MORNING BRIEFING
March 16, 2022

Wage-Price-Rent Spiral

Check out the accompanying chart collection.

Executive Summary: Company fundamentals have been scaling dazzling new heights since mid-2021, yet stock market valuations have toppled ignominiously from their 2021 peaks last spring. That disconnect reflects a tug of war between the opposing effects of high inflation and excess M2 liquidity on valuation multiples. … We have two big concerns about higher-for-longer inflation: Rent inflation is getting uglier, and the wage-price spiral is spiraling faster. In fact, we now see potential for a wage-price-rent spiral. … And: Melissa examines why rents have gone through the roof.

Strategy I: Tug of War. What do the lyrics of the official song of the US Air Force have to do with the stock market? "Off we go into the wild blue yonder, climbing high into the sun" describes our Blue Angels model.

To be more specific, the forward earnings of all three S&P 500/400/600 indexes have continued to set higher and higher altitude records through the week of March 10 (*Fig. 1*). They've been doing so since mid-2021, having bottomed around mid-2020. Following the end of the pandemic lockdown recession in early 2020, they've had V-shaped recoveries in their forward revenues, forward earnings, and forward profit margins (*Fig. 2*, *Fig. 3*, and *Fig. 4*). However, there has been a tug of war between the S&P 500/400/600 indexes' strong fundamentals and their forward P/Es. Consider the following:

(1) *S&P 400/600.* The tug of war first started with the S&P 400/600 indexes (i.e., the SMidCaps) early last year when their stock price indexes flattened out (*Fig. 5*). So far this year through Monday's close, they are down 9.4% and 10.4%, respectively. That's notwithstanding their very strong forward earnings. As a result, their forward P/Es dropped from their 2021 peaks last spring of 20.8 and 21.6 to 13.7 and 13.4 now (*Fig. 6*).

(2) *S&P 500.* The S&P 500, meanwhile, rose to new record highs last year and then to its all-time record high so far on January 3 of this year. The ascent was earnings-driven, not valuation-driven: While the index's forward earnings was rising to new highs last year, its forward P/E remained range-bound between 20.0 and 22.7. However, this year, the S&P 500's price action has been valuation-driven: The index is down 12.4% through Monday's close, reflecting a drop in its forward P/E from 21.5 on January 3 to 18.1 on Monday.

(3) *MegaCap-8.* The MegaCap-8 (i.e., the eight highest-capitalization stocks in the S&P 500) accounted for much of the outperformance of the S&P 500 during the pandemic years of 2020 and 2021. Now they are accounting for its underperformance. The market capitalization of the MegaCap-8 fell 18.2% from the start of this year through March 11 (*Fig. 7*). Over the same period, the market cap of the S&P 500 with and without the MegaCap-8 fell 11.7% and 9.4%. And over the same period, the collective forward P/E of the MegaCap-8 fell from 33.8 to 26.5, while the forward P/Es of the S&P 500 with and without these eight stocks fell from 21.4 to 18.1 and from 19.1 to 17.3 (*Fig. 8*).

(4) *Flight recorder.* Joe and I see some more downside to the forward P/E of the S&P 500 to 16.0, which implies 4000 on the S&P 500 given our upbeat outlook for earnings. We expect the S&P 500 to resume its climb to new highs either later this year or early next year.

The US Air Force song says: "We live in fame or go down in flame." We are betting on the former outcome for the market.

Strategy II: Inflation vs Liquidity. The tug of war in the stock market is all about the opposing effects of inflation and liquidity on valuation multiples. As we reviewed in Monday's *Morning Briefing*, Joe and I believe that there is plenty of excess M2 liquidity in the financial system that should be bullish for valuations. It should partially offset the Fed's tightening of monetary policy, which we expect will be gradual. On the other hand, last week, Debbie and I raised and extended our 2022 and 2023 outlook for inflation, which should put more upward pressure on interest rates. That can't be good for valuations.

Indeed, as we noted above, some of the air has already come out of valuation multiples. They seem to be bottoming for the SMidCaps at reasonably low levels, but the forward P/E of the S&P 500 might have lower to go, i.e., from 18.1 to 16.0 in our outlook.

