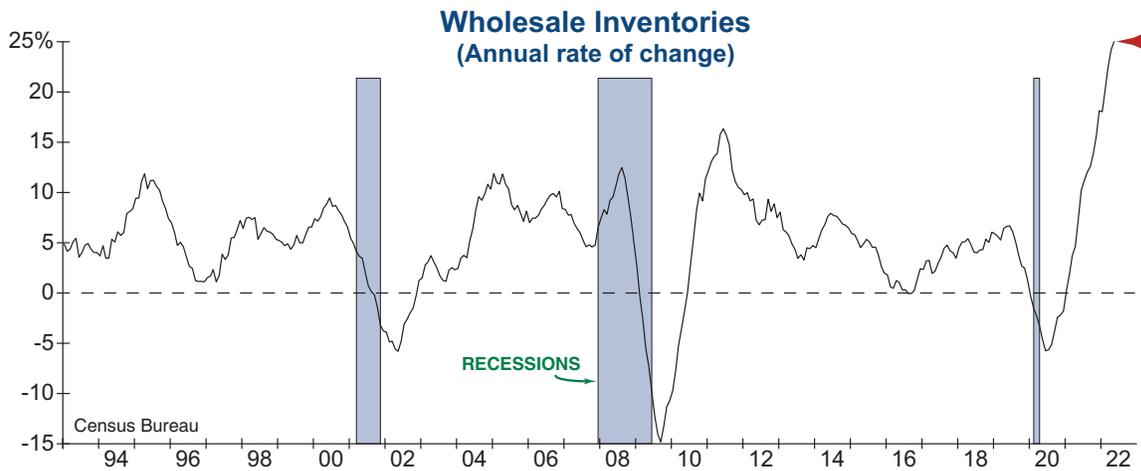


Inflation Outlook – Is inflation peaking, and will it matter?

Over the past two years, our research has forecast that inflation would be higher and more persistent than expected. While this is exactly what has happened, there is growing evidence today suggesting that inflation may be peaking. In the next few pages, we will show why inflation may soon turn lower and why this won't necessarily be the bullish development for the stock market for which many are hoping.

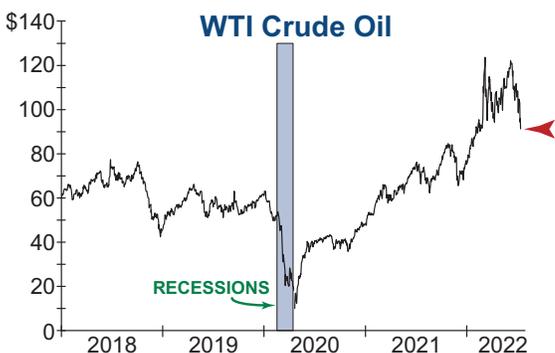
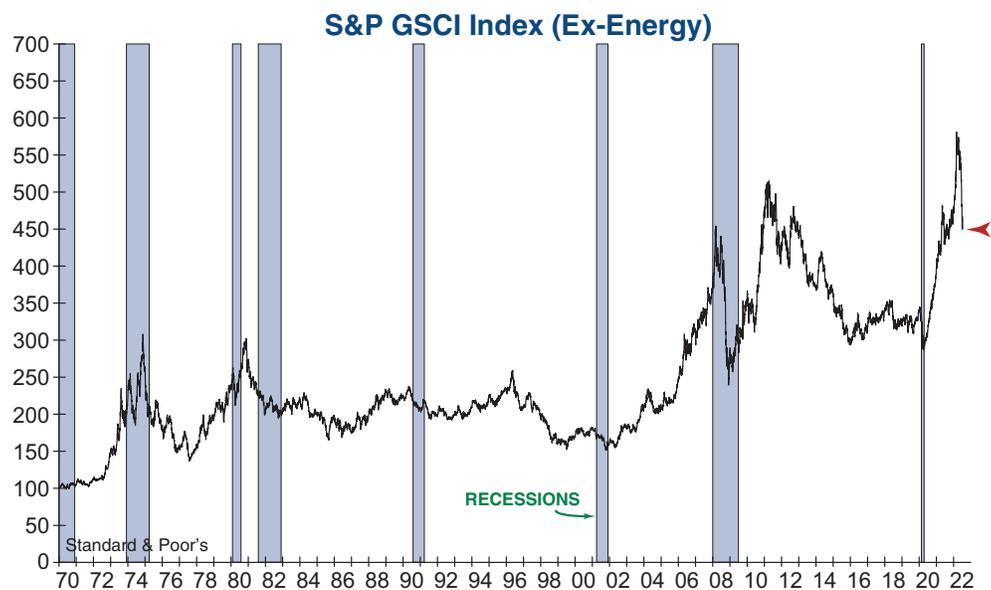
Key factors indicate that inflation could soon peak...

The most apparent reason why inflation may soon find its peak is that companies have significantly overstocked their shelves. Early in the pandemic, purchasing managers frantically stocked up on goods as they contended with shifting consumer preferences, supply-chain disruptions, and widespread shortages; however, this has caused a massive inventory glut now that the surge in demand is dissipating. Going forward, discounts will be necessary to work through this excess inventory, which will almost certainly suppress goods inflation and weigh on retail profit margins.



Another important change in the inflationary environment is that commodity prices have dramatically cooled after having gained +102% from their pandemic low.

Soaring commodity prices have been a major contributor to rising inflation over the past 18 months, but they are starting to have the opposite effect as the GSCI Index (Ex-Energy) has recently fallen by -23% to a nine-month low.

