**MORNING BRIEFING**
**August 24, 2022**

## Will Inflation Persist?

*Check out the accompanying chart collection.*

**Executive Summary:** If inflation is peaking, definitive proof could make all the difference to the near-term direction of the stock market. It could also affect how hard the Fed pumps the monetary brakes and what that does to the economy. Our happy outlook features inflation peaking, tightening ending sooner rather than later, and the economy slowly growing. … Recent data releases provide peeks into upcoming inflation readings—and some signs that it is peaking. … Biden's Inflation Reduction Act seems almost satirically named: The Act is more about climate than inflation, think-tanks say it will hardly move the inflation needle, and Melissa found several aspects to be downright inflationary.

**Inflation: What Could Go Right.** It's showtime for inflation. The rally in stock prices since June 16 was largely attributable to investors' expectations that inflation might be peaking. If that's so, then the Fed's monetary policy tightening cycle will end sooner rather than later at a lower terminal federal funds rate than otherwise.

In this relatively upbeat scenario, the economy should continue to grow slowly overall, with any recession rolling through different sectors at different times, as occurred during the first half of this year. This scenario might mean that the S&P 500's latest bear market ended when its price index bottomed on June 16 at 3666.77 and its forward P/E bottomed at 15.3.

So it is also showtime for our inflation forecast. We've been predicting that the headline PCED inflation rate would peak during the first half of this year between 6%-7% and fall to 4%-5% during the second half of this year and to 3%-4% next year (*Fig. 1*). The headline PCED inflation rate rose to 6.8% during June, the highest since January 1982. The core PCED inflation rate rose to 5.3% during February this year and fell to 4.8% during June.

We'll all be looking for confirmation that inflation has peaked in the major inflation indicators that will be released in coming weeks. The next big one will be August's CPI to be released on September 13. So far this year, the headline CPI inflation rate rose to 9.1% during June and fell to 8.5% during July, while the core CPI inflation rate rose to 6.5% during March and fell to 5.9% during June and July (*Fig. 2*).

There already are some indicators that can give us a glimpse of what to expect for August's

CPI. Let's have a look at them:

(1) *Regional business surveys.* Three of the five regional business surveys are now available through August. They are conducted by the Federal Reserve district banks of New York, Philadelphia, and Richmond. The average of their prices-paid and prices-received indexes clearly peaked earlier this year, but they remained above their previous cyclical peaks (*Fig. 3*).

The average of the three regional prices-paid indexes suggests that August's national M-PMI prices-paid index continued to fall but also remained high (*Fig. 4*).

(2) *Supply chains.* The three regional business surveys include indexes for delivery times and unfilled orders (*Fig. 5*). The average of these indexes fell from 19.9 in March to -8.9 in August, suggesting that the supply-chain disruptions are easing either because the chains have been fixed, demand has fallen, or both (*Fig. 6*). Whatever the cause, this development should reduce inflationary pressures. The average of the regional surveys is highly correlated with the national M-PMI's supplier deliveries index.

(3) *Food and energy commodities.* The major contributors to headline CPI inflation have been food and energy prices, which rose 10.9% y/y and 32.9% y/y through July (*Fig. 7*). There are some signs of relief on both fronts. The S&P Goldman Sachs Commodity Price Indexes for both agricultural and energy commodities are down 18% and 20% from their peaks in May and June, respectively, through Monday (*Fig. 8*). The GSCI Grain Index is down 26% since it peaked in May (*Fig. 9*).

The CPI food inflation index for the US is highly correlated with the yearly percent change in the UN world food index, which has dropped from a recent peak of 39.7% in May 2021 to 13.1% in July (*Fig. 10*).

On the energy front, the CPI gasoline index is derived from a weekly data series on the national retail pump price (*Fig. 11*). Both fell sharply during July. The four-week average of the pump price continued to decline through the August 22 week.

The bad news on the energy front is that natural gas prices have soared in recent days as the energy crisis in Europe has worsened.

(4) *Durable goods prices.* The CPI for durable goods peaked at 18.7% y/y in February; it fell to 7.9% in July (*Fig. 12*). Consumers have been pivoting away from buying goods toward

purchasing services, resulting in unintended inventories for retailers, forcing them to cut their prices.

