Yardeni Research

MORNING BRIEFING
August 1, 2023

Mostly All About Inflation

Check out the accompanying chart collection.

Executive Summary: Rates of inflation are a function of the business cycle as well as the monetary cycle, and there tends to be symmetry to their ascents and descents, especially for goods inflation. … The latest bout of high inflation was triggered by demand shocks resulting from the pandemic, which led to supply shocks, aggravated by the Ukraine war. … Since last summer, however, inflation in the US has been on a disinflationary trend. Deflation in China's PPI suggests that the US could experience immaculate disinflation, i.e. lower inflation without a recession.

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

Inflation I: Symmetry & Shockwaves. Inflation tends to be a symmetrical phenomenon. It tends to come down as quickly or as slowly as it went up when measured on a y/y basis. We can see this consistent pattern in the CPI inflation rate for the US since 1921 (*Fig. 1*). The inflation symmetry has been particularly pronounced in the goods-producing sector (*Fig. 2*).

That's because goods prices tend to respond quickly to changes in supply and demand caused by price changes. Rising (falling) prices of goods, especially of commodities, tend to dampen (boost) demand while stimulating (depressing) supply. Prices in the services-providing sector tend to be stickier because labor costs tend to be more important there than among goods-producing industries, which are less dependent on labor thanks to productivity-enhancing innovations. Nevertheless, the CPI inflation rate in services has also been relatively symmetrical since the start of the monthly data in 1957.

The boom-and-bust business cycle plays a role in the symmetry of inflation; inflation typically accelerates during the later stage of booms and moderates during busts. Monetary policy plays an important role in the inflation cycle as central banks fall behind the inflation curve during economic expansions, thus boosting inflation. They then scramble to get ahead of the inflation curve by aggressively tightening monetary policy, which triggers recessions.

That's a simple and stylized description of the relationship of the inflation cycle to the business and monetary cycles. Ever since Milton Friedman taught us all during the 1970s that inflation is always and everywhere a monetary phenomenon, experience has taught us that lots of other factors besides monetary policy also influence inflation. In fact, Friedman later clarified that he was referring to episodes of persistent inflation. In the short run, he acknowledged that supply shocks can impact price levels.

Indeed, our central thesis since inflation reared its ugly head in 2021 and 2022 has been that the high rates of inflation were triggered by various supply shocks attributable mostly to the pandemic and to the Russian invasion of Ukraine. In the March 16, 2022 *Morning Briefing*, we wrote: "Debbie and I raised our inflation forecast as a result of the Ukraine crisis. We now expect that the core PCED inflation rate will peak at 6.0%-7.0% around mid-year and fall to 4.0%-5.0% by the end of the year. Then it might decline to 3%-4% in 2023, maybe."

More recently, in the July 17 *Morning Briefing*, we wrote: "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. 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. This index soared from 0.11 during October 2020 to 4.31 during December 2021. It was down to -1.20 during June." We added that services inflation, particularly rent inflation, would also turn out to be transitory.

Inflation this time around has been attributable to supply shocks that were exacerbated by demand shocks. In our opinion, the inflationary pandemic-related shockwaves should continue to moderate through next year without an economy-wide recession.

Inflation II: Global Perspective. The latest inflation cycle was certainly attributable to a demand shock that occurred when fiscal and monetary authorities provided excessively stimulative policies during 2020 and 2021. They triggered a goods-buying binge that caused durable goods inflation to soar. Russia's invasion of Ukraine early last year caused nondurable goods inflation to soar, led by energy and food prices.

The demand shock caused a supply shock. Supply-chain disruptions proliferated around the world, as evidenced by the New York Fed's Global Supply Chain Pressure Index, mentioned above (*Fig. 3*). Supply chains are working properly again, and the US and Eurozone increasingly are importing goods deflation from abroad. Consider the following:

(1) The US import price index is down 6.1% y/y through June (*Fig. 4*). Excluding petroleum imports, the index is down 2.0%. The US import price index from newly industrialized economies in Asia (Hong Kong, Singapore, South Korea, and Taiwan) is down 6.2% y/y, while the comparable China index is down 2.3% (*Fig. 5*).

