



# Great-West Investments Capital Markets Perspective

Week in Review: July 11<sup>th</sup> – 17<sup>th</sup>

INDEX/ SECURITY	ASSET CLASS	LEVEL (CLOSE)	% CHANGE (THROUGH FRIDAY'S CLOSE)		INDEX/ SECURITY	ASSET CLASS	LEVEL (CLOSE)	% CHANGE (THROUGH FRIDAY'S CLOSE)	
			1 WK.	YTD				1 WK.	YTD
Dow Industrials	Lg. Cap Eq.	31,288.26	-0.16%	-13.90%	FTSE 100	UK Equity	7,159.01	-0.63%	-3.05%
S&P 500®	Lg. Cap Eq.	3,863.16	-0.92%	-18.95%	Nikkei 225	Japan Equity	26,788.47	1.02%	-6.96%
NASDAQ Comp.	US Equity	11,452.42	-1.57%	-26.80%	EEM:US	Emkt. Equity	\$38.63	-3.64%	-20.92%
S&P Midcap 400®	Mid-Cap Equity	2,303.68	-0.72%	-18.94%	EFA:US	Non-US Equity	\$61.40	-1.52%	-21.96%
Russell 2000®	Sm. Cap Eq.	1,744.37	-1.41%	-22.31%	UST 10y (yield)	US Treasury	2.92%	-0.17%	1.41%
Stoxx 50	Europe Eq.	3,477.20	-0.84%	-19.10%	Bloomberg U.S. AGG	Fixed Inc.	2,124.39	0.89%	-9.80%

Past performance is not a guarantee of future results. Investing involves risk, including possible loss of principal.

## That inflation report was, like, totally bogus.

With all the comparisons to the 1980s tucked inside last week's news release, you'd think the Bureau of Labor Statistics – official keepers of inflation data like the Consumer Price Index (CPI) and Producer Price Index (PPI) – had somehow time-warped back to the days when the mall was still a cool place to hang out and hair-metal bands reigned supreme. Here are three of the most prominent examples, each from Wednesday's CPI report: **food prices** were up 10.4% year-over-year in June, the **biggest increase since February 1981**; meanwhile, **energy prices** were up 41.6%(!) year-over-year, the biggest jump since **April, 1980**<sup>1</sup>. And the **headline** figure, at 9.1%, was the **highest it's been since December, 1981**.

Yeah, I know what you're thinking: "food and energy prices are pretty volatile, so doesn't the Fed care a lot more about core inflation, which excludes both of those things?" Sure, and **it's probably a positive that core inflation decelerated a little bit** (but, like headline CPI, you still have to go back to around **1982** to find a period when core prices were rising as quickly as they are today.)

But here's the thing – last week's CPI report showed that **inflation had become so broad-based that there's almost no place to find relief**: for background, the CPI's own version of an ESPN-type highlight reel appears in Table 1 of its monthly CPI release. That table includes around 37 separate line items – categories and sub-categories (some of which overlap, obviously,) that are designed to give you a quick view into which specific types of goods and services are driving the overall inflation numbers higher or lower.

This month, **you had to look pretty far down that table to find anything that was getting cheaper**: in fact, there were only three. And **those three were pretty small in the grand scheme of things**: Fuel oil (which eased -0.4% month-over-month, but represents only 0.2% of the overall CPI calculation<sup>2</sup>), meat/fish/poultry/eggs (-0.4%, 1.91% of the headline number,) and airline fares (-1.8%, 0.76% importance.) And I wouldn't get too excited about any of those, either: in all three cases, prices were still *way* higher than a year ago. That, coupled with the small relative importance of all three

<sup>1</sup> <https://www.bls.gov/news.release/pdf/cpi.pdf>.

<sup>2</sup> Refers to each commodity's "relative importance" within the BLS calculation of headline CPI



commodities, means that June's small declines may not really feel all that great after all. (Plus, have you tried scheduling a flight – any flight – recently? Good luck: even if it happens to be a few bucks cheaper than it was in May, there's a pretty decent chance that you might find it cancelled from underneath you, anyway...)

**So here's the point: inflation is as high as its been since even the oldest of us were kids** (or, in some cases, angsty teen mall-rats...) **and that's bad**. But one thing last week's CPI and PPI reports showed is that **inflation has also become extremely broad-based, and that's maybe even worse**. Why? Well, for one reason because when inflation gets as pervasive as it is today, it starts to become embedded in our collective consciousness.

As evidence, consider this from last Friday's mid-month update of the University of Michigan's consumer sentiment index: consumer's plans to buy durable goods increased this month, owing in part to **worries that delaying such purchases would only mean paying even higher prices in the future**<sup>3</sup>. That could be an early warning sign of something that nobody – least of all the Fed – wants to see: the **development of an inflationary psychology** wherein higher prices can become self-reinforcing, the same way that forest fires (or extremely bad hairstyles like “the mullet”) do.

**But for all that, it's important to note that last week's market declines never really got out of hand**. Stocks were lower during four of last week's five sessions, but the declines were never really all that extreme, and a **strong rebound on Friday** kept losses for the week manageable. Friday's recovery **could be a function of some of last Friday's economic data**, like word that **retail sales** advanced a robust 1.0%<sup>4</sup>. Or, that same UofM report with the disappointing nugget about self-reinforcing inflation, which showed that **consumer sentiment more generally bounced a little bit** off its recent (and still depressing) record low. And, just for good measure, the **Empire State Manufacturing index**<sup>5</sup> had a happy little bounce of its own, rising 11.1 points when economists thought it would continue to decline.

