PALLAS
CAPITAL ADVISORS

# Week in Review

Friday, February 11th, 2022

## 1. Inflation Remains Elevated

The Consumer Price Index (CPI) increased at a 7.5% annual rate in January, versus a consensus expectation of 7.3%. This represented the fastest rise since 1982, as well as an acceleration from 7.0% in December.

US Consumer Price Index, Year Over Year Change


Hover over chart to view data.
Note: Shaded area represents recession, as determined by the National Bureau of Economic Research.
Source: U.S. Bureau of Labor Statistics.

The increase in prices was realized broadly across categories with certain categories such as energy, new and used cars, and meats within at-home food seeing double-digit increases. These price increases are having an impact on the consumers with current estimates that the incremental monthly year-over-year spending equates to nearly $300 per household. Short-term and long-term interest rates both rose following the release of the data. The assumption is that the data supports a more hawkish tightening of interest rates by the Federal Reserve.

The goal of raising rates will be to curb inflation by increasing the cost of borrowing to consumers and businesses with an expectation that will dampen demand and economic activity. Prices for goods and services typically go up when demand rises and down, or at least stabilize, when demand falls. The unknown currently is how much raising interest rates will have on inflation that to a large extent has been driven by supply constraints and a catch-up for deferred spending due to the pandemic. Inflation driven by these factors may be less sensitive to the Federal Reserve raising rates in the near term, but their impact should lessen as their underlying causes are addressed.

**12-month percentage change, Consumer Price Index, selected categories, January 2022, not seasonally adjusted**

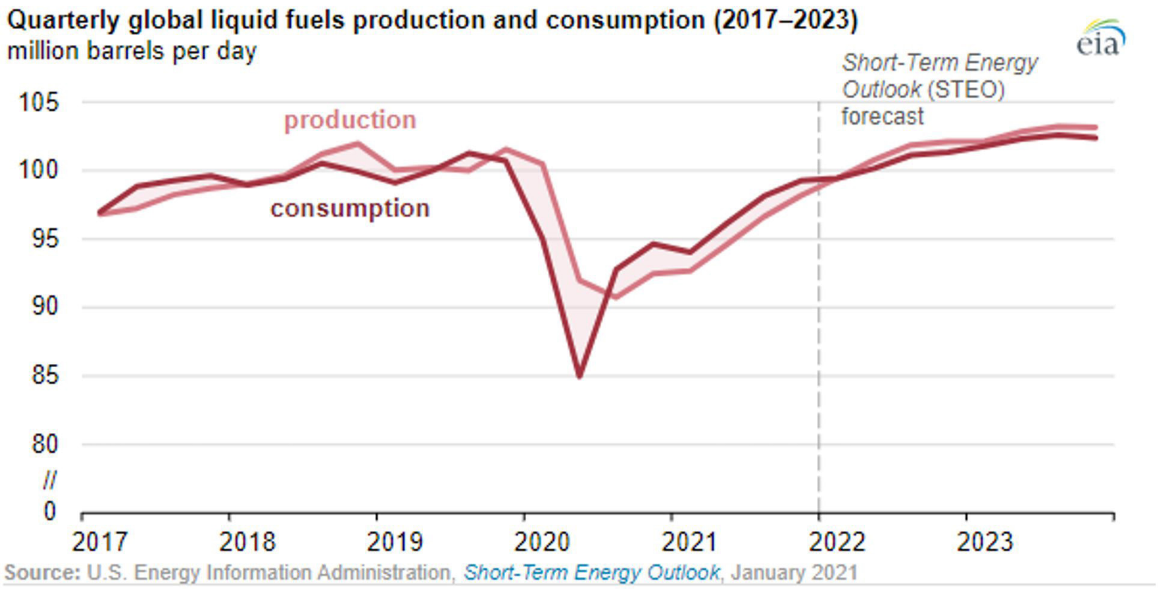
| Category | 12-month percent change, Jan 2022 |
|---|---|
| All items | 7.5% |
| Food | 7.0% |
| Food at home | 7.4% |
| Cereals and bakery products | 6.8% |
| Meats, poultry, fish, and eggs | 12.2% |
| Dairy and related products | 3.1% |
| Fruits and vegetables | 5.6% |
| Nonalcoholic beverages and beverage materials | 5.0% |
| Other food at home | 7.4% |
| Food away from home | 6.4% |
| Full service meals and snacks | 7.1% |
| Limited service meals and snacks | 8.0% |
| Energy | 27.0% |
| Energy commodities | 39.9% |
| Fuel oil | 46.5% |
| Gasoline (all types) | 40.0% |
| Energy services | 13.6% |
| Electricity | 10.7% |
| Natural gas (piped) | 23.9% |
| All items less food and energy | 6.0% |
| Commodities less food and energy commodities | 11.7% |
| Apparel | 5.3% |
| New vehicles | 12.2% |
| Used cars and trucks | 40.5% |
| Medical care commodities | 1.4% |
| Alcoholic beverages | 2.7% |
| Tobacco and smoking products | 7.0% |

Source: Us Bureau of Labor Statistics

The Federal Reserve's mission will be to thread the needle to balance the need to curb inflation, while not putting the brake on too hard in order to maintain a healthy economy and job market.

