MORNING BRIEFING
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Transitory Inflation Sets Stage For Immaculate Disinflation

Check out the accompanying chart collection.

Executive Summary: Big banks' top managements sounded relatively sanguine about the economy as they reported solid Q2 results, though JP Morgan CEO Jamie Dimon hasn't totally abandoned the recession storyline that spooked investors a year ago. … There are two versions of the bearish economic script now, one seeing recession at the hands of savings-drained consumers and other seeing recession at the hands of the inflation-fighting Fed. We counter these narratives with data on consumers and liquidity and by making our case for "immaculate disinflation," the notion that disinflation doesn't require a recession.

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US Economy I: Dimon in the Rough. Some of the largest banks in the country—JPMorgan Chase, Wells Fargo, and Citigroup—kicked off the official start to earnings season on Friday with relatively upbeat results and comments from their top managements. All three banks beat earnings expectations for Q2. BlackRock did so as well.

In June 2022, JPMorgan Chase CEO Jamie Dimon warned that the economy could be in a recession by about now. Now he sounds more optimistic. American consumers are still driving the US economy, which "continues to be resilient," Dimon *stated* on Friday. "Consumer balance sheets remain healthy, and consumers are spending, albeit a little more slowly," he said. However, he once again noted that consumers' excess savings are slowly being drained. While job growth remains strong, he said there are still "salient risks in the immediate view," including stubborn inflation, the risk of more rate hikes from the Federal Reserve, and geopolitical tensions. "While we cannot predict with any certainty how these factors will play out, we are currently managing the firm to reliably meet the needs of our customers and clients in all environments," he said.

Asked whether moderating inflation has made him more optimistic that a recession could be avoided, Dimon said, "I don't know if it's going to lead to a soft landing, a mild recession or a hard recession." He cited "tailwinds" in the economy that "are receding over time," including the strength of consumer spending amid fiscal and monetary stimulus. Headwinds he sees include inflation, high US government debt, high interest rates, the Fed's efforts to shrink its balance sheet, and the war in Ukraine. He noted that the war has been going on for 500 days and could still "get worse."

Last June, Dimon contributed to investors' fears of a recession and a prolonged bear market in stocks by saying he was certain that a hurricane was coming, though how bad a hurricane he didn't know: "That hurricane is right out there down the road coming our way." But nobody knows if it's "a minor one or Superstorm Sandy."

US Economy II: Consumers Still Doing What They Do Best. There's not much left for the bears to growl about, but Jamie Dimon continues to side with them. There are two versions of the bearish script now: Either consumers run out of excess savings, resulting in a consumer-led recession, or the Fed continues to tighten, fearing that a more resilient-than-expected economy will keep inflation above its 2.0% target. The bears don't believe in immaculate disinflation, the idea that inflation can come down without a recession pulling it down. We do.

Let's challenge the first bearish script before turning to the second one:

(1) *Consumers still have lots of cash.* Dimon is right, of course, about consumers' excess savings. By most estimates, they accumulated about $3.0 trillion of it during the pandemic, including what they saved during the lockdown and what they didn't immediately spend of their government pandemic relief checks (*Fig. 1*). Now it is widely estimated that they have $0.5 trillion left, which should be depleted over the next few months. Then watch out for a consumer-led recession.

This is essentially the same argument made by today's latter-day monetarists, who observe that M2 peaked at $21.7 trillion during July 2022 and fell by $897 billion through May, led by a $737 billion drop in commercial banks' total deposits from the final week of July 2022 through the week of July 28 (*Fig. 2*). Today's monetarists correctly observe that some of the decline in deposits is attributable to the Fed's ongoing quantitative tightening program.

Nevertheless, M2 is still about $1.0 trillion above its pre-pandemic trendline, and its demand deposits component is a whopping $2.0 trillion above its pre-pandemic trendline. The sum of total banks deposits plus money market mutual funds (MMMF) rose to a record $22.8 trillion during the July 5 week and is still $2.0 trillion above its pre-pandemic trendline (*Fig. 3*).

