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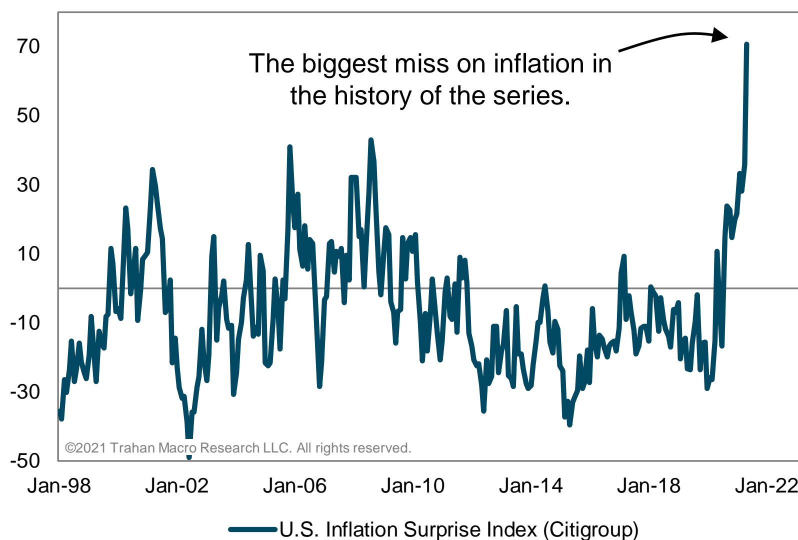
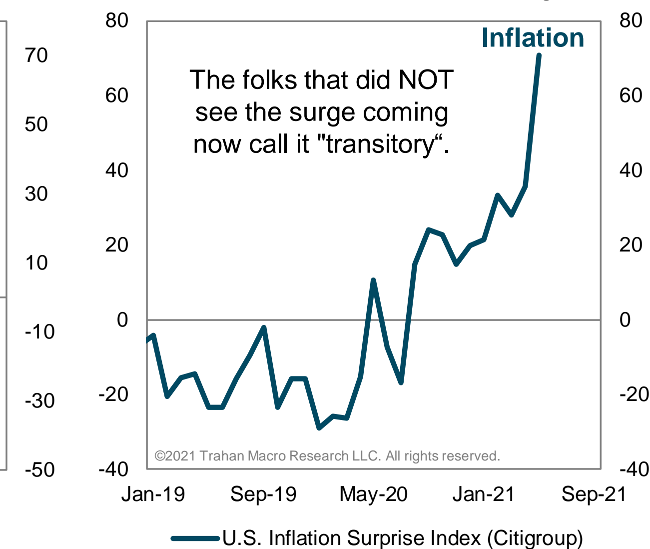
June 10, 2021

What Happens To Equities If The Fed Is Wrong About Inflation?

Inflation is a problem. Now, if you don't believe that inflation is a problem then I think we can probably agree that it's an issue. Core inflation, which is at the heart of the Fed's reaction function, now sits at a 25-year high. More importantly, perhaps, few folks saw this surge in inflation coming, and that includes the Fed which has over 400 economists on its staff. The message from the Fed is inflation will be "transitory" and that is their justification for keeping rates at historic lows. It is a bit strange that we have to trust the folks that did not see this coming and hope they are right on the "transitory" view. There is still a cost to the "transitory" view as anyone who has gone to a restaurant or supermarket lately will attest. The alternative where the Fed raises rates also has a cost, a large one for equities as we will address in this report.





Inflation has rarely been an issue in recent decades. I am not giving economists a pass here. I am merely trying to explain why it's not a risk economists or investors think about a whole lot. The chart above shows Citigroup's Inflation Surprise Index which we think of as a gauge of forecasting accuracy when it comes to inflation. It is fair to say that this has been a lousy performance from forecasters. In fact, we have just witnessed the largest short-term move in the Index in its history. Actually, this is the biggest one-year change in the history of all Economic Surprise Indices regardless of category, Citigroup or Bloomberg.

In today's report we try to take an impartial view of the inflation debate. It's pretty clear this is more than just "transitory". Surely, some parts of the inflation story will wane, but it's not so clear with others. The conclusion is that the Fed might have to raise rates sooner rather than later, and that has enormous implications for the equity market. We are not exactly alarmists but it is clear that this story is about more than just supply chain issues or the impact of benefits on employment. Food for thought as always. Francois

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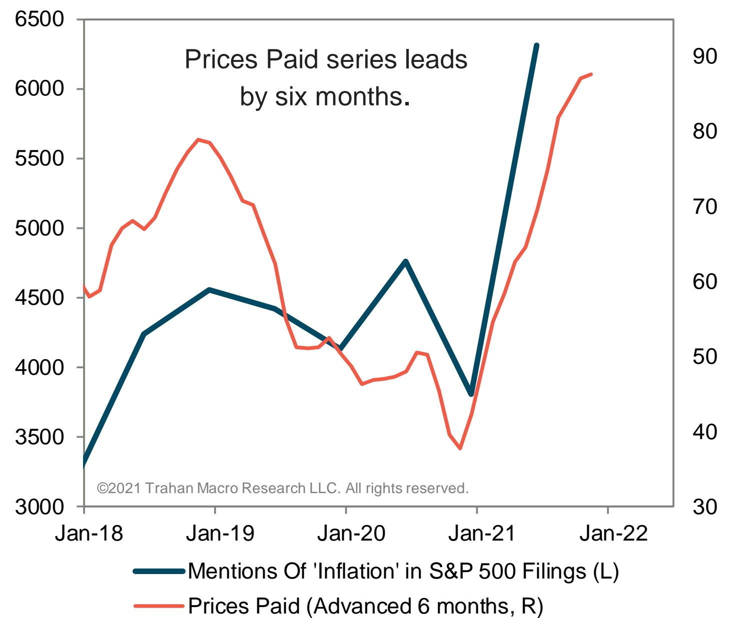
Companies And Investors Are Already Concerned About Inflation

The title of this page is not exactly controversial since the Prices Paid series from the ISM report sits near historic highs. It is nonetheless interesting to see that this surge in Prices Paid has coincided with a rebound in the use of the word “inflation” in S&P 500 company filings. Surprisingly, perhaps, this series did not decline much during the pandemic. The recent surge we have observed began from levels close to those seen in 2018/19 when the Fed was raising rates. The left chart almost looks like this has been one cycle with a slight pullback in 2020.

