MORNING BRIEFING
April 13, 2022

On the Lookout for Peak Inflation

Check out the accompanying chart collection.

Executive Summary:. War, supply-chain disruptions, soaring labor and commodity costs, monetary tightening causing possible recession—pshaw! All the disturbing global and US economic developments of late haven't shaken industry analysts' confidence that their companies are headed for record revenues, earnings, and profit margins over coming months, as passing inflated costs through to customers has been a cake walk. Our analysis of forward revenues and earnings reveals that and more. … Also: We slice and dice March CPI data, inflation expectations, and wage inflation—ever on the lookout for "peak inflation," which may show up in June or July. … And: Is the housing market cooling off?

Strategy: Analysts Are Carefree. Collectively, the industry analysts who cover companies in the S&P 500/400/600 indexes remain amazingly bullish on the outlook for earnings. They haven't been fazed by Fed officials' increasingly hawkish pronouncements or by Russia's invasion of Ukraine, which has sent commodity prices soaring, or by the worsening of supply-chain disruptions, owing to the war and China's latest Covid lockdowns, just when the disruptions had begun to show signs of abating. None of these developments has disturbed the steep upward trends in forward revenues per share and forward earnings per share (i.e., the time-weighted average of analysts' consensus estimates for this year and next). Consider the following:

(1) Forward revenues per share rose to record highs during the final week of March (*Fig. 1*). Forward earnings per share did so during the first week of April (*Fig. 2*). The analysts who cover the S&P 400/600 indexes (a.k.a. the SMidCaps) have been even more bullish than those who cover the S&P 500 LargeCaps (*Fig. 3*). After the lockdown recession and the resultant bottoming of forward earnings during May and June 2020, the forward earnings of the S&P 500/400/600 indexes are up 65.7%, 130.0%, and 189.1% through the first week of April this year.

Just as impressive is that the forward profit margins (which we calculate from forward revenues and earnings) of all three remain around their recent record highs, with readings of 13.3%, 8.8%, and 6.9% during the last week of March (*Fig. 4*).

(2) Also on steep uptrends are the forward revenues per share and the forward earnings per

share of the S&P 500 Growth and Value indexes (*Fig. 5* and *Fig. 6*). All four are at or near their recent record highs. Since their post-lockdown lows in 2020 through the last week of March this year, the forward earnings of Growth and Value are up 65.5% and 51.9%, respectively.

(3) And what about the rapid increase in commodity and labor costs and the shortages of labor and parts? They haven't dented profit margins at all, suggesting that companies are meeting no resistance from their customers when they push these costs through to their selling prices. We've seen an immaculate wage-price spiral so far. As we've previously explained, analysts' forecasts imply that earnings are growing as fast as revenues, since margins are remaining at their record highs. Since revenues fully reflect inflation, so do earnings. Inflation is bullish for earnings, according to the analysts.

(4) Inflation will be bearish for both earnings and valuation multiples, if and when inflation forces the Fed to cause a recession to bring it down. So what do analysts think about the rising risk of slower economic growth, if not an outright recession? To be fair, analysts don't forecast recessions. That's not their job. When recessions occur, they rapidly cut their estimates. However, there's no sign of a slowdown in forward earnings, which occurred during previous economic slowdowns such as in 2011-12 and 2014-15. Perhaps it is being masked this time by the impact of high inflation.

(5) In any event, the record highs for the weekly forward revenues, earnings, and profit margin of the S&P 500 suggest that their actual quarterly counterparts either remained at or rose to new record highs during Q1-2022 (*Fig. 7*). We will find out shortly during the current earnings reporting season whether that's so.

Interestingly, industry analysts have been lowering their y/y earnings growth expectations for Q1, while raising them for Q2-Q4 (*Fig. 8* and *Fig. 9*). Here are the current growth rates expected as of the April 7 week: Q1 (4.7%), Q2 (6.0), Q3 (10.0), and Q4 (13.0). We wouldn't be surprised by an upside surprise this earnings-reporting season. A 4.7% y/y increase seems low given that the CPI jumped 8.5% over this same period. For the same reason, we think that Q2's 6.0% estimate may also be too low.

