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Persistent Price Pressures

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Inflation Came in Hotter Than Expected

Markets were unpleasantly surprised by the hotter than expected inflation numbers reported yesterday. The August Consumer Price Index (CPI) was up 0.1%, by no means a bad inflation number, but it missed the estimate of a 0.1% decline and did not show the year-over-year improvement that the market and the Federal Reserve had been expecting. Because the low inflation number was driven by the sharp fall in gasoline prices during the month, a better assessment of the broader inflationary trends can be made by excluding the volatile energy and food components. This so-called "core" price index registered a 0.6% increase, above the 0.4% estimate, with the year-over-year price increase higher than estimates and higher than July. This has at least temporarily dashed growing hopes that inflation was about to embark on a multi-month decline.

Persistent inflation, the likes of which we have not seen in 40 years, has caused the Fed to increase the magnitude of their tightening policies beyond the steady quarter point increases it initially envisioned. A peaking and gradual decline in inflation would allow the Fed to begin taking its foot off the monetary brake. Markets are fearing this most recent inflation report may cause an acceleration and extension of the tightening program well into next year. A 75-bps increase in the fed funds rate to 3.25% at next week's FOMC meeting is now virtually certain, with some economists calling for a 100-bps increase. The market prediction of the terminal rate at which the Fed stops tightening is now roughly 4.25%, up from 3.75% before the report.

Increased Risk of Recession

The longer and more intense the Fed thinks it must tighten monetary policy, the stronger the possibility that tighter financial conditions will cause an economic recession. In looking at the inflation landscape, the stickier components are in shelter costs and medical services. However, ultimately the problem may lie with the American consumer still having too much money to spend, which will continue to drive prices higher. Massive fiscal policy support last year, in addition to very loose monetary policy until this year, have tipped the scales towards higher prices in a still supply-constrained economy.

The tight jobs market with a labor force participation rate that still hasn't recovered to pre-pandemic levels keeps wage growth high. While there remains quite a bit of slack between job openings and unemployed, which should close over the coming months, the Fed would likely want to see unemployment increase and wage growth slow before it stops increasing rates.

Watch for Earnings Revisions

In addition to the equity market being down 4-5% on the day, yields rose across the treasury curve, with the two-year treasury yield rising to 3.75% and the two-to-ten year yield curve inversion widening by 10 basis points. The dollar also strengthened dramatically, which will exert further pressure on multinational corporate earnings.

The year-to-date equity market decline has been almost purely a function of rising rates as earnings in the first half of the year have grown in the mid-to-high single-digit range. While intermediate-term interest rates may increase a little from here, most of the increase has likely occurred, and earnings will now be the primary driver of the market. The inherent strength of the consumer has allowed companies to pass on any cost increases, which have kept margins largely intact. There currently exists a wide gap between the earnings estimates of macroeconomic strategists and those of security analysts, whose conclusions are largely driven by company commentary. So far, companies are not reporting substantial impairments in their bottom lines. Third-quarter earnings are expected to grow around 5%. If earnings are not about to collapse, the market is likely fairly to slightly undervalued.

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