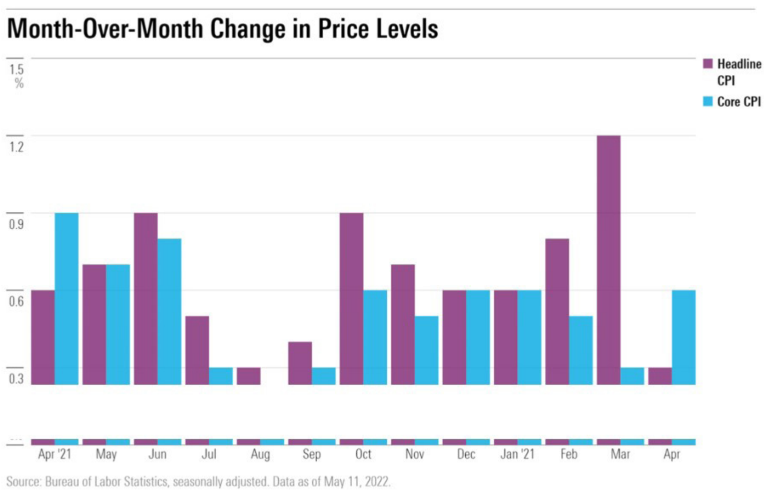
Week in Review

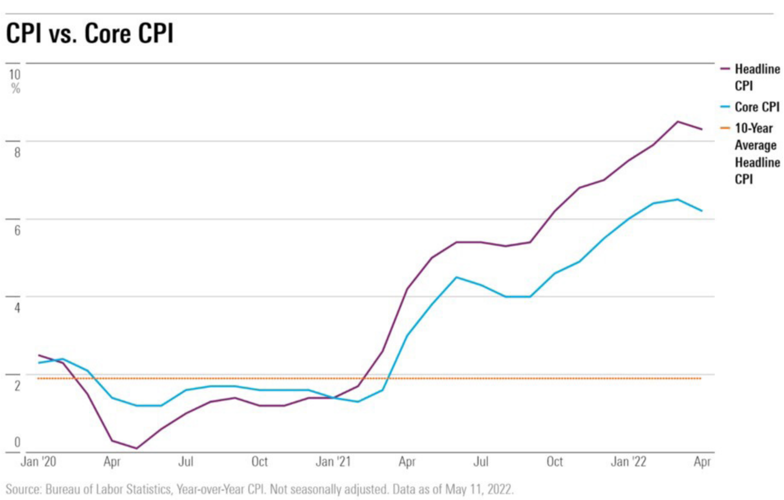
Friday, May 13th, 2022

1. Inflation Remains Elevated

April core CPI, which excludes food and energy prices, rose by 0.57% month-over-month, well above the consensus of +0.4% and the fastest pace since January. The year-on-year rate nonetheless fell three-tenths to 6.2% as last April's surge in used car prices dropped out of the calculation. Core CPI excludes the volatile categories of food and energy. Headline April CPI which includes these categories rose 0.33%, 0.13pp above consensus, as a 2.7% pullback in energy prices partially offset the strength in the core. Headline CPI was down substantially from the 1.2% jump recorded in March and the annual rate of inflation retreated slightly to 8.3% in April from 8.5% in March but remains near 40-year highs.

