GOVERNMENT PORTFOLIO ADVISORS

Weekly Economic Update—January 30th, 2023

The raft of economic data released this week conveyed a mixed message. On balance, however, it gives a modest lift to those who view the glass as half empty rather than half-full. True, the fourth quarter GDP report revealed somewhat more strength than expected, with the headline growth rate coming in at 2.9 percent, only a tad weaker than the buoyant 3.2 percent recorded in the third quarter. We caution, however, that this is a preliminary reading on the economy's performance based on incomplete data which, as they become available, could change the outcome considerably. The initial estimate for the third quarter pegged the growth rate at 2.6 percent before two upward revisions lifted the final reckoning to 3.2 percent. Importantly, most monthly data have recently been revised in the other direction – down – suggesting that the next estimate for the fourth quarter may well reveal a slower growth rate than the one reported this week.

Given the uncertain fate of the headline GDP, a look under the hood gives a better understanding of important trends. The most striking observation is that tenuous forces provided the major thrust to the headline growth rate. Most notably, fully 75 percent of the 2.9 percent advance in GDP came from two sources -- inventory accumulations and declining imports, neither of which is a source of sustained strength. Much of the inventory buildup was involuntary as the backlog of unfilled orders that were bogged down due to supply-chain snarls finally reached customer shelves just as demand for goods dried up. Likewise, weaker domestic demand accounted for the slump in imports.

Take out those two sources as well as government spending, and a soft underbelly in the private sector is exposed. Real final sales to domestic purchasers edged up by a slim 0.2 percent in the fourth quarter. You would have to go back to the first quarter of 2002 to find a weaker increase outside of a recession – and that quarter was the first coming out of the 2001 downturn. Granted, the economy's main growth driver, consumers, flexed their spending muscles during the period, upping real outlays by 2.1 percent, almost spot-on with the previous two quarters. But the contours differ markedly; whereas consumers were stepping up spending over the previous six months, they were clearly winding down as 2022 limped to a close. Indeed, the entire heft behind the fourth-quarter increase in personal consumption took place in October.

That subsequent downdraft is strikingly revealed in the monthly personal income and spending report released on Friday. There are two key takeaways from the report that underscore the fading momentum heading into 2023. First, real personal consumption fell by 0.3 percent in December following a 0.2 percent decline in November. That was the first back-to-back setback in a year and totally erased the robust gain in October. While households continue to reorient spending from goods to services, they kept service spending unchanged last month while the ongoing slump in goods purchases continued, something that was presaged by last week's retail sales report. Second, the November dip in spending reflected another downward revision from the original estimate of an unchanged reading for the month. As we noted before, downward revisions to previous month's data releases have become a regular feature of incoming reports, which is usually a leading indicator of further weakness.

With consumers pulling back on spending, it is hard to see what would make up for the slack as the curtain rises on 2023. The business community retains a gloomy mindset regarding the outlook, which showed up vividly in the GDP report. Spending on equipment fell by 3.7 percent, the second decline in the past three quarters. And like the consumer sector, the trend is going in the wrong direction. In the monthly durable goods report released this week, shipments of core capital goods tracked a steeply descending path, from a 1.5 percent jump in October to a 0.2 percent decline in November punctuated by a 0.4 percent retreat in December. Nor is the future promising as new orders for these same goods fell by 0.2 percent in December

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following no change in November (which was again revised down from a 0.2 percent gain in the previous estimate). This downbeat trend aligns with recent surveys, most notably by the Institute for Supply Management that reports the lowest level of new orders by manufacturers since May 2020 in December. Importantly, capital spending is among the first key indicators to turn south as the economy heads into a recession.

The sector that leads the way even earlier is housing, and the news here is anything but upbeat. Residential outlays plunged by 26.7 percent in the fourth quarter on the heels of an even steeper 27.1 percent drop in the third and a 17.8 percent decline in the second quarter. Declines of this magnitude and length have not been seen since the 2006-2008 mortgage market collapse. Of course, that episode stretched over a 15 quarter period and included declines in excess of 20 percent in seven of them. The current retreat is not likely to be nearly as bad, albeit it did sap nearly 1.3 percentage points from the fourth quarter's growth rate, offsetting nearly all of the positive contribution from consumer spending. That's an outsized drag considering that consumer spending is 24 times as large as residential outlays.

