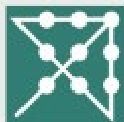
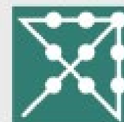
 Yardeni Research 

MORNING BRIEFING
October 26, 2022

ECB On Thursday, Inflation On Friday

Check out the accompanying chart collection.

Executive Summary: ECB hawks will be squawking at their meeting on Thursday. Fed hawks will be all over the critical US inflation data that comes out on Friday: The Employment Cost Index may suggest a peaking of wage inflation, and September's PCED may reflect a declining headline rate (albeit rising core rate, as did September's CPI, due to services inflation). Today, we examine the significance of each. … Also: We drill down to inflation within services industries, where the worst of it now roosts. … And: Once again, the ECB is on a mission and vowing to "do whatever it takes" to achieve it. This time, the goal is smothering Europe's inflation fire even if GDP is dampened in the process.

Inflation I: Getting Ahead of It. The ECB meets on Thursday and is expected to raise the central bank's official interest rate again by 75bps. The Fed meets November 1-2 and is expected to do the same.

The FOMC is likely to provide some guidance for the December 13-14 meeting of the FOMC following the November meeting. Two important economic indicators that may influence that guidance will come out on Friday.

Q3's Employment Cost Index (ECI) is likely to signal a peak in wage inflation, though not a convincing one. A surprise is more likely to be on the upside than the downside given the strength of the labor market. September's PCED will be released along with personal income. Like for the month's CPI, the PCED headline inflation rate should be down, while the core is up, but less so partly because rent has a lower weight in the PCED than in the CPI. Let's get ahead of these numbers:

(1) *ECI.* The Fed pays close attention to the ECI because it shows the underlying trend of inflation in the labor market. Labor costs tend to be marked up into selling prices. The ECI for private industry includes wages, salaries, and benefits (*Fig. 1*). It was up 5.5% y/y during Q2, the highest reading since Q2-1984. It is a less volatile measure of the underlying trend in compensation costs than is the broader but more volatile hourly compensation measure that comes out on a quarterly basis along with nonfarm business productivity.

The ECI's wages and salaries component was up 5.7% y/y during Q2. It tends to closely

track the monthly series for the average hourly earnings (AHE) of all private-sector workers, also on a y/y basis. The latter might have peaked this year at 5.6% during March; it was down to 5.0% during September.

The ECI for benefits rose 5.3% y/y during Q2, the highest since Q1-2005. It's hard to tell whether this ECI component has peaked.

Debbie and I will also focus on the performance of Q3's ECI in goods-producing versus service-providing industries (*Fig. 2*). During Q2, the former rose 4.7%, while the latter increased 5.8%. The current concern among Fed officials and investors is that while goods inflation is showing signs of peaking and moderating, inflation seems to be spreading in services. A related concern is that labor costs are more likely to be passed through to selling prices in services than in goods.

In addition to the possible (maybe?) peak in the AHE measure of wage inflation, the Atlanta Fed medium wage growth tracker might have peaked during June at 7.4% (*Fig. 3*). It was down to 6.5% during September. Another possible sign of a peak in the ECI wages and salaries inflation rate is the apparent peak in the quits rate, which tends lead the ECI inflation rate by nine months (*Fig. 4*).

(2) *PCED.* The Fed also pays close attention to the PCED. It is one of the five macroeconomic variables that the FOMC forecasts in its quarterly *Summary of Economic Projections*. During September, the committee projected that the headline PCED inflation rate will be 5.4% this year, 2.8% next year, and 2.3% in 2024. We say: "Good luck with that!" Nevertheless, our forecast is also relatively optimistic, with this rate likely to fall to 4%-5% during H2-2022 and 3%-4% in 2023 and in 2024 (*Fig. 5*).

The headline PCED inflation rate was 6.2% during August. It might have peaked this year during June at 7.0%. The core PCED inflation rate was 4.9% during August. It might have peaked at 5.4% during February and March. The headline and core CPI inflation rates were significantly higher in September at 8.2% and 6.6% (*Fig. 6*). Friday's core PCED inflation rate during September is expected to be up 0.5% m/m and 5.2% y/y.