Inflation Surging In S&P 500 Filings …

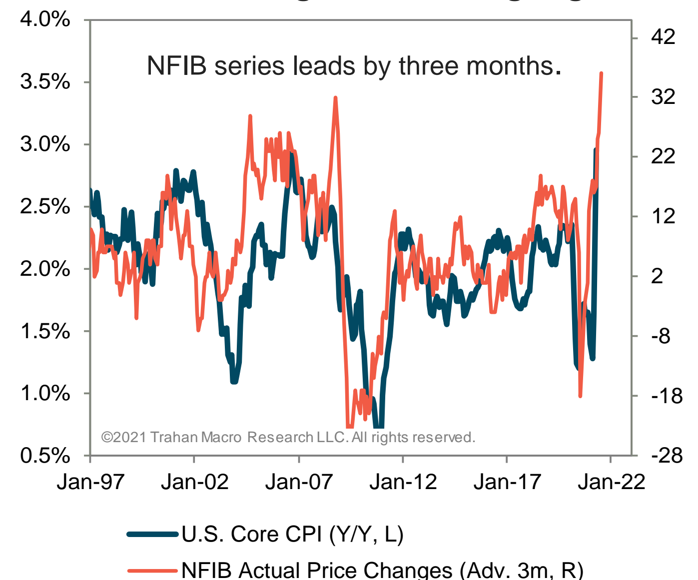
… And Company Surveys



The impact of inflation on the consumer is visible to anyone who has gone grocery shopping, tried to buy furniture, or purchase a car lately. Even getting a haircut has become more expensive. Proponents of the “transitory” theory state that the former is due to supply chain issues and the latter about the impact that government benefits are having on the availability of labor. We believe the effects of these forces on inflation are undeniable. We do wonder, however, if this is all it is. Are there other forces at play that could make inflation linger even after supply chain issues have been resolved and benefits have ended?

Core CPI Highest In Over 25 Years …

… And NFIB Argues It’s Going Higher



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Benefits A Double-Edged Sword … Or Are They?

It's fairly easy to find a survey that shows U.S. consumers are concerned about inflation. This should not be surprising, as the chart below reveals that consumers have always been allergic to rising prices. Indeed, there exists an inverse correlation between consumer confidence and inflation, which makes sense since inflation essentially erodes income. With that said, Consumer Confidence has remained elevated in the past year despite the rise in inflation. All other things equal, we believe the three rounds of government benefits help explain the breakdown in the relationship. What happens when benefits end? For the sake of the U.S. economy, the Fed better be right about inflation being "transitory".

Consumers Worried About Inflation …

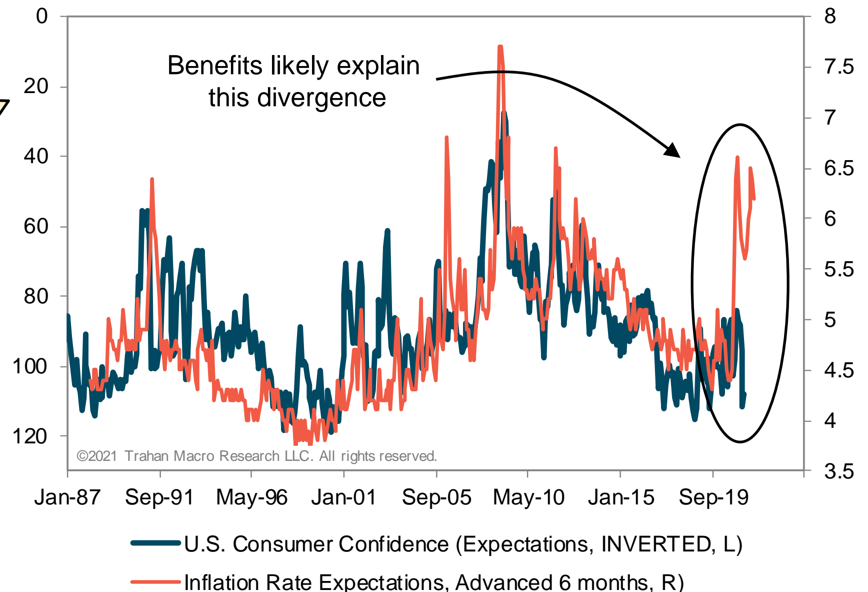
"83% Of Americans Are Belt Tightening Due To Inflation Pressures" - Forbes, 5/24/21

77% of Americans aware of an acceleration of the inflation rate. In fact, **54% very concerned about it.**

86% indicated they experience price increases on everyday goods and services.

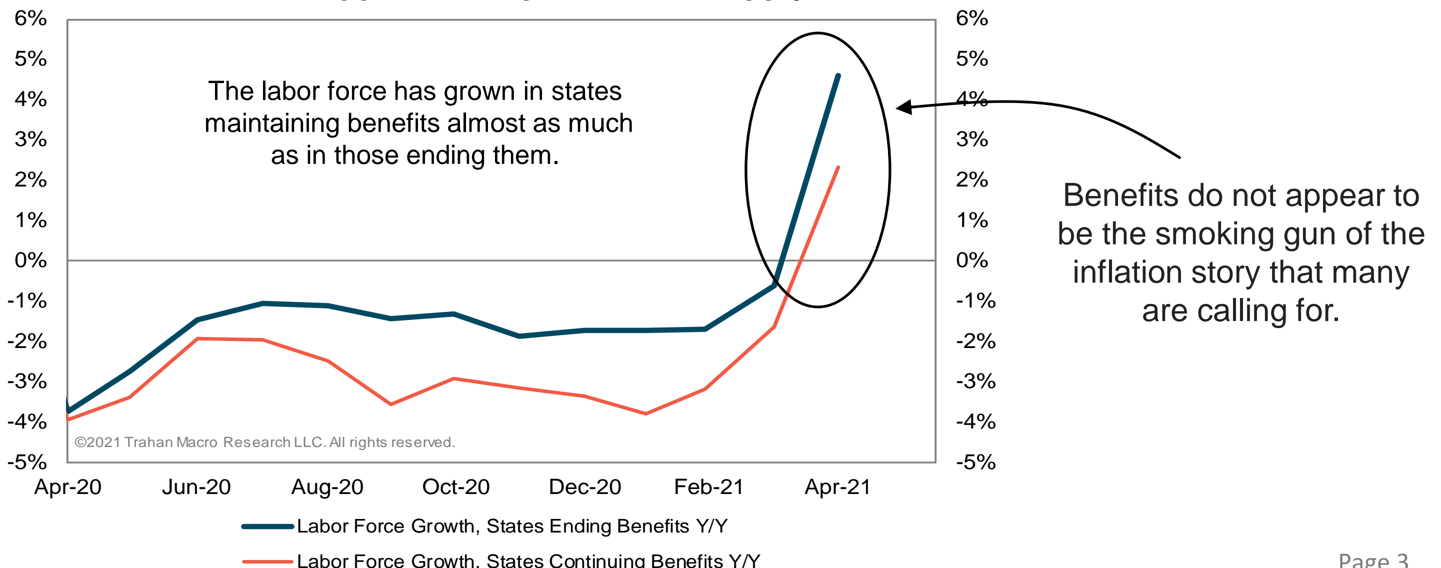
42% plan to tighten their budgets lightly and **41%** to tighten their budgets significantly.