The rate of price increases for housing-related durable goods has been moderating also as a result of the housing recession. And the rate of price inflation for used cars has moderated in recent months, though remains high for new cars.

(5) *Services.* In the services sector, even though Americans have been traveling more, the inflation rates for lodging away from home, airfares, and car & truck rentals have moderated greatly from much higher inflation rates earlier this year (*Fig. 13*).

The rent components of the CPI are likely to remain troublesome over the rest of the year. Both rent of primary residence and owners' equivalent rent (OER) have seen their three-month annualized inflation rates exceed the y/y rate since early 2021 (*Fig. 14*). Both have large weights in the CPI.

The current weights of the OER and tenant rent components of the headline CPI are 24% and 7%, respectively, and those of the headline PCED are 11% and 4%. The combined weights for tenant rent and OER are unrealistically high in the CPI at 31% but about right in the PCED at 15%.

OER is a bizarre concept reflecting how much homeowners would have to pay themselves in rent if they were their own landlords. The good news is that median existing home prices, which tend to lead the OER inflation rate, have been falling (*Fig. 15*).

**US Fiscal Policy I: Inflation Redux Act.** President Joe Biden's *Inflation Reduction Act of 2022* (the Act) is better described as the "wannabe Build Back Better (BBB)" act. It won't substantially reduce inflation as an August 15 White House *briefing* claimed. But it may be a "breakthrough" on climate policy, as the nonprofit Wilderness Society has *proclaimed*.

The Act is a scaled-back version of part of the climate-focused BBB agenda proposed by Biden early in his administration—although supporter Democratic Senator Joe Manchin (WV) might not agree. Manchin staunchly *opposed* the BBB, finding it to be too spending-heavy and potentially inflationary, and he recently *called* the BBB "dead," apparently to bury his former reactions and to disassociate the two acts.

To appease Manchin, the Act includes plenty of new "pay-fors" that offset its incremental spending on climate. However, the "inflation reduction" branding seems more like an

attempt to justify special interest funding (backed by elite lobbyists, including *Bill Gates*), even though the Act really has little to do with inflation.

Let's have a quick look at the Act by the numbers from a big-picture perspective, then outline some of the major provisions and how they could impact inflation:

(1) *Big picture: Major components.* In a *one-pager* summarizing the Act's major components, the Senate conveniently did not outline the spending timing. The summary does show that an incremental $400+ billion would be offset by $700+ billion in additional revenues from increased taxes and drug price reform. But any offsetting effects won't be seen until well into the 10-year budget window ending in 2031. Not until 2027 does the Act result in net reductions to the deficit, a Penn Wharton Budget Model (PWBM) *analysis* showed. Before that, the Act adds to the deficit, meaning that it could be inflationary over the near term!

(2) *Inflation impact: Statistically zero.* Even after the full effects of the Act are seen a decade from now, PWBM concluded that any impact on inflation is "not statistically different from zero."

Similarly, Moody's *expects* that the Act "will modestly reduce inflation over the 10-year budget horizon," giving the economy a "nudge" in the right direction. By Q4-2031, the CPI will be just 0.33% lower because of the legislation, Moody's found.

Also, the Congressional Budget Office (CBO) has *estimated* that the Act will have a "negligible effect on inflation" in 2022. In years beyond, inflation could be somewhere between 0.1ppt lower and 0.1ppt higher than now as a result of the Act, the CBO said.

**US Fiscal Policy II: The Act's Provisions.** Let's go over some of the Inflation Reduction Act of 2022's major provisions and examine the potential for them actually to raise inflation, rather than lower it as misleadingly implied by the name of the Act:

(1) *Climate and energy provisions (-$385 billion addition to deficit).* This provision includes numerous investments in climate advancements, including tax credits for households to offset energy costs, investments in clean energy production, and tax credits for reducing carbon emissions. Putting aside the Act's climate benefits, are not such measures textbook-inflationary? Public investments require public workers and resources, and mandating the reduction of carbon emissions will increase production costs for manufacturers.

