MORNING BRIEFING
November 15, 2022

Where Inflation Is Plummeting & Soaring

Check out the accompanying chart collection.

Executive Summary: US inflation is sticking roughly to the script we've been expecting, having peaked in the summer and fallen since. We expect further declines through 2023. Today, we review what's been going on beneath the surface of the headline rate, including the recent trajectories of nondurable goods, durable goods, and services inflation along with our expectations for each. … Also: The central banks of Europe, Japan, and China each are battling inflation along with daunting challenges specific to them.

US Inflation: Colder & Hotter. Inflation is following our script, more or less. Earlier this year, we expected that the headline PCED would range between 6%-7% during H1-2022 and that it would peak during the summer, falling to 4%-5% by H2-2022 (*Fig. 1*). In our forecast, it would continue to decline to 3%-4% in 2023.

How is that working out so far? So-so. Here is an update:

(1) *Forecast.* The headline PCED inflation rate peaked at 7.0% during June. It was down to 6.2% in September. October's headline CPI suggests that the headline PCED might have fallen below 6% that month but remained above our 4%-5% target range for the second half of this year (*Fig. 2*). Nevertheless, we are sticking with our forecast, for now.

(2) *Nondurable goods.* One of the basic premises of our forecast has been that food and energy prices would stop soaring and start weighing on the nondurable components of the two measures of consumer inflation (*Fig. 3*). After all, food and energy prices are mostly determined in commodity markets where "high prices are the best cure for high prices," to paraphrase the age-old adage.

The CPI energy inflation rate peaked at 41.6% y/y during June and fell to 17.6% during October. The CPI food inflation rate edged down to 10.9% from its recent peak of 11.4% during August. The SPGS commodity indexes for both energy and agriculture and livestock peaked during the summer (*Fig. 4*). Food and energy account for 13.7% and 8.1% of the headline CPI, respectively, and for 51.1% and 16.4% of its nondurable goods component.

By the way, apparel accounts for 2.5% of the CPI and 9.2% of nondurables. Its inflation rate peaked at 6.8% y/y during March and was down to 4.1% during October (*Fig. 5*). It is likely to continue to moderate since retailers are reporting that their inventories are bulging because they ordered more goods than consumers wanted or needed after their post-lockdown buying binge during 2020 and 2021.

(3) *Durable goods.* Another basic premise of our inflation outlook has been that durable goods inflation would drop as rapidly as it soared during the first half of this year. Again, that's supported by retailers' reporting that they must slash their prices to clear bloated inventories of both nondurable and durable merchandise.

That's working out just as we expected. The lockdown and subsequent social restrictions, as well as the relief checks sent by the federal government to millions of Americans, boosted the personal income and personal saving of consumers. The result was a demand shock in the goods market that triggered a supply shock (i.e., supply-chain disruptions) that caused the CPI durable good inflation rate to soar from 3.7% y/y during March 2021 (when the third and final round of checks was disbursed) to a peak of 18.7% during February this year, the highest since the early 1940s (*Fig. 6*).

Retailers and importers couldn't keep up with demand and ordered more goods from domestic and foreign manufacturers. However, starting this summer, Americans satisfied their pent-up demand for goods and pivoted to spending more on services now that these industries were no longer capacity constrained by government social distancing restrictions. The inflation rates for used cars and trucks, furniture and bedding, and household appliances have tumbled in recent months (*Fig. 7*). The CPI durables inflation rate was back down to 4.8% y/y during October.

From the mid-1990s until just before the pandemic, durable goods prices tended to fall on a y/y basis because of productivity gains, cheap imports, and the commoditization of many durable goods products. We expect history soon to repeat itself in this segment of consumer prices.

(4) *Services.* Just as unintended inventories of goods started to pile up, putting downward pressure on durable goods inflation, services inflation started to take off—literally, as airfares soared from -4.6% in October 2021 to 42.9% in September and held there in October (*Fig. 8*). Lodging away from home, on the other hand, peaked at 25.1% in February and March and was back down to 5.9% in October.

Another major source of inflationary pressure in services has been transportation services, which includes airfares and accounts for 6.0% of the CPI and 9.9% of services (*Fig. 9*). It was up 15.2% y/y through October.

Of course, the overall CPI services inflation rate was also driven higher by rent of primary residence and owners' equivalent rate, as housing affordability plunged because of rapidly rising home prices since the end of the lockdowns and soaring mortgage rates this year (*Fig. 10*). The former accounts for 7.4% and the latter 24.0% of the headline CPI, 9.5% and 30.7% of the core CPI, and 12.2% and 39.5% of CPI services—which soared 7.2% y/y through October, up from 3.6% a year ago (*Fig. 11*).

