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Going Forward

Some stock markets, and the US markets amongst them, have endured the worst 6-month start of a year since 1970, over half a century ago and when Richard Nixon was President. We can recap upon the problems associated with and leading to that worst six-month start: constraints prompted by the implementation of various lockdown measures during the Covid pandemic; subsequent demand for goods and services overwhelming the ability of shippers to get products to market; and more importantly manufacturers' inability to produce the right mix of goods and in sufficient quantities to satisfy that resurgent demand following the ending of the Covid restrictions; and the unprovoked Russian attack on Ukraine, and China's ongoing zero-Covid policies and associated mass lockdowns also acting to exacerbate these supply-side problems and resulting inflationary issues. All of which factors have driven up prices for energy, food, logistics, raw materials and general goods and services, raised inflation expectations amongst consumers and financial markets alike, and crumpled shoppers' confidence in the process.

The last item above, consumer confidence, is symptomatic of the collective central bank response to raised inflation expectations, and this is problematic from an economic growth point of view. Major central banks around the world are tightening monetary policy (by increasing interest rates) in an attempt to keep adherence with their appointed mandates, most central banks in developed countries having a mandate to keep inflation at or near to 2 per cent. The above market-disrupting factors however, have made staying in line with this mandate virtually impossible at present.

The US Federal Reserve in fact has a dual mandate of pursuing economic goals which achieve (a) stable prices - *inflation held at or near to the rate of 2 percent, as measured by the annual change in the Price Index for Personal Consumption Expenditures (PCE),* and (b) maximum sustainable employment – which measure is *informed by a wide range of labour market indicators/estimates of the longer-run normal rate of unemployment consistent with this employment mandate, which feed into the Summary of Economic Projections (SEP). The most recent median estimate suggests that this rate is 4.1 per cent.*

In May of this year, the Federal Reserve stated that…"it thought that as it tightens monetary policy, inflation will fall back to its 2 per cent target and the labour market will remain strong." In June it effectively scrubbed the line on the labour market, affirming its commitment only or primarily to succeeding on the inflation front, in an apparent clear favouring of its 'price stability mandate' over its 'maximum employment mandate'.

In short, fears that central banks can no longer guarantee both stable prices and maximum employment in the near term, coupled with notably tighter monetary policy measures, have fostered the prospects of a recession in the US and elsewhere.

With both consumers and businesses being squeezed by a higher cost of living and tighter monetary policy, demand for big-ticket purchases such as homes and cars would likely be dulled or delayed, prompting companies to cut back on or postpone expansion plans or investments which would otherwise have created additional new jobs.

The Components of Inflation

Sharply rising inflation has been the root cause of the current woes being experienced in financial markets at present. It is useful to take a snapshot view of the factors currently driving US inflation (as this is the main driver of global market movements at present), to then understand what this potentially means for our client portfolios going forward.

