Nolte Notes

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“My mama told me there’ll be days like this”. If Thursdays 2% drop in the averages was not enough, Friday’s inflation report pushed stocks down another 2%, making it a full 5% on the week. The market is now back to the May lows. The coming week will have plenty for investors to watch, from the Fed meeting to retail sales and other inflation reports. The strong consumer inflation report came as little surprise to main street as they watched gas prices jump daily and every trip to the grocery store was ever more expensive. Even the core rate was above expectations, so the hope of “peak inflation” remains somewhere in the future. As a result, interest rates shot higher, with short-term rates moving more than long rates. The implication is that the Fed could now justify a 0.75% hike in rates this week, up from 0.50% that had been expected. There was a time when the Fed wanted inflation, fearing that persistently low inflation could tip toward a deflationary cycle and persistently poor economic growth. The thought was the Fed could better deal with inflation than deflation, now that inflation is here, the Fed will be put to the test in the months and years ahead.

If inflation is always and everywhere a monetary phenomenon means, according to Milton Friedman, inflation is caused by increases in monetary supply. Historically, monetary growth has been between zero and 10% on a year-over-year basis, with spikes usually occurring as the economy hit a recessionary period. The pandemic gave the Fed and the government a reason to send out huge amount of money as the economy was thrown into reverse. The supply of money just from the Fed jumped 15% in five months and continued higher until last month, when the series turned negative. The chore ahead will be to remove that monetary accommodation from the economy in the months ahead, which is likely to push the economy into a recession. The economy remains in a strange place, with China largely shutdown, demand for goods/services very high and companies trying to expand production. There are signs that the higher rates since the start of the year are biting some sectors, with lumber prices off more than 50% from the start of the year and housing activity beginning to slow as mortgage rates surpass 5% from under 3% at yearend.

The interest rate complex reacted swiftly to the inflation news. Short-term rates rose much quicker than long-term rates, flattening the yield curve. When short rates are above long rates (inversion), it has historically been a recession warning. Rates were briefly inverted in early April and are today merely 0.09%. One other sign of rising risks is the difference between yields on junk bonds and treasuries. That is once again widening, indicating investors prefer the safety of treasury bonds vs. the higher returns and risks in junk bonds. Combined with a once again rising commodity complex, the inflation genie is not likely to be bottled up until 2023 at the earliest.

The decline into the weekend left negative signs across the board, with large, small, value, growth and international all declining as investors sold anything/everything they could. Volume expanded, but not to the level that would indicate panic selling. Investor sentiment is very bearish and could spark a short/sharp rally of 5-10% like March and May. Even the energy sector saw losses last week. For the fourth time since last Thanksgiving, the volume on declining stocks was over three times that of rising stocks for three consecutive days. After each occurrence, the markets managed to mount a “reflex” rally. Add to the mix very pessimistic investors, a rally could be a launching pad for significant gains over the coming year. In the short-term however, investors will still have to deal with the Fed meeting this week. The discussion of how high and quick the Fed will be in hiking rates is likely to be center stage. The short-term pain could turn toward long-term gains IF the inflation picture brightens during the summer.

The impact of the inflation data is likely to roll into this week as well, especially with the Fed meeting that ends Wednesday afternoon. Expectations for rate increases going forward should get reset and the markets may be able to “move on” and turn their focus toward the beginning of earnings season that will start after the 4th of July.