Inflation is Running Hot and Investors Don't Care

The BLS gave us our monthly reminder that inflation is running hot. CPI is now running at a 6.8% annual pace, well above last month's 6.2% rate. Markets did not seem too bothered by the news. The S&P 500 and Nasdaq 100 were up about 1% on the day. The Russell 2k (small-cap stock index) fell .50% as smaller companies tend to feel the adverse effects of inflation more than larger companies. Interestingly, bond yields were relatively flat, despite inflation running at levels last seen 40 years ago. Stock and bond investors still seem to have a lot of faith that high inflation is temporary.

Futures are pointing towards a higher open this morning, with investors believing the market has already priced in 3-rate hikes in 2022. While that is unlikely, investor confidence near-term remains exceptionally bullish. **While we expect further upside for the S&P 500 into year-end, this week's FOMC meeting and options expiration on Friday could provide some near-term volatility.**

[Chart Courtesy Of SimpleVisor.com](https://simplevisor.com)

[dmc]

What To Watch Today

Economy

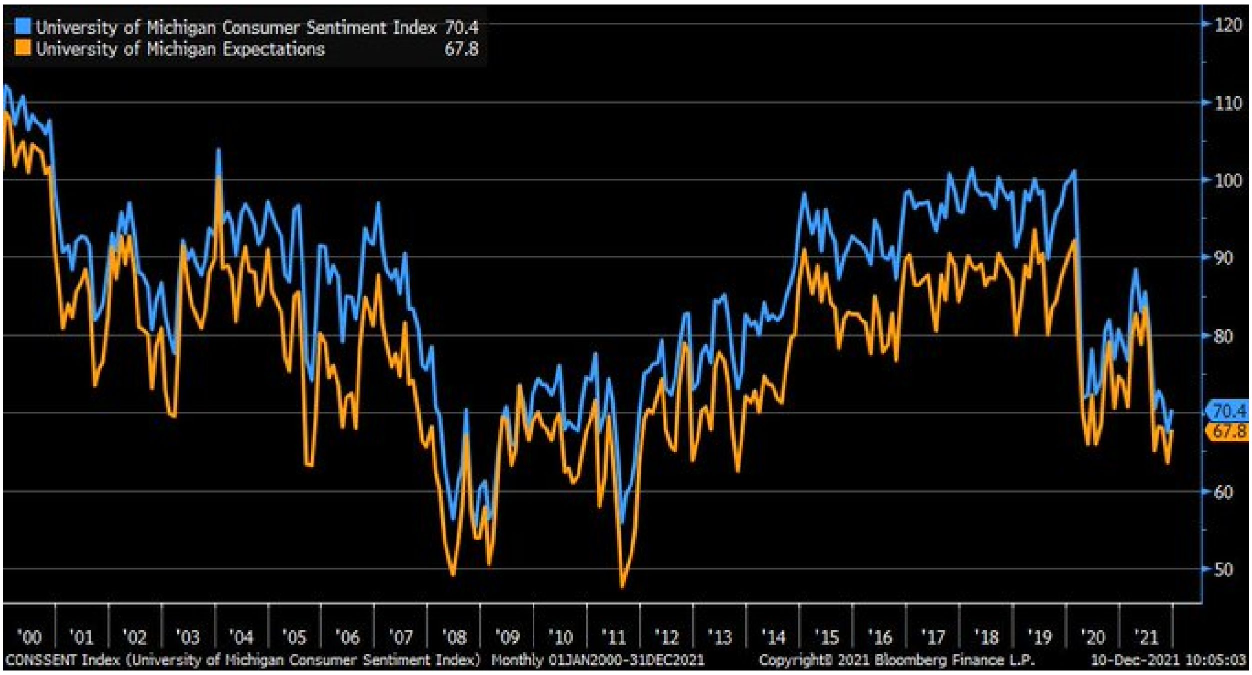
- *No notable reports scheduled for release*

Earnings

- *No notable reports scheduled for release*

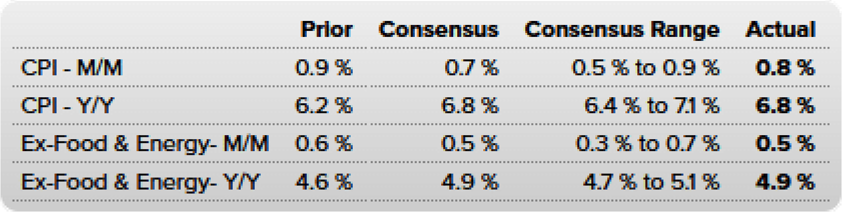
Consumer Sentiment Wallows as Investor Sentiment Flourishes

The disconnect between investors and consumers continues. As shown below, the University of Michigan Consumer Sentiment and Expectations rose slightly this month but are near 10-year lows and at the same levels as of March 2020. In the second graph, Investor sentiment remains bullish and well above the lows of last March. No rule says the two measures should be aligned. However, given the outsized role consumers contribute to economic activity and corporate earnings, we must consider that either consumer sentiment will improve soon or investor sentiment may drop.