… Benefits Have Offset Its Tax-Like Effect Thus Far



Benefits have helped consumers offset the effects of inflation. That said, some argue that they are also contributing to the inflation story. Indeed, there are countless anecdotal stories about employers not being able to find qualified staff and benefits are usually blamed. We are not convinced. When we look at labor supply in states that are ending benefits, it is only marginally higher than what is seen in states maintaining benefits, and both are growing in response to the improving economy. So, benefits might play a small role, but it is unlikely to be the driving force behind the surge in inflationary pressures.

Benefits Do Not Appear To Explain Labor Supply Issues



Wage Inflation More Than Just About Government Benefits

Labor markets are tight. That is clear. What is not so clear is whether government benefits are the driving force at play. We do not see actual evidence to support this belief. If we did not know about the benefits, we would call this an "inflationary" backdrop. Indeed, the NFIB "Jobs Hard To Fill" series has soared to multi-decade highs – this is a series that historically leads wage inflation, which itself is a driver of core inflation! Notice that even at the depth of the pandemic slowdown, the NFIB series sat near the highs of the last cycle in 2006/07. We might just be starting a new cycle of tight labor markets.

The Labor Market Points To Higher Wage Inflation

NFIB Sm. Business Job Openings Hard to Fill (Adv. 12 months, L)
Atlanta Fed Wage Growth Tracker (R)

Quality Of Labor Is Now Hard To Find

Single Most Important Problem (April 2021)		
Problem	**Current**	**1 Year Ago**
Quality of Labor	24	15
Taxes	19	15
Govt. Regulation	13	10
Cost of Labor	8	8
Poor Sales	8	19
Inflation	6	1

Source: NFIB, April 2021

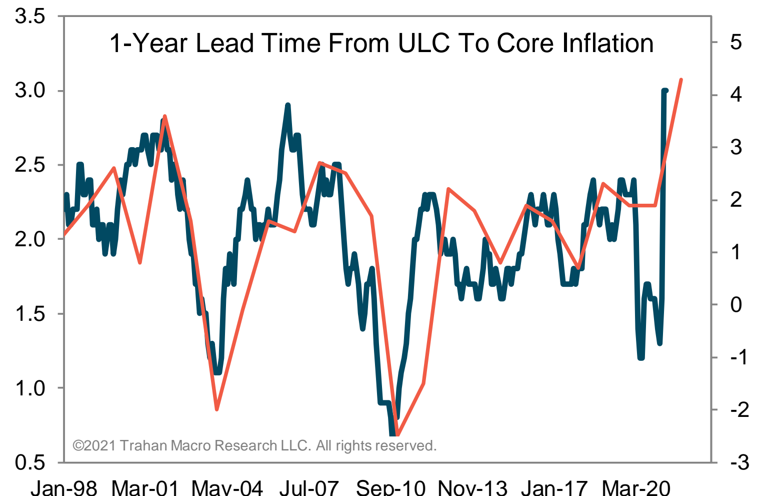
Again, let's assume a no-benefits angle. We start 2021 with gauges of labor markets that are tight by historical standards. Could it be that the "wage inflation" story is a combination of the re-opening of the economy, plenty of government stimulus, and labor markets tighter than usual at the beginning of a recovery? Wage inflation across time has been the biggest influence on underlying inflation trends (see chart on the right below). Yes, the rise in inflation has been sudden, but so has the vaccine-fueled re-opening of the U.S. economy. This argues for something more than "transitory".

Lagging Economic Index (LAGITOTL Index)

- Duration Of Unemployment
- Inventories To Sales
- **Services Inflation**
- **Labor Costs**
- Commercial And Industrial Loans
- Consumer Credit To Personal Income
- Average Prime Rate

Source: The Conference Board

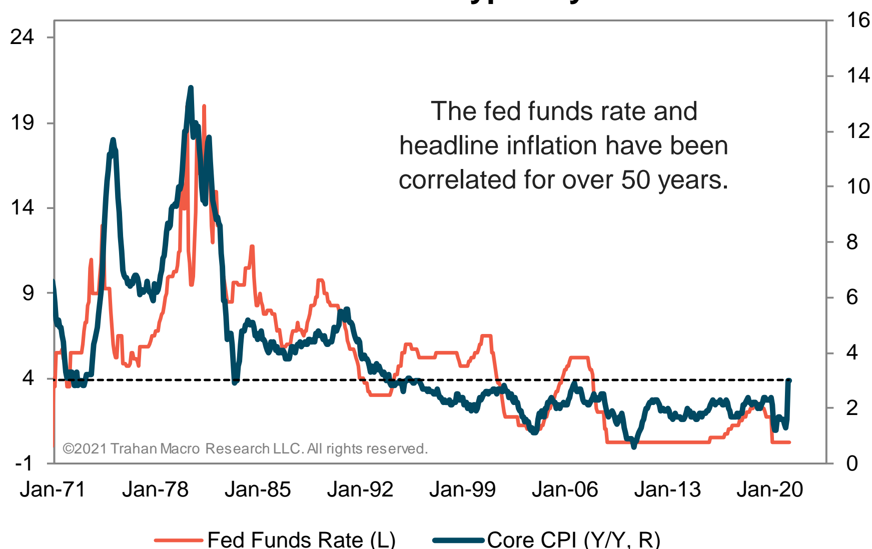
Wage Inflation Largest Influence On Core Inflation Readings

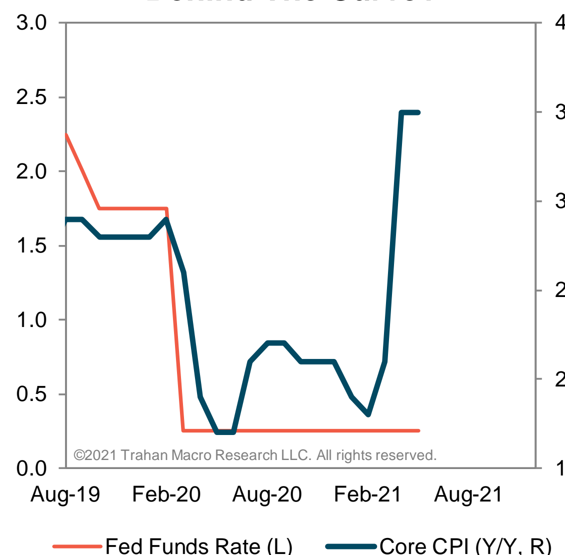


Core CPI (Y/Y, L)
U.S. Nonfarm Unit Labor Costs (Y/Y, R)

