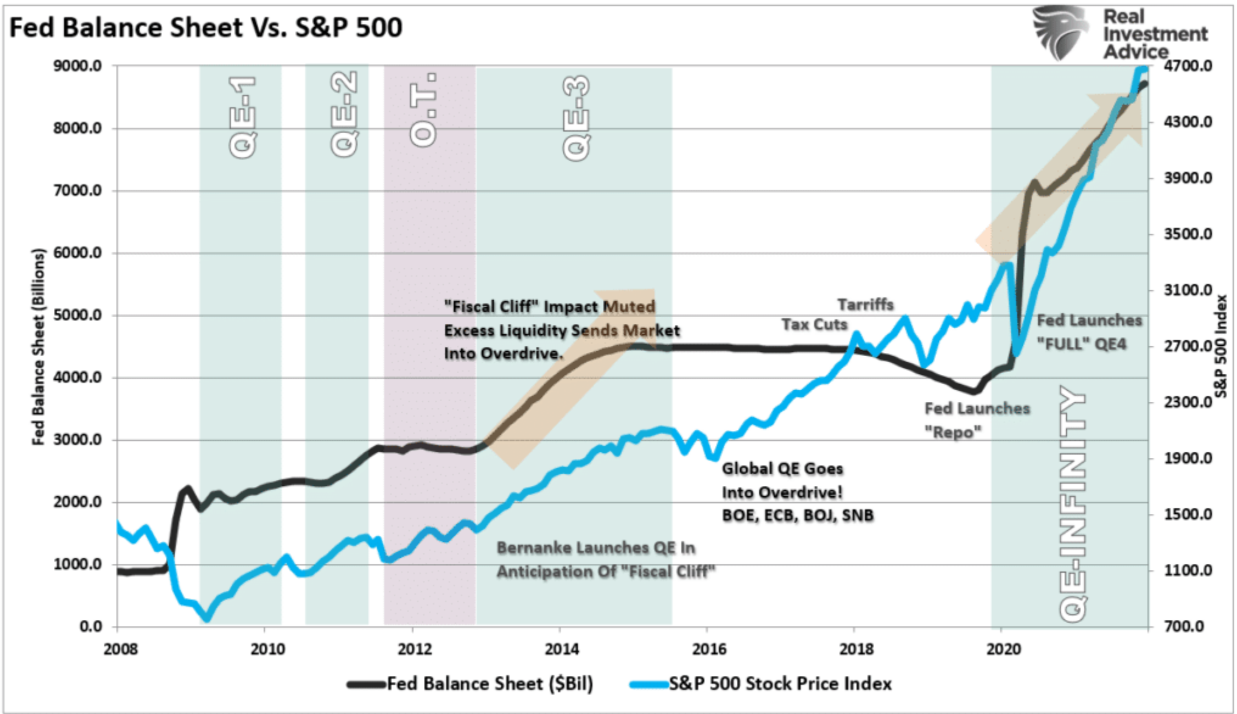
At 8:30 am ET, the BLS will release the December CPI Report. Expectations are for an annual increase from 6.8% to 7.1%. Analysts expect the monthly inflation rate to slow from 0.8% to 0.4%. With the release of the CPI report, we are likely to see volatility in the stock and bond markets. The Fed is making it very clear that fighting inflation is their number one priority. The tools to fight inflation are ending QE, higher interest rates, and reducing the Fed's balance sheet. QE and lower interest rates provided massive liquidity to markets. How will the markets fare without the excess liquidity?



[dmc]

What To Watch Today

Economy

- 7:00 a.m. ET: **MBA Mortgage Applications,** week ended January 7 (-5.6% during prior week)
- 8:30 a.m. ET: **Consumer Price Index (CPI)**, month-over-month, December (0.4% expected, 0.8% in November)
- 8:30 a.m. ET: **CPI excluding food and energy,** month-over-month, December (0.5% expected, 0.5% in November)
- 8:30 a.m. ET: **CPI year-over-year,** December (7.0% expected, 6.8% in November)
- 8:30 a.m. ET: **CPI excluding food and energy,** year-over-year, December (5.4% expected, 4.9% in November)
- 2:00 p.m. ET: **Monthly budget statement,** December (-$191.3 billion in November)
- 2:00 p.m. ET: **U.S. Federal Reserve Releases Beige Book**

