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Consumer inflation expectations

Central bank credibility is on the line, so we will want to follow inflation expectations closely.

Earnings reports

As earnings season begins, all eyes will be on guidance for the future, as investors nervously await an “earnings recession.”

China’s reopening

China’s economy has been benefiting from its post-COVID reopening, but infection rates are on the rise again.

1. Inflation

The US Consumer Price Index (CPI) will be released this week, and expectations are for a 1.1% month-over-month increase in headline CPI.¹ That would be a whopper, following a 1% month-over-month increase from the previous month. So how would stocks react if this happens? I suspect that, even if there is an initial negative reaction, they would soon take it in stride for two reasons:

- First of all, inflation “feels” very high to consumers, so a headline CPI reading like the one expected should come as little surprise. Energy and food prices, which are included in headline CPI, tend to shape consumer inflation expectations. In fact, the New York Fed just released the results of its most recent Survey of Consumers, which shows consumers have increased their expectations for inflation in the short term; they expect inflation to rise 6.8% in the year ahead, up from 6.6% in the previous reading.²
- Second, longer-term inflation expectations remain relatively well-anchored, as we saw in the most recent New York Fed Survey. Three-year ahead consumer inflation expectations fell to 3.6% from 3.9% in the previous month’s reading.² In addition, the bond market’s expectations of inflation have fallen meaningfully from their cycle highs reached a few months ago.³

2. Consumer inflation expectations

As I mentioned above, in the most recent NY Fed Survey, longer-term inflation expectations fell materially. I will be looking for the University of Michigan Consumer Survey to indicate a similar drop in longer-term inflation expectations. As Fed Chair Jay Powell shared at the last Federal Open Market Committee (FOMC) press conference, the Fed decided to raise rates by 75 basis points rather than 50 points in June largely because of two data points – inflation and inflation expectations – so both will be important to follow closely in order to help understand what the Fed might do next.

Just because longer-term inflation expectations seem relatively well-anchored thus far, we need to be vigilant. St. Louis Fed Bank President James Bullard issued a warning last week regarding inflation and the Federal Reserve (Fed): “US inflation expectations could become unmoored without credible Fed action, possibly leading to a new regime of high inflation and volatile real economic performance.”⁴ Bullard pointed out that there is a large chasm between inflation, which is at extremely elevated levels, and inflation expectations, which are far more tame. He suggested this dichotomy “will have to be resolved, possibly resulting in still higher inflation expectations.”⁴

It is true that central bank credibility is on the line, so we will want to follow inflation expectations closely.

3. Market interventions

Western authorities are working on significant new interventions that are intended to solve for current problems – but could create more problems. In the coming month, we may get more clarity on two such measures: G7 countries are working on a Russian oil cap (ROC) in order to try to protect their economies from sky-high energy prices, and the European Central Bank is debating an anti-fragmentation tool to lower rising yields in government bonds of peripheral European countries.

There is little detail around exactly what each mechanism will look like. However, investors should keep an eye on such market interventions. These are complex measures for complex times, of course, but they represent an increasing use of otherwise relatively free markets for political as well as normal policy goals. We have to recognize that that they can cause distortions of market pricing and flows and other unintended consequences, so the details will be very important.

4. Earnings downgrades

Some of the big banks will be reporting earnings this week, but many companies from a variety of sectors will be reporting this month. I will be focused on guidance for the future, given investor concerns about an “earnings recession.” We haven’t seen many downward earnings revisions just yet, so we will want to pay attention to the forward guidance that companies offer this month on earnings calls. The caveat is that I believe much of earnings disappointment has already been priced into stocks.

5. US employment

Some have suggested that the US may already be in a recession. However, last week saw a strong jobs report, which may indicate that the US is not nearing a recession after all. The Sahm Recession Indicator, devised by former Fed economist Claudia Sahm, is considered a very accurate indicator of recession, and it relies on the unemployment rate. As the Federal Reserve Bank of St. Louis explains, “Sahm Recession Indicator signals the start of a recession when the three-month moving average of the national unemployment rate (U3) rises by 0.50 percentage points or more relative to its low during the previous 12 months.”⁵

Unemployment remains very low, and so the Sahm indicator has not been triggered. Also, last week’s US jobs report showed low wage growth, which suggests some inflationary pressures are easing. We will want to follow both metrics closely, as they will help determine the Fed’s path in the last quarter of the year.

6. The July FOMC meeting

There has been much debate over whether the Fed will actually go ahead with another 75 basis point hike in July; the number of doubters seems to be growing by the day. However, I believe a 75 basis point hike in July is a fait accompli for two reasons:

- First, the US economy remains relatively strong, especially when it

comes to the labor market, and so it can tolerate such a big increase.

