# Weekly Market Commentary

## *February 21, 2023*

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Most January data are now in the books, and the general consensus is that the economy entered the year like a lion after exiting 2022 like a lamb. Indeed, following two months of steady downside surprises, the economic reports for January featured an avalanche of upside surprises. Both real activity and inflation indicators came in above expectations which, unsurprisingly, have led to widespread reassessments of the near-term outlook as well as of monetary policy. The bandwagon has made a near 180-degree turn over the past three weeks.

Recall that everyone rode the “woe is me” narrative as the curtain rose on 2023, thanks to the weak handoff provided by the lackluster performance of key sectors late last year. Consumer spending retreated for two consecutive months, housing activity was mired in a slump and manufacturing output contracted, weighted down by a surfeit of inventories and a dearth in demand for goods. Recession fears escalated and inflation fears decelerated, mirroring several months of slowing price gains. That confluence of events prompted investors to dial back interest rate expectations, including a Federal Reserve pivot away from its aggressive policy tightening sooner than officials had forecasted in December.

Fast forward a month and the consensus now views those past events more as a head fake than prologue. The blockbuster jobs report for January ignited the abrupt change in perceptions, and the slew of releases this week gave it added momentum. A surprisingly robust increase in retail sales indicates that consumers regained their spending mojo in January, factory output rebounded and even the moribund housing sector showed nascent signals of stabilizing, as building permits increased for the first time in four months and mortgage loan applications bounced off their December lows. Importantly, the optimism linked to several months of slowing price gains was rudely squelched by the latest inflation releases, with both consumer and wholesale prices coming in hotter than expected. Unsurprisingly, the financial markets, which had been skeptical of the Fed’s steadfast commitment to its elevated rate projections, have now become believers. Expectations of a rate cut later in the year have all but vanished; according to the options market as of Friday, traders are assigning a greater than 50 percent probability the federal funds rate will be at least half percent higher than now at the end of the year.

This head-spinning turn of events only heightens the already high level of uncertainty over the state of the economy, inflation prospects and how the Federal Reserve will react. From our lens, conditions were neither as dire as they looked late last year nor as vibrant as they now appear. Perceptions that the economy had already entered a recession at the start of the year were clearly off-base, as incoming soft data, particularly on consumer spending, overstated the economy’s weakness in the final months of 2022. Households did not go into hibernation, despite the spending retreat in November and December, but took a breather after pulling forward holiday shopping into October. The altered timing of purchases likely reflected heavily promoted sales by Amazon and other retailers as well as fears of goods shortages that were so prevalent during the previous year.


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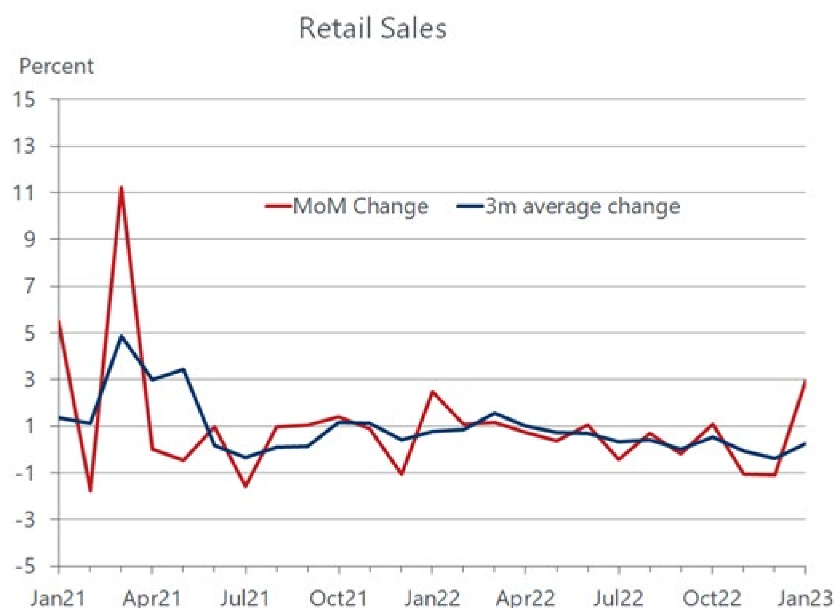
Likewise, the stronger-than-expected 3.0 percent burst in January retail sales reported this week is not a sign that consumers are off to the races, propelling the economy onto an overheated growth trajectory. For one, seasonal quirks were probably at play, as the soft sales in November and December means that less of a pullback than usual occurred in January, giving the raw data more of a seasonal boost than is normally the case. To be sure, there were some solid fundamentals behind the January spurt in outlays, which was spread across virtually all spending categories. The outsized gain in payrolls during the month fattened worker paychecks and imparted considerable muscle to the collective purchasing power of households. In addition, many cost of living adjustment (COLA) clauses kicked in, most notably a sizeable upward adjustment to Social Security benefits, as well as year-end bonuses that may have been larger than usual as companies strive to retain workers in the face of acute labor shortages. The accelerated timing of holiday shopping may also have stripped merchandise from shelves in December, prompting a greater than normal amount of gift card purchases that boosted sales in January.

