Overheard late last Friday afternoon in a conference room at Everly Investment Management, high above midtown Manhattan, one stock market maven to another:

Wake up, little Susie, wake up!
We’ve both been sound asleep
The market’s over, it’s four o’clock
And we’re in trouble deep.

For most of the summer, American equity portfolio managers apparently were dozing through their workdays, perhaps dreaming of weekends in the Hamptons. Stock prices rose through July and August, as inflation data began appearing less bad, and as hopes rose that perhaps the Fed would declare an early victory in its campaign to curb consumer prices through interest rates.

Yet throughout the summer, Federal Reserve officials were consistently saying exactly the opposite: The nation’s central bank would not let up until inflation had returned to its 2% target level. The drop in the consumer price index from 9.1% in June to 8.5% in July was a nice first step, but nowhere close to the end of the road. And so, when Fed Chair Jerome Powell used eight minutes of his Jackson Hole retreat to remind investors that the Fed was serious, alarm bells rang all over Wall Street. Stocks tanked 3% on Friday, but they are still well above their mid-June lows. In contrast, bond market investors – who apparently weren’t daydreaming about the Hamptons – took Mr. Powell’s comments in stride, as bond yields barely budged on Friday.

Inflation isn’t going to disappear overnight. Its character has mutated over the course of the past 18 months, and it is different here than it is in Europe or Asia. When inflation first showed up midway through the pandemic, the Fed was quick to blame supply chain problems and product shortages caused by Covid lockdowns; in this view, inflation was transitory and would dissipate as soon as the world’s economies resumed their normal footing.

What wasn’t noticed initially was the beginning of a demand problem. Consumers spent the lockdown months using their stimulus payments to buy stuff, and we kept at it even after we returned to work and the economy began to look more familiar. We also began shifting more of our spending from stuff to service. We resumed traveling, and eating out, and going to Red Sox games, and pretty much everything else we used to do. Spending rose much faster and for much longer than the Fed expected.

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1 This seems about right to me: Inflation is indeed a tad better, and second-quarter earnings reports were likewise not quite as bad as investors had feared. It makes sense that stock prices are modestly above their recent bottoms, but also that they are far below the heights they reached before the Fed got serious about raising rates.
As the main impetus of inflation shifted from insufficient supply to excessive demand, and from goods to services, two things happened: First, inflation kept rising, defying the idea of a “transitory” spike in prices. Second – and this is the scary part – it became stickier. To see why, consider these three pictures of inflation:

Chart 1 shows the rate of price increases for several important categories, as well as for the economy as a whole. The two categories with the highest price increases, energy and vehicles, have been leading the way for months – the former because of limited drilling activity even before the disruptions in global energy supplies that followed Russia’s invasion of Ukraine, and the latter because supply chain problems caused severe manufacturing delays at the world’s major automakers. It would be easy to read this chart and conclude that inflation would shrink rapidly when American energy producers sniffed higher profits and started pumping more oil, or as soon as car manufacturers could get their hands on needed semiconductor chips.

That’s not what happened. Since early summer, energy prices have come down sharply – a barrel of crude is now about $94, down from $124 earlier this year – and supply of new motor vehicles has improved markedly. Yet the overall inflation rate has only inched down. The reason for the apparent disconnect is that these two categories – energy and vehicles – aren’t a very big part of the overall picture.

When the government’s bean counters survey prices, they do so according to a hypothetical shopping basket, apportioning different weights to different sectors. Chart 2 shows the most recent composition of the consumer price index. Energy (including gasoline, heating oil, natural gas, and all other forms of household energy consumption) constitutes only 5.6% of the hypothetical consumer’s budget; vehicles (new and used) add another 4.4%. Together, these two categories make up only 10% of consumers’ expenditures. Prices are volatile – both upward and downward – but they don’t sway the overall index as much as one might imagine.
The big slices of the consumer spending pie are shelter and food; for the purposes of this chart, all services and other categories are lumped together as “all else.” Energy and food prices tend to be volatile, rising and falling with geopolitical events and the outcomes of crop harvests. Prices in other categories tend to be stickier – they go up, but they don’t go down. So when consumer spending shifts from goods to services, it is also shifting from items with volatile prices to items with more stable prices. With this in mind, Chart 3 tells a worrisome story.
This chart shows the \textit{contribution} of price changes in selected categories to the overall inflation rate – the product of each category’s inflation rate and its weighting in the shopping basket. Last December, as shown in the left column, the high price increases in energy and vehicles were responsible for more than half of the total 7.0\% inflation rate; today, they constitute little more than one-third of total CPI, mostly because used and new vehicle prices have come back to earth. Conversely, the contributions of food, shelter, and “all else” rose substantially over the course of this year, from very low levels.