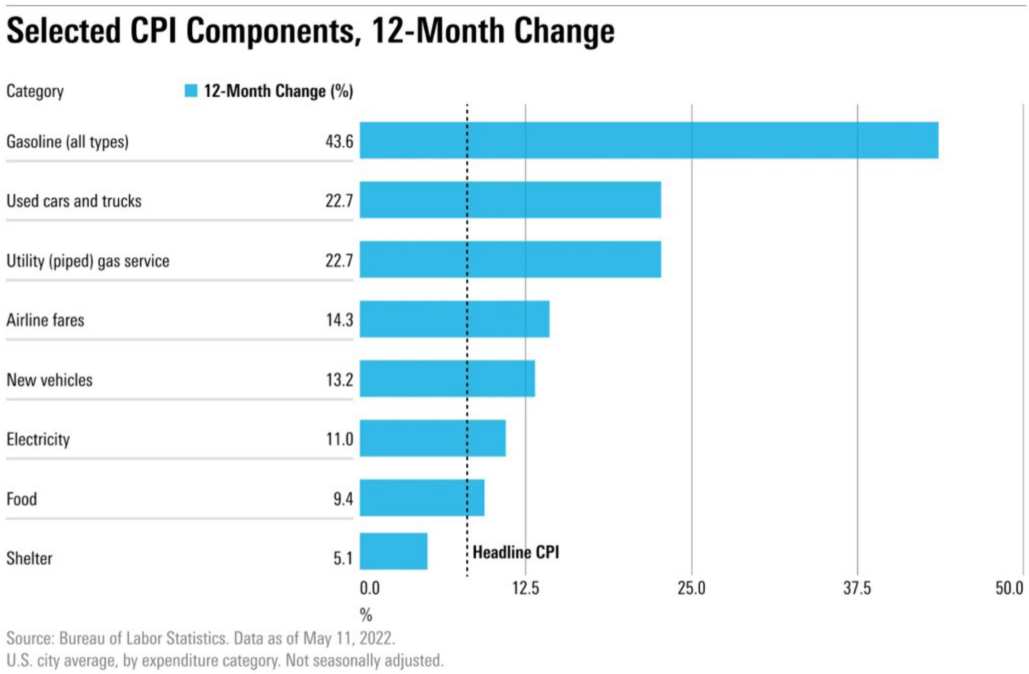


Source: Morningstar



Source: Morningstar

Driving the month-to-month increase in CPI was shelter, food, airline fares, and new-vehicle costs. The food index rose 0.9% for its 17th consecutive monthly increase, while the food-at-home index rose 1%. Notably, the energy index declined in April after months of increases, as gasoline prices fell 6.1%, which offset increases in natural gas and electricity. Meanwhile, costs for apparel, communication, and used cars and trucks all declined in April from March. However, on a year-over-year basis, gasoline, used cars and trucks, and utility prices have contributed to the greatest drivers of higher CPI.

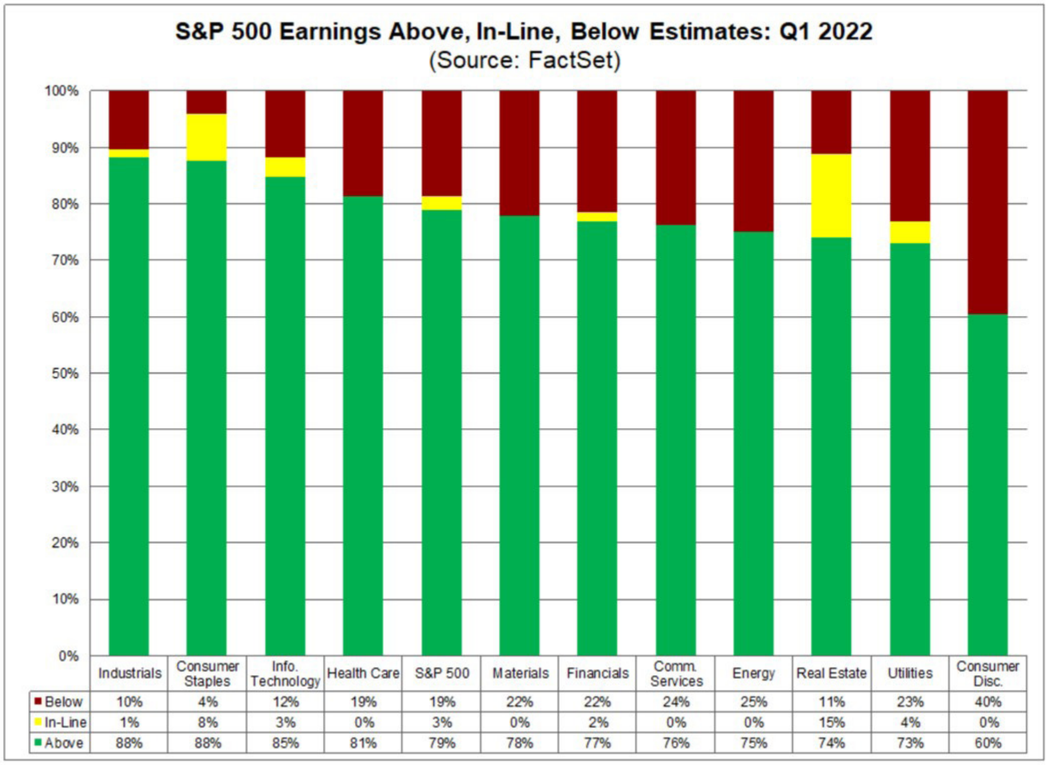


Source: Morningstar

The slowdown in some CPI components that have led to the high level of inflation suggest that CPI year-over-year has likely peaked, but the stubbornly high levels suggest the Federal Reserve will maintain its stance to rapidly tighten monetary policy to combat inflation. This has important ramifications for financial markets as higher rates weigh on valuation multiples and elevates concerns that the Fed's policy risks inducing a recession in the process of bringing down inflation.

