

‘The End of the Beginning’ of This War on Inflation

Analysis by John Authers | Bloomberg

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The End of the Beginning

Winston Churchill has a phrase for any occasion. After German troops were defeated in a pivotal battle at El Alamein in 1942, he commented that it was “not the end, not even the beginning of the end but, possibly, the end of the beginning.” That’s probably a fair assessment of the state of the west’s war against inflation after a week that looked a turning point. War and killing dragged on for 30 months after El Alamein before Hitler was defeated, but with the Allies the increasingly likely victors throughout; and while the stakes aren’t that high this time, it’s fair to expect something similar for today’s global economy.

This comment from Bespoke Investment LLC sums up the mood by the end of the week:

“After a strong jobs report last Friday reignited fears of an overheating economy, markets were edgy heading into a busy week for inflation data. It doesn’t happen that often, but bulls hit the inflation superfecta. It started with Monday’s release of the July Survey of Consumer Expectations which showed a continued decline in inflation expectations. On Wednesday, the big bad CPI report for July was released and that came in lower than expected for a change. The weaker-than-expected CPI was followed by a weaker PPI Thursday and then a weaker-than-expected report on Import Prices Friday. After months where it seemed as though every inflation report was coming in hot, this week’s data on prices was cold, cold, cold, and cold. The heat wave has been broken!”

This is a fair enough summary. In particular, the headline US CPI index for July was unchanged from June, meaning that month-on-month inflation had actually dropped to zero. This a truthful and significant fact that can be seen clearly through the political fog of recriminations over whether it’s true (it is) and whether it’s a sensible way to say that the problem is over (it absolutely isn’t).

The response on stock markets also suggested that the end of the beginning of the bear market that started in the US at the outset of this year had finally been reached. With some wobbles, the rally in stocks has now gone on for four consecutive weeks, and more than half of the fall in the S&P 500 has been retraced. Some technical analysts suggest the S&P 500 still has to move above its 200-day moving average, which is close, while many are now prepared to declare that this is a full-fledged new bull market. Markets often get things wrong and create opportunities for profit, of course. But this degree of confidence and momentum demands at least some respect. Get in the way of it at your peril.

How can we best quantify where inflation has reached and the issues ahead? I think it's worth returning to the Inflation Indicators that we published weekly for most of last year. The aim was to try to tell whether the low-inflation paradigm that had persisted since the Global Financial Crisis of 2007-09 had at last been broken. The idea was to decide on a list of indicators of different aspects of inflation, and give them a Z-score, which measured how many standard deviations they were above or below their mean for the previous 10 years. For each indicator, the more standard deviations above normal, the darker blue they would appear in our heat map.

This graphic, compiled by Elaine He, shows how the indicators moved month by month through 2021. You can find our attempt at a full explanation of what happened here. At the turn of the year, everything seemed to be in line with the established trend. By year-end, much of the map had turned blue. This is how inflationary pressure steadily took hold over the course of 2021 as central banks fatefully continued to prime the pump:

With the exception of lumber futures and car rental prices, both of which proved to be genuinely transitory and had subsided by the end of the year, it was obvious that inflation pressure was taking hold. For that reason, we discontinued weekly updates. The indicators had done their job.

Now that inflation looks as though it may have reached a turning point, it's interesting to look at what the indicators tell us now, so Elaine kindly ran the graphic once more. It does help to shed light. This is what the heat map looked like when we last published it in December:

And this is what it would look like now:

The amount of blue has increased slightly, but that's largely because the economic forecasters polled by Bloomberg are more nervous about inflation. These numbers don't change often and aren't as helpful as I had hoped. Beyond that, economic measures of inflation show up almost exactly as they did eight months ago — way above the norm for the post-crisis era. The key lines of differences are:

- Raw material prices. They show significantly less pressure than they did.
- Consumer and business sentiment: After proving great leading indicators last year, the surveys we cover suggest that the peak in concern about inflation is already behind us — despite the ongoing intense news coverage.
- Wages. Without being extreme, they now show significantly more pressure — all the measures we track are above their long-term average.

There's also an important compositional effect within the five inflation components I chose to track. There are hundreds of components in the full index, but I thought these might prove particularly sensitive. Shelter inflation is now four standard deviations above its norm for the last decade. As it accounts for a third of the index and tends to come through with a lag, this bodes ill for headline inflation descending quickly to 2%. Meanwhile, the cost of recreational services is also now rising at two standard deviations above the mean as the economy reopens. Prices that rocketed due to transitory effects, such as car rentals, are now right back to normal, while college tuition and drug costs, both politically sensitive, have stayed under control.

Where does this leave us? The turn of the sentiment indicators, and the decline of raw materials prices, are both positive signals. Wages, hotter than they were at any point in 2021, are the great remaining concern. Barring a fresh geopolitical shock to send commodity prices higher again (which could easily happen, but let's not discuss it now), the remaining concerns are house prices and rents (which are now inflating far faster than they once did, and which take a while to turn around) and wage inflation.

So this exercise justifies an outbreak of market happiness. But the extent of the rally looks overdone, because of the critical issue of how long it will take to bring inflation down. It's nice that the peak is (probably) in; but the Fed wants us to believe that it won't desist from high interest rates until its target of 2% core inflation is in sight. That won't be easy.

For a really good breakdown of why the "peak" isn't as big a deal as some might hope, I'd recommend this video by Campbell Harvey of Research Affiliates LLC, which appears to have gone viral among the financial Twitterati over the weekend. He lays out the issues very clearly and makes one critical point: If month-on-month inflation continues at July's -0.01% from now until December, then headline inflation at the end of the year will still be over 6%. That would have been regarded as a nightmare scenario when this year began, and with wage negotiations concentrated in the beginning months of the year the risks of a "wage-price spiral" would intensify.

