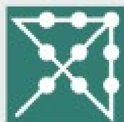

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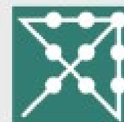

MORNING BRIEFING
November 2, 2022

On Powell, Inflation & Home Prices

Check out the accompanying chart collection.

Executive Summary: After Fed Chair Powell's press conference today, investors are bound to see more light at the end of the tightening tunnel. We're hoping he'll suggest that just two more 75bps turns of the federal-funds-rate screw—one announced today and another in December—may be tight enough. … Also: We assess the latest persistently high inflation data with an eye toward assessing whether our inflation forecast for the rest of this year is overly optimistic. … And: Housing prices are falling in the wake of rising mortgage rates. But we don't see the market crashing as in 2007, Melissa explains. The downward drivers then and now are nothing alike.

The Fed: What Will Powell Say? This afternoon, the FOMC is widely expected to increase the federal funds rate by 75bps to a range of 3.75%-4.00%. There is much less certainty about what Fed Chair Jerome Powell will say at his press conference at 2:30 p.m. after the meeting. The bulls, including yours truly, are hoping to hear that after another rate hike of 75bps next month to 4.50%-4.75%, the Fed is likely to pause rate-hiking to assess the economic impact of raising the federal funds rate by a whopping 450bps during the 10 months since March of this year. That's probably asking for more than Powell is likely to deliver.

More likely, Powell will say that inflation remains persistent. It seems to be moderating in the goods sector, though food inflation remains troublesome as does energy inflation. If the Russians terminate their agreement with Ukraine over grain shipments, that could push global grain prices higher. The drought in the US could continue to put upward pressure on US food prices (*Fig. 1*). A shortage of diesel fuel in the US could boost its price significantly, raising the costs of transporting food and lots of other goods (*Fig. 2*). Powell may not get that far down into the weeds, but he certainly will mention that the inflation pandemic has spread more broadly into services prices, not just rents (*Fig. 3*).

Nevertheless, Powell is likely to acknowledge that the federal funds rate at 3.75%-4.00% is more restrictive and getting closer to the median forecast of 4.40% shown in September's *FOMC Summary of Economic Projections*. A 50bps rate hike in December would match this forecast. A 75bps hike would frontload the committee's

4.60% projection for 2023.

Powell undoubtedly will reiterate that the Fed remains data dependent. Any pause in rate-hiking won't last very long if inflation remains stubbornly high. In any event, any pause at a sufficiently restrictive level will be maintained for quite a while even while inflation subsides. The FOMC wants to be certain that inflation has been subdued before lowering interest rates again.

While there is more talk about a 5.00% (or higher) terminal federal funds rate, the 2-year US Treasury note yield remains around 4.50% (*Fig. 4*). Also suggesting that the federal funds rate will be sufficiently restrictive just below 5.00% is the ongoing inversion of the 10-year versus 2-year Treasury yield spread (*Fig. 5*).

Inflation: Not There Yet. Now let's drill down into the latest batch of inflation data to assess whether we need to change our inflation forecast. We've been expecting the headline PCED inflation rate to moderate from a range of 6%-7% during the first half of this year to 4%-5% during the second half of this year and 3%-4% next year (*Fig. 6*). The FOMC's projection is that the headline PCED will end up this year at 5.4% and next year at 2.8%. We may be too optimistic about the rest of this year, while the Fed is probably too optimistic about next year.

In any case, inflation remains persistently high. It might have peaked at 7.0% y/y during June, but it was 6.2% during September. So it remains in the 6.0%-7.0% range. The core PCED peaked this year at 5.4% during February and March, but it was still 5.1% during September, basically fluctuating around 5.0% since the start of this year. Let's see where inflation is moderating and where it isn't:

(1) *Commodity prices.* Both the CRB all commodities index and the CRB raw industrials spot price index have been falling since they peaked this summer (*Fig. 7*). The S&P-GS commodity index also peaked this summer; it has stopped falling recently, as both its agricultural & livestock and energy indexes have edged up (*Fig. 8* and *Fig. 9*). The US national pump price of gasoline also edged up during October, as the crack spread has widened again (*Fig. 10* and *Fig. 11*). On the other hand, natural gas prices have been coming down.

(2) *Business surveys.* The prices-paid index included in October's survey of manufacturing purchasing managers (the M-PMI) dropped to 46.6 during October

(*Fig. 12*). That's down from a recent peak of 87.1 during March 2022 and the first reading below 50.0 since the pandemic lockdown ended.

