Bridgewater®
Daily Observations
June 13, 2022 ©2022 Bridgewater Associates, LP

(203) 226-3030
Jason Rotenberg
Nikolai Doytchinov
Archie Hall

It Will Take a Minor Recession to Get Inflation to Fall Much and a Major One to Get Inflation Back to the Fed Target

Weaker equity prices continue to reflect higher discount rates, not a recession. But rising rates and lower equity prices do make at least a mild recession and modest dip in inflation increasingly likely.

Inflation continues to be the main driver of monetary policy and markets. The market action to a broadly strong CPI print was consistent with more tightening being needed to bring inflation down but not much of a rise in discounted inflation. For now, the economy is still growing, and inflation is too high for comfort, so bringing it down is likely a more important policy priority than avoiding a contraction or worrying about the equity market action. Once the economy begins to weaken in response to the tightening in financial conditions, while inflation stays sticky, the trade-offs for the Fed will become more difficult and the range of policy actions less predictable.

The current inflationary process is self-reinforcing and sticky. We see inflation differently from market pricing and consensus expectations. Rising nominal wages drive nominal spending, which in turn makes it easier for companies to raise prices and wages. This is a self-reinforcing dynamic that will require a tightening and real economic contraction to reverse. This is how business cycles work, with higher rates slowing real economic activity, employment, and then eventually inflation with a lag. It will likely take a material real contraction to get inflation to fall as much as discounted and close to the Fed target.

Moderation in inflation from supply issues easing may be a 2023 story. While the dynamic above is dominant in our view, it is still important to understand each major driver. As we walk through below, we do expect some moderation in inflation, but probably not immediately. Goods inflation will eventually ease as auto production comes online and the commodity flow-through to inflation fades, but these are mostly 2023 stories. Commodity prices will drive core inflation higher for the remainder of the year. Housing inflation will remain high as the market remains tight and leases turning over this year are poised to reset at much higher levels. But the most important driver of lower inflation is economic weakness. And we do see the financial tightening and higher commodity prices leading to a modest contraction in economic activity—just not enough economic weakness to get inflation to target.

We expect higher-than-discounted inflation and lower-than-discounted growth rates. We are still positioned for higher discounted inflation and higher bond yields, even as we also see a contraction and further equity sell-off ahead. Inflation is at this point the most important driver. But the possibility of a tightening pause once the economy and inflation turn makes these bets less compelling to us than they were. The strong CPI print made the short-term risks of a turn in inflation less likely.

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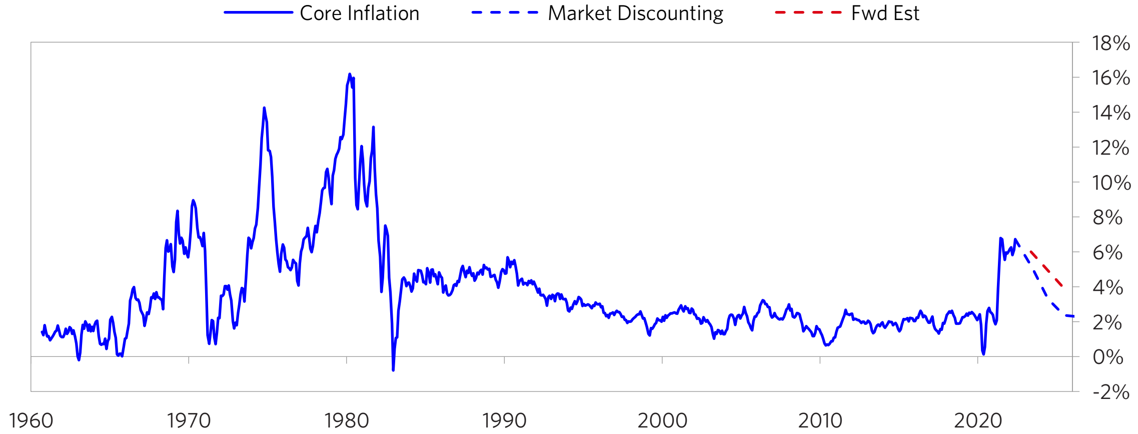
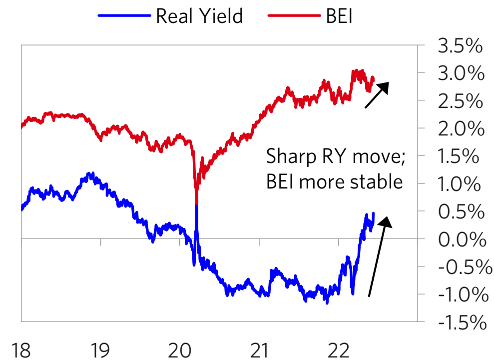