(6) We raised our estimates for 2022 and 2023 S&P 500 earnings-per-share estimates to $240 (up 15.1%) and $260 (up 8.3%) recently, mostly to reflect higher-for-longer inflation (*Fig. 10*). The S&P 500 industry analysts are currently projecting $227 this year and $250 next year. Are we concerned that our numbers are too high? Not really, since the analysts continue to raise their numbers almost every week since the beginning of the year! The

same can be said about our forward earnings forecasts of $265 and $300 for the end of 2022 and the end of 2023 (*Fig. 11*).

Inflation I: Great & Not-So-Great Expectations. Debbie and I are on the lookout for a peak in the inflation rate. We think a peak could come by June or July. Before we slice and dice the March CPI data, let's focus on inflation expectations and then on wages.

Fed officials give the available data on inflation expectations a great deal of weight in their deliberations. Indeed, while they've acknowledged that inflation has turned out to be more persistent and higher than they had expected a year ago, they seem to take comfort in observing regularly that inflation expectations remain "well anchored." Indeed, in his March 21 *speech* titled "Restoring Price Stability," Fed Chair Jerome Powell said:

"Our monetary policy framework, as embodied in our Statement on Longer-Run Goals and Monetary Policy Strategy, emphasizes that having longer-term inflation expectations anchored at our longer-run objective of 2 percent helps us achieve both our dual-mandate objectives. While we cannot measure longer-term expectations directly, we monitor a variety of survey- and market-based indicators. In the recent period, short-term inflation expectations have, of course, risen with inflation, but longer-run expectations remain well anchored in their historical ranges."

Powell included a *chart* compiled by the University of Michigan Surveys of Consumers showing the medians of the survey responses about average inflation during the next five to 10 years. It shows that longer-run expectations have remained "well anchored" around 3.0% since 1998. The data we prefer to monitor are shorter term inflation expectations, which aren't well anchored:

(1) On Monday, the Federal Reserve Bank of NY (FRB-NY) reported that median one-year-ahead inflation expectations increased again in March, climbing from 6.0% in February to a new series high of 6.6% (*Fig. 12*). The good news (sort of) was that longer-term inflation expectations over the next three years ticked down to 3.7% from 3.8%, "a decrease driven by respondents with no college education and with annual household incomes under $50,000."

(2) The Conference Board also compiles a 12-months-ahead inflation expectations series (*Fig. 13*). It has consistently been above 4.0% since 2003, while the FRB-NY measure has been mostly hovering around 3.0% since the start of the data in 2013 through 2020. According to the former series, expected inflation over the next 12 months soared from

4.5% during March 2020 to a record high of 7.9% during March of this year.

Inflation II: Wages Rising. Inflation is causing havoc in the labor market. It explains why quits are at a record high. The Atlanta Fed's Wage Growth Tracker (WGT)—which shows the y/y percent change in the three-month moving average of wages—jumped from last year's low of 3.0% during May to 6.0% during March (*Fig. 14*). That's the highest pace since August 1990's identical rate—and only a tick below its 6.1% record high. However, it is still below the CPI inflation rate of 8.0% over the same period.

Workers are quitting their jobs en masse for higher-paying ones. Sure enough, the WGT for job switchers showed a gain of 7.1% during March, while job stayers saw their wages rise by 5.3% (*Fig. 15*).

Inflation III: March CPI Shocker, As Expected. On Monday, the day before the release of fresh monthly inflation data, White House Press Secretary Jen Psaki admitted that the data will be "extraordinarily elevated"—after the CPI inflation hit a 40-year high of 7.9% during February. "We expect March CPI headline inflation to be extraordinarily elevated due to [Russian President Vladimir] Putin's price hike, and we expect a large difference between core and headline inflation reflecting the global disruptions in energy and food markets," Psaki said at her regular press briefing. That was a good call. Instead of going to work for MSNBC, Psaki should consider starting an economic forecasting firm.