What about the fundamentals? Lots of excess liquidity reduces the risk of a recession, while increasing inflationary pressures at the same time. S&P 500/400/600 revenues tend to keep up with inflation. Inflation is likely to be a wash for earnings as long as revenues rise as fast as costs do.

Our recent concerns about higher-for-longer inflation are centered on our view that while some categories of the CPI are likely to cool off in coming months, the outlook for rent inflation is getting uglier. We've also been concerned that the wage-price spiral might be spiraling at a faster pace. Now we see the potential for a wicked wage-price-rent spiral.

US Inflation: Another Tug of War. At the beginning of last week, Debbie and I raised our inflation forecast as a result of the Ukraine crisis. We now expect that the core PCED inflation rate will peak at 6.0%-7.0% around mid-year and fall to 4.0%-5.0% by the end of the year (*Fig. 9*). Then it might decline to 3%-4% in 2023, maybe. Let's review the latest inflation numbers before we explain our wage-price-rent inflation spiral thesis:

(1) *PPI.* February's PPI inflation rate remained elevated. Here are the y/y increases in some of the key components of the PPI for final demand: total (10.0%), goods (14.4), services (7.8), finished goods ex food & energy (7.7), private capital equipment (8.0), trade services (14.4), transportation & warehousing services (16.6), and construction (16.6) (*Fig. 10* and *Fig. 11*).

Here are the y/y stats for the components of the PPI for personal consumption: total (9.0), goods (16.0), and services (6.9) (*Fig. 12*).

(2) *CPI.* The CPI was up 7.9% y/y during February, the highest inflation rate since January 1982, which marked the tail end of the Great Inflation of the 1970s (*Fig. 13*). Leading the way higher was the CPI for consumer durable goods with a record-high gain of 18.7%. Here are the y/y increases for some of the specific items in this category: used cars (41.2), new cars (12.1), furniture & bedding (17.1), and household major appliances (11.1) (*Fig. 14*).

We are expecting that inflation in these prices will cool off significantly during the second half of this year and next year. After all, they were mostly deflating from the mid-1990s until just before the pandemic.

(3) *Rent.* While consumer durables prices may push CPI inflation lower, rent inflation is likely to pull it higher. The median existing home price is up 33.0% over the past 24 months through January (*Fig. 15*). Melissa and I explain in the next section that this extraordinary development is causing rents to soar.

As we reported yesterday, we are increasingly concerned about rent inflation. We observed that the CPI tenant rent inflation rate, on a y/y basis, rose 4.2% through February, the highest since July 2007 (*Fig. 16*). This series is highly correlated with the Atlanta Fed's wage growth tracker, which jumped to 5.8% during February, the highest since September 1990.

Hence, our concern that the wage-price spiral could easily spiral into a wage-price-rent spiral. Labor shortages are boosting wages, which are fueling higher price inflation, including rents, which puts more upward pressure on wages, and so on.

Keep in mind that tenant rent accounts for 7.4% and 9.3% of the headline and core CPI. It accounts for 3.6% and 4.1% of the headline and core PCED. Owners' equivalent rent closely tracks tenant rent and accounts for 24.0% and 30.4% of the headline and core CPI, and 11.2% and 12.7% of the headline and core PCED. Altogether, rent accounts for 31.4% and 39.7% of the headline and core CPI, and 14.8% and 16.8% of the headline and core PCED.

One more reminder: The cost of current new rental leases will be fully reflected in the CPI tenant rent index in one to two years. So the worst is yet to come.

US Housing: Crowding Out. The rental market is crowded. More competition for units and low eviction rates are largely responsible for low vacancy rates and higher rents. Vacancy rates plunged to 5.6% during Q4-2021, the lowest since the mid-1980s (*Fig. 17*). The yearly percent change in the CPI for rent of primary residence leaped from a recent low of 1.8% last spring to 4.2% during February, the fastest pace since July 2007 (*Fig. 18*).

More granular rental statistics show a broad and even more alarming picture of the rising cost of rent. Because of the heightened demand, rents are up in every US state except for two, according to *research* by Apartment Guide. Nationally, the average price of a one-bedroom apartment increased by 19.8% between September 2020 and September 2021.

