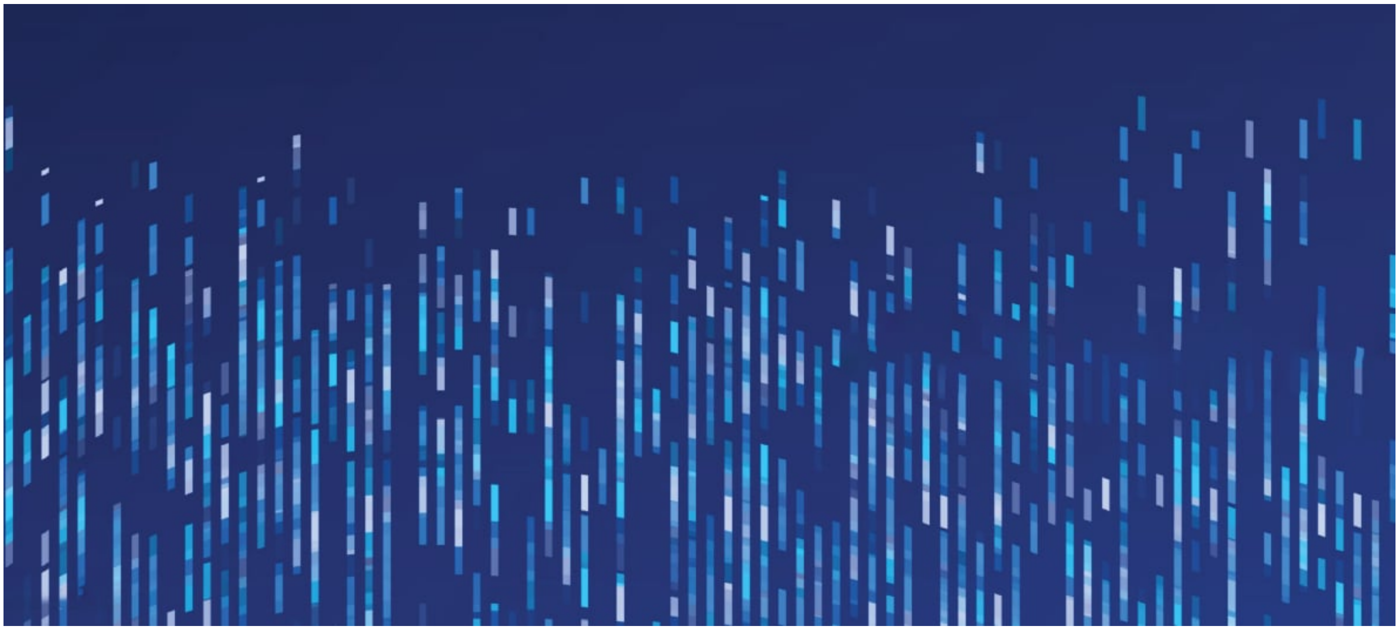

Capital Bytes – November 17, 2022

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Capital Bytes: The Necessary Evils of Reducing Inflation

Up until Wednesday, equities had a strong week as reassuring inflation data gave investors hope that the Federal Reserve’s restrictive interest rate period would be less severe and hopefully shorter in duration. At the consumer level, prices were up 6.9% in the month of October versus the same period in 2021, driven largely in part by fuel and food prices, both of which could be argued as transitory … at least in the short to intermediate terms. Month over month, price increases for food, clothing and furniture decelerated, reaffirming the thesis that Fed policy is working its way through the markets and that above-trend inflation is indeed easing.

At the wholesale level, the Bureau of Labor Statistics announced its last producer price index (PPI) reading ahead of December’s Federal Open Market Committee (FOMC) meeting. The index rose just 0.2% in October, below the 0.4% consensus estimate. On a year-over-year basis, PPI jumped 8% compared to an 8.4% increase in September and while still elevated, was down from the all-time peak of 11.7% in March. A significant contributor to the slowdown in PPI was a 0.1% decline in the services component of the index, the first decline in that metric since November 2020. When you couple this with the increasing number of layoffs we’ve seen from big tech, retail and the latest 10,000-person cut by Amazon, one could surmise that not only could labor costs be at least stabilizing, if not declining, but also that strong employment reports may be quickly fading. Again, the question now is just how “bad” does the data have to get in order to turn the “rate pain switch” off?

Will the Fed respond quickly by stopping or dramatically slowing its rate hike trajectory as seemingly durable consumers are starting to show some potential weakness? That’s a hard call to make. As it stands now, the majority of market participants expect a 50-basis-point hike from the Fed in December, but bets for a 25-basis-point hike have been on the rise, suggesting the doves could fly from the doors of the boardroom at the Eccles Building in Washington, D.C. (the FOMC’s typical meeting place).

The federal funds rate has also helped drive mortgage rates to a 20-year high, which has severely impaired the strength of America’s housing market. Its actions have also pushed rates higher than they would normally be as the central bank, the largest buyer of mortgage-backed securities, has sharply curtailed its buying. In fact, the gap between mortgage rates and their benchmark, Treasury yields, is the greatest it’s been since the early 1980s. When you compound this with the fact that many banks and investors have also stepped away from buying, you have a greatly reduced pool of purchasers. This means mortgage rates soar to meet the demands of fewer buyers — not a good thing for consumers. Let’s hope we don’t see a repeat of the 1978-1982 housing market, as the current economic situation looks eerily similar.

Consumer readings still remain mixed as government retail sales data released Wednesday still shows a relatively resilient consumer as sales rose 1.3% in October from September, up from a flat reading in September from August. Car sales and rising fuel costs helped drive the retail sales number and some economists are attributing a good portion of the increase to an October Amazon Prime Day event, as well as state of California stimulus checks (middle class tax refund) ranging from $200 to $1,050. But that data can be misleading, as retail giant Target reported much lower-than-expected earnings Wednesday, slashing its forecasts for the holiday period due to a slowdown in consumer spending. There’s also been a 15% jump in household credit card balances nationwide during the July-September quarter versus a year ago, the largest year-over-year increase in two decades. The Fed obviously has all this data — the question is how it chooses to interpret it. We believe it might be best for them to pause here and let the softening trends play out.

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