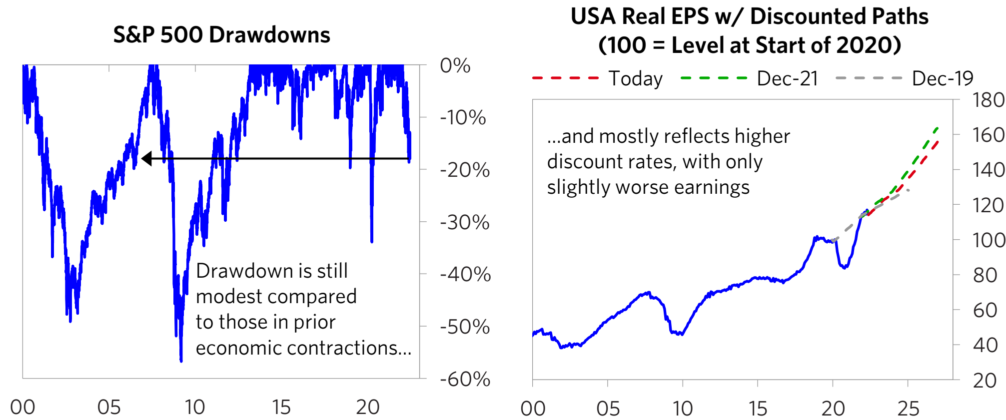
High and Sticky Inflation Is Driving Tightening Market Action

Friday's market action was consistent with the pattern we've seen over the last several months: in response to the upside surprise in the magnitude and breadth of inflation, markets discounted more Fed tightening and that this tightening would be mostly enough to contain the inflation with only a mild hit to growth.

Bond yields rose 12bps, with almost all of the move coming from rising real yields, while discounted inflation barely ticked up. The rise in yield was sharpest at the short end of the curve. The 2-year rate surged 25bps, about twice as much as the 10-year rate.

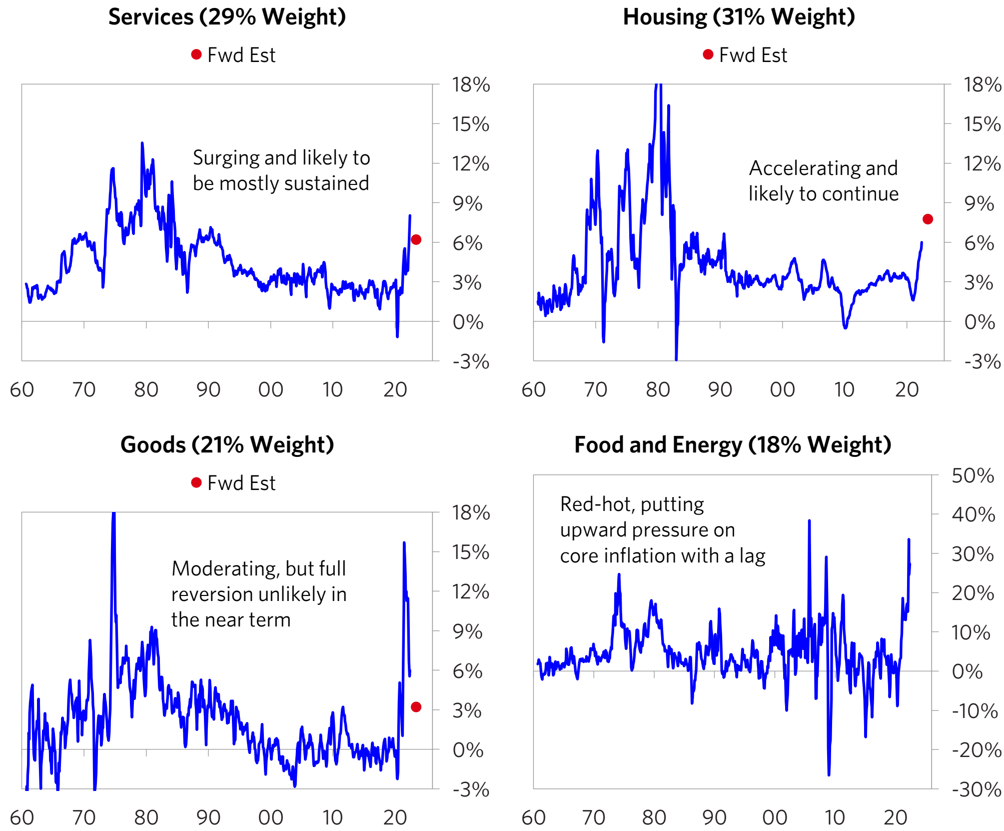


The equity bear market deepened, with the S&P 500 falling 2.9%, and the longer-duration, tech-focused Nasdaq down 3.5%. Still, equities are far from pricing a recession. Since the beginning of the year, the vast majority of the equity drawdown has been attributable to higher discount rates—government bonds of similar duration have sold off about as much as stocks—not to a hit to expected cash flows. While this sell-off isn't discounting a real contraction, it does make one more likely, reversing some of households' wealth gains during the pandemic and weighing on their willingness and ability to spend.



In the rest of today's *Observations*, we discuss the major cross-cutting pressures we see on core inflation. But first, to summarize how these affect each component:

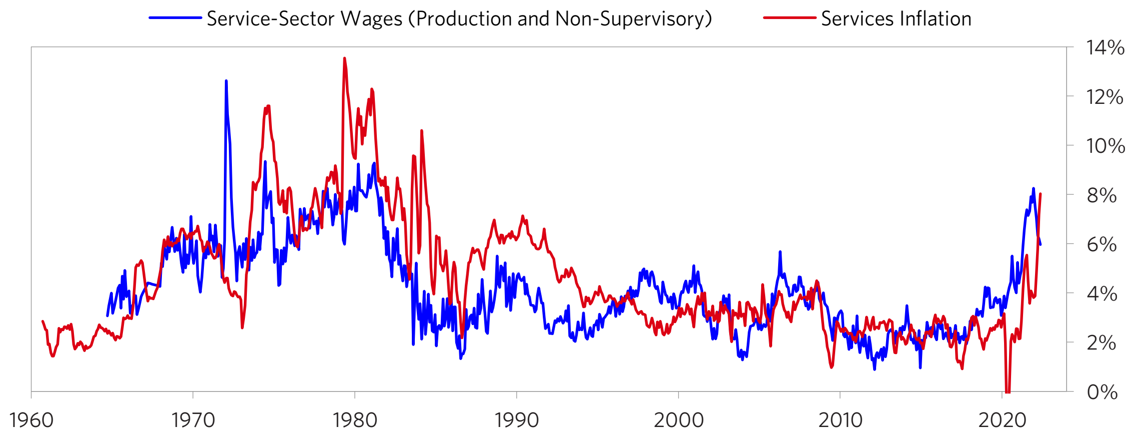
- **Services** inflation has surged, driven by a rotation of demand back into these sectors and strong wage pressures (especially for hourly workers), with further supports from the spikes in fuel and food costs. While wage growth has moderated slightly, we continue to see an extremely tight labor market and rapid services demand growth and expect services inflation to be sustained near its current high level.
- **Housing** inflation has also accelerated, reflecting inadequate housing supply relative to strong demand. This dynamic has been particularly pronounced in the home purchase market and on new leases, and we expect it to continue flowing through to the broader rental market over the next year. While the impact of tightening on home sales will bite, this will take longer to flow through. A lot of rents will reprice at higher levels through time. We net these pressures to expect very strong housing inflation in the near term.
- **Goods** inflation has slowed over the last few months as the extraordinary surge in demand has faded and some bottlenecks have improved. The pressures are more cross-cutting going forward. We expect the downward effect of the normalization of COVID spending patterns and supply chain moderation to outweigh the upward impact of commodity price flow-through and disruptions from China's lockdowns over the next year, but the range of outcomes is wide. Moreover, the drags are mostly far out while the supports are imminent, so we would expect much of the downward move to come in 2023.



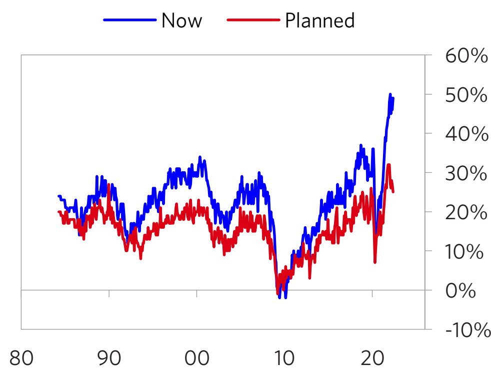
Below, we walk through the major pressures we see on inflation in more detail.

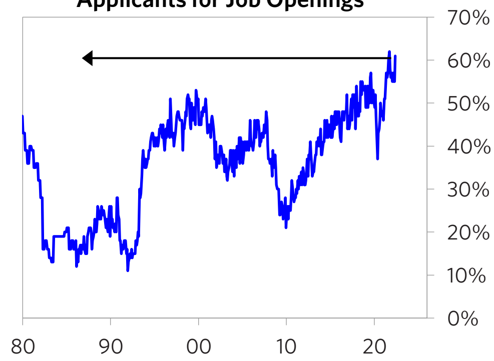
The Tightest Labor Market in a Generation Will Keep Wage Growth High—and Inflation with It

Demand for labor has vastly outstripped supply. Wage pressures are strong and self-reinforcing. Historically, wages have moved closely in line with inflation, especially services. On a backward-looking basis, the softness in the headline wage number from the payroll report is the only thing that looks weak. Surveys of consumers and businesses point to continued tightness in the labor market and strong wage pressures. Looking ahead, however, we do expect the economy to stall or contract modestly, so there may be a bit less pressure as this slowdown narrows the gap between labor supply and demand.

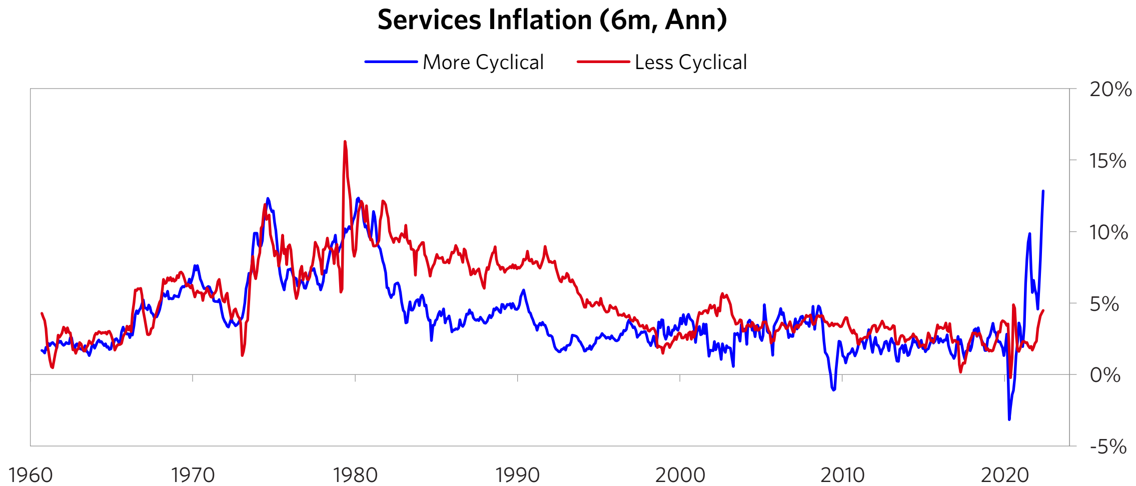


Surveys of businesses point to extremely strong current wage pressures, with some moderation expected in the months ahead.