(2) *Prescription drug pricing reforms (+$229 billion budget reduction).* This provision permits Medicare to negotiate certain prescription drug prices to lower the price for beneficiaries. Sure, bringing down healthcare costs is helpful for family budgets. But the money that people would have spent on drugs will likely be spent elsewhere, so this provision won't be broadly disinflationary. It is also worth noting that prescription drugs have *low weights* in both the CPI and PCED, so even big changes in drug prices would impact overall inflation only marginally.

(3) *Minimum tax on corporations' book income (+$199 billion budget reduction).* A new tax rate of 15% will be applied to corporations with at least $1 billion in income. Individual and household tax rates will not be directly impacted. This component of the Act obviously "pays for" the climate provisions along with the drug reform. But affected corporations may well pass on their increased costs to the consumer by raising prices.

By the way, stock buybacks by corporations also will face a 1% excise tax.

(4) *IRS funding (+$146 billion).* The Internal Revenue Service will receive funding to substantially increase its employee base, largely focused on increasing audits to target tax evaders. Again, this provision directly will raise revenues and reduce the budget deficit, offsetting the climate investments. But the added costs to businesses (particularly smaller ones) from increased audits (and possibly higher tax bills) could limit their capacity expansion plans, constraining supply and thereby worsening inflation.

Other less significant provisions total +$73 billion.

(FYI: We don't ascribe much merit to the Joint Committee on Taxation's report indicating that the Act would increase taxes at nearly every income level given the opinion of several outside evaluators, including the Tax Policy Center, faulting the analysis for overlooking important components of the Act.)

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## Calendars

**US:** **Wed:** Durable Goods Orders Total, Core, and Core Nondefense Capital Goods Orders 0.5%/0.2%/0.3%; Pending Home Sales -3.8%; MBA Mortgage Applications. **Thurs:** GDP -0.8%; GDP Price Index & Core PCED Prices 8.7%/4.4%; Initial & Continuous Unemployment Claims 253k/1.442m; Kansas City Manufacturing Index; Natural Gas

Storage; Jackson Hole Symposium. (Bloomberg estimates)

**Global: Wed:** Nakamura. **Thurs:** Germany Ifo Business Climate Index, Current Assessment, and Business Expectations 86.8/96.0/79.0; Germany GDP 0.0%q/q/1.5%y/y; France Business Survey104; Japan CPI; ECB Publishes Account of Monetary Policy Meeting. (Bloomberg estimates).

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## Strategy Indicators

**S&P 500 Earnings, Revenues, Valuation & Margins** (*link*): The S&P 500's forward profit margin dropped 0.1ppt w/w to a 13-month low of 13.0% last week, down from its record high of 13.4% achieved intermittently from March to June. Since the end of April 2020, it has exceeded its prior record high of 12.4% in September 2018. It's now up 2.7ppts from 10.3% during April 2020, which was the lowest level since August 2013. Forward revenues rose 0.1% w/w to a new record high, but forward earnings was down 0.1% to 1.6% below its record high in mid-June. Both had been steadily making new highs from the beginning of March 2021 to mid-June; prior to that, they peaked just before Covid-19 in February 2020. Forward revenues growth remained steady w/w at a 22-month low of 6.1%. That's down from a record high of 9.6% growth at the end of May 2021. Still, that's up from 0.2% forward revenues growth during April 2020, which was the lowest reading since June 2009. Forward earnings growth was steady at a 24-month low of 7.5%. That's down from its 23.9% reading at the end of April 2021, which was its highest since June 2010 and up substantially from its record low of -5.6% at the end of April 2020. So far this year, analysts' revisions to their forecasts for 2022 revenues have outpaced their revisions for 2022 earnings, so the imputed 2022 profit margin estimate that we calculate from those forecasts has ticked down 0.4ppt to 12.8%. They expect revenues to rise 12.3% (up 0.3ppt w/w) in 2022 and 3.9% in 2023 (down 0.1ppt w/w) compared to the 16.4% gain reported in 2021. They expect earnings gains of 9.7% in 2022 (unchanged w/w) and 7.3% in 2023 (unchanged w/w) compared to an earnings gain of 51.0% in 2021. Analysts expect the profit margin to drop 0.3ppt y/y to 12.7% in 2022 (down 0.1ppt w/w) compared to 13.0% in 2021 and to improve 0.5ppt y/y to 13.2% in 2023 (unchanged w/w). The S&P 500's weekly reading of its forward P/E rose 0.2pt w/w to a 15-week high of 18.2, up from a 26-month low of 15.8 in late June. That's down from an eight-month high of 21.7 at the end of 2021 and compares to 23.1 in early September 2020, which was the highest level since July 2000 and up from a 77-month low of 14.0 in March 2020. The S&P 500 weekly price-to-sales ratio rose 0.03pt w/w to a 15-week high of 2.38, up from a 26-month low of 2.10 during June. That compares to a

