MORNING BRIEFING
November 15, 2023

Transitory After All

Check out the accompanying chart collection.

Executive Summary: It's no longer debatable: October's headline and core CPI excluding shelter reveal that inflation has turned out to be a transitory rather than persistent problem. Rent-of-shelter inflation and nonhousing services inflation are coming back down to Earth more slowly but surely too, as the pandemic effects lifting them all are finally dissipating. … Treasury Secretary Yellen said that the supply of Treasuries didn't push yields up in October, yet her actions easing supply concerns speak louder. … Also: Small business owners have plenty of job openings but not enough qualified job applicants. …. And: Joe finds just a handful of big companies account for lowered S&P 500 Q4 earnings expectations.

Inflation: Back to 2.0%. You read that right: Inflation is back to 2.0%. That's based on October's CPI less food, energy, and shelter on a y/y basis (*Fig. 1*). Excluding only shelter, the CPI inflation rate was even lower at just 1.5%. You might be thinking: "Why are economists always taking out what doesn't support their story? After all, the headline and core CPI inflation rates were 3.2% and 4.0% in October" (*Fig. 2*).

Good point, but there is good reason for taking out shelter at least. Here it is as explained by Fed Chair Jerome Powell in his Jackson Hole *speech* on August 25:

Because leases turn over slowly, it takes time for a decline in market rent growth to work its way into the overall inflation measure. The market rent slowdown has only recently begun to show through to that measure. The slowing growth in rents for new leases over roughly the past year can be thought of as "in the pipeline" and will affect measured housing services inflation over the coming year. Going forward, if market rent growth settles near pre-pandemic levels, housing services inflation should decline toward its pre-pandemic level as well.

Sure enough, CPI rent inflation is coming down but more slowly than the headline and core CPI inflation rates since last summer. The CPI rent of shelter index peaked at 8.3% y/y this March (*Fig. 3*). It was down to 6.8% in October, which is still a high reading. However, the Zillow current rent index was down to 3.2% y/y in October. It reflects new leases (*Fig. 4*). As Powell observed, it should be a leading indicator for the CPI shelter inflation rate.

Now consider the following related observations about the latest CPI report:

(1) *Nonhousing services CPI.* In his Jackson Hole speech, Powell reiterated his concern about the stickiness of inflation in the nonhousing services sector:

> The final category, nonhousing services, accounts for over half of the core PCE index and includes a broad range of services, such as health care, food services, transportation, and accommodations. Twelve-month inflation in this sector has moved sideways since liftoff. Inflation measured over the past three and six months has declined, however, which is encouraging. Part of the reason for the modest decline of nonhousing services inflation so far is that many of these services were less affected by global supply chain bottlenecks and are generally thought to be less interest sensitive than other sectors such as housing or durable goods. Production of these services is also relatively labor intensive, and the labor market remains tight. Given the size of this sector, some further progress here will be essential to restoring price stability. Over time, restrictive monetary policy will help bring aggregate supply and demand back into better balance, reducing inflationary pressures in this key sector.

This "supercore" component of the PCED inflation rate has been stuck around 5.0% since October 2021 (*Fig. 5*). It was down to 4.3% in September. So it may finally be turning less sticky. In any event, the Fed's job isn't to finetune the components of the CPI, as Melissa and I have observed recently; what matters is that the overall inflation rate is heading downward, which it is.

By the way, the CPI's version of supercore inflation (i.e., CPI services less rent of shelter) fell to 3.0% during October, down from last year's peak of 8.2%. That should be a good harbinger of further declines in the PCED supercore inflation rate.

(2) *Durable goods CPI.* Inflation has turned out to be transitory for the goods components of the CPI (*Fig. 6*). This index edged up just 0.4% y/y through October, the lowest reading since December. The CPI for durable goods fell 2.1%. It is deflating again, which is what it has tended to do since the second half of the 1990s until the end of the pandemic lockdown.

(3) *Nondurable goods CPI.* The nondurable goods CPI inflation rate was well over 10% last summer. Now it is back down to just 1.7%. The most volatile components of this index, of course, are food and energy (*Fig. 7*). Food inflation peaked last year at 11.4% during August and was back down to 3.3% in October. Energy inflation peaked at 41.6% last year during June and was -4.5% in October. Food and energy prices were boosted by the initial supply shocks caused by Russia's invasion of Ukraine in late February of last year. Now, weak global economic growth is moderating food and energy inflation.

(4) *Transitory after all.* There can be no debate about the transitory nature of goods inflation

since H2-2020. It turned out to be mostly attributable to the shocks and aftershocks of the pandemic, which have been dissipating since the end of the pandemic.