(2) China's CPI was flat over the past year through June, while its PPI for industrial products was down 5.4% y/y (*Fig. 6*). China's PPI inflation rate tends to be a coincident indicator of PPI goods inflation in the US and the Eurozone, which were down 2.8% and 1.5% in June (*Fig. 7* and *Fig. 8*).

A global perspective shows that China's lackluster economic recovery from last year's pandemic lockdowns, which were lifted in early December, is having a deflationary impact on goods markets around the world. This suggests that the US and the Eurozone can experience disinflation in the goods sector without a recession. This still leaves the question of inflating services prices.

(3) The Eurozone's headline CPI inflation rate fell to 5.3% in July based on the flash estimate, down from a peak of 10.7% in October 2022 (*Fig. 9*). However, the core rate edged up to 5.5%, not much below its recent peak of 5.7% in March. The CPI for goods was down to 5.5% from a peak of 15.1% in October 2022 (*Fig. 10*). The CPI service inflation rate rose to a new high of 5.4% for the current inflation cycle (*Fig. 11*).

Inflation III: Disinflating Prices. In the United States, both June's CPI and PCED inflation rates continued to confirm their disinflationary trends since last summer for goods. Services inflation has been stickier but should be less so over the rest of this year. Consider the following:

(1) July's prices-paid and prices-received indexes for the US regional surveys conducted by five of the Federal Reserve district banks flattened in July but are down sharply from last year's highs and the lowest since late 2020 (*Fig. 12*). Odds are good that the national M-PMI prices-paid-index (which is correlated with the comparable regional index) remained below 50.0 in July (*Fig. 13*).

(2) June's PCED inflation rate for goods was down to -0.6% y/y from last year's peak of 10.6% in March and June (*Fig. 14*). The services price component remained sticky, declining to 4.9% from a recent peak of 5.8% in February.

The good news is that rent inflation, which is a major component of the PCED services inflation rate, is likely to head lower at a faster pace in coming months. Rent inflation in the PCED, including both rent of primary residence and owners' equivalent rent, edged down to 8.0% in June from a recent high of 8.4% in April (*Fig. 15*). It lags behind measures of rent on new leases such as the Zillow Index and the ApartmentList Index, which were down to 4.1% in June and -0.7% in July, respectively.

Other components of the PCED inflation rate are showing some stickiness, such as personal care (10.2%) and recreation (4.7%). But transportation services inflation has dropped to 3.6% from 16.3% in January of this year (*Fig. 16*). Remaining low are communication services (-0.5%), health care (2.2%), and education (2.5%).

Calendars

US: Tues: JOLTs Job Openings 9.62m; ISM M-PMI & Price Index 46.5/42.5; Construction Spending 0.0%; Weekly Crude Oil Inventories. **Wed:** ADP Nonfarm Employment 188k; MBA Mortgage Applications; Crude Oil Inventories & Gasoline Production. (Bloomberg estimates)

Global: Tues: Eurozone, Germany, and France M-PMIs 42.7/38.8/44.5; Eurozone Unemployment Rate 6.5%; Germany Unemployment Rate 5.7%; Italy Unemployment 7.7%; UK M-PMI 45.0; RBA Interest Rate Decision 4.35%. **Wed:** Japan M-PMI & NM-PMI 50.4/53.9; China Caixin NM-PMI 52.5; Australia Retail Sales -1.8%. (Bloomberg estimates)

Strategy Indicators

S&P 500/400/600 Forward Earnings (*link*): Forward earnings rose last week for LargeCap and SmallCap, but fell for MidCap. While it's been 58 weeks since any of these indexes has hit a record high, all three are up from their lows during February and March. Through the week ending July 28, LargeCap's forward earnings is 3.4% above its 54-week low during the week of February 10. MidCap's is 2.9% above its 55-week low during the week of March 10, and SmallCap's is 1.5% 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 2.6% below its record high at the end of June 2022; MidCap's is 5.4% below its record high in early June 2022; and

SmallCap's is 12.3% below its mid-June 2022 record. Forward earnings momentum remains near two-year lows. The yearly rate of change in LargeCap's forward earnings was negative for a 26th straight week, and up to -1.9% y/y from a 29-month low of -3.2% y/y during the June 23 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 -4.1% y/y is up from a 31-month low of -5.9% in early June, which compares to a record high of 78.8% in May 2021 and a record low of -32.7% in May 2020. SmallCap's -11.0% y/y rate is up from a 32-month low of -12.9% in mid-June and 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 (-0.1% and 12.5%), MidCap (-11.3, 13.4), and SmallCap (-10.4, 12.8).