The headline and core CPI jumped by 8.5% y/y and 6.5% during March. Such rates would have been shocking had they not been expected. So the initial responses in both the bond and stock markets were positive, reflecting relief that the data weren't even worse, as Psaki suggested they might be. The headline rate was boosted by a 32.0% increase in energy and an 8.8% increase in food.

Debbie and I have been predicting that the CPI for durable goods is likely to peak in coming months, while the CPI for services is likely to move higher, inflated by its rent component. That seems to be happening already.

Here are the three-month percent changes at annual rates in the CPI durable goods category and its key components: total (2.7%), used cars & trucks (-10.5), new cars (2.1), household furniture & bedding (12.2), and household appliances (29.4). All of them except the household appliances rate are down from recent highs, and it may cool off along with homebuilding (as Melissa discusses below).

On the other hand, on the same basis, the rent of primary residence rose 6.2% and owners' equivalent rent increased 5.2%. Both have been on uptrends over the past year.

US Housing: Cooling Off. Inflation might cool down soon in the housing market. Buyers have encountered steep home prices for the limited inventory on the block since pandemic trends catapulted the value of staying at home. Median existing home prices are up over 30% nationwide over the past two years through February (*Fig. 16*). Forecasters surveyed by Zillow expect price appreciation to moderate but continue to rise over the next several years.

Lessening the financial burden of purchasing a new home in recent years, mortgage rates have remained historically low. But homebuying has become increasingly less affordable as a result of rising prices during the pandemic, and many potential homebuyers have been priced out of the market. Now with the Fed likely to accelerate the pace of rate hikes, the full price of purchasing a home on loan has just gone up even more. As a result, prices are likely to come down to compensate for the increase in borrowing rates. Some homebuyers may even lose their loan-to-value eligibility because of the rising monthly cost of a mortgage, which may be a factor pulling the rug from the demand side of the market.

But we highly doubt that declines in home prices will be anywhere near the scale of the 2008-09 home bubble bursting. That's because demand for housing is significantly outpacing supply, and homebuilders now aren't building fast enough to keep up. Back in 2008, the housing market was oversupplied. Keeping supply tight today, higher mortgage rates may incent potential sellers to stay locked into their current rates at home. The elevated costs of building have kept a lid on the supply of new homes too. Here's more:

(1) Mortgage rates are up above 5.0% on a fixed 30-year term, at 5.18% Monday, the highest since mid-December 2010 (*Fig. 17*). An April 10 *Fortune* *article* did the math on the rising cost of rates approaching 5.0%: "In December 2021 the average 30-year fixed mortgage rate sat at 3.11%. A borrower who took out a $500,000 mortgage at that 3.11% rate would have seen a monthly principal and interest payment of $2,137. Now that the average rate is up to 4.72%, a new loan at that size would equal a $2,599 monthly payment. Over the course of 30 years, that's an additional $166,106."

(2) Researchers from RedFin recently *noted*: "The market still feels hot, but a slowdown in online searches, home tours, and mortgage applications suggests more buyers are getting priced out." Indeed, mortgage applications have dramatically fallen from pandemic era highs for both refinancings and new home purchases (*Fig. 18* and *Fig. 19*). The National

Association of Realtors Housing Affordability Index based on a 30-year fixed-rate mortgage has fallen 48.4 points since January 2021, the steepest 13-month decline on record.

(3) The total inventory of homes has fallen from a monthly average of 1.6 million units in 2018 and 2019 to just over 1.0 million in 2021. The latest *Zillow Home Price Expectations Survey* of real estate experts indicated that housing inventory is unlikely to return to a monthly average of at least 1.5 million available units until the end of 2024.

