

It's not a good sign when incoming data is accompanied by downward revisions to previous months, especially when the new data features downside surprises, as was the case with retail sales, industrial production and housing starts this week. Once that dynamic spreads to the employment data, we suspect that recession fears will escalate sharply. First, however, jobs data would have to come in weaker than expected, and so far, that has not been the case. For sure, attention-getting layoffs in the tech sector are grabbing headlines, with more than 100 thousand pink slips doled out over the past four months; that includes nearly 40 thousand in January alone, which still has more than a week to go.

But it seems that these workers are having little difficulty landing new positions. New applications for unemployment benefits remain near historic lows, sliding to 190 thousand in the latest week, the lowest since last April. The weekly data can be noisy, particularly around the turn of the year and close to the holiday season when turnover among temporary workers can fluctuate wildly. But smoothing out the data into four-week moving averages doesn't change the picture. Apparently laid-off tech workers are getting snapped up quickly by competitors or by employers in other industries where their skills are readily transferable. Alternatively, they may have received hefty severance packages and feel confident enough in finding another job quickly that they are simply forgoing signing up for unemployment benefits.

In any event, until the job market shows visible signs of cracking, the downside surprises of incoming data will not sway the Federal Reserve from its rate hiking campaign. What it does do, however, is inject more nuance into the Fed's strategy. Another rate hike at the conclusion of its next policy meeting on February 1 is virtually a done deal. But the size of the increase is still up for grabs, although a strong consensus has formed that it will be 25 basis points. That would be a step down from the half-point increase taken in mid-December and the four consecutive three-quarter point increases at the previous meetings. The expected slimmer hike is in recognition of the weaker-than-expected data in recent months as well as tangible signs that inflation is slowing.

However, not all Fed officials are on the same page with the consensus. Over the past week, at least two Fed bank presidents – Bullard of St. Louis and Mester of Cleveland – have staked out a more hawkish stance, reflecting their preference to be overly aggressive rather than do too little to stem inflation. While neither put a number on their preferred rate increase at the next meeting, both are clearly of the view that rate hikes should continue beyond that meeting and stay elevated until the Fed's 2 percent target is within reach. That said, neither Bullard nor Mester is a voting member of the FOMC this year so odds are the more dovish participants will prevail and push through a 25 basis point rate hike. On that score, the financial markets and Fed rate prospects are in accord.

Beyond the next meeting, however, expectations start to splinter, not only between the market and the Fed but within the Fed itself. The markets are pricing in one more rate hike to the 4.50-4.75 percent range from the current 4.25-4.50 percent range but no more. According to the fed funds futures market, there is a slim 2 percent chance that the FOMC will hike rates again at the March meeting. Those odds increase somewhat over the next two meetings, but by November the probability that the Fed would start cutting rates rises to over 50 percent. That sentiment is roughly priced into the broader bond market as well. The Fed, of course, does not disseminate daily probabilities of its actions but it does issue a quarterly summary of projections by its members. In the last SEP released at the December meeting, 17 of the 19 members of the FOMC expected the federal funds rate to rise above 5 percent this year, with 5 expecting it to go to 5.4 percent and 2 to above 5.6 percent. We suspect that the latter includes the aforementioned Bullard and Mester who won't have a vote on the matter this year.

However, the SEP projections are a moving target. A year before the December forecast, the FOMC expected the Federal funds rate to peak at 0.9 percent at the end of 2022. But as the facts changed, so too did the forecast – albeit far too slowly in the minds of many. By March, the Fed ditched the term transitory to describe the inflation outbreak that began in 2021 and lifted the expected fed funds rate target to 1.9 percent. By June, the Russia-Ukraine war had further revved up the inflation fires, prompting another boost in the expected rate to 3.4 percent. With the consumer inflation rate hitting a 40-year high of 9.1 percent in June, the hawkish pivot continued, with the expected funds rate rising to 4.4 percent at the September meeting before settling at the latest 5.1 percent in December.

Against this backdrop of sequential upward moves in the projected funds rate target, it's reasonable to question if the December projection will stick. This time, however, the facts are changing in the other direction and the question is whether the Fed will be fast or slow to respond. Given the Fed's laser focus on labor costs and the persistent shortage of workers relative to job openings, the odds of the Fed hiking rates again in March is high, which would lift it to the 5 percent threshold. But as we noted, the facts are changing as incoming economic indicators are signaling more weakness than expected even as key inflation gauges have slowed precipitously in recent months.

