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Consumer Prices Weigh In

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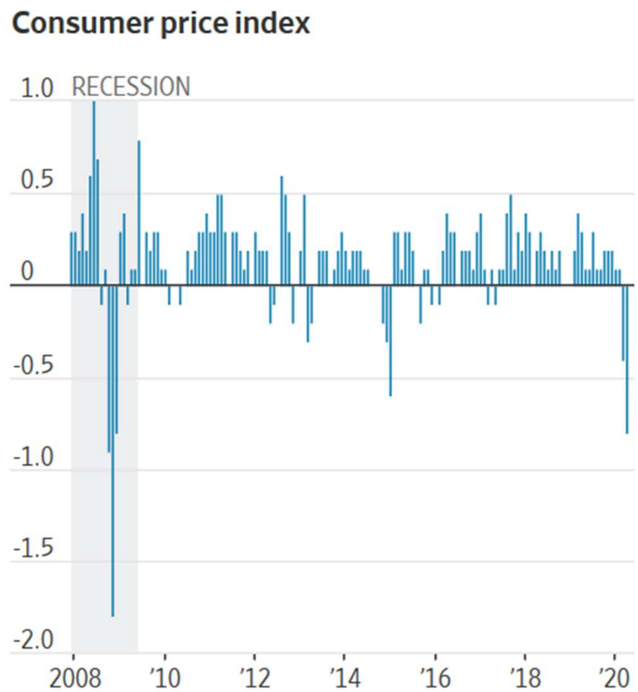
The stock market fell sharply on Tuesday giving up part of the rally from last week. The S&P 500 fell 60 points, or 2.05% to close at 2870. The Dow Jones Industrial Average dropped 457 points, or 1.89% to close at 23,765. The Nasdaq Composite declined 190 points, or 2.06%, closing at 9003 and finally the Russell 2000 index plunged 46 points, or 3.46% to close at 1275.

Today, the Labor Department announced that the consumer price index (CPI) fell by 0.8% in April -- the second month in a row that prices have fallen. April's decline is the largest since 2008. Business closures and stay at home orders for public health purposes creased falling prices for air travel, clothing, energy, and other goods and servcies. If we exclude the volatile food and energy categories, core inflation droped 0.4%. Realize that food prices are rising so when we exclude food and the CPI rises, that shows how much energy prices have fallen in a month – in fact, gasoline prices tumbled 20.6% in April.



Note: All items in U.S. city average, all urban consumers, seasonally adjusted
Source: U.S. Bureau of Labor Statistics

High inflation is not good for the economy, but neither is deflation. In a deflationarey world, consumers defer purchases thinking that prices will be lower tomorrow. The delay in engaging in an economic transaction perpetuates economic malaise. Slight inflation is preferable, because it induces consumers to buy today and spurs economic activity.

While the month-to-month inflation drops were substantial, the price changes from a year ago are up 0.3% and core prices are 1.4% higher than a year ago. With the economy opening up, there is expecation that the extremely depressed prices of goods and services will begin to rise. The coronavirus exacted a huge demand shock on the world economy, a plunge in oil prices and a strong dollar, which are all deflationary. To counter these impacts the Federal Reserve and the U.S. Treasury are pumping trillions of dollars into the economy. Watching the annual price changes (rather than month-to-month) may be a better long run measure of where inflation is headed.

Interestingly, the two sectors that lead the market lower today were S&P 500 Real Estate (off 4.2%) and S&P 500 Financial Sector (off slightly more than the market at 2.1%). These two sectors are the most sensitive to the credit market. The Federal Reserves monetary poilicy and Congress' fiscal policy have been vital in filling the hole in the economy created by the coronavirus mediation efforts. With Chariman Powell planning to speak Wednesday and the House Democrats rolling out a 3 Trillion spending bill, perhaps these two credit sensitive sectors are suggesting that the market is hedging its bets today.