(3) *PCED vs CPI.* As we've previous discussed, the core CPI inflation rate tends consistently to exceed the core PCED inflation rate (*Fig. 7*). The food and energy components tend to be identical.

Over the past 12 months through August, the durable goods components of the CPI and

PCED are up 7.8% y/y and 5.3% (*Fig. 8*). No one item stands out as a consistent source of the divergence. The CPI tends to be a fixed basket of goods and services and may not reflect substitution into discounted goods as well as the PCED does.

The CPI reflects the out-of-pocket expenses of urban consumers for medical care services, while the PCED also reflects government-subsidized prices for hospital stays and physician services. The same can be said about health care insurance that's subsidized by employers. So over the past 12 months through August, here are the CPI and PCED inflation rates for medical care services (5.6%, 2.5%), hospitals (4.1, 3.0), physician services (1.1, 0.4), and health care insurance (24.2, 1.3) (*Fig. 9*). Here are September's CPI inflation rates for medical care services (6.5), hospitals (3.9), physician services (1.8), and health insurance (28.2). Odds are that the comparable PCED components will be up less, especially the one for health insurance.

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. During September, rent inflation in the CPI was 7.2% for tenants and 6.7% for owners (*Fig. 10* and *Fig. 11*). They tend to be identical to their comparable PCED components but have higher weights.

Inflation II: A Closer Look at CPI Services. Last year, Fed officials believed that the rebound in inflation was transitory. That was because it was mostly attributed to the temporary impact of the pandemic on goods prices. It depressed them at first, but then boosted them. So Fed officials blamed rising inflation on the so-called "base effect." They also believed that supply-chain disruptions were mostly attributable to the pandemic and therefore would abate, also bringing down inflation, particularly for goods.

This year, they've concluded that inflation is more persistent and more pernicious than they had thought because it has spread from goods (where it is moderating) to services (where it is accelerating). Within services, they've observed that inflation has spread beyond rent to service industries where it might be harder to subdue. Let's drill down:

(1) Services less energy accounts for 56.8% of the headline CPI. Most of that is attributable to shelter, which accounts for 32.4% of the headline CPI. Here are the weights of the five other major components of CPI services and their y/y inflation rates during September: medical care services (6.9 weight, 6.5 inflation), transportation services (5.9, 14.6), recreation services (3.1, 4.1), education & communication services (5.3, 1.4), and other personal services (1.4, 5.9) (*Fig. 12*).

(2) Fed officials and investors were freaked out when the core CPI inflation rate jumped to 6.6% y/y during September, the highest reading since August 1982. That was mostly attributable to big m/m and y/y increases in components with small weights in the index: health insurance (0.9 weight, 2.1 m/m, 28.2 y/y), car & truck rental (0.1, 2.5, -1.4), motor vehicle maintenance (1.1, 1.9, 11.1), motor vehicle insurance (2.4, 1.6, 10.3), airline fares (0.6, 0.8, 42.9), pet services including veterinary (0.5, 1.6. 11.0), day care & preschool (0.6, 2.0, 5.1), and delivery services (0.01, 2.9, 16.4) (*Fig. 13* and *Fig. 14*).

European Central Bank: 'Whatever It Takes,' Part *Deux*. Ahead of their next meeting on October 27, the 25-member Governing Council of the ECB is getting set to fight inflation. They are expected to frontload their monetary tightening aggressively without a pause. Council members also are warning fiscal policymakers not to fight them with too much fiscal stimulus. The ECB is expected to begin shrinking its balance sheet sometime in 2023.

For now, the ECB's central bankers are turning a blind eye to slowing growth in the Eurozone. Echoing the infamous words of former ECB President Mario Draghi, ECB Vice President Luis de Guindos *said* in October that the bank "will do whatever it takes" to bring down inflation (Draghi, however, used the phrase in talking about supporting the euro). De Guindos recently called reducing inflation "the main contribution we can have to improve the economic situation," *according* to Bloomberg.

That's even though ECB Bank President Christine Lagarde is *forecasting* a technical recession for the Eurozone this winter, when Europe's energy crisis could worsen. But she has reiterated the bank's commitment to lowering inflation with interest-rate hikes nonetheless.

