

The U.S economy is closing out the year with a whimper. True, there is still a full month of data yet to digest, and the all-important jobs report for December scheduled for release on January 6 will still depict a relatively tight labor market. But momentum is fading and the economy's main growth driver, the consumer, is running out of fuel. The business sector is not poised to take up the slack and the Federal Reserve is not inclined to bail out the economy – at least not yet. Perhaps the biggest source of strength heading into 2023 is the Federal Government which is on the cusp of passing a \$1.7 trillion spending bill, powered by a 9.7 percent increase in defense and 5.5 percent for everything else, a combined increase that adds a positive inflation-adjusted boost to overall activity.

But the final batch of data for the year released last week was hardly promising and came in front of a frightful winter storm that blanketed much of nation over the weekend, an ominous portent of dark clouds overhanging the economic landscape during the Christmas weekend. That said, there were some silver linings amid the grim tidings. The inflation scourge that is provoking the most aggressive monetary tightening in forty years – and is the biggest domestic threat to the economy next year – continues to cool and provides hope that the Federal Reserve will ease its foot off the brakes before it is too late. We reported the step-down in inflation as measured by the consumer price index last week but noted that the Fed follows a different price gauge, the personal consumption deflator, as its primary yardstick in achieving its 2 percent inflation target.

That gauge was released last week as part of the comprehensive income and spending report for November. Mirroring the improvement in the CPI, the headline personal consumption deflator increased by a slim 0.1 percent during the month, a marked slowdown from the 0.4 percent October increase, while the core personal consumption deflator that excludes volatile food and energy items and is the Fed's preferred measure, rose by a slim 0.2 percent compared to 0.3 percent in October. Taking a longer perspective, the trend clearly confirms that the inflation peak is behind us. Compared to a year ago, the headline PCE slowed to 5.5 percent – the weakest annual increase since October of last year – from 6.1 percent and the core PCE slipped to 4.7 percent from 5.0 percent. The slowing trend is clearly encouraging, but the pace is still too high for the Fed's comfort. We expect the next policy meeting on February 1 will see another rate hike, although by a more modest quarter-point compared to the half-point hike implemented at the December 14 confab.

What the income and spending report also confirmed was the retail sales data released last week that depicted a pullback in consumer spending. That report included mostly sales of physical goods, which fell by 0.2 percent and overstated the weakness in consumer spending because it did not include the more important outlays on services. As telegraphed, the broader measure of personal consumption did eke out a 0.1 percent gain last month, thanks to the boost provided by services, particularly at establishments providing food and accommodations. Service outlays rose by a robust 0.7 percent in November, while spending on durable goods fell by a sizeable 2.3 percent, dragged down mostly by a slump in auto sales.

Keep in mind that these changes are in current dollars. Adjusted for inflation consumers were not in as festive a buying mood. Indeed, despite the small inflation increase last month, it was large enough to wipe out the entire spending gain as real personal consumption was flat in November. To be fair, the flatlining follows a sturdy 0.5 percent increase in October. It appears that some sales in October borrowed from November, as households for a variety of reasons decided to do their holiday shopping a month earlier, reflecting fears of product shortages and some heavy promotions by retailers. Thanks to the strength in October, consumer spending started the fourth quarter on an elevated base; so even with the stagnant

showing in November, the quarterly average growth rate in personal consumption – which accounts for about 70 percent of GDP – is tracking about 3 percent. The rubber match will be decided in December, but it does appear that the economy will notch a decent growth rate in the fourth quarter.

What's more, with the job market still churning out a hefty number of additional payrolls last month, personal incomes got a nice lift from wages and salaries. The 0.5 percent increase in labor compensation boosted total personal income by a respectable 0.4 percent. And with incomes increasing faster than spending, households were able to save a bit more, boosting the savings rate to 2.4 percent from 2.2 percent. But that's still historically low, indicating that households are using up the firepower of pandemic-era savings as well as relying on credit cards to sustain spending. This is not a sustainable trend. The excess savings built up during the pandemic is running out, particularly for lower income households. In this regard, one source of important purchasing power for his group, the expanded child tax credit, has lapsed and was not renewed in the omnibus spending bill passed this week. Meanwhile, rates on credit cards are spiking along with the Fed's rate increases, even as banks are turning more cautious towards consumer lending.