record high of 2.88 at the end of 2021 and a 49-month low of 1.65 in March 2020.

**S&P 500 Sectors Earnings, Revenues, Valuation & Margins** (*link*): Last week saw consensus forward revenues and earnings rise for seven of the 11 S&P 500 sectors, but the forward profit margin fell for three sectors as none moved higher. Most of the sectors are below recent record highs in their forward revenues, earnings, and profit margins. Energy, Real Estate, and Utilities are the only sectors with forward earnings at a record high now. Consumer Staples, Financials, and Health Care are the only sectors with forward revenues at a record high this week. All sectors now have forward profit margins that are below their record highs, but those of Energy and Real Estate remain closest to their post-pandemic highs. Energy still has forward revenues well below a record high, and Utilities' forward revenues and margin are lagging too. Only three sectors have posted a higher profit margin y/y so far during 2020: Consumer Staples, Tech, and Utilities; during 2021, all of the sectors but Utilities posted a y/y improvement. Seven sectors are expected to see margins decline y/y for full-year 2022, followed by four sectors in 2023. Here are 2022's decliners: Communication Services, Consumer Discretionary, Consumer Staples, Financials, Health Care, Information Technology, and Real Estate. Here's how they rank based on their current forward profit margin forecasts along with their record highs: Information Technology (24.6%, down 0.1ppt w/w and from its 25.4% record high in early June), Financials (18.4, down from its 19.8 record high in August 2021), Real Estate (18.3, up 0.1ppt w/w and down from its 19.2 record high in 2016), Communication Services (15.3, down from its 17.0 record high in October), Utilities (13.9, down from its 14.8 record high in April 2021), Materials (12.9, down from its 13.6 record high in early June), S&P 500 (13.0, down 0.1ppt w/w and from its record high of 13.4 achieved intermittently from March to June), Health Care (10.6, down 0.2ppt w/w and from its 11.5 record high in early March), Industrials (10.3, down from its 10.5 record high in December 2019), Energy (12.2, down 0.1ppt from its 12.3 record high a week earlier), Consumer Discretionary (7.4, down from its 8.3 record high in 2018), and Consumer Staples (7.2, down from its 7.7 record high in June 2020).

**S&P 500 Sectors Net Earnings Revisions** (*link*): The S&P 500's NERI was negative for a second month in August as it weakened for the 11th time in 13 months. NERI tumbled to a 25-month low of -9.0% in August from -1.9% in July. It had been negative for 13 straight months through July 2020 due to the pandemic shutdown. The 23-month positive streak that ended in June had exceeded the prior 18-month positive streak during the cycle that ended October 2018, when NERI reached a tax-cut-induced, then-record high of 22.1% in March 2018. August's reading compares to a record-high 23.1% in July 2021 and an 11-year low of -37.4% in May 2020. Just two of the 11 S&P 500 sectors had positive NERI in August, down from five in July. Seven sectors had NERI readings at post-pandemic two-

year lows during the month as all 11 had NERI weaken m/m, down from one rising in July. Among the underperforming sectors, Communication Services was negative for a tenth month, Consumer Staples for a sixth, and Consumer Discretionary and Health Care for a fifth month. Here are the August NERIs for the S&P 500 and its sectors compared with their July readings: Energy (25.8% in August, down from 35.5% in July), Utilities (2.8, 4.3), Real Estate (-0.6 [16-month low], 4.6), Industrials (-7.9 [25-month low], 1.1), S&P 500 (-9.0 [25-month low], -1.9), Health Care (-9.3 [25-month low], -7.8), Financials (-9.4 [25-month low], -3.1), Information Technology (-9.9 [26-month low], -1.8), Consumer Staples (-11.5 [26-month low], -5.7), Consumer Discretionary (-16.4 [25-month low], -10.2), Materials (-17.4 [25-month low], 3.3), and Communication Services (-23.4 [26-month low], -17.8).