Looking ahead, increases in rents and occupancy rates are likely to ease as markets adjust to more normal conditions following the pandemic. However, tight conditions in the for-sale housing market and an increasing preference for renting may preclude many lower-income households from becoming homeowners.

Let's explore the factors behind the current demand for rental units and rising rental prices, as discussed by Harvard's Joint Center for Housing Studies (JCHS) *America's Rental Housing 2022* report:

(1) *Federal programs halted evictions.* Eviction filings fell from the start of the pandemic to 40% below historical averages as of November 2021, according to data from *Eviction Lab* cited in the JCHS report. Federal pandemic eviction bans, emergency rental assistance, and income supports allowed distressed renters to stay put despite the economic calamity of the time. Eviction Lab estimates that 1.6 million renters were spared from eviction thanks to these programs.

Eviction moratoriums were put into place at the start of the pandemic with the Coronavirus Aid, Relief, and Economic Security (a.k.a. CARES) Act during March 2020, remaining effective until the end of July 2020. Orders from the Centers for Disease Control and Prevention then banned evictions from August 2020 through August 2021.

Emergency rental assistance (ERA) provided through the Consolidated Appropriations Act ($25 billion) and American Rescue Plan Act ($21.55 billion) passed in 2021 also helped many renters in arrears. The funds, however, were difficult to disburse to states and localities, so ERA distributions continued into 2022. Economic impact payments and federal pandemic unemployment assistance also helped to boost household incomes to keep up with the cost of basic needs.

(2) *Would-be homeowners rented.* During the pandemic, housing demand rose for the space to work, learn, and play remotely. For-sale inventory dramatically dropped. Homeownership became out of reach of many would-be homeowners. Many lower-income renters struggled to save for a down payment toward a home purchase because of the rising cost of rents and home values. Home values rose 18.9% during September 2021 at an annual rate versus 5.7% during the prior year, according to Zillow.

The number of renter households grew by 1.7 million from Q4-2020 to Q4-2021, to 43.7 million (*Fig. 19*). The renters' rate (i.e., the percent of households renting rather than owning a housing unit) rose to 34.5% during Q4-2021 from a recent low of 32.1% during Q2-2020 (*Fig. 20*).

Higher-income earners priced out of for-sale housing markets during the pandemic competed with lower-income ones for rental units. Even leading up to the pandemic, however, more higher-income households also were opting to rent. JCHS observed that 70% of the renter household growth from 2009 to 2019 was attributed to higher-income earners, pushing the share of renter households earning over $75,000 annually to 26% in 2019 from 20% in 2009.

(3) *Apartment buildings under construction.* Builders struggled to keep pace with multifamily housing demand early in the pandemic but are catching up. Multifamily housing starts reached a three-decade high of 466,000 units at a seasonally adjusted annual rate (saar) through November 2021, well above the 350,000-unit annual pace averaged from 2014 to 2020, observed JCHS. While more than 375,000 multifamily units were completed in 2020, nearly 650,000 units remain under construction. And so, "the pipeline of new apartments coming on the market should remain robust for some time," observed JCHS.

Apartment building construction still may not meet the shortage of 1.5 million rental units that are "both affordable and available to households making up to 80 percent of the area median income," however. The supply of low-cost units is constrained by regulatory barriers in addition to the rising costs of construction that push developers to build for the higher-income segments of the market. By now, the rising costs of materials, labor, and land throughout the pandemic are well known.

(4) *Demographic demand for rentals.* The pandemic prevented many would-be young adult renters from moving out on their own. This pent-up demand combined with the number of household formations that otherwise would be expected from the large number of young adults moving into the rental market led to a sizable increase in household formations for adults under age 35 (*Fig. 21*).

Household headship rates for adults under age 35 who are not currently enrolled in school reversed all the declines from the height of the lockdown by mid-2021, according to Current Population Survey data. Many cash-strapped Millennials and Gen Zers moving through their 20s and 30s when renting is typical may delay homeownership beyond the typical age of purchase. Even leading up to the pandemic, the younger generations were showing a preference toward continued renting later in life.