Almost all the inflationary pressures on durable goods and many nondurable goods stemmed from the pandemic-related supply-chain disruptions, which can be seen in the Global Supply Chain Pressure Index compiled by the Federal Reserve Bank of New York (*Fig. 8*). The index jumped from 0.1 during October 2020 to peak at 4.3 during December 2021. It has plunged since then to -1.7, the lowest reading in the series, which started in September 1997.

As Debbie and I have often observed, the end of the pandemic lockdown during March and April 2020 led to a goods buying binge. We all had cabin fever and saved some money for a couple of months, then Washington provided three rounds of pandemic relief checks to millions of Americans. To relieve our cabin fever, we all went shopping. The buying binge overwhelmed supply chains, which were also disrupted by labor shortages. Consumers then pivoted away from goods toward purchasing services as they became more available starting around March 2021 (*Fig. 9*).

That's all behind us now, as is the goods inflation shock. Now the services inflation shock is showing signs of dissipating.

Fiscal Policy: In Yellen We Trust. When Janet Yellen was Fed chair from October 2010 through February 2014, I often fondly (and respectfully) referred to her as the "Fairy Godmother of the Bull Market." I noticed that almost every time she spoke publicly about the outlook for monetary policy and the economy, the stock market moved higher.

She hasn't been as bullish for the stock market since January 2021, when she became the secretary of the US Treasury in the Biden administration. Under her watch so far, the federal budget deficit rose to the pre-pandemic record high of $1.7 trillion over the 12 months through October (*Fig. 10*). The same can be said about the $2.3 trillion increase over this same period in marketable US Treasury securities, which are up to a staggering $5.0 trillion since Yellen joined the Biden administration.

The deficit outlook has been exacerbated by the record $26 trillion in marketable debt held by the public that the Treasury must refund at higher interest rates than when Yellen took charge at the Treasury. Over the past 12 months through October, the Treasury's net interest outlays rose to a record $692.2 billion (*Fig. 11*).

Under Yellen's watch so far, the debt that the Treasury department issues has been downgraded by Fitch Ratings in August and Moody's this past Friday. Yet on Monday, Yellen said she disagrees with Moody's decision and countered that the Biden administration is "completely committed to a credible and sustainable fiscal path."

On October 26 at an *event* in Bloomberg's Washington office, Yellen dismissed the notion that bond yields were rising just because the Treasury's financing needs have swelled. She stated: "I don't think much of that is connected." She blamed higher interest rates on the strong economy: "The economy is continuing to show tremendous robustness, and that suggests that interest rates are likely to stay higher for longer," she said.

Nevertheless, the Treasury helped to spark a significant bond rally on November 1 by announcing that the next round of auctions would have more bills and fewer notes and bonds. In other words, Yellen in effect admitted that supply does matter.

US Economy: Still Lots of Jobs But Few Qualified Applicants. Our main takeaway from October's small business owners survey conducted by the National Federation of Independent Business is that there are still plenty of job openings. Indeed, 43% of respondents said they have unfilled positions. This series is highly correlated with the JOLTS job openings series, which Fed Chair Powell often mentions in his remarks about the labor market (*Fig. 12*).

Fewer small business owners are expecting to hire. The percentage saying so fell from a record 32% during August 2021 to 17% in October 2023 (*Fig. 13*). That's partly because the percentage who say that there are no qualified applicants rose from 51% at the end of 2022 to 55% in October.

Strategy: Q4's Weaker Growth Outlook Narrowly Based. Last week, we discussed the strong Q3 results reported so far by the S&P 500 companies and noted that industry analysts' estimates for Q4-2023 have been falling at the fastest rate since the end of 2022. Today, we're taking another look at the S&P 500's Q4 expectations and uncovering where the hits to earnings are taking place.

Here are our main takeaways:

(1) *Brief pause ahead for record-high S&P 500 quarterly EPS.* The S&P 500's blended EPS for Q3-2023 has come in at a record-high $58.20, exceeding its prior record of $57.62 during Q2-2022. Looking ahead, the consensus forecast for S&P 500 earnings in Q4-2023

has dropped 4.7% to $55.36 in the six weeks since the start of the quarter. The consensus is expecting below-record-high quarterly EPS of $56.85 in Q1-2024, before rising to new record highs of $60.31 and $63.73 in Q3- and Q4-2024.

According to LSEG, the S&P 500's expected Q4-2023 growth rate is now down to 5.8% y/y from 11.0% at the start of the quarter. That growth forecast represents a deceleration from the blended 6.3% y/y rate recorded so far for Q3-2023. On its face, the weaker Q4 growth rate appears to be a new worry for investors and provides ammo for those expecting a recession shortly. We disagree.

