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GLOBAL FUNDAMENTAL PROCESS

Why US inflation will fall

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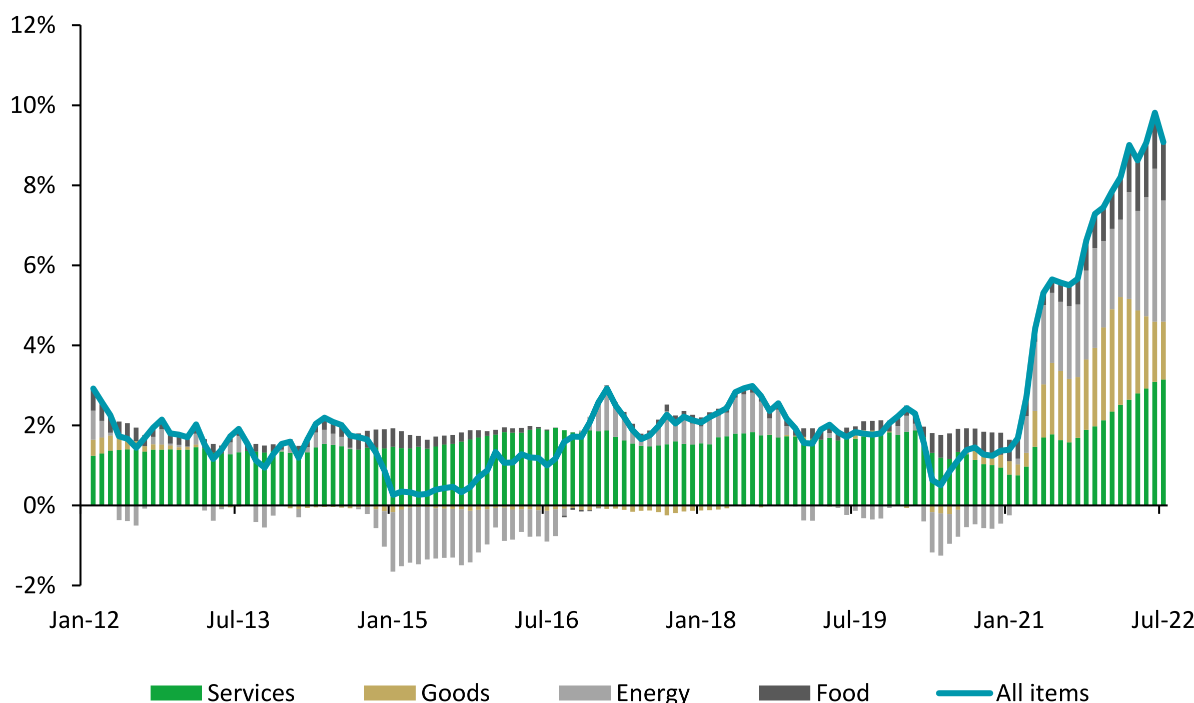
US inflation has hit 40-year record levels this year. The extent to which the Federal Reserve will hike rates to counter price rises is the key issue facing investors in the world's largest economy this year. But is US inflation set to run away, or are there factors at play that will dampen it in the coming months, allowing the Fed to 'pivot' and take a less harsh position on the economy?

The main contributors to US inflation

There are five main categories that contribute to the US Consumer Price Index (CPI), as shown in **Fig. 1** below. Prior to Covid, CPI was mainly driven by inflation in the Services sector. Commodities such as Food and Energy fluctuated but they were relatively minor contributors over time. Goods was a disinflationary category for many years with ever-improving functionality in consumer electronics and cheap imports flooding American shelves.

But in 2021, Covid hit supply chains. Goods inflation spiked higher as economic stimulus measures stoked demand and retailers struggled to replenish shelves. Food and Energy prices grew strongly as transportation bounced back after lockdowns and OPEC+ exhibited strong discipline in maintaining agreed cuts to oil production. Services inflation also increased as shelter inflation climbed with rising house prices and rents.

Fig. 1: The main contributors to year-on-year US CPI inflation



Source: Bloomberg, August 2022

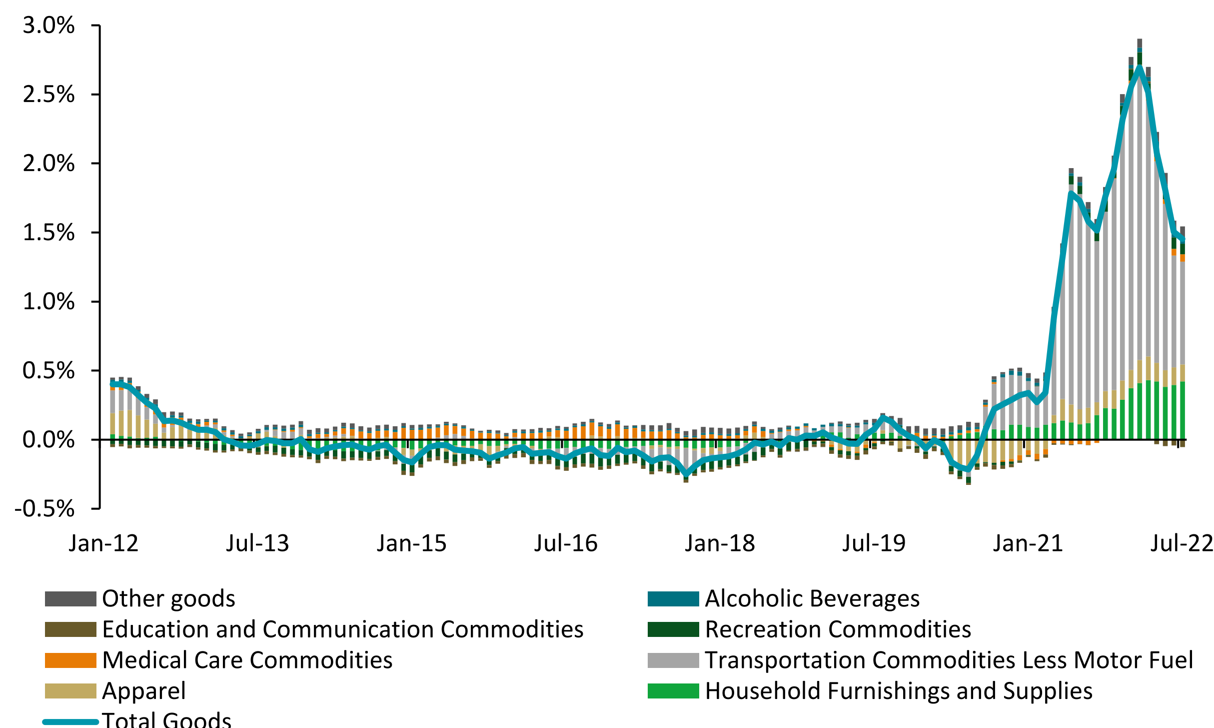
Going forwards, what impacts will each category likely have?

