The Change in the Change Can Change

How confusing is it when the gyrations of economic data causes the markets to swing from expectations of a booming economy to fears of impending stagnation? Reading the "tea leaves" is our business, but the volatility in sentiment isn't just about whether the leaves are good or bad, but rather follow the change. Do green shoots indicate fresh new growth or are the tea leaves withering? This latter analysis is the view of "second order" effects. The change may look good (i.e. the pace of the economy), but it is the change in the change, or rather the change in the rate of change to which market participants seem to instantly overreact.

We have previously written how we are in the midst of a booming economic recovery from the pandemic shutdown. However, we believe that it will come with higher sustained price inflation than markets previously expected. Our opinion stated in the February 2021 client newsletter titled, *The Great Inflation Awakening*, has not changed. In fact, the 6.2% year-to-year Consumer Price Index (CPI) change blows away all previous forecasts and any argument in favor of the belief that rising price inflation would be "transitory." Even Treasury Secretary Janet Yellen and Federal Reserve Board Chairman Jerome Powell have now confessed that higher than expected price inflation could last at least through the middle of 2022 before beginning to fall back to the 2% target. Don't bet on it falling quickly.

This is our first example of the change in the change changing. Take a look at the sequence in monthly CPI changes over 2020 and 2021 in the table below, followed by the year-to-year rate of change in the price index in the bottom row (through October).

Monthly and Year to Year CPI Percent Changes

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec
2020	0.2	0.1	(0.3)	(0.7)	(0.1)	0.5	0.5	0.4	0.2	0.1	0.2	0.2
2021	0.3	0.4	0.6	0.8	0.6	**0.9**	0.5	0.3	0.4	**0.9**		
2021 Yr/Yr %	1.4	1.7	2.6	4.2	4.9	**5.3**	**5.3**	**5.2**	**5.4**	**6.2**		

Source: Bureau of Labor Statistics (www.bls.gov)

When the economy shut down in March of 2020, naturally businesses slashed prices to retain any customers they could to survive, but as the economy began to reopen in June, the CPI index rebounded by 0.5%. This was also not surprising, but its persistence is the issue both the Treasury and Federal Reserve Board have chosen to ignore. Furthermore, the change in the change shifted rapidly higher in the first six months of 2021, peaking out a 0.9% in June. Rather than recognizing that the 5.3% year to year rise was a serious problem, Fed Chairman Powell in his June press conference stated it was transitory because:

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1. It only rose due to "base effects," meaning the year-to-year change was high due to the negative monthly CPI comparisons in March through May of 2020.
2. It would subside when the supply chain problems were resolved and shortages ended.

The base effects are now gone—they proved transitory. The supply chain problems have gotten worse. And the Fed is still printing money and suppressing interest rates with its bond buying program. And everyone has gotten the message—buy before prices go up further! The result will likely be a higher for longer change in the rate of change in inflation. If the monthly CPI change moderates to only 0.4% in November and December, the year-to-year change will still reach 6.5% by yearend! The highest such measure in over 30 years.

But what about the real economy? Isn't demand slipping? Our answer is not really. Yet, every day new data points offer changed perspectives on the outlook. Diffusion indexes, among many others, tell the story, both up and down. A diffusion index represents a survey of business conditions (some from purchasing managers) as to what percent of businesses are seeing improving or deteriorating conditions. With the Institute for Supply Management (ISM) manufacturing and non-manufacturing indexes, any reading above 50% suggests the real economy is expanding and index values above 60% indicate a robust level of activity. Below, the January 2020 levels before the pandemic driven disruption are a base and an indication of more normal levels. The rest of the table below takes a quick look at that month's overall index values and the "Prices Paid" sub-indexes along with the high that each hit in the spring of this year, the summer lows and the October recovery.

Index and Sub-Index Levels	January 2020	Spring High March to June	Summer Low August to September	October 2021 Rebound
ISM Manufacturing (Overall)	50.9	64.7	59.5	60.8
ISM Non-Manufacturing (Overall)	55.5	64.1	61.9	66.7
ISM Manufacturing Prices Paid	53.3	**92.1**	**79.4**	**85.7**
ISM Non-Manufacturing Prices Paid	55.5	**82.3**	**75.4**	**82.9**

Source: Institute for Supply Management (www.ismworld.org)

Note that from the spring of 2021 through October of this year, both the ISM manufacturing and non-manufacturing indexes indicated a robust level of economic expansion with index levels near or above 60. The levels are more important than the change. This year's summer slowdown, during which the change in the level was negative, was primarily due to the surge in Delta variant cases. Yet the levels remained high, and the change (rise) from the summer lows was restored to an even higher level of business momentum for non-manufacturing companies, previously the weakest part of the economy.

The Prices Paid Index experienced a positive change in the change in the index all the way to the extraordinary spring highs at which time 92% and 82% of business respondents indicated prices had risen. This is an indication of red-hot pricing pressures—which the Fed has also ignored. With values currently in the 80's, there is no sign that inflationary price pressures are abating. Will the latest news regarding the Omicron variant change these pressures? Not likely as economic lock downs tend to reduce supply relative to demand.

COVID cases in the U.S. have seen an accelerated change to the upside and to the downside depending on where you are. The change in the change of late has generally been rising in northern states where case rates were recently low and falling in southern states where they had previously surged. Yet with the increased adoption of vaccines and improving therapeutic drugs becoming available, COVID should begrudgingly turn into a more manageable endemic disease. While frustrating, this would allow the U.S. economy to regain its robust growth stage after the transitory slowdown of the summer.

And if you don't like today's data points, just know that the change in the change can change—tomorrow.

So don't freak out if your stocks periodically go haywire from the change in the change. Remember the importance of a long term investment outlook and instead enjoy this coming holiday season in thankfulness.

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