S&P 500/400/600 Valuation (*link*): Valuations rose for these three indexes through the July 28 week. LargeCap's forward P/E gained 0.1pt w/w to an 18-month high of 19.6. It's up 4.4pts 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 0.1pt to a 21-week high of 14.4, and is just 0.3pt below its recent 10-month high of 14.7 in early February. It's now up 3.2pts from 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 21-week high of 14.1, which compares to a 19-week low of 12.5 during the May 12 week and is now just 0.3pt below its recent 12-month high of 14.3 in early February. It's 3.5 pts 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 27% discount to LargeCap's P/E remains near its 24-year-low 30% discount during the June 23 week. It had been at a 21% discount during the March 17 week, which was near its best reading since November 2021. SmallCap's 28% discount to LargeCap's P/E last week is not much above its 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 an 111th straight week; the current 2% 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 a 9.6% 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 -6.4% in Q2, down from a 0.1% gain in Q1-2023. However, S&P 500 ex-Energy earnings are forecasted to be down only 0.3% y/y in Q2-2023, an improvement from the 1.6% 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 that did so in Q1-2023 and up from only two in Q4-2022. Here are the S&P 500 sectors' expected earnings growth rates for Q2-2023 versus their final earnings growth rates for Q1-2023: Consumer Discretionary (36.3% in Q2-2023 versus 56.2% in Q1-2023), Communication Services (16.1, -8.9), Industrials (11.5, 27.1), Financials (8.0, 7.7), Consumer Staples (6.2, 0.4), Information Technology (0.3, -8.3), S&P 500 ex-Energy (-0.3, -1.6), Real Estate (-2.9, -6.2), Utilities (-3.6, -21.8), S&P 500 (-7.9, 0.1), Health Care (-29.0, -14.8), Materials (-29.3, -22.2), and Energy (-48.5, 21.0).

S&P 500 Q2 Earnings Season Monitor (*link*): With the Q2-2023 earnings season now 51% complete, the indications from the companies that have reported so far suggest a similar earnings surprise than in Q1-2023 but a weaker revenues surprise. During Q4-2022, the earnings surprise was the lowest since Q4-2008 and the revenue surprise the smallest since Q1-2020. Furthermore, the earnings surprise failed to outpace the revenue surprise in Q4-2022 for the first time since we began tracking that data in Q1-2009. With 255 of the S&P 500 companies finished reporting for Q2-2023, revenues are ahead of the consensus forecast by 1.4%, and earnings have exceeded estimates by 6.8%. At the same point during the Q1 season, revenues were 2.1% above forecast, and earnings had beaten estimates by 7.7%. For the 255 companies that have reported Q2 results so far through mid-day Monday, 63% has reported a positive revenues surprise, while 79% has reported an earnings beat. That's on pace for the narrowest revenues beats reading since Q1-2020; but the percentage with positive earnings surprises is slightly above the pace of the prior six quarters. Their aggregate y/y revenues and earnings growth rates are mixed from their Q1-2023 readings: improving to -0.2% from -0.6% for earnings growth and dropping to 2.5% from 3.8% for revenues growth. Over the past 57 quarters through Q1-2023, y/y earnings growth has trailed y/y revenues growth in only 15 quarters including the past five, and it's already doing so again in Q2-2023 as Energy sector results are being reported. Significantly fewer companies have been reporting positive y/y earnings growth in Q2 (58%) than positive y/y revenues growth (70%). These figures will continue to change as more Q2-2023 results are reported in the coming weeks. While we expect the overall y/y revenues growth rate to remain positive in Q2, upcoming releases from additional companies in the Energy and Materials sectors are likely to result in the biggest y/y earnings decline for the S&P 500 since Q2-2020.

