INFLATION TO ABATE

Last week's 7.5% Headline Inflation Report for January (the highest since 1982), shook markets and prompted forecasts of the Fed raising interest rates by 50 bps in March with some even speculating of an "emergency" intra-meeting rate increase.

What has been less publicized is the fact that the University of Michigan Consumer Sentiment Index fell 8.2% in January 2022, to the lowest level in more than a decade. This comes, not coincidentally, at a time when real inflation-adjusted wages are falling for the first time since 2008 and at the sharpest pace in over twenty years.

While supply chain issues and essential workers initially sparked increases in prices and wages, a real wage spiral has subsequently developed. Household spending has been supported by an extraordinary pace of rising home and stock prices that is likely to stagnate in the year ahead.

"… [T]he entire February (sentiment) decline was among households with incomes of $100,000 or more; their sentiment index fell by 16.1% from last month, and 27.5% from last year," Richard Curtin, director of the surveys, said in a statement.

This reflects a "growing belief among consumers that no effective policies have yet been developed to reduce the damage from surging inflation," Curtin wrote.

High inflation is already cutting into spending. Retail sales (ex gas and autos) fell -2.5% in December after a small -0.1% decline in November.

Similar to how the pandemic triggered a sanitizer and toilet paper buying spree, consumers also flocked to the real estate market in 2021. As demand for houses picked up, interested buyers have pulled out all the stops to outbid the competition.

This caused all sorts of strange and perhaps reckless behavior, including buyers forgoing contingencies in the sales contract meant to protect them and their earnest money, which can amount to thousands of dollars. Some buyers were using their retirement savings, while others were getting loans so they could appear to be all-cash buyers.

There are now signs emerging, however, that suggest that housing market activity is cooling off. Pending home sales fell for the second month in a row in December, with all four regions of the U.S. posting drops in month-over-month and year-over-year contract activity.

Prices have also fallen rather substantially on a seasonal basis. The average price of the most common U.S. home slid to $337,000 last week and is now $26,000 below the 2021 peak of $363,000, the largest seasonal gap going back to 2012.

At the end of 2021, many forecasters were calling for mortgage rates to rise by one half of a percentage point to the “upper 3’s” over the course of next twelve months, which would in turn keep many marginal home buyers on the sidelines.

What has actually happened since then is that the average 30-year Mortgage rate has increased by a stunning 1% to 4.20% in under two months, the fastest such move since 1994. Keep in mind that the U.S. has not seen 5% Mortgage rates since early 2010 (which did not last very long) and before the subprime crisis.

In short:

The impact of consumer spending declines will be more impactful than Fed Action as:

- Drivers, who see the cost of filling their gas tanks go from $40 to $65, look for alternatives such as a return to remote work, carpooling, public transportation, etc.

- Every 25-basis point increase in Mortgage rates translates to approximately a 3% increase in the monthly payment for entry-level buyers. Therefore, the near-140 basis point spike over the last twelve months equates to a 16.6% increase in borrowing costs, at a time when the cost of basic necessities is already taking a bigger bite of out their paychecks.

This cycle permeates across all sectors of the economy and will further exacerbate the economic slowdown, which has begun.

We believe this to be the next phase of the cycle and investors should position their portfolios to take advantage of declining inflation and slower economic growth.

Sincerely,

Bradford Stanley, CFA
CIO, The Stanley-Laman Group, Ltd.

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