PALLAS CAPITAL ADVISORS

# Week in Review

## Friday, October 14th, 2022

### 1. Inflation data for September hits 40-year high

The Bureau of Labor Statistics (BLS) released its Consumer Price Index (CPI) this week and the all-items index for the 12 months ending September increased 8.2%, driven largely by increases in the shelter, food, and medical care indexes. The figure rose by more than forecast to a 40-year high in September and adds to the pressure for the Federal Reserve to raise interest rates even more aggressively to battle persistent inflation before it becomes entrenched.

Consumer Price Index – Month-Month and Annual Change

| | Seasonally adjusted changes from preceding month | | | | | | | Un-adjusted 12-mos. ended Sep. 2022 |
|---|---|---|---|---|---|---|---|---|
| | Mar. 2022 | Apr. 2022 | May 2022 | Jun. 2022 | Jul. 2022 | Aug. 2022 | Sep. 2022 | |
| All items | 1.2 | 0.3 | 1.0 | 1.3 | 0.0 | 0.1 | 0.4 | 8.2 |
| Food | 1.0 | 0.9 | 1.2 | 1.0 | 1.1 | 0.8 | 0.8 | 11.2 |
| Food at home | 1.5 | 1.0 | 1.4 | 1.0 | 1.3 | 0.7 | 0.7 | 13.0 |
| Food away from home(1) | 0.3 | 0.6 | 0.7 | 0.9 | 0.7 | 0.9 | 0.9 | 8.5 |
| Energy | 11.0 | -2.7 | 3.9 | 7.5 | -4.6 | -5.0 | -2.1 | 19.8 |
| Energy commodities | 18.1 | -5.4 | 4.5 | 10.4 | -7.6 | -10.1 | -4.7 | 19.7 |
| Gasoline (all types) | 18.3 | -6.1 | 4.1 | 11.2 | -7.7 | -10.6 | -4.9 | 18.2 |
| Fuel oil(1) | 22.3 | 2.7 | 16.9 | -1.2 | -11.0 | -5.9 | -2.7 | 58.1 |
| Energy services | 1.8 | 1.3 | 3.0 | 3.5 | 0.1 | 2.1 | 1.1 | 19.8 |
| Electricity | 2.2 | 0.7 | 1.3 | 1.7 | 1.6 | 1.5 | 0.4 | 15.5 |
| Utility (piped) gas service | 0.6 | 3.1 | 8.0 | 8.2 | -3.6 | 3.5 | 2.9 | 33.1 |
| All items less food and energy | 0.3 | 0.6 | 0.6 | 0.7 | 0.3 | 0.6 | 0.6 | 6.6 |
| Commodities less food and energy commodities | -0.4 | 0.2 | 0.7 | 0.8 | 0.2 | 0.5 | 0.0 | 6.6 |
| New vehicles | 0.2 | 1.1 | 1.0 | 0.7 | 0.6 | 0.8 | 0.7 | 9.4 |
| Used cars and trucks | -3.8 | -0.4 | 1.8 | 1.6 | -0.4 | -0.1 | -1.1 | 7.2 |
| Apparel | 0.6 | -0.8 | 0.7 | 0.8 | -0.1 | 0.2 | -0.3 | 5.5 |
| Medical care commodities(1) | 0.2 | 0.1 | 0.3 | 0.4 | 0.6 | 0.2 | -0.1 | 3.7 |
| Services less energy services | 0.6 | 0.7 | 0.6 | 0.7 | 0.4 | 0.6 | 0.8 | 6.7 |
| Shelter | 0.5 | 0.5 | 0.6 | 0.6 | 0.5 | 0.7 | 0.7 | 6.6 |
| Transportation services | 2.0 | 3.1 | 1.3 | 2.1 | -0.5 | 0.5 | 1.9 | 14.6 |
| Medical care services | 0.6 | 0.5 | 0.4 | 0.7 | 0.4 | 0.8 | 1.0 | 6.5 |

Source: BLS

On a monthly basis, CPI rose 0.4% in September after rising 0.1% in August. While stepping up on a month over month basis, the monthly pace rate has decelerated from the peak of 1.3% in June.

The core consumer price index, which excludes food and energy, increased 6.6% from a year ago, the highest level since 1982. From a month earlier, the core CPI climbed 0.6% for a second month.

