Weekly Economic Update—December 19th, 2022

It's been a rough week for investors struggling to digest the inflation/recession dynamic so vividly playing out in the headlines. The attention-grabbing Fed policy meeting ramped up the drama, albeit the half-point rate hike came as no surprise and the new Summary of Economic Projections compiled by Fed officials were also in the ballpark of expectations. Compared to the previous forecast made in September, the Fed now expects higher inflation in 2023 and 2024, higher unemployment and a higher target for its policy rate, suggesting that at least two more increases are in the cards next year. This week's half-point increase leaves the target range for the federal funds rate at 4.25%-4.50%, which the Fed expects to lift to a range of 5.1%-5.4% in 2023 – a half percent higher than the median forecast made three months earlier. Considering that the rate was sitting at near zero in March, this ranks among the most aggressive tightening cycles on record.

Perhaps more than the prospective rate hikes, what particularly rattled investors was the Fed's projection that the elevated level of rates would stay in effect throughout next year. That, together with Chair Powell's comments at the post-meeting press conference indicating that the Fed was determined to stay the course in fighting inflation even at the expense of bringing on a recession heightened the risk that the economy will indeed fall into a recession next year. That message was not what the markets wanted to hear and all but short-circuited the likelihood of a Santa rally in stocks. The post-meeting response was brutal, with the S&P 500 index plunging almost 5 percent since the meeting. Importantly, the markets are not convinced the Fed will follow through on its plans, as traders are pricing in a rate cut at some point in 2023.

Ironically, the Fed's steadfast commitment to wrestling inflation down to its 2 percent target comes amidst mounting evidence that price pressures are easing. The November consumer price report released this week revealed a slowing in the annual pace of retail prices for the second month in a row. To be sure, Powell acknowledged the slowdown but opined that two months is not enough evidence that inflation is firmly on the path to 2 percent. We agree that one month does not make a trend. But with two consecutive months of cooling and – with a posthumous nod to Senator Everett Dirksen – pretty soon it adds up to real disinflation. From our lens, the slowing inflation trend is poised to continue. The Fed doesn't quarrel with that outlook but believes the trend will only continue if it nudges it along with higher interest rates.

No doubt, the Fed has reason to be somewhat skeptical about the cooling inflation trend. A similar – but aborted – slowdown in prices occurred last summer, which encouraged the Fed to stick with its transitory narrative and keep its foot off the monetary brakes throughout the year. That erroneous assessment continues to tarnish the Fed's reputation and prompted a mea culpa early this year. Many believe that its aggressive rate-hiking campaign underway is a belated effort to compensate for that misguided delay in pulling the trigger earlier. The about-face has also drastically changed the Fed's narrative, which now favors the risk of over-tightening than easing prematurely.

That said, the slowdown in consumer prices over the past two months is impressive. The headline CPI increased by a slim 0.1 percent in November, well below the consensus forecast of 0.3 percent, and sharply lower than the 0.4 percent increases in each of the previous two months. Compared to a year ago, the increase cooled to 7.1 percent from 7.7 percent in October and 8.2 percent in September. In June, the annual inflation rate was running at 9.1 percent. To be sure, falling gasoline prices contributed mightily to the drop-off in the headline CPI. But more encouragingly, core inflation, which excludes volatile food and energy prices, also eased faster than expected. The core CPI advanced 0.2 percent in November, below the expected 0.3 percent and the smallest monthly gain in 16 months, lowering the annual gain to 6.0 percent from 6.3 percent in October and 6.6 percent in September.

While the slowdown is impressive, there's still a long ways to go before hitting the Fed's 2 percent target. However, there's a good chance that the gap will be closed sooner than the Fed expects. Prices of goods are already in deflationary territory, thanks to the healing of supply-chain snarls and shifting consumption patterns towards services. Prices of goods excluding food and energy contracted for two consecutive months and are only 3.7 percent higher than a year earlier. In February, they were rising at a 12.4 percent pace. Odds are, goods prices will continue to come under downward pressure, as retailers strive to move excess inventories and consumers continue to shun products that were in high demand when they were homebound during Covid lockdowns.

Still, good prices account for less than 40 percent of the consumer price index, and progress on the inflation front will only gain traction when service prices also cool off. Encouragingly, there are signs of this happening. Service prices, excluding energy, slowed to 0.4 percent in November from 0.5 percent in October and 0.8 percent in September. The biggest stumbling block preventing a faster decline is the cost of housing, which carries the heaviest weight in the consumer price index – almost 33 percent of the overall CPI and 40 percent of the core CPI. Shelter prices continued to rise by an outsize 0.6 percent in November, propelled by an 0.8 percent increase in rents on primary residences. Take out shelter, and the inflation cooling looks far more dramatic. Over the past three months, all other components of the core consumer price index increased by a wholly tolerable 1 percent annual rate.

