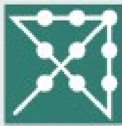

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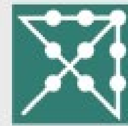

MORNING BRIEFING
June 21, 2023

Inflation Here & There

Check out the accompanying chart collection.

Executive Summary: High rates of US inflation are one of the pandemic's many shock waves. As these continue to recede, so should inflation—and without further Fed tightening. Goods inflation already has plummeted from 14.2% y/y at its peak to 0.6% in May. High rent inflation is buoying the headline CPI rate, but it should normalize as pandemic effects fade. … In Europe, elevated inflation rates are dropping as well, even though the war in Ukraine grinds on. … In China, inflation isn't the problem; post-lockdown economic weakness is. The ailing property market doesn't help. The PBOC is easing in response.

Weekly Webcast. If you missed yesterday's live webcast, you can view a replay *here*.

Inflation I: Pandemic Shock Continues To Abate. Debbie and I are coming to the conclusion that inflation might have been one of the many results of the pandemic shock, which is abating. If so, then inflation should continue to moderate without any additional tightening by the Fed. In our opinion, high inflation may turn out to be relatively transitory rather than persistent as widely feared. It has certainly turned out to be transitory for the CPI goods inflation rate (*Fig. 1*). It was only 0.6% y/y in May, the lowest since March 2021 and well below the 14.2% y/y peak during March 2022.

As a result, the headline CPI inflation rate has dropped significantly since last summer, from a peak of 9.1% y/y during June 2022 to 4.0% y/y in May (*Fig. 2*). That's the lowest reading since March 2021 but still well above the Fed's 2.0% inflation target. The problem is that the core CPI inflation rate has been stuck around 6.0% since early last year.

The core CPI inflation rate has been mostly boosted by the rent component of the CPI, which accounts for 34.6% of the total CPI and a whopping 43.5% of the core CPI. The core CPI inflation rate excluding shelter rose just 3.4% during May, down from last summer's 7.7% (*Fig. 3*). As rent inflation continues to moderate, so will the core CPI. Consider the following:

(1) During the pandemic, many landlords faced state-mandated moratoriums on raising rents and even collecting them. As these restrictions were lifted, landlords increased rents dramatically in 2021. However, this shockwave from the pandemic has been dissipating:

(2) The CPI rent inflation measures are starting to reflect the drop in new leases (*Fig. 4*). The CPI primary residence rent index seems to be peaking, edging down to 8.7% through May. This index tends to lag the Zillow and ApartmentList rent inflation rates because it includes all current rents, while the latter two include just new leases. The three-month annualized CPI rent of primary residence fell to 8.0% during March, the lowest rate since June 2022 (*Fig. 5*).

(3) In his post-FOMC-meeting *press conference* last Wednesday, Fed Chair Jerome Powell stated: "And rental is a very large part of the CPI, about a third; it's about half of that for the PCE. So it's important. And so it's something that we're watching very carefully. It's part of the overall picture. I wouldn't say it's the decisive part, but take a step back. … [L]ook at core inflation over the past six months, a year. You're just not seeing a lot of progress, not the kind of progress we want to see."

Fed officials have acknowledged that the CPI rent inflation measure has some serious drawbacks. However, they've countered that inflation in the core PCED services excluding housing also has remained persistently high, at around 4.0%-5.0% for the past year (*Fig. 6*). However, the comparable CPI measure peaked at 6.6% during September 2022 and fell to 4.5% in May.

We expect to see more progress ahead in bringing core inflation down as the rent inflation component of the CPI falls. We are still targeting 3.0%-4.0% by the end of this year for both the headline CPI and PCED inflation rates. The stock and bond markets seem to share our optimistic view.

Inflation II: Dropping in Europe Too. Inflation in Europe has fallen to its slowest pace since Russia invaded Ukraine, bolstering the case for the European Central Bank (ECB) to stop raising interest rates sooner rather than later. The Eurozone's CPI rose 6.1% y/y last month, down from 7.0% y/y in April (*Fig. 7*). That's the lowest rate of inflation since February 2022, when Moscow launched a full-scale invasion of Ukraine, sending global energy prices soaring.