US Economic Indicators

Regional M-PMIs (*link*): Five Fed districts have reported on *manufacturing activity* for July—New York, Philadelphia, Richmond, Kansas City, and Dallas—and show manufacturing activity (to -10.5 from -10.1) contracted at the same pace as June, slowing from March's recent bottom of -16.5. Activity in the Dallas (-20.0 from -23.2) and Philadelphia (to -13.5 from -13.7) regions continued to contract at a fast pace, while Richmond's (-9.0 from -8.0) and Kansas City's (-11.0 from -12.0) activity levels contracted at a fairly steady pace. Meanwhile, activity in the New York (1.1 from 6.6) region expanded at a slower rate than last month, falling toward the breakeven point of zero. *New orders* (-14.2 from -10.9) declined at a slightly faster pace in July, as billings in four of the regions deteriorated: Kansas City (-20.1 from -14.0), Richmond (-20.0 from -16.0), Dallas (-18.1 from -16.6), and Philadelphia (-15.9 from -11.0). Meanwhile, New York (3.3 from 3.1) orders held steady. *Employment* (4.5 from –3.0) showed factories hired workers in the Dallas (10.0 from 2.2) region for the fifth successive month and Kansas City (4.0 from -12.0) factories for the fifth time this year. Meanwhile, New York (4.7 from -3.6) factories added to payrolls for the first time this year, while the Richmond (5.0 from -1.0) factories posted the second gain this year; Philadelphia (-1.0 from -0.4) factories continued to fluctuate just below the breakeven point of zero.

Regional Prices Paid & Received Measures (*link*): We now have July prices-paid and -received data for the five Fed regions—New York, Philadelphia, Richmond, Dallas, and Kansas City. (Note: The New York, Philadelphia, Dallas, and Kansas City 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.) The *prices-paid* measure in July ticked up to 17.3, after easing the prior four months, from 40.3 in February to 16.7 in June—which was the lowest since July 2020; it peaked at a record high of 90.1 during November 2021. Looking at prices-paid indexes, the New York (16.7 from 22.0) region posted its lowest reading since August 2020, while Richmond's (40.7 from 45.6) was the lowest since January 2021. Meanwhile, the Philadelphia (9.5 from 10.5) and

Kansas City (9.0 from 4.0) measures remained on steep downtrends, with the former not far from April's 8.2 reading—which was its lowest since mid-2020 and the latter not far from June's reading—which was the lowest since mid-2020. The Dallas (10.5 from 1.4) saw an acceleration in pricing. Turning to the *prices-received* measure, it also saw a slight uptick in July, to 12.5, after easing the prior seven months, from 38.1 in November to a 32-month low of 11.3 in June; it was at a record high of 59.0 in March 2022. Regionally, the indexes were mixed: Kansas City's (-7.0 from 3.0) eased to its lowest reading since May 2020, while New York's (3.9 from 9.0) was the lowest reading since July 2020. Meanwhile, Philadelphia's measure was up for the second month in July to 23.0 (from 0.1 in June)—after falling from 37.6 last November to -7.0 this May—which was the weakest since April 2020. Richmond's (40.1 from 45.6) was the weakest since March 2021. Meanwhile, prices-received in the Dallas (2.3 from -1.0) remained low, though moved from negative to positive territory.

Global Economic Indicators

Eurozone CPI Flash Estimates (*link*): The CPI rate for July is expected to move down again, to 5.3%—its lowest since January 2022—from 5.5% in June; it peaked last October at a record-high 10.7%. Looking at the main components, *energy* is forecast to fall 6.1% y/y, its fourth negative reading in five months and the weakest since December 2020, following double-digit yearly gains from April 2021 through February of this year. It peaked at a record high of 44.3% last March. The rate for *food, alcohol & tobacco* is predicted to slow for the fourth month to 10.8% y/y after accelerating steadily from June 2021's 0.5% to a record high of 15.5% this March. The rate for *non-energy* industrial goods is expected to ease for the fifth month to 5.0% y/y from February's record-high 6.8%. Meanwhile, the *services* rate is forecast to accelerated to 5.6% y/y in July, the highest since fall 1992. Of the *top four Eurozone economies*, only Germany (6.5% y/y) and Italy (6.4) showed rates above the Eurozone's expected 5.3% rate, while France's (5.0) was a few ticks below. Meanwhile, Spain's (2.1) rate was one of the lowest of the overall Eurozone economies, though did accelerate from June's 1.6%. Here are the record-high inflation rates and dates they were achieved for the four countries: Germany (11.6%, October 2022), Italy (12.6%, October & November 2022), France (7.3%, February 2023), and Spain (10.7%, July 2022).

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