Nolte Notes

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“Inflation is dead, long live inflation”. With serious apologies to royalty everywhere, the financial markets celebrated the well below inflation prints this week by rallying into Friday’s close. The “zero inflation” print on consumer prices and below estimates on producer prices has given rise to the “peak” inflation is now behind us and the Fed can afford to back off the hiking cycle. A rather prescient mathematician weighed in, saying one point does not make a trend, but a trend starts with one point. To be sure, there is plenty of movement below the calm inflation surface. Energy price declines wiped out the gains elsewhere in the report. Core (taking out food/energy) remains above 6%. Finally, taking out the “wild” pops and drops in the inflation report, the leftover “trimmed-mean” inflation has not yet peaked. There will be plenty of data points as well as Fed speakers over the next five weeks, when the Fed will once again decide on what to do with interest rates on September 22nd. There will be comments at Jackson Hole, the Feds annual off-site confab, that may provide a window into the likely pace of rate increases. A very good inflation report, but the story of inflation has not been finished.

The markets took off on the better-than-expected inflation data, with the market registering the third day of nine times stocks rising vs. falling. There have been six days of at least three times the advancing volume to declining over two days. All point to a “blast-off” phase for the markets that could carry stocks back toward the highs of the beginning of the year. One concern is that volume has dried up and over the past month has been the lowest of the year. Since mid-July, the entire gain in the market has come during the first hour and last hour of trading. Putting it all together, the markets are working on a strong rally that has boosted the market by 15% since June and pure momentum could push stocks higher still. Valuations remain elevated and have been for much of the past six years. Each market decline has pushed valuations toward the *peak* of the 2004-’16 period and not even close to the median valuation of the past 30 years. Stocks have never been “cheap” save for the 2009 market bottom. The culprit for the “permanent” high valuations has been the very easy monetary policy by the Fed. Even after the interest rate hikes this year, monetary policy is easier than anytime of the past 30 years!

The bond market was not as impressed with the inflation report as the equity market. Yields remained at high levels all week and the yield curve became more negative as the week progressed, indicating a rising recessionary risk due to the Fed rate increases. How can bonds be projecting a recession while monetary conditions remain “easy”? The markets recognize the Fed is a long way from tight monetary policies and if they are serious about getting inflation closer to their 2% target, the Fed will have to hike rates much higher. Those ever-higher rates would induce a recession. One series is looking at conditions today, one series is looking forward at the implications of a tightening path.

The now nearly two-month rally has been led by the usual suspects, consumer discretionary (heavily weighted toward Amazon) and technology. Surprisingly has been the good performance of utilities, which generally do well when interest rates are falling rather than rising. One other interesting dynamic looking at the various asset class performance charts has been the “re”-rallying in commodity prices. While stocks have jumped over the past month, commodity prices are up roughly 5% over the same time. Commodity prices have been a very good signal for the inflation reports a month or two later. The big decline from early June to mid-July was a precursor to the good CPI report last week. If commodity prices continue their move higher into Labor Day, expect a “surprise” higher for inflation when it gets reported in September and October.

The market rally could take stocks higher, but as usual, there are some clouds on the horizon that could cut the rally short. Interest rates, the Fed, inflation, and valuations all could keep a lid on stocks. If investors are chasing stocks, the rally can continue, but the upside may be limited over the next few months.