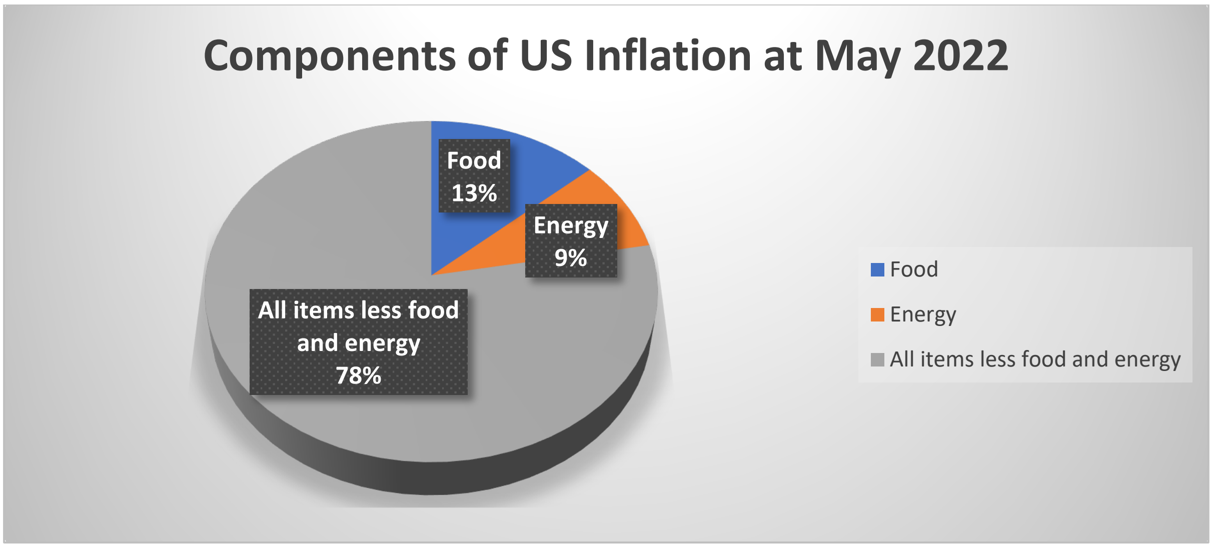
The Consumer Price Index (CPI) measures the change in prices paid by consumers for goods and services over a defined period. The CPI reflects spending patterns for each of two population groups: all urban consumers, urban wage earners and clerical workers. The all-urban consumer group represents about 93 percent of the total U.S. population. It is based on the expenditures of almost all residents of urban or metropolitan areas, including professionals, the self-employed, the poor, the unemployed, and retired people, as well as urban wage earners and clerical workers. Not included in the CPI are the spending patterns of people living in rural non-metropolitan areas, farming families, people in the Armed Forces, and those in institutions such as prisons and mental hospitals. Consumer inflation for all urban consumers is measured by two indexes, namely the Consumer Price Index for All Urban Consumers (CPI-U) and the Chained Consumer Price Index for All Urban Consumers (C-CPI-U).

The CPIs are based on a basket of prices for items including food, clothing, shelter, fuels, transportation, doctors' and dentists' services, drugs, and other goods and services that people buy to provide for normal day-to-day living.

In calculating the Index, price changes for the various items in each location are aggregated using weights, which represent their importance in the spending of the appropriate population group. Local data are then combined to give a US city average.

The following chart shows the weighted components of US CPI as of May 2022.

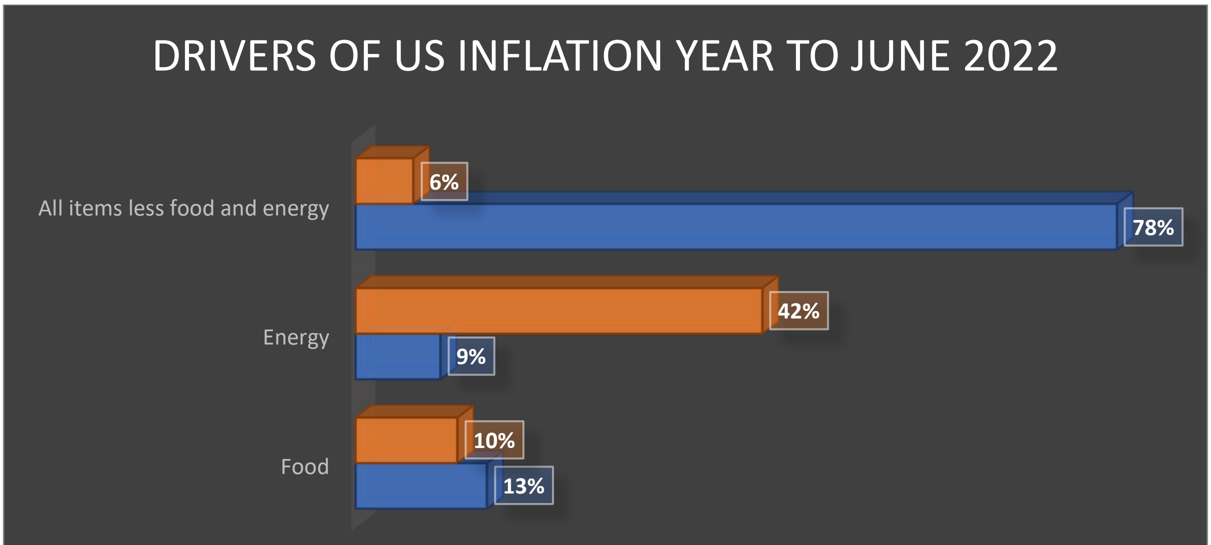
WEIGHTED COMPONENTS OF US CONSUMER PRICE INDEX (CPI)



Source: US Bureau of Labor Statistics/MPL

In the year to June 2022, the components which drove the 9.1% increase in US inflation are shown in the illustration below.

