Summary

Economic data for the week included higher ongoing readings for producer and consumer price inflation—the latter rising at the fastest year-over-year rate in three decades. The trend in improving jobless claims also slowed, and consumer confidence fell.

Global equity markets declined in keeping with a higher U.S. inflation report, weaker sentiment, and rising foreign Covid cases. Bonds reversed course and pulled back as long-term rates ticked higher. Commodities were mixed, but energy fell back contrary to recent trends.

Economic Notes

(-) The **producer price index** for October rose by 0.6%, which was in line with the median forecast, led by energy prices rising nearly 5%. On a core level, removing food and energy, the gain was just lower at 0.4%. On a year-over-year basis, PPI was up 8.6% and 6.7% on a headline and core level, respectively. This was at the same rate as September, which may have provided some reassurance about producer prices not worsening. However, lack of supply, labor shortages, and logistical hang-ups continue to keep PPI elevated in a variety of industries (semiconductors being a prime culprit).

(-) The **consumer price index** in October rose 0.9% on a headline level, and 0.6% for core, removing food and energy. Both exceeded expectations by a few tenths of a percent. Energy commodities specifically pushed headline prices higher, being up 6% for the single month, while food prices gained nearly a percent. Shelter and medical care costs each rose 0.5%, which were below most other segments. On the other hand, cars and recreational items continued to recover at a faster rate. Overall, in looking at a list of all inflation inputs, the outcomes were mixed, but not all biased in an upward direction.

Year-over-year, the headline and core CPI increases were 6.2% and 4.6%, which represent the highest rates of change since 1990, when oil prices spiked in conjunction with the Iraqi-Kuwait war. Interestingly, perhaps the most-complained about categories of inflation in recent years (education and medical care) were up less than 3% on a trailing 12-month basis. Shelter costs have also begun to contribute at a more significant degree, on the heels of housing prices increases, but also rents that have begun to rise again (this tends to be a trailing effect in CPI). The end of the national eviction moratorium may also pressure rents again upwards.

Arguments continue about the persistence of this inflation episode. Without beating to death the same arguments discussed in the media constantly, the period of expected inflation has obviously lengthened. Estimates at this point have moved to mid-2022 or a bit later, but these are based on the ability to alleviate production and logistics disruptions across the global supply chain (no small feat). Inflation levels are likely to remain challengingly high until then. However, once those hurdles have passed, the same forces reversing into higher inventories and easier movement of goods could have a downward effect on prices. This isn't being looked at closely today, but could come into great focus next year.

(-) The early November **Univ. of Michigan index of consumer sentiment** fell by -4.9 points to 66.8, disappointing compared to the 72.5 level expected. In fact, this was the lowest reading in ten years, which was blamed in the high inflation as of late, but is still considered unusual due to the strength in economic growth and the stock market—which tends to coincide with positive sentiment. Assessments of both current conditions and future expectations declined to a similar degree. Inflation expectations for the coming year rose a tenth of a percent to 4.9%, while those for the next 5-10 years were unchanged at 2.9%. Again, the latter is telling, as it implies a rise in assumed levels, but not any type of consumer 'panic', despite the general weaker overall reading.

(0/+) The government **JOLTs** job openings report for September showed a decline of -191k to 10.438 mil., which still exceeded expectations calling for 10.300 mil. As with other government reports for that month, a substantial decline in state/local education jobs was a negative contributor. The rate of job openings fell by -0.1% to 6.6%, while the hiring rate was flat at 4.4%. The layoff rate was flat at 0.9%, while the quits rate rose another tenth to 3.0% (which was an all-time high for that series). It's apparent that the demand for labor remains mismatched with the supply of labor, with employees apparently more cavalier about the job market.

(0/-) **Initial jobless claims** for the Nov. 6 ending week fell by 4k to 267k, but came in above the 260k level expected by consensus estimate. Claims were mixed by state, with declines in CA and WA, while they spiked in KY. **Continuing claims** for the Oct. 30 week rose by 59k to 2.160 mil., above the 2.050 mil. expected.

(+) The Fed's **Senior Loan Officer Opinion Survey** for Q3 showed a general easing of lending standards, while demand for borrowing rose. This survey represents a unique set of data points, which are less quantitative than some data, but are generally depicted in the form of percentage of banks seeing positive/neutral/negative results.

About a fifth of banks surveyed eased standards for mid- to larger-sized firms, but was at a decreased pace than the prior quarter when about a third of banks eased. Interestingly, spread pricing fell for larger firms, but rose generally for smaller firms. In the commercial and industrial loan segment, three-quarters of banks noted a more favorable/less uncertain outlook, with lower percentages showing improvements in banks' capital positions and risk tolerance; demand for such loans continued to rise. In commercial real estate, loan standards eased for a greater number of banks, especially for multi-family residential properties; however, demand for such loans was little changed or even a bit weaker. Residential mortgages saw eased standards as well for all loan sizes, and including subprime. The willingness of banks to make consumer installment loans remained positive, but less so than in the prior quarter, with eased standards and greater demand for credit cards. Auto loan demand fell, which was likely due to supply issues.

