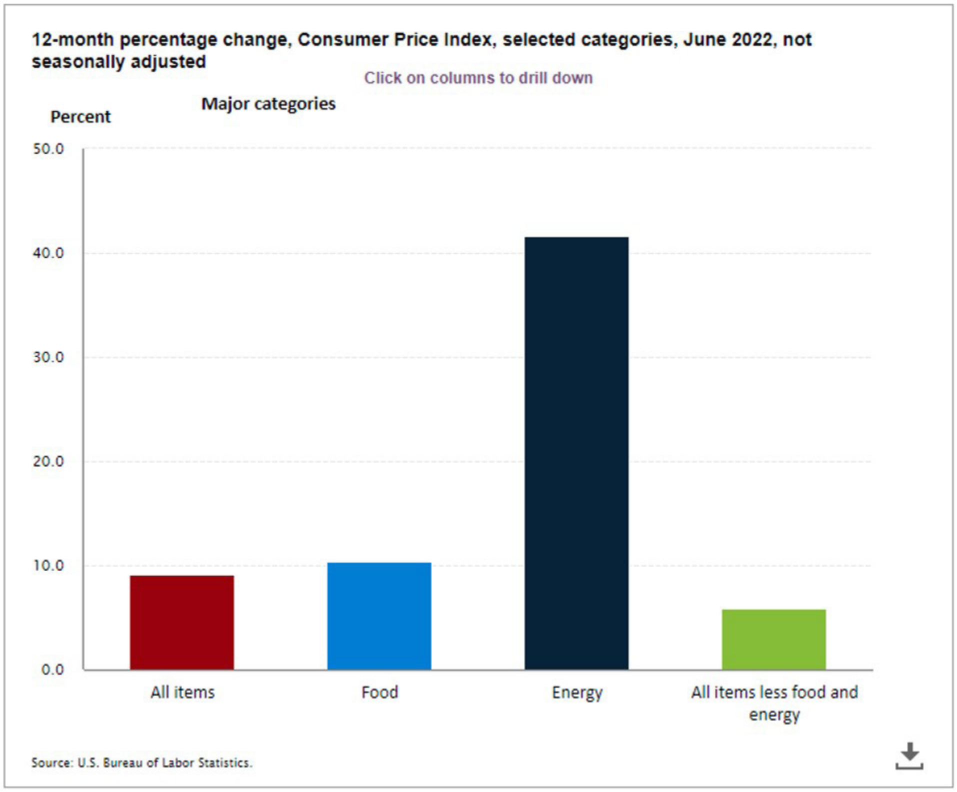
Week in Review

Friday, July 15th, 2022

1. June Inflation Still Hot. Is This The Peak?

Inflation for June set a new 40-year record as the consumer price index (CPI) rose to 9.1% over 12 months, the fastest pace since November 1981. The June rate was also above the May rate of 8.6%, which influenced the Federal Reserve to accelerate the pace of Fed Funds rate increases to bring down inflation.

The high pace of inflation was endemic across all consumer price categories but particularly pronounced in energy and food which rose 42% and 10.4%, respectively. Excluding food and energy, the so-called "core" rate of inflation was 5.9%. This was slightly less than May's 6.0% gain.



The initial market reaction to the release was negative as the print is seen as supportive of continued Federal Reserve hawkish policy. Following the release, the probability for a 75-basis point increase in July and another 75-basis point increase in September rose. The overall effect was to increase the expected terminal rate (the expected end-target rate for the Federal Funds rate in 2023) to 3.5-3.7%, or an additional 50 basis points above the terminal rate expectation coming into the release.

Bond markets reacted with a rise in the 2-year Treasury to 3.1% (after peaking at 3.22% following the release). The 2-year is generally seen to move directionally with expectations for the forward Federal Funds rate. However, the 10-year Treasury saw its yield decline to 2.92% which continued the recent trend of yield curve inversion (10-year Treasury yielding lower than the 2-year Treasury). The inferred reading of this yield curve action is that the probability of recession increases with ongoing inflation and the expected increased hawkish policy response by the Federal Reserve.

Equity markets remain volatile and indecisive in the wake of the inflation print. Near-term earnings risk is elevated, given the rising sentiment towards recession, but potentially offset by a lower bar for long-term interest rates, supportive of valuation multiples, as the Fed would be expected to loosen policy if a recession were to occur.

While the high CPI print was disappointing, the lagging nature of the CPI data and the observed recent easing of some of the CPI inputs looking forward suggest June could be the peak. Supportive of this position is data showing commodity prices peaked in mid-June and have been declining subsequently.

