MORNING BRIEFING
July 19, 2022

More On Inflation

Check out the accompanying chart collection.

Executive Summary: Consumer prices, wages, home prices, rent: They've all been surging northward at stunning rates. Today, we take a deep dive into the wage-price-rent spiral. … We examine recent rent data, how they're measured, and the forces that drive them—such as the plummeting affordability of home purchasing. … Regarding wages, one measure suggests wage inflation may be moderating, while the other shows it is still very high. … We still expect inflation to moderate, led by nondurable and durable goods inflation. The risk is that the wage-price-rent spiral continues, forcing the Fed to trigger a recession—which always has brought inflation down in the past.

Inflation I: Wages. Debbie and I have some good news and some bad news on the inflation front. Wage inflation appears to be moderating according to the average hourly earnings (AHE) measure of wages but is still moving higher based on the Atlanta Fed's wage growth tracker (WGT). Consider the following:

(1) *AHE.* The AHE is available for all workers since March 2006 and for production and nonsupervisory (PNS) workers since January 1964. This measure reflects not only changes in basic hourly and incentive wage rates but also such variable factors as premium pay for overtime and late-shift work and changes in the output of workers paid on an incentive plan. It also reflects shifts in the number of employees between relatively high-paid and low-paid work and changes in workers' earnings in individual establishments.

The AHE inflation rate for all workers moderated from a recent peak of 5.6% y/y during March to 5.1% during June (*Fig. 1*). For PNS workers, who account for 81.5% of payroll employment, it moderated from 6.8% to 6.4% (*Fig. 2*). Both series have been very volatile since the pandemic. During the lockdowns, more of the lower-wage PNS workers lost their jobs than higher-wage workers, who could work from home. That misleadingly boosted the AHE measure of wage inflation. Then the AHE misleadingly went the other way when the lockdown ended, allowing more of the lower-wage workers to find jobs again.

By now, the AHE measure should be a more accurate measure of underlying wage inflation. If so, then it is showing that wage inflation may be moderating. During June, when the AHE rose 5.1% y/y, it rose 4.2% on a three-month percentage-change basis, suggesting that

inflationary pressures are subsiding (*Fig. 3*). Interestingly, lower-wage workers have been getting bigger wage increases than higher-wage workers, with the former up 6.4% y/y (and 5.8% over the past three months) through June and the latter up 2.5% (but just 0.6% over the past three months) (*Fig. 4*).

(2) *WGT.* The WGT series tracks the median wage growth rate, not the median wage. It calculates the wage growth of surveyed people who were working over the course of a year and constructs a distribution of growth rates, which is used to calculate three-month moving-average medians. As a result, the WGT has been less volatile than the AHE measure of wage inflation (*Fig. 5*).

According to the WGT, wage inflation hasn't yet slowed down; it rose to 6.7% during June from 6.2% during May. There are also no signs of moderating wage pressures in the WGT's various components. For example, during June, the WGT for job switchers and job stayers jumped to 7.9% and 6.1%, respectively (*Fig. 6*). That 1.8ppt differential certainly explains why so many workers have been quitting their jobs for better paying ones (*Fig. 7*).

According to the WGT, on a 12-month moving average basis through June, wages are up 5.4%. For younger workers, they're soaring, with gains of 12.5% for 16- to 24-year-olds versus 5.6% for 25- to 54-year-olds and 3.7% for workers 55 and older (*Fig. 8*). By industry, the 12-month gains are: leisure & hospitality (6.4%), trade & transportation (5.9), manufacturing (5.8), finance & business services (5.5), construction & mining (4.9), education & health (4.9), and public administration (4.6).

(3) *Real wages.* In a perfect world, wages would be rising at a moderate pace that exceeds price inflation by the growth rate in productivity. During a wage-price spiral, productivity growth suffers as wages and prices spiral higher. So real wages tend to stagnate. That's what is happening currently: On an inflation-adjusted basis, AHE for all private workers is down -1.0% y/y through May, while AHE for PNS workers is up just 0.1% (*Fig. 9* and *Fig. 10*).

Inflation II: Rents. As we've previously discussed, the wage-price spiral is really a wage-price-rent spiral. While there are a few glimmers of moderating wage inflation in the AHE measure, there's no sign of relief from the uptrend in rent inflation that started during March 2021. Consider the following:

(1) *Home prices & rents.* The Fed's ultra-easy monetary policies in response to the pandemic caused home prices to soar, and now rents are soaring. Over the 24 months

through May, the median single-family existing home price is up an astonishing 44.5% (*Fig. 11*).

This year's jump in mortgage rates only exacerbated the affordability problem facing would-be first-time homebuyers, leaving many of them with no choice but to rent. That's reflected by the jump in the Zillow Observed Rent Index, which was tracking around 3% y/y before the pandemic; it fell close to 0% in late 2020 and early 2021 before shooting up to peak at 17.2% during February 2022 (*Fig. 12*). It declined slightly to 14.8% in June.

