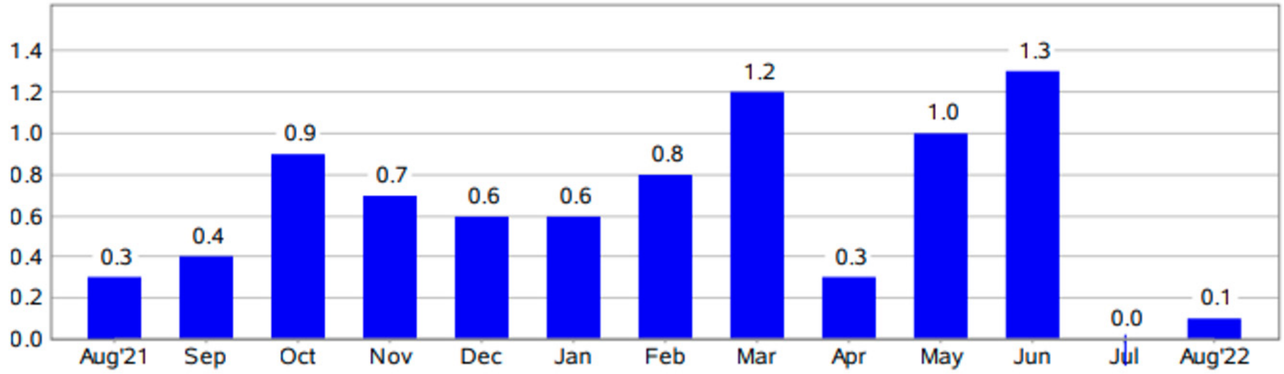
Week in Review

Friday, September 16th, 2022

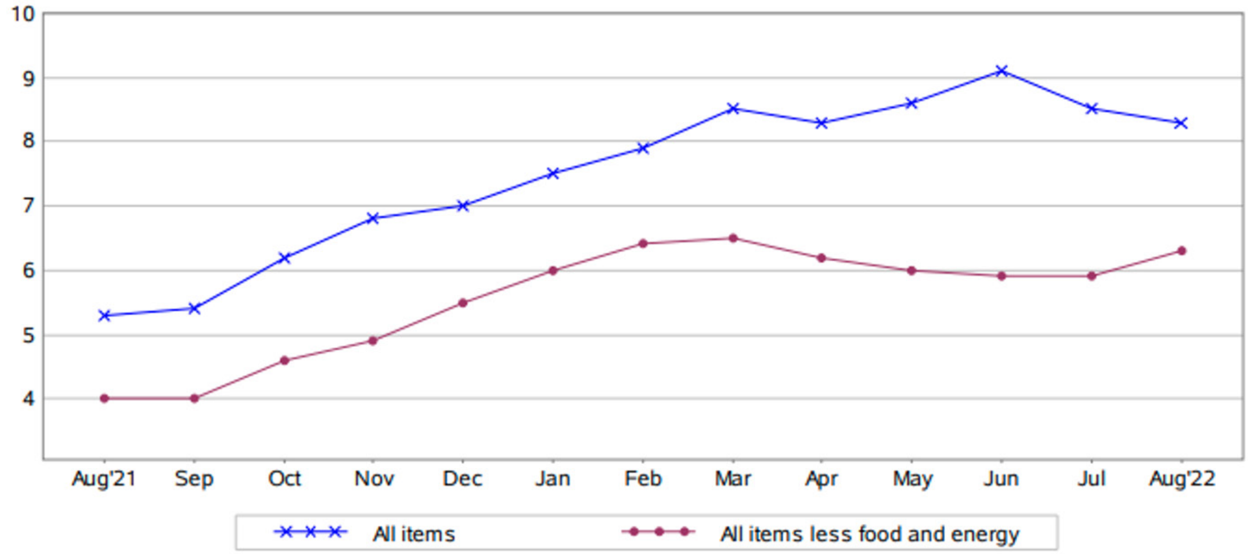
1. Disappointing CPI Report Raises Fed Funds Rate Expectations and Sets Back Market Sentiment

The eagerly awaited Consumer Price Index (CPI) data for August was released this week which disappointed expectations that the data might show a meaningful deceleration in inflation. The September CPI, reflecting August 2022 inflation data, rose 0.1 percent in August after being unchanged in July. Over the last 12 months, the all items index increased 8.3 percent, which was higher than the consensus forecast but lower than the two previous readings. The all items less food and energy index rose 6.3 percent over the last 12 months, a larger increase than in July.

Month-Over Month Change in CPI



Year-Over-Year Change in CPI



Source: BLS

Increases in the shelter, food, and medical care indexes were the largest of many contributors to the broad-based monthly all items increase. These increases were mostly offset by a 10.6 percent decline in the gasoline index. The food index continued to rise, increasing 0.8 percent over the month as the food at home index rose 0.7 percent. The energy index fell 5.0 percent over the month as the gasoline index declined, but the electricity and natural gas indexes increased. There were some indexes that declined in August, including those for airline fares, communication, and used cars and trucks.