Commodity prices have broadly declined in recent weeks

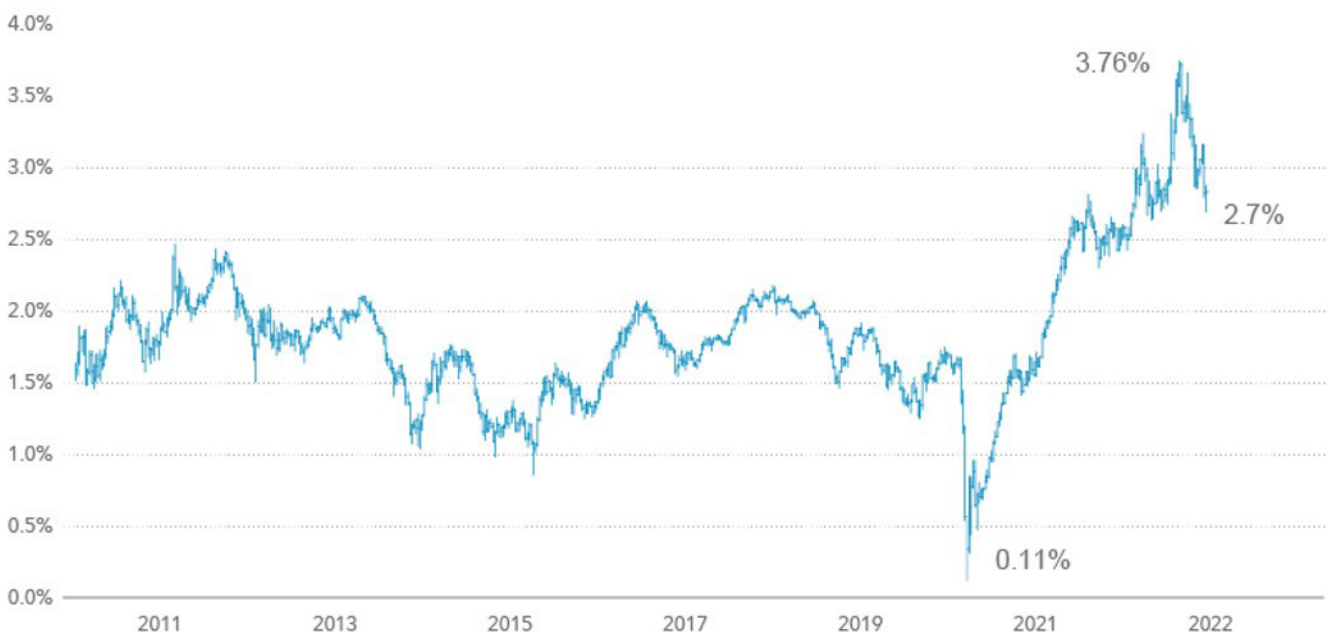
Bloomberg Commodities Index price

Source: FactSet, as of July 6, 2022.

In addition, the Treasury markets are signaling a similar forward expectation of lower inflation. As mentioned above, the 10-year Treasury yield has declined. In addition, Treasury inflation-protected securities (TIPS), which adjust for longer-term expected inflation rates, have repriced in the past few weeks for a lower expected level of inflation.

TIPS chart suggests investors expect lower inflation

TIPS 5-year breakeven



Source: FMRCo, Bloomberg. Weekly data, as of June 27, 2022.

In any case, the release of record-level inflation no longer appears to be a shock to the financial markets. Financial markets have potentially absorbed much of the higher inflation and, accompanying higher interest rate policy, have now moved on to the next phase of the economic cycle. Unfortunately, in this case, the next phase of the cycle looks to be at least a shallow recession.

2. Euro Falls to Dollar Parity

While projected growth in the U.S. economy has been downgraded by the International Monetary Fund (IMF) to 2.3% in 2022 and 1.0% in 2023, growth for Europe is seen at an even higher risk of falling into recession. The impact of higher energy costs in Europe due to the Ukraine war is seen as the primary culprit for the deterioration of the outlook. Other factors driving the exchange rate include the U.S. dollar's status as a safe haven and higher interest rates.

Euro/USD Five Years

Source: Yahoo

The impact of the stronger dollar may have a positive mitigating effect on U.S. inflation as global commodities priced in dollars and imports may see relative price declines. However, a strong dollar is likely to weigh on U.S. business growth as U.S. exports will be less competitive from a price perspective. In addition, foreign sales and profits by U.S. companies will be worth less when translated back into U.S. dollars. It is likely that the impact of currency will be a topic and have a negative bias on corporate outlooks during this coming earnings season.

Thinking Ahead

The release of CPI this week reaffirmed the record level of inflation, which has been the primary weight on the financial markets this year, is still with us. However, while the numbers remain high, the market no longer seems shocked but rather potentially anticipatory of potential decline.

The market has instead moved on to discounting slowing growth and the potential for recession. Given the financial markets muted response to the latest inflation data, it would appear slowing growth with lower inflation is to some degree the lesser of evils. Meanwhile, given the significant appreciation of the U.S. dollar to the Euro and other currencies, the U.S. still appears to be the best house in a world beset by headwinds.