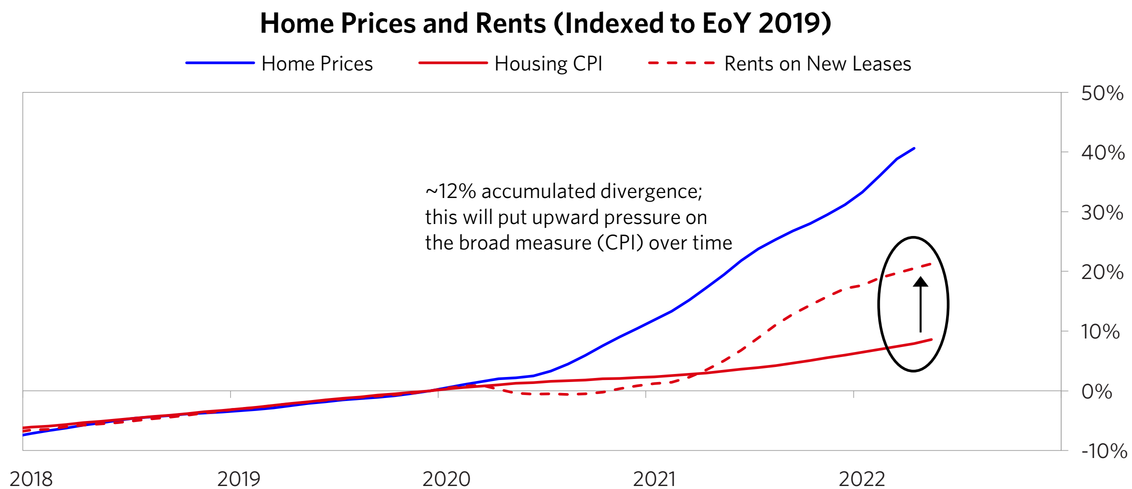
Inflation in more cyclical sectors is very strong (partly due to labor market tightness and partly due to the surge in commodities prices), but less cyclical sectors are also now at the high end of their recent range. It takes time, but even less cyclical services like healthcare and telecommunications are not immune to the pressures of rising wages and equipment prices, and we have started to see accelerating inflation.



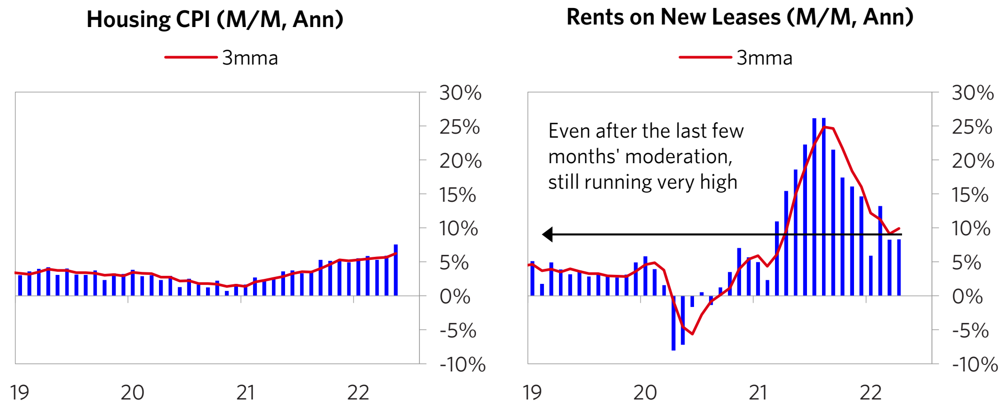
Red-Hot Housing Demand Is Flowing Through to Inflation with a Lag

Housing inflation is now at multidecade highs, and we see continued upward pressure. Over the last year, home prices and timely measures of rents on new leases have surged, reflecting strong demand and short supply of homes both for purchase and for rent. The increase in the CPI's measure—which estimates average rents in the economy as a whole—has trended up more gradually, though the sharp acceleration in this component (a month-over-month increase at a 7.6% annualized pace) was a major driver of the strength of Friday's print and likely to be sustained.

The difference between these measures doesn't mean that the CPI measure is wrong. The timelier data often captures tenants who are proactively moving and are seeing larger rent increases, while landlords renewing existing leases are often cautious to avoid the expense of lease turnover. But as rental units gradually turn over, rents will reset at higher levels, sustaining housing inflation in the ballpark of this month's print or higher. Home prices are more likely to flatten out or fall based on the rise in rates but do not figure directly in reported inflation. And in the near term, the backward-looking surge in home prices, coupled with the spike in mortgage rates, will only add to strong rental demand as some prospective buyers find themselves priced out. Given the limited new housing supply coming online, continued strength in demand, and historically poor rental inventories, we net the forward-looking picture in a clearly bullish direction.



