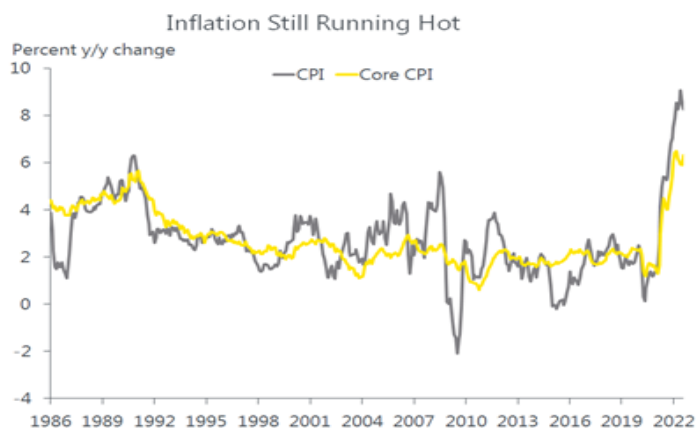


The plunge in stock prices following this week's consumer price report starkly reveals what can happen when events fall short of expectations, even if the miss is relatively minor. The unsightly 178-point decline in the S&P 500 on Tuesday, the day of the CPI release, was the steepest for a single day since the pandemic-induced shock in March 2020, when the economy looked considerably bleaker than now, and inflation was not on the radar screen of investors. However, inflation is now the primary scourge of the economy. The uncertainty it is generating regarding future profits, jobs, and the economy's overall health is just as intense as it was during the onset of Covid 19.

Unsurprisingly, the markets were laser-focused on the consumer price report for August, hoping that it would confirm the widespread notion that the peak in inflation was in the rearview mirror, as indicated by the slower price gains seen in July. Unfortunately, the outcome was just the opposite. Despite the headline-grabbing decline in energy prices, which was expected to produce a negative print for the CPI, the index ticked up by 0.1 percent in August, following a flat reading in July. And while the annual inflation rate did slow from 8.5 percent in July to 8.3 percent in August, a steeper retreat – closer to 8 percent – was widely expected. Worse, the core inflation rate – which is more indicative of the underlying inflation trend – leaped by 0.6 percent last month, double the July increase, lifting the annual rate to 6.3 percent from 5.9 percent in July.

The surprising resilience of inflation means that the Fed has more work to do than earlier thought. Heading into the CPI release, the consensus was that the upcoming FOMC meeting on September 20-21 would deliver an interest rate increase of 75 basis points, the third consecutive hike of that size. Still, some felt that a smaller 50 basis point increase might be taken in deference to the inflation slowdown seen in July. Following the CPI release, that sentiment has been flipped on its head. The consensus still predicts a 75 basis point increase, but now a sizeable share of market participants think the Fed might – and should – go bolder, hiking rates by a full percentage point. The doves have been left in the dust.



The elevated reading on consumer prices has upped the odds that the Fed will be more aggressive in curbing inflation. A 75 basis point increase is the most probable outcome at the upcoming FOMC meeting, with another hike of that size possible in November, leaving the Fed's benchmark federal funds rate just a tad under 4 percent by the end of the year. The stricter stance also lowers the odds that the Fed will be able to achieve the elusive soft landing, curbing demand just enough to bring down inflation without inducing a recession. We now expect a mild recession next year, a sentiment that is increasingly influencing market prices. Treasury yields, paced by shorter maturities, staged another sizeable increase this week, with the steepening 2-year/10-year yield inversion reflecting more substantial recession expectations linked to potentially overly aggressive Fed rate hikes. Likewise, the ongoing slump in stock prices throughout the remainder of the week signals diminished prospects for corporate earnings as the economic outlook turns darker.

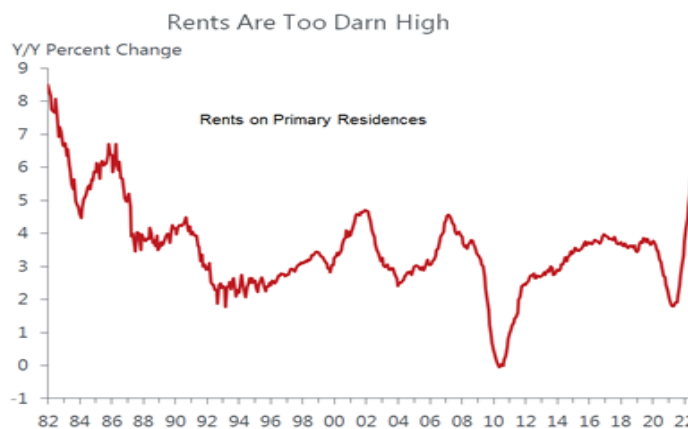
While inflation is turning out to be more stubborn than the Fed would like, investors may be overreacting to the latest consumer price report. It's unrealistic to think that the disinflation trend suggested by the July slowdown in the CPI would travel a straight line, given the myriad unpredictable forces influencing prices. Supply disruptions, while easing, are far from dormant given the ongoing war in Ukraine, lockdowns in China, worker shortages in the US, and labor disputes, like the short-circuited railroad strike this week, can have a crippling impact on the flow of goods. And while Fed policy is aimed at curbing aggregate demand, shifting post-pandemic spending patterns that amplify demand/supply imbalances in specific sectors can dilute its impact on inflation. Service providers are coping with an upsurge in pent-up demand that previously flowed to physical goods when consumers were homebound during the pandemic. Hence, service prices are now the driving force behind inflation.



