What's Hot: The end of the tightening cycle is nigh

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The decline in the US inflation rate to more than a two-year low, marks a major step towards the end of the Fed's historic monetary tightening cycle[1]. We believe key deflationary forces are in play – (1) weaker commodity prices (2) improvement in global supply chains (3) moderation in demand (4) lower inflation expectations. Therefore, the June decline in inflation is just the start of a series of decreases.

Softer than expected inflation report

As highlighted in the chart below, the details for June were also better than expected with key measures of underlying inflation coming in below forecasts. The inflation report suggests that some of the stickier components of inflation such as used cars and airline fares are also moderating.

Source: Bloomberg, WisdomTree as of 12 July 2023.

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It's important to note that most of the rise in the June CPI can be attributed to housing, however because of the way it is calculated it tends to lag current conditions. The S&P Case Shiller Home Price Index which tends to lead CPI shelter by roughly a year, is already flat which highlights US inflation is likely headed lower. Inflation for labour intensive services such as restaurants, recreation and personal care remained higher in June reflecting the pass -through of higher wages and robust services demand[2]. Potential further softening in the labour market could bring these categories back to target consistent levels. Softening in the labour market was evident in June's employment report (nonfarm payrolls rose by 209k versus consensus 230k) which was weaker than expected for the first time in 15 months[3].

US Producer Prices confirmed a similar deflationary theme. The US Producer Price Index (PPI) inflation for June was softer than expected with headline and core PPI advancing 0.1% over the prior month[4]. Business surveys are also pointing to weakening pricing power, such as the Institute of Supply Management (ISM) services index which ties in with a lower inflation backdrop.

US inflation can't prevent the July rate hike

While expectations for the July rate hike of 25Bps remain firmly in place, the market has scaled back expectations for a second hike – with 21bps / 3bps / 3bps of hikes priced for the July / September /

November FOMC meetings[5]. The disinflation trend increases our belief that the Fed is close to, or will be, at the end of the current rate hike cycle.

Earnings take centre stage for the next leg of the rally

The key question now remains whether the market continues to trade off expectations of an easing narrative. Central bank policy has been the biggest drag for equities last year. The timing of the easing narrative comes at the heels of a volatile Q2 2023 earnings season. The S&P 500 Index earnings in the Q2 2023 are expected to decline 6.8% y/y, worse than the decline of 3.9% in the Q1 2023[3]. This would be the largest earnings decline since the pandemic-fuelled 31.6% y/y decline in the Q2 2020. Earnings will be the key deciding factor for an extension in the current rally.

Investors will be keen to hear from management whether they are looking to adopt a leaner cost structure and ways they are looking to remove excess capacity. Investors will be looking for guidance on productivity and efficiency gains rather than the financial engineering we have witnessed over the past decade.

[1] Bloomberg 12 July 2023

[2] Bloomberg 12 July 2023

[3] Bloomberg 7 July 2023

[4] Bureau of Labor Statistics, 13 July 2023

[5] Bloomberg as of 13 July 2023

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