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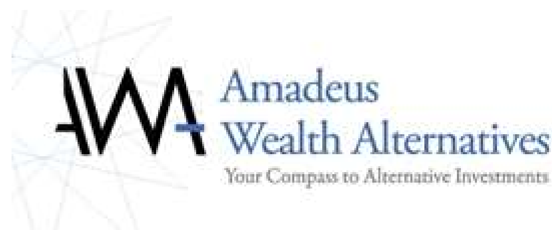

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In this week's recap: Stocks dip on inflation report.

Weekly Economic Update

Presented by Ed Papier, June 13, 2022

THE WEEK ON WALL STREET

A higher-than-expected inflation report triggered a sell-off on Friday, leaving stocks in the red for the week.

The Dow Jones Industrial Average lost 4.58%, while the Standard & Poor's 500 dropped 5.05%. The Nasdaq Composite index slid 5.60% for the week. The MSCI EAFE index, which tracks developed overseas stock markets, declined 1.81%. [1,2,3]

INFLATION UPENDS STOCKS

Stocks gyrated between gains and losses last week until sliding lower on Friday's hot inflation report, which heightened worries over a more aggressive Fed and a further economic slowdown. Stocks moved higher to begin the week, despite rising bond yields, a profit warning from a major retailer, and Senate testimony by Secretary of Treasury Janet Yellen, who said that inflation was likely to remain elevated.

Stocks turned lower later in the week on renewed concerns of an economic slowdown, sparked by a downward revision in The Federal Reserve-Atlanta's real-time estimate of second-quarter GDP growth and a drop in new mortgage applications. Investors lightening up on stocks ahead of Friday's inflation report may have also contributed to Thursday's selling.

INSIDE INFLATION

Consumer prices rose 8.6% year-over-year in May, marking the highest rate since December 1981. Price increases over the last 12 months were driven by a 34.6% jump in energy prices and by food costs, which climbed 10.1%. Used car and truck prices, which had seen three straight months of declines, rose 1.8% from April, while airfares soared 12.6% in May. [4]

May's inflation exceeded economists' forecasts and dashed the hopes that inflation had plateaued. In a separate economic report on Friday, real wages (net of inflation) fell 0.6% in April and were lower by 3% from 12 months ago. [5]

THE WEEK AHEAD: KEY ECONOMIC DATA

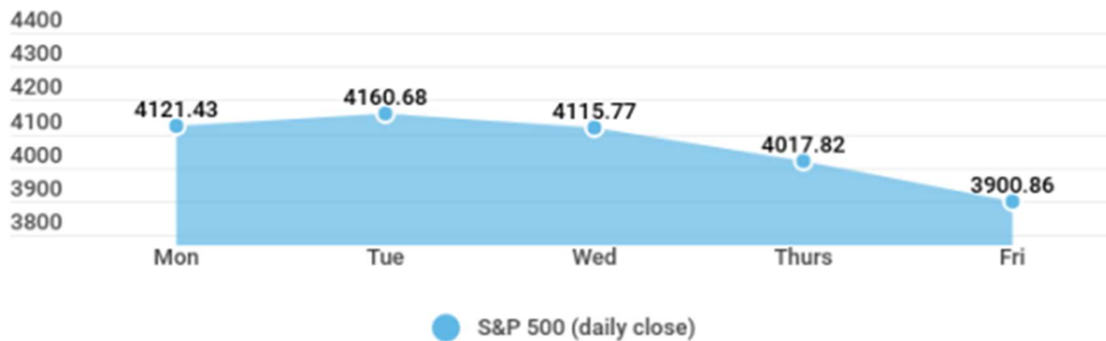
Tuesday: Producer Price Index.
Wednesday: Retail Sales. FOMC Announcement.
Thursday: Jobless Claims. Housing Starts.
Friday: Industrial Production. Index of Leading Economic Indicators.

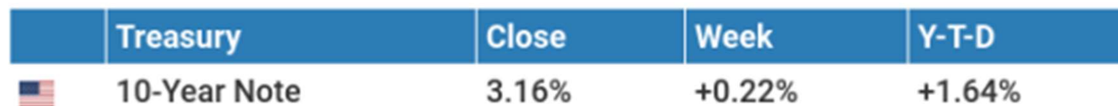
QUOTE OF THE WEEK

"The right to dissent ... is surely fundamental to the existence of a democratic society. That's the right that went first in every nation that stumbled down the trail to totalitarianism."