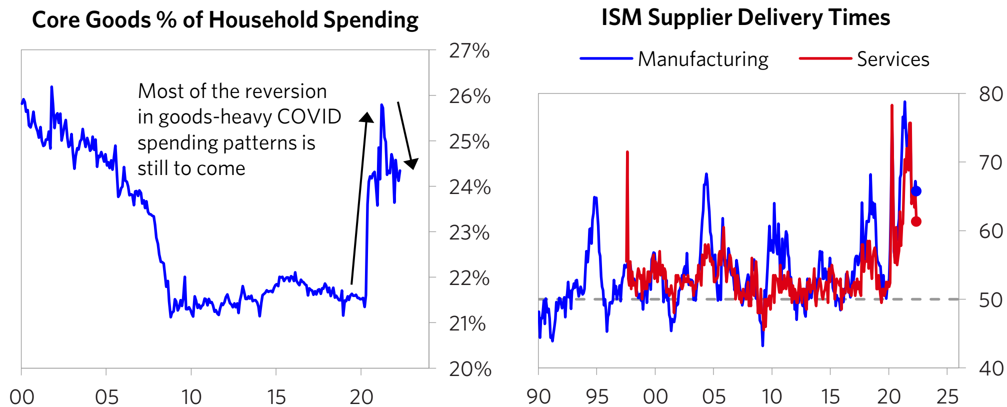
Price increases on new leases have slowed from last year's extremes but are still running above housing CPI, and the accumulated divergence remains.



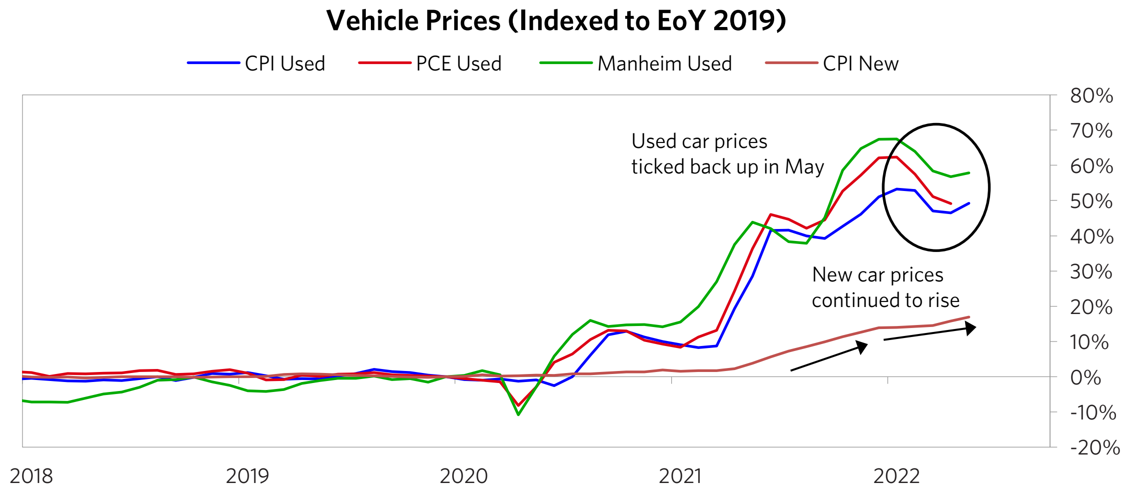
Housing has a much lower weight in PCE than CPI; as it becomes a larger driver of overall inflation, we're likely to see a widening divergence between the measures.

Goods Price Inflation Should Ease but It Will Likely Take Time

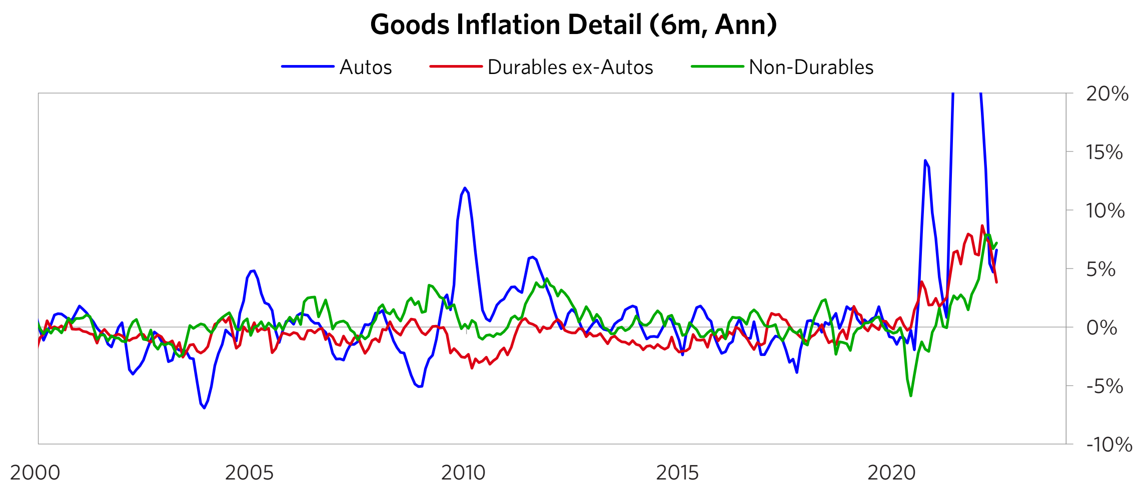
We see a few key drivers: domestic wages staying high (see above), further rotation of spending from goods back to services (disinflationary for goods, though net inflationary as labor-intensive service sectors face additional strain), the normalization of supply chains (disinflationary, but likely a 2023 story), and higher commodity prices (still inflationary). On balance, we see goods inflation easing, but a lot of that happening in 2023.