(4) Despite the undersupply in the market, the S&P 500 Homebuilding industry price index is the worst performer ytd among S&P 500 industries, with a decline of 23.9%. That's likely in part because the cost of building a home increasingly has become more expensive, with labor costs and raw material prices elevated as supply-chain problems persist. Lumber costs remain at historical highs but have come down after soaring 549% from April 1, 2020 to May 7, 2021 (*Fig. 20*).

(5) Builders are still unlikely to build fast enough to keep up with the supply shortage even with demand coming down. However, inventory should rise soon nonetheless as the cost to build allows for better homebuilder returns. Housing starts have slightly picked up in recent months (*Fig. 21*). Building permits too have picked up ahead of completions (*Fig. 22*).

Calendars

US: Wed: Headline & Core PPI 1.1%m/m/10.6%y/y & 0.5%m/m/8.4%y/y; MBA Mortgage Applications; Crude Oil Inventories; IEA Monthly Report. **Thurs:** Retail Sales Total, Core, and Control Group 0.6%/1.0%/0.2%; Consumer Sentiment Index Total, Current Conditions, and Expectations 59.0/68.0/54.2; Initial & Continuous Jobless Claims 171k/1.50m; Business Inventories 1.3%; Import & Export Prices 2.3%/2.2%; Natural Gas Storage; Mester. (Bloomberg estimates)

Global: Wed: Eurozone Industrial Production 0.1%; Italy Industrial Production 0.7%m/m/1.4%y/y; Spain CPI 3.0%m/m/9.8%y/y; UK Headline & Core CPI 0.7%m/m/6.7%y/y & 0.5%m/m/5.4%y/y; UK PPI Input & Output 2.5%m/m/13.9%y/y & 1.2%m/m/11.1%y/y; BOC Interest Rate Decision 1.00%; Australia Employment Change 40k; Australia Unemployment & Participation Rates 3.9%/66.5%; Kuroda. **Thurs:** ECB Interest Rate Decision & Deposit Facility Rate 0.00%/-0.50%;UK BOE Credit Conditions; China FDI. (Bloomberg estimates)

Strategy Indicators

S&P 500 Q1 Earnings Season Monitor (*link*): With just 4% of S&P 500 companies finished reporting revenues and earnings for Q1-2021, revenues are beating the consensus forecast by a 1.1%, but earnings have only exceeded estimates by a well-below-trend 1.5%. At the same point during the Q4 season, revenues were 3.0% above forecast and earnings beat by 6.6%. For the 21 companies that have reported Q1 earnings through mid-day Tuesday, the aggregate y/y revenue and earnings growth rates is on par with Q4-2021's rates, but have slowed considerably from their readings during Q2 and Q3 of 2021. The small sample of Q1 reporters so far collectively has a y/y revenue gain of 13.4% and an earnings gain of 27.9%. While just 68% of the Q1 reporters so far has reported a positive earnings surprise, 81% have beaten revenues forecasts. Fewer companies have reported positive y/y earnings growth in Q1 (71%) than positive y/y revenue growth (100). These figures will change markedly as more Q1-2022 results are reported in the coming weeks. While we expect y/y growth rates to remain strong in Q1, we think revenue and earnings surprises will moderate q/q due to missed deliveries, higher costs, and increased company guidance ahead of the earnings season.