EDWARD R. MURROW

Market Index	Close	Week	Y-T-D
DJIA	31,392.79	-4.58%	-13.61%
NASDAQ	11,340.02	-5.60%	-27.52%
MSCI-EAFE	1,992.38	-1.81%	-14.71%
S&P 500	3,900.86	-5.05%	-18.16%





	Treasury	Close	Week	Y-T-D
	10-Year Note	3.16%	+0.22%	+1.64%

Sources: The Wall Street Journal, June 10, 2022; Treasury.gov, June 10, 2022
Weekly performance for the Dow Jones Industrial Average, Standard & Poor's 500 Index, and NASDAQ Composite Index is measured from the close of trading on Friday, June 3, to Friday, June 10, close. Weekly performance for the MSCI-EAFE is measured from Friday, June 3, open to Thursday, June 9, close. Weekly and year-to-date 10-year Treasury note yield are expressed in basis points.

OF NOTE:

After a few days of fairly listless trading, US equity markets took a deep dive late in the day on Thursday; protective cover, perhaps, for those fearing a hotter-than-expected inflation report on Friday morning when the Bureau of Labor Statistics was due to release the May Consumer Price Index report. That defensive impulse would seem to be validated, as the numbers for both headline and core (ex-food and energy) inflation did come in ahead of expectations.

The CPI report is the last piece of hard data members of the Fed's Open Market Committee will take into their monetary policy meeting next Tuesday and Wednesday. That meeting is widely expected to result in another increase of 0.5 percent in the Fed funds target rate, with another one to follow when the FOMC meets again in July. The big question market participants have been debating in recent weeks

is whether economic conditions support a "peak Fed/peak inflation" narrative that would imply a more subdued path for rate hikes following the June and July measures. Friday's inflation report brings into focus a question: what can the Fed actually do about inflation, and what are its limits?

In some periods in the past (most notably during the high-inflation era from 1968 to 1982) headline and core inflation moved more or less in tandem. In other periods, particularly during the first decade of the 21st century, there was a fairly wide dispersion between core and headline. This was a period which included a commodities super cycle related to China's rise as an economic power during the early-mid 2000s, and then a bust in energy and other commodity prices following the financial crisis and recession of 2008 (and again when energy prices collapsed in 2014). During these periods, headline CPI deviated markedly from the core trend.

When the Fed talks about fighting inflation, it is important to understand that it is talking about core inflation. Essentially, what the central bank is saying is that it does not have tools available for controlling what you pay at the grocery store or the gas pump – those prices are driven by supply and demand forces happening all around the world that are not going to change much when US interest rates go up or down. What the Fed hopes is that by raising rates it can influence consumer demand in such a way as to bring down price levels for a broad range of goods and services outside those two volatile categories. The trick, of course, is to dampen demand by just enough to bring down prices without choking off growth entirely and precipitating a recession.

So what does all this mean for the present period? If you look at the headline and core inflation trends for the past year, you can see headline and core inflation rising together, though with a decisive move higher by the headline number in the report that came out Friday (8.6 percent year-on-year rise in headline CPI and 6.0 percent jump in the core number). That is largely due to the resurgence in both food and energy prices over the past 30 days, a large amount of which is due to the ongoing war in Ukraine. Russia is the world's largest grain exporter, and Ukraine is the fifth-largest. Russia's blockade of the Black Sea, preventing Ukrainian grain exports from reaching their destinations, is pushing many countries in Africa and the Middle East into an acute food crisis and a looming famine. True to its stated policy, there is nothing the Fed can do to address this crisis.

There is another problem, though, as it relates to the various categories that make up core inflation, that is also outside the Fed's purview. Global supply chains, battered by the effects of the pandemic and the insatiable demand for goods that followed, are a major impediment to a normalization in prices. China continues to be a source of instability with its monomaniacal zero Covid policy. Other major supply chain hubs such as Vietnam are also struggling to resume full-capacity operations. The shortage in semiconductor chips continues to affect prices for a wide variety of products, including new and used automotive vehicles. Prices for used cars, to give one example, are 16.1 percent higher than they were a year ago, according to Friday's report.

The equity market already seems to be moving on from "peak inflation/peak Fed." As always, though, we are just as interested in what the bond market will have to say. Although credit risk spreads have trended up recently, the spread between 10-year Treasuries and low-investment grade corporate bonds is still below its three-year average. Five-and ten-year breakeven rates suggest that longer-term inflationary expectations have not broken out of the barn, which in turn implies that a decent degree of confidence remains in credit markets that the Fed will get the job done. We'll nonetheless have to continue to pay very close attention to developments in those things the Fed cannot control. [6]

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