Less encouraging is the average of the prices-paid indexes of the regional business surveys conducted by five of the 12 Federal Reserve Banks. It has declined sharply this year but remained elevated in October. The same can be said about the average of the regional prices-received indexes (*Fig. 13*).

(3) *PCED nondurable goods* accounts for 21.5% of the headline PCED. Food and energy account for 11.8% and 55.9% of this component. As of September, the headline and core nondurable goods inflation rates rose 9.5% and 3.8% y/y (*Fig. 14*).

Food inflation might have peaked during August at 12.3% y/y; it edged down to 11.9% in September (*Fig. 15*). Energy inflation peaked at 43.6% during June and fell to 20.3% in September.

(4) *PCED durable goods* accounts for 12.5% of the PCED. This category was inflated by the demand shock for goods following the end of the pandemic lockdowns. It overwhelmed the supply chains, resulting in shortages and rapidly rising prices. The PCED durable goods inflation rate peaked at 10.6% y/y during February 2022 (*Fig. 16*). It was down to 5.7% during September. On a three-month annualized basis, it was only 2.8% through September (*Fig. 17*).

Housing-related durable goods inflation rates are moderating because new and existing home sales are in a recession. Used car prices turned negative on a y/y basis during October, falling 10.4% (*Fig. 18*).

(5) *PCED services* accounts for 66.0% of the PCED. Rent of primary residence and owners' equivalent rent account for 5.4% and 16.7% of the services PCED. Both inflation rates continued to move higher during September, to 7.2% and 6.7%. Their comparable three-month annualized rates were even higher at 9.2% and 8.7%. As is widely recognized, the rent component reflects all currently active leases. The Zillow observed rent index, reflecting new leases, peaked at 17.1% y/y during February. It is down to 10.7% as of September (*Fig. 19*).

There are lots of other services components with smaller weights than rent in the PCED, and they are also showing more signs of inflating than disinflating: motor

vehicle maintenance (11.1% y/y), motor vehicle insurance (3.9), airline fares (32.9), pet services including veterinary (11.0), day care & preschool (5.1), and delivery services (16.4).

(6) *Bottom line.* Inflation may have peaked, but it remains too high. Progress has been made in bringing down goods inflation, though food inflation remains troublesome. The problem is that the inflation in services is no longer just about the funky measure of owners' equivalent rent. We will wait until October's CPI is released on November 10 to reassess our outlook for inflation.

The question is whether a persistently high federal funds rate of 4.50%-5.00% will be restrictive enough to bring inflation down in 2023. We think it could bring inflation down to our target range of 3.0%-4.0%. We doubt it will bring inflation down below 3.0% as the FOMC projected in September.

US Housing: Now & Then. With mortgage rates rising to the highest levels since the early 2000s, it is no surprise that home prices are starting to fall. The question is: How low will housing prices go? Most housing market analysts are not expecting a crash as was seen during 2007 when the housing bubble burst. Melissa and I agree. Consider the following:

(1) *This time is different.* Mortgage rates are causing prices to drop this time around. Last time, mortgage rates were on the way down when home prices dropped. The 2007-09 housing crisis instead was driven by poor lending standards, which led to lots of foreclosures. Now lending standards are much tighter, and household balance sheets are strong.

(2) *Mortgage rates weighing on home prices.* The S&P/Case-Shiller US National Home Price Index (HPI), released last week, showed that home prices fell 1.1% m/m in August, the biggest monthly decline since 2010. But on a y/y basis, the HPI was 13.0% higher than in August 2021, down from July's 15.6% increase (*Fig. 20*). During August 2021, the index was 19.9% above the prior year. Since then, the 30-year fixed mortgage rate has risen from 2.87% to 5.50% through this August. The latest mortgage rate was above 7.0% this October, the highest in 20 years (*Fig. 21*).

(3) *More downside.* Pending and existing home sales are at their lowest levels since June 2010 and September 2012, respectively, excluding a brief drop at the start of the

pandemic (*Fig. 22*). Traffic of prospective homebuyers fell 64% from January of this year through October to the slowest pace since the lockdown recession (*Fig. 23*).

(4) *Supply shortage persists.* Supply dynamics continue to favor higher prices despite the rise in mortgage rates. Housing prices are still expected to be up 11% for 2022, followed by 2% in 2023, according to the National Association of Realtors' (NAR) most recent *forecast*. "Inventory will remain tight in the coming months and even for the next couple of years," Lawrence Yun, NAR's Chief Economist, recently *said*. "Some homeowners are unwilling to trade up or trade down after locking in historically low mortgage rates in recent years, increasing the need for more new-home construction to boost supply."