Previously, we observed that the Baby Boom generation held $8.9 trillion in demand deposits and MMMFs at the end of Q1-2023, or about $2.5 trillion more than at the end of Q4-2019, just before the pandemic (*Fig. 4*). That's about $1.5 trillion above its pre-pandemic trend. (See our "Baby Boomers Retiring On $75 Trillion In Net Worth," *Morning Briefing*, June 26, 2023.)

(2) *Consumers have lots of income.* We've also countered the consumers' doubters by observing that both inflation-adjusted wages and total disposable income have been rising again in recent months after mostly stagnating during 2021 and 2022. Real average hourly earnings rose 1.5% over the past 11 months through May (*Fig. 5*). This series is once again climbing along its 1.2% annual growth trendline, as it has been since the mid-1990s.

Real disposable personal income mostly fell during H2-2021 and H1-2022 as price inflation outpaced wage inflation. It has been trending higher since June 2022 and is up 4.4% since then through May (*Fig. 6*).

Consumers also have other sources of record unearned income including (during May, at a seasonally adjusted annual rate [saar]): proprietor's income ($1.9 trillion), interest income ($1.8 trillion), dividend income ($1.7 trillion), Social Security benefits ($1.4 trillion), and rental income ($0.9 trillion) (*Fig. 7*). May's total was $7.7 trillion, equivalent to 65% of wages and salaries (*Fig. 8*).

(3) *Consumers are turning more optimistic.* We've often observed that American consumers spend money when they are happy and spend even more money when they are depressed, if they have money to spend (as they certainly do currently). We note that the Consumer Sentiment Index (CSI) fell to a record low of 50.0 during June 2022, which was well below the 2020 lockdown low of 71.8 during April 2020. The CSI rose to 72.6 during the first half of July (*Fig. 9*). That was just above its pandemic low. Inflation has clearly been depressing consumers and more than offsetting the positive effects of the strong labor market.

What have consumers been doing to counter their depression? They've been going shopping to release some dopamine in their brains to make themselves feel better. After the Covid lockdowns, they went on a buying binge for goods. Over the past year, they've pivoted to purchasing more services (*Fig. 10*).

(4) *Corporations have lots of cash.* Consumers aren't the only ones with tons of cash. Corporate cash flow rose to a record high during Q4-2022 and edged down to $3.1 trillion (saar) during Q1-2023 (*Fig. 11*). The Fed's measure of liquid assets held by nonfinancial

corporate business was a near-record $6.5 trillion and $3.6 trillion with and without their holdings of equities and mutual fund shares (*Fig. 12*).

(5) *The federal government's deficit is widening again.* Meanwhile, the federal government continues to pump liquidity into the economy with its huge and widening budget deficit. It rose to $2.3 trillion over the 12 months through June, as outlays increased while revenues decreased (*Fig. 13* and *Fig. 14*).

US Economy III: The Case for Immaculate Disinflation. The second bearish script is that it takes a recession to bring inflation down. Here's how that narrative goes: While inflation has moderated since last summer, it remains well above the Fed's 2.0% target. So the Fed will have to raise interest rates further until that causes a recession, which would bring inflation down to 2.0% for sure. A few Fed officials suggested as much in reaction to last week's better-than-expected CPI and PPI inflation readings for June. They apparently agree with the bears that expecting an immaculate disinflation (i.e., without a recession) is delusional. We don't agree.

Consider the following counterpoints:

(1) *So far, so good for goods.* Last week was a good one for disinflationists. June's reports on expected inflation, the CPI, and the PPI showed that inflation continues to moderate without an economy-wide recession. According to the University of Michigan's Survey Research Center, consumers' one-year-ahead expected inflation fell to 3.3% last month, the lowest readings since March 2021; it was little changed at 3.4% in mid-July. On a y/y basis, the headline and core CPI inflation rates fell to 3.0% and 4.8%, the lowest readings since March 2021 and October 2021. The PPI for final demand was up just 0.1%.