What's more, the path ahead towards lower shelter prices is promising as current lease renewals are generating much smaller rent increases than earlier ones. As these newer rents carry more weight in the shelter cost component of the CPI next year, they will have an increasing influence in dragging down the inflation rate. We expect that drag to unfold steadily over the course of 2023 and reinforce other influences that will help bring inflation to heel. Among these influences is the ability and willingness of consumers to sustain spending on ever-more expensive goods and services. The latest retail sales report suggest that households are starting to pull back, as sales slumped by 0.6 percent in November, the weakest reading for the year. Worse, the so-called control group of sales that feed directly into the GDP calculation also fell for the first time since last December.

To be sure, it would be a mistake to read too much into a single monthly report. For one, the November weakness follows a strong gain in October, and consumers may well have pulled some holiday shopping forward, either out of fear of product shortages or to exploit heavy promotions of retailers seeking to unload excess inventory. Despite the setback, sales are still a healthy 6.5 percent higher than a year ago. Likewise for the control group of sales, as the 0.2 percent contraction follows gains of 0.5 percent in each of the previous two months and still stands a respectable 5.5 percent higher than a year ago. Taking the average sales for October and November still points to a sturdy contribution to GDP growth in the fourth quarter from consumer spending.

It's also worth mentioning that retail sales are not adjusted for inflation, and as noted, prices of goods – which comprise the bulk of retail sales – have been falling in recent months. Hence, consumers got a bigger bang for the buck; they doled out fewer dollars but got more in return. And while they shunned some goods in November, they likely compensated by upping spending on services. We will get a better sense of their overall consumption patterns in the more comprehensive income and spending report later this month. We suspect that it will reveal a stronger reading on consumer spending than the retail sales report. But unlike the retail sales report, it's also likely that higher service prices wiped out most of the gain in spending on services. And with labor costs a key driver of service inflation, many – including the Fed – find it hard to believe that much progress on the inflation front can be achieved until the still-robust gains in worker pay slows. That, in turn, argues for the Fed to keep interest rates higher and longer than otherwise. It also suggests that the Fed is willing to inflict more pain on the job market to curb inflation, something that underscores the heightened recession risk buffeting the financial markets.

FINANCIAL INDICATORS

INTEREST RATES	Dec 16	Week Ago	Month Ago	Year Ago
3-month Treasury bill	4.30	4.30	4.23	0.05
6-month Treasury bill	4.70	4.73	4.63	0.13
3-month LIBOR	4.74	4.73	4.67	0.21
2-year Treasury note	4.20	4.36	4.46	0.66
5-year Treasury note	3.63	3.77	4.01	1.18
10-year Treasury note	3.49	3.58	3.78	1.41
30-year Treasury bond	3.55	3.56	3.89	1.82
30-year fixed mortgage rate	6.31	6.33	6.61	3.12
15-year fixed mortgage rate	5.54	5.67	5.98	2.34
STOCK MARKET				
Dow Jones Industrial Index	32,920.46	33,476.46	33,745.69	35,365.44
S&P 500	3,852.36	3,934.38	3,965.34	4,620.64
NASDAQ	10,705.41	11,004.62	11,146.06	15,169.68
COMMODITIES				
Gold ($ per troy ounce)	1,803.00	1,809.40	1,752.60	1,810.10
Oil ($ per barrel) - Crude Futures (WTI)	74.50	71.58	80.11	71.18

ECONOMIC INDICATOR	Latest Month/Quarter	Previous Month/ Quarter	Two-Months/ Quarters Ago	Average-Past Six Months or Quarters
Consumer Price Index (November) - % change	0.1	0.4	0.4	0.4
Core CPI (November) - % change	0.2	0.3	0.6	0.4
Retail Sales (November) - % change	-0.6	1.3	-0.2	0.3
Industrial Production (November) - % change	-0.2	-0.1	0.4	0.1

DISCLAIMER: This communication has been prepared by Government Portfolio Advisors LLC solely for informational purposes for institutional clients. Sources for this commentary include Bloomberg and Oxford Economic/SMRA It is not an offer, recommendation, or solicitation to buy or sell, nor is it an official confirmation of terms. It is based on information generally available to the public from sources believed to be reliable. No representation is made that it is accurate or complete or that any returns indicated will be achieved. Changes to assumptions may have a material impact on any returns detailed. Past performance is not indicative of future returns. Price and availability are subject to change without notice. Additional information is available upon request.