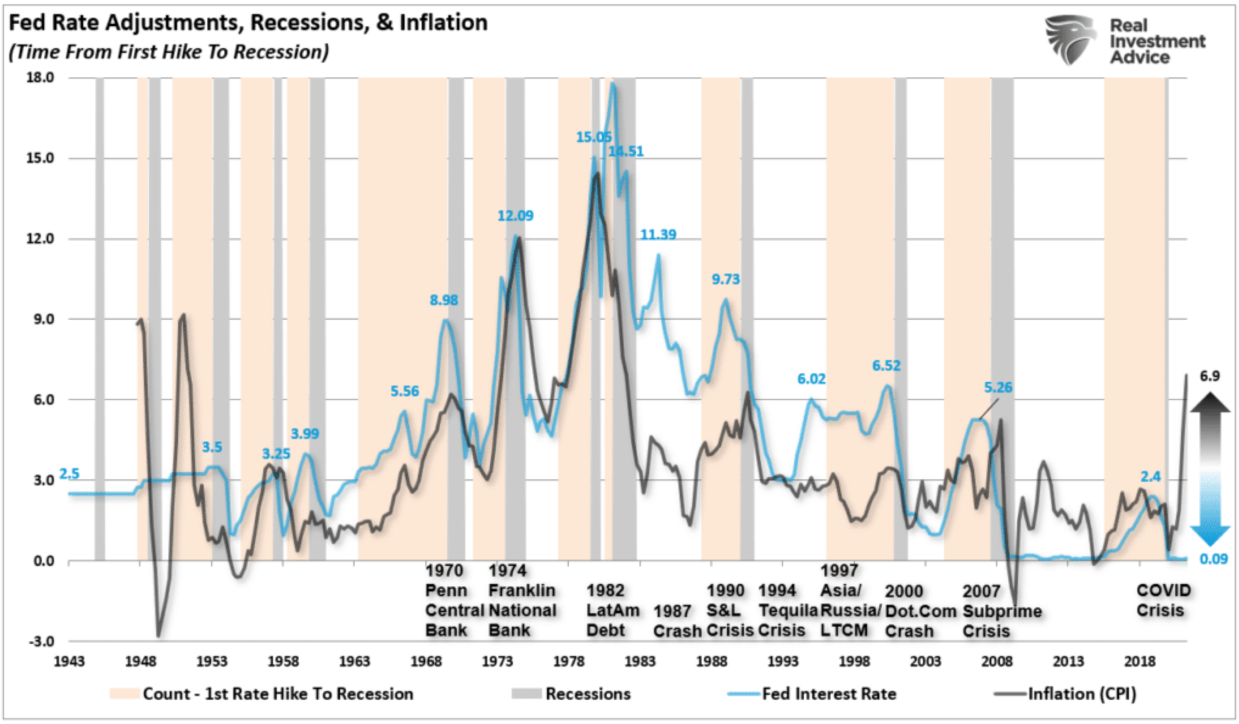
Earnings

- *Post-market:* **Jefferies Financial Corp. (JEF)** to report adjusted earnings of $1.34 on revenue of $1.82 billion

QT Is Top of Mind At The Fed

The following headlines hit the tape on Tuesday. Jerome Powell and two other Fed members are heavily hinting that not only is balance sheet reduction (QT) likely, but the Fed may do so at a much faster pace than market participants are expecting.