For the first time in 11 years, ECB bankers raised their key interest rate this year—by 50 basis points on July 21 and 75bps on September 8 to 0.75% (*Fig. 15*). The financial markets see this deposit rate continuing to rise without a pause, to about 2.00% by year-end and about 3.00% by next spring. Eurozone inflation, however, is still well above the ECB's 2% target, now approaching 10% (*Fig. 16*). In addition, the bankers are discussing reducing the ECB's €5 trillion of securities held for monetary purposes," built up during the pandemic-led recession, but not until interest rates rise further (*Fig. 17*).

While Fed officials often signal their future moves in interviews and speeches, that's less common across the pond. But ECB policymakers are prepared to be "more readable" to the markets, Austria's central bank chief recently said, *according* to CNBC. Here are some indications of their hawkishness revealed in lots of recent public comments:

(1) *Inflation takes priority over growth.* "Those who thought inflation was dead now know better," said Joachim Nagel, the head of Germany's Bundesbank central bank. "Now the beast has woken up from its slumber ... it's up to monetary policymakers to tame it again," he recently *told* students at Harvard University. "The data unequivocally points to a robust rate move," he *said* in October according to Reuters.

Similarly, Irish central bank chief Gabriel Makhlouf said this month that the bank wishes to avoid "expectations of higher inflation" becoming embedded, *according* to Bloomberg.

In January, Croatian national bank governor Boris Vujcic will become the 26th member of the ECB's Governing Council when his nation adopts the euro. Last month, he likened double-digit inflation to a disease: "As we learned in Croatia over the last decades, when inflation is high, when it nears double-digit levels, it can become a disease in itself," Vujcic said according to a September 26 Bloomberg *article*. He added: "Paying much attention to lower growth now, at the expense of fighting inflation, is often luring. But letting inflation become entrenched always has a higher cost than a temporary decline in GDP."

(2) *No gradualism anticipated here.* "Until early this year, I was in favour of gradualism but for now, there is a stronger case for frontloading and determined action," Finnish central bank chief Olli Rehn *told* Reuters at the end of September. Rehn also told Reuters that ECB rates could reach a level that no longer stimulates the economy before Christmas. "There is a case for taking a decision on another significant rate hike, be it 75 or 50 basis points or something else," he said.

Latvian central bank chief Martins Kazaks *told* Reuters on October 13 that the ECB should lift its 0.75% deposit rate by 75 basis points at the October meeting and make another large hike in December. Bloomberg *wrote* on October 16: "Belgian central bank Governor Pierre Wunsch said last week that a deposit rate of 3% … isn't unreasonable, given the outlook for consumer-price growth that's already five times the 2% target."

(3) *No pause after neutral.* Officials recently voiced similar views on how far they'll go with rate hikes after reaching a neutral rate. "We won't stop at the neutral rate, we need to keep powering through," Peter Kazimir, Slovakia's central bank chief, *told* Reuters. "I'm of the opinion that we will have to go above the neutral level in order to calm inflation pressures, which are currently in the pipeline," Bostjan Vasle, Slovenia's central bank governor said.

"I do not expect policy rate hikes to come to an abrupt end," Dutch central bank chief Klaas Knot *said* this month. However, he added: "The farther we hike and the closer we get to

restoring a credible prospect of inflation moving back to target, the smaller rate steps will likely become."

"Given the current trend, I don't see any need to pause after [removing accommodation]," Latvia's Kazaks also *said* in October, according to Reuters. "The pace could slow down somewhat, and I would say that we start to use a wider set of instruments."

(4) *Fiscal policy excesses will not be accommodated.* Lagarde *told* members of the European Parliament during a recent hearing in Brussels that the ECB would not use its tools to help countries that apply untargeted fiscal stimulus that would further fuel inflation, opposing the ECB's efforts to contain it.

The ECB's Transmission Protection Instrument recently was announced as a mechanism to buy the bonds of fragile Eurozone countries while not adding to the ECB's overall bond portfolio. "It's (used in) a situation where ... there are disorderly market dynamics that are not justified by fundamentals or by economic policy errors that will have been made," Lagarde said.

