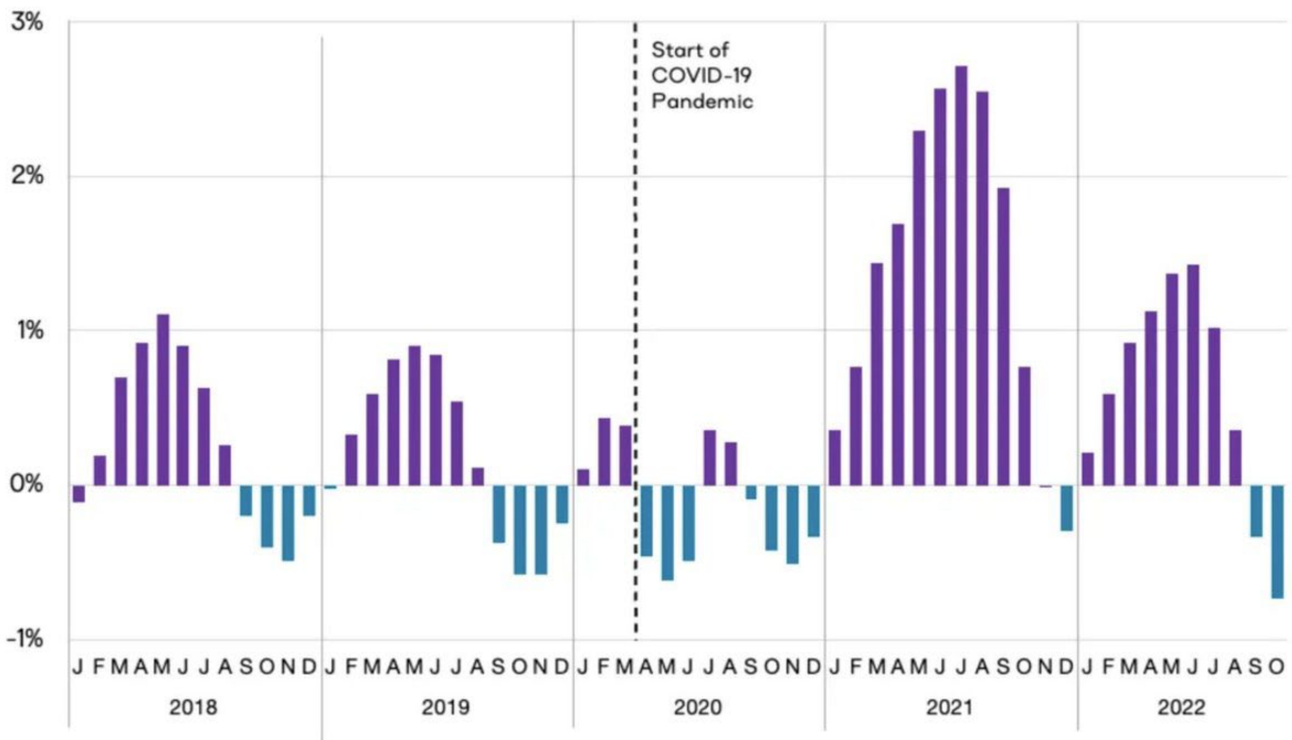
More Inflation Dumpster Diving

The combination of Inflation Dumpster Dive and Wile E. Coyote has led to some really interesting discussions. Several people forwarded a report to me stating that if the Fed only raises rates 50 bps tomorrow (which I think is unlikely), we could see the S&P 500 rally 10% in a day! Again, that is more than I'm hoping for in my **"Everything Rally"** mode, but the 10-year at 3.6% and SPX at 4,100 are the goals.

We get S&P Global Manufacturing PMI, JOLTS, ISM, Wards, and ADP all ahead of the FOMC meeting tomorrow (presumably the Fed gets some insight into NFP tomorrow as well, even if only a rough guesstimate). So, we might have one more update ahead of the FOMC meeting, but let's get through a few other subjects that have come up in conversations or just deserve an update as new information has come out.

Rents

Yes, CPI uses OER and apparently the Fed uses that as well. I cannot understand why we would base decisions on knowingly misleading data rather than on what is current!



I cannot attest to the accuracy of Apartment List's data above, but I see it referenced by several people that I trust and respect and it seems about right (not just because it shows declines in September and October, but because it shows much higher previous increases than "official" records indicate). I'd be shocked if Zillow and other services that purport to track current changes show anything different.

