GOVERNMENT PORTFOLIO ADVISORS

Weekly Economic Update—January 22nd, 2024

In recent weeks, investors have had second thoughts about when the Fed would start its widely expected series of rate cuts as well as how deep the cuts would turn out to be. Late last year, the consensus view was that the first reduction would take place in March, followed by as many as six reductions in rapid succession throughout the year. Underscoring this expectation was the firm conviction the economy was poised to enter a new phase of slower growth and receding inflation. The recession forecast so widely held earlier in the year was scrapped as it became evident that the economy was holding up much better than thought amid the Fed's aggressive rate-hiking campaign. But with inflation still receding despite the economy's show of resilience, the financial markets embraced the view that the disinflation process would continue, allowing the Fed to cut rates and avoid a recession.

The perception of a soft landing is still considered the most likely scenario. But recent data suggest that the slowdown may be shallower and not begin as early as thought. Meanwhile, the inflation retreat is running into a few roadblocks that may slow the advance towards the Fed's 2 percent target. Indeed, three key indicators reported so far in the new year – on jobs, consumer prices and retail sales – all came in hotter than expected. Understandably, the markets – which tend to overreact to data surprises – have responded in a time–honored fashion. Bond yields have backed up by 25-50 basis points and only a powerful rally on Friday kept the stock market from spilling red ink this month. Importantly, traders are less confident in their earlier bets that the Fed would start cutting rates as early as March, the prevailing view at the end of 2023.

We concur that that the March launching of the first rate cut was too early of a call, if only because the Fed retains a real fear of easing prematurely, repeating historical mistakes that led to embarrassing reversals when the inflation embers reignited. From our lens, the initial move is likely to occur in May, as it provides the Fed with more time to assess if the disinflation process is unfolding in a sustainable fashion, which we believe will be the case. That said, the hotter-than-expected data noted above provides a cautionary signal that patience and humility are warranted. Granted, all the reports tracked activity that took place in December, and conditions may look strikingly different when fresh indicators for January come out. At the very least, 2023 ended with more momentum than thought, handing off a higher starting level of activity in the new year and imparting an upward bias to growth during the first quarter.

This week's retail sales report reaffirms that momentum. Consumer spending, the economy's main growth driver, ended the year with a flourish, sending sales at retailers up by a robust 0.6 percent in December, following an upwardly revised 0.3 percent increase in November. Any thoughts that households were running out of fuel and would pull back during the holiday season were misplaced, as sales at department stores surged and other retailers catering to holiday shoppers saw their cash registers light up. Critically for the broader economy, the control group of sales, which excludes food, building materials, autos, and gasoline, that tracks consumer spending in the GDP accounts, rose by a torrid 0.8 percent, matching the strongest monthly gain since last January. Compared to a year earlier, the control group rose 5.8 percent, which is slower than the 6.3 percent annual increase recorded in 2022. But inflation fell more sharply, from 6.4 percent to 3.3 percent as measured by the CPI, so consumers got far more bang for the buck during the year.

To be sure, consumers would be hard-pressed to maintain spending at the pace seen in recent months. Lower inflation is boosting household purchasing power, but hiring is slowing and weaker job growth in coming months will restrain wage gains. A host of uncertainties during an election year that will feature a

barrage of negative political headlines amid rising geopolitical tensions is not a confidence-building backdrop. And while lower income workers have been enjoying larger wage gains than other segments of the work force, they are also struggling to meet debt obligations built up during last year's rising rate environment, resulting in climbing delinquency rates on auto loans and credit cards. We expect consumer spending to gradually slow over the course of the year and lead the economy onto the now widely accepted soft landing, helped by the Fed's pivot towards lower rates.

No doubt, the surprising resilience of consumer spending in the face of sharply rising interest rates since the spring of 2022 caught many by surprise, including the Fed. Clearly, the robust labor market that generated 2.7 million jobs during the year played a key role. But another reason undergirding consumer resistance – as well as that of businesses – is that the higher rates had little impact on a broad swath of borrowers who locked in lower rates on loans obtained before the Fed's rate-hiking campaign got underway. Many of those loans are coming due this year and must be refinanced at prevailing higher rates or paid down, either of which will be a drag on spending.

That said, both households and businesses are entering the year with strong balance sheets and the budgetary squeeze from increased debt-servicing charges are unlikely to derail spending or investment. Importantly, even as the locked in low-rate loans cushioned borrowers from the steep rise in rates last year, those higher rates also locked in a potentially huge source of spending power embedded in household assets. Simply put, household balance sheets received an outsized boost from the astonishing increase in housing equity in recent years, thanks to the surge in home prices. Over the past three years, homeowners have acquired $10.5 trillion of additional equity in their homes. However, the more than doubling of mortgage rates since 2021 stifled refinancing activity, preventing homeowners from extracting even a small fraction of that equity for spending purposes.

That may be changing, as mortgage rates have declined by more than a full percentage point from their peak in late October. So far, the recent run-up in the 10-year Treasury bond yield against which mortgage rates are linked has not reversed that trend, as the 30-year fixed mortgage rate continued to decline last week according to Freddie Mac. At 6.60 percent, it is still historically high, but the slide from the 7.76 percent peak last October is stirring the refinancing pot. The index of refinancing activity compiled by the Mortgage Banking Association surged in the first two weeks of January, reaching a nine-month high in the week ending January 12. Should that trend continue, it could potentially unleash an important source of funds for households, partially offsetting the spending drag that we believe will come as consumers strive to increase savings amid a slowing economy as the year progresses.

FINANCIAL INDICATORS

INTEREST RATES	Jan 19	Week Ago	Month Ago	Year Ago
3-month Treasury bill	5.36	5.35	5.38	4.67
6-month Treasury bill	5.23	5.19	5.30	4.82
2-year Treasury note	4.38	4.14	4.34	4.18
5-year Treasury note	4.05	3.83	3.87	3.56
10-year Treasury note	4.13	3.94	3.90	3.41
30-year Treasury bond	4.33	4.18	4.05	3.57
30-year fixed mortgage rate	6.60	6.66	6.67	6.15
15-year fixed mortgage rate	5.76	5.87	5.95	5.28
STOCK MARKET				
Dow Jones Industrial Index	37,863.80	37,592.98	37,385.97	33,375.49
S&P 500	4,839.81	4,783.83	4,754.63	3,972.61
NASDAQ	15,310.97	14,972.76	14,992.97	11,140.43
COMMODITIES				
Gold ($ per troy ounce)	2,031.80	2,053.50	2,064.50	1,927.70
Oil ($ per barrel) - Crude Futures (WTI)	73.71	72.76	73.49	81.40

ECONOMIC INDICATOR	Latest Month/Quarter	Previous Month/ Quarter	Two-Months/ Qtrs Ago	Average-Past Six Months or Quarters
Retail Sales (December) - % change	0.6	0.3	-0.3	0.5
Industrial Production (December) - % change	0.1	0.0	-0.8	0.0
Housing Starts (December) - 000s of units	1,460	1,525	1,376	1,412
Building Permits (December) - 000s of units	1,027	1,124	974	1,004

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