HIGHTOWER

FARR MARKET COMMENTARY

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Why Inflation Is Not Likely Long for This World

June 8, 2022

This Friday we will receive the May reading for the Consumer Price Index (CPI). Just about everyone thinks this data point has more potential to move the markets than any other this week. I even heard one commentator on Bloomberg TV say this morning that "the trading week begins on Friday." While I somewhat agree with that assessment, I also think the obsession with near-term inflation may be a bit excessive at this point. Yes, inflation readings above projections could cause the Fed to accelerate interest-rate hikes. And yes, a more aggressive Fed would likely lead to more volatility in both the bond and stock markets. But should it really matter that much if the May CPI comes in at 8.1% or 8.3%? Nobody expects inflation to remain this high for very long.

In my opinion, there should be more focus on whether there are enough countervailing forces in place to bring down inflation to more palatable levels within a reasonable amount of time. The bond market continues to tell us that this is by far the most likely scenario, as prices for Treasury bonds and Treasury Inflation-Protected bonds (TIPs) continue to suggest that inflation will be coming way down from current levels over the intermediate term.

So what are the forces that will bring inflation down over the next year? From where I sit, there are many:

- **High inflation** – As someone once said, the cure for high inflation is high inflation. Consumers struggling with rising prices (and wage growth that is not keeping up) will increasingly cut back on spending, especially as their savings become depleted. Lower consumer spending should lead to a moderation in inflation.
- **Sharply higher interest rates** – Rising interest rates will affect demand for anything bought using credit, including housing, autos, appliances, home improvements, etc.
- **Big losses on stocks and bonds** – The increases in inflation and interest rates to date have led to historic losses on stocks and bonds this year. These losses are sure to affect demand through an inverse wealth effect in an economy heavily dependent on spending by the well-to-do.
- **Housing market cooling dramatically** – Housing shortages notwithstanding, a doubling in mortgage rates is certain to cool an overheated housing market. The evidence is accumulating in the form of lower new and existing home sales; a sharp drop in housing affordability; a drop in household formations; and drops in both homebuilder sentiment and buying conditions.
- **China reopening** – The Chinese government has begun the process of reopening the economy in key regions. As supply-chain pressures resolve, input costs should begin to moderate for the corporate sector.
- **Inventory gluts at retailers** – Several large retailers, including Target and Wal-mart, are reporting big surges in inventories as they failed to anticipate a falloff in demand as the economy reopened from COVID. We expect that many retailers will follow Target's lead and announce

plans to reduce inventories through markdowns, which will reduce inflationary pressures for goods.

- **Sky-high gas prices –** Gas prices are now averaging close to $5 per gallon as the price of a barrel of oil is up 70% in the past year. Higher spending on gas will leave less money for the consumer to spend elsewhere.
- **Mix shift in consumer spending –** It is becoming clear that consumers are changing their buying preferences from goods to services, which could help alleviate the shortages that have led to price spikes.
- **Surge in value of the dollar –** The dollar has appreciated over 14% (based on the US Dollar Index (DXY)) against a basket of foreign currencies over the past year. A rising dollar is deflationary in the US as prices for imports fall. At the same time, a sharply higher dollar exacerbates the effects of rising commodity prices, especially oil, for other countries due to the fact that commodities are priced in dollars. The double whammy of rising commodity prices and a rising dollar will surely lead to demand destruction for many commodities in many parts of the world. Finally, a sharply higher dollar will be a drag on corporate earnings, as we learned from Microsoft's recent guidance reduction. If earnings estimates start to decrease from unrealistically high levels, the impetus to hire more workers may decrease and alleviate pressure on wages.
- **Many consumers have already resorted to dipping into savings and running up credit card debt –** As we wrote about in last week's Market Commentary, the savings rate has plummeted to just 4.4% compared to a long-term average of about 9%. At the same time, household debt, including credit card debt, has been surging in recent months. Both of these trends suggest that despite the $2+ trillion in aggregate excess savings still on consumer balance sheets, many consumers are struggling as a result of the spike in inflation.
- **Plummeting federal budget deficits –** Government budget deficits have plummeted so far this year, which reflects reduced COVID support (like enhanced child tax credits) and higher tax revenue from capital gains taxes. Both the reduction in transfer payments and the increase in taxes reduce consumer spending power.

The areas of potential concern, in my opinion, continue to be the housing and labor markets. But even these markets could soon see some relief. Big increases in input costs, coupled with sagging demand, will cause at least some businesses to scale back the current aggressive pace of hiring. And absent continued strong wage gains, it may not make sense to expect rents to keep rising at the current outsized pace.

To sum it up, we are not in the camp that thinks prices will keep rising at a breakneck pace indefinitely. However, the reasons for the moderation in inflation are not particularly comforting either. It's becoming pretty clear that the economy will not be able to withstand the rise in inflation and interest rates that we've already witnessed. We could be teetering on the brink of recession within the next few quarters. Unless supply disruptions in the oil market persist or even intensify, we expect the economic slowdown will also bring much lower rates of inflation. And if we're right, highly rated bonds would seem to hold much more appeal at today's yields.

Peace,
Michael

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