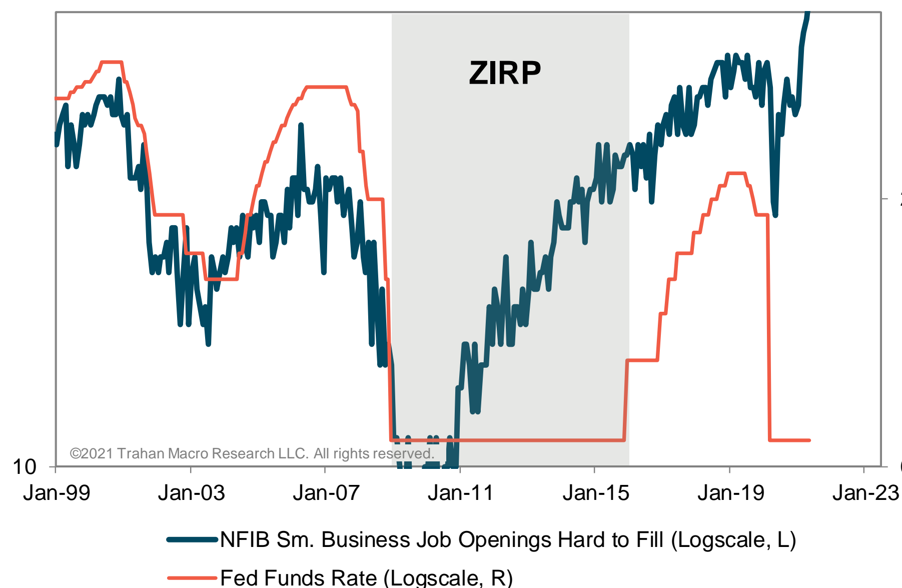
How Much Inflation Can The Fed Really Tolerate?

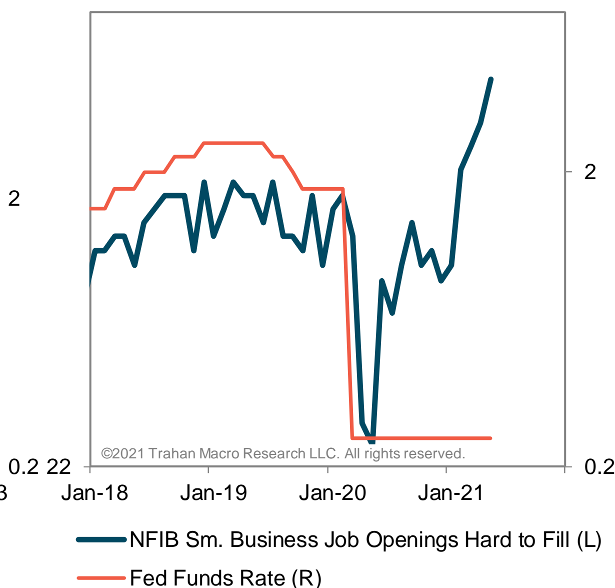
We've established that labor markets are tight, that the re-opening of the economy began with tighter labor markets than typical, AND that wage inflation is a powerful driver of core inflation trends. The chart below shows the link between core inflation and Fed policy. Surely, it's not a perfect relationship but the correlation is still fairly clear. If an improving economy is going to lead to even tighter labor markets, higher wage inflation, and pressure on core prices, we do wonder how much the Fed can tolerate. Check out where the FFR was the last three times core CPI was at these levels … higher is the answer.





The links between labor markets and Fed policy that we define above are not far-fetched. In fact, if one wants to cut out the middleman, it is easy to see the relationship between labor market tightness and the fed funds rate. The chart below shows the NFIB "Jobs Hard To Fill" series and the FFR. Admittedly, the Fed is usually raising rates when this series is surging as per the clip, BUT they now view all of this as "transitory". We are not trying to lecture or do arm-chair policy here. We are trying to show that there is a significant risk that the Fed is wrong that inflation's rebound is "transitory", and they are behind the curve on policy. The Fed has gone from not raising rates to raising them rapidly before. We shall see.

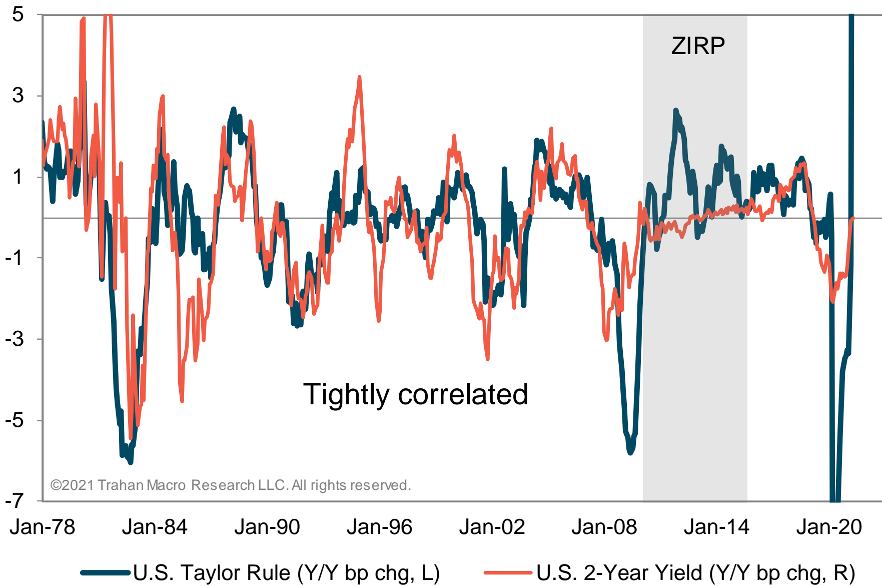




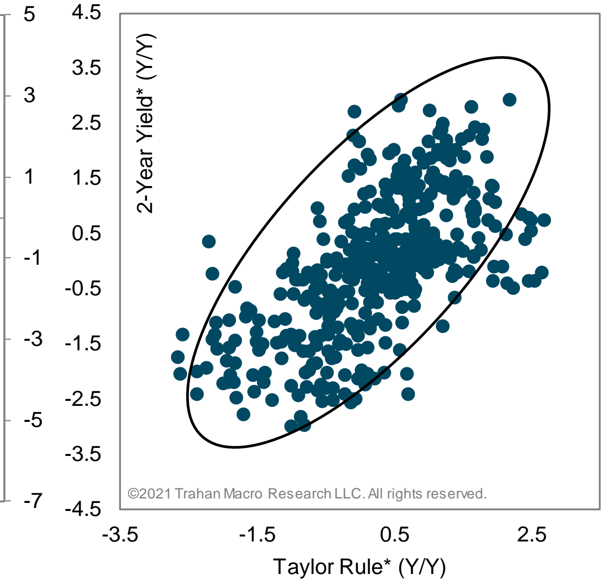
Inflation Is Either "Transitory" OR The Fed Is Behind The Curve

The Taylor Rule (TR) was once thought of as a central component of forecasting Fed policy albeit its popularity has diminished in recent years. It remains a helpful tool in our opinion and its correlation to the 2-year yield proves its relevancy. It is designed to mimic the Fed's policy reaction function and has skyrocketed higher alongside higher inflation readings. It is purely mathematical, so it does not get to say that a data point is "transitory". The whole concept of the TR is to have a non-judgmental tool for policy and in today's context, it clearly argues the Fed is behind the curve calling for a 4%+ Fed funds rate.

Taylor Rule Argues Fed Is Behind The Curve



Will Short Rates Follow TR or FFR?



