GOVERNMENT PORTFOLIO ADVISORS

# Weekly Economic Update—December 18th, 2023

Let the speculation begin as to when the Fed will implement its first rate cut in more than three and a half years. Following the highly anticipated policy meeting this week the financial markets lost no time pricing in quick and frequent rate reductions in 2024 that runs well ahead of the projections set forth by Fed officials. True, the markets are prone to overreact to perceived policy shifts, even minor ones, but the reaction this time was particularly sharp. Stock prices roared ahead, with the Dow Jones Industrials hitting a new record following the meeting, market yields tumbled, with the 10-year Treasury yield falling below 4 percent for the first time since July and the 2-year yield, most sensitive to policy expectations, staging one of the biggest single-day plunges in fifteen years. Things settled down a bit on Thursday and Friday, but the easing trend in financial conditions remained firmly on track.

Ironically, the widespread view heading into the meeting was that the Fed would beat back growing market expectations that policy was set to pivot towards rate cuts early next year. However, that was anything but the case, either in the fresh set of projections that pointed to three rate reductions next year, or in the post-meeting comments by Fed Chair Powell. Essentially, Powell stated that the markets will do what they do, but policy will stay focused on doing the right thing; presumably, the markets will eventually come along. Simply put, the Fed is tolerating the easing of financial conditions because it believes inflation is firmly on track towards its 2 percent goal and the risk of a resurgence from an economy that is turning softer has been greatly diminished.

We agree that that the unfolding economic backdrop justifies the more dovish stance embraced by the Fed. But we also think the markets are getting ahead of themselves and possibly being set up for a sharp correction, as bumps along the way to a soft landing may well pop up. Indeed, the euphoria generated by the Fed's meeting overshadowed data this week that could otherwise be viewed as a reality check for policy doves who fear that sustained high rates will break the back of the economy. For one, consumers, the economy's main growth driver, are not downshifting their spending gears as dramatically as expected.

Contrary to earlier indications, it turns out that the grinch has not stolen the Christmas spirit after all. After a halting start to the season that saw retail sales sag in October, consumers reopened their wallets in November, providing retailers with stronger sales than expected. It was not a blockbuster month for cash registers by any means; but forecasters expected the 0.2 percent sales decline in October to be followed by another negative reading in November. Instead, retail sales rose by a respectable 0.3 percent, which was held back by a price-driven 2.5 percent decline at gasoline stations. Excluding sales at the pump, retail sales jumped by 0.6 percent, led by strong gains in online sales and at restaurant and bars. The pattern so far in the fourth quarter is the mirror image of last year when retailers enjoyed a torrid sales gain in October followed by setbacks in November and December. However, the front-loaded strength last year lifted the average for the quarter, resulting in a stronger gain for holiday sales than will be the case this year, barring a surprising surge in December.

The retail sales report mainly tracks purchases of goods, although restaurants and bars, which saw a sturdy 1.6 percent gain last month, fall into the service category. We will be getting the more comprehensive measure of consumer spending, including services, later this month in the personal income and spending report. But the fact that households continue to spend freely at eating and drinking establishments suggests that personal consumption is still receiving major support from spending on services. What's more, the control group of retail sales, which feeds directly into personal consumption, notched a respectable 0.4 percent increase last month following no change in October.

Importantly, retail sales rose faster than the 0.1 percent increase in consumer prices last month, so most of the gain was in real purchases. That, in turn, is further evidence that the economy remains out of recession territory in the fourth quarter, although growth for the period will be significantly weaker than the outsized 5.2 percent pace recorded in the third quarter, which, as noted, derived most of its strength early in the period. The subdued rise in prices together with the sustained spending by consumers also enhances the odds that the elusive soft landing pursued by the Fed is within reach. This prospect, of course, is the ultimate sweet spot that the Fed is pursuing and the promising trends towards that goal was clearly evident in the message conveyed at the policy meeting as well as Powell's post-meeting press conference.