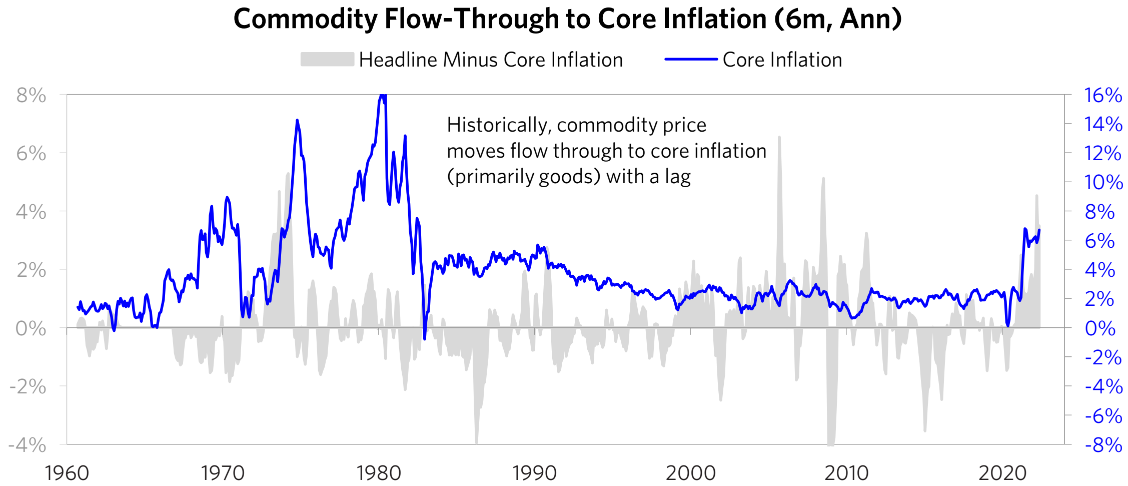
Autos have experienced some of the most extreme inflation due to acute shortages. A normalization of supply would help to ease those pressures, but a full resolution of shortages and corresponding big decline in prices are unlikely until 2023. Used car prices were a renewed support to inflation in May, and the moves in wholesale prices are consistent with further strength or at least stability in the near term. New car prices are generally less flexible than those for used autos and have not surged to the same degree, but they face continued upward pressure as undersupply persists.



The shortages in other categories of goods have been less extreme and driven more by the surge in demand than by large supply disruptions. But elevated inflation is now broad-based across virtually all types of goods and supported by higher raw material costs and wages.



We see further upward pressure on goods prices from the recent surge in commodity prices. While these moves are largely already reflected in the retail prices of gasoline and groceries, they also impact core inflation with a lag (typically on the order of several months). Prior increases in commodity prices will likely add about 0.4% to core inflation over the next 6-12 months, with a lot of that hitting goods.



Aside from commodity prices and supply disruptions in China, most of the pressures on goods do point downward. Renormalization in spending patterns will reduce demand for goods, especially durables. But this relief will come only gradually and will not be enough on its own to bring inflation back to target.