	Seasonally adjusted changes from preceding month							Un-adjusted 12-mos. ended Aug. 2022
	Feb. 2022	Mar. 2022	Apr. 2022	May 2022	Jun. 2022	Jul. 2022	Aug. 2022	
All items	0.8	1.2	0.3	1.0	1.3	0.0	0.1	8.3
Food	1.0	1.0	0.9	1.2	1.0	1.1	0.8	11.4
Food at home	1.4	1.5	1.0	1.4	1.0	1.3	0.7	13.5
Food away from home[1]	0.4	0.3	0.6	0.7	0.9	0.7	0.9	8.0
Energy	3.5	11.0	-2.7	3.9	7.5	-4.6	-5.0	23.8
Energy commodities	6.7	18.1	-5.4	4.5	10.4	-7.6	-10.1	27.1
Gasoline (all types)	6.6	18.3	-6.1	4.1	11.2	-7.7	-10.6	25.6
Fuel oil[1]	7.7	22.3	2.7	16.9	-1.2	-11.0	-5.9	68.8
Energy services	-0.4	1.8	1.3	3.0	3.5	0.1	2.1	19.8
Electricity	-1.1	2.2	0.7	1.3	1.7	1.6	1.5	15.8
Utility (piped) gas service	1.5	0.6	3.1	8.0	8.2	-3.6	3.5	33.0
All items less food and energy	0.5	0.3	0.6	0.6	0.7	0.3	0.6	6.3
Commodities less food and energy commodities	0.4	-0.4	0.2	0.7	0.8	0.2	0.5	7.1
New vehicles	0.3	0.2	1.1	1.0	0.7	0.6	0.8	10.1
Used cars and trucks	-0.2	-3.8	-0.4	1.8	1.6	-0.4	-0.1	7.8
Apparel	0.7	0.6	-0.8	0.7	0.8	-0.1	0.2	5.1
Medical care commodities[1]	0.3	0.2	0.1	0.3	0.4	0.6	0.2	4.1
Services less energy services	0.5	0.6	0.7	0.6	0.7	0.4	0.6	6.1
Shelter	0.5	0.5	0.5	0.6	0.6	0.5	0.7	6.2
Transportation services	1.4	2.0	3.1	1.3	2.1	-0.5	0.5	11.3
Medical care services	0.1	0.6	0.5	0.4	0.7	0.4	0.8	5.6

1 Not seasonally adjusted.

Source: BLS

The key outcome from the data release was a rise in the expectations for Federal Funds rate increases in the coming months and an increase in the Federal Funds rate ultimate peak and duration. The market is now pricing in a certain 75-basis point hike next week, with a low probability of a 100-basis point hike.

Financial markets reacted negatively to the release with both equity and bond markets giving up gains from the previous week leading up to the data release. The rationale for the sell-off is two-fold with valuation concerns from multiple contraction and growing fear of higher rates precipitating a recession. The fundamental issue of uncertainty around inflation and recession risk remains unfortunately in place.

2. Higher Cash Yields A Silver Lining in Choppy Market

The silver lining to the higher Federal Funds rates is the upward movement in yields for U.S. treasuries and money market funds for cash and cash surrogates. At the beginning of the year, yields were close to zero. Now treasuries are approaching 4 percent reflecting expected further Federal Reserve tightening and money market funds stepping up in line with the current Federal Funds rate approaching 2 percent and expected to increase in the coming weeks.

Current Treasury Yields

TICKER	COMPANY	YIELD
US3M	U.S. 3 Month Treasury	3.206
US1Y	U.S. 1 Year Treasury	3.992
US2Y	U.S. 2 Year Treasury	3.863
US5Y	U.S. 5 Year Treasury	3.669
US10Y	U.S. 10 Year Treasury	3.459
US30Y	U.S. 30 Year Treasury	3.481

Source: CNBC

While this is incrementally positive news for investors holding cash, the rise in yields is also a tailwind for companies that need to hold cash or have business models with short term investment portfolios. Many of these types of companies are in the financial sector and include property and casualty insurers as well as regional banks with excess deposits.

While treasury yields and money market funds are still yielding below inflation, cash is no longer sitting idle.

Thinking Ahead

Overall CPI for August came in relatively unchanged from July, disappointing hope for a greater moderation. The result was resignation that the Federal Reserve will continue a hawkish path to combat inflation pushing up interest rates and weighing on financial markets. While the market was disappointed, trends for inflation should moderate going forward but perhaps at a more measured pace. Stepping back, there was nothing that should have been shocking in the data but patience waiting for a more meaningful turn in the data has worn thin. Short term, the data will likely continue to fuel negative market sentiment and increase the risk of slower economic growth, but longer term the steps being taken to curb inflation should bring greater stability to the economy and markets. The silver lining is that yields on cash have risen to the highest levels in two decades, dampening some of the impact from inflation and providing some good news in an otherwise choppy market.

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