**But don't get too excited**: the retail sales figure that appeared so impressive at first glance isn't adjusted for inflation, meaning that real sales might actually be failing to keep pace with prices. Moreover, that UofM consumer sentiment number is pretty sensitive to gasoline prices, which have relented a little bit in recent weeks, and consumer attitudes still remain stuck at levels that are far more consistent with recession than expansion. And the Empire State survey? For all its improvement, survey respondents reflected a **deep pessimism that has been “expressed only three other times in the survey's history”**<sup>6</sup>.

**But I also think last week's relatively tame market performance in the face of truly discouraging inflation numbers is more evidence, at least in my view, that the Fed is ceding its monopoly power over what matters to markets** to things like corporate earnings. Which brings us full-circle to what is likely to set the market's tone for at least the next several weeks: second quarter results. And last week's preview was **kind of a mixed bag**, with high-profile misses and a generally downbeat tone from big banks like JPMorgan, Morgan Stanley and Wells Fargo at least partially neutralized by more upbeat results from Citigroup<sup>7</sup>. Looking forward into the next several weeks, the way companies outside of the financial sector are dealing with inflation and fears of a more general slowdown in economic activity will likely dictate how markets react.

And let's be clear, the news isn't all bad. As high (and as troubling) as inflation trends are, there are at least **a few signs that pressures might be easing** at the margin. One thing companies will have to navigate is whether that tentative come-down in price pressures – which has so far been **more obvious on the “prices received” side of the equation than the “prices paid” side** – will leave **profit margins** intact. Add that to the list of things **that will matter a lot inside the growing flurry of earnings reports** as markets and the economy try to find their respective footing(s).

Regardless, I think its safe to say that **inflation** – like many things from the 1980s, including Vince Neil's leather pants and the much-maligned (but surprisingly comfortable to wear) mullet – **would make us all a little happier if it just stayed put in the 80s**.

<sup>3</sup> <http://www.sca.isr.umich.edu/>

<sup>4</sup> [https://www.census.gov/retail/marts/www/marts\\_current.pdf](https://www.census.gov/retail/marts/www/marts_current.pdf)

<sup>5</sup> [https://www.newyorkfed.org/survey/empire/empiresurvey\\_overview](https://www.newyorkfed.org/survey/empire/empiresurvey_overview)

<sup>6</sup> Ibid

<sup>7</sup> Company reports, Zacks.com, Bloomberg



## What to Watch This Week: July 18<sup>th</sup> – 24<sup>th</sup>

### Notable economic events (July 18<sup>th</sup> – 22<sup>nd</sup>)

**Monday:** NAHB Housing Market Index; *earnings:* IBM, GS, BAC

**Tuesday:** Housing starts/permits; *earnings:* NFLX, JBHT, HAL

**Wednesday:** Existing home sales; *earnings:* TSLA, UAL, KMI, BKR

**Thursday:** Weekly jobless claims, Philly Fed, LEI; *earnings:* UNP, AAL, DHI

**Friday:** Flash PMIs; *earnings:* TWTR, SLB

Source for index data: Bloomberg.com; GWI calculations.

This week **the housing market takes center stage**, with the NAHB's builder sentiment survey on Monday, followed by starts and permits on Tuesday and existing home sales on Wednesday. **For a more contextual view, homebuilder DH Horton reports earnings** on Thursday.

**Housing markets have a huge and well-documented impact on economic activity** more generally given the number of relatively well-paying jobs represented by the sector as well as the numerous "knock-on" effects on demand that a strong housing market implies. **However, trends are clearly aligned against the market** given dramatically higher mortgage rates and persistently high home prices. Add to that growing economic uncertainty and fears of an eventual recession, and housing market volumes are **likely to remain at least muted** (if not downright negative) for the foreseeable future. This week's data will likely bear that out, even if prices remain stubbornly high when those data are released next week.

Probably the single most important economic release this week will be **Friday's flash PMI reports** from S&P Global. PMIs have been softening significantly in recent months but **have yet to indicate contraction** except in a handful of specific cases. Moreover, regional PMI-type data like last week's Empire State Manufacturing index (discussed above,) have become a little less consistent in the messages they're sending. That could indicate an inflection point in the cycle as much as a budding return to growth, a theory will get another test on Thursday when the **Philadelphia Fed** releases its own survey of regional manufacturers.

Ditto for the Conference Board's **index of leading economic indicators, or "LEI"**: while this data rarely gets much attention in these pages, it could become relevant soon as the "are we/aren't we in recession" debate gets more intense. Again, the key to this data in my view is the extent to which **the gap between the LEI and** its close cousin, the index of coincident indicators ("**CEI**") has narrowed. If this **week's data show that to be happening, look for the recession debate to intensify.**

Finally, the earnings calendar transitions from its current focus on financials toward the "real" economy, with plenty of interesting stuff to choose from. For example, a few companies involved in **logistics and the physical movement of goods** from Point A to Point B will report this week including trucker JB Hunt (Tuesday) and railroad Union Pacific (Thursday.) The tone set by these kinds of companies on their earnings calls always provides an interesting **read-through into the macroeconomic environment, but doubly so during the current period**, when supply chain stresses are one of the leading causes of economic uncertainty.

Other potentially interesting reports could come from the **energy services sector** (most notably Halliburton on Tuesday, Baker-Hughes on Wednesday and Schlumberger on Friday.) It's easy to argue that energy prices are as central to the economic outlook as supply chains, and these kinds of companies **will provide a window into whether it's reasonable to expect energy supply stresses to ease** anytime soon.



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