This week's batch of economic reports confirm that both the demand and output sides of the economic ledger are sagging and taking air out of the inflation bubble. The most critical, from the macro perspective, is the surprising weakness in retail sales, which fell by 1.1 percent in December following a downwardly revised 1.0 percent drop in November, punctuating a disappointing holiday shopping season. The December setback was broadly based, as 10 of the 13 major spending categories notched declines during the month. True, consumers apparently pulled forward some holiday shopping into October, when retailers carried out heavy promotional sales to rid themselves of excess inventories. But the 1.1 percent increase in October's sales was more than erased by the declines in November and December. By the end of the month, overall retail sales were 1.1 percent lower than at the end of September. Importantly, the control group of sales that feeds directly into GDP fell by 0.7 percent in December, following a 0.2 percent drop in November, the first back-to-back declines since April/May 2021.

No doubt, falling prices for goods contributed to the overall decline, as retail sales are reported in current dollars. The decline in prices for gasoline and used cars was particularly pronounced during the fourth quarter. But cheaper goods did not encourage consumers to buy more items. Commodity prices fell 1.0 percent between September and December while retail sales fell by 1.1 percent; so, while the dollar went a longer way, consumers still cut back their unit purchases of goods. However, because the quarter started on a high note, due to the strength in October, the average volume of sales in the fourth quarter increased from the third quarter. What's more, retail sales do not include purchases of services, which comprise a much bigger share of consumer spending and, by all accounts, are still rising both in current and inflation-adjusted dollars. We will get a better sense of overall spending in the fourth quarter in next week's personal income and consumption report for December.

Our calculations indicate that real personal consumption increased by a healthy annual rate of just over 3 percent in the fourth quarter, contributing to a 3.5 percent increase in GDP. But momentum is clearly fading as the curtain rises on 2023. In addition to sagging consumer spending over the last two months, factories are cutting back production and the housing slump is deepening, as this week's soft reports on industrial production and housing starts attest. But the economy's growth engine still has fuel to run as long as it continues to crank out more paychecks than pink slips, which gives workers the financial means to sustain spending. This is not a deal breaker for the Federal Reserve, which still hopes to break the back of inflation without causing a major spike in unemployment. Indeed, a resilient job market enhances the prospect of achieving a soft landing, particularly if the noncyclical forces driving inflation – most notably supply-chain problems and geopolitical tensions – fade more quickly. Encouragingly, some Fed officials are acknowledging the disinflationary influence that the waning of these forces are having, most recently in a speech by Fed Governor Lael Brainard this week. Whether that leads the Fed to move the goal post for the

federal funds rate again remains to be seen, but the facts this time are pointing more to a downward than another upward shift in the endgame.

FINANCIAL INDICATORS

INTEREST RATES	Jan 20	Week Ago	Month Ago	Year Ago
3-month Treasury bill	4.67	4.61	4.32	0.17
6-month Treasury bill	4.82	4.79	4.66	0.35
3-month LIBOR	4.82	4.83	4.73	0.26
2-year Treasury note	4.18	4.22	4.32	1.02
5-year Treasury note	3.56	3.54	3.86	1.56
10-year Treasury note	3.41	3.51	3.75	1.76
30-year Treasury bond	3.57	3.61	3.82	2.08
30-year fixed mortgage rate	6.15	6.33	6.27	3.56
15-year fixed mortgage rate	5.28	5.52	5.69	2.79

STOCK MARKET				
Dow Jones Industrial Index	33,375.49	34,302.61	33,203.93	34,265.37
S&P 500	3,972.61	3,999.09	3,844.82	4,397.94
NASDAQ	11,140.43	11,079.16	10,497.86	13,768.92

COMMODITIES				
Gold (\$ per troy ounce)	1,927.70	1,923.00	1,806.00	1,836.10
Oil (\$ per barrel) - Crude Futures (WTI)	81.40	80.06	79.35	84.83

ECONOMIC INDICATOR	Latest Month/Quarter	Previous Month/Quarter	Two-Months/Quarters Ago	Average-Past Six Months or Quarters
Retail Sales (December) - % change	-1.1	-1.0	1.1	-0.2
Industrial Production (December) - % change	-0.7	-0.6	0.0	-0.1
Housing Starts (December) - 000s of units	1,382	1,401	1,426	1,427
Building Permits (December) - 000s of units	1,330	1,351	1,512	1,497
Producer Price Index (December) - % change	-0.5	0.2	0.4	0.0

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.