

For the US, this has been 'the summer of our disinflation'

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Kristina Hooper
Chief Global Market Strategist



US disinflation

Lower-than-expected inflation and falling inflation expectations have led to “the summer of our disinflation” in the US.

What about Europe?

A similar disinflationary scenario could unfold in Europe, but anemic growth and stubborn inflation may make it more difficult.

Energy prices

Energy prices could disrupt the story, but I don't expect them to significantly alter the core disinflationary process that's underway.

When I was reviewing the US inflation data for last week, I was reminded of the title of an old John Steinbeck novel, “The Winter of Our Discontent.” In the US, at least, it's clearly the summer of our disinflation.

- The US Consumer Price Index (CPI) clocked in lower than expected at 0.2% month-over-month and 3.2% year-over-year (versus 3.3% expected).¹ Core CPI, which excludes food and energy prices, was up 0.2% month-over-month and 4.7% year-over-year.¹ While some categories of inflation are stickier than others, the progress that has been made is significant — and very welcome.
- The preliminary University of Michigan Survey of Consumers for the month of August provided some positive data.² Five-year-ahead inflation expectations hit a five-month low of 2.9%. One-year-ahead inflation expectations moved slightly lower, from 3.4% in July to 3.3% in August (preliminary). What's more, while consumer sentiment edged lower, to 71.2, that's a small drop from a high level — the reading of 71.6 in July was the highest reading since October 2021. The key takeaway is that not only is inflation improving, but so are inflation expectations — which has been an important consideration for the Fed in determining its monetary policy. This survey indicates that longer-term inflation expectations are well-anchored.
- The NY Fed Survey of Consumer Expectations for July also showed a decline in inflation expectations. Median inflation expectations for the year ahead fell to 3.5% from 3.8% the previous month, while median inflation expectations for three years ahead dropped to 2.9% from 3% in June.³

Why are inflation expectations important?

As I've said before, inflation expectations matter. In a speech last year, former US Federal Reserve Chair Ben Bernanke articulated the important role inflation expectations play in monetary policy: “The conventional story, which is dominant in central banks around the world, rests on two key premises. First, that inflation expectations... are an important determinant of realized inflation... The second key premise is that central bank behavior and possibly central bank communications can influence inflation expectations and through them macroeconomic outcomes... If inflation expectations are well-anchored in the sense that they don't respond very much to short-term movements in realized inflation and other variables, then policymakers can respond more aggressively to recessionary demand shocks and less aggressively to inflationary supply shocks, leading to better dual mandate outcomes.”⁴

History has shown that inflation expectations can be very predictive — just look at University of Michigan consumer inflation expectations back in the late 1970s and early 1980s; consumers expected high inflation, and their spending habits then helped make it a reality.

For example, the February 1980 survey showed inflation expectations for the year ahead period at 10%.⁵ It's no wonder the Fed had to act so aggressively.

Europe may face a tougher path to disinflation

Consensus is growing that a similar disinflationary scenario will unfold in Europe, although I believe that scenario will be more imperfect than that of the US. Growth in Europe is more anemic, and some forms of inflation could be more stubborn. However, it is possible that more anemic growth could be a blessing in disguise, helping the disinflationary process.

Energy prices could temporarily disrupt the story

But even in the US, this is not a perfect fairytale. As I've said before, not every data point will be beautiful and fit the disinflationary narrative. We could see upward pressure on headline inflation in the near term if energy prices increase in coming months.

Natural gas price trends in 2023 have been below those implied by historical norms, likely driven by high storage levels in Europe and slower-than-expected demand growth in China. However, the recent threat of strikes in Australian liquefied natural gas facilities have reminded us of the risks to energy supply and energy prices, and supply disruptions remain a threat as the Ukrainian counteroffensive gathers pace. Demand may also increase if Chinese growth reaccelerates and "El Nino" causes a colder winter in Europe. However, I believe a temporary increase in energy prices will not significantly alter the core disinflationary process that is underway.

Property woes continue in China

Property sector fears reared their ugly head again in China last week when a major property developer, Country Garden, failed to make \$22.5 million in debt payments.⁶ However, there is a 30-day grace period, and I must stress that we've seen other property developers miss their coupon payment deadline but ultimately pay up within the 30-day grace period.

I think there's a silver lining to China's current property woes. I expect this situation to accelerate the rollout of property support — and perhaps even prompt greater policy support than had originally been planned. That, in turn, could be a positive catalyst for Chinese stocks, which have been under pressure this year.

Additionally, recent economic data releases for China have been largely disappointing, while those in the US have surprised to the upside; that too could help prompt more policy support in China, which in turn could be a positive catalyst for Chinese stocks.

Italy levies a significant tax on bank profits

This has been a summer of discontent for banks. Actually, I should be more accurate: Politicians haven't been content with bank profits in recent months. Some governments are threatening to do something about it, while others have already acted.

Last week saw the announcement of a 40% tax on bank profits in

Italy.⁷ Italian policymakers, concerned that banks have experienced windfall profits without passing on significant rate increases to its depositors, have levied a significant tax on these banks. Prime Minister Giorgia Meloni has softened the tax by capping it at 0.1% of a bank's assets, but it clearly spooked investors.

