Zacks INVESTMENT MANAGEMENT

Mitch on the Markets

Portfolio Manager Investing Insights

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How to Think About Inflation

There's a new inflation story every day, but that doesn't mean investors are any closer to making sense of it all.

For one, the varying measures of inflation – and all of the categories and sub-categories that go along with it – are nothing short of head-spinning. Most readers have heard of the commonly cited Consumer Price Index (CPI), but that's not even the measure of inflation the Federal Reserve uses when making policy decisions. The Fed focuses on the Personal Consumption Expenditures (PCE) price index, and these days the central bank also seems to prefer stripping out food, energy, goods, and shelter (housing).[1]

All told, the Atlanta Federal Reserve tracks nine inflation indices that all use slightly different methodologies to measure "underlying" inflation. As you can see below, the results often vary widely, painting significantly different inflation pictures depending on which metric is being used:

Measure of Underlying Inflation	12-Month Growth Rate (December 2022)
Core CPI	5.7%
FRB Cleveland Median CPI	6.9%
FRB Cleveland 16% Trimmed-Mean CPI	6.5%
Atlanta Fed Sticky CPI	6.7%
Core PCE	4.7%
Market-Based Core PCE	4.9%
FRB Dallas Trimmed-Mean PCE	4.6%
FRB San Francisco Cyclical Core PCE Inflation	7.5%
Cyclically Sensitive Inflation (Stock and Watson (2019))	6.7%

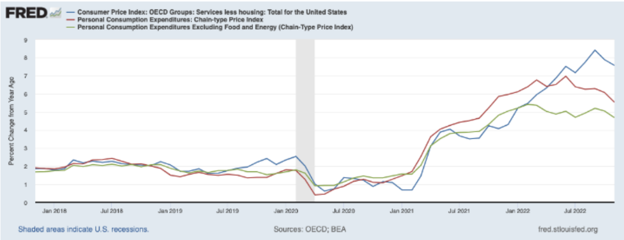
Source: Federal Reserve Bank of Atlanta[2]

In any given year, as an investor determines their outlook for inflation, interest rates, and corporate earnings, using CPI and Core CPI is likely satisfactory for the inflation piece of the analysis. But I'm not sure that works for 2023.

This year, I think investors should focus on what the Federal Reserve is focused on. Minutes from the December Fed meeting – in addition to numerous comments and press conferences from Chairman Jerome Powell – say the focus should be *core services inflation excluding housing*. In other words, while analysts and experts are breaking down changes to the prices of eggs, gas, and refrigerators each month, investors can likely look past these commentaries and data points. At this stage, "goods inflation" is not bearing nearly as much weight on the Fed's thinking as many investors and market watchers may think.

Last month, for instance, CPI fell to 6.5% in December from 7.1% in November and a peak of 9.1% in June, and overall consumer prices also fell -0.1% in December from November – the first monthly drop since May 2020. The Fed was largely unmoved. That's because core services inflation (blue line on the chart below) remains elevated even as broad-based measures of inflation are in a downward trend.

Services Inflation Excluding Housing (Blue Line) Remains Elevated



Source: Federal Reserve Bank of St. Louis[3]

Services inflation is driven in large part by a tight labor market's effect on wages. That means investors' approach to inflation this year should involve monitoring average hourly wage data, as well as keeping an eye on the Bureau of Labor Statistic's employment cost index release. These are the inflation metrics the Fed is watching most closely to determine the path of interest rates, so it makes sense that investors should be honing-in on this aspect of inflation, too.

Bottom Line for Investors

December 2022 wage data was encouraging. Year-over-year, wages rose by 4.6%, a marked improvement from a 5.6% peak in March but still not compatible with the overarching goal of 2% core inflation. Looking at just Q4 2022, wages grew at a 4.1% annual rate, which may be confirmation that a softening trend is firmly underway.

Later in January, the Labor Department will release its quarterly employment-cost index, which is not likely to receive much press but that investors should keep a close eye on. The Fed sees this index as the most reliable gauge of worker pay, so it is likely to factor heavily into their plans for interest rate policy. Better data on wages could offer a clearer understanding of where interest rates will peak, which many would argue is what the stock market needs for a sustained rally.

ABOUT MITCH ZACKS

Mitch is the CEO & Senior Portfolio Manager at Zacks Investment Management. Mitch has been featured in various business media including the Chicago Tribune and CNBC. He wrote a weekly column for the Chicago Sun-Times and has published two books on quantitative investment strategies. He has a B.A. in Economics from Yale University and an M.B.A in Analytic Finance from the University of Chicago.