France's central bank governor Francois Villeroy de Galhau *said* in October that Europe's energy subsidies could reduce the current rate of inflation but also could lead to higher readings and complicate the task of monetary policy. "Fiscal policy must not add to inflationary pressures and that's a fine line to walk," Latvia's Kazaks has added to the discussion, *according* to Reuters.

(5) *Rates to go up before balance sheet comes down.* "[W]e should have an orderly use of our palette of instruments: first, interest rate hikes," France's de Galhau *said* in an October speech at Columbia University. "Once we will have reached neutral territory with our policy rate, it makes sense to consider the roll-off of asset purchases by limiting reinvestments," the Netherlands' Knot said on October 15, *reported* Reuters.

"A tentative conclusion about the impact of balance sheet actions on financial conditions in a normalisation phase is that the signalling channel will be weaker for a given adjustment to the size and composition of our balance sheet," the ECB's Philip Lane said on October 12, *according* to Reuters. Translation: The ECB's primary approach to combating inflation will be to raise interest rates before reducing the balance sheet.

Lagarde also recently *said* that the bank would be reviewing the terms of extending its long-term bank lending operations "in due course." Some say that more restrictive policies could

be applied to this lending, perhaps with shrinking the balance sheet in mind.

Whether recession descends on Europe or not, one thing is clear: The ECB is planning to fly with the hawks.

Calendars

US: Wed: New Home Sales 585k; MBA Mortgage Applications; Goods Trade Balance Advance; Retail & Wholesale Inventories; Crude Oil Inventories & Gasoline Production. **Thurs:** Real GDP & Price Index 2.4%/5.3%; Core PCED 4.5%; Durable Goods Orders Total & Nondefense Capital Goods Orders Ex Aircraft 0.6%/0.5%; Kansas City Manufacturing Index; Initial & Continuous Jobless Claims 220k/1.388k; Natural Gas Storage. (Bloomberg estimates)

Global: Wed: France Consumer Confidence 77; Japan Leading & Coincident Indicators; China Industrial Profits; BOC Interest Rate Decision 4.00%; BOJ Outlook Report. **Thurs:** Germany Gfk Consumer Climate Index -41.9; Italy Business & Consumer Confidence100.0/93.8; Spain Unemployment Rate 13.0%; Japan Unemployment Rate & Japan Job Applications Ratio 2.5%/1.33; Australia PPI; ECB Interest Rate Decision 2.00% & Deposit Facility Rate 1.50%; BOJ Interest Rate Decision -0.10%; Lagarde. (Bloomberg estimates)

Strategy Indicators

S&P 500 Growth vs Value (*link*): The S&P 500 Growth price index was still in a deep 28.7% bear market as of Monday's close, while the Value index was only in a 13.4% correction. Growth made a new low for the year on October 12 while Value remained above its September 30 bottom. At that October 12 low, Growth was down 20.1% from its recent high on August 15 to 32.8% below its December 27 record high. Value was down a lesser 14.6% on September 30 from its August 16 high to 19.2% below its January 12 record high. Looking at their ytd performance through Monday's close, Growth has tumbled 27.7% ytd, well behind the 12.1% decline for the S&P 500 Value index. Growth's underperformance relative to Value began on November 30, 2021 when its price index peaked at a record high. Since then, Value's price index has dropped 6.1%, while Growth's is down 26.0%. Looking at the fundamentals, Growth is expected to deliver higher revenue growth (STRG)