**S&P 500 Sectors Net Revenue Revisions** (*link*): The S&P 500's NRRI weakened for a fifth straight month in August and turned negative for the first time in 25 months. It has weakened m/m in nine of the past 12 months, and dropped markedly in August to a 25-month low of -5.1% from 1.7% in July. Before the just-ended 24-month positive streak, it had been negative for 21 straight months. That positive streak exceeded the prior 19-month streak during the cycle that ended October 2018, when NRRI reached a tax-cut-induced then-record high of 14.7% in March 2018. August's reading compares to a record-high 25.9% in August 2021 and an 11-year low of -35.8% in May 2020. Four of the 11 S&P 500 sectors had positive NRRI in August, down from six a month earlier and down from all 11 during July-October 2021. Financials and Utilities were the only sectors to have NRRI improve m/m. Six sectors had NRRI readings fall to post-pandemic lows during the month. Communication Services was negative for a tenth straight month, followed by Health Care at five months and Consumer Discretionary at four. Here are the August NRRIs for the S&P 500 and its sectors compared with their July readings: Energy (30.7% in August, down from 40.6% in July [11-month high]), Utilities (16.4, 16.2), Consumer Staples (11.6, 18.6 [9-month high]), Real Estate (10.0 [16-month low], 19.6), Materials (-2.2 [25-month low], 17.5), Financials (-3.4, -4.8 [24-month low]), S&P 500 (-5.1 [25-month low], 1.7), Industrials (-5.2 [25-month low], 4.8), Health Care (-8.8 [26-month low], -6.4), Information Technology (-11.6 [26-month low], -2.7), Consumer Discretionary (-14.6 [26-month low], -7.0), and Communication Services (-20.2 [26-month low], -19.4).

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## US Economic Indicators

**New Home Sales** (*link*): New home sales (counted at the signing of a contract) in July plunged to its lowest level since January 2016, contracting for the sixth time this year,

tumbling 12.6% in July and 39.1% ytd to 511,000 units (saar). Of the 511,000 homes sold in July, only 145,000 units were completed, while 165,000 units were not yet started and 201,000 units were under construction. Meanwhile, there were 464,000 units for sale at the end of July (the most since March 2008), with only 45,000 units completed and 107,000 units not started; 312,000 units were under construction. At the current sales pace, it would take 10.9 months to run through the supply of new homes—the highest since March 2009. “Tighter monetary policy from the Federal Reserve and persistently elevated construction costs have brought on a housing recession,” noted Robert Dietz, NAHB’s chief economist. He expects single-family starts to fall this year—which would be the first decline since 2011. NAHB’s homebuilder’s confidence dropped for the eighth time this year, by 6 points in August and 35 points ytd, to 49—the lowest level since May 2020 during the height of the pandemic.

