Week in Review

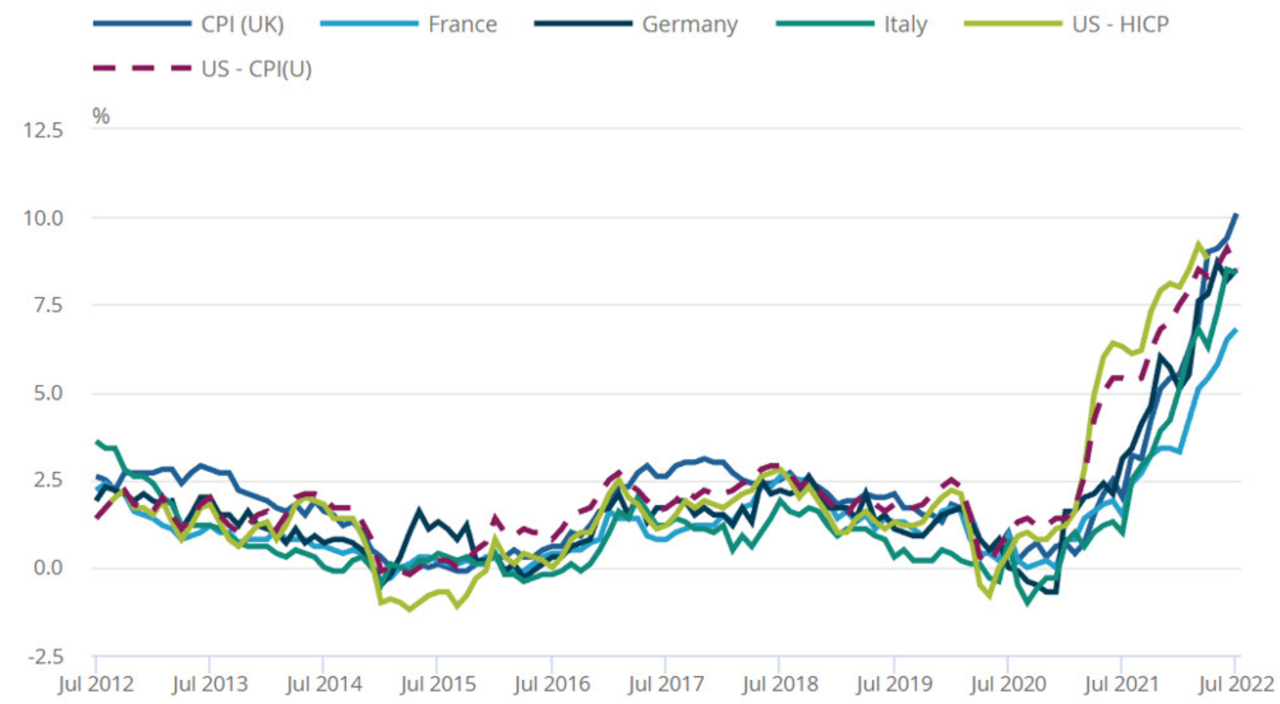
Friday, August 26th, 2022

1. European Inflation Remains Elevated and Likely to Go Higher

The Federal Reserve is meeting in Jackson Hole this week and hopes are high that commentary may indicate the belief that the U.S. might be past peak inflation and the Fed may temper the pace of rate hikes in the coming months. Core to this position is that the U.S. saw some good inflation news recently. Falling energy costs brought down inflation for the month of July. However, trends in the U.S. may not translate to the broader global economy.

Europe, in particular, may not be so lucky. As with the U.S., Europe has been experiencing well above trend inflation post-Covid. However, rather than seeing signs of peaking, Europe's inflation rates may have to rise further. Last week, the inflation rate in the Euro Area came in at a new record high of 8.9% in July of 2022, compared to 8.6% in June and 2.2% a year earlier.

CPI compared with selected G7 annual inflation rates, July 2012 to July 2022



Source: Office for National Statistics - Consumer price inflation, Eurostat

Looking at the U.K. as an example, the country's consumer price index showed a 10.1% year-over-year increase in July, surpassing the previous month's 9.4% reading. This represented a 40-year high for the nation. Surging energy prices have already pushed the U.K. Misery Index, an economic indicator to gauge how the average person is doing, to three-decade highs.

But rather than being a peak, a recent report from the chief U.K. economist at Citigroup has U.K. inflation hitting 18% next January. Meanwhile, Germany's inflation rate could surge above 10% this fall, the highest in seven decades, according to the country's central bank chief. That makes the current U.S. inflation rate of just over 8% look relatively mild. Current projections by the OECD suggest that all European nations except France and Switzerland will see higher inflation in 2022 than the U.S.

The primary reason for the difference in inflation rates is energy costs. Specifically, the issue is the rising cost of natural gas. Last week the cost of natural gas peaked in the U.S. at $9.30 per MMBtu but in Europe, prices are now trading at an equivalent of $70-80 per MMBtu. The driver of the European prices is the loss of natural gas supplies from Russia which have been curtailed by the Ukraine War.

Soaring energy costs are causing considerable stress across the European consumer and business sectors and leading to lower economic forecasts. The ramifications for the financial markets are headwinds for international developed market investments as well as headwinds for U.S. companies with significant exposure to Europe, as demand declines and the translation of European revenue to U.S. dollars will pressure profit margins as the dollar strengthens versus the Euro. Currently, the Euro to the dollar is now at parity and at a twenty-year low.

Source: Yahoo Finance

So, though the U.S. may have passed peak inflation, Europe may still have more inflation to come as natural gas prices surge on the continent. In a world of global trade, even if the U.S. dodges a recession, sluggish European growth could weigh on global markets into 2023.

2. Federal Reserve Positioning Widely Anticipated But Forthcoming Data in September Likely More Relevant

Financial markets are waiting for Friday's widely anticipated Jackson Hole speech by Federal Reserve Chairman Jerome Powell and are expecting he'll signal the continued need for aggressive interest rate hikes to combat inflation despite the risks to economic growth. That being said, there is also an expectation that comments may indicate progress is being made in slowing inflation and that a more moderate pace of tightening from the previous two 75-point increases may be pursued.

The expectations on the surface seem contradictory as the Fed is deemed to remain hawkish to keep a lid on asset prices and dampen demand. On the other hand, the pace of rate hikes has been historical and the need for continued shock may not be necessary as time to digest the current pace is needed.

In any case, the Jackson Hole meetings and commentary this week may very well provide no definitive course of short-term action but rather be a revalidation of the Fed's mission to balance economic growth and employment with price stability. In terms of short-term actions, the Fed has repeatedly stated that data and the emergence of clear trends will drive policy actions. So, while Jackson Hole commentary is much anticipated, likely of greater weight will be the next release of the consumer price index (CPI) on September 13th (at least it is not Friday the 13th).

Thinking Ahead

While the U.S. is enduring high inflation and turbulent markets, the pathway forward on a relative basis versus global markets looks relatively attractive, particularly versus Europe. However, in an interconnected world, high global energy prices and the strong dollar versus currencies such as the Euro will weigh on financial markets in the U.S. as well, even if U.S. markets are likely the best game in town currently. Of course, a resolution to the Ukrainian War and energy disruption in Europe could rapidly improve international prospects. Meanwhile, back in the U.S., attention is focused on inflation and Federal Reserve policy this week. While some pundits expect material announcements or direction, actual policy is likely well in place and dependent more upon data that will be forthcoming over the next few months.

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