Inflation is Running Hot

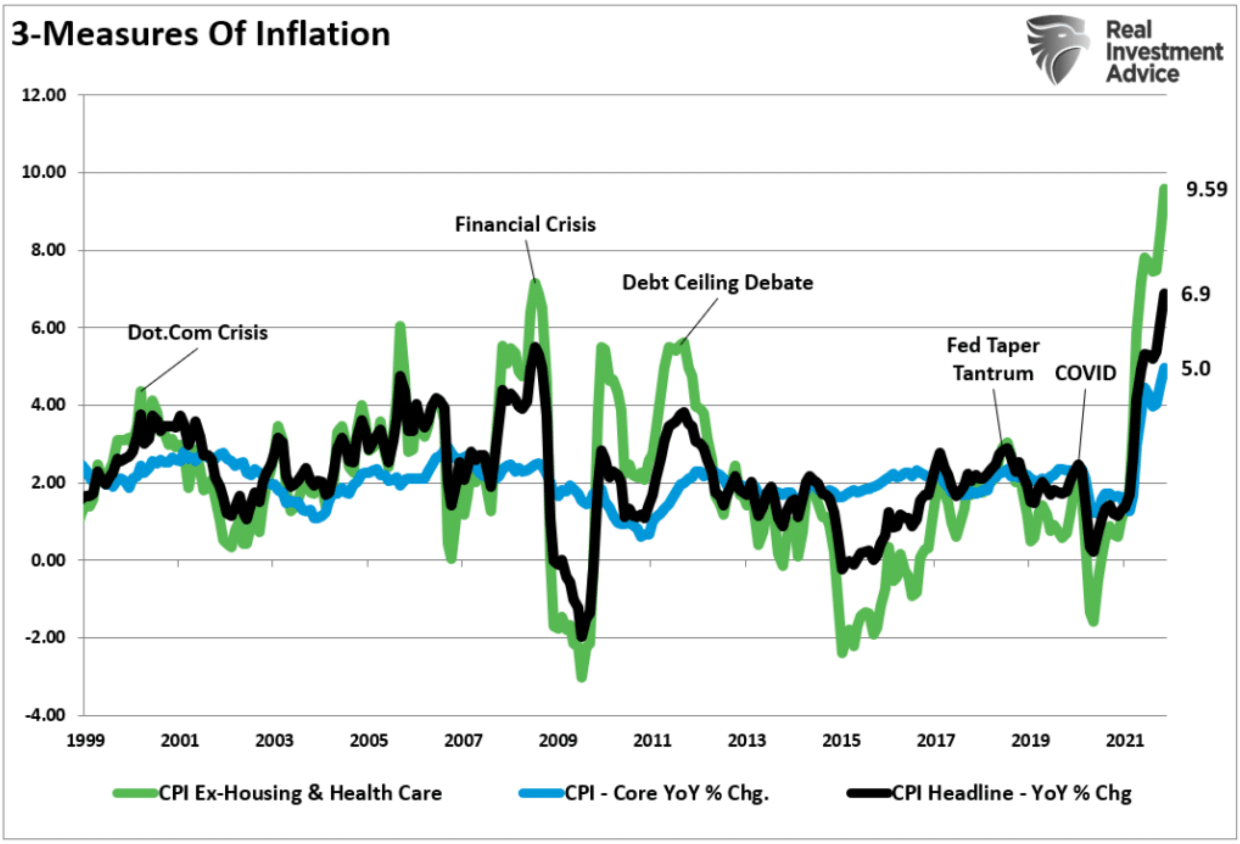
As expected, CPI rose 6.8% year over year, the highest level since 1982. The only positive to the report is the monthly rate of inflation at .8% is .1% less than last month. While significant, the rate of change of inflation may be peaking. Rent and Owners Equivalent Rent rose 0.4% in November, equalling about 5% annually. The two measures of housing costs account for about 30% of CPI. The two BLS measures of housing tend to lag actual rents. Per a report from Fannie Mae- *?On a* *year-over-year basis, house price gains historically lead to changes in the CPI shelter cost measures by about 5 quarters.?* Such implies that a third of CPI will continue to contribute to high inflation rates.