(2) *Transitory after all.* The CPI inflation rate for goods has turned out to be transitory, peaking last summer and falling to -1.2% y/y, with the CPI durable and nondurable goods down 0.8% and 1.3% respectively during June (*Fig. 15*). Inflation has been one of the shockwaves unleashed by the pandemic that is abating.

Excessively stimulative fiscal and monetary policies during the pandemic resulted in a buying binge for goods that overwhelmed global supply chains, as can be seen in the New York Fed's Global Supply Chain Pressure Index (*Fig. 16*). This index soared from 0.11 during October 2020 to 4.31 during December 2021. It was down to -1.20 during June.

(3) *Rent inflation is also transitory.* In the CPI, rent inflation tends to be a laggard because it

reflects rents on all outstanding leases. It is only now showing signs of peaking, while inflation in indexes of new rental leases peaked in early 2022 and are down sharply since then (*Fig. 17*). The headline and core CPI inflation rates excluding shelter were down to only 1.7% and 2.7% during June (*Fig. 18*).

(4) *One counter example.* The naysayers say that that the history of the CPI inflation rate since 1921 shows that the only way to bring inflation down is with a recession (*Fig. 19*). There was just one exception, immediately following the end of World War II. We are arguing that the current situation may turn out to be the second historical exception.

(5) *Inflation isn't always and everywhere just a monetary phenomenon.* What's different this time is that the high inflation was mostly caused by transitory shockwaves related to the pandemic. As they abate, so does inflation. Monetary policy is an important driver of inflation, but it isn't the only cause of inflation. Even the Great Inflation of the 1970s was attributable to various developments, including commodity shortages, two oil price shocks, and a widening federal budget deficit.

(6) *Inflation is usually symmetrical.* The history of the CPI inflation rate suggests that inflation tends to be very symmetric. Once it peaks, it tends to fall at the same pace as it went up. It's doing so again during the current inflation cycle.

Calendars

US: **Mon:** Empire State Manufacturing Index 0.00. **Tues:** Headline & Core Retail Sales 0.5%/0.3%; Headline & Manufacturing Industrial Production -0.1%/-0.2%; Capacity Utilization 79.5%; Business Inventories 0.1%; NAHB Housing Market Index 55; TIC Net Long-Term Transaction; API Weekly Crude Oil Inventories; Barr. (Bloomberg estimates)

Global: **Mon:** Italy CPI 0.1%m/m/6.7%y/y; Spain Consumer Confidence 79.4; Germany Buba Monthly Report; RBA Monetary Policy Statement; Lagarde; Lane. **Tues:** Canada CPI 0.3%m/m/2.9%y/y; Ramsden. (Bloomberg estimates)

Strategy Indicators

Global Stock Markets Performance (*link*): The US MSCI index rose 2.6% last week for its seventh gain in nine weeks, and moved further out of a correction to end the week at 7.2% below its record high on December 27, 2021. The US MSCI ranked 36th of the 48 global stock markets that we follow in a week when 45 of the 48 countries rose in US dollar terms. The AC World ex-US index outperformed with a 4.7% gain, but remains in a 13.4% correction from its June 15, 2021 record high. All regions rose w/w, but EM Eastern Europe was the best performer with a 7.4% rise, ahead of EMU (6.2%), EM Asia (5.5), and EAFE (4.9). EM Latin America was the worst performing region last week, albeit with a gain of 1.0% and followed by EMEA (2.4) and BIC (4.3). Hungary was the best-performing country last week, with a gain of 10.0%, followed by South Africa (9.4), Ireland (9.0), Colombia (8.5), and the Netherlands (7.9). Among the 26 countries that underperformed the AC World ex-US MSCI last week, the 2.1% decline for Pakistan was the biggest, followed by Sri Lanka (-1.1), Argentina (-0.5), Brazil (0.6), and Jordan (0.6). Looking at 2023's performance so far, the US MSCI is up 17.8% as its ytd ranking fell two spots w/w to 16/48. The AC World ex-US's ytd gain of 10.8% is trailing the US, with 36/48 countries now in positive territory. EM Eastern Europe is the best regional performer ytd, with a gain of 29.0%, followed by EMU (19.3), EM Latin America (16.0), and EAFE (12.6). The regional laggards so far in 2023, albeit with gains: BIC (1.7), EMEA (5.7), and EM Asia (7.2). This year's best ytd country performers: Greece (49.3), Argentina (37.8), Ireland (33.0), Hungary (31.9), and Poland (29.8). Here are the worst-performing countries of the year so far: Pakistan (-26.3), Turkey (-13.1), Finland (-8.6), Malaysia (-8.2), and Hong Kong (-7.8).