than Value over the next 12 months, but Value is expected to have higher earnings growth (STEG). Growth has forecasted STRG of 7.3%, but its STEG is barely higher at 7.6%. Value has forecasted STRG and STEG of 4.2% and 6.4%, respectively. Growth's forward P/E peaked at a 20-year high of 30.4 on January 26, 2021, and tumbled 40% to a 27-month low of 18.4 on June 16. After rebounding to 23.3 in mid-August, it tested the June low with its 18.5 reading on October 12. It was back up to 19.7 on Monday. Value's forward P/E fell 24% from 17.6 in January 2021 to 13.4 on June 16. It made a new 30-month low of 13.0 on September 30, and has since risen to 14.0 as of Monday's close. Regarding NERI, Growth's and Value's were negative for a third straight month in September following 26 positive monthly readings. Growth's dropped to a 27-month low of -9.9% in September from -8.4% in August, and Value's was down to a 26-month low of -9.1% from -8.6%. Growth's forward profit margin of 18.0% is down 1.1ppts from its record high of 19.1% in mid-February and compares to its prior pre-Covid record high of 16.7% during September 2018. Value's has held up better, dropping to 0.5ppt to 10.9% from its record high of 11.4% in December.

S&P 500 Q3 Earnings Season Monitor (*link*): The Q3-2022 earnings season is off to the poorest start of a quarterly reporting season since Q1-2020, assessed by the four surprise metrics we measure for both earnings and revenues. With nearly 26% of S&P 500 companies finished reporting revenues and earnings for Q3, revenues are ahead of the consensus forecast by just 1.4%, and earnings have exceeded estimates by 6.0%. At the same point during the Q2 season, revenues were 1.6% above forecast and earnings had beaten estimates by 4.5%. For the 128 companies that have reported Q3 earnings through mid-day Tuesday, the aggregate y/y revenue and earnings growth rates have slowed from their readings from Q2-2021 to Q2-2022. The 128 reporters so far collectively has a y/y revenue gain of 10.1%, but an earnings gain of only 4.1% as higher costs are pressuring profit margins. Just 67% of the Q3 reporters so far has reported a positive revenue surprise, and 73% has beaten earnings forecasts. Furthermore, significantly fewer companies have reported positive y/y earnings growth in Q3 (59%) than positive y/y revenue growth (85%). These figures will change markedly as more Q3-2022 results are reported in the coming weeks, particularly from non-Financial firms with greater exposure to the strong dollar. While we expect y/y growth rates to remain positive in Q3, we think the revenue and earnings surprises will deteriorate q/q due to the slowing economy, missed deliveries, higher costs, and currency translation.

US Economic Indicators

Consumer Confidence (*link*): "Consumer confidence retreated in October, after advancing in August and September," noted Lynn Franco, senior director of economic indicators at The Conference Board. "The Present Situation Index fell sharply, suggesting economic growth slowed to start Q4. Consumers' expectations regarding the short-term outlook remained dismal. The Expectations Index is still lingering below a reading of 80—a level associated with recession—suggesting recession risks appear to be rising." Consumer confidence slipped 5.3 points this month to 102.5 after two-month jump of 12.5 points. The *present situation* component plunged 11.3 points to an 18-month low of 138.9—more than erasing the 10.5-point jump during the two months through September. Meanwhile, the 1.4-point drop in the *expectations* component to 78.1 pales in comparison—retaining 90% of the 13.9-point gain during the two months through September. *Current business conditions* were less favorable: The percentage of consumers saying business conditions were good fell from 20.7% to 17.5%, while the percentage saying conditions were bad rose from 20.9% to 24.0%. As for the *current labor market*, 45.2% of consumers said jobs were plentiful this month, down from 49.2% last month, while 12.7% said jobs were hard to get, up from September's 11.1%. *Short-term business conditions* (six-month outlook) were mixed: The percentage of consumers expecting business conditions to improve rose from 18.6% in September to 19.2% this month, while 23.3% expect them to worsen, up from 21.9% last month. *Short-term labor market*: The percentage of consumers expecting more jobs to be available six months from now improved from 17.4% to 19.8%, while the percentage anticipating fewer jobs was up from 17.8% to 20.8%. As for their *short-term financial prospects*, the outlook was mixed, with 18.9% of consumers expecting their incomes to increase, up negligibly from 18.3% in September, while 15.1% expected their incomes to decrease, up from 13.8% last month. On the *inflation front*, inflation concerns, which had been easing since July, have resurfaced with pickups in food and gas prices being the main drivers, according to the latest report.