The pace of food price rises eased for the second month running in May, while energy prices fell. Core inflation, which strips out food and energy, slowed to 5.3% y/y, a four-month low. Inflation has fallen sharply in Germany, France, Italy, and Spain, national data published last Wednesday showed (*Fig. 8*). Price rises eased across a broad range of product categories in Europe's biggest economies.

The ECB has increased interest rates by 400bps in less than a year from minus 0.50% in July 2022 to 3.50% today (*Fig. 9*). The implosion of Silicon Valley Bank in the US and the emergency sale of Switzerland's Credit Suisse to UBS also have tightened credit conditions in the region. In Q1-2023, net demand for loans to businesses fell the most since the end of 2008, the ECB found after polling 158 banks in the region between March 22 and April 6. "From a historical perspective, the pace of net tightening in credit standards remained at the highest level since the euro area sovereign debt crisis in 2011," the ECB said.

Nevertheless, the ECB's Governing Council proceeded to hike its official interest rate by 25bps to 3.25% on May 4 and another 25bps to 3.50% on June 15. The ECB has raised its benchmark interest rate at eight consecutive meetings since last July.

The rate hikes and the global banking crisis during March seem to be stopping the growth in bank lending in the Eurozone. Total loans outstanding at the Eurozone's monetary financial institutions edged down 0.2% over the past three months through April (*Fig. 10*).

"We need to see a sustained decline in core inflation that gives us confidence that our measures are starting to work," Isabel Schnabel, a top ECB official, said in a recent *interview* with Politico. "What really matters," she added, is that inflation recedes to the central bank's 2% target over the medium term.

Inflation III: Deflation in China. Since April, Jackie and I have been observing that China's economic recovery over the six months since the government lifted pandemic lockdown restrictions in early December has been surprisingly weak. The country's total imports have been flat since late 2021 through May of this year (*Fig. 11*). The rallies in the price of copper and in the China MSCI stock price index late last year and early this year have fizzled in recent weeks (*Fig. 12*). May's CPI was up by just 0.2% y/y, while the PPI was down 4.6% y/y (*Fig. 13*).

The government is scrambling to stimulate the economy. Over the past 12 months through May, bank loans are up a near-record $3.3 trillion (*Fig. 14*). Nevertheless, the People's Bank of China cut key interest rates on Tuesday for loans issued by the state-controlled banking system. The interest rate cut was small—a tenth of a percentage point for the country's benchmark one-year and five-year interest rates for loans. However, it was a clear signal that the Chinese government is concerned that the country's economy is stalling in the face of the ongoing recession in the property market.

Trader's Perspective. We asked Joe Feshbach for an update on his view of the market

from a trader's perspective: "Breadth has improved for the S&P 500. But the cumulative advance/decline line for the Nasdaq is a galaxy away from confirming the strength in the S&P 500. Sentiment is way too complacent here. Friday had the lowest put/call ratio in many months. Yes, it's always difficult to predict the end and duration of a blow-off rally, but I'm in the camp that believes that the market rally is close to done—although in fairness, I've said that before. I think that the market could take a big hit to the downside when momentum breaks, as I expect it will."

Correction. In yesterday's *Morning Briefing*, we wrote: "A fleet of trucks can drive through the difference between our S&P 500 earnings-per-share estimate for this year and the Morgan Stanley outlook. As we reiterated last week, we are at $225 this year (up 3.2%), $250 in 2023 (up 11.1%), and $270 in 2024 (up 8.0%)." We meant: "$250 in 2024 (up 11.1%), and $270 in 2025 (up 8.0%)."

