MORNING BRIEFING
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More Inflation (News) Is Coming

Check out the accompanying chart collection.

Executive Summary: The financial markets have been laser focused on inflation news this year, and are bracing for the next couple of days' releases. Thursday's CPI report for September is bound to move the markets, and tomorrow should bring a sneak peek of what it holds in store via the PPI release, specifically its personal consumption expenditures index. … Today, we examine the inflation information available to date in preparation for the big releases. … Notably, global supply-chain pressures eased in September, and the prices-paid indexes in both manufacturing and nonmanufacturing PMIs are way down from their peaks.

US Inflation I: Moving Markets & Fed Policy. The stock market's performance this year has been mostly driven by the CPI inflation news releases and perceptions of how the Fed will respond to the news. Almost all the releases caused the S&P 500 to drop so far this year (*Fig. 1*). Here's a quick recap of events:

(1) The CPI releases for June (on July 13) and July (on August 10) didn't interfere with the rally from June 16 to August 16, which turned out to be a bear-market rally on the hope (we shared) that the sharp drop in gasoline prices during July and August might lead to a moderation of inflation broadly (*Fig. 2*). That hope was dashed when August's CPI was released on September 13. It suggested that inflation might be broadening notwithstanding the drop in gasoline prices and declines in some durable goods prices.

(2) Fed Chair Jerome Powell announced his latest pivot toward a more hawkish stance on August 26, after July's CPI release and before August's. Powell morphed into a "Volcker 2.0" hawk, seeming to channel his 1970s era predecessor Paul Volcker.

(3) The September 13 CPI release came out during the Fed's blackout period prior to the September 20-21 meeting of the FOMC. As soon as the blackout period ended on September 22, a chorus of Fed officials started chanting the Fed's new party line: Inflation is too high, and interest rates must be raised until it shows clear signs of subsiding toward 2.0%. They've all joined Powell's Volcker 2.0 campaign without any dissenters so far.

(4) In the past, the Fed's preferred inflation measure was the core PCED. But now, the

headline PCED rate is more important to the Fed since food and energy prices have been rising rapidly and Fed officials recognize that we all need food and fuel. Their prices can have a significant impact on inflationary expectations, consumer confidence, and actual purchasing power. However, the financial markets seem to be giving more attention to the CPI because it is released before the PCED inflation rate.

US Inflation II: The PPI Measure of Consumer Prices. September's CPI is coming. It will be released on Thursday. The day before, on Wednesday, September's PPI will be released. Here are the consensus forecasts that the markets are anticipating for each:

(1) The headline and core PPIs are expected to be up 0.2% and 0.3% m/m, and 8.4% and 7.3% y/y. (On a y/y basis, they peaked at 11.7% and 9.7% during March.)

(2) The headline and core CPIs are expected to be up 0.2% and 0.5% m/m, and 8.1% and 6.5% y/y. (On a y/y basis, they peaked at 9.1% during June and 6.5% during March.)

The PPI includes an index for personal consumption expenditures (PPI-PCE). Its y/y inflation rate closely tracked both the CPI and PCED inflation rates prior to 2021 (*Fig. 3*). The same can be said about the core inflation rates of all three (*Fig. 4*). The headline measures of all three peaked during March and continued to decline in August. The core rates of the CPI and PCED moved higher in August, but the core PPI for personal consumption continued to fall sharply.

We will be watching September's PPI-PCE as an indicator of the CPI and PCED. The big difference between the PPI-PCE and the CPI and PCED is that the former does not include rent, which pushed August's CPI inflation rate for services above that for the services component of the other two measures (*Fig. 5*). (As discussed below, rent has a much bigger weight in the CPI than in the PCED.)

US Inflation III: The CPI for Better or Worse. Thursday's CPI release is likely to move the markets, as the previous releases this year did. This time, it will come out well before the FOMC's blackout period from October 22 to November 3. So the "Federal Open Mouth Committee" will have plenty of time to opine about the latest CPI before the FOMC's next meeting on November 1-2. The release is coming out at the beginning of the Q3 earnings reporting season. It might even have some influence on the mid-term congressional elections on November 8.

What do we know so far? Consider the following:

(1) *Food and fuel.* The S&P Goldman Sachs Commodity Index peaked during the summer and continued to fall through September (*Fig. 6*). The same can be said for both the index's agricultural & livestock and energy sub-indexes (*Fig. 7*). The four-week average of the national pump price of gasoline was $3.82 per gallon at the end of September, down 5.2% from the end of August (*Fig. 8*). These developments confirm that September's headline CPI should increase by less than the core CPI.