Regional M-PMIs (*link*): Three Fed districts (New York, Philadelphia, and Richmond) have reported on manufacturing activity for October and show the manufacturing sector continued to contract, with manufacturing activity falling at a slightly faster pace, dropping to -9.3, after narrowing from -11.0 in August to -3.8 in September. *Manufacturing activity* in the New York (to -9.1 from -1.5) region declined at a faster pace, though not as steep a pace as in August (-31.3). Philadelphia's (-8.7 from -9.9) activity contracted at a comparable pace to last month, after moving briefly into expansionary territory in August (6.2). Richmond's (-10.0) returned to contractionary territory after improving a bit from -8.0 to 0.0 in September.

New orders (-11.4 from -8.3) contracted for the sixth month, with the decline widening again after narrowing a bit in September. Billings in the Richmond (-22.0 from -11.0) region contracted at double September's pace, while those in Philadelphia (-15.9 from -17.6) continued to contract at a fast pace. Meanwhile, orders in the New York (unchanged 3.7) region continued to rise at a sluggish pace. *Employment* (12.1 from 7.2) continued to climb this month, with the pace accelerating after slowing a bit in September. Factories in the Philadelphia (28.5 from 12.0) region hired at more than double September's pace, while New York's (7.7 from 9.7) pace held relatively steady; hiring in the Richmond region was at a standstill for the second month, unchanged at 0.0. Looking at *prices-paid* indexes, the New York region's index picked up slightly to 48.6 this month after easing from a record-high 86.4 in April to a 21-month low of 39.6 in September, while Philadelphia's moved up to 36.3 after slowing from a cyclical high of 84.6 in April (which wasn't far from its record high of 91.1 in the 1970s) to 29.8 in September, the lowest since December 2020. Richmond's measure accelerated to 128.1 after easing to a 15-month low of 103.4 in September; it was at a record high of 150.1 in May. *Prices-received* indexes were mixed: Philadelphia's measure picked up for the second month to 30.8 after slowing from November's 62.9 peak to an 18-month low of 23.3 during August, while Richmond's has been volatile just below June's 103.1 record high, climbing to 86.2 this month after easing from 93.1 to 76.6 last month. In the meantime, New York's prices-received measure slowed to a 21-month low of 22.9, down from its record high of 56.1 in March. (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

Germany Ifo Business Climate Index (*link*): "Sentiment in the German economy continues to be grim," noted Ifo, warning that Germany is facing a difficult winter, with energy worries a major concern. The overall index hasn't posted an increase since May, sinking from 93.3 in May to 84.3 this month—the lowest since May 2020. It was as high as 101.4 in June 2021. The *expectations* component barely budged, ticking up to 75.6 this month, after plunging 23.3 points—from 98.6 in February to 75.3 in September—which was the lowest since April 2020; it was at 102.9 last June. Meanwhile, *current conditions*, which had been fluctuating in a volatile flat trend earlier this year, has dropped 5.7 points the past five months to a 19-month low of 94.1. The downturn is hitting all four sectors of the German economy: The *manufacturing sector* saw its business climate index deteriorate to a 28-month low of -15.9 as expectations has plunged 11.5 points the past two months to -40.7—

the lowest since April 2020; it was at 10.0 in February, the last reading above zero. Meanwhile, the present situation ticked up from 12.8 to 12.9, though is down 23.3 points since February. The *service sector* held in contractionary territory, with its business climate index little changed at -8.6 this month, after plunging 10.4 points in September to -8.9—the first contractionary reading since February 2021. The expectations (-34.4 from -36.0) component remained deep in negative territory, while businesses remained less satisfied with their current conditions; the measure fell to a seven-month low of 21.2. Sentiment in the *trade sector* (-31.9 from 32.3) held near September's 28-month low, as expectations (-57.1 from -57.6) remained at historical lows. Current conditions (to -2.2 from -2.5) posted the first back-to-back negative readings since the start of 2021. The *construction sector* continued to deteriorate, as its business climate index dropped to -24.0, the weakest since February 2010, on widespread weakness. Expectations (-47.1 from -46.6) contracted at a faster pace this month, while businesses continued to be less satisfied with current conditions (2.6 from 6.9), falling to its lowest level since January 2016; this measure was at 33.4 in February.

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