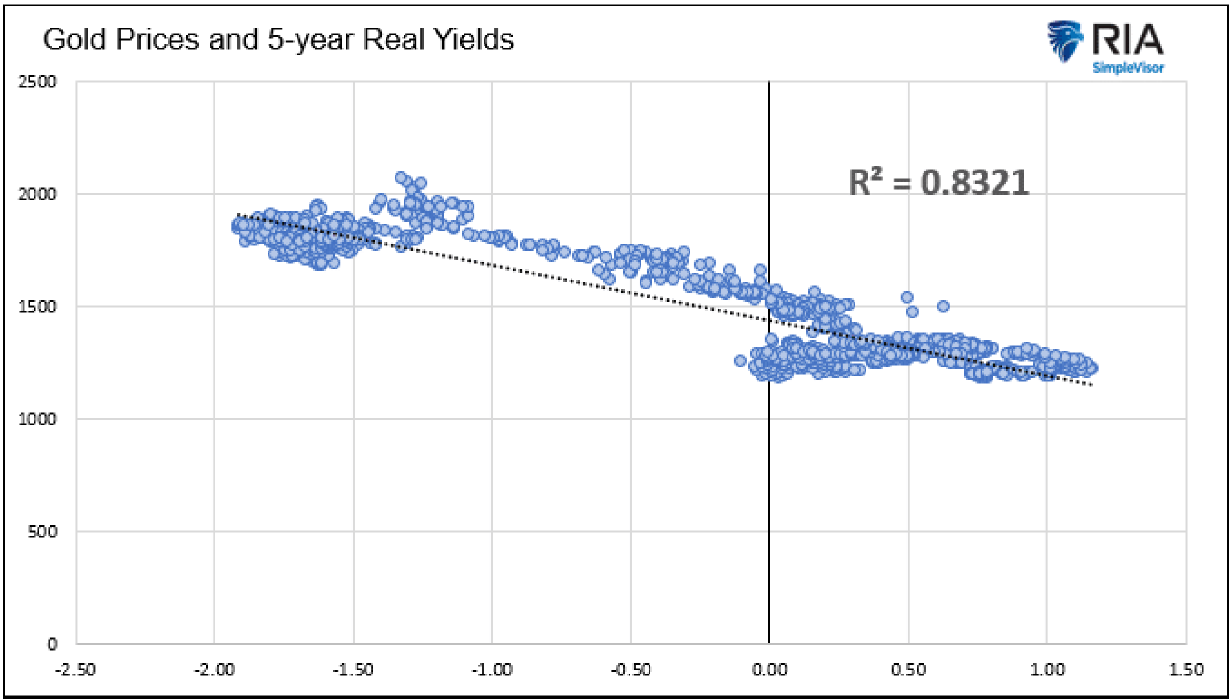
- *BOSTIC SAYS **FED COULD EASILY PULL $1.5 TRILLION OF "EXCESS LIQUIDITY" FROM FINANCIAL SYSTEM**, THEN WATCH MARKET REACTION FOR FURTHER BALANCE SHEET REDUCTIONS*.
- *MESTER: **ABLE TO LET BAL SHEET TO RUN DOWN FASTER THAN LAST TIME***.
- *POWELL: WE EXPECT TO ALLOW **BALANCE-SHEET RUNOFF LATER IN 2022**.*
- *POWELL: **BALANCE SHEET IS FAR ABOVE WHERE IT NEEDS TO BE**.*