Simply put, the economy likely stayed above water in the year's closing quarter despite the myriad headwinds it faced, most notably the Fed's aggressive pivot towards a restrictive policy and surging inflation that weakened the purchasing power of households. One sector that is not faring well, of course, is housing, which is the most vulnerable to worsening financial conditions. Home sales are falling off a cliff and homebuilders are pulling in their horns. Building permits, a more forward-looking indicator, fell 11.2 percent in November.

The decline in permits, along with gloomy homebuilder sentiment, points to ongoing weakness in housing construction, particularly in the single-family sector in the months ahead. Housing starts for the fourth quarter so far are averaging 1.3 percent below the third-quarter pace, and the weak permits data point to a sharp decline in starts in December. We currently estimate that residential investment outlays will decline about 16 percent annualized in the fourth quarter and subtract 0.7 percentage points from real GDP growth, which we current estimate is tracking around 2.5 percent. That's an outsized drag from a sector that constitutes less than 5 percent of the total economy.

The good news is that there is a huge volume of partially built homes in the pipeline that will hit the market in 2023. That's particularly the case in the multifamily segment of the market, where rents have been climbing swiftly and driving up inflation in the service sector. With the new supply coming on stream, the upward pressure on rents will diminish. Indeed, that seems to be already happening. Although the rental component in the consumer price index is still accelerating, that's because it includes the huge rent increases made earlier in the year. New leases are commanding much smaller rent increases and as those earlier hikes are aged out of the CPI in coming months, that source of upward price pressure will likewise vanish. The shelter component represents 40 percent of the core consumer price index (although a smaller share in the personal consumption deflator) and some believe that the pending slowdown in rental costs will usher in a more pronounced retreat in the inflation rate later next year than is widely forecast.

Ironically, the Federal Reserve's rate-hiking campaign, aimed at cooling inflation, may actually be having the opposite effect on housing costs. To be sure, the steep climb in mortgage rates this year has added hundreds of dollars to monthly house payments, pushing millions of potential home buyers out of the market. That's crushing home sales as well as ancillary purchases, such as for appliances, furnishings, moving expenses and brokers fees, which reinforces the Fed's attempt to cool off aggregate demand and, hence, price pressures. But in the process of making homes unaffordable for a growing swath of the population, the Fed is also driving more would-be homebuyers to the rental market. That, in turn, is propping up the very demand for apartments that has been driving rents upwards.

FINANCIAL INDICATORS

INTEREST RATES	Dec 23	Week Ago	Month Ago	Year Ago
3-month Treasury bill	4.32	4.30	4.15	0.08
6-month Treasury bill	4.66	4.70	4.70	0.18
3-month LIBOR	4.73	4.74	4.74	0.21
2-year Treasury note	4.32	4.20	4.51	0.71
5-year Treasury note	3.86	3.63	3.87	1.25
10-year Treasury note	3.75	3.49	3.70	1.50
30-year Treasury bond	3.82	3.55	3.73	1.91
30-year fixed mortgage rate	6.27	6.31	6.58	3.05
15-year fixed mortgage rate	5.69	5.54	5.90	2.30

STOCK MARKET				
Dow Jones Industrial Index	33,203.93	32,920.46	34,347.03	35,950.56
S&P 500	3,844.82	3,852.36	4,026.12	4,725.79
NASDAQ	10,497.86	10,705.41	11,226.36	15,653.37

COMMODITIES				
Gold (\$ per troy ounce)	1,806.00	1,803.00	1,755.00	1,811.00
Oil (\$ per barrel) - Crude Futures (WTI)	79.35	74.50	76.55	71.63

ECONOMIC INDICATOR	Latest Month/Quarter	Previous Month/Quarter	Two-Months/Quarters Ago	Average-Past Six Months or Quarters
Existing Home Sales (November) - mlns	4.10	4.43	4.71	4.66
Personal Income (November)- % change	0.4	0.7	0.4	0.5
Personal Consumption (November) - % change	0.1	0.9	0.6	0.6
Savings Rate (November) - Percent	2.4	2.2	2.4	2.6
Housing Stats (November) -- 000s	1,427	1,434	1,465	1,464
Building Permits (November) - 000s	1,342	1,512	1,564	1,557

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