The months' supply of existing homes on the market remained puny at 3.2 months during September 2022 (*Fig. 24*). Back in 2010, the supply was over 10 months. Compared to existing homes, there is a notable divergence in the supply of new homes, which are up to around nine months from a pandemic low near three months. However, the market is much more heavily weighted toward existing homes, with 1.3 million existing homes currently available for sale versus 462,000 new homes (*Fig. 25*).

(5) *Lending standards/foreclosures.* Foreclosures are near record lows, so they're unlikely to pressure housing prices downward as happened during the GFC (*Fig. 26*). High prices—buoyed by inventory shortages and a pandemic-driven surge in demand for suburban homes—are unlikely to pop owing to nonpayment of mortgages by distressed homeowners because there's not much evidence of their financial stress.

During the GFC, many buyers lacking evidence of sufficient income were approved for mortgages, artificially propping up home prices. That would be highly unlikely to happen today. Data from the Federal Reserve Bank of New York recently *showed* that the typical credit score for newly originated mortgage debt during Q2 was above 700 (*Fig. 27*). The share of mortgage balances 90+ days past due remained at 0.5%, near a historical low, Fed data show (*Fig. 28*).

(6) *Demographics.* Millennial homebuyers would likely swoop into the market en masse if home prices fell further from here (assuming that mortgage rates don't rise too much further), providing a floor of sorts. Millennials finally are aging into the housing market—buying their first homes but later in life than their Baby Boom

parents did; that's primarily because many have had difficulty saving for a down payment while burdened with huge student loan debt.

Millennials' main hurdles to homeownership now are affordability and qualifying for a loan. But they do now make up the largest share of home buyers, at 43%, according to the NAR's 2022 Home Buyers and Sellers Generational Trends *report*.

Gen Zers, right behind Millennials in age, also have begun to enter the housing market, currently composing 2% of home buyers.

(7) *Institutional investors.* Not only Millennials but institutional investors as well would swoop in to provide a floor for housing prices if they began to tank—as these investors did for the asset fire sales during the GFC. That's especially true as institutional ownership represents a growing, though small, share of the real estate market.

(8) *Money supply.* By the way, in recent years, a close correlation between the monetary aggregate M2 and the S&P/Case-Shiller Home Price Index has emerged (*Fig. 29*). The monetary aggregate represents the liquid dollars floating around and available to buy up other assets. M2 would have to fall a lot further for the correlation to imply declining housing prices too, all else being equal, because currently there's still a lot of money in circulation chasing scarce housing assets.

Calendars

US: Wed: ADP Nonfarm Employment 193k; MBA Mortgage Applications; Crude Oil Inventories & Gasoline Production; FOMC Interest Rate Decision 4.00%; FOMC Press Conference. **Thurs:** Trade Balance -$72.1b; Factory Orders 0.3%; Initial & Continuous Jobless Claims 220k/1.45m; Productivity & Unit Labor Costs 0.6%/4.1%; ISM NM-PMR 55.5; Natural Gas Storage. (Bloomberg estimates)

Global: Wed: Eurozone, Germany, France, Italy, and Spain M-PMIs 46.6/45.7/47.4/46.9/47.5; Germany Unemployment Employment Change & Unemployment Rate 15k/5.5%; Germany Trade Balance €0.7b; China NM-PMI 49.2; Wuermeling; Nagel. **Thurs:** Eurozone Unemployment Rate 6.6%; Italy Unemployment Rate 7.8%; UK C-PMI & NM-PMI 47.2/47.5; BOE Interest Rate Decision 3.00%; RBA

Monetary Policy Statement; Lagarde; Panetta; Elderson; McCaul; Bailey; Mann; Nagel. (Bloomberg estimates)