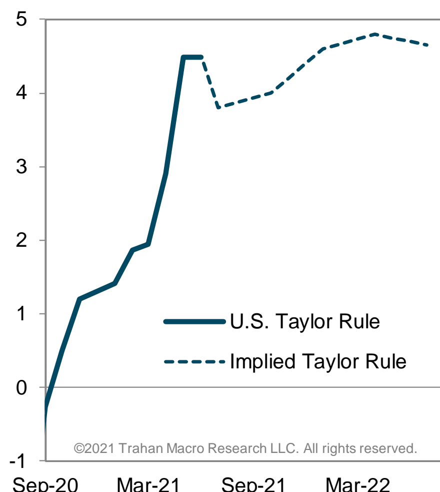
We can estimate future values of the TR using consensus forecasts of core inflation and unemployment. This exercise sees further gains in the TR as economists expect the unemployment rate to fall by almost 1.5 percentage points, which pressures the TR rate higher. Interestingly, consensus sees core inflation waning lower in the next 12 months. Given the relationship between the TR and the 2-year yield highlighted above, these subdued estimates would imply a rise in short rates to about 1.4% over the next year. We are not making a forecast for rates here, but if inflation is indeed more entrenched than transitory, then it's difficult to see how rates don't have significant upside ahead. In any case, this tool helps demonstrate that anything other than "transitory" for inflation likely leads to a Fed tightening cycle.

Consensus Forecasts Point To A Sharp Rise In Rates Ahead

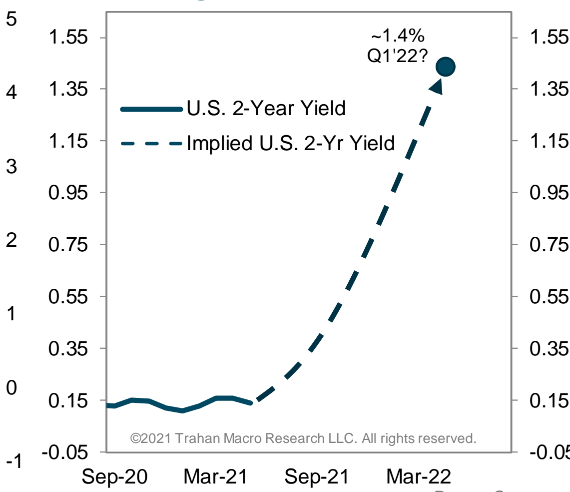
United States | Mo
1) Taylor Rule Model | 2) Forward Looking E
Contributor | ECFC Contributor Compos

Month	Inflation Core PCE Forecast	Unemp. Forecast	Taylor Rule Estimate
Jun 21	2.40	5.80	3.80
Jul 21	2.30	5.58	3.87
Aug 21	2.20	5.37	3.93
Sep 21	2.10	5.15	4.00
Oct 21	2.13	5.00	4.20
Nov 21	2.17	4.85	4.40
Dec 21	2.20	4.70	4.60
Jan 22	2.20	4.63	4.67
Feb 22	2.20	4.57	4.73
Mar 22	2.20	4.50	4.80
Apr 22	2.13	4.45	4.75
May 22	2.07	4.40	4.70
Jun 22	2.00	4.35	4.65

Higher Taylor Rule Ahead?



Higher 2-Year Yield?



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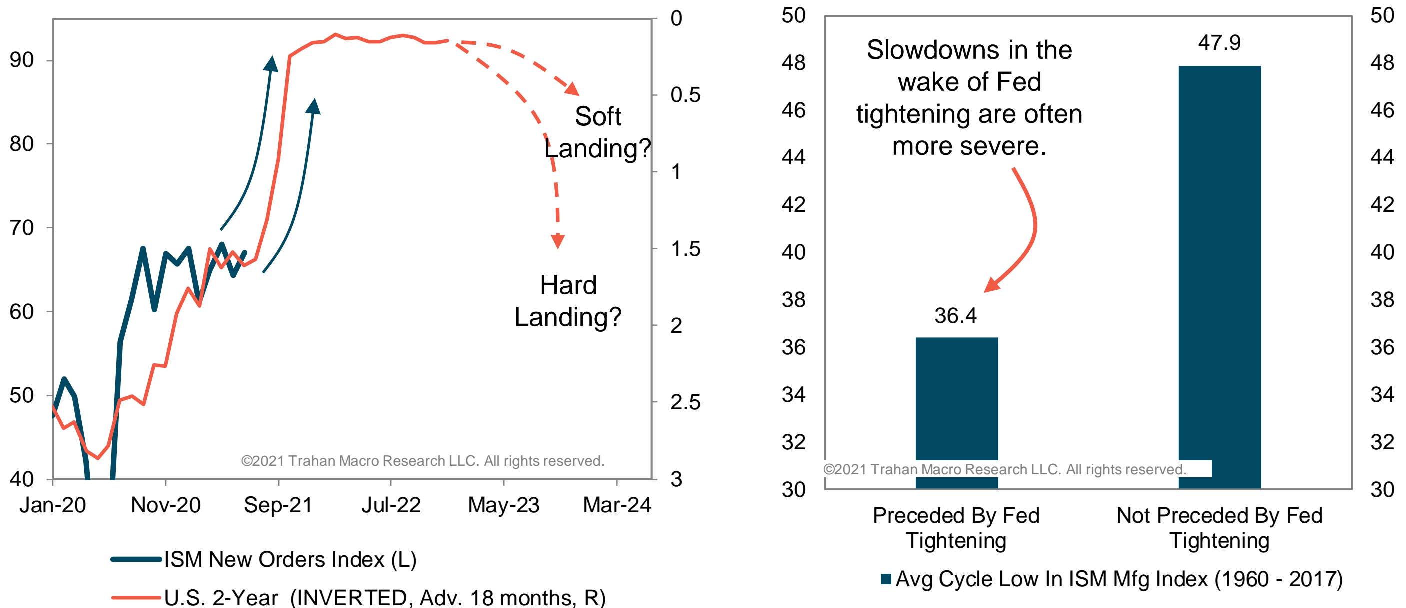
If "Transitory" Is Wrong: Inflation → Fed Tightening → Bear Market?

