businesses in energy importing regions like Europe and Japan, further exacerbating the high inflation problem.

How should investors respond?

From an economic perspective, we do see the risk of weakening economic momentum feeding into consumer and business activity. As noted above, businesses and consumers are in better economic health than in prior periods of prospective downturn, and as always, capital markets discount what is coming next, not just what is happening now. The pendulum of optimism and pessimism invariably produces opportunities for patient and disciplined investors, and we continue to monitor capital markets for favorable risk/reward opportunities for clients.

While every financial situation is unique, individual investors should use every opportunity to engage with their wealth management professional to develop and confirm their financial plan. Our institutional clients should reaffirm that their investment policy statement reflects their organizational or specific asset pool objective. As always, we appreciate your trust and will keep you posted on our thoughts. Please do not hesitate to contact us if we can answer specific questions or help in any way.