(2) *A transitory "auto-immune deficiency" in Q4*. A deeper dig into where expectations primarily have been falling leads us to believe that Q4's earnings deterioration is transitory too. More than half of the decline in expectations is attributable to just six big companies in two industries: three automakers and three drug companies.

Q4 earnings expectations for Ford and General Motors have deflated due to the impact of the recently ended United Auto Workers strike. Non-unionized Tesla is seeing the effects of reduced prices for its line of electric vehicles as well as high startup production costs for its unprofitable Cybertruck.

The total expected Q4 earnings for these three automakers has fallen 33% since the start of the quarter to a still profitable $4.1 billion. While large, their collective decline in Q4 earnings expectations accounts for just 9% of the overall S&P 500's $24 billion drop.

The three drug companies (Merck, Moderna, and Pfizer) have accounted for the bulk of the drop in the S&P 500's total Q4 earnings expectations. Their income statements are experiencing withdrawal symptoms, as demand has evaporated quickly for Covid vaccines and other drugs. All three companies are expected to report a loss in Q4. Altogether, their $11.1 billion drop in expected earnings since the quarter started accounts for 80% of meltdown in the S&P 500 Health Care sector's anticipated Q4 earnings and 46% of the drop in the overall S&P 500's.

Calendars

US: Wed: Headline & Core PPI 0.1%/0.2%; Retail Sales, Headline & Ex Gas & Autos -0.1%/0.1%; Business Inventories 0.3%; Empire State Manufacturing Index -2.60; MBA Mortgage Applications; Crude Oil Inventories & Gasoline Production; Barr. **Thurs:** Import

Prices -0.3%; Philadelphia Fed Manufacturing Index -11.0; KC Manufacturing Index; Industrial Production -0.4%; Capacity Utilization 79.4%; Initial Jobless Claims 222k; NAHB Housing Market Index 40; Natural Gas Storage; Williams; Barr; Cook; Waller; Mester. (FXStreet estimates)

Global: Wed: Eurozone Industrial Production -0.7%m/m/-6.3%y/y; Eurozone CPI; Germany WPI 0.2%; UK Headline & Core CPI 0.1%m/m/4.8%y/y & 0.4%m/m/5.8%y/y; UK Input & Output Prices 0.1%/0.1%; Japan Core Machinery Orders 0.9%m/m/-3.6%y/y; Australia Employment Change 18.0k; Australia Unemployment & Participation Rates 3.7%/66.7%; Haskel. **Thurs:** Lagarde; Enria; Wuermeling; DE Guindos; Ramsden. (FXStreet estimates)

US Economic Indicators

Consumer Price Index (*link*): Both headline and core prices came in lower than expected in October. The *headline CPI* was unchanged (vs 0.1% expected), following gains of 0.4% and 0.6% the prior two months and was the lowest monthly reading since July 2022, while core inflation increased 0.2% (vs 0.3% expected), slowing from gains earlier this year and matching its recent low. On a yearly basis, the headline CPI eased to 3.2%, after increasing from a recent low of 3.0% in June (lowest since March 2021) to 3.7% during August and September. October's rate is one-third of last June's 9.1% peak. *Core prices* yearly rate continued to ease, slowing from a recent peak of 6.6% last September to a 25-month low of 4.0% this October, above the 2.0%-2.5% range pre-Covid. Here's a laundry *list of CPI yearly rates* for October: The rate for consumer durable goods fell 2.1% y/y, its 11th negative reading, while the rate for *consumer nondurable goods* excluding food (-0.1 y/y) dipped back into negative territory after brief moves above in August (0.6) and September (2.7). The *services rate excluding energy* eased a bit for the eighth month, to 5.5% y/y, after rising from 1.3% in January 2021 to 7.3% this February—which was the highest since summer 1982. *Food* costs (3.3% y/y) eased for the 14th month from last August's 11.3%, which was the fastest pace since April 1979. Within food, the rate for *food at home* (2.2) has slowed steadily from 13.5% last August (the highest since March 1979); the yearly rate for *food away from home* slowed for the seventh month to 5.4% y/y from March's 8.8%—which was the highest since fall 1981. *Energy costs* were below zero for the eighth month. They tumbled from last June's 41.6%—the fastest pace since April 1980—to -16.7% y/y this June; more recently, the decline narrowed to -0.5% in September before widening again to -4.5% in October. Within energy, the yearly rate for *fuel oil* plummeted to -36.6% y/y in June, down from last May's record high of 106.7%, though it picked up to -5.1% in September before tumbling -21.4% y/y in October. The rate for gasoline prices bottomed at -26.5% in

