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INFLATION NOT JUST IN GOODS, BUT ALSO LABOR

MAY 05, 2022 — MARKET UPDATE

After a relief rally this week, culminated by Fed Chair Jerome Powell's somewhat dovish comments in the FOMC press conference, equity markets again broke down on Thursday to last week's lows. While Powell was applauded by markets Wednesday afternoon for implying a more gradual approach to monetary tightening, both the bond and stock markets found reason to worry on Thursday that the approach would not be aggressive enough to confront the worst inflationary environment since the 1980s.

The primary economic catalyst of the Thursday downturn was likely the report on first quarter 2022 productivity, which came in at -7.5%, a big miss of the -1.0% estimate. Declining productivity, combined with higher wages and benefits paid by companies desperate to bring on workers to meet recovering demand, led to a nearly 12% increase in unit labor costs during the quarter. In a services-oriented economy, which the U.S. has become, labor inflation can be a more sinister condition than an increase in materials costs.

Despite Powell's claim of signs inflation is peaking, the bond market reacted to this recent inflationary indicator by driving prices down and the yield on the 10-year treasury up 13 basis points to 3.04%. This spike higher in yields caused a further contraction in valuations on equity securities. A silver lining in this cloudy picture could be gleaned from the lack of a similar spike higher in shorter term bond yields, which led to a steepening of the yield curve. It was only a month ago the markets were worried about a flat-to-inverted yield curve being a harbinger of recession.

Another issue spooking market participants is the continued approach in China to addressing Covid outbreaks. Mandatory lockdowns of key cities such as Shanghai may be pushing the world's second largest economy into a recession which could impact global demand. The lockdowns could also put greater strain on the already stretched global supply chains. The government has pledged sufficient fiscal and monetary support to offset the effects of the lockdowns, but these events exacerbate market worries that we are falling into a global "stagflation" environment reminiscent of the 1970s. The Bank of England's move Thursday morning to increase their benchmark rate and revise their 2023 and 2024 economic forecasts to virtually zero growth did not help market psychology.

In analyzing the inflation landscape, growing inventories and an increasing labor force participation rate should begin to take some pressure off goods prices and wages over the coming months. The long-awaited transition from consumer spending on goods to services will likely mute that improvement somewhat as pricing in travel/leisure/hospitality will rise. Markets will be closely watching Friday's April employment report for continued progress on prime age labor force participation, as well as Wednesday's April inflation report for confirmation that core price inflation is beginning to abate.

Central banks fully understand their blunt force rate increase and balance sheet reduction tools work effectively on muting demand but do nothing to solve inflation caused by supply shortages. However, the inflation rate in the U.S. and most other developed economies has increased to the extent that even the dovish policymakers are being forced to acknowledge the need for more aggressive tightening. They are likely hoping higher bond rates - which are flowing into mortgage rates as well as the strong dollar -will assist the Fed in controlling inflation.

The 2022 equity market correction continues to be a function of valuation multiple contraction in an environment where the economy and earnings are still growing. The multiple contraction has been driven by a doubling of intermediate term interest rates, as crisis-driven monetary and fiscal ease is removed from the system. A further shift up in the treasury yield curve can continue to challenge valuations but an outright bear market happens only when the economy contracts and earnings decline. The Fed under Chair Powell is trying to avoid tightening too aggressively, as that approach does not appear necessary given the current inflationary conditions, which should soon begin to improve naturally.

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