Appendix: Detailed Attribution of Inflation

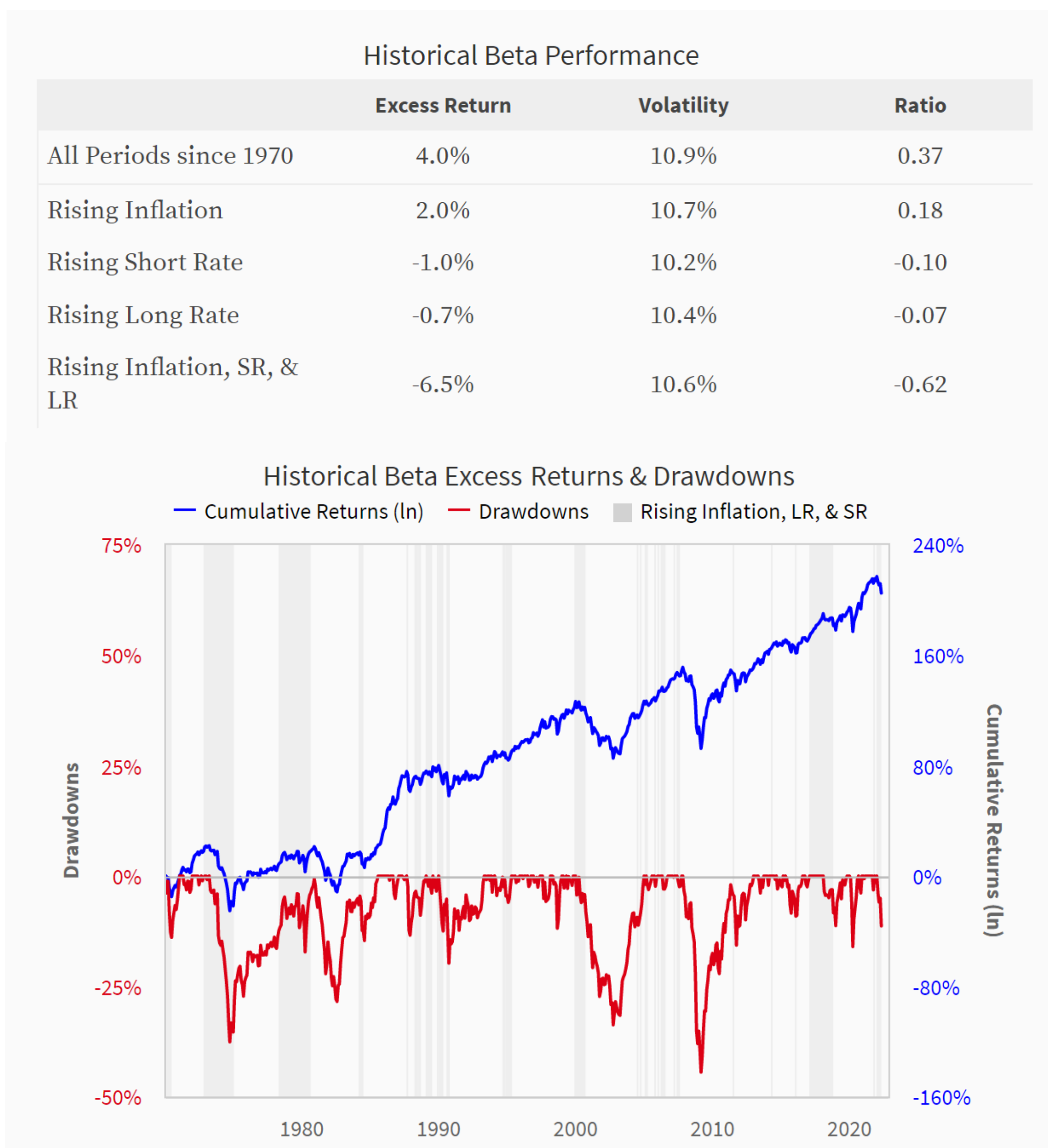
Looking at the details, a few things stand out:

- Core inflation ran at an 8.8% annualized pace in May, one of the hottest prints of the last four decades. This monthly increase was only slightly smaller—and far more broad-based—than the massive moves driven by durable goods last spring.
- Most goods prices rose fast, including autos.
- Housing inflation meaningfully accelerated. The 7.6% annualized pace of this monthly increase was the strongest in over three decades.
- Services inflation has been extremely strong for some time, with broad-based strength across categories, including many less cyclical sectors.

US CPI Inflation Report for May 2022

	Weight	M/M (Ann) May	M/M (Ann) Apr	M/M (Ann) Mar	M/M (Ann) 3m Avg	Y/Y May	Y/Y Pre-COVID
Headline	**100%**	**13.3%**	**4.0%**	**17.3%**	**11.5%**	**9.0%**	**2.2%**
Core	**81%**	**8.8%**	**6.8%**	**3.7%**	**6.4%**	**6.4%**	**2.1%**
Goods	**21%**	**9.3%**	**2.6%**	**-5.0%**	**2.3%**	**8.4%**	**-0.2%**
Motor Vehicles & Parts	*8%*	*18.2%*	*5.2%*	*-18.9%*	*1.5%*	*13.4%*	*-0.3%*
Furnishings & Durable Household Equipment	*3%*	*-1.9%*	*5.1%*	*13.3%*	*5.5%*	*9.8%*	*-0.6%*
Recreation Goods & Vehicles	*3%*	*-1.9%*	*-2.8%*	*-4.6%*	*-3.1%*	*1.2%*	*0.0%*
Other Durable Goods	*0%*	*17.4%*	*-13.5%*	*27.2%*	*10.4%*	*3.0%*	*0.5%*
Clothing & Footwear	*2%*	*8.3%*	*-7.2%*	*5.3%*	*2.1%*	*5.8%*	*-0.5%*
Pharmaceuticals & Other Medical Products	*1%*	*3.1%*	*0.7%*	*2.5%*	*2.1%*	*2.6%*	*1.3%*
Recreational Items	*1%*	*8.9%*	*7.4%*	*9.9%*	*8.7%*	*6.4%*	*-1.7%*
Household Supplies	*1%*	*13.2%*	*16.3%*	*7.7%*	*12.4%*	*9.5%*	*0.6%*
Other	*1%*	*12.8%*	*3.0%*	*7.8%*	*7.9%*	*5.4%*	*-0.8%*
Housing	**31%**	**7.6%**	**5.9%**	**5.3%**	**6.3%**	**5.2%**	**3.4%**
Housing Rent	*7%*	*7.9%*	*6.9%*	*5.3%*	*6.7%*	*5.3%*	*3.7%*
Imputed Rent	*24%*	*7.5%*	*5.6%*	*5.3%*	*6.1%*	*5.1%*	*3.3%*
Services	**29%**	**9.7%**	**10.9%**	**8.6%**	**9.7%**	**6.3%**	**2.2%**
More Cyclical Services	13%	17.0%	19.7%	13.8%	16.8%	9.8%	2.3%
Transportation	*3%*	*53.0%*	*72.3%*	*41.9%*	*55.8%*	*18.7%*	*1.0%*
Recreation Services	*2%*	*0.4%*	*1.2%*	*6.3%*	*2.6%*	*4.4%*	*2.5%*
Food Services & Accommodation	*6%*	*9.6%*	*9.7%*	*9.3%*	*9.5%*	*8.6%*	*2.5%*
Household Maintenance	*1%*	*23.7%*	*17.7%*	*5.5%*	*15.6%*	*7.7%*	*4.3%*
Generic Services	*1%*	*7.4%*	*9.3%*	*1.8%*	*6.2%*	*6.5%*	*2.6%*
Less Cyclical Services	17%	4.4%	4.6%	4.9%	4.7%	3.5%	2.1%
Utilities	*1%*	*3.4%*	*3.7%*	*0.9%*	*2.6%*	*4.1%*	*3.4%*
Healthcare	*6%*	*3.1%*	*2.3%*	*4.1%*	*3.2%*	*2.8%*	*2.1%*
Financial Services & Insurance	*4%*	*9.2%*	*12.2%*	*13.7%*	*11.7%*	*7.1%*	*5.1%*
Communication	*3%*	*3.0%*	*2.0%*	*-1.1%*	*1.3%*	*1.3%*	*-2.2%*
Education	*2%*	*2.6%*	*2.8%*	*3.0%*	*2.8%*	*2.4%*	*2.5%*
Non-Core	**18%**	**35.4%**	**-7.9%**	**101.8%**	**43.1%**	**22.2%**	**2.6%**