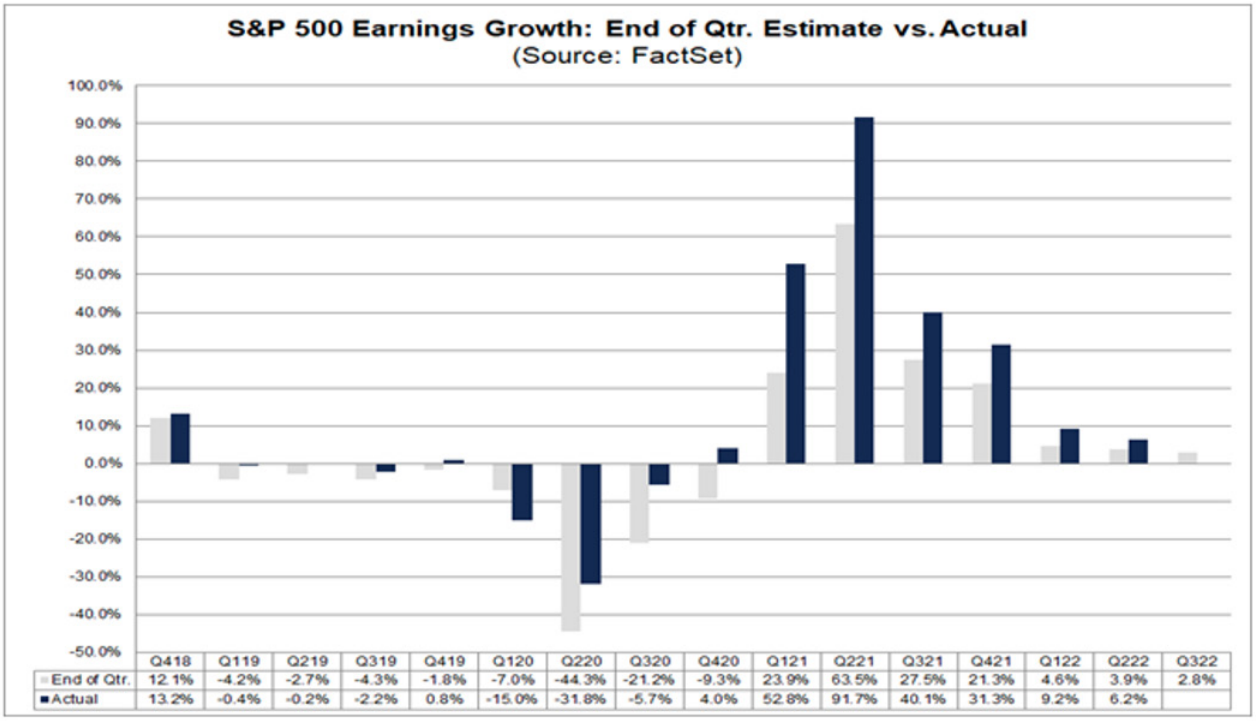
The composition was strong, with broad-based strength in cyclical and wage-sensitive services categories including shelter, medical services, daycare, and car repair. Shelter costs, which are the biggest services' component and make up about a third of the overall CPI index, rose 0.7% for a second month. Rent was up the most on record on an annual basis, as was owners' equivalent rent. The housing components of the report will likely remain elevated for quite some time, given the lag between real-time changes in rents and home prices and when those are reflected in Labor Department data.

In terms of other significant drivers, food costs rose 0.8% for a second month and were 11.2% higher from a year ago. Higher energy costs remain a major driver on a year over year basis but did see a third month in a row of decline on a month over month basis. Unfortunately, energy prices have started to climb again on recently announced OPEC production cuts and the onset of cooler weather.

The expected impact of elevated readings for CPI is resolve by the Federal Reserve to continue a course of hawkish policy. In the immediate aftermath of the CPI release, the probability for a 75-basis point increase for the Federal funds rate for each of the November and December FOMC meetings has increased. Driven by this increase, the terminal or peak rate for the Federal funds rate moved closer to 5% from its prior level of 4.6%. Generally higher rates put pressure on both bond prices and equity valuation multiples. Heightened market volatility after the release indicates a level of bad news or stubborn inflation has been embedded in the financial markets, but an all-clear signal for inflation being defeated and positive inflection point for valuation pressure on the back of closely watched CPI data has yet to be established.