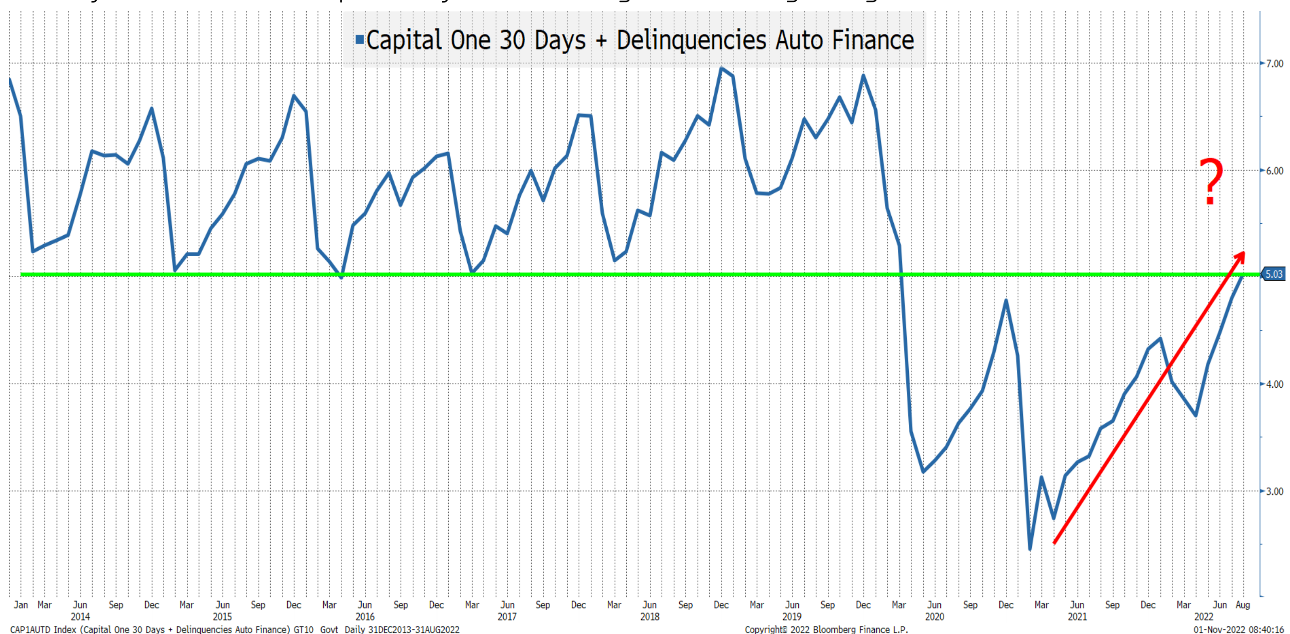
The flaws in using OER are well known and the fact that they flow into CPI and Core CPI are also well known. The Fed risks credibility if they highlight this data as a major source of their inflation concern.

Autos

While we get new auto sales today, I've been asked to clarify my view that WFH helped create demand for automobiles. My explanation was clunky at best, so I will try to clarify it.

1. Initially shutdowns and work from home REDUCED demand for driving and automobiles.
2. Then, as lockdowns eased, many people realized that public transportation was no longer an option. Everything from grocery shopping to getting to jobs where you still had to go to work (healthcare, food service, pharmacies, etc.) required you to drive. This affected lower income people more than others, and sowed the seeds for the surge in older/less desirable used cars to catch a bid.
3. Then as the re-opening took off and full WFH was replaced with hybrid models or work from satellite offices, demand for cars increased. Public transport remained shunned, and people needed to get to places (including vacations which were skewed to driving vacations). Many parents (when schools opened) were not comfortable sending their kids to school in buses. By this time, stimulus checks had hit and low rates were in place. Also, supply chain issues had decreased the availability of new cars. **This was nirvana for car dealers.** At this point, the combination described in Inflation Dumpster Dive took off, creating the demand and the purchasing power to fuel auto prices!

These underlying circumstances created unusually high demand for used cars, which is already dropping, but will hurt new vehicle sales as enough people pulled their demand forward. That has been a drag already and has been amplified by the much higher financing charges.



According to this chart, auto loan delinquencies remain below what is "normally" a low level, but we don't know how lax lending standards may have been during the boom. Residual values, inflated income versus expenses (stimulus and moratoriums), etc. all likely led to easy money (it is the typical pattern). Lending standards are already likely tightening (probably have been since March), which will affect the consumption going forward.

Big ticket items seem to be unlikely suspects for driving inflation higher in the coming months.

Inventory Build-Up is "Positive"

GDP came in at a "reasonable" 2.6%. About 2.8% of that was due to trade (exports versus imports). That all gets a bit wonky for my taste, but the people who live and breathe this stuff told me that this number was expected as trade had been too big of a drag in Q1 and is now catching up. I'll buy that.

What the people who dig into this stuff also tell me is that inventory build-up contributed meaningfully to GDP. In a world where we already seem to have excess inventory, building up more doesn't seem like a good thing. It just means that we will have to sell more at a discount in the future.

Chicago PMI yesterday saw:

- A big miss at 45.2.
- **New orders, employment, and order backlogs declining,** signaling contraction.
- **Supplier deliveries and inventories increasing**, signaling expansion.

Hmmm…

Filling your warehouses faster is "good" when sales are weaker? This seems like one of those paradoxes that has to be resolved. In theory, it could be via higher sales, but that seems unlikely to me, at least not until we see discounting and profit margin erosion (or the Fed takes their foot off the gas).

Europe, Japan, China, Russia, & Domestic Politics

I could care less what European inflation is. Their currencies and energy markets are in shambles.

Japan is sticking to an easier money policy and their currency seems to be stabilizing. They are also likely incorporating FX into policy discussions with the United States. **FX has shifted from economic to geopolitical.**

Mere hints that China is rethinking their zero Covid policy will help global markets, at least from the inflation standpoint.

No progress on Russia/Ukraine, but nothing much worse either.

The shift in D.C. is almost palpable, at least in terms of the swing from "inflation is the only concern" to "jobs are also important."

This week, it might be nice for Powell to say something to the effect of "inflation is getting under control and we see a soft landing ahead" (which would make inflation less of an election influencer). Okay, that is probably just wishful thinking on my part, but I expect a more balanced press conference.

QT remains an issue and seems to be weighing most heavily on the mortgage market.

Bottom Line

Let the everything rally continue for now.

On the rates side of the equation, long-dated/low dollar price IG bonds and mortgages are my favorite ways to play it (on the off chance that the FOMC tweaks QT to be less of a drag on mortgages).

The other way might be to buy some 20-year Treasuries or off-the-runs that are trading cheaply as it would be logical for the Treasury to consider buying these to i) insert some liquidity and ii) create some gains that can be used to offset the negative carry on the Fed's balance sheet.

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