	Prior	Consensus	Consensus Range	Actual
CPI - M/M	0.9 %	0.7 %	0.5 % to 0.9 %	**0.8 %**
CPI - Y/Y	6.2 %	6.8 %	6.4 % to 7.1 %	**6.8 %**
Ex-Food & Energy- M/M	0.6 %	0.5 %	0.3 % to 0.7 %	**0.5 %**
Ex-Food & Energy- Y/Y	4.6 %	4.9 %	4.7 % to 5.1 %	**4.9 %**

Here is the real problem with inflation running hot, as noted in this past weekend's newsletter:

> For most Americans, **their food and energy consumption is something they deal with every week. However, healthcare, mortgage, and rent payments are fixed for a contractual period.** Therefore, the impact on discretionary incomes is far more insidious when we adjust for those realities.



Given that wages are not keeping up with rising inflation in the daily cost of living, it is not surprising we are seeing weak consumer confidence. While it is likely we have seen a peak in inflationary pressures, it doesn't mean the higher prices won't be weighing on consumers for a while.

Lisa Abramowicz @lisaabramowicz1

Wages are increasing at a rapid pace in the U.S., but they're still not keeping pace with consumer price inflation. U.S. real average hourly earnings are still deeply negative.

Heading into 2022, the risk of disappointment in economic growth expectations is very high. Such also means current estimates of earnings growth are also at risk.

Dealer Gamma Agony

> *"Still wonder why the moves lower are so violent, followed by almost equal squeezes and then the zzzz phase? Add poor liquidity to the mix and you understand why so many have been selling lows and buying highs. Kolanovic writes: "Once the market starts to roll over, dealers are quickly taken short gamma, and their hedging flows reinforce market moves in both directions, leading to a significant boost in realized volatility. Then, once the market recovers and we rally into a range with more calls outstanding than puts, dealers turn long gamma and their hedging activity suppresses market moves/volatility. The effects of these flows were further reinforced by weak liquidity conditions?liquidity collapsed to record lows early in the pandemic and has only partially recovered?which causes flows to have outsized price impact." - @themarketear*