What's more, despite the disappointing uptick in August, inflation has peaked. The high-water mark for both the headline and core CPI is in the rear-view mirror and not likely to be surpassed in the coming months, notwithstanding possible hiccups along the way. Price pressures in the pipeline are also easing, as evidenced by the second consecutive decline in the producer price index in August reported this week. Importantly, inflation expectations are declining. The latest New York Federal Reserve survey shows that consumers expect inflation in five years to recede below the level that prevailed before the pandemic. Their expected inflation rate in three years fell to 2.8 percent from 3.2 percent in July. Household inflation expectations also fell in the University of Michigan survey released on Friday, although by less than shown in the NY Fed's survey.

That said, the Fed is not expected to deviate from its aggressive rate-hiking campaign over the near term. Inflation expectations may be well behaved now, but a few more months of upside surprises on the price front could easily change that. And while the signs indicate that inflation has peaked, the retreat will be slow and erratic. Service prices are sticky, and the key shelter-cost component that accounts for more than a third of the consumer price index continues to accelerate. Rents on primary residences are increasing at the fastest pace since 1986; as leases expire and are renewed at higher market levels, that trend will continue for the foreseeable future.

Simply put, the Fed will continue to apply the brakes until tangible evidence of a sustained drop in inflation is underway. Chair Powell noted that the expected rate hikes will cause some pain, but their economic impact has been relatively modest so far. Job growth is still sturdy, and consumers are still spending, albeit at a slower pace. Retail sales in August reported this week were hardly a barnburner, advancing by a modest 0.3 percent led by strong auto sales, indicating that higher prices are still not much of a deterrent to spending. We suspect, however, that the lagged impact of higher rates will take an increasing toll on jobs and consumer spending late this year and in early 2023 when a mild recession should take hold and usher in a meaningful slowdown in inflation. Unless the economic damage turns out to be more severe than expected or a financial crisis occurs, the Fed should hold the line on rates at the higher level through most of next year.



The FOMC next week will provide the Fed's updated projections for the funds rate – perhaps providing some clues about the path of interest rates – as well new forecasts for GDP, unemployment, and inflation. Will the new projections reflect expectations for a recession? Fed officials typically don't forecast recessions explicitly, but we expect to see the FOMC's forecasts for GDP growth and unemployment marked down, particularly for 2023. In June, the FOMC median forecast was for real GDP growth of 1.7% in 2023 and an average unemployment rate of 3.9% in the fourth quarter of 2023. Look for that jobless rate to be revised significantly higher at the meeting.

FINANCIAL INDICATORS				
INTEREST RATES	September 16	Week Ago	Month Ago	Year Ago
3-month Treasury bill	3.14%	2.96%	2.37%	0.04%
6-month Treasury bill	3.81	3.55	3.11	0.05
3-month LIBOR	3.53	3.24	2.98	0.12
2-year Treasury note	3.87	3.56	3.23	0.22
5-year Treasury note	3.64	3.40	3.07	0.86
10-year Treasury note	3.45	3.32	2.97	1.37
30-year Treasury bond	3.52	3.45	3.01	1.91
STOCK MARKET				
Dow Jones Industrial Index	30822.42	32151.31	37706.74	34584.88
S&P 500	3873.33	4067.36	4228.48	4432.99
NASDAQ	11448.40	12112.31	12705.22	15043.97
Commodities				
Gold (\$ per troy ounce)	1684.40	1727.60	1760.30	1753.9
Oil (\$ per barrel) - Crude Futures (WTI)	85.30	86.10	89.95	71.96
ECONOMIC INDICATOR	Latest Month/Quarter	Previous Month/Quarter	Two-Months/ Qtrs Ago	Average-Past Six Months or Quarters
Consumer Price Index (August) - % change	0.1	0.0	1.3	1.7
Core CPI (August) - % change	0.6	0.3	0.7	0.5
Producer Price Index (August) - % change	-0.4	-0.4	1.0	0.6
Retail Sales (August) - % change	0.3	-0.4	1.0	0.5
Industrial Production Index (August) - % change	-0.2	0.5	0.0	0.3

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