At the same time, the number of renter households headed by a person aged 65 or older is climbing and likely to continue to rise as the Baby Boomer population ages into their mid-70s, when renter rates typically rise. It is also notable that "renter households are much more likely than homeowners to be single, to be households of color, and to have lower incomes," observed JCHS.

Calendars

US: Wed: Retail Sales Total, Core, and Control Group 0.4%/0.9%/0.4%; Import & Export Prices 1/5%/1.6%; Business & Wholesale Inventories 1.1%/3.9%; Crude Oil Inventories; NAHB Housing Market Index 81; MBA Mortgage Applications; Fed Interest Rate Decision 0.50%; EIA Monthly Report. **Thurs:** Headline & Manufacturing Industrial Production 0.5%/0.6%; Capacity Utilization Rate 77.8%; Housing Starts & Building Permits 1.69mu/1.85mu; Initial & Continuous Jobless Claims 220k/1.485m; Philadelphia Fed Manufacturing Index 15; Natural Gas Storage. (Bloomberg estimates)

Global: **Wed:** Italy CPI 0.9%m/m/5.7%y/y; Canada Headline & Core CPI 5.5%/4.5% y/y; Japan Industrial Production -1.3%; Japan Core Machinery Orders -2.2%m/m/8.1%y/y; Australia Employment Change 37k/Panetta; Australia Unemployment & Participation Rates 4.1%/66.3%; Elderson. **Thurs:** Eurozone Headline & Core CPI 0.9%m/m/5.8%y/y & 0.5%m/m/2.7%y/y; Japan BOE Interest Rate Decision 0.75%; BOJ Interest Rate Decision -0.10%; Lagarde; Schnabel; Lane; McCaul. (Bloomberg estimates)

Strategy Indicators

S&P 500 Buybacks (*link*): S&P 500 quarterly buybacks rose 15.1% q/q during Q4-2021 to a record-high $270.1 billion from its prior record of $234.6 billion during Q3-2021. That's up from a 22-quarter low of $88.7 billion during Q2-2020, when companies were seeking to preserve cash amid the highly uncertain economic outlook caused by Covid-19. The four-quarter sum of buybacks rose 18.8% q/q to $881.7 billion, its first record-high since Q1-2019 and up from $742.2 billion in Q3-2021. S&P 500 buybacks as a percentage of the S&P 500's total market capitalization improved to a seven-quarter high of 0.67% in Q4-2021 from 0.64% in Q3-2021. That's up from an 11-year low of 0.35% during Q2-2020, and compares to a 29-quarter high of 1.06% in Q4-2018 and the record high of 1.28% during Q3-2007.

S&P 500 Sectors Buybacks (*link*): Buybacks rose q/q during Q4-2021 for eight of the S&P 500's 11 sectors and fell for three. Communication Services was at a record high, Consumer Discretionary was at a 57-quarter high, and Materials was at its highest in 29 quarters. Among the 11 sectors, all have now exceeded their pre-pandemic Q4-2019 buyback level. The Tech sector accounted for 27.7% of the S&P 500's buybacks in Q4-2021, the most of any sector, but down from 28.2% in Q3-2021 and at its lowest share of the S&P 500 since Q4-2018. Financials' 19.1% share of the buyback total was down sharply from 26.4% in Q3-2021, and below its average 22% in the two years before Covid-19. However, Financials was still the most prolific repurchaser during Q4, as those companies repurchased 1.19% of their market cap, followed by Communication Services (1.06%), Materials (0.89), Tech (0.64), and Consumer Discretionary (0.61).