**Regional M-PMIs** (*link*): Three Fed districts (New York, Philadelphia, and Richmond) have reported on manufacturing activity for August and show the manufacturing sector fell further into contractionary territory, sinking to -11.0 from -0.4 in July as manufacturing activity in both the New York (to -31.3 from 11.1) and Richmond (-8.0 from 0.0) areas returned to negative territory. Meanwhile, manufacturing activity in the Philadelphia (6.2 from -12.3) area moved from contraction to expansion. New orders (-18.2 from -9.5) have been in a freefall since climbing to 13.0 in April, with billings in New York (-29.6 from 6.2) factories posting the weakest month since the pandemic, while new orders in the Richmond (-20.0 from -10.0) region contracted at double July’s pace, while Philadelphia’s (-5.1 from -24.8) declined at a slower pace. Employment (14.2 from 15.1) slowed a bit but continued its strong readings, as factories in the Philadelphia (24.1 from 19.4) and Richmond (11.0 from 8.0) regions hired at a faster pace, while New York’s (7.4 from 18.0) rate continued to slow. Turning to prices-paid indexes, the New York region’s eased further from April’s record-high 86.4, falling to a 19-month low of 55.5 this month, while Philadelphia’s slowed from a cyclical high of 84.6 in April (which wasn’t far from its record high of 91.1 in the 1970s) to a 20-month low of 43.6 in August. Richmond’s (124.7 from 124.9) was virtually unchanged, down from its record high of 150.1 in May. As for prices-received indexes, New York’s (32.7) was little changed from July’s 16-month low of 31.3, down from its record high of 56.1 in March, while the Philadelphia measure slowed to an 18-month low of 23.3 from November’s 62.9 peak. Richmond’s (93.1 from 89.2) accelerated a bit, though remained below its record high of 103.1 in June. (Note: The New York and Philadelphia measures are diffusion indexes, while Richmond’s measures are average annualized inflation rates—which we multiply by 10 for easier comparison to the other regional measures.)

## Global Economic Indicators

**US PMI Flash Estimates** (*link*): Business activity in the private sector during August was the weakest since May 2020, according to flash estimates, sinking for the fifth successive month. The C-PMI plunged from 57.7 in March to 45.0 this month, with output contracting at the nearly the fastest pace since the series began 13 years ago (excluding only the pandemic-impacted period between March and May 2020). The report notes the reduction in output was broad-based, with both manufacturers and service providers registering lower activity—though the service sector saw a sharp drop in output, while goods producers saw only a modest setback. The NM-PMI fell from 58.0 in March to a 27-month low of 44.1 this month, while the M-PMI eased from 58.8 to a 25-month low of 51.2 over the period, remaining in expansionary territory. Optimism among manufacturers improved, reflecting hopes of stable supply chains and increased customer demand. Meanwhile, on the inflation front, things are looking better, with input and output prices rising at the slowest rates in a year and a half on reports that some key component costs have fallen.

**Eurozone PMI Flash Estimates** (*link*): Manufacturing activity in the Eurozone contracted again in August, according to flash estimates, the first readings in contractionary territory since the Covid-19 lockdowns of early 2021. The Eurozone C-PMI eased for the fourth month from 55.8 in April to 49.2 this month, as the M-PMI plummeted from 58.7 in January to a 26-month low of 49.7 and the NM-PMI dropped from 57.7 in April to a 17-month low of 50.2—showing the service sector to be at a near-standstill. The recent weakness in the Eurozone was mainly centered in Germany and France, with output increasing outside of the Big Two though only marginally. Germany's C-PMI contracted for the second month, falling to a 26-month low of 47.6 from 55.6 in February, with the NM-PMI sliding to an 18-month low of 48.2 and the M-PMI increasing to a two-month high of 49.8, after contracting in July for the first time since mid-2020. Meanwhile, France's C-PMI fell below 50.0—the breakeven point between expansion and contraction—for the first time since March 2021, dropping from a recent high of 57.6 in April to 49.8 this month. The M-PMI remained just below 50.0 for the second month, at a 27-month low of 49.0 in August, down from 57.2 in February, while the NM-PMI slowed for the fourth month, from 58.9 in April to 51.0 this month. The overall Eurozone saw a slight lift in confidence for the year ahead, though sentiment was the second lowest since the initial wave of the Covid-19 pandemic.

**Japan PMI Flash Estimates** (*link*): Activity in Japan's private sector contracted for the first time in six months, according to flash estimates, with both manufacturing and service companies posting output declines this month—the former declining at its fastest pace in 11

months. August's C-PMI dropped for the second month to 48.9 this month; it had climbed from 45.8 in February to 53.0 in June. The NM-PMI dropped from 54.0 in June to 49.2 this month, while the M-PMI eased to a 19-month low of 51.0 in August—though the manufacturing output index slid to 48.3, its second reading in negative territory. Business confidence eased for the fifth month in August amid growing economic headwinds, "as businesses are concerned about the impact of the Ukraine was, inflationary pressures due to rising raw material and energy costs, and a global economic slowdown," according to the report.

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