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QFC's Insights

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Market Outlook

The Fight Against Inflation: High Food & Energy Costs

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The June 2022 CPI (Consumer Price Index) was released earlier this month and it was 'hotter' than forecasted. While investment markets opened significantly lower after its premarket release, surprisingly the impact of the 'unwelcome news' was managed very well by the markets and closed far above their lows for the day. When the data was analyzed a little deeper, I believe this market move can be explained and may indicate improving news in the future.

The CPI and PPI (Producer Price Index) are lagging indicators, meaning the information released reflects historical data and is not necessarily a predictor of future trends. Leading indicators are data points which may indicate the direction of trends such as the economy or inflation. Examples of leading indicators are the monthly jobs reports, the number of jobs created or lost; volume of goods moved by the transportation industry; and the price of commodities such as oil, soybean, corn, wheat, copper, aluminum, or iron ore to name a few.

The CPI reflects prices for goods or services the consumer purchased during the month the data was collected. In this case, June 2022. However, goods purchased by consumers in June were likely manufactured weeks or months earlier and then transported to retailers from plants or distribution centers at a time when those costs were also high. The goal of every retailer is to price their inventory to recover its costs (manufacturing & transportation), and then mark it up sufficiently to cover the operating cost of the store, overhead, and provide a profit. Some retailers have pricing power and thus their markups do not reduce demand for their products, but for others there may be competition or other factors where the retailer has to use a smaller markup in order to still achieve sales targets. As a result, the profits for these companies may be less unless other steps are taken. Thus, while it is a June sales transaction, depending on the time to manufacture and ship, these costs could easily be from April, March, or earlier. To see where costs may be headed and thus future retail prices, commodity prices may provide a glimpse into the future.

Commodity prices are currently declining although this can change quickly. In the following table is a sampling of the most common commodities and their price change since their 2022 peak value. Just like increases in the Federal Funds rate by the Federal Reserve, it generally takes six to nine months to document the impact in the economy of each rate hike imposed. The same is true for changes in value of the commodities. In many cases a change in a commodity's price does not have a proportionate price change at the retail level. There are times when the manufacturer elects to absorb the increase. This could be due to the price change is believed to be temporary, or the product is price sensitive by the consumer and an increase could cause a sales decline. Commodity prices incurred a sudden drop in price caused by the economic shutdown, manufacturing, and business stoppages all triggered by CoVID. Their values started to recover and soon surpassed prior

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'normal' values. Demand could have caused some of these increases, but the lack of supply probably contributed more to the rise in prices. The new higher prices began working their way into the products and services consumers purchase on a daily basis. Eventually, retail prices reflected the higher manufacturing and transportation costs. Add the impact of the incredible logjam in the supply chain reducing supply followed by the start of the Russia-Ukrainian war, and the U.S. started experiencing the highest inflation levels in over forty years. However, it appears peak commodity prices for those reviewed occurred this past March.

Commodity	Units	Peak	Price	Current	Price	Change
Soybeans	Bushels	06-09-22	$17.69	07-27-22	$15.80	(10.68%)
Wheat	Bushels	03-07-22	$12.94	07-27-22	$9.25	(28.52%)
Corn	Bushels	04-20-22	$8.16	07-27-22	$6.00	(26.47%)
Copper	Pound	03-04-22	$4.94	07-27-22	$3.48	(29.55%)
Iron Ore	Ton	03-07-22	$158.53	07-27-22	$110.00	(30.61%)
Aluminum	Ton	03-04-22	$3,839.50	07-27-22	$2,454.00	(36.09%)
WTI Oil	Barrel	03-08-22	$123.70	07-27-22	$98.07	(20.72%)

The Federal Reserve raised the fed funds rate for the fourth time this year. This increase was 0.75% and now stands at 2.5%. The first increased occurred in March and thus its impact should be documented in economic data beginning in September. Many financial analysts and economists had been hoping for, no demanding, the Federal Reserve increase a full one percent! I am pleased with the most recent increase and per Chairman Powell's comments, economic data is driving their decisions. Whether the economic slowing is caused by higher interest rates or energy costs does not matter, but energy's impact is also key. The objective is to reduce demand sufficiently, but not too much, so prices come down resulting in lower inflation. The question arises as to which increase is the magic one and no additional adjustments are needed. Since another four to six months must pass before the full impact of the last three rate increases are known and the expected one or two increases still to occur, knowing which adjustment is the magic one is extremely difficult. History shows the Reserve generally raises rates too many times causing the economy to end in a *recession*. It is possible Chairman Powel is monitoring data closely that he manages a 'soft' landing where the negative impact to the economy is minimal.

On the morning of the 27th, the government released the GDP results for the second quarter, and instead of three tenths increase, it was down 0.93%. This follows the decline of 1.57% for the first quarter which meets the current definition of a recession, two consecutive quarterly declines in the GDP. However, this does not look like any recession the U.S. has experienced in the past. For instance, during the second quarter, jobs were still added in the economy where past recessions experience significant lay-offs and higher unemployment rates. In past recessions the Federal Reserve would be looking to lower interest rates to stimulate the economy out of the recession, but they are currently raising rates. The National Bureau of Economic Research (NBER.org) is the organization which determines when a recession occurs and how long it lasts. Their announcement of when a recession starts always follows the actual date by four to six weeks as they are evaluating historical data. The GDP decline for the last two quarters confirms the economic output declined and perhaps more quickly than expected thus pressure on prices may be lessening.

With the decline in economic output, the U.S. is clearly in a recession. With this recession is not incurring

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the traditional attributes of a recession, how the government and the Federal Reserve responds to this shrinkage in output should also be unique. Both Secretary Treasurer Yellen and Chairman Powell responded on the 27th they did not believe the U.S. was in a recession. The crystal ball is obviously a little hazy on what the future holds. Quality investments still recover the quickest when conditions improve thus, we continue to evaluate holdings.

The focus of the Federal Reserve is on price stability and interest rates hikes will continue in the near term. Fortunately, rates remain significantly below historical averages. During this period, the unintended consequence may be a rise in the unemployment rate which is also historically low. Whether the markets have seen the low for this period is yet to be determined. The monthly CPI and Jobs reports will be key data releases to watch. Expect the markets to remain volatile until data hints inflation numbers are declining, and more time must pass to allow the past rate increases and the expected additional increases to be incorporated into the economy.

Patience is the virtue that best serves investment portfolios.

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