(2) *Consumer durable goods.* Both the CPI and PCED durable goods inflation rates peaked during February at 18.7% and 10.6% respectively (*Fig. 9*). They were down to 7.8% and 5.3% in August. We know that the Manheim Index of wholesale used car prices has plunged from 46.6% y/y at the end of last year to -0.1% during September (*Fig. 10*). Meanwhile, the three-month annualized inflation rates for these four durable goods were below their y/y rates as follow: new cars (8.1%, 10.9%), used cars & trucks (4.4, 7.8), furniture & bedding (10.1, 12.8), major household appliances (-14.2, 2.2) (*Fig. 11*).

(3) *Services excluding rent & medical.* A similar analysis shows that the three-month annualized inflation rates were below the y/y rate for the following services: lodging away from home (-21.6%, 4.1%), airfares (-54.8, 33.4), car & truck rental (-47.6, -6.2) (*Fig. 12*).

(4) *Medical services.* Inflation in the medical services component of the CPI tends to exceed that of the PCED (*Fig. 13*). That's because hospital fees and health insurance are inflated in the CPI by the out-of-pocket expenses of urban consumers. They don't reflect that some of these expenses are subsidized or capped by the government (for hospital stays) and employers (for health insurance premiums). The PCED does so. The CPI medical services inflation rate was boosted by a 24.3% y/y increase in health insurance in the CPI through August versus a 1.3% increase for this item in the PCED.

(5) *Rent.* The 800-pound gorilla in the CPI inflation rate is rent. Rent has a bigger weight in the core CPI than in the core PCED. The weights for rent of primary residence and owners' equivalent rent are 9.3% and 30.5% in the core CPI. They are 4.0% and 12.6% in the core PCED.

Here are August's three-month annualized and y/y inflation rates for the CPI's rent of primary residence (8.9%, 6.7%) and owners' equivalent rent (8.2, 6.3) (*Fig. 14*). Unfortunately, rent inflation isn't likely to cool off for a while because it is based on the rent levels reflected in all existing leases rather than just in newly signed ones. Rents in new leases rose sharply over the past year, but are showing signs of peaking in recent months, according to Zillow (*Fig. 15*). Indeed, Zillow's rent index peaked at 17.2% during February and fell to 12.3% in August. That's still high, but it is heading down quickly.

(6) *The pipelines.* In our opinion, inflation is moderating in the inflation pipeline while the Fed is tightening based on the gush of price increases currently coming out of that pipeline. The Fed could overdo it, as Fed Chair Jerome Powell acknowledged at his July 27 press conference; he said that the interest-rate hikes have been large and quick, so "it's likely that their full effect has not been felt by the economy. So there's probably some additional tightening, significant additional tightening, in the pipeline." He said that before he morphed into the Volcker 2.0 super-hero on August 26 at Jackson Hole, as we discussed in yesterday's *Morning Briefing*.

US Inflation IV: Less Inflation in Supply Chains. The Federal Reserve Bank of New York compiles a monthly *Global Supply Chain Pressure Index* (GSCPI) (*Fig. 16*). Global supply-chain pressures decreased in September, marking a fifth consecutive month of easing. The September decline was quite broad based. The GSCPI's ytd movements suggest that global supply-chain pressures are beginning to fall back in line with historical levels. Here is a description of what is reflected in the index:

"The GSCPI integrates a number of commonly used metrics with the aim of providing a comprehensive summary of potential supply chain disruptions. Global transportation costs are measured by employing data from the Baltic Dry Index (BDI) and the Harpex index, as well as airfreight cost indices from the U.S. Bureau of Labor Statistics. The GSCPI also uses several supply chain-related components from Purchasing Managers' Index (PMI) surveys, focusing on manufacturing firms across seven interconnected economies: China, the euro area, Japan, South Korea, Taiwan, the United Kingdom, and the United States."

US Inflation V: Now & Then. The prices-paid index in the M-PMI survey peaked at a near record high of 92.1 during June 2021 (*Fig. 17*). It plunged to 51.7 in September, the lowest reading since June 2020. The prices-paid index in the NM-PMI survey isn't down as dramatically so far. It peaked at a record 84.6 during April and fell to 68.7 during September.

It's interesting to compare the performance of the M-PMI now and during the Great Inflation of the 1970s (which started in 1965 with President Johnson's guns-and-butter policies). The data are available since 1948 and show that this index always fell well below 50.0 during recessions (*Fig. 18*). But it also did so during the mid-cycle slowdowns in the mid-1980s, mid-1990s, and mid-2010s. During the Great Inflation, the M-PMI's prices-paid index stayed stubbornly high except during the two recessions of that period (*Fig. 19*).

