



CAPITAL INVESTMENT COUNSEL

The Columns

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Inflation. We can't escape it. It's in every headline, every market move, every grocery aisle. And interest rates? At this point, most of us are ready to retire that conversation altogether. But here's the thing: these two forces, as tired as we are of hearing about them, remain the keys to nearly every economic door.

Think of the economy as a house. Inflation and interest rates are the master keys. They unlock rooms like housing, investment, consumer spending, and credit. And when the locks get sticky: when inflation rises or rates stay high, well, the whole household feels it.

Lower rates, in particular, are what tend to keep the gears turning. Low rates allow consumers to borrow, refinance, and spend more freely. And in an economy where nearly two-thirds of GDP comes from consumer spending, that's no small thing. So yes, the consumer is still king. Or queen. And interest rates are the invisible throne they sit on.

Let's start with something that doesn't sound like a crisis: the July Consumer Price Index showed a 1% rise in furniture and household supply prices. Just 1%, that's hardly worth mentioning, is it? But stretch that over twelve months, and suddenly you're looking at 12% annual inflation and that type of increase will leave a mark.

That's the thing about inflation. It's rarely loud. It's subtle, you might even call it sneaky. It seeps. And slithers. Before long, it can reshape not only how we live, but also *where* we live: in other words, housing. In 2020, the median home cost \$290,000, and

mortgage rates hovered at 3%. A 20% down payment bought your monthly bill, including taxes and insurance to roughly \$1,335. Manageable, doable for most of us. Fast-forward to now, and it's a different story. The median home tips the scale at \$416,000, and your new loan is financed at 6.7%(!!). Your all-in monthly cost? Well, that's roughly doubled to \$2,635. That math changes things. The annual salary to afford the median priced American home jumped 80% since Covid. We keep looking at the Federal Reserve, hoping Jerome Powell will bring rates back down. Easier money and maybe a little breathing room for everyone.

Now here's where things get interesting. While the talking heads prattle on about tariffs and oil prices, something else is quietly happening in the background. Tech companies, the giants that shape our digital lives, are doing two things at once: they're investing billions in artificial intelligence, and they're laying people off. At Meta, that's currently a 5% headcount reduction. At Microsoft, it's 15,000 jobs. The same tech giants that are spending the most on AI are cutting the most workers.

People see the billions spent on AI and think it's inflationary, but what if it's the opposite? This AI spending wave may ironically turn out to provide the inflation relief that the Federal Reserve and the rest of us crave. All this AI spending may potentially be *deflationary* over the longer term.

Let's work through it. These new employees don't ask for raises or time off to attend the school play. They don't need dental or a company car. Your new AI co-workers just churn out code, write legal briefs and provide customer support and "they" don't need a 401k. Wage inflation tends to be the stickiest part of inflation and the Covid-driven salary increases lingered longer than the Fed would like.

While the headlines shout about healthcare costs and Federal Reserve press conferences, the real shift in the inflation story could be lurking in the shadows, and it's

powered by AI. If AI can continue making meaningful strides in the next few years, the Fed's inflation problem starts to look like it has a potential solution.

Ironically, I'm writing this piece on the same day the CPI was released. Markets are red across the board: except for big tech and semiconductors. Microsoft, Apple, Nvidia, and Broadcom. The usual AI suspects. Sure, that's just one day but maybe the future isn't waiting patiently at the door. Maybe it's already slowly slipping in through the side window. The story may already be slowly changing, even if we haven't realized it yet.

Enough big picture talk, let's zoom in. For the week ending, July 13th, the S&P 500 didn't just climb, it traded *above* its upper standard deviation band every day that week. That's technical talk for "this market is lifting heavy". New highs day after day, while already running potentially hot. This is like hitting your one-rep max on a lift. And then doing it over and over again.

Even the strongest lifters need a break and Jason Goepfert at Sentiment Trader flagged a potential cooling phase that may be in our future. The above behavior with the market consistently trading above its upper band occurred several times since 1962 and we could see stocks trading flat to slightly down over the next two months. I don't feel a big downturn is in the cards and the average drop is only .7%. Nothing major, just a potential recalibration. If you're looking for more fireworks, you may be disappointed.

That is unless you own small caps. While July's extended run may have tired the S&P, that same data suggests a shift may be going on underneath the surface: possible rotation from large caps into small. Historically, similar shifts have driven average gains of 5% for the small caps. Sure, small caps have had a tough time over the last few years. Jerome Powell's steady hand on seemingly high interest rates made him public enemy number one for small cap investors. There are signs of life as small caps recently traded above longer-term resistance, hinting that they may finally be ready for a run toward the promised land. History doesn't repeat but the odds may be in our favor of a small cap revival through the rest of summer. If

you have any comments, feel free to contact me at heddins@capital-invest.com or call at 919-656-0836.

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