GOVERNMENT PORTFOLIO ADVISORS

# Weekly Economic Update—October 16th, 2023

The conflict in the Middle East adds to the litany of uncertainties clouding the outlook. Among the new additions this week, Republicans struggled to replace the ousted Speaker of the House, as the nominee to be his potential replacement abruptly dropped out of contention on Thursday. The ongoing autoworkers strike also ramped up, as the UAW expanded its work stoppage to Ford's Kentucky plant, idling another 8700 workers. These new disruptions are far from being resolved and are likely to reverberate through the financial markets in coming days and weeks. At stake, beyond the terrible human sacrifices that accompany any military conflict, is the direction of oil prices and the upsetting impact on trade, currency markets and government priorities that the prospect of broader geopolitical tensions could have. Meanwhile, the impasse over electing a House Speaker heightens the odds of a government shutdown in mid-November and undermines the ability of Congress to make urgent decisions that may be critically needed in the current turbulent geopolitical environment.

It is well known that the markets abhor uncertainty, and the escalating turmoil can only add to the angst that investors are feeling. Remarkably, the market impact so far has been relatively tame, with the predictable safe haven bid reversing some of the steep ascent in Treasury yields over the past month. Importantly, the headline-grabbing and uncertain impact of the external shocks this week overshadowed fresh inflation data that had been eagerly awaited for its policy implications. While consumer prices came in a touch stronger than expected in September, it is not likely to prompt a knee-jerk reaction from the Fed. A one-month mild upside surprise does not derail the disinflationary trend that remains firmly intact. What's more, the tightening of financial conditions over the past month, highlighted by a surge in bond yields, is doing some of the heavy lifting for the Fed aimed at curbing demand. That assessment was confirmed by several Fed officials over the past two weeks and will likely prevent another rate increase at the upcoming October 31-November 1 meeting. That said, the mildly disappointing CPI report does increase the odds of a rate hike at the December meeting, particularly if the next two employment and jobs reports also come in stronger than expected.

It is hard to derive a clear-cut message from the September CPI report. The overall index increased 0.4 percent during the month, a tad higher than the expected 0.3 percent, leaving the increase over the past year at the same 3.7 percent as August.  The core consumer price index that strips out volatile food and energy prices and is considered a better gauge of underlying inflation trends, advanced by 0.3 percent for the second consecutive month, although the increase over the past year retreated to 4.1 from 4.3 percent in August. While both readings have come a long way down from the 9.1% and 6.6% peaks reached last year, they are still well above the Fed's 2% target, reflecting the difficulty in completing the last leg of the inflation fight.

A deeper dive into the consumer price report, however, suggest that underlying inflation has shown more progress than depicted in the headline readings. A 1.5 spike in energy prices helped drive the rise in the overall CPI last month and its potential contribution this month could go either way. Oil prices plunged by more than $10 a barrel between September 27 and October 5 but have since rebounded, spiking by about $5 over the past two days. The average for the month so far is still well below the September average, but that could change depending on how oil supplies are affected by events in the Middle East. But while the response of oil prices to the rise in geopolitical tensions is predictable, a surprising boost to overall prices last month came from shelter costs, which staged a robust 0.6 percent increase, double the increase in August and matching the strongest advance in six months. Take out the housing component, and the inflation trend looks much more encouraging. In fact, the core CPI excluding housing costs has already hit the Fed's 2 percent target, rising by 1.9 percent from a year ago.

The boost from housing costs – which accounts for about 40 percent of the core CPI – comes as somewhat of a surprise. According to industry data, market rents on new leases have been coming down for several months. While the Labor Department's calculations include all rents that were negotiated over the past year, it was thought that the new leases would be starting to filter through and have a slowing impact on housing costs in the consumer price index. So far, that has not happened. Rents on primary residences increased 0.5 percent for the second consecutive month in September and in four of the past five months. Still, that's smaller than the 0.8 percent average monthly gains recorded over the first half of the past year, and the year-over-year increase has slowed to 7.4 percent from a peak 8.8 percent over the past five months. We expect that slowing trend to continue, reflecting the ongoing drag from new leases and the huge supply of apartments that is poised to hit the market.