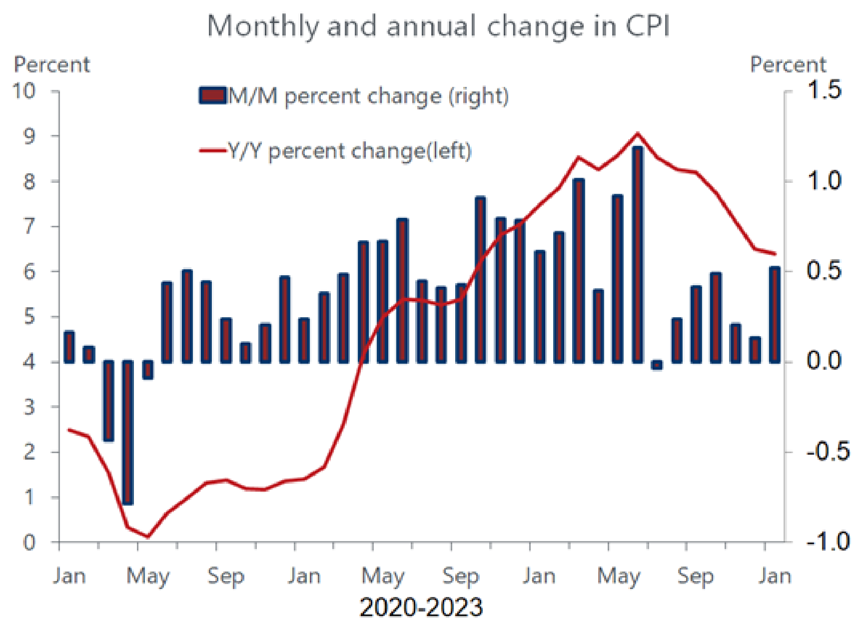
Simply put, monthly economic data around the turn of the year tend to be more volatile and unreliable as a gauge of underlying trends. Looking at three month averages, which provide a better perspective by smoothing out this volatility, retail sales are edging higher, but are hardly at a barn-burning pace. The trend is still well below the pace of most of last year and is still negative when adjusted for inflation. We suspect that the tailwinds boosting consumer spending will fade in coming months. The pool of pandemic-era savings is dwindling, particularly among lower and middle-income households, the COLA and bonus impetus is not a sustainable spending resource and the rapid increase in debt burdens is eating into household budgets. Consumers will be relying more on paychecks to satisfy spending needs, and job growth is poised to slow as employers scale back hiring in the face of softer demand and rising labor costs.




That said, the spending rebound in January does give the first quarter more of a lift-off than expected and is likely to impart more heft to the period's growth rate than previously thought. It also is likely to keep a fire under inflation concerns, which were further inflamed by this week's consumer and producer price reports.