Banks are clearly coming under pressure on a variety of fronts. Several other European countries have also imposed taxes similar to Italy's in recent months. And in the US, Moody's has downgraded some small- to mid-sized banks and has warned it could downgrade some larger banks. This seems similar to the Fitch downgrade of US debt, as it is based on information we have been well aware of for some time. We know that the period following the peak in net interest margins has historically been difficult for banks, and that there are likely headwinds to come as the economy slows. However, for patient longer-term investors who are looking for bargains and are discerning, there may be significant opportunities to be found in the European and US banking sectors.

In the near term, I'm more concerned about what additional stress on banks will do to the tightening of credit conditions, which has already been significant. And tighter credit conditions is a real risk to the "soft landing" scenario many have subscribed to (while I don't expect a hard landing, I do anticipate some bumps because of factors such as tighter credit conditions).

Looking ahead

Earnings season is almost over — but not yet. We'll be hearing from a lot of US retailers this week, which will be helpful in assessing the strength of the US consumer — who is critical to the future of the economy.

I'll also be very focused on upcoming data releases for China, including retail sales and industrial production, which will give more clarity on the state of the Chinese economy.

And we'll be getting the minutes this week from the Federal Open Market Committee's (FOMC) July meeting. More insight into what the Fed is thinking will be helpful, as always, although we may get more current insights from the Fed's Jackson Hole Symposium.

I'll also be paying close attention to US inflation data in the coming weeks, since that will be important to FOMC members when they deliberate on the need for any more rate hikes at their meeting in September. However, I think markets will soon come to the conclusion that the rate hike cycle in the US is over — and anticipation about Fed rate cuts will begin.

Interestingly, there's a quote from "The Winter of Our Discontent" that I believe applies to central bankers: "...most people live ninety per cent in the past, seven per cent in the present, and that only leaves them three per cent for the future." I think this is largely true of the Fed and other central banks, which spend most of their time assessing past data rather than accounting for the impact of policy lags on future data. Spending more time understanding what future data will look like because of past policy would be a prudent approach, in my opinion. And so perhaps the Bank of England's current exercise into reviewing its forecasting may be timely and valuable.

Unfortunately, I suspect most investors spend too much time focused on the past as well. It's important to understand historical market

patterns and also learn from past mistakes, but I believe more time needs to be spent on positioning for the future: building a sustainable, diversified long-term asset allocation while also being opportunistic — exploring the most unloved asset classes, ones weighed down by negative sentiment that may or may not be justified, and also considering those asset classes that are simply overlooked.

With contributions from Paul Jackson and Andras Vig

Notes

¹Source: US Bureau of Labor Statistics, Aug. 10, 2023

²Source: University of Michigan, Aug. 11, 2023

³Source: New York Fed Survey of Consumer Expectations, Aug. 14, 2023

⁴Source: National Bureau of Economic Research, keynote by Ben Bernanke — “Inflation Expectations and Monetary Policy,” May 19, 2022

⁵Source: Reuters, “Country Garden misses bond payments as China property fears flare,” Aug. 9, 2023

⁶Source: Reuters, “Italy hits banks with 40% windfall tax,” Aug. 8, 2023

⁷Source: Reuters, “Italy hits banks with 40% windfall tax,” Aug. 8, 2023

Important information

Past performance is not a guarantee of future results.

This does not constitute a recommendation of any investment strategy or product for a particular investor.

Investors should consult a financial professional before making any investment decisions.

All investing involves risk, including the risk of loss.

A value style of investing is subject to the risk that the valuations never improve or that the returns will trail other styles of investing or the overall stock markets.

Diversification does not guarantee a profit or eliminate the risk of loss.

An investment cannot be made into an index.

In general, stock values fluctuate, sometimes widely, in response to activities specific to the company as well as general market, economic and political conditions.

The risks of investing in securities of foreign issuers, including emerging market issuers, can include fluctuations in foreign currencies, political and economic instability, and foreign taxation issues.

Investments in companies located or operating in Greater China are subject to the following risks: nationalization, expropriation, or confiscation of property, difficulty in obtaining and/or enforcing judgments, alteration or discontinuation of economic reforms, military conflicts, and China’s dependency on the economies of other Asian countries, many of which are developing countries.

The profitability of businesses in the financial services sector depends on the availability and cost of money and may fluctuate significantly in response to changes in government regulation, interest rates and general economic conditions. These businesses often operate with substantial financial leverage.

The Consumer Price Index (CPI) measures change in consumer prices as determined by the US Bureau of Labor Statistics.

The Survey of Consumers is a monthly telephone survey conducted by the University of Michigan that provides indexes of consumer sentiment and inflation expectations.

The New York Fed’s Survey of Consumer Expectations is a nationally representative, Internet-based survey of a rotating panel of approximately 1,300 household heads.

Net interest margin is the difference between interest earned and interest paid, which gauges how successfully a company, typically a bank, made its investments relative to its debt situation.

Tightening monetary policy includes actions by a central bank to curb inflation.

The opinions referenced above are those of the author as of August 14, 2023. These comments should not be construed as recommendations, but as an illustration of broader themes. Forward-looking statements are not guarantees of future results. They involve risks, uncertainties and assumptions; there can be no assurance that actual results will not differ materially from expectations.