Question of the Week

How do various asset classes perform in inflationary environments?

Some results may be more surprising than others.

- Fixed income. Traditional government and corporate bonds haven't tended to fare well during short-term inflationary spikes, assuming interest rates rise as well. For bonds generally, increases in yields erode current bond prices, due to the effects of inflation and market segmentation (investors prefer newly issued bonds at higher yields, while existing bonds have to reprice lower to provide the same yield to maturity). Bonds tend to especially shine in deflationary or low-growth episodes, when interest rates are also falling—making higher coupons increasingly more attractive. It's a nuanced story, though, and based on how fast rates rise. As might be expected, less damage happens during periods when rates rise gradually compared to when the rise is rapid. On the positive side, a higher interest rate raises the longer-term total return expectation for bonds since multi-year return is closely tied to starting yield.
- TIPs. By design, the returns of Treasury Inflation-Protected Securities are tied to CPI inflation readings. However, the market for TIPs remains small relative to that of standard nominal treasuries, and they've gone through stretches of appearing perpetually expensive, likely due to high demand for the concept but limited supply. Unbeknownst to some buyers, many TIPs are longer-duration bonds, a trait that can also enhance volatility when real yields change, as is the case with long-term traditional bonds with changes in nominal yields. There is a positive correlation with inflation no doubt, but other asset classes may offer more bang for the buck. One negative is that TIPs can have a higher correlation to equities and risk assets than do other bonds, so they tend to provide less portfolio diversification than do conventional treasuries and corporates.

- From a shorter-term standpoint, it's all about the breakeven rate, which is the anticipated inflation built into TIPs yields (currently about 2.7% on the 10-year and 3.1% on the 5-year). If realized inflation over that maturity period is higher than breakeven, an investor is better off in TIPs. Otherwise, TIPs are likely to underperform nominal treasury bonds of the same maturity. Ideally, a time to invest in TIPs is when inflation expected by the market is low, but then starts rising at a faster rate than anyone expects—however, these bonds have tended to reprice quickly, making that window of opportunity fairly small.

- Floating rate bank loans. These act in an almost opposite fashion from traditional bonds in that the yield is not based on a fixed rate, but a variable one tied to short-term market rates (and a credit spread). As these rates rise, as they can in response to central bank policy, the yield-based return for bank loans also rises. While many companies that issue such loans tend to be mid- to lower-rated, loans are collateralized and lie higher in the capital stack than traditional bond debentures. The correlation of bank loan returns with inflation has been stronger than that of fixed-rate bonds, due to the different responses to interest rate changes. These have been effective hedges against traditional bonds in the past, although they do contain credit sensitivity.
- Equities. Results are mixed, depending on the sector and level of inflation. Low to moderate inflation can be a positive influence on company revenues, assuming that this coincides with underlying economic demand, and underlying costs can be passed on to consumers. However, if inflation rises to higher levels (such as 6%+, for example), companies are less able to profitably pass on cost increases without sacrificing sales volume. In that event, high inflation can become problematic for equities. Additionally, higher interest rates that can accompany inflation can raise borrowing costs and can decrease modeled company valuations due to the present value of money effect. Over time, of course, the embedded risk premium has resulted in higher returns for equities, which have outperformed inflation over longer time periods.
- Real estate. Real assets have been sought out due to their nature of having traditionally at least tracked inflation, making these a bit of a classic hedge. For commercial properties, leases can contain CPI escalators, which insulate real rental income from inflation's impacts. Rising interest rates can be a problem for real estate, however, due to higher financing costs and a carryover effect on capitalization rates used in valuations.
- Commodities. These have been one of the best performers in an inflationary regime, particularly in one where 'stagflation' has occurred. In fact, the broad S&P GSCI Commodities Index has a high rolling 3-year 'beta' vs. CPI over the past 50 years, although correlation isn't perfect. The reason for this is that commodities are both a cause and effect of inflation forces—a chicken-and-egg problem. The CPI inflation basket includes several commodities, including petroleum and food, as well as derivatives of those products (plastic, trucking rates, restaurant meals, etc.) so as commodity prices rise, so do costs and consumer inflation. Such expectations or underlying supply/demand conditions can exacerbate commodity hoarding or speculation, driving these prices higher and perpetuating the cycle. We have certainly seen this during the pandemic recovery, breaking commodities out of their long slump associated with two decades of contained inflation and few surprises.
- Precious metals. Often thought of as a classic inflation hedge, the historical results are actually mixed. In some inflationary environments, gold and silver have provided protection, but in others, they haven't. In fact, their correlation to equities and fixed income is literally close to zero over the long-term, which is a byproduct of their randomness of returns. Technically, they could still be considered useful from a portfolio construction standpoint, but less so than commodities broadly (mostly due to the energy sector). This group—gold in particular—has fared well in investor 'risk off' environments, much like long-term treasury bonds. Inflation and 'risk off' haven't tended to be correlated, though, as financial distress tends to be deflationary force on the economy. The strength and weakness of the U.S. dollar also plays a key role in the performance of this segment.
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- Cash (U.S. dollar). This is another mixed bag, interestingly, based on the definition used. Currencies for nations experiencing high relative inflation have tended to depreciate, so cash under a mattress can buy less and less. However, short-term money market assets may benefit as interest rates rise, providing more income and serve as a shelter from volatility in other assets. At the same time, inflation can cause costs to rise at a faster rate than cash can be preserved and grown, so it has still been an eroding asset long-term.
- Cash (non-dollar). Assuming inflation isn't a global phenomenon, currencies of countries with more stable/lower inflation should maintain their value better than currencies of less stable/higher inflation countries. (This has been a big reason why certain developed market currencies, such as the Japanese yen and Swiss franc, have been sought out for stability compared to, say, those of emerging markets.) At the same time, higher relative real yields in a country can be attractive to investors, and help bolster demand for a currency. If inflation is global, though, this basic relationship can be cloudy (which could be the case today).