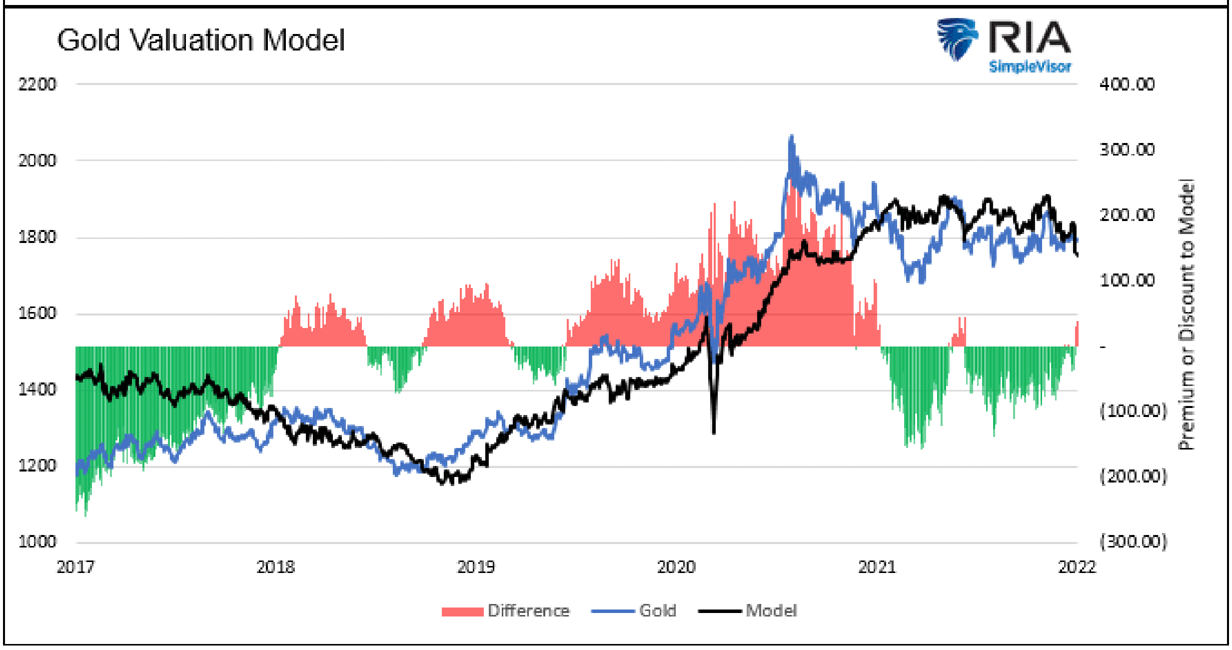


Real Yields Drive Gold Prices

It is not inflation, runaway fiscal deficits, or the Fed that are the primary driver of gold prices. Believe it or not, real yields or the difference between nominal yields and expected inflation has a strong relationship with gold prices. As real yields fall, gold prices rise. The scatter plot below shows the statistically strong inverse correlation (r-squared .8321) between the two. The chart also provides an equation to model gold versus real yields. The second graph shows that gold is currently about $40 overvalued.

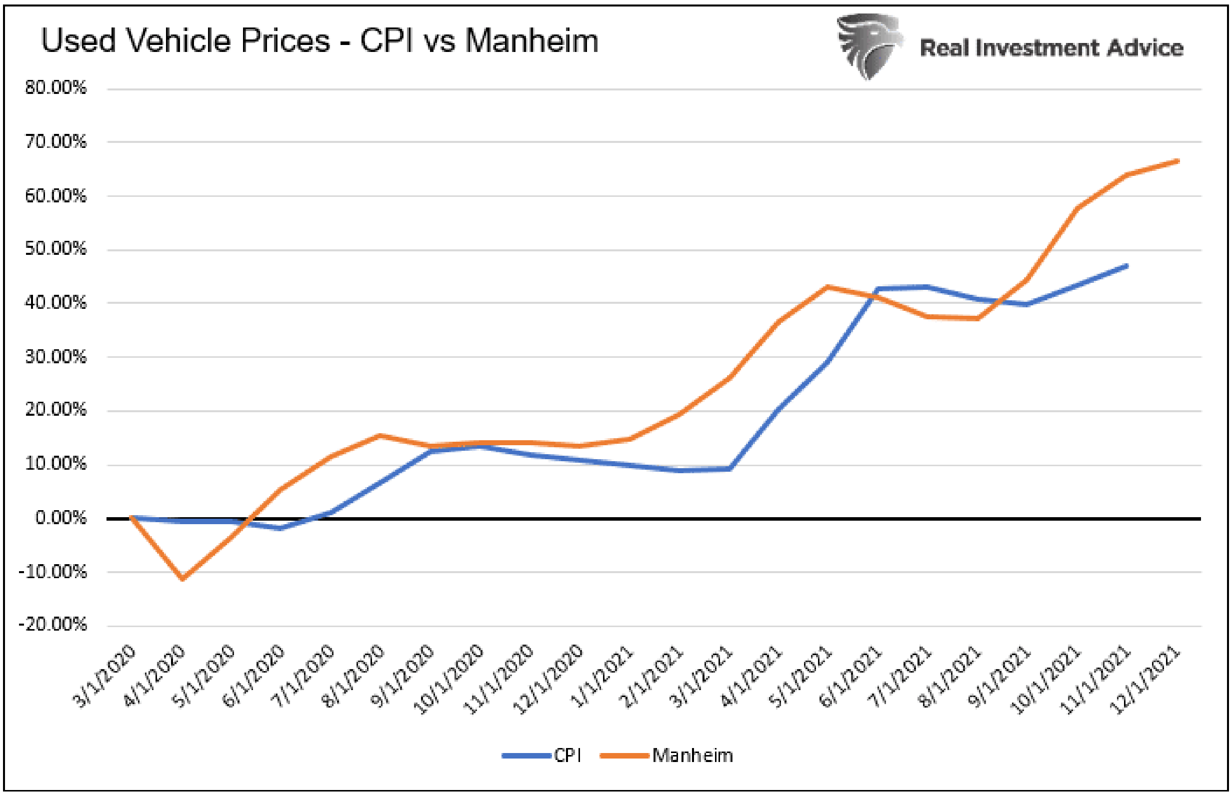
As a rule, every one basis point increase in real yields should result in a $2.5 decline in gold prices and vice versa. Since December 1, 2021, inflation expectations rose by .07% and nominal yields by .35%, resulting in real yields rising by .28%. Over the same period, gold inched higher by $5. Based on the model, gold should have fallen by $69. These dynamics help explain why gold went from undervalued to its current overvaluation.