Clearly, the underlying details of the GDP report point to slower growth in the quarters ahead, which likely presages a recession starting about or before mid-year. For one, the thrust provided by the inventory stockpiling in the fourth quarter is poised to morph into a headwind going forward as retailers, factories and warehouses attempt to reduce excess merchandise on their shelves, which incur much higher financing costs to maintain than a year ago. Their efforts could be thwarted if sales fall even faster than inventories are reduced. That, in turn, would lead to another quarterly build-up in stockpiles; but any positive contribution it provides to growth would come about for the wrong reason – a disruptive collapse in sales. Inventory swings rarely cause recessions although they do amplify changes in GDP around cyclical turning points, making things look much better or worse than they actually are.

Meanwhile, the tepid pace of consumer spending in the final months of the year means that the first quarter will be starting out at a mere 0.3 percent above the average for the fourth quarter. Hence, there is a hill to climb this quarter if personal consumption is to match the 2.1 percent growth rate reached in the fourth quarter. That's not likely to occur. True, real disposable incomes staged a healthy 3.3 percent increase in the fourth quarter that handily outpaced the advance in spending. But households used a big slice of that increased purchasing power to rebuild depleted savings, which had been run down to a 15-year low 2.4 percent rate in September. The rebuilding process began in earnest in November and December, as the rate rose to 2.9 percent and 3.4 percent, respectively, mirroring the pullback in spending.

With interest rates on credit cards and auto loans surging, consumers are expected to curb borrowing and pay off outstanding balances if possible, which will act as a restraint on spending. And while high borrowing costs are a spending deterrent, they are also a savings incentive. Indeed, for the first time in 21 months, interest received on financial assets increased as a share of personal income, rising from 7.9 percent to 8.0 percent in December. The lure of obtaining rates on savings accounts and liquid assets that is higher than any seen in more than fifteen years is a powerful incentive to forego some discretionary spending, as the opportunity cost of doing so is far less than when the alternative of parking cash provided near zero returns. Combine that incentive with headline-grabbing recession fears and the urge to build up precautionary savings become ever-more compelling.

To be sure, that's precisely what the Federal Reserve strives to accomplish in its rate-hiking campaign, and the question is whether it thinks the demand-retarding effects of its actions so far are sufficient to send inflation decisively towards its 2 percent target. The perceptible downshift in the PCE deflators during the fourth quarter is an encouraging sign, but probably not sufficient enough to prompt a halt to the rate increases. The personal consumption deflator fell to a 3.2 percent annual rate in the fourth quarter from 4.3 percent, which is clearly tolerable if sustained, but the preferred core PCE notched a smaller decline to a still-elevated 3.9 percent from 4.7 percent in the third quarter. Compared to a year earlier, both measures are running far too high for the Fed's comfort – 5.5 percent and 4.7 percent. Hence, we expect the Fed will lift the funds rate by a quarter-point at next week's policy meeting with little dissent. And while the odds of another similar increase in March are high, we suspect that dissension among Fed officials is growing, as several have expressed a desire to pause while assessing the impact of previous increases. If the economy and inflation continues on its current slowing path, the potential rate increase in March would have considerably less support.

FINANCIAL INDICATORS

INTEREST RATES	Jan 27	Week Ago	Month Ago	Year Ago
3-month Treasury bill	4.67	4.67	4.45	0.17
6-month Treasury bill	4.84	4.82	4.67	0.35
3-month LIBOR	4.80	4.82	4.76	0.26
2-year Treasury note	4.20	4.18	4.38	1.02
5-year Treasury note	3.61	3.56	4.01	1.56
10-year Treasury note	3.51	3.41	3.84	1.76
30-year Treasury bond	3.62	3.57	3.93	2.08
30-year fixed mortgage rate	6.13	6.15	6.52	3.56
15-year fixed mortgage rate	5.17	5.28	5.68	2.79
STOCK MARKET				
Dow Jones Industrial Index	33,978.08	33,375.49	33,147.25	34,265.37
S&P 500	4,070.56	3,972.61	3,839.50	4,397.94
NASDAQ	11,621.71	11,140.43	10,466.48	13,768.92
COMMODITIES				
Gold ($ per troy ounce)	1,927.60	1,927.70	1,829.80	1,836.10
Oil ($ per barrel) - Crude Futures (WTI)	79.38	81.40	80.45	84.83

ECONOMIC INDICATOR	Latest Month/Quarter	Previous Month/ Quarter	Two-Months/ Quarters Ago	Average-Past Six Months or Quarters
New Home Sales (December) - 000s	616	602	598	593
Real GDP (4thQtr) - % change (Saar)	2.9	3.2	-0.6	2.3
Durable Goods Orders (December) - % change	5.6	-1.7	0.7	0.8
Personal Income (December) - % change	0.2	0.3	0.8	0.4
Personal Consumption (December) - % change	-0.2	-0.1	0.8	0.3
Savings Rate (December) - Percent	3.4	2.9	2.5	2.8

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