That said, Powell did not take another potential rate hike completely off the table, and NY Fed president Williams on Friday said that policy makers were not really discussing rate cuts yet. Williams may be playing the bad cop role instead of Powell, striving to beat back overly aggressive market expectations that would stoke easier financial conditions that the Fed would like to see. Still, there are tangible reasons for investors to curb their enthusiasm. The ongoing retreat in headline inflation is encouraging, with the year over year increase in the consumer price index slipping 0.1 to 3.1 percent in November, the slowest since March 2021. But falling gasoline prices are a big reason behind the declining trend and that may or may not be sustainable. Strip out gasoline, and prices look much stickier. The core CPI, which excludes volatile food and energy prices, increased by the same 4.0 percent in November as October, the first time it hasn't declined in eight months. Worse, the change over the previous month ticked up, to 0.3 percent from 0.2 percent in October.

More concerning for the Fed is that the so-called supercore inflation – core service prices excluding shelter – is running at more than a 5 percent annual rate over the past three months, well above the Fed's 2 percent target and showing no sign of slowing. It may be valid to question whether the Fed should pay as much attention to a measure that comprises less than 30 percent of the consumer price index, but its tight link to labor costs heightens its importance. Unsurprisingly, wage growth is slowing amidst a softer job market, but is still running well above the estimated 3 ½ percent pace that would be consistent with a 2 percent inflation rate. According to the Atlanta Fed's wage tracker, released this week, the median wage growth for a worker on the same job over the past year was 5.2 percent in November, the same as October and September. What's more, the premium wage increment for jumping ship to a new job jumped to 1.1 percent In November from 0.8 percent in October, suggesting that the competition for workers is still intense, notwithstanding the drop in vacant positions.

None of this belies the fact that the economy is going in the right direction – not too hot or too cold – which brings a soft landing within reach. But the risk of a premature rate cut that could stall the disinflation trend is real and still on the minds of Fed officials. The markets are priced for an early rate cut next year, as soon as March, and as many as 4 or 5 during the year. We think the Fed will wait a little longer to see how conditions evolve and put through fewer cuts than investors expect.

# FINANCIAL INDICATORS

| INTEREST RATES | Dec 15 | Week Ago | Month Ago | Year Ago |
|---|---|---|---|---|
| 3-month Treasury bill | 5.38 | 5.38 | 5.37 | 4.30 |
| 6-month Treasury bill | 5.33 | 5.38 | 5.38 | 4.70 |
| 2-year Treasury note | 4.43 | 4.73 | 4.91 | 4.20 |
| 5-year Treasury note | 3.92 | 4.25 | 4.44 | 3.63 |
| 10-year Treasury note | 3.91 | 4.23 | 4.44 | 3.49 |
| 30-year Treasury bond | 4.01 | 4.32 | 4.59 | 3.55 |
| | | | | |
| 30-year fixed mortgage rate | 6.95 | 7.03 | 7.44 | 6.31 |
| 15-year fixed mortgage rate | 6.38 | 6.29 | 6.76 | 5.54 |
| **STOCK MARKET** | | | | |
| Dow Jones Industrial Index | 37,305.16 | 36,247.87 | 34,947.38 | 32,920.46 |
| S&P 500 | 4,719.19 | 4,604.37 | 4,514.02 | 3,852.36 |
| NASDAQ | 14,813.92 | 14,403.97 | 14,125.48 | 10,705.41 |
| **COMMODITIES** | | | | |
| Gold ($ per troy ounce) | 2,033.80 | 2,019.00 | 1,983.50 | 1,803.00 |
| Oil ($ per barrel) - Crude Futures (WTI) | 71.78 | 71.20 | 75.84 | 74.50 |

| ECONOMIC INDICATOR | Latest Month/Quarter | Previous Month/ Quarter | Two-Months/ Qtrs Ago | Average-Past Six Months or Quarters |
|---|---|---|---|---|
| Consumer Price Index (November) - % change | 0.1 | 0.0 | 0.4 | 0.3 |
| Core CPI (November) - % change | 0.3 | 0.2 | 0.3 | 0.2 |
| Producer Price Index (November) - % change | 0.0 | -0.4 | 0.4 | 0.2 |
| Retail Sales ( November) - % change | 0.3 | -0.2 | 0.8 | 0.4 |



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