Calendars

US: Wed: MBA Mortgage Applications; API Weekly Crude Oil Inventories; Powell; Cook; Jefferson; Goolsbee; Mester. **Thurs:** Leading Indicators -0.8%; Existing Home Sales 4.25mu; Initial & Continuous Jobless Claims 260k/1.782m; Kansas City Fed Manufacturing Index; Chicago National Activity Index 0.0; Crude Oil Inventories; Gasoline Production; Powell; Mester; Bowman; Waller; Barkin. (Bloomberg estimates)

Global: Wed: UK Headline & Core CPI 8.5%/6.7%y/y; UK Input & Output PPI 2.4%/4.1%y/y; UK Nationwide HPI; UK CBI Industrial Trends; Canada Retail Sales 0.2%; Nagel; Balz; Noguchi. **Thurs:** Eurozone Consumer Confidence -17.0; France Business Survey 99; BoE Interest Rate Decision 4.75%; Japan Total & Core CPI 4.1%/3.1%y/y; De Guindos; Nagel; Panetta. (Bloomberg estimates)

Strategy Indicators

S&P 500/400/600 Forward Earnings (*link*): Forward earnings rose last week for two of these three indexes; but for a 51st straight week, none were at a record high. During the May 4 week, all three had risen simultaneously for only the third time since they peaked at record highs last June. However, all three are up from their lows during February and March. Through the week ending June 16, LargeCap's forward earnings improved to 2.9%

above its 54-week low during the week of February 10. MidCap's rose to 2.6% above its 55-week low during the week of March 10, and SmallCap's edged down to 0.8% above its 72-week low during the March 17 week. The forward earnings downtrend since mid-2022 for these three indexes has been relatively modest this time around compared to their deep double-digit percentage declines during the Great Virus Crisis and the Great Financial Crisis. LargeCap's is now 3.1% below its record high at the end of June 2022; MidCap's is 5.8% below its record high in early June 2022; and SmallCap's is 12.9% below its mid-June 2022 record. Forward earnings momentum remains near two-year lows. The -3.1% yearly rate of change in LargeCap's forward earnings was negative for a 20th straight week, but up from a 28-month low of -3.2% y/y during the May 18 week; that compares to a record-high 42.2% at the end of July 2021 and is up from -19.3% in May 2020, which was the lowest since October 2009. MidCap's rate of -5.7% y/y is up from a 31-month low of -5.9% a week earlier, which compares to a record high of 78.8% in May 2021 and a record low of -32.7% in May 2020. SmallCap's rate fell to a 32-month low of -12.9% y/y, down from a record high of 124.2% in June 2021; it compares to a record low of -41.5% in June 2020. Analysts' consensus earnings forecasts for 2023 and 2024 had been heading steadily lower since last June, but 2023's estimates briefly ticked higher during the Q1 reporting season as analysts incorporated the strong earnings beats into their forecasts. Here are the latest consensus earnings growth rates for 2023 and 2024: LargeCap (1.1% and 11.8%), MidCap (-10.1, 12.9), and SmallCap (-10.5,14.7).

S&P 500/400/600 Valuation (*link*): Valuations rose for these three indexes through the June 16 week. LargeCap's forward P/E surged 0.5pts w/w to a 14-month high of 19.0. It's up 3.9pts from its 30-month low of 15.1 at the end of September, which compares to an 11-year low of 11.1 during March 2020. MidCap's forward P/E rose 0.2pt to a 15-week high of 13.7, and is 1.0pt below its recent 10-month high of 14.7 in early February. It's now 2.6pts above its 30-month low of 11.1 at the end of September, which 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 rose 0.1pt to a 15-week high of 13.5, which compares to a 19-week low of 12.5 during the May 12 week and is now 1.0pt below its recent 12-month high of 14.3 in early February. It's 2.9pts above its 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. The forward P/Es for the SMidCaps have been mostly below LargeCap's since August 2018. MidCap's 28% discount to LargeCap's P/E remains near its 24-year-low 29% discount during the May 26 week. It had been at a 21% discount during the March 17 week, which was near its best reading since November 2021. SmallCap's 29% discount to LargeCap's P/E last week has improved slightly from a 21-year low of 32% in April 2022. That compares to a 22% discount

during the March 10 week, which was near its lowest discount since August 2021. 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 105th straight week, but barely so; the current 1% discount is near its lowest since July 2021 and an improvement from its 20-year-low 9% discount in December 2021.