Not the end or the beginning of the end, then. But the end of the beginning. Now to see if victory can be obtained more rapidly than it was after El Alamein.

Soft Landing?

Returning to optimism, last week's data does suggest that a "soft landing," in which inflation comes down without a major recession, does at least now seem possible. The very strong employment numbers make it look as though recession talk has been premature.

It also continues to be the case that the shifts in the economy are happening in a more egalitarian direction. As I pointed out last week, wages are growing faster for the lower-paid. Data from the University of Michigan on Friday further showed that it was they who were gaining most in optimism about inflation. Chun Yao of Barclays PLC summed up the Michigan findings as follows:

"The press release noted that improvement in consumer expectations is "particularly among low and middle income consumers for whom inflation is particularly salient." Notably, the index for consumers' expectation for near-term gas prices decreased substantially, to 10.3, from 21.0 in July and 41.2 in June, suggesting that falling gasoline prices may play an important role in the improvement of consumer sentiment. Buying conditions for durables, including motor vehicles, deteriorated in August after the improvement in July, as "high-income consumers registered large declines in both their current personal finances as well as buying conditions for durables."

The impact of oil prices is exaggerated, of course. They make up less than 10% of the whole index. But gas prices are uniquely visible (you can see them in huge numbers on signs at the side of the road), and do influence expectations in both directions. The horrifying increase in pump prices earlier this year may have led to exaggerated concern about broader inflation; the sharp fall in gas prices may now be causing more relief than it should. But as expectations matter, it looks as though oil prices themselves matter.

After a post-crisis recovery in which the lower-paid were left behind, an economic slowdown that saw them catch up to some extent might well feel that much more like a "soft landing."

If there's a worrying indication for the economy, it comes from inventories. They are now very high. That implies that prices might have to come down (because supply is too great for demand). It also implies that production will come down, which means slower economic growth. This chart from Bank of America Corp. looks at the amount that CEOs in the US and Europe complained about excess inventories and weakening demand:

When companies feel like this, it gives hope on inflation. It also suggests that a lot of things still need to go right if the economy is to avoid a recession.

Credit Where It's Due

One dog that has not barked during the bear markets for stocks and bonds this year: the credit market. That matters, as it's credit that tends to act as the regulator for everyone else. If credit investors want to tighten conditions, then there is a problem. But investment-grade corporate debt has done nothing more than adjust to the higher yields on Treasuries — spreads are no wider than they were at the beginning of the year, and remain much lower than they were for most of the last decade:

High-yield credit has also seen a rebound, after a nasty selloff. This is one asset class that might naturally be expected to suffer from a rise in rates, but it isn't happening yet:

As with stocks, the rally embodies a lot of macroeconomic optimism. This summary from BofA is useful. It says three factors are in play:

- First, last week's jobs report has made a serious dent in the recession theory. Simply put, this economy does not hire half a million new workers into a recession.
- Second, the CPI report on Weds offered the first tangible piece of evidence that inflation peak may be happening. We have been consistently emphasizing weakness in commodities as a leading indicator of this, but the CPI print offers a hard data point to support this.
- Third, credit conditions have been improving fast on the back of a major market rebound from July.

If the perilous descent from Peak Inflation continues successfully, the credit market will continue to validate the recovery in other risk assets. But it wouldn't take much difficulty for the credit market to shake some of today's positive assumptions. These data are encouraging, but it's too soon to call the all-clear. —Assistance by Isabelle Lee

Survival Tips

Recent days have been marked by the appalling news of the attack on Salman Rushdie. The incident is like a step back in time. Way back in 1989, during my brief stint as a trainee reporter on the English south coast, I once got to write a story about how *The Satanic Verses* was the most popular book of the year at the town's public libraries, while the local Islamic community urged the council not to let anyone see it. It's hard to overstate how much Rushdie, his novel and Ayatollah Khomeini's death sentence dominated politics and society at that time.

More than three decades later, with Rushdie long returned to public life, a young man who was not even born then has tried to carry out the Ayatollah's wishes. It's a bad dream.

Rushdie is a divisive figure in Britain, where many saw the irony in his seeking protection from a police service loyal to Margaret Thatcher (or "Mrs. Torture" as she was referred to in Rushdie's novel). And I tend to agree with those who complain that "*The Satanic Verses*" is unreadable. I've tried to read it several times, and never got very far.

However, there is genius in the man. If you doubt this, try *Midnight's Children*, which I read in 1989 thanks to Rushdie's notoriety. Telling the story of India, and the tragedy of Partition, it's an extraordinary experience to immerse in it. And it's timely as Indian independence, and Partition, happened exactly 75 years ago. The children of the title would now be 75. If you haven't read it, and you have time, give it a try — once you're into Rushdie's rich idiom, it's magical.

For something more musical if you have less time to spare, this is Rushdie's appearance on Desert Island Discs from 1988, on the eve of the fatwa that would change his life; it's a delicious irony that one of his chosen songs is Sympathy for the Devil by the Rolling Stones. Or you can watch his strange appearance in a U2 video. You could also listen to J.K. Rowling from 2000, when she was already famous but not one of the most famous people on the planet. Given the response to her comments in recent years on transgender issues, and the death threats she has received after voicing her support for Rushdie, there again might be some irony in her choice of "Bigmouth Strikes Again" by The Smiths. Now she probably knows how Joan of Arc felt.

Have a good week everyone.

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