Greg Smith: High inflation — soon to be yesterday's news?

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Falling oil prices have been good news not only for consumers, but for many industries. Photo / Bloomberg

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By Greg Smith
OPINION:

After a traumatic first half of the year for financial markets, the second half of 2022 has started off on a much brighter note.

After losing more than 16 per cent in the six months to June, the NZX50 rallied by 5.7 per cent in July. This is the strongest monthly gain since the April 2020 rebound (after markets had lurched downwards in March 2020 at the start of the pandemic).

It is a similar story across the Tasman, where the ASX200 also rose by 5.7 per cent last month. Many other global markets, which saw steeper declines in the first half, were even more robust. In the US, the S&P500 rose 9.1 per cent last month, marking the best July since 1939.

Markets have pushed on further at the start of August.

So, what has been the catalyst?

A month ago in an article titled Peak Inflation and What That Means for Markets, I suggested that the central bank tightening processes (higher interest rates) may endure for a shorter time than was currently priced in by markets — either because the economy stutters, or perhaps because inflation is brought under control more quickly than expected. This may now be playing out.

Stock markets last year discounted rising levels of inflation as a problem associated with the pandemic, and something that would likely be transitory. Central banks then pivoted to the idea that it wasn't, a matter that was put to rest by Russia's invasion of Ukraine in February, which turbo-charged the prices of a host of commodities.

While the war continues, the heat has come out of many commodities. Crude oil has fallen towards US$90 a barrel and is down 25 per cent since pre-invasion highs. Petrol should be, and is, getting, cheaper.

Weakness in energy will be taking further heat out of inflation. Oil is endemic across most manufacturing processes and is a key input for many industries. Relief here will be welcomed, and also effectively lowers a tax on an economy which is having to wear higher interest rates.

Many base metals have also weakened, as have soft commodity prices. The price of corn has dropped by 25 per cent, while wheat has fallen by more than a third in recent months. This is likely to filter through to consumer prices for food.

So, are markets now finally pricing in the narrative that inflation might not be quite as entrenched as some are thinking? Central bank efforts to cool red-hot demand look to be having some success.

Supply chains, while not back to normal, are also slowly freeing up. Shipping costs have also eased from the record levels seen in 2021.

Backward-looking inflationary data, meanwhile, has continued to deliver some big numbers. In the US, annual inflation hit 9.1 per cent in June. But numbers this week have shown the US CPI easing to 8.5 per cent annually, less than the 8.7 per cent expected by the market.

Time for a cool change? One month does not make a trend, but US inflation moderated last month as energy prices broadly declined by 4.6 per cent and gasoline by 7.7 per cent. This countered a gain in food prices and increase in "shelter" costs.

Energy prices were always going to have a big say in the persistence of inflationary pressures.

Even stripping out volatile food and energy items, there are signs that inflation has peaked. Core CPI rose 0.3 per cent on the previous month and eased to 5.9 per cent annually. This compared to respective estimates of 6.1 per cent and 0.5 per cent. The numbers are consistent with evidence that inflationary pressures are easing across the board.

Many corporates are also seeing some cost pressures ease, including Tesla. Elon Musk recently tweeted: "Inflation might be trending down. More Tesla commodity prices are trending down than up."

In New Zealand, the CPI came in at a higher than expected 7.3 per cent for the June quarter. Australian CPI came in at 6.1 per cent for the past quarter, slightly lower than consensus forecasts of around 6.2 per cent. Tight labour markets are also seeing wages creep up (by 3.4 per cent in the year to June in New Zealand's case).

But are the June quarter inflation numbers already yesterday's "fish and chip wrapper"?

The world's central banks are clearly sticking to the task at hand (we will hear from the RBNZ this coming week) in terms of trying to get multi-decade highs in inflation down, but at the same time there are signs that the tightening that has occurred has already had some initial success.

Data out early this month showed that US manufacturing activity expanded in July for the 26th straight month. The latest Institute for Supply Management (ISM) reading registered 52.8 (anything above 50 indicates expansion), which was above estimates. While growth slowed, this was largely due to a fall in prices.

This is significant. The ISM prices sub-index fell to a two-year low, well below economists' forecasts. Cost pressures may be easing for companies, and this also supports the view that we are possibly on the other side of the inflationary hill.

Recent second-quarter GDP numbers, meanwhile, have confirmed that technically, the US is in recession. The view from central bank officials however is that the recession is not a "real" one, particularly with the economy creating around 528,000 jobs last month. This is hard to dispute.

The recent rate increase takes the Fed's benchmark to a "neutral" rate which the central bank sees as neither stimulating nor restricting growth. This sets up the possibility of the central bank (depending on economic data) tilting to a more gradual pace of increases from here and dialling back to a 50 basis points rise next month. With the economy slowing and inflation "potentially" peaking, investors seem receptive to the Fed taking the middle ground.

And as we know, generally (but not always), where the Fed goes, other central banks tend to follow. The Reserve Bank of Australia has already done so recently, with officials echoing a slightly less hawkish tone. The recent slight rise in New Zealand unemployment may set up the RBNZ to do the same this week.

Investors are looking for the corporate sector to confirm that earnings and operational outcomes are better than feared, and better than priced in by markets in the first half of the year.

The New Zealand reporting season is due to start this week, and we will have around 40 companies reporting by the end of August. However, an interesting lead can be taken from the US earnings season which is drawing to its conclusion. The majority of releases have been on the positive side of the ledger, but even for those that haven't, there have been upward share moves when outlook statements have been upbeat.

Corporates have been feeling the pressure of inflation, and this has been another theme to come out of the US earnings season. Companies with strong pricing power are handling cost inflation better than those that don't have it. Coca-Cola and McDonald's are two prime examples of companies that have been able to leverage their strong market positioning and mega-brands to pass rising costs on to consumers.

At Devon, we continue to back high-quality companies that have pricing power and strong economic moats. Even if inflation has peaked, cost pressures are not going to go away overnight. Furthermore, even if an actual recession is avoided, consumer spending could continue to be under pressure, given that mortgage bills (generally the biggest expense for most households) aren't going down too much any time soon.

A reminder of the pain from inflation being faced by Kiwi households came from Stats NZ recently. The cost of living for the average NZ household, as measured by the household living-costs price indexes (HLPIs), increased 7.4 per cent in the June 2022 quarter compared with a year ago. Higher prices for housing and petrol were the main contributors to the increase.

The HLPIs are arguably a better reflection of the cost-of-living pressures than the CPI in that they capture (rising) mortgage payments. Against this challenging backdrop, there is perhaps one ray of light. Oil prices have dropped, which could ease pain at the pumps, and plenty of other places, down the track.

Back to the original question: Are we nearing peak inflation? Certainly, the high inflation numbers clocked up recently will be hard to top mathematically, all the more so with prices of key commodities coming down. Indeed, as last week's US CPI figure may highlight, record inflation may already be yesterday's news.

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