(2) *Rent measures.* The CPI includes rent of primary residence and owners' equivalent rent of primary residence (OER). The former measures tenant rents, while the OER measure imputes the rent that homeowners would have to pay to themselves if they were their own landlords. This strange concept makes sense since owner-occupied housing provides a service that is consumed every day, i.e., shelter. On the other hand, when rents go up, tenants have to pay more for rent, while nothing really changes for homeowners—unless higher rents are the result of higher home prices; in that case, they benefit.

Tenant rent in the CPI is based on a sample of all existing leases, not based on new leases. New lease rents will show up in the CPI over the coming 12-24 months depending on the renewal terms of those leases. The Bureau of Labor Statistics uses statistical techniques to infer OER using rental prices for similar units in the area. As a result, the OER inflation rate tends to closely follow the tenant rent inflation rate (*Fig. 13*).

(3) *Rent inflation.* Tenant rent inflation in the CPI rose from a 2021 low of 1.8% y/y during March through May to 5.8% during June of this year, the highest since July 1986. The OER measure rose to 5.5% during June, the highest since September 1990.

Economist Larry Summers coauthored a February 2022 *study* titled "The Coming Rise In Residential Inflation." It concluded that these rent inflation measures are likely to move close to 7% during 2022, and to remain high during 2023. The authors base that prediction on private-sector data on home prices and rents on new leases. They observe, "Historically, the year-over-year growth in home prices and market rents have been powerful leading indicators for OER inflation and [tenant] rent inflation [in the CPI]."

(4) *CPI vs PCED rents.* The PCED and CPI inflation rates for tenant and OER rent are nearly identical (*Fig. 14* and *Fig. 15*). However, they have higher weights in the CPI than in the PCED.

Rent of primary residence (a.k.a. tenant rent) and OER account for 7% and 24% of the headline CPI, 9% and 31% of the core CPI, and 12% and 40% of CPI services. So both together account for 31% of the headline CPI, 40% of the core CPI, and 52% of CPI services.

Rent of primary residence and OER account for 4% and 11% of the headline PCED, 5% and 13% of the core PCED, and 6% and 17% of PCED services. So both together account for 15% of the headline PCED, 18% of the core PCED, and 23% of PCED services.

As a result of the different weights, the Summers study concludes that "housing will make a significant contribution to overall inflation in 2022, ranging from one percentage point for headline PCED to 2.6 percentage points for core CPI."

That all makes sense to us. Nevertheless, we expect to see inflation rates moderating for both nondurable and durable goods during H2. So we are sticking with our forecast that the headline PCED inflation rate will ease from 6%-7% during H1-2022 to 4%-5% during H2-2022 and get down to 3%-4% next year. Our inflation rate projections would be lower but for the upward pressure from the rent components of the consumer price measures.

(5) *Rents & wages.* The risk for any optimistic outlook on inflation is that the wage-price-rent spiral continues to spiral. The CPI tenant rent component, on a y/y basis, closely tracks the WGT (*Fig. 16*). If inflation doesn't cool off during the second half of this year, Fed Chair Jerome Powell may have no choice but to "go Volcker" and push interest rates up to whatever level it takes to cause a recession, as former Fed Chair Paul Volcker did during the 1970s. History shows that recessions do break the back of inflation.

Calendars

US: Tues: Housing Starts & Building Permits 1.585mu/1.650mu; API Weekly Crude Oil Inventories. **Wed:** Existing Home Sales 5.38mu; MBA Mortgage Applications; Crude Oil Inventories & Gasoline Production. (Bloomberg estimates)

Global: Tues: Eurozone Headline & Core CPI 0.8%m/m/8.6%y/y & 0.2%m/m/3.7%y/y; UK Average Earnings Including & Excluding Bonus 6.9%/4.3%; UK Employment Change & Unemployment Rate 3m/3m 170k/3.8%; Bailey; Lowe. **Wed:** Eurozone Consumer Confidence -24.9; Germany PPI 1.3%m/m/33.9%y/y; UK Headline & Core CPI

0.7%m/m/9.3%y/y & 0.5%m/m/5.8%y/y; UK PPI Input & Output 1.4%m/m/23.2%y/y & 1.1%m/m/16.0%y/y; Canada Headline & Core CPI 8.4%/5.9% y/y; Japan Trade Balance – 1.5t; Japan Exports & Imports 17.5%/45.7% y/y; Australia Quarterly Business Confidence; China New Loans; BOJ Interest Rate Decision -0.19%. (Bloomberg estimates)