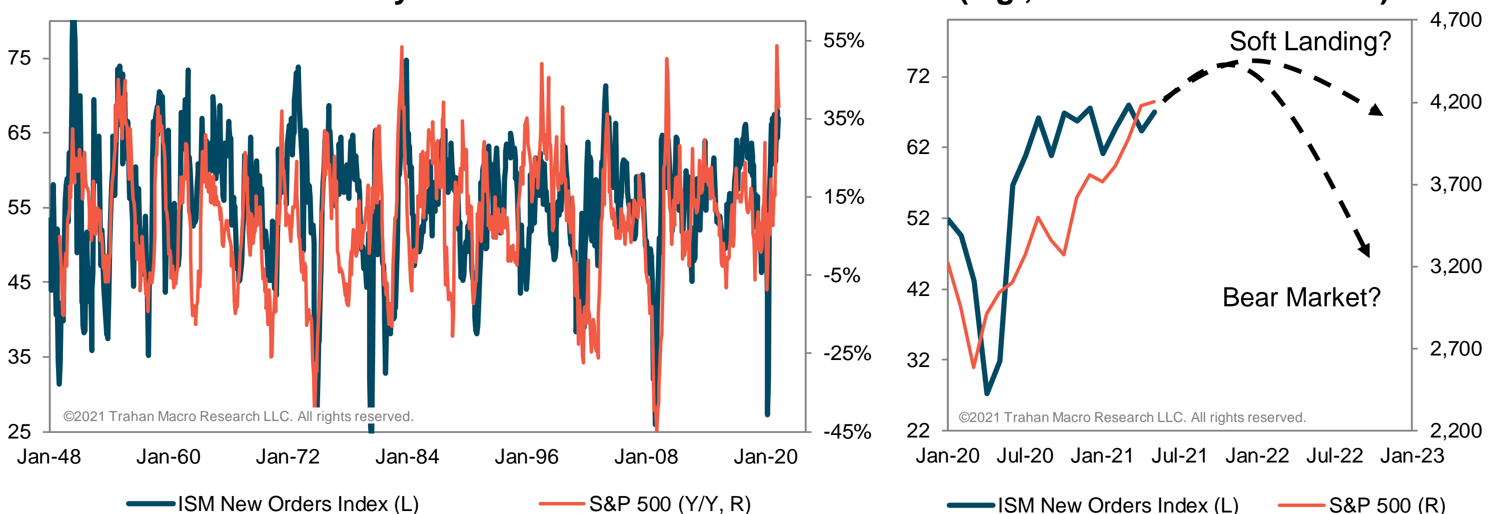
The 2-year yield rising to 1.4% by Q1'22 is NOT our forecast; it is merely an exercise to illustrate Fed policy and its role in the economy. After all, it has been stimulative policy in place since the end of 2018 that has helped PMIs recover in the wake of the COVID-19 slowdown, and cyclicals by the same token. While a stronger economy is good for unemployment, earnings, and markets, it can also be inflationary as we see today. Thus, this is ultimately the same recovery that will bring about Fed tightening, slower growth, and an unfavorable backdrop for cyclicals down the road. The pace and the magnitude of Fed tightening will likely shape the type of slowdown we experience (i.e., a soft vs a hard landing), as slowdowns are often more severe (~10pts lower in the ISM Index) in the wake of a tightening cycle.

Fed Tightening Is Often The Difference Between A Soft vs. Hard Landing In The U.S. Economy



There is an undeniable relationship between the ISM Manufacturing Index and the S&P 500's return (see page 2 of our report from last week to read more about these two LEIs). A more severe economic downturn can be detrimental to equities, as investors can recall from prior experiences in which the S&P 500 was down double digits with an ISM deep in contraction territory (somewhere in the 30s range or below). In a "softer landing" (i.e., the ISM somewhere in the 40s range), the S&P 500 can still experience a correction albeit not to the same degree.

The S&P 500 Closely Follows The Ebb And Flow Of LEIs (e.g., ISM New Orders Index)



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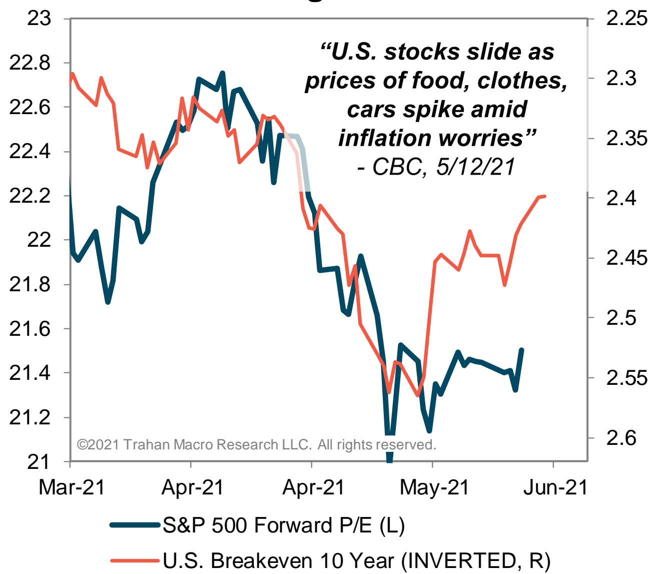
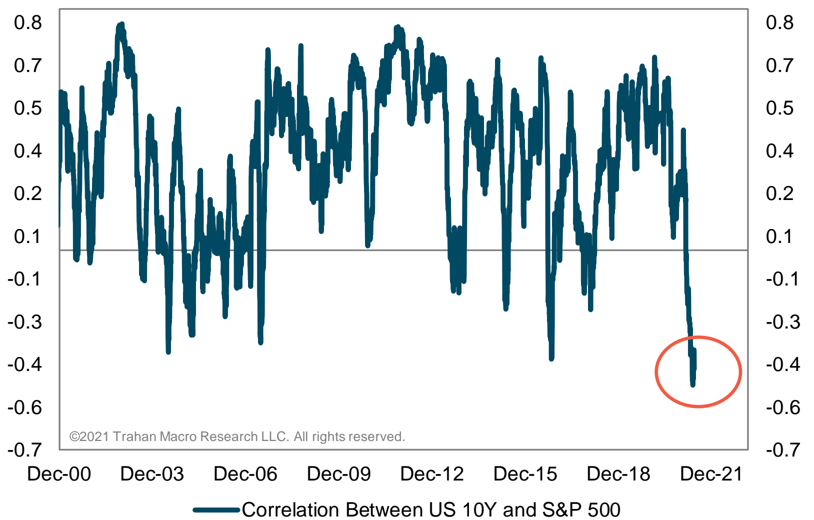
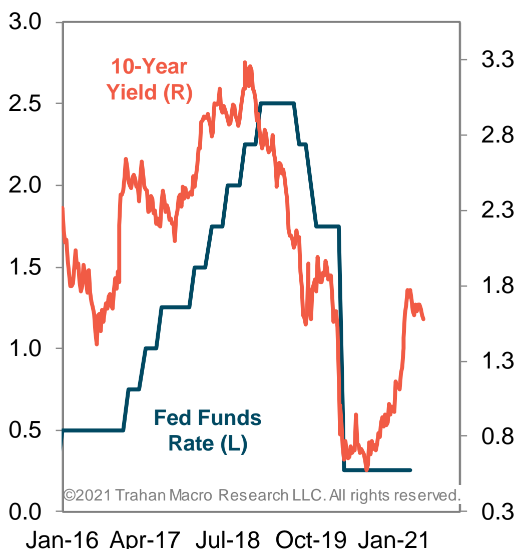
The S&P 500 Today Is Allergic To Fed Tightening/Higher Rates