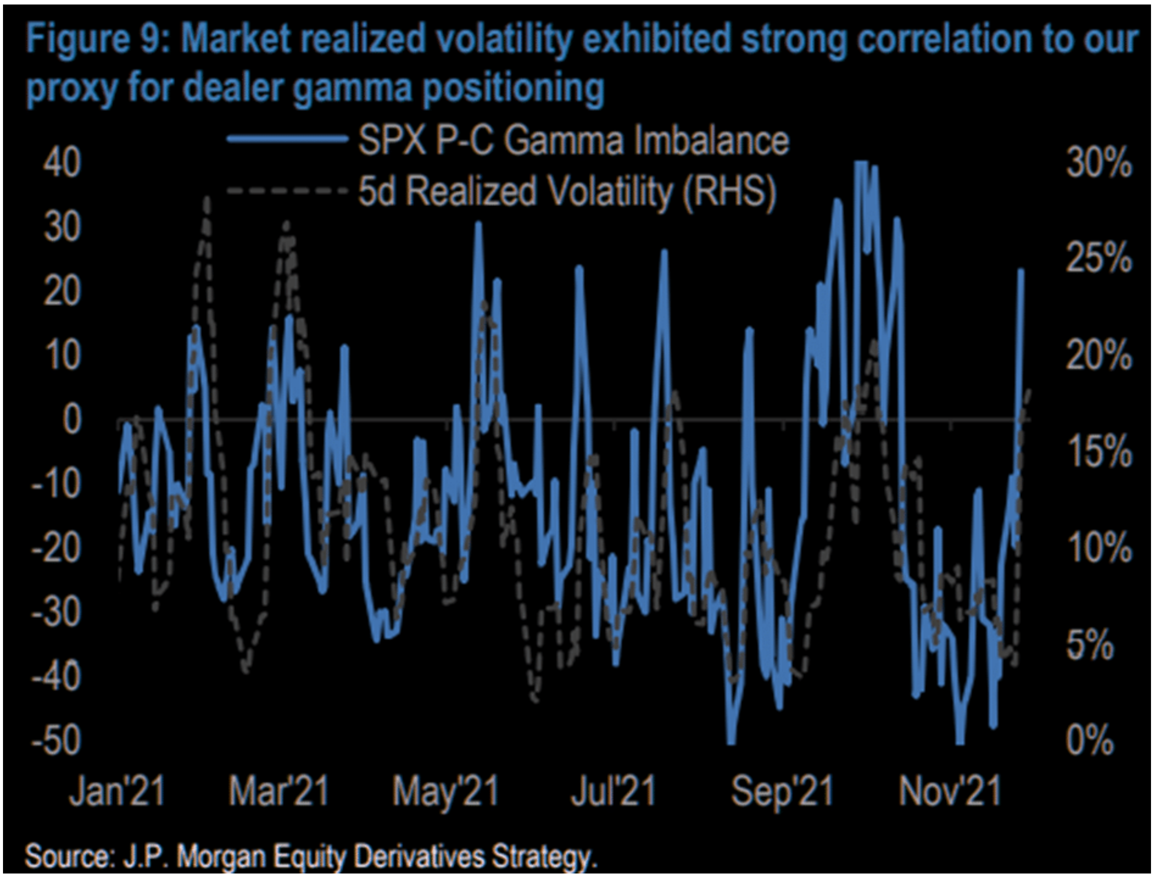
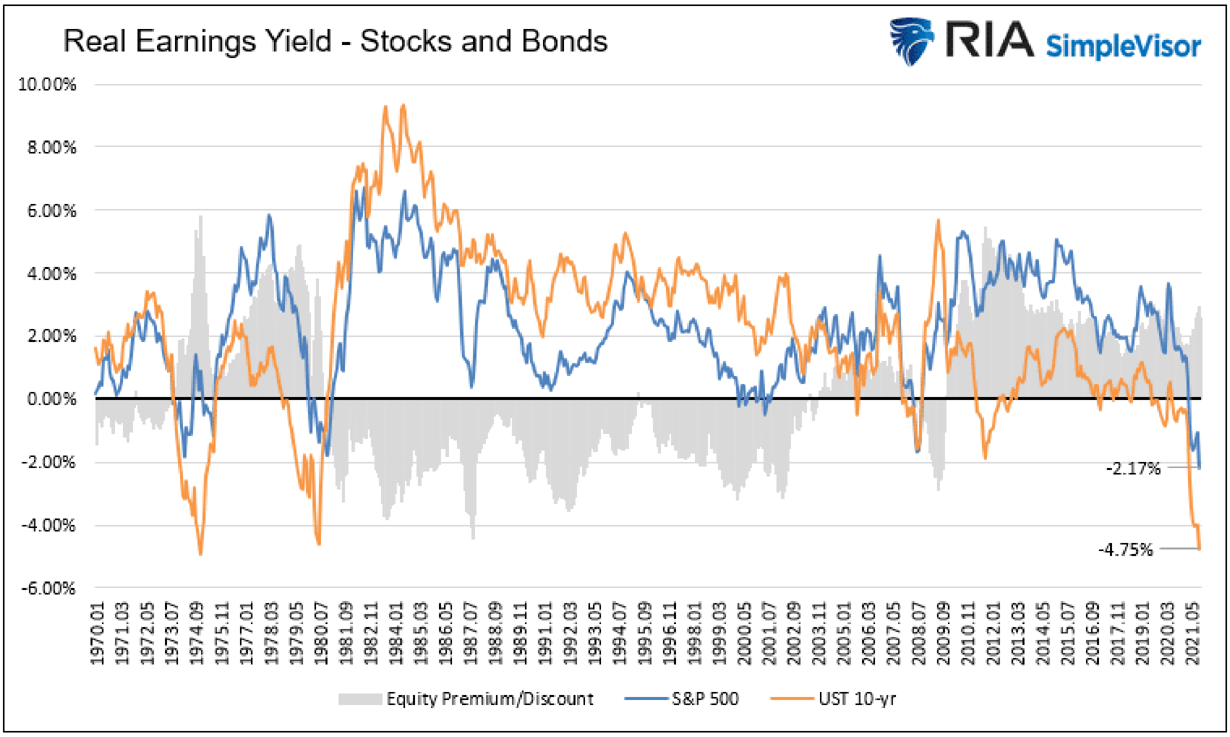


Figure 9: Market realized volatility exhibited strong correlation to our proxy for dealer gamma positioning

Source: J.P. Morgan Equity Derivatives Strategy.