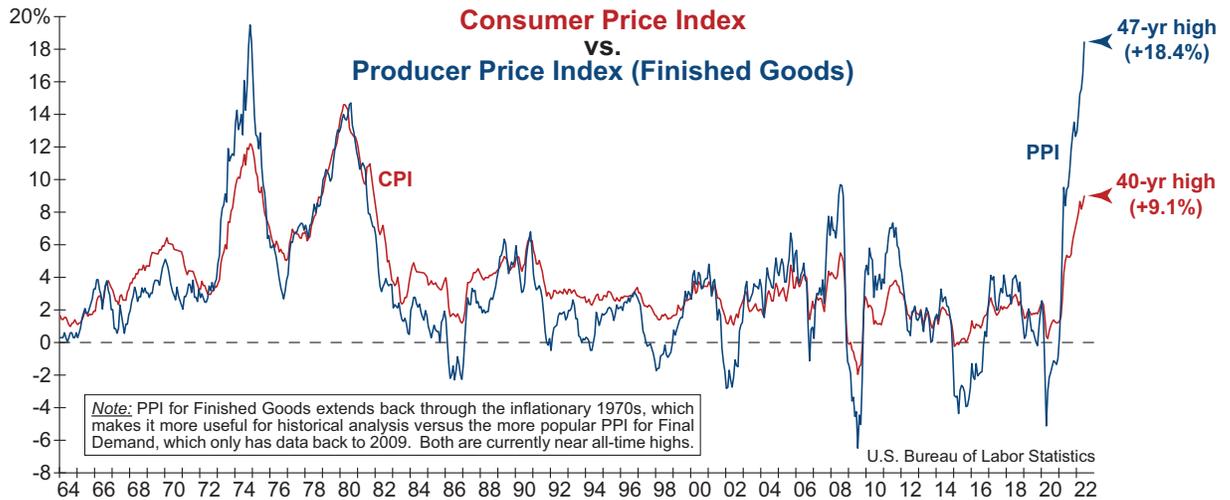


Even energy prices are showing some respite after an extraordinary post-COVID run-up. WTI crude oil has fallen from its peak of \$124/bbl to \$91/bbl – a level last seen prior to Russia's invasion of Ukraine. If crude oil remains under \$100/bbl, broader inflation pressures should ease as energy costs touch the majority of goods in the global economy, either directly or indirectly.

These graphs show that inflation could peak soon as a number of catalysts for rising prices are set to ease, yet there are two problems that are likely to keep inflation in the headlines for some time to come...

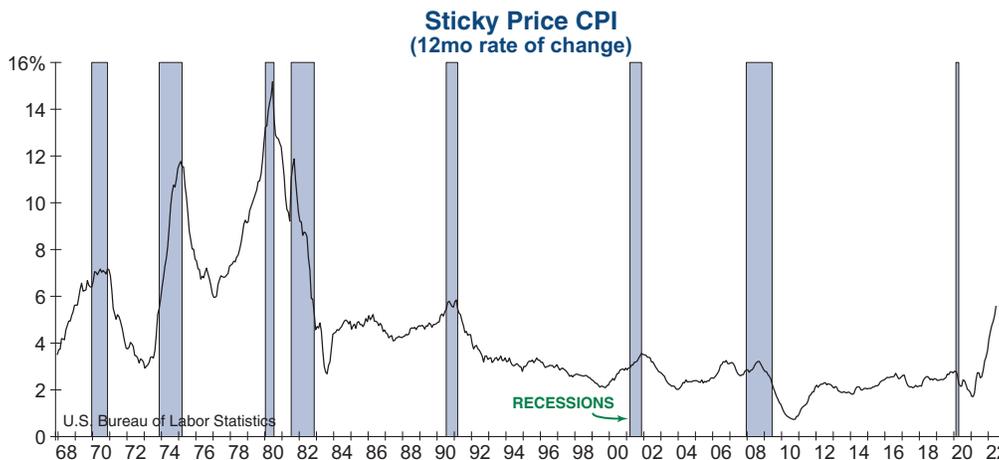
Problem 1: Inflation remains FAR above the Fed's target...

Even if inflation is set to peak, pricing pressures have a lot of unwinding to do before the Fed can achieve its inflation target, as both the Consumer Price Index (CPI) and a key segment of the Producer Price Index (PPI) have moved to 40+ year highs. This week's CPI reading was worse than expected, hitting +9.1%, the highest level since 1981, and the PPI for Final Demand rose to 11.3%. Even more extreme, the PPI for Finished Goods recently surged to +18.4% – its third highest reading ever.



Problem 2: Inflation will likely remain stubbornly high...

One of the reasons we knew inflation wouldn't be "transitory" last year was that sticky prices were trending strongly upward. For this same reason, we expect inflation to remain at a persistently elevated level, even if it doesn't continue to make new highs in the second half of 2022.



Sticky Price CPI measures the inflation of items that are inherently less volatile. Once their prices go up, they're hard to bring down. Today, Sticky Price CPI is rising rapidly and is at 5.6% year-over-year, the highest level since 1991 (see graph at left). Furthermore, on a month-over-month basis, sticky prices accelerated at an annualized rate of 8.1% in June, the second highest reading since 1982! This will keep overall inflation readings at a high level for a longer period.

Perhaps the biggest danger with today's inflation is that it has become ingrained in the minds of consumers. As shown in the graph at right, consumers' inflation expectations for the next 12 months have reached the highest level in the survey's 35-year history. The Fed knows inflationary psychology was a central driver of inflation in the 1970s and desperately wants to keep it from taking hold.

Why Consumers' Inflation Psychology Is Stoking Anxiety at the Fed

Wall Street Journal – 7/5/22

If the Fed can't get control of the situation quickly, inflationary psychology could become a longer term problem.

