GPA SOLUTIONS

Weekly Economic Update—December 26th, 2023

GPA GOVERNMENT PORTFOLIO ADVISORS

It is hard to remember another week that generated so much positive economic news for so many parties as the one just ended. That includes investors, the Federal Reserve, households and, if the more upbeat readings on consumer confidence is any indication, perhaps the administration as well. With a nod to the holiday season, it's beginning to look a lot like --- a soft landing. Incomes are rising, inflation is declining, and consumers are still spending. What's not to like. Certainly, the financial markets are sounding a festive note, as stock prices are forging ahead, and yields are easing. Despite a slight uptick on Friday that lifted the 10-year Treasury yield to 3.90 percent, this bellwether issue essentially traveled a round trip this year. After surging to over 5 percent at one point in October, it is now hovering close to the 3.88 that prevailed on the final trading day of 2022. Meanwhile, stock prices recouped their losses from last year and the Dow Jones Industrial Average is an eyelash away from a record high. There is still a week to go before the books close on 2023, but things are looking far brighter than earlier this year.

Indeed, incoming data are adding credibility to the Fed's decision to pivot away from more belt-tightening at its December 13 policy meeting. At his post-meeting press conference, Fed chair Powell expressed pleasant surprise that inflation continues to retreat without the assist of a deteriorating job market, belying the notion that only a surge in unemployment and lower wages could tame inflation. Powell was not sure if this benign trend could continue but he is giving it the benefit of the doubt by ending the rate-hiking campaign. So far, his tolerance is paying off.

Some skeptics doubted that pausing rate hikes in July was a good decision, as inflation was still running well above the 2 percent target and the economy was on track to far outpace its potential growth rate. The latest revision to the economy's performance in the third quarter, released this week, showed that such worries were overblown. According to the updated figures, growth in GDP was shaved a bit from the previous estimate of 5.2 percent to a still formidable 4.9 percent. More important is that despite that eye-opening growth, inflation retreated even more than thought, with the headline personal consumption deflator revised down by 0.2 percentage points and the core PCE (which is the Fed's preferred measure) revised down by 0.3 percent.

On an annualized basis, the core deflator increased by 2 percent during the third quarter, the slowest reading since 2020, which suggests that that year-over-year rate will continue to fall from its current 3.8 percent pace. Shortly after the quarterly revisions were released, the news got even better as updated figures from the Commerce Department reveal that the disinflation trend has gathered momentum in the fourth quarter. On Friday, the monthly deflator for November was released along with personal income and spending for the month. All sides of the ledger were positive, most notably on the inflation side. The overall PCE deflator fell by 0.1 percent in November, the first decline since April 2020, lowering the year-over-year increase to 2.6 percent from 2.9 percent in October and 3.3 percent in the third quarter.

To be sure, falling gasoline prices was a big reason for the decline in the headline PCE deflator last month. But the progress with the core inflation rate discussed above, which excludes volatile food and energy prices, continued apace. The core PCE increased by a slim 0.1 percent in November and over the past six months has increased at an annual rate of less than 2 percent. From a year ago, the core deflator is still up by 3.2 percent but that should fall rapidly in coming months and could be close to 2 percent by the middle of 2024. Not coincidentally, that's when the Federal Reserve is expected to start cutting interest rates, the first of three projected by Fed officials at the December 13 policy meeting.

The financial markets are pricing in earlier and more frequent cuts—as many as six – but we believe traders are getting ahead of themselves. To be fair, we expected the Fed to hold off on cuts until the third quarter, but with core inflation approaching 2 percent faster than we thought, that opens the door for a sooner start than before. With core inflation likely to be below 2.5 percent as early as the spring, we think the Fed will be ready to start loosening policy as soon as May once those data are available. Keep in mind that Chair Powell has repeatedly said that inflation does not have to hit 2 percent before policy turns easier, only that it is on a sustainable downward path towards that target. By all accounts, that yardstick is well on its way to being met.