US Economic Indicators

Producer Price Index (*link*): February saw the producer price index for final demand post another sizeable gain, of 0.8%, following January's 1.2% increase, while core prices increased 0.7% for the second successive month—up from 0.4% during the final month of 2021. The yearly rate for the headline measure remained at its record high of 10.0% last month, while the core rate accelerated to a new record high of 9.6%. They were at 3.0% and 2.7% a year ago. The PPI for personal consumption climbed 1.7% during the two months through February, pushing the yearly rate (9.0%) back near December's record high of 9.1%, suggesting the PCED rate could keep climbing; it was at 6.1% y/y in January—the highest since the early 1980s. During February, prices for final demand goods posted its biggest monthly gain on record, jumping 2.4% after a 1.5% gain to start the year—pushing the yearly rate (14.4%) back near November's record-high 14.8%. Two-thirds of February's 2.4% jump can be traced to an 8.2% surge in final demand energy—led by gasoline prices, which advanced 14.8% during the month. Meanwhile, final demand services was flat in February after averaging gains of 0.9% the prior three months. The yearly rate slowed a bit for the second month, to 7.8% in February, from December's record-high 8.2%. Looking at pipeline prices, pressures remain very high, though have eased. The yearly rate for intermediate goods prices slowed to 23.4% y/y in February, down from November's 26.5% y/y—which was its highest rate since the mid-1970s. The rate for crude goods prices accelerated 35.4% y/y after slowing steadily from 59.0% last April—which was within a tick of its 59.1% record high in April 1973—to 32.1% in January.

Regional M-PMI (*link*): The New York Fed has provided the first glimpse of manufacturing activity in March and shows business activity in the region contracted noticeably this month, while price pressures remained intense—with the prices-received measure reaching a yet another new record high. March's composite index sank to -11.8—the weakest since May 2020's -48.5 reading at the height of the pandemic—and only the second negative reading since mid-2020 (this January's -0.7 was the other). The composite index averaged -3.1 during the first quarter, after averaging 29.7 during the final half of 2020. The new orders (to -11.2 from 1.4) and shipments (-7.4 from 2.9) measures fell by 12.6 points and 10.3 points, respectively, to their weakest readings since May 2020, while unfilled orders (13.1 from 14.4) held at a steady pace and inventories (21.5 from 11.7) expanded at the fastest pace since 2001. Meanwhile, delivery times (32.7 from 21.6) continued to lengthen substantially. Labor indicators showed employment (14.5 from 23.1) increased at a solid though slower pace, while hours worked (3.5 from 10.9) were only slightly longer. The prices-paid measure eased slightly for the fourth month from 83.0 in November to 73.8 this month—not far from last May's record-high 83.5. The prices-received gauge, meanwhile, shot up to a new record high of 56.1 this month after slowing from 50.8 in November to 37.1 in January. Firms remained generally optimistic about the six-month outlook, climbing from 28.2 to 36.6 this month, but the intensity has faded in recent months—with the measure easing every month but one since peaking at 52.0 in October. The report noted, “longer delivery times, higher prices, and increases in employment are all expected in the months ahead, and capital spending plans remained firm.” Both the prices-paid (72.9 from 70.3) and prices-received (58.9 from 51.3) measures remained close to their January record highs of 76.7 and 58.9, respectively.

Global Economic Indicators

Eurozone Industrial Production (*link*): Headline production in the Eurozone showed no growth at the start of 2022 after rebounding 3.8% the last two months of 2021 to within 1.1% of its pre-Covid level. Consumer nondurable goods production was the sole industrial sector to post a gain in January, climbing 3.1% during the month and 4.1% since its recent bottom last October. Meanwhile, capital goods production slumped 2.4% in January after jumping 8.5% during the three months through December to a 10-month high. Intermediate (-0.3%) and consumer durable goods (-0.5) production both edged slightly lower in January, remaining in volatile flat trends. Versus a year ago, the consumer nondurable goods (7.0% y/y) sector posted the biggest gain in production, while capital goods (-8.4) is the only sector showing a decline. Consumer durable and intermediate goods output were up 1.0% and 0.6%, respectively, over the period. Production data are available for the top four economies for January, and it was a mixed bag. The Eurozone’s two largest economies, Germany (1.4) and France (1.6), recorded an increase in production at the start of the year, while Italy (-3.4) saw a sharp decline; output in Spain was unchanged. Output in Spain is within 0.6% of its pre-pandemic levels, with Italy’s 1.9% below. Meanwhile, France (-4.0) and Germany are (4.1) have more ground to cover to reverse their losses.

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