## 2. Oil Prices Hit Recent Highs

At the top of the items driving inflation has been rising energy costs. In the past month, crude oil prices surpassed $90 a barrel as demand continues to bounce back from the pandemic, while supplies around the world lag resulting in low inventories. The key determinant of the volatility in oil prices has been the large changes in global production and consumption during 2020 and 2021.




Prior to the pandemic, demand and production for oil were roughly in balance with production even surpassing consumption in 2018 and 2019 putting downward pressure on prices. This dynamic, followed by the pandemic, which saw a significant drop off in demand, led to lower investment and curtailed production.

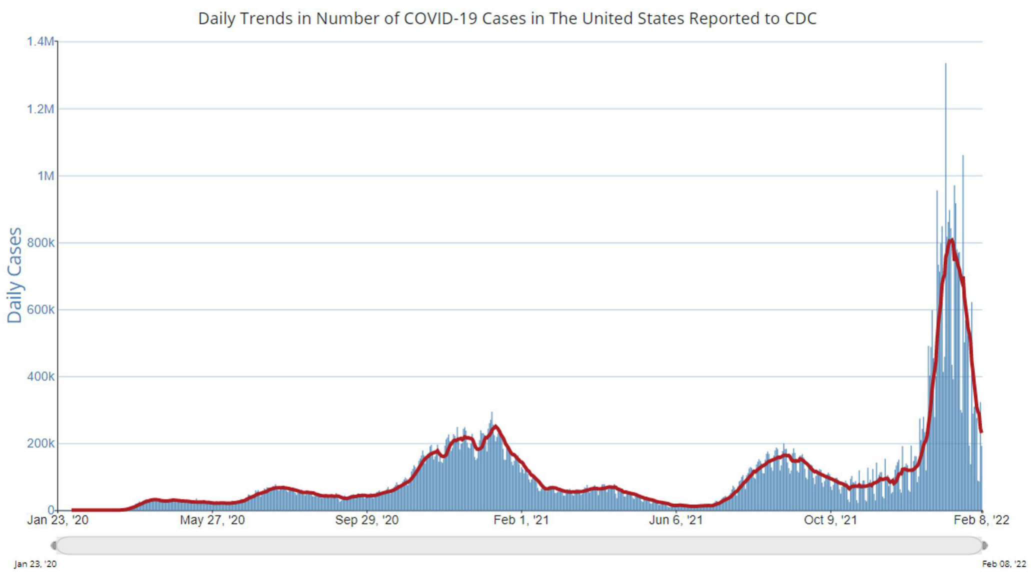
Coming out of the pandemic, 2021 saw the demand versus supply dynamic reverse with demand outstripping supply. A change in this dynamic will likely reverse, or at least halt, the ongoing rise in prices.

The US Energy Information Administration currently projects that global production can ramp up during 2022 and into 2023 and surpass consumption, resulting in a restocking of inventories and directionally lower prices. The timing of the production change and impact on prices, though, is unknown. While a likely eventuality, factors influencing the timing may be geopolitics (Ukraine & Russia), removal of restrictions on Iran, OPEC policy, and reacceleration of investment in US shale production.

In any case, an eventual pullback in energy prices will be an important factor in curbing inflation and likely contributor to getting long-term inflation back to the Federal Reserve's policy target of 2%.

## 3. Covid Cases Well Off Recent Peak Level

Covid cases have pulled well off the record levels for the pandemic realized during January of this year. Luckily, the Omicron variant that precipitated the latest surge, while the most contagious, has also been the least virulent.




Source: US CDC

The pull back in cases is leading to the relaxation of many restrictions both domestically and internationally. This could be a welcome boost for the economy and perhaps as important a reduction to ongoing supply chain constraints. Longer-term, the hope is that the latest Omicron surge coupled with vaccination efforts will have helped lead to greater natural immunity, reducing the impact of Covid in the near future.

# Thinking Ahead

This week's data releases confirmed that inflation, for the time being, is well entrenched. As such, inflation and the pending response by the Federal Reserve will continue to be a factor in the near-term direction and volatility in the markets. Longer-term, factors contributing to inflation, including energy prices and Covid, will likely see their impact mitigated. Identifying businesses to benefit from positive long-term fundamental trends will continue to be a focus.

Pallas Capital Advisors will continue to monitor economic, political, and corporate data for implications to markets.