Global Central Banks I: ECB in the Danger Zone. Higher energy costs are feeding through to more and more sectors of the economy, said Christine Lagarde, the head of the European Central Bank (ECB), in a November 1 *interview*. Indeed, headline inflation topped historical readings at 10.7% in the Eurozone, with the core also at a record 5.0% during October (*Fig. 12*). Here's more:

(1) *Not done yet.* That's why "we decided to raise our interest rates for the third time in a row" during the last ECB meeting, Lagarde continued. She added: "Since July we have raised interest rates by 200 basis points—the fastest increase in the history of the euro. But we are not done yet." That's all consistent with what we had expected based on commentary from central bankers, as we detailed in our October 26 *Morning Briefing*.

(2) *Support for some.* The bank is concerned about the potential for consumers and companies to start expecting higher inflation rates in the future, a "dangerous" development. However, the risk that some households might be vulnerable to increasing debt-servicing costs needs to be addressed by country-specific policies, Lagarde observed, nodding to the ECB's recently announced policy tool for financially unstable countries. The ECB's biannual Financial Stability Review, coming out later this month, will provide a more detailed picture of how this tool will work. So far, we do know that countries deemed to have a lack of fiscal discipline will not receive this support.

(3) *Looking ahead.* Lagarde reiterated that the ECB foresees "inflation at 8.1% this year, 5.5% next year and 2.3% in 2024. Growth is expected to slow to 0.9% next year and to reach 1.9% in 2024." The risks to the downside have increased since the ECB made its baseline projections in September, she said.

(4) *Discord on the board.* Other ECB board members do not seem to be in favor of raising

rates as aggressively as Lagarde implied. In a speech yesterday, ECB board member Fabio Panetta said that monetary policy should not "ignore the risks of overtightening."

Global Central Banks II: BOJ in the Twilight Zone. The Bank of Japan (BOJ) remains an outlier when it comes to global monetary policy. Japan's September inflation rate of 3.0% was the highest reading that the country has seen in a more than a decade. The rate is comfortably above the BOJ's inflation target of 2.0%. Compared to inflation in Europe and the US, however, Japan's inflation rate looks almost measly (*Fig. 13*).

That partly explains why the bank isn't tightening while most other global central banks are doing so. At its October meeting, the BOJ decided to *hold* its key short-term interest rate at -0.1%. It continued to pledge to hold 10-year Japanese government bond yields around 0.0% and said it would take additional easing measures if needed. Here's more:

(1) *Wages wanted too.* BOJ Governor Haruhiko Kuroda recently reiterated that the bank aims to achieve its 2% inflation target accompanied by wage increases, according to an *article* in yesterday's *WSJ*. Real wages in Japan have been on a downtrend since 2013 (*Fig. 14*).

(2) *Easing resource prices.* Additionally, Kuroda recently said that there are some signs of local inflation easing, reducing pressure on the bank to tighten its ultra-loose monetary policy. At a news conference, Kuroda explained his thinking: "Recent price increases are due mostly to the rise in import costs and their pass-through to consumer prices. But resource prices have already started falling." The government's currency interventions have helped to slow the decline in the yen in recent months, he added.

(3) *Projections heading down.* In the BOJ's quarterly outlook *report*, the board edged up its 2022 inflation forecast to 2.9%, from 2.3% back in July, due to rises in prices energy, food, and durable goods. Looking further ahead, the CPI is expected to drop below the bank's target to 1.5% for fiscal 2023 and fiscal 2024. The board also cut its 2022 GDP growth forecast to 2.0% from 2.4% due to slowdowns in overseas economies and the effects of the spread of Covid-19 this summer. For 2023, the bank cut slightly its GDP outlook to 1.9% from 2.0%.

Global Central Banks III: PBOC in the Red Zone. In a recent note to employees, the People's Bank of China (PBOC) pledged to keep the currency stable and to maintain the "reasonable" growth of money supply and credit, *reported* Bloomberg on November 11. Support will be increased for struggling sectors of the Chinese economy, the bank wrote.

The statement followed the release of data that showed China's credit growth slowed in October on the backs of Covid closures and a weak property sector. Central bank governor Yi Gang said earlier this month that he hoped the property market could achieve a "soft landing." Yesterday, Bloomberg *reported* that Chinese authorities have issued a 16-point plan to boost the real estate market and a 20-point plan to reduce the negative economic and health consequences of Covid.