Importantly, the upside surprise in inflation last month not only buttresses the sentiment that the Fed will keep rates higher for longer, but it also saps purchasing power from ordinary households. For the second month in a row, consumer prices increased faster than worker earnings, resulting in lower real earnings. This nascent trend threatens to undo the rise in real worker pay over the past year, when the plunge in the overall inflation rate from 9.1 percent to 3.7 percent was far steeper than the slowdown in earnings growth, lifting real worker pay; by June of this year, average hourly earnings was running 1.3 percent faster than the CPI over the previous year. Since then, the gain in purchasing power has steadily eroded and is now down to a slim 0.4 percent over the past year.

For a while, inflation took a bigger toll on higher-earning workers than those further down the pay scale, as the latter enjoyed stronger wage increases than workers in higher paying occupations, according to the Atlanta Federal Reserve Wage Tracker. By last October, the gap in wage growth hit 3 percent, as labor shortages were more acute in lower paying industries and the competition for those workers drove up wages. However, that gap has narrowed considerably with only a 0.4 percent difference separating wage growth between the lowest and highest earning workers in September. Meanwhile, the median wage growth for all workers has slowed from 6.4 percent to 5.2 percent.

The Atlanta Fed's data, however, only tracks wages for people who are working. There are 71 million Americans that rely heavily on social security benefits for living support, and most do not hold jobs. With the latest CPI report now in the books, the third-quarter inflation rate will deliver an average 3.2 percent increase in benefits next year. That's down from a record-setting 8.7 percent increase this year. More disconcerting for seniors is that the CPI data which determines the benefit increase underestimates the inflation rate that they actually face. The Labor Department compiles an experimental series that tracks prices for people 62 and older, and it turns out that their inflation rate is higher than that for the general public. So far this year, the inflation penalty seniors are incurring is the steepest since the 1990s, although it has recently narrowed a bit. With an aging population and seniors accounting for an ever-larger fraction of personal consumption, this trend may become more of a drag on growth than is generally perceived.

GPA SOLUTIONS

# FINANCIAL INDICATORS

| INTEREST RATES | Oct 13 | Week Ago | Month Ago | Year Ago |
|---|---|---|---|---|
| 3-month Treasury bill | 5.50 | 5.51 | 5.47 | 3.71 |
| 6-month Treasury bill | 5.56 | 5.58 | 5.52 | 4.32 |
| 2-year Treasury note | 5.01 | 5.07 | 5.04 | 4.51 |
| 5-year Treasury note | 4.65 | 4.76 | 4.46 | 4.27 |
| 10-year Treasury note | 4.63 | 4.79 | 4.34 | 4.02 |
| 30-year Treasury bond | 4.77 | 4.96 | 4.42 | 4.00 |
| | | | | |
| 30-year fixed mortgage rate | 7.57 | 7.49 | 7.18 | 6.92 |
| 15-year fixed mortgage rate | 6.89 | 6.78 | 6.51 | 6.09 |

| STOCK MARKET | | | | |
|---|---|---|---|---|
| Dow Jones Industrial Index | 33,620.29 | 33,407.58 | 34,618.24 | 29,634.83 |
| S&P 500 | 4,327.78 | 4,308.50 | 4,480.32 | 3,583.07 |
| NASDAQ | 13,407.23 | 13,431.34 | 13,708.33 | 10,321.39 |

| COMMODITIES | | | | |
|---|---|---|---|---|
| Gold ($ per troy ounce) | 1,945.80 | 1,844.60 | 1,945.20 | 1,650.20 |
| Oil ($ per barrel) - Crude Futures (WTI) | 87.69 | 82.83 | 91.34 | 85.55 |

| ECONOMIC INDICATOR | Latest Month/Quarter | Previous Month/ Quarter | Two-Months/ Qtrs Ago | Average-Past Six Months or Quarters |
|---|---|---|---|---|
| Consumer Price Index (September) - % change | 0.4 | 0.6 | 0.2 | 0.3 |
| Core CPI (September) - % change | 0.3 | 0.3 | 0.2 | 0.3 |
| Producer Price Index (September) - % change | 0.5 | 0.7 | 0.6 | 0.3 |



**HEADQUARTERS:**
6650 SW Redwood Ln Suite 365
Portland OR 97224