DRIVERS OF THE US CONSUMER PRICE INDEX (CPI) SINCE JUNE 2021



	Food	Energy	All items less food and energy
Increase in price %	10%	42%	6%
Weight in Index	13%	9%	78%

Source: US Bureau of Labor Statistics/MPL

This shows the disproportionate effect that energy has had over the past year upon overall inflation. Despite only representing around 9% of the basket of components which are used to measure inflation on an ongoing basis, prices here have risen over 42% in the past year. So, this it could be argued, has been the single biggest contributor to inflation in this period.

Reviewing the dateline from early 2021, the easing of lockdown measures, the ongoing and subsequent supply chain disruptions, plus acute demand increases from early last summer prompted the spike in energy costs. In particular, the seasonal changes in energy demand later that year, then coupled in early 2022 with the onset of conflict in Ukraine, served to substantially compound the already-existing inflationary issues here.

These issues have created a far less certain environment for business leaders to be facing; taking a snapshot from the last set of US Manufacturing Purchasing Managers Indices released earlier this month, when questioned about the current business environment, executives from various US companies made the following comments:

New Orders: Price elevation and extended lead times have resulted in a continuing slowing in new order rates across the supply chain;

Employment: Companies are still struggling to meet their labour management plans, though there are more signs of improvement. An overwhelming majority of panellists again indicated their companies are (still) hiring. Among those respondents, 42 percent expressed difficulty in filling positions, up from 30 percent in May;

Customers' inventories: These are too low for the 69th consecutive month, a positive for future production growth;

Prices: Continued price increases in oil and fuel, packaging supplies (including corrugate), food ingredients, and petroleum-based products and petrochemicals, were the primary causes of price growth (which tallies with the comments made above). Notably, 8.3% of respondents reported lower prices in June, supporting a continued slow but steady move towards price softening;

Backlog of Orders: Backlogs expanded in June at a slower rate, as output remains stable at low levels and new orders have slowed due to excessive lead times and historically high prices.

What these collective statements tell us, is that the sharp spikes upwards in energy prices experienced over the past year should we hope not be experienced to anything like the same extent going forward (albeit as the rate of price increases slows). We will however have to wait whilst supply chain bottlenecks and labour shortages (products effectively of and following the tailing-off of the global pandemic) subside over a longer period, this easing of supply chain problems being likely to become increasingly apparent as 2022 progresses and the post-covid economic and labour market normalisations continue.

Current portfolio changes

We have maintained a relatively high cash weighting across client portfolios in the last quarter in the hope and expectation that the elevated inflation prints of late would begin to roll-over or decline, leading to improving market sentiment and a brighter and more visible growth outlook, which could lead us to begin reallocating this cash weighting back to the markets.

Whilst this rolling-over of high inflation has not occurred so far (it could yet be some while before we see a comfortable trend of declining rates), taking a contrarian approach there are some signs from a technical standpoint that a short-term market rally could occur. The S&P 500 recaptured its 50-day moving average on Tuesday 19th July, meaning that the markets appear to be stabilising, and whilst high levels of investor pessimism still abound, that pessimism is becoming moderated by some improving data sets coming out of the economy, data that is improving from the standpoint of what is driving inflation.

Our information lead as to what may prove the next major trigger for stock valuations, will be the forthcoming corporate earnings season for the second quarter. Within that we will be looking particularly for company statements and indications on margin pressures prompted by a backdrop of high costs and an overly strong US Dollar.

If there is predominantly negative news here, this could lead to a further sell-off in markets which we think will give us opportunities to invest some of the available cash, as this further sell-off may serve to exhaust the selling pressures, and may constitute that point at which the newsflow is unlikely to get any worse.

On the other hand, a more positive news flow could also present us with opportunities to invest that available cash; more visibility could be given in sectors (such as energy) which are expected to continue to benefit in any higher inflation environment, and in numerous other sectors such as financials, industrials, and consumer discretionary areas, which we would expect to do better in any environment where inflation is moderating back to more acceptable levels.

With Kind Regards

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