Officials say that policymakers are sticking to China's "three red lines" policies. Introduced in August 2020, these financial regulatory guidelines relate to keeping liabilities to assets, debt to equity, and cash reserves within "healthy" boundaries. Their primary intent is to promote the financial stability of the highly indebted property-development sector in China. Since December 2021, however, larger institutions have been excluded from the rules to encourage mergers and acquisitions among less stable firms in an effort to mitigate some of the pressure of bad loans.

Calendars

US: Tues: Headline & Core PPI 0.5%m/m/8.3%y/y & 0.4%m/m/7.2%y/y; Empire State Manufacturing Index -7.00; API Weekly Crude Oil Inventories; IEA Monthly Report; Cook; Barr. **Wed:** Retail Sales Total, Core, and Control Group 1.0%/0.4%/0.3%; Headline & Manufacturing Industrial Production 0.2%/0.2%; Capacity Utilization 80.4%; Business Inventories 0.5%; NAHB Housing Market Index 36; MBA Mortgage Applications; Import & Export Prices -0.4%/-0.4%; Crude Oil Inventories & Gasoline Production; TIC Net Long-Term Transactions; Williams; Barr; Waller. (Bloomberg estimates)

Global: Tues: Eurozone GDP 0.2%q/q/2.1%y/y; Eurozone Trade Balance -€43.9b; Eurozone Employment Change; Germany ZEW Economic Sentiment -50.0; France Unemployment Rate 7.3%; France CPI 1.3%m/m/7.1%y/y; Spain 0.4%m/m/7.3%y/y; CPI UK Employment Change 3m/3m -155k; UK Unemployment Rate 3.5%; UK Average Earnings Including & Excluding Bonus 6.0%/5.6%; Canada Manufacturing & Wholesale Sale -0.5%/-0.2%; Japan Core Machinery Orders 0.7%m/m/7.4%y/y; Japan Tertiary Industry Activity Index 0.6%; Mauderer; Balz; Buch; Elderson. **Wed:** Italy CPI 3.5%m/m/11.9%y/y; UK Headline & Core CPI 1.7%m/m/10.7%y/y & 0.6%m/m/6.4%y/y; UK PPI Input & PPI Output 0.3%m/m/18.0%y/y & 0.5%m/m/14.6%y/y; Japan Trade Balance –¥2.23t; Canada CPI 0.7%m/m/6.9%y/y; Australia Employment Change 15k; Australia Unemployment & Participation Rates 3.6%/66.6%; ECB Financial Stability Report; UK Inflation Report Hearings; Lagarde; Balz; Fernandez-Bollo; Bailey. (Bloomberg estimates)

Strategy Indicators

S&P 500/400/600 Forward Earnings (*link*): Forward earnings fell last week for all three of these indexes for a sixth straight week. LargeCap's forward earnings has fallen in 13 of the 20 weeks since it peaked at a record high in late June. Over the same time period, MidCap's has dropped 14 times, and SmallCap's has moved lower 13 times. For a 20th straight week, none of these three indexes had forward earnings at a record high. LargeCap's is at a 36-week low and 4.2% below its record high at the end of June. MidCap's is at a 32-week low and 5.3% below its record high in early June; and SmallCap's is at a 33-week low and 5.8% below its record high in mid-June. Forward earnings momentum continues to fade. The yearly rate of change in LargeCap's forward earnings was down to a 20-month low of 4.8% y/y from 6.0% a week earlier; 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 tumbled w/w to a 20-month low of 10.2% y/y from 12.1%. 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 sharply w/w to a 22-month low of 4.8% y/y from 8.0%. 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 have been heading lower lately for both years. Here are the latest consensus earnings growth rates for 2022 and 2023: LargeCap (5.9%, 5.0%), MidCap (14.3, -1.9), and SmallCap (10.5, 3.1).

