Rochester Wealth Strategies

439 S Main St, Suite 250
Rochester, MI 48307
(248) 434-6550

Data Dependency in Action

By Mike Skoric

All year we have used the term "Data Dependency" to help describe a market that makes big and often unexpected moves based on various data points that are reported each month. This would typically include information on employment, inflation, consumer sentiment, corporate earnings, GDP, etc. We recently had a perfect example of this sensitivity on September 13th with the Consumer Price Index (CPI) reporting monthly inflation for August of 8.3%. Despite being the third consecutive month of decelerating annual inflation (9.1% in June and 8.5% in July) – this was still higher than the consensus 8.1% forecast. The market was primed for a lower figure, eagerly awaiting even stronger signs that inflation has peaked and started falling. This would then allow the Federal Reserve to slow and eventually end the aggressive pace of interest rate hikes. However, it was not to be, and stocks experienced their biggest one-day drop in over two years, falling around 4% and giving up most of their strong gains from earlier in the month.

Despite the lower-than-expected drop in inflation, we are encouraged by the slow but declining year-over-year trend. There will be high anticipation for the next monthly CPI report which will be published on October 13th. We expect that the steady pace of interest rate hikes will slow the broader economy and help reduce the demand for goods and services; in turn, leading to a continued reduction of inflationary pressure. The modest deceleration in CPI has been helped by falling energy prices, and hopefully higher interest rates and the resulting slowdown in home price appreciation will also lead to a meaningful slowdown in rent appreciation. This is critical because the CPI accounts for housing inflation by looking at "Owners' Equivalent Rent (OER)," which is designed to measure what homeowners would have to rent their homes. Given that we are in the second year of double-digit rental growth nationwide – the OER metric has been a key driver of inflation data. This is especially true for the "Core CPI" metric that the Fed focuses on and where OER has the largest single weight at around 40%.

In addition to inflation, investors will continue to look for direction in the coming months from GDP data. We are hopeful that this figure will be modestly positive for the 3rd and 4th quarters of 2022. This would at least lower fears of an imminent recession despite two prior quarters of economic contraction. We also need to see corporate earnings growing at high single-digit levels to justify the still rich equity valuation levels. While we still see near-term challenges in the equity market, the clouds are slowly clearing over the fixed income market. Yields have risen to attractive levels of over 5% for investment grade corporate bonds with 5-year maturities. And similar after-tax yields can be found in municipal bonds for tax-sensitive investors. We just need to see a few more months of falling inflation to confirm that rates/yields have likely peaked in order to have a greater conviction level; allowing us to comfortably capitalize on the relatively safe and most intriguing bond yields we have seen in years.

As always, we continue to closely track all relevant developments and look for emerging trends and opportunities that may result in more attractive risk-adjusted return opportunities.