Goods inflation could turn into deflation

The biggest contributor post-Covid to Goods inflation has been new and used cars (**See Fig. 2**). This has been driven by the well-documented semiconductor shortages in the autos supply chain, which has limited production of new cars. The lack of supply of new cars has driven up prices for used cars.

The Manheim Used Car Index indicates that US used car prices increased more than 60% in 2021. Clearly, this environment is unsustainable. Used car prices will normalise in time and we have started to see prices softening in the first half of 2022. So far this has been driven by demand, but we expect used car prices to continue to normalise as supply improves in the coming months. The magnitude of the potential correction could even mean Goods becomes a *deflationary* contributor to CPI.

Fig. 2: Goods' contribution to year-on-year CPI inflation



Source: Bloomberg, August 2022

In other Goods categories, supply has improved as demand cools. There have been well-publicised excess inventory issues at retailers such as Walmart and Target. Retailers have had to start discounting again. Logistics bottlenecks are clearing and freight rates are beginning to normalise.

Input costs are also falling as metals prices have corrected sharply with expectations of slowing growth. The Bloomberg Industrial Metals Index has fallen 35% from its peak in early 2022. This should start feeding into Goods prices in due course.

Energy market set to remain oversupplied

Oil prices peaked in March and are now down more than 25%. The Russian invasion of Ukraine and the subsequent sanctions imposed by the west initially stoked fears of potential oil shortages. However, reduced demand for Russian barrels from Europe has been replaced by demand from India and China.

Oil supply is estimated to be in surplus as of Q2, according to the US Energy Information Agency. Oil supplies continue to grow, with non-OPEC+ countries adding an estimated 2.5-3mb/d this year. Meanwhile, oil demand is stalling as consumers shun record gasoline prices. Should we see a recession, oil demand could even fall.

Food inflation should slow

Food inflation should slow in the near term as agricultural commodity prices have also fallen in recent months. There tends to be a lag of up to six months before this feeds into grocery prices. In July, Turkey helped Ukraine and Russia reach a deal to resume grain shipments from Black Sea ports. This should help ease soft commodity markets.

Fed tightening is impacting housing market

Shelter inflation makes up about 60% of the weighting within Services inflation. It mainly consists of housing costs. It has been the main driver of the recent increase in Services inflation as house prices and rents rise.

There is a long lag between changes in house prices and Shelter inflation because of the way it is calculated by the Bureau of Labour Statistics. Furthermore, house price inflation itself lags broader housing market activity, such as Existing Home Sales volumes. Recently, we have seen a significant cooling in activity as mortgage rate rises driven by Fed tightening have impacted affordability.

Given these long lags, despite the sharp downturn in housing market activity in recent months, we will likely only see Shelter inflation peak towards the end of 2022 and it will likely remain high before fading in the back half of 2023.

Disinflationary forces are pressuring Goods, Energy and Food inflation

Despite sticky Shelter inflation, we see disinflationary forces providing downwards pressure on Goods, Energy and Food inflation in the near to medium term. This is driven by normalising supply chains, in particular normalising used car prices, and demand destruction for crude oil as economic growth slows. Indeed, recessions were historically disinflationary/deflationary affairs, and we think this time will prove no different should the current growth slowdown become a recession. Covid created a unique environment of increasing demand for goods from stimulus and lockdowns and constrained supply from bottlenecks. This is in the process of reversing as demand is hit by rising costs and fading stimulus, and supply chains ease with the addition of new capacity. This inflation may prove transitory after all.

For students of Milton Friedman, who famously said that “inflation is always and everywhere a monetary phenomenon”, you will be pleased to know that this view corroborates with the latest data on money supply. M2, a measure that includes cash and bank deposits, has decelerated from 27% annual growth at its peak to 5% in July.

Lower inflation could reduce the pressure on the Fed to raise rates and allow them to pivot to lower incremental rises or even pause. In this scenario, bond yields would likely decline and benefit higher multiple, growth-oriented stocks as discount rates fall. Recently, we added new positions in higher growth companies. One example is Intuit, the tax and accounting software provider. Its multiple has contracted significantly with higher bond yields. However, we believe the business should be resilient. Tax and accounting are not discretionary spends and the software as a service (SaaS) nature of the software should mean a steady revenue stream despite slowing economic growth.

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