S&P 500/400/600 Performance (*link*): All three of these indexes moved higher w/w. LargeCap rose 2.4% w/w, but trailed the 3.1% and 2.7% gains for SmallCap and MidCap. At Friday's close, LargeCap finished the week at 6.1% below its record high on January 3, 2022, MidCap moved out of a correction to end at 8.1% below its record high on November 16, 2021, and SmallCap improved to 15.6% correction from its November 8, 2021 record high. Thirty-two of the 33 LargeCap and SMidCap sectors moved higher for the week, up from seven rising a week earlier. SmallCap Financials was the best performer with a gain of 4.4%, ahead of MidCap Consumer Discretionary (4.1), SmallCap Consumer Discretionary (3.9), SmallCap Utilities (3.8), and SmallCap Health Care (3.7). Among the biggest underperformers for the week were SmallCap Communication Services (0.0), MidCap Energy (0.5), LargeCap Energy (0.6), MidCap Communication Services (0.6), and MidCap Consumer Staples (0.7). Looking at performances so far in 2023, LargeCap, with a gain of 17.3%, remains well ahead of MidCap (10.0) and SmallCap (6.8); 22 of the 33 sectors are higher ytd compared to 17 a week earlier. The top sector performers in 2023: LargeCap Tech (43.9), LargeCap Communication Services (39.7), LargeCap Consumer Discretionary (36.3), MidCap Tech (27.2), SmallCap Tech (22.8), and MidCap Industrials (22.8). Here are 2023's biggest laggards: SmallCap Financials (-12.2), MidCap Utilities (-10.1), LargeCap

Energy (-7.3), MidCap Financials (-5.7), and SmallCap Utilities (-5.4).

S&P 500 Sectors and Industries Performance (*link*): All 11 S&P 500 sectors rose last week, and five outperformed the composite index's 2.4% gain. That compares to a 1.2% decline for the S&P 500 a week earlier, when 10 sectors fell and eight outperformed the index. Communication Services was the best performer, with a gain of 3.4%, followed by Consumer Discretionary (3.3%), Tech (2.8), Real Estate (2.6), and Materials (2.5). Energy was the worst performer, albeit with a gain of 0.6%, followed by Consumer Staples (1.2), Financials (2.0), Health Care (2.0), Industrials (2.2), and Utilities (2.3). Looking at 2023's performance so far, the S&P 500 is up 17.3% ytd, with just three sectors still outperforming the index but seven are now higher for the year. The best ytd performers: Tech (43.9), Communication Services (39.7), and Consumer Discretionary (36.3). These are 2023's worst performers: Energy (-7.3), Utilities (-5.2), Health Care (-3.2), Financials (0.0), Consumer Staples (0.1), Real Estate (4.7), Materials (7.1), and Industrials (10.5).