S&P 500/400/600 Valuation (*link*): Valuations soared last week to their highest levels in three months. LargeCap's forward P/E rose 1.1pt to a three-month high of 17.4 from 16.3, and is now up 2.3pts from its 30-month low of 15.1 at the end of September. That compares to a four-month high of 18.1 in early August and an 11-year low of 11.1 during March 2020. MidCap's forward P/E rose 0.8pt w/w to a seven-month high of 13.4 from 12.8, up 2.3pts from a 30-month low of 11.1 at the end of September. That compares to 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 also rose 0.8pt w/w, but to a seven-month high of 12.8 from 11.9. That's up from a 14-year low of 10.6 at the end of September 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 23% discount to LargeCap is near its biggest since September 2000. SmallCap's P/E was below LargeCap's for a 117th straight week. That's the longest stretch at a discount since 1999-2002; SmallCap's current 27% reading is near its biggest discount since February 2001. SmallCap's P/E has been mostly above LargeCap's since 2003. Looking at SmallCap's P/E relative to MidCap's, it was at a discount for a 74th straight week; the current 5% discount is an improvement from its 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 considerably for Q3-2022. In the latest week, the Q3-2022 S&P 500 earnings-per-share blended actual fell 7 cents w/w to $55.90, and is now 6.0% below its $59.49 forecast at the start of the quarter. The S&P 500's blended Q3 earnings growth has weakened q/q to 3.7% y/y from 9.9% in Q2 on a frozen actual basis, and to 4.1% from 8.4% on a pro forma basis. Just four sectors have recorded double- and triple-digit percentage growth in Q3-2022, and five have y/y declines. 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. Looking ahead to Q4, a 0.1% y/y decline is expected for the S&P 500, with just four sectors expected to record positive y/y earnings growth and seven expected to decline. Here are the S&P 500 sectors' latest expected earnings growth rates for Q4-2022 versus their blended Q3-2022 growth rates: Energy (70.9% in Q4-2022 versus 140.8% in Q3-2022), Industrials (42.0, 19.4), Real Estate (7.1, 14.8), Utilities (5.1, -7.1), S&P 500 (-0.1, 4.1), Consumer Staples (-3.5, 0.1), Financials (-3.5, -16.4), Health Care (-6.0, 1.5), Information Technology (-7.7, -0.7), Consumer Discretionary (-11.4, 12.5), Materials (-20.1, -8.8), and Communication Services (-20.4, -26.4).

S&P 500 Q3 Earnings Season Monitor (*link*): As the Q3-2022 earnings season enters the home stretch, the results to date indicate it's the poorest quarterly reporting season since Q1-2020 as assessed by the four surprise metrics we measure for both earnings and revenues. With over 91% of S&P 500 companies finished reporting revenues and earnings for Q3, revenues are ahead of the consensus forecast by just 2.2%, and earnings have exceeded estimates by only 3.4%. That's weaker than the same point during the Q2 season when revenues were 2.6% above forecast and earnings had beaten estimates by 5.9%. For the 457 companies that have reported Q3 earnings through mid-day Monday, the aggregate y/y revenue and earnings growth rates have slowed from their readings from Q2-2021 to Q2-2022. For Q3, they have a y/y revenue gain of 12.0% but an earnings gain of only 5.4%, as higher costs are pressuring profit margins. Excluding Energy, S&P 500 revenue growth falls to 8.7% y/y from 12.0% and earnings growth drops to -3.2% from 5.4%. Just 70% of the Q3 reporters so far has reported a positive revenue surprise, and 71% has beaten earnings forecasts. Furthermore, significantly fewer companies have reported positive y/y earnings growth in Q3 (58%) than positive y/y revenue growth (79%). These figures will change less markedly as the remaining Q3-2022 results are reported in the coming weeks, but with a downward bias as retailers are more likely to miss forecasts and guide lower in this difficult economic environment.

Global Economic Indicators

Eurozone Industrial Production (*link*): Headline production, which excludes construction, rose for the fourth time in five months in September, by 0.9% m/m and 3.3% over the period; it had contracted 2.3% in July—which was the first decline since March and the fourth this year. *During September*, production of consumer nondurable (3.6%) and capital (1.5%) goods orders rose, with the former reaching a new record high and the latter climbing within 4.0% of its record high. Meanwhile, consumer durable and intermediate goods orders both contracted 0.9%, with the latter the lowest since October 2020, while energy output fell 1.1%. *Compared to a year ago*, headline production was up 4.9%, with capital (13.5%) goods output posting a double-digit gain, followed by consumer nondurable (5.7) and consumer durable (3.6) goods output, while energy output (-3.0) and intermediate (-2.1) goods production were in the red. Production data are available for the *top four Eurozone economies* and show only Germany (0.8%) posted a gain in September, while output in Spain (-0.4), France (-0.7) and Italy (-1.8) all contracted. Over the 12 months through September, Germany (3.6) and Spain (3.5%) showed the biggest increase in output, followed by France (2.1); production in Italy (-0.5) was just below year-ago levels.

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