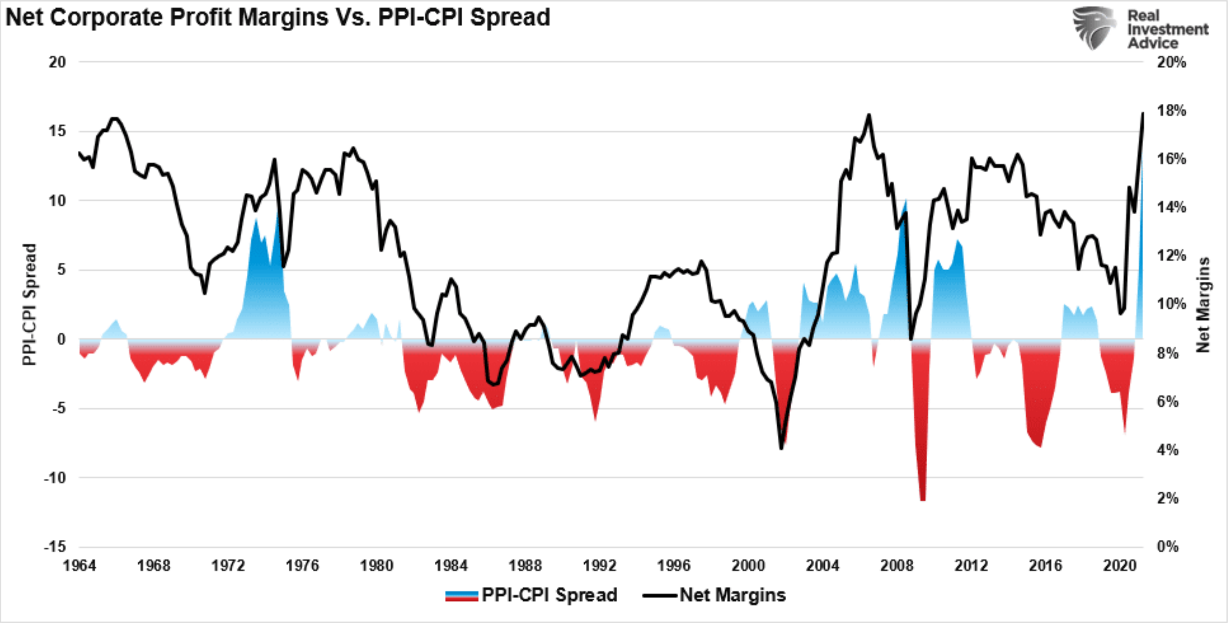
Earnings Yield In Context

The graph below shows the earnings yield on the S&P 500 is now the lowest in 30 years. When viewed on its own, the graph and what it says about valuations should be of great concern. However, after looking at the second graph below, a case can be made that owning stocks is better than the alternative. The earnings yield on the 10-year UST note is now -4.75%. The premium real earnings yield of stocks over bonds, shown in gray, is over 2.5% and in line with the premium for the last decade. The average premium since 1970 is only 0.17%.



The Week Ahead

Following last Friday's CPI report, the BLS will release producer prices (PPI) on Tuesday. The margin between CPI and PPI is a big determinant of corporate profit margins, especially for goods-producing companies. Retail Sales will be released on Wednesday. Current estimates are for a 1% increase. Unusual shopping habits this year due to Covid and supply shortages and seasonal adjustments may cause the number to be much larger or smaller than expected. We should not read too much into monthly Retail Sales. Instead, we prefer to look back at the data series in February for a more robust assessment of holiday spending.



The Fed holds its FOMC meeting on Wednesday. Expectations are they will drop usage of the word "transitory" to describe inflation. It is likely they will speed up the pace of tapering. The wild card will be whether or not they have more firm discussions on rate increases in 2022.

Costco Earnings

Costco (COST)reported earnings for its first fiscal quarter of 2022. GAAP EPS of $2.98 beat expectations of $2.65. Similarly, revenue of $50.4B (16.5% YoY) beat expectations of $49.8B. Comparable sales increased 9.8% YoY. The stock is trading higher following the upbeat results. We hold a 3% position of COST in the Equity Model.

***Please* *subscribe to the daily commentary*to receive these updates every morning before the opening bell.**