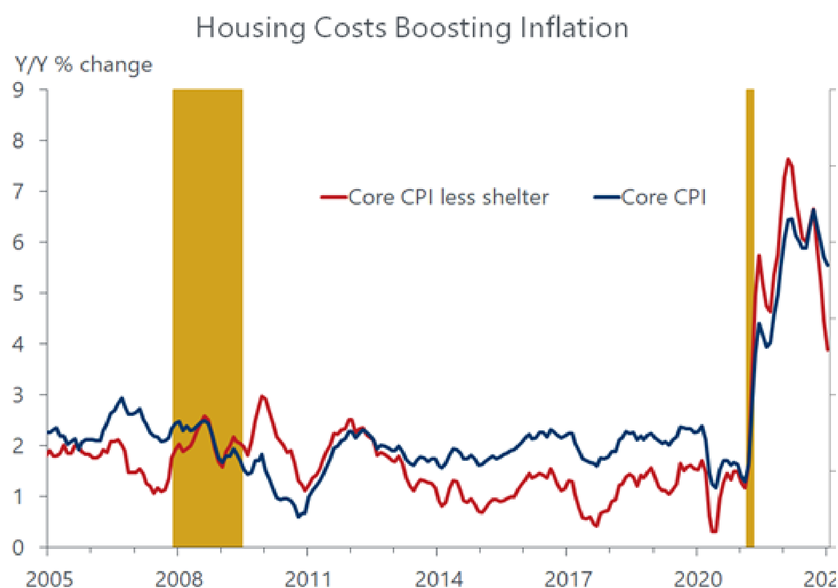
Indeed, inflation watchers had already received a rude awakening prior to the January readings, as new seasonal adjustments released last week revealed that the slowdown in price gains late last year was not as pronounced as initially estimated. Instead of slowing to an average annual pace of 3.1 percent over the final three months of the year, the new seasonals put the increase in the core CPI at 4.3 percent. That's still slower than the 7.1 percent climb in June, but the disinflationary process is turning out to be more of a grind than originally thought.

Worse, the inflation rate sped up in January, with the three-month average in the core rising to 4.6 percent and the year-over-year increase slipping by only 0.1 percent to 5.6 percent, a smaller descent than expected. The headline CPI was even more alarming, leaping by 0.5 percent in January, the fastest climb in four months, even as the December outcome was revised from a minus to a plus 0.1 percent change. Compared to a year ago, the overall CPI is up 6.4 percent, down 0.1 percent from the December pace but 0.2 percent above what the markets were expecting. The headline inflation rate has slowed markedly from the 9.1 percent peak in June, but there is still a wide gap between the current pace and the Fed's two percent target.




Although prices of goods increased, thanks mainly to a 2.0 percent increase in energy prices, the main thrust behind the unsettling spike in the CPI last month came from services, which increased by 0.6 percent. This is where the rubber meets the road for the Federal Reserve, as service prices are stickier than goods prices and are greatly influenced by labor costs. Since wages are tied to the strength of the job market, the Fed understandably feels it needs to keep its foot on the monetary brakes until there are clear signs that labor conditions are cooling, something that was obviously not evident in January. But sturdy wage growth is not the only influence slowing the disinflation process. A more tangible component that feeds directly into the CPI calculation is housing costs, which continues to rise rapidly and contributed fully 50 percent to the CPI increase in January.

Shelter prices, which rose by another sizzling 0.7 percent during the month, also accounts for an outsized 40 percent of the core CPI, and the impact they are having in sustaining inflation at elevated levels is palpable. If not for the 7.9 percent increase in housing costs over the past year, the core CPI would have increased by 3.9 percent instead of 5.5 percent. The major component driving housing costs is rents, which has soared by 8.6 percent over the past year.




The good news is that the climb in rents is nearing an inflection point as new leases are being signed at lower market rates. As older leases roll over into the newer ones, we expect the climb in rents will slow considerably and pull down the overall inflation rate. However, the slowdown will probably not fully kick in until the second half of the year and, hence, pressure on the Fed to raise rates until then should remain strong. This, in turn, will contribute to the headwinds that we see curbing growth markedly by the second quarter, ushering in a mild recession over the second half of the year. That prospect, in turn, would follow a time-honored pattern, as inflation is a lagging indicator that typically peaks after the economy falls into a recession. The question then is whether the Fed will overstay its commitment to keep rates elevated, as the markets are now coming to grips with, or eases up before the downturn becomes more severe than necessary.