

Wentz Weekly

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With Higher Inflation, Is the Fed Behind the Curve?



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Consumer inflation continues to run at a hotter pace than economists and the Fed have expected, reflected again in the most recent consumer price index report from last Wednesday. The index shows prices rose another 0.6% in January and are 7.5% higher from a year ago, the fastest increase since 1982. Inflation is not just being felt in areas that were sensitive to the pandemic and the accompanied supply chain shortages, like cars and energy (gas) prices, but is broadening and being seen in areas that tend to be stickier, such as shelter (includes rent/owner's equivalent rent). Core prices, which exclude the often volatile food and energy categories, rose 0.6% in the month and 6.0% from a year earlier, also the highest in 40 years.

Consumer prices have shown no signs of slowing down, although we expect year-over-year rates to come down due to the base effect, and shows inflation has never been transitory. The Fed now admits it recognizes that while suggesting it is also late in recognizing that. As a result, there is now a wider belief the Fed will choose to "front load" the process of raising rates, by doing more rate hikes sooner to combat inflationary pressures, rather than a longer and more gradual rate hike cycle. On the same morning as the inflation report St. Louis Fed President James Bullard said he would favor a 50 basis point rate increase in March and would like to see rates 100 basis points higher by June. While Bullard is just one Fed voting member, his thoughts may provide hints on what the Fed's rate setting committee is thinking. Immediately following the inflation report and Bullard's comments, the futures markets were pricing in about a 95% chance of a 50 basis point increase in March versus just 30% in the morning. While the markets should be able to handle this, it reflects the Fed admitting it is behind the curve. This expectation is also causing a tighter spread between short-term and longer-term yields and moving the curve closer to an inversion (when shorter dated bond yields are higher than longer dated yields). This, in addition to the geopolitical concerns in Eastern Europe as it appears Russia is preparing to invade Ukraine, are all things we continue to monitor. We believe we will continue to see weakness in the markets will this uncertainty and prefer high quality, strong cash flow, income producing investments.

Equity markets were rebounding on Friday until early afternoon when the U.S. National Security Advisor urged U.S. citizens, along with the UK warning its citizens, to leave Ukraine as soon as possible in a White House briefing. The warning comes after U.S. intelligence reports a Russian invasion of Ukraine could take place over the next several days and could happen before the Olympics conclude. There are mixed reports saying Putin has already chosen to go to war in Ukraine, due to the military buildup and exercises on its border. Russia denies the possibility, suggesting it is just internal troop movement. Russia has responded to the US and European allies calls for de-escalation by insisting NATO pulls back its activity in Eastern Europe. The US and its allies have threatened Russia with severe economic sanctions if Putin follows through.

The US trade deficit increased to an all-time high in 2021, increasing 27% to \$859.1 billion (i.e. the U.S. imported \$859.1 billion more in goods and services than it exported in the year). Trade data shows the deficit widened again in December to \$80.7 billion, matching the largest monthly deficit ever. The wider deficit was due to a \$4.8 billion increase, or 1.6%, in imports to \$308.9 billion, while exports rose just \$3.4 billion, or 1.5%, to \$228.1 billion. The 2021 trade gap well exceeded the previous high of \$763 billion in 2006. The wider deficit underscores the strength of the U.S. economy, which is struggling to keep up with demand. Adding to the deficit was lower levels of service exports and lower exports to China, despite the Trump trade agreement made several years ago. The deficit with China reversed its shrinking trend in 2021 and grew by 15% in the year with China buying just 57% of the goods and services it committed to purchase over 2020 and 2021 under the Trump trade agreement. Biden officials said they are committed to having China comply with the agreement's terms but have yet to disclose how.

Walt Disney Co bounced back last week with strong fourth quarter 2021 results. The company said subscriber additions for its Disney plus streaming service picked up pace and reported 11.8 million more Disney plus subscribers, well above the 7.8 million additions that was expected. Adding on to strength in its streaming services was the parks/resorts segment that reported record operating income results thanks to a surge in spending in its parks. The company expects to spend another \$33 billion on new content this year, which it expects to drive subscriber additions, and points to its success with recent films such as Encanto and Luca. The company is still forecasting 230 to 250 million subscribers across its platforms over the longer-term.

Company News

- Interactive fitness company Peloton said its co-founder and CEO would be stepping down and is making moves to cut costs including laying off 2,800 employees (20% of its corporate positions), while reducing capital expenditures by \$150 million, resulting in cost savings of \$800 million. The company recently was reported to halt production of its exercise bikes due to softening demand.
- Nvidia said it has decided to terminate its planned acquisition of semiconductor and software design company Arm Holdings from SoftBank due to regulatory issues with approving the deal. Nvidia will pay a \$1.25 billion breakup fee. SoftBank reportedly plans to IPO Arm Holdings.
- Shares of Alibaba were on a roller coaster ride last week with reports on Softbank's stake in the company. It was first reported Softbank was looking to sell its 24% stake in the company, then shares recovered after Softbank said it will not be selling shares.

The Week Ahead

Fourth quarter earnings season continues on this week with roughly 60 S&P 500 companies set to report. Notable reports include Advanced Auto Parts on Monday, Airbnb, ViacomCBS and Wynn on Tuesday, Cisco, Kraft Heinz, Nvidia, and Shopify on Wednesday, Walmart and Roku on Thursday, and Deere on Friday. The week will include another inflation reading in the producer price index where estimates see a 9.2% increase in prices that producers pay. Several reports on the housing market are released including new housing construction and permits on Thursday and existing home sales on Friday. In addition, manufacturing survey results are released from the New York region on Tuesday and Philadelphia region on Thursday, along with the January retail sales report on Wednesday and weekly jobless claims report on Thursday. The FOMC meeting minutes are released Wednesday which could give investors additional clues on the pace of monetary policy tightening after another month of strong economic data.

The S&P 500 is an unmanaged index of 500 widely held stocks that is generally considered representative of the U.S. stock market. The Dow Jones Industrial Average (DJIA), commonly known as "The Dow" is an index representing 30 stock of companies maintained and reviewed by the editors of the Wall Street Journal. The Russell 2000 Index measures the performance of the 2,000 smallest companies in the Russell 3000 Index, which represent approximately 8% of the total market capitalization of the Russell 3000 Index. The NASDAQ composite is an unmanaged index of securities traded on the NASDAQ system. Every investor's situation is unique and you should consider your investment goals, risk tolerance and time horizon before making any investment. Sector investments are companies engaged in business related to a specific sector. They are subject to fierce competition and their products and services may be subject to rapid obsolescence. There are additional risks associated with investing in an individual sector, including limited diversification. Information contained herein was received from sources believed to be reliable, but accuracy is not guaranteed. Information provided is general in nature and is not a complete statement of all information necessary for making an investment decision and is not a recommendation or a solicitation to buy or sell any security. Investing always involves risk and you may incur a profit or loss. Keep in mind that individuals cannot invest directly in any index. Past performance does not guarantee future results. There is no assurance these trends will continue, or forecasts will occur.