Ropes Wealth Urges Caution on Cooling Inflation

The focus of the markets this week was squarely on inflation, and some relief was finally delivered with a modest cooling of prices reported. July's CPI report (Consumer Price Index) was probably as good as the market & Fed could have hoped for, showing a decline from 9.1% to 8.5% year-over-year. Likewise, July's PPI report (Producer Price Index) showed inflation slowed from 11.3% to 10.4% year-over-year, in another hopeful sign for investors that inflation pressures may have peaked.

The headline inflation figures decelerated at a faster than expected pace, thanks in good part to cooling prices at the pump, down -7.7% from last month. Retail gas prices have dropped to $4/gallon as of yesterday, compared to the July average of $4.53/gallon. Aside from energy, core goods inflation also slowed as prices for used cars, apparel, and education (which includes electronics and computers) also dropped. Services inflation was more sticky, though travel-related categories notably turned around with declines in prices for airfares and hotels. All in all, it would seem pressures from commodity prices, supply chain issues, and reopening (travel) are finally starting to fade.

Even so, while investors are anxious to call a peak in prices and put forth a view that the worst of cost pressures are behind us, Fed policy makers have been clear they need to see several months of a significant reduction in prices before the Committee will be convinced inflation is on a sustainable downward trend. For this reason, we are wary of some of the current market rhetoric that this data changes the Fed's course for an interest rate hike at the September 21 meeting. There are still plenty of economic reports to be released between now and then, including August inflation numbers. Their policy decision next month will likely be based on the nominal level of growth still near a four-decade high, as opposed to the market's perception of a modest second-derivative decline. This Fed is on a focused path to get control over the problem, restore their credibility, and protect their legacy.

In other words, even as we are enjoying some of the relief rally in stock prices over the last six weeks, we are mindful that rising interest rates, elevated inflation, and supply chain issues remain formidable operating headwinds for companies that must still be factored into valuations.

To that point, labor, housing costs, and food costs continue to push higher in a relentless upward trend that will continue to put pressure on consumers and businesses, despite relatively lower pump prices. We think these costs continue to be an issue, which is likely to put a floor under inflation around 4%-5%, still well above the Fed's target rate of 2%. In order to shed that excess inflation, the Fed will have to create slack in the labor market which will require a more significant policy overshoot. For this reason, it is very possible, and even probable in our view, that the fed funds target interest rate will reach 4% next year. It is at a range of 2.25%-2.50% today.

We remind our readers that well managed companies can perform well in periods of higher interest rates and higher inflation, which is why we reiterate our mantra of quality in this day and time. We will no longer be operating in a Fed-financed, liquidity-boon environment where capital flows freely to companies indiscriminate of their underlying quality. Fundamentals will matter again, and the ability to be profitable in the face of these headwinds will separate the strong from the weak. It is also true that now is not the time to count out the companies that represent the transformational trends and themes of the future. Indeed, the megatrends of digital transformation, healthcare innovation and sustainability will continue to drive research and development, investment, and value creation. We are therefore making careful shifts to rotate capital in the direction of quality but view that there is a balancing act to navigate in this moment. We don't want to shun the leaders of the future for the security of today. Diversification is therefore critical, and as ever we are grateful for your support of that approach and your trust in us.

Thank you for your interest in our investment commentary. If you would like to speak personally with a member of our team at any time, please click **here**.

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