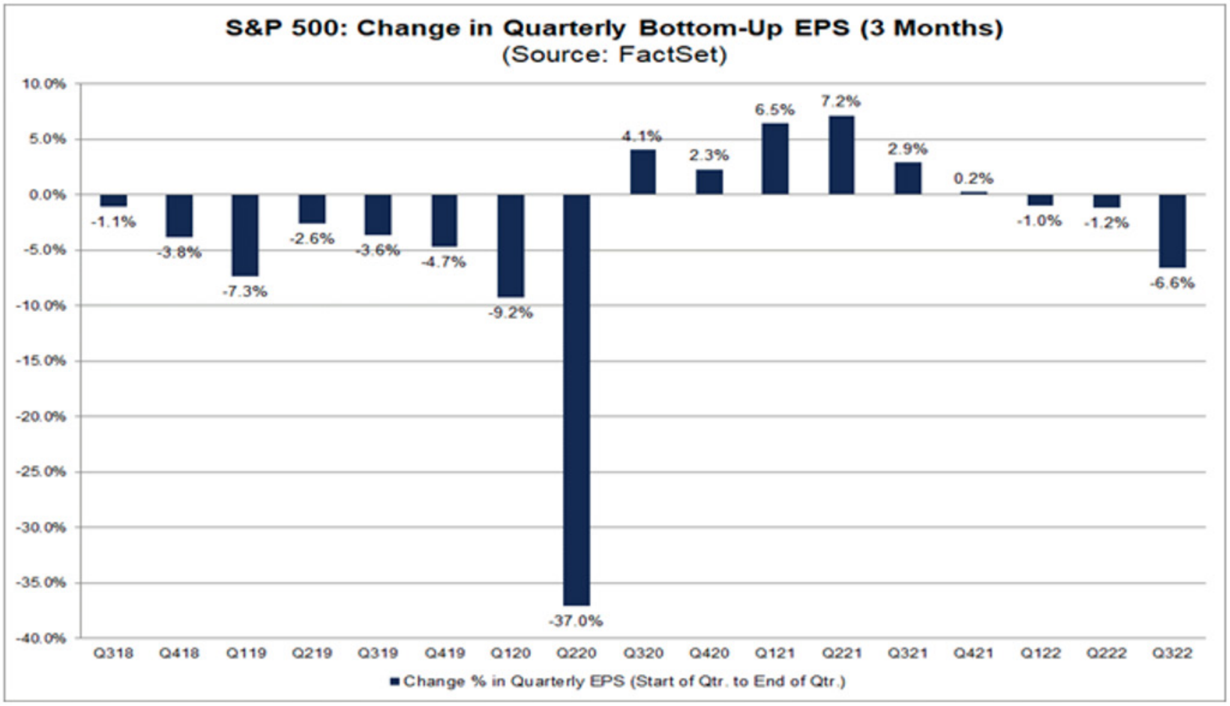
## 2. Earnings season commences on lowered expectations – which may be a sign of prospectively lower inflation and a bottoming process

With the commencement of earnings season, the S&P 500 is expected to report (year over-year) earnings growth of 2.4% for the third quarter, which would be the lowest earnings growth reported by the index since the third quarter of 2020. However, historical trends would suggest that most S&P 500 companies report actual earnings above estimates, and according to FactSet data and analysis, the index may be poised to report growth between 6% and 7% for the third quarter.



Over the past ten years, actual earnings reported by S&P 500 companies have exceeded estimated earnings by 6.5% on average. During this same period, 73% of companies in the S&P 500 have reported actual EPS above the mean EPS estimate on average. As a result, from the end of the quarter through the end of the earnings season, the earnings growth rate has increased by 5.5 percentage points on average (over the past ten years) due to the number and magnitude of positive earnings surprises.

However, the ability for earnings to be surpassed may to some degree be driven by whether expectations have been lowered enough. Over the past three months, third quarter 2022 earnings expectations for the S&P 500 have been lowered by 6.6% as of the end of the third quarter.




Diving down deeper, the level of earnings revisions has been much higher when excluding energy. At the sector level, ten of the eleven sectors witnessed a decrease in their bottom-up EPS estimate for the third quarter 2022, led by the Materials (-14.9%), Communication Services (-13.1%), and Consumer Discretionary (-11.9%) sectors. On the other hand, the Energy (+7.9%) sector is the only sector that recorded an increase in its bottom-up EPS estimate for the third quarter.

So based on history, the lowered bar for the third quarter for earnings is likely to be surpassed, and guidance will be very important in terms of setting the direction of stock prices. The consensus is that earnings for the rest of 2022 and 2023 will come down, particularly as belief in recession is at a high level. A reduction in estimates may not be all bad news, as a reduction in estimates may also be consistent with prospectively lower inflation and a catalyst for a less hawkish Federal Reserve policy. History has shown that often negative earnings prospects are consistent with a bottoming process in financial markets and the seed for recovery.

# Thinking Ahead

Incremental data on inflation has not been the all-clear signal that financial markets have hoped. However, stubborn inflation for the time being was not unexpected. Similarly, lower earnings growth and negative revisions is also well embedded in market sentiment as we enter the third quarter 2022 earnings season. The combination will likely result in heightened financial market volatility. Best of breed business franchises trading at attractive valuation levels generating free cash flow and built on sound capital structures should be best positioned to weather the turbulence.

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