[1] Wall Street Journal. January 11, 2023. https://www.wsj.com/articles/forget-core-cpi-market-pros-are-searching-for-supercore-inflation-11673413222?mod=djem10point

[2] Federal Reserve of Atlanta. 2023. https://www.atlantafed.org/research/inflationproject/underlying-inflation-dashboard

[3] Fred Economic Data. January 13, 2023. https://fred.stlouisfed.org/series/USACPGRLH01IXOBM#

IN FOCUS THIS WEEK

- **A supply squeeze for orange juice**
- **U.S. inflation falls again**
- **Decline in retail sales**
- **China's economic recovery**

A Supply Squeeze for Orange Juice

Florida's orange harvest hasn't been this bad in 90 years. According to the Agriculture Department, Florida is expected to produce just 18 million 90-pound boxes of oranges, a startling 93% decline from the peak production reached in 1998. A combination of factors is driving the weak crop yield – the December freeze that swept most of the country came at a terrible time; Hurricane Ian wreaked havoc on a large portion of land where oranges grow; and a citrus disease continues to ravage crops in large numbers. For the first time, Florida will produce fewer oranges than California, and the trendlines indicate that poor crop yields are likely to continue. The number of Florida acres with orange trees has fallen by almost 50% since the late 1990s, and the weather and citrus disease barriers seem likely to continue. From a market perspective, frozen concentrate orange juice prices have reached a near record, and the price of orange juice at the grocery store has never been higher. Even though much of the U.S.'s supply of orange juice is made from oranges imported from Brazil and Mexico, strains in supply from Florida could keep upward pressure on prices for the foreseeable future.[1]

U.S. Inflation Falls Again

Last week the Bureau of Labor Statistics reported that U.S. inflation – as measured by the Consumer Price Index (CPI) – fell for the sixth straight month in December. The broad CPI measure was seen rising 6.5% year-over-year in December, which was down from 7.1% in November and marks a significant decline from June's 9.1% peak. When the volatile food and energy categories are stripped out of the CPI measure, prices rose by a lesser 5.7% in December, also encouraging but still a significant distance from the Fed's goal of 2% average inflation. The inflation data is generally parsed-out between goods inflation and services inflation, of which the latter is the Fed's main concern. Goods inflation has fallen for three straight months, as supply chain pressures have faded almost completely and as consumers shift spending to services. At this stage in the inflation narrative, investors should be eyeing the employment-cost index and wages, as these are the main concerns of the Fed. Regardless, the Fed appears on track to raise the benchmark fed funds rate by 25 basis points at its February 1 meeting.[2]

Retail Sales Fall in December – A Signal of Economic Weakness?

U.S. consumers pulled back on spending at stores, restaurants, and online in December. According to data released by the Commerce Department, retail sales fell by -1.1% from November to December, a slowdown reached the peak of the holiday shopping season. The weak reading came following a November decline of -1% from October, which was an atypically strong month for sales. The harsh winter weather in December played a role, but consumers were also seen pulling holiday purchases into October, as retailers offered early holiday shopping discounts to unload an inventory glut. Consumers also increasingly shopped for bargains in an inflationary environment, which had an impact on overall sales. Notably, the retail sales figures do not include spending on travel, housing, or utilities, which are figures released later in the month.[3]

China Had a Bad Year in 2022. Will It Recover in 2023?

China's National Bureau of Statistics reported that the country produced 3% GDP growth in 2022, the second-worst year of output since 1976. The main culprit in 2022 was China's unwavering pursuit of "zero-Covid" policies, which resulted in rolling lockdowns around the country and made production and consumption fluctuate in fits and starts. China's abandonment of restrictive Covid-19 policies has given way to a massive surge in hospitalizations and deaths, which are likely to serve as even more headwinds in Q1. Looking ahead, however, if China follows the path of the rest of the world, the Covid surge should give way to some form of normalization, which could also lead to an economic resurgence in the second half of the year.[4]

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[1] Wall Street Journal. January 18, 2023. https://www.wsj.com/articles/why-orange-juice-is-so-expensive-right-now-11674010877?mod=djemRTE_h

[2] Wall Street Journal. January 13, 2023. https://www.wsj.com/articles/inflation-weary-americans-find-some-relief-as-prices-fall-for-dozens-of-products-11673585724?mod=economy_more_pos11

[3] Wall Street Journal. January 18, 2023. https://www.wsj.com/articles/us-economy-retail-sales-december-2022-11673990047?mod=economy_lead_story

[4] Wall Street Journal. January 17, 2023. https://www.wsj.com/articles/chinas-economic-growth-fell-to-near-historic-lows-as-covid-took-a-bite-11673921199?mod=djemRTE_h

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