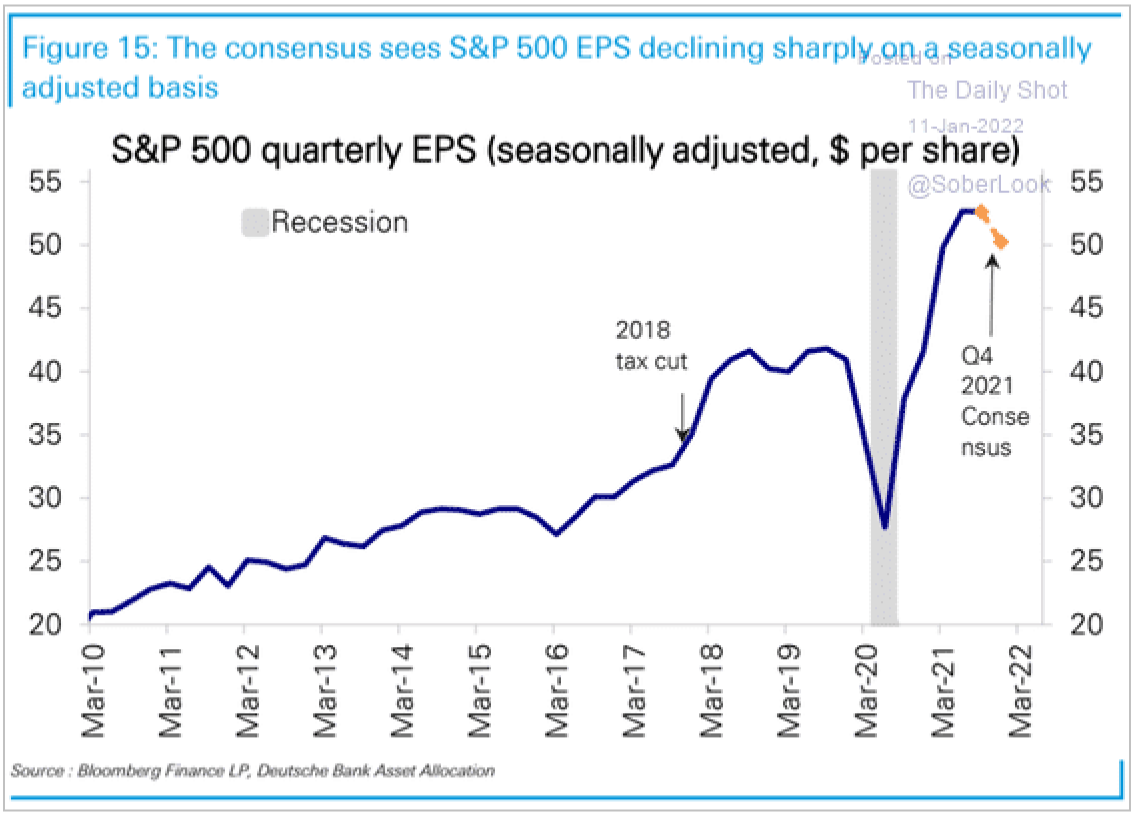
Used Car Prices Drive CPI

Since March 2020, used vehicle prices have skyrocketed. While they only account for about 2.5% of the CPI index, they added approximately .60% to CPI annually in each of the last two years. The graph below compares the Manheim and CPI used car price changes since March 2020. As shown, the CPI index is lagging Manheim by about 20%. If CPI catches up to Manheim in tomorrow's CPI report, used cars will add .40% CPI. That is a significant contribution for such a small component.