Importantly, the disinflation process is unfolding amid an economy that continues to grow at a healthy pace. We saw a week ago that sales at retail stores were stronger than expected in November. Those sales were mainly for goods, although the one category that falls into the services category – eating and drinking places – showed a sizeable pop, which suggested that spending on services also held up. The more comprehensive income and spending report released on Friday handily confirmed that expectation. While retail sales are reported in nominal dollars, the personal consumption data are reported in both current and inflation-adjusted dollars. It is the latter, real spending, which matters most for GDP, as it comprises 70 percent of the total.

Simply put, households are keeping their wallets open. Real consumption increased by 0.3 percent in November following a 0.1 percent gain in October. With two months of the quarter now in the books, personal consumption is tracking a 2.2 percent growth rate for the fourth quarter. That would be slower than the 3.1 percent of the third quarter, but virtually equal to the average pace of the 10-year expansion leading up to the pandemic recession. It would also serve as the backbone of another sturdy growth rate in GDP, one that is not as strong as the outsized 4.9 percent surge in the third quarter but spot on with the 2.2 percent average quarterly pace over the past twenty years. Unless activity falls off a cliff in December, the economy remains far above the recessionary waters that, earlier in the year, the consensus of economists thought it would be sinking into by now.

Importantly, households still have fuel in the tank to keep on spending. Thanks to a hefty increase in wages and salaries, real disposable income increased by 0.4 percent in November. And since that exceeded the increase in spending, households were able to add to their savings, lifting the personal savings rate to 4.1 percent from 4.0 percent in October. All this good news on the economic and inflation front, together with the boost to 401K plans from rising stock prices, is lifting the spirits of households, as reflected in the latest upbeat readings from the surveys compiled by the Conference Board and University of Michigan. Taken together, with inflation melting away and rate cuts on the horizon, the downside risks to the economy have significantly decreased. Growth should slow as we head into next year, reflecting the lagged impact of past rate increases, depleted savings among lower-income households and less hiring by companies, resulting in weaker income gains. However, the Fed's pivot to lower rates comes just in time to cushion the slowdown and keep the economy out of a recession. It will be a close call, but the prospect of a soft landing has risen from highly unlikely to quite possible.

FINANCIAL INDICATORS

INTEREST RATES	Dec 22	Week Ago	Month Ago	Year Ago
3-month Treasury bill	5.38	5.38	5.42	4.32
6-month Treasury bill	5.30	5.33	5.47	4.66
2-year Treasury note	4.34	4.43	4.96	4.32
5-year Treasury note	3.87	3.92	4.49	3.86
10-year Treasury note	3.90	3.91	4.47	3.75
30-year Treasury bond	4.05	4.01	4.60	3.82
30-year fixed mortgage rate	6.67	6.95	7.29	6.27
15-year fixed mortgage rate	5.95	6.38	6.67	5.69

STOCK MARKET				
Dow Jones Industrial Index	37,385.97	37,305.16	35,390.15	33,203.93
S&P 500	4,754.63	4,719.19	4,559.34	3,844.82
NASDAQ	14,992.97	14,813.92	14,250.85	10,497.86

COMMODITIES				
Gold ($ per troy ounce)	2,064.50	2,033.80	2,003.70	1,806.00
Oil ($ per barrel) - Crude Futures (WTI)	73.49	71.78	75.18	79.35

ECONOMIC INDICATOR	Latest Month/Quarter	Previous Month/ Quarter	Two-Months/ Qtrs Ago	Average-Past Six Months or Quarters
Housing Starts (November) - 000s	1,560	1,359	1,356	1,408
Building Permits (November) - 000s	1,460	1,498	1,471	1,476
Existing Home Sales (November) - mlns of units	3.8	3.8	4.0	4.0
Personal Income (November) - % change	0.4	0.3	0.3	0.4
Personal Consumption (November) - % change	0.2	0.1	0.8	0.4
Personal Savings Rate (November) - Percent	4.1	4.0	3.8	4.3

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