June, climbed to +3.0% in September, and returned to negative territory in October (-5.3); it peaked at 59.9% last June (fastest since March 1980). The rate for *natural gas* prices has been dropping y/y: The price fell below the year-ago level in April (-2.1) for the first time since August 2020 and was at -15.8% in October. The y/y rate was 38.4% last June, which was the highest since October 2005. The *electricity* rate (2.4% y/y) continued to hold around 2.0%, after easing to a 31-month low of 2.1% y/y in August; it peaked at 15.8% last August—which was the highest since August 1981. Within *consumer durable goods*, the rate for *new cars* rose 1.3% y/y, the lowest rate since March 2021, down from last April's record high of 14.2%, while the rate for *used cars & trucks* was –7.1% y/y last month, up from February's -13.6% bottom—which was the lowest since November 1960. It was as high as 41.2% last February and at a record-high 45.2% during June 2021. The rate for *furniture & bedding* was in negative territory for the sixth month, narrowing to -2.9% in October from -5.4% in September (which was the lowest since mid-2010). It's down dramatically from last February's record high of 17.1%. The rate for *major appliances* fell to -9.6% y/y, down from its recent peak of 12.4% last March, though narrowing from June's record low of -10.7%. Within *consumer nondurable goods*, the rate for apparel prices was 2.6% y/y, little changed from September's 2.3%, which was the lowest since April 2021 and down from last March's recent peak of 6.8% (the highest since the end of 1980). Before the recent move down, it fluctuated in a 5.0%-5.5% range from last April through September. Within services, *owners' equivalent rent* eased for the sixth month, to 6.8% y/y, not far from its record high of 8.1% in April, while the rate for rent of *primary residence* dipped to 7.2% y/y, easing from 8.8% y/y during February through April (the highest since fall 1981). These rates compare with recent lows of 1.8%. Meanwhile, the yearly rate for *lodging away from home* slowed to 1.2% in October after accelerating from 3.3% in April to 7.3% y/y in September; it was at a record high of 25.1% in both March and February of 2022. Turning to *medical care*, the yearly rate for *hospitals' services* has been fluctuating in a volatile flat trend in recent months, accelerating 4.5% y/y in September from a recent low of 2.7% in March. The *physicians' services* (-1.2) rate had hovered around zero for the prior seven months before its move above zero in October. Meanwhile, the yearly rate for *airfares* fell 13.2% y/y, up from June's -18.9%, which was its steepest drop since February 2021; that compares with last October's 42.9%, which wasn't far from the record high of 45.0% in September 1980.

NFIB Small Business Optimism Index (*link*): "This month marks the 50th anniversary of NFIB's small business economic survey," said NFIB Chief Economist Bill Dunkelberg. "The October data shows that small businesses are still recovering, and owners are not optimistic about better business conditions. Small business owners are not growing their inventories as labor and energy costs are not falling, making it a gloomy outlook for the remainder of

the year." October's *Small Business Optimism Index* (SBOI) fell for the third month, slipping 0.1ppt during October and 1.2ppts during the three months through October to 90.7; that's after climbing the prior three months by 2.9ppts to an eight-month high of 91.9. That marks the 22nd consecutive month that the index was below its 49-year average of 98.0, not having exceeded the average since December 2021. In October, five of the 10 components increased, two decreased, while three were unchanged—expect economy to improve (-43%), current job openings (43), and capital outlay plans (24). Sales expectation (+3ppts to -10%) posted the biggest positive contribution, while the remaining four positive contributors all rose by just 1.0ppt: now is a good time to expand (to 6), plans to increase inventories (0), current inventory (-3), expected credit conditions (-9). The biggest drag on October's SBOI earnings trends (-8ppts to -32%), with plans to increase employment (-1 to 17) a minor drag. Quality of labor (23) and inflation (22) were small business owners' *single biggest business problem*, with taxes (13), cost of labor (9), and government requirements (9) rounding out the top five. The net percentage of owners *raising selling prices* climbed for the third month to 30% in October after sinking to a 29-month low of 25% in July; it was at a near-record-high 66% last March. The net percentage of owners *planning to increase selling prices* climbed from 30% during August and September to an 11-month high of 33% in October, after slipping from 31% in June to 27% in July. It was at a recent low of 21% in April and at a record high of 54% during November 2021. A net 36% of owners reported *raising compensation* last month, unchanged from September and August—and matching June's 25-month low. It was at 46% the first two months of this year and at a record-high 50% at the start of 2022. A net 24% of owners *plan to increase compensation* in the next three months, up from 23% in September but down from August's 26%, which was the highest this year.

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