Earnings Season Set To Kick Off

As we enter earnings season, expectations have only softened mildly despite surging inflation, wages, and the subsequent risk to profit margins.

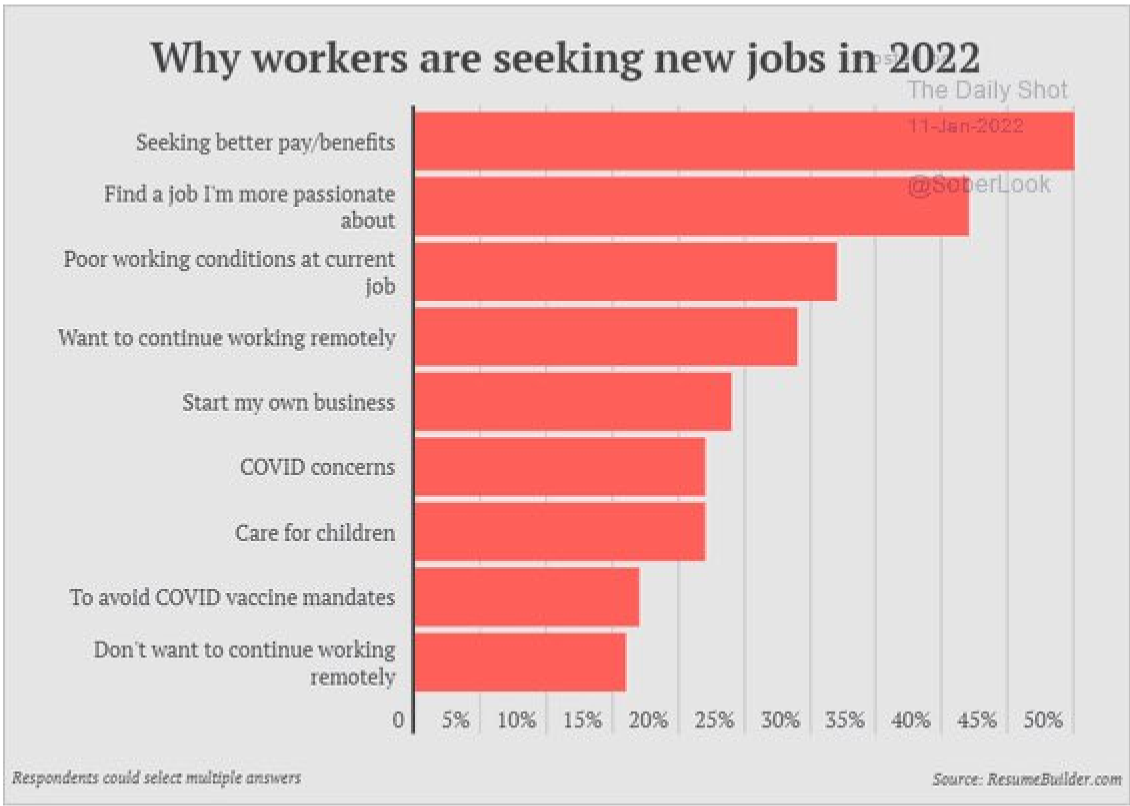


Importantly, as we have discussed previously, it is quite likely we will see substantial reversions in estimates later this year, which doesn't bode well for the broader market.

https://twitter.com/LanceRoberts/status/1480870881966669829?s=20

The Quits Rate is Driving The Fed's Inflation Concerns

The graph below from the Daily Shot shows why workers are quitting jobs at a record pace. As it shows, higher wages and benefits account for half the workers. The "quits rate" is at 4.527 million, almost a million above where it stood pre-Covid and about 2 million above the average of the last 20 years. The combination of record job openings and record quits rate puts leverage in the hands of employees and prospective employees. The Fed's concern is that as wages rise, prices will follow, creating a wage-price spiral. We expect to hear more about the risks of a wage-price spiral at its next meeting.



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