Below, we show what an environment of rising inflation and rising rates could mean for a typical institutional investor portfolio. You can follow this link to explore an interactive version of this perspective, which will allow you to see how your own portfolio would have performed through environments of rising inflation and rates.



Historical Beta Performance

	Excess Return	Volatility	Ratio
All Periods since 1970	4.0%	10.9%	0.37
Rising Inflation	2.0%	10.7%	0.18
Rising Short Rate	-1.0%	10.2%	-0.10
Rising Long Rate	-0.7%	10.4%	-0.07
Rising Inflation, SR, & LR	-6.5%	10.6%	-0.62

Performance is shown gross of fees through April 2022. HYPOTHETICAL PERFORMANCE RESULTS HAVE MANY INHERENT LIMITATIONS, SOME OF WHICH ARE DESCRIBED BELOW. NO REPRESENTATION IS BEING MADE THAT ANY ACCOUNT WILL OR IS LIKELY TO ACHIEVE PROFITS OR LOSSES SIMILAR TO THOSE SHOWN. IN FACT, THERE ARE FREQUENTLY SHARP DIFFERENCES BETWEEN HYPOTHETICAL PERFORMANCE RESULTS AND THE ACTUAL RESULTS SUBSEQUENTLY ACHIEVED BY ANY PARTICULAR TRADING PROGRAM. ONE OF THE LIMITATIONS OF HYPOTHETICAL PERFORMANCE RESULTS IS THAT THEY ARE GENERALLY PREPARED WITH THE BENEFIT OF HINDSIGHT. IN ADDITION, HYPOTHETICAL TRADING DOES NOT INVOLVE FINANCIAL RISK, AND NO HYPOTHETICAL TRADING RECORD CAN COMPLETELY ACCOUNT FOR THE IMPACT OF FINANCIAL RISK IN ACTUAL TRADING. FOR EXAMPLE, THE ABILITY TO WITHSTAND LOSSES OR TO ADHERE TO A PARTICULAR TRADING PROGRAM IN SPITE OF TRADING LOSSES ARE MATERIAL POINTS WHICH CAN ALSO ADVERSELY AFFECT ACTUAL TRADING RESULTS. THERE ARE NUMEROUS OTHER FACTORS RELATED TO THE MARKETS IN GENERAL OR TO THE IMPLEMENTATION OF ANY SPECIFIC TRADING PROGRAM WHICH CANNOT BE FULLY ACCOUNTED FOR IN THE PREPARATION OF HYPOTHETICAL PERFORMANCE RESULTS AND ALL OF WHICH CAN ADVERSELY AFFECT ACTUAL TRADING RESULTS. Past performance is not indicative of future results. Returns of the Illustrative Portfolio are simulated. For more on the Illustrative Portfolio, please review the "Important Disclosures and Other Information" located at the end of this document.

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Asset Type	Asset	Nominal Exposure	% Hedged FX	Beta Volatility	Beta Ratio	Alpha Volatility	Alpha Ratio
Equities	World Equities	58.3%	0.0%	15.3%	0.31	5.0%	0.30
Nominal Government Bonds	Developed World Bonds	11.2%	0.0%	4.4%	0.31	2.0%	0.30
Real Estate	Developed World Real Estate	7.1%	0.0%	18.8%	0.31	6.0%	0.30
MBS	United States MBS	6.1%	0.0%	4.3%	0.25	-	-
Corporate Bonds	World Corporate Bonds	5.1%	0.0%	6.7%	0.33	3.0%	0.30
Absolute Return	Absolute Return	5.1%	0.0%	-	-	7.0%	0.50
Equities	Emerging Market Equities	3.1%	0.0%	21.4%	0.25	5.0%	0.30
High Yield Bonds	United States High Yield Bonds	2.0%	0.0%	11.6%	0.30	-	-
IL Bonds	Developed World IL Bonds	2.0%	0.0%	5.6%	0.30	1.0%	0.30