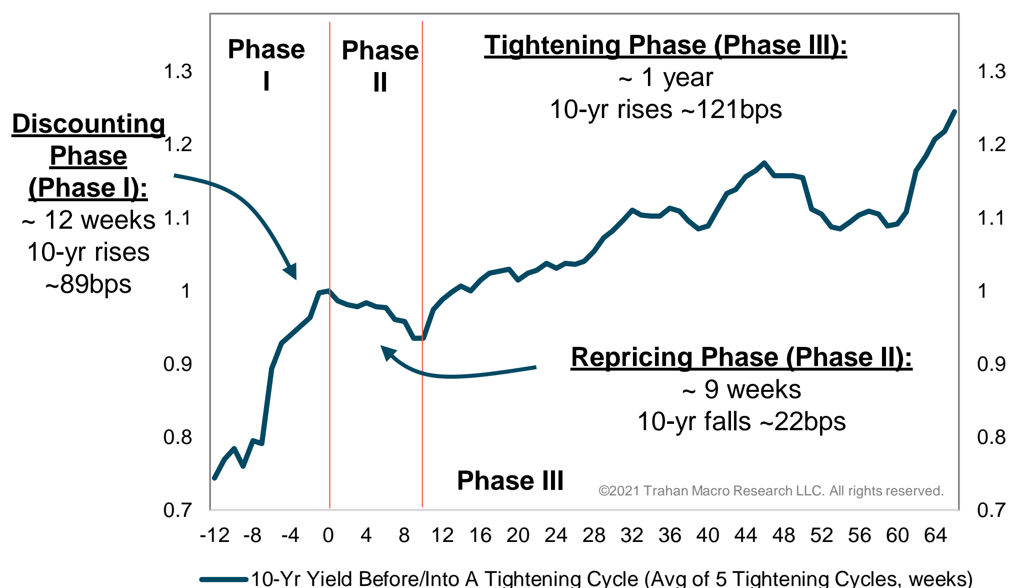
In the initial phase of the recovery investors and markets welcomed any news that was positive for the economy, even if it was reflationary. Things stand in contrast nowadays with an S&P 500 that almost looks allergic to news of inflation, higher rates and Fed tightening. We have the large representation of Growth in the S&P 500 to thank for that as Long-Duration stocks tend to have multiples that are very sensitive to rates. In mathematical terms, it is accurate to say that the S&P 500 has not been this inversely correlated to U.S. interest rates in over 20 years, as the chart below right illustrates. This makes Fed policy front and center in any forecast and highlights the importance of the inflation debate.





We have not even had a Fed rate hike yet and bond yields are already sitting about 100bp higher from their lows, as illustrated on the chart below left. Interestingly, the behavior of the 10-year yield in past Fed tightening cycles has been very consistent – yields kept rising until the last Fed rate hike was on the horizon. If all of this does lead to eventual Fed tightening, then investors should expect higher bond yields with all of the implications this implies for Long-Duration assets and the S&P 500's overall market multiple. Again, all of this shows just how important the Fed's "transitory" call is.





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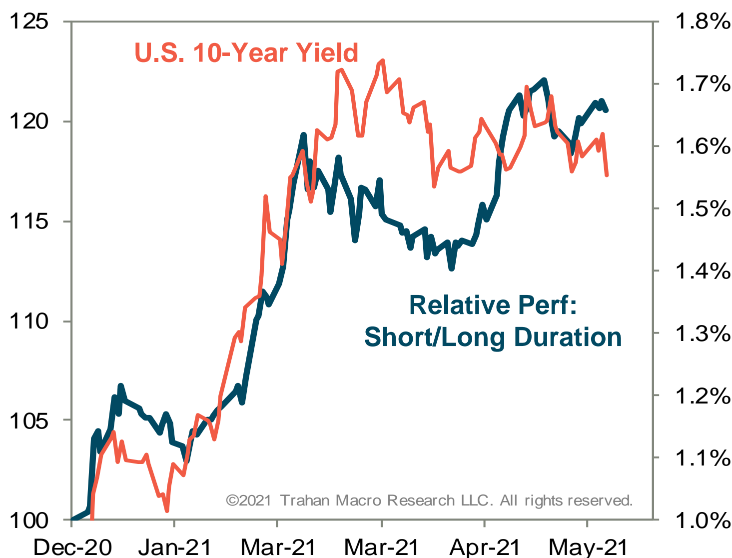
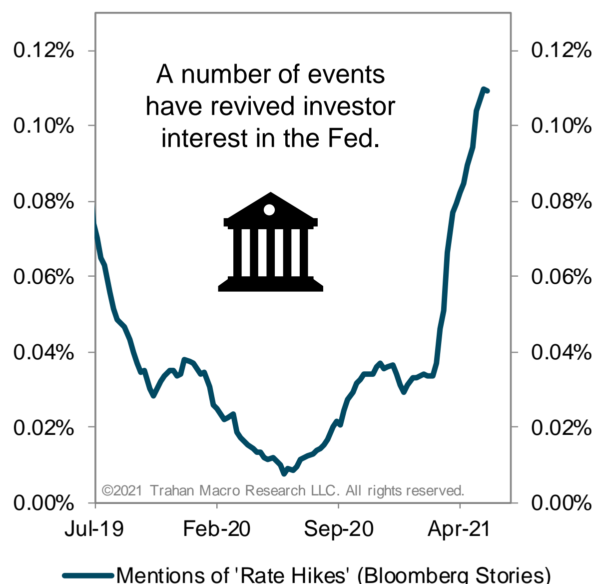
Inflation Is A Big Problem For Long-Duration Stocks

It is old news that the performance of Long- versus Short-Duration stocks is highly tied to the ebb and flow of interest rates. Thus far this year, the rise in interest rates has created a difficult backdrop for Long-Duration stocks, which are mostly comprised of Growth stocks with higher P/Es than their Value counterparts. This helps explain why higher rates have been weighing on the S&P 500's P/E, as Growth stocks are such a large share of the overall Index. As the likelihood of Fed rate hikes intensifies, there will likely be additional pressure on this already-expensive segment of the S&P 500.

Higher Rates Hurting Long-Duration Stocks



Fed Tightening Now "In Play"



Below we show an abbreviated list of the Long-Duration Growth stocks within the S&P 500 universe that are hyper-sensitive to changes in interest rates. These are the companies that are ranked as most at-risk of any further increase in rates from today's levels. In our minds, the conditions for a return of a legitimate rally in these stocks are still a ways away, as we will likely have to go through the entire Fed tightening cycle before Growth/Long-Duration stocks are in favor once again.