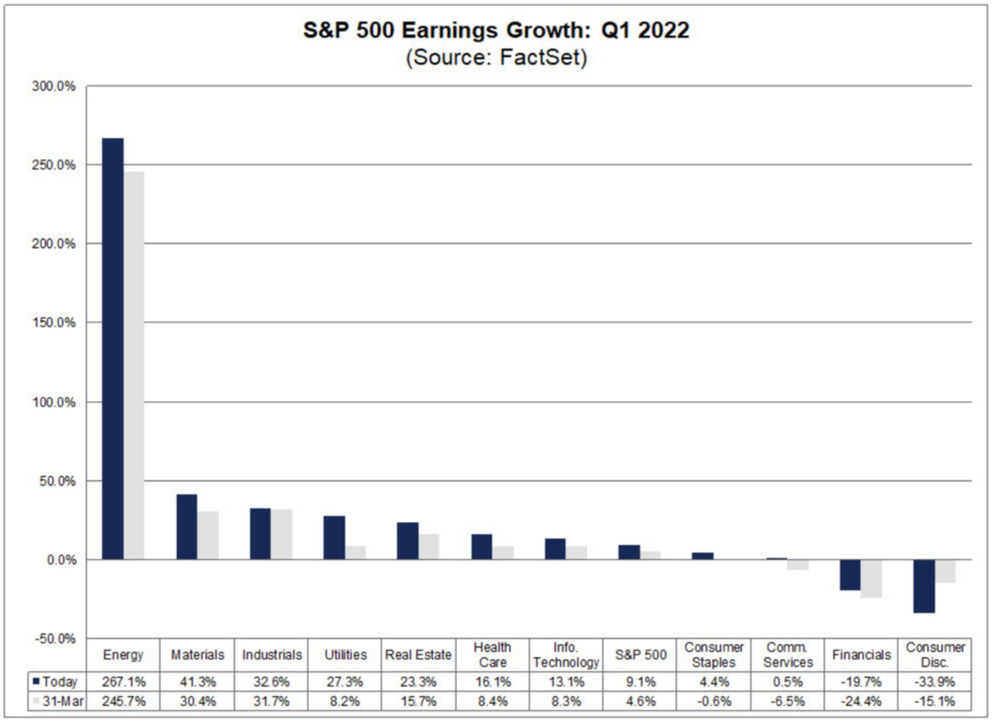
2. Corporate Earnings Continue to be Resilient

As of the start of this week, 87% of the companies in the S&P 500 have reported results for Q1 2022. Of these companies, 79% have reported EPS above estimates, which is above the five-year average of 77%. The magnitude of the beats is 4.9% above estimates, which while positive, is below the five-year average of 8.9%.



Positive earnings surprises are being reported by companies across multiple sectors led by industrials, consumer staples, information technology and healthcare. The Consumer Discretionary sector has been the laggard relative to the S&P 500 universe as a whole.

Due to these positive EPS surprises, the S&P 500 index earnings growth rate for the first quarter has risen relative to expectations at the beginning of the year and relative to the end of the 1st quarter in March. Earnings growth for the first quarter is now expected to be 9.1% versus 4.6% as of the end of March. In terms of relative growth, the overall projected rate of 9.1% is led by the Energy, Materials, and Industrials sectors. On the other hand, two sectors are reporting a year-over-year decline in earnings: Consumer Discretionary and Financials.



Looking ahead, analysts expect earnings growth of 4.8% for Q2 2022, 10.6% for Q3 2022, and 10.1% for Q4 2022. For the calendar year 2022, analysts are predicting earnings growth of 10.1%.

Concerns are clearly elevated that earnings expectation may be set too high considering Fed policy, the war in Ukraine, inflationary pressure on margins, and risk of deteriorating consumer sentiment. History suggests, though, those concerns are often embedded in expectations providing the basis for the ongoing trend of companies surpassing expectations even if the margins of beats narrow.

3. Continued Market Volatility

This week's CPI release did not provide the hoped-for clear signal that inflation has peaked, although there were green shoots. The market responded with significant volatility with new index lows for the year occurring on Thursday and pushing the S&P 500 into the definition of a bear market with a 20% pullback from the highs at the beginning of the year.

Notably on Thursday, more than 29% of the issues on the NYSE hit a 52-week low and on the NASDAQ the number was more than 33%. This level of coincident new lows has only happened on 18 days since 1984. While past performance is no guarantee of future performance and the current high inflation rate coming off a period of low rates is also unique, the S&P 500 showed a loss a year later only once a year after similar days and was only down -0.2%. On the other hand, the median return a year later was +32%. Near-term volatility and potential further downside should be expected, but longer-term history provides a positive guidepost.

Thinking Ahead

Another volatile week in the financial markets has come and gone as valuation levels react to inflation and concerns of slowing growth. April's CPI data saw some diminution in the pace of inflation but remains at levels not seen in 40 years. Overall, positive corporate earnings reports have had a difficult time offsetting the macro concerns. Ultimately, we believe that this macro storm will eventually pass and companies with quality characteristics and long-term earnings growth should recover with time. Pallas Capital Advisors will continue to monitor economic, political, and corporate data for implications to markets.