S&P 500 Technical Indicators (*link*): The S&P 500 rose 2.4% last week and improved relative to its 50-day moving average (50-dma) and its 200-day moving average (200-dma). The index was above its 50-dma for a 16th week and its 200-dma for a 17th week. It had been above its 200-dma for eight weeks through early March in its longest positive 200-dma streak since it was above for 81 straight weeks through January 2021. The S&P 500 improved to 4.8% above its rising 50-dma from 3.1% a week earlier, but is down from a 20-week high of 5.4% above its rising 50-dma in mid-June. That compares to a 20-week low of 3.6% below at the beginning of March, a four-month low of 10.6% below at the end of September, a 23-month high of 8.7% above the index's rising 50-dma in early August, and a 27-month low of 11.1% below its falling 50-dma in June 2022. The index had been mostly trading above its 50-dma from late April 2020 to early April 2022; in June 2020, it was 11.7% above, which was the highest since its record high of 14.0% in May 2009. That compares to 27.7% below on March 23, 2020—its lowest reading since it was 29.7% below on Black Monday, October 19, 1987. The price index closed Friday at a 22-month high of 11.3% above its rising 200-dma, down from 9.1% above its rising 200-dma a week earlier. The S&P 500 is well above its 26-month low of 17.1% below its falling 200-dma in June 2022 and compares to 10.8% above its rising 200-dma in November 2021. That also compares to 17.0% above in December 2020, which was the highest since November 2009 and up from the 26.6% below registered during the Great Virus Crisis on March 23, 2020—the lowest reading since March 2009. At its worst levels of the Great Financial Crisis, the S&P 500 index was 25.5% below its 50-dma on October 10, 2008 and 39.6% below its 200-dma on November 11, 2008. The 50-dma moved higher for a 17th week, and the 200-dma rose for a seventh week but has risen in just 19 of the past 60 weeks.

S&P 500 Sectors Technical Indicators (*link*): All 11 S&P 500 sectors are trading above their 50-dmas, up from eight a week earlier. Health Care, Consumer Staples, and Utilities all moved above in the latest week. Eight sectors have a rising 50-dma, up from seven a week earlier as Energy turned up in the latest week. These three sectors are the only members in the falling 50-dma club: Consumer Staples, Health Care, and Utilities. Looking at the more stable longer-term 200-dmas, the positive club improved to eight members w/w from seven as Financials turned up w/w. Energy, Health Care, and Utilities are the only sectors still trading below their 200-dma. The rising 200-dma club was unchanged w/w at 10 members, but Utilities turned and Energy turned down.

US Economic Indicators

Producer Price Index (*link*): June's *headline PPI* rose only three months during the first half of the year, pushing the yearly rate down to its lowest reading since August 2020. Final demand ticked up 0.1% last month after falling two of the prior three months by 0.7%. The yearly rate has been in a freefall since peaking at a record-high 11.7% last March, sinking to 0.1% this June. *Core prices*—which excludes food, energy, and trade services—have increased only 0.3% during the four months through June, after jumping 0.8% during the first two months of the year. The yearly rate eased to a 28-month low of 2.6%, down from March 2022's record-high of 7.1%. *Final demand goods* was flat in June, after dropping three of the prior four months by 2.9%—with the yearly rate easing from a record high of 17.6% last June to -4.4% in June. It posted its first negative reading since November 2020 in May, falling further below zero during June to its lowest rate since April 2020. *Final demand services* rose 0.2% for the second month though is up only 0.5% ytd, with the yearly rate sinking to a 29-month low of 2.3%, down sharply from its record high of 9.4% last March. The PPI for *personal consumption* rose 0.3% in June after falling two of the prior three months by 0.6%—posting only two gains during the past five months. The yearly rate slowed to a 34-month low of 0.5% from its record high of 10.4% last March. The yearly rate for *personal consumption excluding food & energy* eased for the second month to 2.9% in June, its lowest percentage since March 2021, after ticking up from a two-year low of 3.1% in March to 3.3% in April; it peaked at a record high of 8.1% during March 2022. Looking at *pipeline prices*, the yearly rate for intermediate goods prices slipped further below zero in June (-9,4% y/y) after dropping below in March (-1.0) for the first time since November 2020; it was at a cyclical high of 26.6% during November 2021. The yearly crude goods rate was in negative territory for the fifth successive month, falling 32.2% y/y in June, the steepest yearly decline since summer 2009; the rate was at a recent peak of 50.3% last

June.