S&P 500 Sectors Quarterly Earnings Outlook (*link*): Following the Q3-2020 earnings season, when the US economy emerged from the Covid shutdown, analysts began raising their consensus forecasts for future quarters instead of lowering them as is the historical norm. That six-quarter streak of positive revisions throughout the quarter ended during Q1-2022, and the estimate declines accelerated considerably for the three quarters ending through Q4-2022 before easing for Q1-2023. Looking ahead to Q2-2023, analysts are forecasting that the S&P 500's y/y earnings growth rate will mark its cyclical bottom with an 8.2% decline, down from -2.8% y/y in Q1-2023. On a pro forma basis, they expect the y/y earnings decline to bottom at -5.6% in Q2, down from a less than 0.1% gain in Q1-2023. S&P 500 ex-Energy earnings are forecasted to be flat y/y in Q2-2023, up from the 1.7% decline in Q1-2023 and the 7.4% drop in Q4-2022. Six sectors are expected to record positive y/y percentage earnings growth in Q2-2023, up from five sectors doing so in Q1-2023 and only two in Q4-2022. Here are the S&P 500 sectors' expected earnings growth rates for Q2-2023 versus their nearly final earnings growth rates for Q1-2023: Consumer Discretionary (26.0% in Q2-2023 versus 56.1% in Q1-2023), Financials (9.7, 7.8), Communication Services (9.3, -9.0), Industrials (6.2, 27.0), Consumer Staples (1.8, 0.4), Utilities (2.8, -21.8), S&P 500 ex-Energy (0.0, -1.7), Information Technology (-3.3, -8.5), Real Estate (-4.9, -6.2), S&P 500 (-5.6, 0.03), Health Care (-15.7, -14.8), Materials (-27.4, -22.2), and Energy (-44.4, 20.9).

US Economic Indicators

Housing Starts & Building Permits (*link*): Housing starts in May posted its biggest monthly gain since October 2016, as single-family starts showed signs of life. *Housing starts* in May jumped 21.7% to 1.631mu (saar) after falling 6.7% during the two months ending April; it had posted a 7.2% gain in February—climbing 20.2% ytd. *Single-family units* climbed for the third time in four months, skyrocketing 18.6% in May and 21.1% over the period to 997,000 (saar). Single-family starts were in a freefall from last March through November, plunging 33.6% over the period. Meanwhile, *multi-family starts* increased 27.1% in May and 34.9% ytd to 634,000 units (saar). *Building permits* rebounded 5.2% to 1.491mu (saar) after a two-month decline of 4.4%, though was up 5.8% ytd. *Single-family permits*

increased for the fourth month, by 4.8% in May and 19.9% over the period, to 897,000 units (saar). Meanwhile, *multi-family permits* increased 5.9% to 594,000 units (saar), but has remained on a downtrend since peaking in December 2021, slumping 25.7% over the period. June's NAHB Housing Market Index showed signs of life, with homebuilders' confidence moving into positive territory for the first time in nearly a year, surpassing the midpoint of 50 (out of 100) for the first time since July 2022.

NAHB Housing Market Index (*link*): "Builders are feeling cautiously optimistic about market conditions given low levels of existing home inventory and ongoing gradual improvement for supply chains," said NAHB Chairman Alicia Huey. "However, access for builder and developer loans has become more difficult to obtain over the last year, which will ultimately result in lower lot supplies as the industry tries to expand off cycle lows," she cautions. *Homebuilders' confidence* has climbed for all six months of this year, by 24pts ytd to an 11-month high of 55, after sliding for all 12 months of last year, by 53 points, to 31—which was the lowest since mid-2021 (excluding a drop to 30 at the height of the pandemic). It was the first reading above the midpoint of 50 since last July. *All three components* of homebuilders' confidence have climbed steadily for the first six months of this year, with future sales (+27pts to 62) showing the biggest gain, followed by current sales (+25 to 61) and traffic (+17 to 37); future and current sales components exceeded 60 for the first time in a year. The three components were at record highs of 89, 96, and 77, respectively, during November 2020. In June, 25% of homebuilders lowered home prices to bolster sales, compared with 27% and 30% in May and April, respectively. NAHB notes that 56% of homebuilders offered incentives to buyers in June, slightly more than May's 54% but below December's 22%.

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