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In the Inflation Crosswinds

August 8th, 2022

Waiting for the Inflation Slowdown

- The longer high inflation persists, the more the Fed may need to tighten, which could cause further economic difficulties

Fed and Market Divergence

- Market's rally reflects a disconnect between the Fed's intentions and investors' interpretation of them

Earnings Got the Memo?

- If earnings begin to turn over, there may be further downside to this bear market, justifying an underweight to risk

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In the Inflation Crosswinds

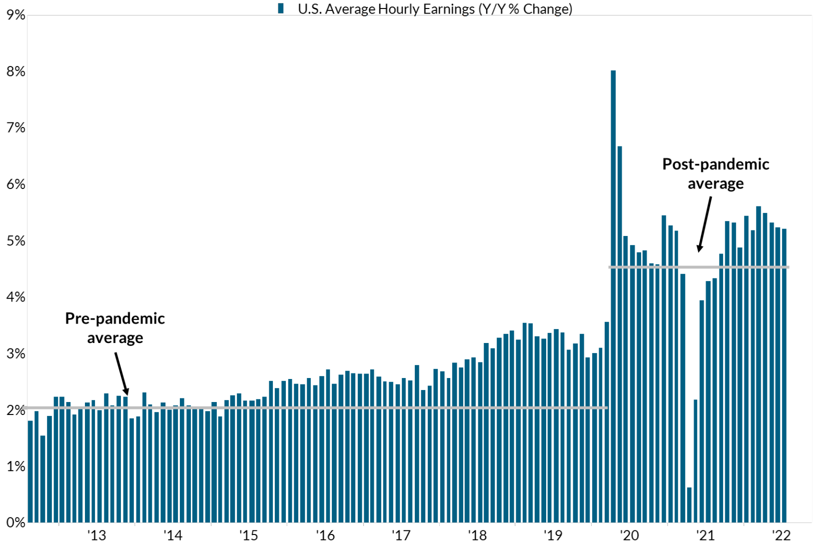
Waiting for the Inflation Slowdown

- **July CPI Preview.** The July print of the U.S. Consumer Price Index (CPI) will be released this Wednesday, with consensus expectations calling for a 0.2% annual pace of inflation. The Cleveland Fed's Inflation Nowcast shows July's month-over-month Core CPI reading, which excludes the typically more volatile food and energy components, is tracking at 0.5%, a level that is still well above the Fed's preferred target range of 0.0-0.3%.
- **Inflation Headwinds.** There are some encouraging signs that disinflation may be in the pipeline. For example, annual changes in CPI are highly correlated with commodity prices, which have recently turned lower via the Bloomberg Commodity Index. This appears to have begun to show signs of feeding through to final goods, as the input price subcomponent of Markit's U.S. PMIs* for the manufacturing and services sectors have started to fall from their post-pandemic peaks.
- **Inflation Tailwinds.** On the flip side, wages are among the factors that may be keeping inflation higher than normal. At face value, last Friday's jobs report continued to highlight the resiliency of the U.S. consumer. However, the acceleration of average hourly earnings to a 0.5% month-over-month growth pace was a concerning detail for those hoping to see inflation come under control. While still not a dreaded "wage-price spiral," strong wage gains should cause the Fed concern that their price stability goal is far from achieved and is perhaps at further risk than the market appears to be discounting. All else equal, this should take away any excuse from the Fed to begin slowing down its tightening pace.

> *The longer high inflation persists, the more the Fed may need to tighten, which could cause further economic difficulties*

Chart of the Week:

Wage gains reinforcing inflationary pressures



Source: Glenmede, FactSet, Bureau of Labor Statistics
Data through 7/31/2022
Data shown is the year-over-year percent change in U.S. average hourly earnings.

*Purchasing Managers' Index

In the Inflation Crosswinds

Fed and Market Divergence

- **Still No Fed Put.** Markets ended last week with the S&P 500 roughly where it started, up 0.4%, en route to a third consecutive week of gains. This extended July's broad rebound which likely reflected an assumption that the Fed was envisioning a pivot away from tightening amid evidence of cooling in the economy. However, an increasing number of Fed officials are pushing back against this assumption, as the Fed remains laser focused on the objective of getting inflation down around its 2% target.
- **Latest Fed-speak.** Remarkably, markets have so far appeared unphased by the Fed's second consecutive 75-basis point increase in July, which was likely sparked by interpretations of Chair Powell's post-release press conference being incrementally dovish. On the other hand, St. Louis Fed President Bullard noted last week that a 50-basis point hike in September is likely, while San Francisco Fed President Daly warned that the U.S. is "nowhere near" finished in its fight against inflation.
- **Still-Hot Labor Market.** July's jobs report confirmed that the labor market remains tight with the unemployment rate ticking down to 3.5%, matching its 50 year low. Notably, some economists, including Larry Summers, have reiterated that the Fed may need to engineer a rise in the unemployment rate to nearly 6% and stay there for some time to bring inflation down, an increase that would likely coincide with a recession. All else equal, this may not be indicative of a Fed that will need to shift gears to begin slowing its tightening pace, as there are still a few concrete signs of inflation returning to normal.

Market's rally reflects a disconnect between the Fed's intentions and investors' interpretation of them

Earnings Got the Memo?

- **Earnings Outlook.** Another earnings season is underway, providing more glimpses of profit trends for the first half of 2022. With 87% of companies reporting so far, the blended year-over-year earnings growth estimate for the S&P 500, which combines actual results with consensus estimates for firms that have yet to report, currently sits at 6.8%. Given the inflationary backdrop, forward guidance will be an important factor to observe throughout the season.
- **Waiting For Earnings Peak.** Despite the economic uncertainty surrounding the Fed's campaign to cool inflation, earnings estimates have so far appeared unphased. For example, consensus earnings per share for the S&P 500 in 2022 remains near its all-time high of $230. However, the Manufacturing PMI release last week suggests a slowdown in earnings growth may be in the making, as there is a strong correlation between the two data series. The latest PMI reading of 52.8 follows a previous reading of 53.0, which indicates that the decline may be slow for now, though the data still directionally points to a weaker profit outlook. As the macroeconomic environment becomes more challenging, earnings estimates may face negative revisions.
- **2023 Earnings Revisions.** Though earnings have remained relatively resilient, 2023 upward revisions have stalled as it appears that analysts have been lowering earnings estimates . The 2023 earnings per share estimate accelerated lower last month and now sits just below $245, down from the $250 estimate as of the beginning of the Q2 earnings season. Tech remains the largest contributor to overall earnings, representing ~30% of the broader index and barring an improvement in the sector, downward revisions are likely to ramp up.

If earnings begin to turn over, there may be further downside to this bear market, justifying an underweight to risk

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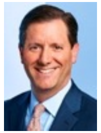

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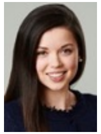

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