Strategy Indicators

S&P 500/400/600 Forward Earnings (*link*): Forward earnings fell simultaneously for all three of these indexes last week for the first time since May 2020. None of these three indexes had forward earnings at a record high for a third straight week. LargeCap's has fallen in four of the past 11 weeks and is now 0.2% below its record high at the end of June. MidCap's has dropped in four of the past five weeks and is 0.8% below its record high in early June. SmallCap's edged down 0.1% w/w to 2.7% below its record high in mid-June. In what was an extraordinary V-shaped recovery, LargeCap's forward earnings has risen during 104 of the past 112 weeks, with the other down weeks due to Tesla's addition to the index in December 2020, Amazon's earnings misses for Q1-2022 and Q2-2021, Walmart's Q1-2022 miss, and index changes last September and December. MidCap's forward earnings is up in 103 of the past 110 weeks, and SmallCap's posted 99 gains in the past 111 weeks. SmallCap had been steadily making new highs each week until mid-December. Forward earnings for these indexes had been on an uptrend from November 2019 until February 2020, before tumbling to a bottom by June 2020 due to the Covid-19 economic shutdown. LargeCap's forward earnings has risen 69.9% from its lowest level since August 2017; MidCap's is now up 139.5% from its lowest level since May 2015; and SmallCap's has soared 196.4% from its lowest point since August 2013. In the latest week, the rate of change in LargeCap's forward earnings fell to a 15-month low of 17.3% y/y from 18.0%; that's down from a record-high 42.2% at the end of July 2021 and up from -19.3% in May 2020, which was the lowest since October 2009. The yearly rate of change in MidCap's forward earnings dropped w/w to a 15-month low of 29.1% y/y from 30.3%. That's down from a record high of 78.8% at the end of May and compares to a record low of -32.7% in May 2020. SmallCap's rate fell to a 16-month low of 27.5% y/y from 28.4%. It's down from a record high of 124.2% in June 2021 and up from a record low of -41.5% in June 2020. Companies have been beating consensus estimates quite handily since the Q2-2020 earnings season, causing analysts' consensus earnings forecasts for 2021 to 2023 to improve instead of decline as is typical, but their forecasts are likely to head lower now. Here are the latest consensus earnings growth rates for 2022 and 2023: LargeCap (9.7%, 9.1%), MidCap (13.9, 6.1), and SmallCap (10.5, 11.4).

S&P 500/400/600 Valuation (*link*): Valuations ticked down for these three indexes last week. LargeCap's forward P/E dropped 0.2pts to 16.1 from 16.3 a week earlier, but is up from a 26-month low of 15.3 in mid-June. It's down from a six-month high of 21.5 in early November. LargeCap's forward P/E also compares to a 19-year high of 22.7 in January 2021 and is up from 13.3 in March 2020, which was the lowest since March 2013. MidCap's fell 0.1pt to 11.6 from 11.7, but is up from a 27-month low of 11.1 in mid-June. That's down from a 13-week high of 17.1 in early November. It had been at a record high of 22.9 in June 2020 and an 11-year low of 10.7 in March 2020. SmallCap's also dropped 0.1pt, to 11.4 from 11.5 a week earlier. Its mid-June reading of 10.7 was the lowest since it bottomed at a record low of 10.2 in November 2009 during the Great Financial Crisis. That compares a 13-week high of 16.1 in early November and its record high of 26.7 in early June 2020 when forward earnings was depressed. LargeCap's forward P/E in February 2020—before Covid-19 decimated forward earnings—was 18.9, the highest level since June 2002. Of course, that high was still well below the tech-bubble record high of 25.7 in July 1999. Last week's level compares to the post-Lehman-meltdown P/E of 9.3 in October 2008. MidCap's P/E was below LargeCap's P/E yet again last week, as it has been for most of the time since August 2018. In contrast, it was last solidly above LargeCap's from April 2009 to August 2017; MidCap's current 28% discount to LargeCap is near its biggest since September 2000. SmallCap's P/E was below LargeCap's for a 100th straight week. That's the longest stretch at a discount since 1999-2002; SmallCap's current 29% reading is near its biggest discount since February 2001. SmallCap's P/E had been mostly above LargeCap's since 2003. Looking at SmallCap's P/E relative to MidCap's, it was at a discount for a 57th straight week; the current 2% discount is up from a 9% discount in December but remains near its lows during 2000-01.

S&P 500 Sectors Quarterly Earnings Outlook (*link*): Since the Q3-2020 earnings season, analysts as a whole have been raising their consensus forecasts for future quarters instead of lowering them as is the norm through the earnings warnings seasons. That six-quarter streak of positive revisions throughout the quarter officially ended with Q1-2022. In the latest week, the Q2-2022 earnings-per-share forecast fell 40 cents w/w to $55.11, and is now down 1.4% from its $55.92 forecast at the start of the quarter. Analysts expect S&P 500 earnings growth to weaken substantially to 4.5% y/y on a frozen actual basis and 5.6% on a pro forma basis. That's down from Q1-2022's 11.6% y/y on a frozen actual basis and an 11.4% y/y gain on a pro forma basis. Double-digit growth is expected for just three sectors in Q2-2022, and five are expected to record a y/y decline. That compares to Q1-2022's count of seven sectors with double-digit growth, one with a single-digit gain, and three with a y/y decline. Here are the S&P 500 sectors' latest earnings growth rates for Q2-2022 versus their Q1-2022 growth rates: Energy (248.8% in Q2-2022 versus 269.5% in Q1-

2022), Industrials (26.7, 40.5), Materials (16.2, 46.3), S&P 500 (5.6, 11.4), Real Estate (3.9, 25.5), Health Care (2.1, 18.3), Information Technology (2.4, 14.6), Consumer Staples (-1.0, 7.9), Consumer Discretionary (-6.2, -27.9), Utilities (-12.4, 24.6), Communication Services (-14.9, -2.8), and Financials (-21.1, -17.1).

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