- In addition, the June FOMC meeting minutes provide a compelling rationale for another 75 basis point hike: “Many participants judged that a significant risk now facing the committee was that elevated inflation could become entrenched if the public began to question the resolve of the committee to adjust the stance of policy as warranted.”⁶

I believe the Fed needs to stay aggressive now so it can assess the situation in September and possibly take a less aggressive path of tightening in the fourth quarter.

7. The next UK prime minister

Boris Johnson has resigned, and there is a large cast of characters who have thrown their hat into the ring to be his successor. Thus far, there has been a marginal impact on UK assets, but we could see increased volatility the longer there is uncertainty surrounding future leadership. However, I believe inflation, interest rates and the growth outlook should matter far more.

8. China’s reopening

China’s Caixin service Purchasing Managers’ Index (PMI) reading for June was an impressive 54.5, a strong rebound from May’s reading of 41.4.⁷ China’s economy has clearly benefited from its nascent post-COVID reopening. However, infection rates have increased modestly – although I would argue that is to be expected with a reopening.

The downside is that if infection rates increase enough, there is the risk of another lockdown, which would obviously be problematic and delay the country’s economic rebound. While I believe this is very unlikely, we will want to follow health and economic indicators closely.

9. The volatile Treasury market

The 10-year Treasury yield has been on a roller coaster ride in the past week, exhibiting a high level of volatility for Treasuries. Mortgage rates in the US fell significantly over the last few days. Also, the 2-year and 10-year yield curve inverted again last week for the first time in several months, although a very modest inversion. This is causing more to worry about the potential for recession, although I continue to believe recession fears remain overblown for the US. We will want to continue to follow Treasuries closely for the signals they might be sending.

10. Japan’s economy

Japan’s June service sector PMI was 54.0, which was its fastest pace of expansion since 2013.⁸ And monetary policy remains very supportive. However, household spending in May fell 1.9% from April, and is down 0.5% year-over-year.⁹ In addition, if the US economy slows significantly, I expect that to have a negative impact on Japan’s

economy. We will want to follow this closely. I believe the Japanese economy will remain strong, but there are certainly some headwinds.

I would be remiss if I did not mention the assassination of former Prime Minister Shinzo Abe. I always admired him for his dedication to Japan, its economic health, and democracy in general. The impact of his loss is widely felt, and I extend my deep condolences to the people of Japan.

With contributions from Arnab Das, Brian Levitt and Emma McHugh

Notes

¹Source: Bloomberg News, "Fed Braces as Another Big US Inflation Number Looms: Eco Week," July 9, 2022

²Source: New York Federal Reserve Bank Survey of Consumers, July 11, 2022

³Source: Bloomberg, L.P., as of July 8, 2022

⁴Source: Federal Reserve Bank of St. Louis, "The First Steps toward Disinflation," June 1, 2022

⁵Source: Federal Reserve Bank of St. Louis

⁶Source: US Federal Reserve, FOMC meeting minutes, June 2022

⁷Source: Bloomberg News, "China Services Recovers Stronger Than Expected: Caixin PMI," July 4, 2022

⁸Source: Reuters, "Japan's service sector activity grows at fastest rate in over 8 years – PMI," July 2, 2022

⁹Source: Reuters, "Japan household spending slips again as chip shortage hits consumers," July 7, 2022

Important information

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.

The US Consumer Price Index (CPI) measures change in consumer prices as determined by the US Bureau of Labor Statistics. Core CPI excludes food and energy prices while headline CPI includes them.

A basis point is one hundredth of a percentage point.

The yield curve plots interest rates, at a set point in time, of bonds having equal credit quality but differing maturity dates to project future interest rate changes and economic activity. An inverted yield curve is one in which shorter-term bonds have a higher yield than longer-term bonds of the same credit quality. In a normal yield curve, longer-term bonds have a higher yield.

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.

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 Federal Open Market Committee (FOMC) is a 12-member committee of the Federal Reserve Board that meets regularly to set monetary policy, including the interest rates that are charged to banks.

The G7 (or Group of Seven) is a forum that brings together the leaders of seven of the world's leading industrial nations: Canada, France, Germany, Italy, Japan, the UK and the US. It also includes leaders from the European Union.

Purchasing Managers Indexes are based on monthly surveys of companies worldwide, and gauge business conditions within the manufacturing and services sectors.

The opinions referenced above are those of the author as of **July 11, 2022**. 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.