US Economic Indicators

Consumer Price Index (*link*): March's CPI increased 1.2%, its biggest monthly gain since September 2005; that pushed the yearly rate up to 8.5%—the highest since December 1981—which is 2.9ppts above the 5.6% gain in average hourly earnings for all employees that month. Core prices climbed 0.3% in March, slowing from gains of 0.5% and 0.6% the prior two months, with the yearly rate ticking up from 6.4% to 6.5%—the highest since August 1982. Here's a look at yearly rates across the spectrum: food (8.8% y/y) costs have been accelerating at their fastest rate since May 1981, with the rate for food away from home (6.9) the highest since the end of 1981 and the rate for food at home (10.0) the highest since March 1981. Energy (32.0) costs accelerated last month, after easing the prior three months from 33.3% in November—which was the fastest pace since September 2005—to 25.6% by February. Fuel oil (70.1% from 43.6% y/y), gasoline (to 48.0 from 38.0), and electricity (11.1 from 9.0) prices all picked up during the 12 months through March—with fuel oil the highest since July 2008 and electricity cost the highest since September 2006. Meanwhile, the yearly gain in natural gas prices slowed for the fifth month from 28.1%

in November (the highest since July 2008) to 21.6% in March. The consumer durable goods (17.4 from 18.7) inflation rate slowed from February's rate—which was its highest percentage since the record high of 20.2% in the early 1940s, while the consumer nondurable goods (13.1 from 10.7) rate was the highest since mid-1980. The rate for furniture & bedding (15.8 from 17.1) slowed from February's record high, while the rate for new vehicles (12.6 from 12.4) accelerated at its fastest pace since spring 1975. Meanwhile, the rate for used cars & trucks remains in a volatile flat trend, slowing to 35.3% y/y in March after accelerating from 24.4% in September to 41.2% in February—which was within striking distance of June 2021's record rate of 45.2%. Apparel prices (6.8 from 6.6) accelerated at the fastest rate since the end of 1980. The yearly rate for medical care commodities (2.7 from 2.5) was positive for the fifth month, posting its highest rate since May 2018, after being in negative territory for 13 successive months. Within services, owners' equivalent (4.5) and tenant-occupied (4.4) rents continue to accelerate—up from recent lows of 2.0% and 1.8%, respectively—with the former the highest since March 2002 and the latter since spring 2007. The rate for lodging away from home (25.1) remained at February's record high. Meanwhile, the yearly rate for hospitals' (3.3 from 3.4) services have been moving in a relative flat trend, while the physicians' (0.7 from 0.5) services rate is holding near zero, down from 2.6% in January and 4.3% in December; it peaked at 5.3% last March. The yearly rate for airfares (23.6 from 12.7) moved further above zero in February after nosediving last year, from 24.6% in June to -3.7% by November, then recovering altitude in December (1.4).

NFIB Small Business Optimism Index (*link*): "Inflation has impacted small business throughout the country and is now their most important business problem," said NFIB Chief Economist Bill Dunkelberg. "With inflation, an ongoing staffing shortage, and supply chain disruptions, small business owners remain pessimistic about their future business conditions." March's Small Business Optimism Index (SBOI) sank for the third month, to a 23-month low of 93.2 (the third consecutive month below the 48-year average of 98.0), after climbing slightly the prior two months from 98.2 during October to 98.9 by the end of the year. Only two of the 10 components of the SBOI improved last month, while five declined, and three—plans to increase inventories (2), expected credit conditions (-4), and earnings trends (-17)—were unchanged. Current inventory (to 9% from 7%) and plans to increase employment (20 from 19) were the only two positive contributors to March's SBOI—and they weren't up by much. Meanwhile, the biggest negative contributors by far were expect the economy to improve (-49 from -35) and sales expectations (-18 from -6), with now is a good time to expand (6 from 8), current job openings (47 from 48), and capital outlay plans (26 from 27) minor drags. Meanwhile, 31% of owners reported inflation as their biggest problem—the highest percentage since Q1-1981 and up from 2% just 13 months ago.

Labor quality is now the number-two biggest problem, holding at 22% this month, but down from its record high of 29% in November. The report highlights the net percent of owners raising average selling prices increased 4ppts to a net 72% (sa)—a survey high—with price hikes most frequent in wholesale (84% higher & 0% lower), construction (83 & 3), agriculture (78 & 2), and retail sales (77 & 2). A net 50% of owners plan price hikes, up from 46% during February.

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