Market Notes

Period ending 11/12/2021	1 Week (%)	YTD (%)
DJIA	-0.56	19.79
S&P 500	-0.27	26.21
NASDAQ	-0.68	23.75
Russell 2000	-1.00	23.11
MSCI-EAFE	-0.34	12.45
MSCI-EM	1.71	1.40
BBgBarc U.S. Aggregate	-0.75	-1.69

U.S. Treasury Yields	3 Mo.	2 Yr.	5 Yr.	10 Yr.	30 Yr.
12/31/2020	0.09	0.13	0.36	0.93	1.65
11/5/2021	0.05	0.39	1.04	1.45	1.87
11/12/2021	0.05	0.53	1.24	1.58	1.95

U.S. stocks fell back on the week, along with CPI inflation results running at their highest levels in 30 years. Results were mixed by sector, with materials stocks having gained nearly 3% along with stronger sentiment surrounding infrastructure plan passage, while consumer discretionary stocks fared worst, down over -3%. The latter was led by an Elon Musk tweet announcing the sale of a portion of holdings. Real estate was little changed, despite the rise in interest rates.

One of the highlights of the prior week, which wasn't discussed to a large degree in the midst of earnings reports, was the announcement of the high efficacy of Pfizer's antiviral Covid treatment. In trials, it appeared to dramatically reduce death and hospitalizations (by 90%), which is significant in terms of treatment options. Along with now-available vaccines for children aged 5-11, such advancements increasingly allow investors to visualize an end-game to Covid, at least in the developed world, although conditions haven't normalized yet from a policy or practical standpoint. Even the hint of normalization has given consumer discretionary stocks and airlines a boost, where activity has continued to plod well below pre-Covid levels.

Foreign stocks were mixed, with declines in Europe and Japan offset by gains in emerging markets. Covid cases continued to weigh on sentiment, particularly in Denmark, Holland, and Italy. In EM, positive results were led by China and Brazil, with an announcement of policy easing in the former, while other areas were down in keeping with global markets generally.

U.S. bonds fell back last week as interest rates rose by Friday, reversing a sharp drop earlier in the week as CPI was released. Treasuries outperformed corporates, in keeping with credit spreads also ending wider. The auction for long bonds didn't end as strongly as the market had perhaps hoped, which may have also contributed to rising yields, in addition to the strong inflation print. The dollar strengthened dramatically, with led to larger declines, of a percent or more, for international bonds.

Commodities were little changed on net, with gains in agriculture and metals offset by a decline in energy prices. The price of crude oil fell back by a fraction of a percent to just under $81/barrel, while natural gas prices corrected by over -10% as production increases beefed up supply.

Have a good week.

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Sources: FocusPoint Solutions, American Association for Individual Investors (AAII), Associated Press, Barclays Capital, Bloomberg, Citigroup, Deutsche Bank, FactSet, Financial Times, First Trust, Goldman Sachs, Invesco, JPMorgan Asset Management, Marketfield Asset Management, Morgan Stanley, MSCI, Morningstar, Northern Trust, PIMCO, Standard & Poor's, StockCharts.com, The Conference Board, Thomson Reuters, T. Rowe Price, U.S. Bureau of Economic Analysis, U.S. Federal Reserve, Wall Street Journal, The Washington Post. Index performance is shown as total return, which includes dividends. Performance for the MSCI-EAFE and MSCI-EM indexes is quoted in U.S. Dollar investor terms.

Notes key: (+) positive/encouraging development, (0) neutral/inconclusive/no net effect, (-) negative/discouraging development.