As the Fed thinks about the future course of inflation, it can probably put food prices to the side. Prices will adapt reasonably quickly to developments in Ukraine and Russia, which likely can’t get much worse and which might begin to improve as exports from those countries begin to reach world markets again. Food supplies from other countries (including the U.S.) can also be redirected rapidly. Prices have risen since the war began, but it’s fair to suggest that the trajectory will likely plateau or decline in the near future.

The shelter and “all else” categories are much more concerning. Housing prices have risen sharply since the pandemic began, and they continue to grow at double-digit rates. Yet Chart 1 shows that “owner-equivalent rent”\textsuperscript{2} has grown by only 4.1\% over the past year. Housing shortages exist in many cities, as inventories nationally are at about 3.1 months of sales; anything below about five months is considered a tight market. As the shocking increase in mortgage rates this year drives more consumers from buying to renting their homes, we expect rental rates to rise unusually quickly.

Referring back to Chart 2, shelter constitutes 31.7\% of the hypothetical consumer budget. Even small increases in rental price inflation have a big impact on the contribution of shelter to overall inflation; just that 4\% increase this year has added a half-percentage point to overall CPI. As higher rental prices filter through the economy, we should expect substantial upward pressure on CPI because shelter is such a big slice of the pie.

Similarly, the “all else” grouping includes many categories that, while individually small, add up to a big part of consumer spending. These categories include travel, dining, leisure, health care, and all other services. Most of these categories saw very low inflation through the pandemic years, which helped keep overall CPI down. Today, however, the combination of a tight labor market, higher food and fuel costs, and recovering demand are all adding to inflationary pressures. Chart 3 shows that the contribution of the “all else” group added more to CPI than any other category this year.

As shelter and services become more important contributors to the overall inflation picture, the Fed must recognize that they share two characteristics: Their prices are more reflective of demand than of supply, and they tend to be sticky. The Fed really has no choice; it must attempt to curb demand in order to prevent these two categories from pushing inflation higher even as prices of energy, vehicles, and food begin to soften.

\textsuperscript{2}Think of the price of a house as consisting of two parts: the real estate itself, and the right to live in it. The CPI only includes the latter part.
All of which brings us back to those two panicked portfolio managers at Everly Investment Management. They were clearly expecting the Fed to declare victory, or at least to offer a “victory is in sight” pep talk; as Chart 4 shows, investors overall have been expecting inflation rates to return to about 2.5% over the next several years. Yet what Mr. Powell delivered last Friday was a “blood, toil, tears, and sweat” admonishment. Mr. Powell quite clearly and emphatically said that the danger of persistently high inflation is greater than the harm of a possible recession; the Fed is prioritizing inflation control over recession avoidance.

![Chart 4: Inflation Expectations](source: Bureau of Labor Statistics)

The Fed Chair’s comments should not have been a surprise; they are consistent with the same message the central bank has been promulgating for months. Nor should the possibility of recession be surprising: I suggested two months ago³ that the U.S. economy is likely headed that way, and nothing has happened to change that point of view.

The data bear out this forecast. The Index of Leading Economic Indicators has been pointing to contraction for six of the past seven months, as shown in Chart 5. Jobless claims (Chart 6) have been rising for most of this year, and job openings (Chart 7) are noticeably down as well.

![Chart 5: Index of Leading Indicators](source: The Conference Board)

None of these indicators suggest a severe or steep recession, but all of them do point toward a mild contraction in overall economic activity. Yet Wall Street still thinks that corporate earnings will continue rising (albeit at a slower pace) through the next year. That’s probably an overly optimistic view; don’t be surprised if earnings estimates begin to drift lower later this year, especially around the time that companies begin reporting their third-quarter earnings in mid-October. We are remaining fully invested, of course, but our clients’ portfolios are still tipped toward more defensive sectors and companies; while we may have already seen the worst, we wouldn’t be surprised to see further weakness in the near future. Eventually, the Fed will indeed declare victory over inflation, but it may take a while.

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