S&P 500 Equity Duration Stock Screen

Lower Quintiles Rank Better

Universe: S&P 500

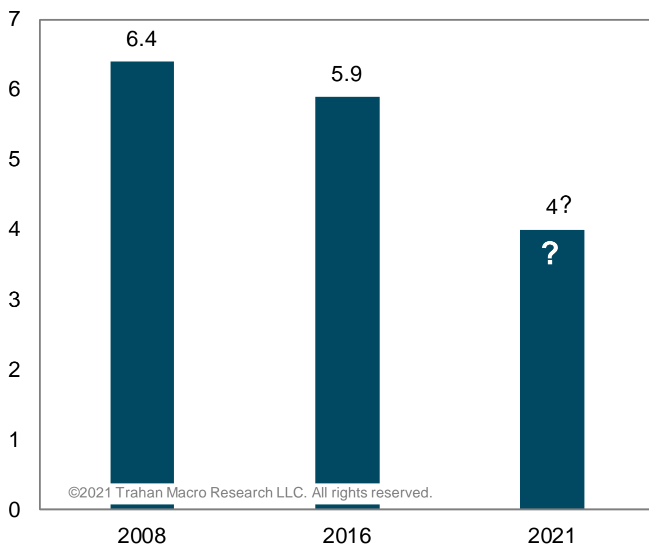
Ticker	Name	Equity Duration	Equity Duration Rank	Price	Market Cap	Style	Sector
ADSK	Autodesk, Inc.	46.3	5	$ 284.78	62655.4	Growth	Information Technology
SPGI	S&P Global, Inc.	44.3	5	$ 384.58	92645.3	Growth	Financials
CTLT	Catalent Inc	39.4	5	$ 101.16	17231.8	Growth	Health Care
MTD	Mettler-Toledo International Inc.	37.9	5	$ 1,256.82	29245.5	Growth	Health Care
NVDA	NVIDIA Corporation	37.4	5	$ 703.13	438050.0	Growth	Information Technology
DXCM	DexCom, Inc.	36.8	5	$ 382.91	37029.6	Growth	Health Care
MPWR	Monolithic Power Systems, Inc.	36.6	5	$ 347.03	15878.0	Growth	Information Technology
CMG	Chipotle Mexican Grill, Inc.	36.6	5	$ 1,326.34	37337.1	Growth	Consumer Discretionary
NOW	ServiceNow, Inc.	36.5	5	$ 460.65	90954.4	Growth	Information Technology
TSLA	Tesla Inc	36.4	5	$ 599.05	577083.1	Growth	Consumer Discretionary

For monthly model updates:
Email quant@trahanmacroresearch.com or visit trahanmacroresearch.com/screens

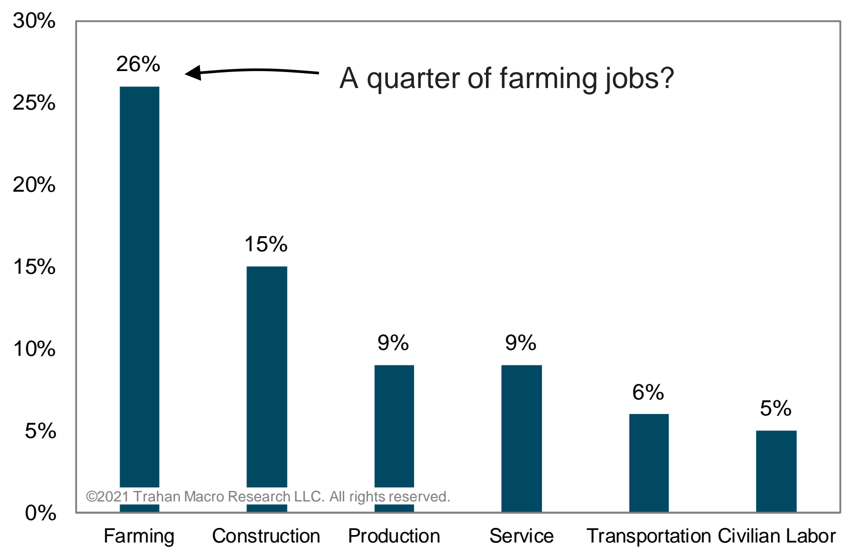
Annex: Is Immigration Playing A Role In The Labor Shortage?

There appears to be a clear case of anchoring bias when it comes to government benefits and their role in explaining tight labor markets. One aspect rarely discussed when it comes to the U.S. labor force is the role of illegal immigrants. Indeed, the number of "unauthorized workers" began to shrink under the Obama administration, a trend which accelerated under the Trump administration. This subset of the U.S. labor force explains a quarter of farming jobs in the country, 15% of construction jobs, and so on. Is it possible that the lower number of illegal immigrants has contributed to the tight labor markets seen before the pandemic slowdown and of course since?

There Are Less "Unauthorized Workers" …

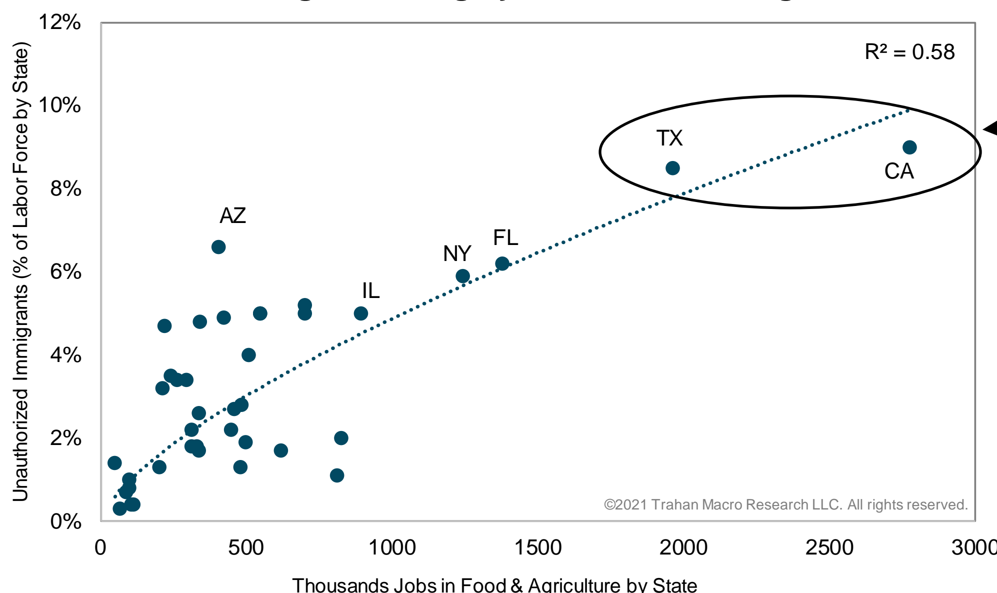


… This Is A Real Problem In Some Industries



We are bringing this up because it makes sense to in the context of a discussion on labor markets. That said, food prices have soared in the recovery, and this is THE industry that has been associated with unauthorized workers. This should not be a controversial comment since there is a clear relationship between the number of illegal immigrants in a state and how many food and agricultural jobs there are in the state. We suspect this is playing a much bigger role than most will admit. How will food inflation come down if there is no labor available? Food for thought. We shall see.

Unauthorized Immigrants Largely Follow Food & Agriculture Jobs



The states that have more jobs in the Food & Agriculture industry have a larger share of unauthorized immigrants in their labor force.

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