Calendars

US: Tues: NFIB Small Business Optimism Index 91.2; Consumer Inflation Expectations; IMF Meetings; Mester; Harker. **Wed:** Headline & Core PPI 0.2%m/m/8.4%y/y/0.3%m/m/7.3%y/y; MBA Mortgage Applications; API Weekly Crude Oil Stock; FOMC Meeting Minutes; OPEC Monthly Report; EIA Short-Term Energy Outlook; WASDE Report; IMF Meetings; Barr; Bowman. (Bloomberg estimates)

Global: Tues: Italy Industrial Production 0.2%m/m/-0.4%y/y; UK Average Earnings Index Including & Excluding Bonus 5.9%5.3%; UK Employment Change 3M/3M -127k; UK Claimant Count Change 4.2k UK Unemployment Rate 3.6%; UK RICS House Price Balance; Japan Core Machinery Orders -2.3%m/m/12.6%y/y; Balz; Lane; Enria; Wuermeling; Cunliffe; Bailey. **Wed:** Eurozone Industrial Production 0.6%m/m/1.2%y/y; UK GDP 0.0%m/m/; UK Headline & Manufacturing Industrial Production -0.2%m/m/0.6%y/y & 0.2%m/m/0.8%y/y; UK Trade Balance – 20.4b; NIESR Monthly GDP Tracker; Japan PPI 0.2%m/m/8.8%y/y; BOE FPC Meeting Minutes; Lagarde; Mann; Pill; Haskel. (Bloomberg estimates)

Strategy Indicators

S&P 500/400/600 Forward Earnings (*link*): Forward earnings fell for all three of these indexes last week in their first simultaneous decline since mid-July. LargeCap's forward earnings has fallen in eight of the 15 weeks since it peaked at a record high in late June. Over the same 15-week time period, MidCap's has dropped nine times and SmallCap's moved lower eight times. For a 15th straight week, none of these three indexes had forward earnings at a record high. However, forward earnings remains close to their record highs. LargeCap's is now 1.3% below its record high at the end of June. MidCap's is 2.4% below its record high in early June, and SmallCap's is 2.0% below its record high in mid-June. However, forward earnings momentum continues to weaken. In the latest week, the yearly rate of change in LargeCap's forward earnings was down to an 18-month low of 9.7% y/y from 10.3%; 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 eased w/w to an 18-month low of 18.3% y/y from 20.0%. 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 was down w/w to a 19-month low of 15.3% y/y from 16.0%. That's down from a record high of 124.2% in June 2021. It had been at 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 2022 to 2023 to improve instead of decline as is typical, but their forecasts are heading lower now for both years. Here are the latest consensus earnings growth rates for 2022 and 2023: LargeCap (7.3%, 7.9%), MidCap (14.6, 1.4), and SmallCap (11.3, 8.1).

S&P 500/400/600 Valuation (*link*): Valuations rose across the board in the latest week after falling in six of the prior seven weeks. LargeCap's forward P/E rose 0.3pt to 15.4 from a 30-month low of 15.1, which compares to a 16-week high of 18.1 in early August and an 11-year low of 11.1 during March 2020. MidCap's forward P/E was up 0.5pt w/w to 11.6 from a 30-month low of 11.1, which compares to a 16-week high of 13.2 in early August, a record high of 22.9 in June 2020, and an 11-year low of 10.7 in March 2020. SmallCap's forward P/E picked up 0.3pt w/w last week to 10.9 from a 14-year low of 10.6. That's down from a 16-week high of 12.8 in early August and compares to a record low of 10.2 in November 2009 during the Great Financial Crisis. That also compares to 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 25% discount to LargeCap is near its biggest since September 2000. SmallCap's P/E was below LargeCap's for a 112th 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 69th straight week; the current 5% 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, and the declines have accelerated for Q3-2022. In the latest week, the Q3-2022 S&P 500 earnings-per-share forecast dropped 15 cents w/w to $55.43, and is now 6.8% below its $59.49 forecast at the start of the quarter. That's the biggest decline since Q2-2020. Analysts expect S&P 500 earnings growth to weaken to 2.9% y/y on a frozen actual basis and 4.1% on a pro forma basis. That's down from Q2-2022's blended actual/estimate of an 9.9% y/y gain on a frozen actual basis and 8.4% y/y on a pro forma basis. Double- and triple-digit percentage growth is expected for just four sectors in Q3-2022, and y/y declines are expected for seven. That compares to Q2-2022's count of four sectors with triple- and double-digit growth, three with a single-digit gain, and four with a y/y decline. Here are the S&P 500 sectors' latest earnings growth rates for Q3-2022 versus their blended Q2-2022 growth rates: Energy (121.0% in Q3-2022 versus 295.5% in Q2-2022), Industrials (26.3, 31.6), Consumer Discretionary (13.5, -12.1), Real Estate (11.0, 13.1), S&P 500 (4.1, 8.4), Materials (-2.1, 17.5), Consumer Staples (-2.4, 2.2), Information Technology (-3.5, 1.5), Health Care (-4.2, 8.7), Utilities (-7.4, -3.7), Financials (-10.5, -19.3), and Communication Services (-16.1, -20.3).

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