Strategy Indicators

S&P 500 Growth vs Value (*link*): As of Monday's close, the S&P 500 Value index was a whisker out of a 10% correction while the S&P 500 Growth price index was still in a deep 28.8% bear market. 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 2.4%, while Growth's is down 26.1%. 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 performances through Monday's close, Growth has tumbled 27.8% ytd, well behind the 8.7% decline for the S&P 500 Value index. Looking at the fundamentals, Growth is expected to deliver stronger revenue growth (STRG) than Value over the next 12 months, but their earnings growth (STEG) is not far apart. Growth has 7.1% forecasted for both STRG and STEG, while Value has forecasted STRG and STEG of 4.1% and 6.3%, 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 with its 18.5 reading on October 12. It was back up to 19.8 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 14.6 as of Monday's close. Regarding NERI, Growth's and Value's were negative for a fourth straight month in October following 26 positive monthly readings. Growth's dropped to a 28-month low of -13.4% in October from -9.9% in September, and Value's was down to a 27-month low of -12.2% from -9.1%. 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 over 55% 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 only 3.9%. At the same point during the Q2 season, revenues were 1.8% above forecast and earnings had beaten estimates by 5.4%. For the 277 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 277 reporters so far collectively has a y/y revenue gain of 11.3% but an earnings gain of only 3.2%, as higher costs are pressuring profit margins. Excluding Energy, S&P 500 revenue growth falls to 8.0% y/y from 11.3% and earnings growth drops to -3.9% from 3.2%. Just 68% of the Q3 reporters so far has reported a positive revenue surprise, and 72% has beaten earnings forecasts. Furthermore, significantly fewer companies have reported positive y/y earnings growth in Q3 (60%) than positive y/y revenue growth (79%). 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

JOLTS (*link*): Job openings in September rose 437,000 to 10.72 million after dropping four of the five prior months, by 1.58 million to a 14-month low of 10.28 million; this compares with a record high of 11.86 million in March. There were 5.75 million unemployed in September, so there were 1.9 available jobs for each unemployed person that month, up from August's 1.7—which was the lowest since the start of the year—moving back toward July's 2.0. By industry, the largest gains in openings were in accommodations & food services (215,000), health care & social assistance (115,000), and transportation, warehousing, & utilities (111,000). Industries showing the largest declines: wholesale trade (-104,000), finance & insurance (-83,000), and durable goods manufacturing (-41,000). Hirings fell for the sixth time in seven months, by 252,000 in September and 750,000 over the period, to 19-month low of 6.08 million. Meanwhile, the number of quits continued to move lower, dropping 449,000 to 4.06 million in September, since reaching a record-high 4.51 million last November.

Construction Spending (*link*): Construction spending in September ticked up 0.2%, soaring 10.9% y/y to a level fractionally below July's record high; that result followed

its first decline since last September in August (-0.6%). Private construction spending climbed 0.4% m/m and 11.9% y/y to within 0.3% of July's record high, while public construction spending fell for the second month, dropping 0.7% over the period, after rising six of the prior seven months by 6.1%. Within private construction spending, residential investment was unchanged after declining the prior three months by 2.9%, after not posting a decline since May 2020; September's level is 2.9% below May's record high. The recent weakness in residential investment was driven by single-family construction spending, which hasn't recorded a gain since April, plunging 11.9% during the five months through September. Multi-family construction remained in a volatile flat trend just below last May's record high. Meanwhile, home improvement spending hasn't posted a decline since September 2020, soaring 62.7% over the two-year period to yet another new record high. Private nonresidential spending has increased in four of the past five months, by 1.0% m/m and 6.6% over the period to a new record high.

US Manufacturing PMI (*link*): ISM's October M-PMI showed manufacturing activity continued to drop closer to the demarcation line between expansion and contraction, while the price measure dropped below 50.0 for the first time since May 2020. Since peaking at 63.7 last March, the M-PMI has dropped to 50.2 this October, the lowest since May 2020 during the height of the pandemic. The new orders (to 49.2 from 47.1) measure moved back up closer to the 50.0 breakeven point; it had a brief trip into expansionary territory in August (51.3), while the production (52.3 from 50.6) gauge climbed further above 50.0. In the meantime, the employment (50.0 from 48.7) measure was back up at 50.0 after falling below in September and rising above in August. (This index is a poor predictor of BLS manufacturing payrolls data.) The inventories measure remains in a volatile flat trend, falling to 52.5 last month after rising from 53.1 to 55.5 in September. Supply chains are functioning more normally, with the supplier deliveries measure continuing its retreat from last May's 78.8 to 46.8 this October—the best since March 2009. The backlog of orders subindex dropped to 45.3 last month from a recent high of 70.6 last May. Meanwhile, ISM's prices-paid measure dropped below 50.0 last month, led by declines in commodity prices, sinking from a recent high of 87.1 in March to 46.6 in October; it was at 92.1 in mid-2021—which was the fastest since the summer of 1979.

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