Import Prices (*link*): Import prices fell for the fifth time in six months in June and the 10th time in the past 12 months, sinking to its lowest yearly percentage since May 2020. *Import* prices fell 0.2% in June, 1.7% ytd, and 6.1% y/y—down from its recent peak of 13.0% in March 2022. *Nonpetroleum* prices followed suit, falling over all three periods, by 0.3% in June, 1.3% ytd, and 2.0% y/y. Fuel prices posted the second gain in the past three months in June, by 0.5% over the period, after a nine-month slide of 37.1%. The yearly rate fell to a of 36-month low of -36.8%, down from its recent peak of 130.1% in April 2021. Meanwhile, here's the yearly rate in *import prices for several industries* from their recent respective peak rates: industrial supplies, which includes fuels & lubricants (to -20.5% from 55.2%); foods, feeds & beverages (-1.1 from 15.7); capital goods (0.7 from 4.2); and consumer goods ex autos (-0.1 from 3.2).

Consumer Sentiment Index (*link*): Consumer sentiment shot up in mid-July, driven by the slowdown in inflation and stability in the labor market. Sentiment improved for every demographic group except lower-income consumers. *Overall consumer sentiment* rose for the sixth time in eight months, by 8.2 in mid-July and 15.8 points over the period, to 72.6. That puts the *headline CS*I halfway between the all-time historical low of 50.0 during June 2022 and the February pre-pandemic reading of 101.0. The *present situation* component climbed 8.5 points and 18.7 points over the comparable periods to 21-month high of 77.5, while the *expectations* component rose 7.9 points and 13.8 points over the comparable periods to a 25-month high of 69.4. Turning to inflation, the *one-year expected inflation rate* was little changed at 3.4% in mid-July, after falling the prior two months from a five-month high of 4.6% in April to 3.3% in June, which was the lowest reading since March 2021. The *five-year expected inflation rate* also was little changed, at 3.1%. It was at 2.9% during the first three months of this year, remaining within the narrow 2.9%-3.1% range in 23 of the past 24 months.

Global Economic Indicators

Eurozone Industrial Production (*link*): Eurozone industrial production for May was a disappointment, raising questions about whether the Eurozone's technical recession continued into Q2. Headline production, which excludes construction, rose in April for the second month, by 0.2% m/m and 1.2% over the period, following March's 4.4% plunge—coming in 3.3% below February's level. Manufacturing production rose 1.8% over the two months through May, after a 5.5% shortfall in March. Among the main industrial groups, *capital goods* production rebounded 15.9% over the two months through May, from March's 14.9% decline, while intermediate goods output advanced 0.5%, following declines of 0.9% and 1.0% the prior two months. *Consumer durable goods* production rose for the second time in three months, by 0.5% in May, though only 0.2% over the period. *Consumer nondurable goods* output climbed 0.3% in May after a two-month loss of 3.9%. Meanwhile, *energy output* dropped in May for the fourth time this year, failing 3.0% ytd. *Compared to a year ago*, headline production was down 2.2%. Capital goods (2.5% y/y) was the only industrial group showing an increase in output versus a year ago, with energy (-6.2) posting the largest decline, followed by intermediate goods (-5.4), consumer durable goods (-5.0), and consumer nondurable goods (-2.8). Production data are available for the *top four Eurozone economies* for May and show Italy (1.6%), France (1.3), and Spain (0.7) recorded gains that month, while German (-0.2) was in the red. Over the 12 months through May, only France (2.9) and Germany (0.9) saw an increase output; production was in the plus column but below year-ago levels in Italy (-3.7) and Spain (-0.4).

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