WEEKLY
Economic Commentary

FEBRUARY 16, 2024

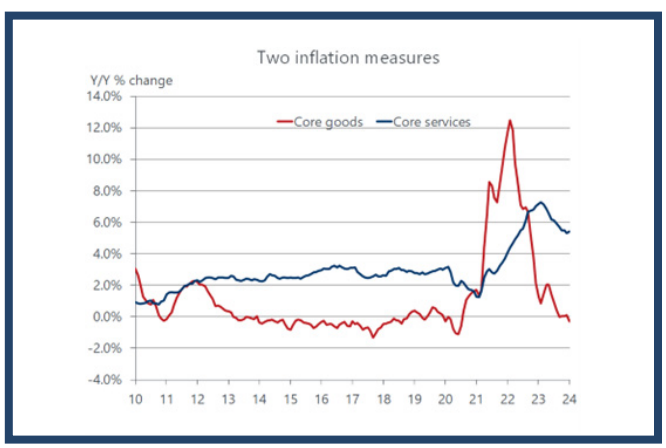
Millennium
CORPORATE CREDIT UNION

Trying to parse this week's batch of economic data invites a splitting headache. For its part, the stock market received a modest case of whiplash, lurching back after absorbing a hotter than expected inflation report, but recovering in response to data revealing cooler economic activity. A Goldilocks scenario may still be unfolding, but the porridge was either too hot or too cold to satisfy the taste buds of skeptical economists. From our lens, incoming data should be viewed with a healthy dose of caution, as January figures tend to be the noisiest of the calendar, reflecting the volatile effects of holidays, weather and one-offs that appear during the first month of the year.

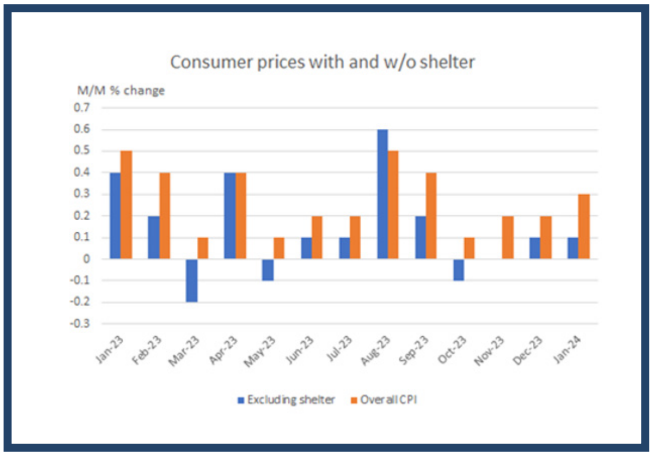
Just as the sizzling employment headlines released a week ago overstated the strength of the labor market, this week's reports delivered hazy messages of underlying trends. The most nerve-rattling of the lot was the consumer price report, which gave the impression that the encouraging disinflation trend has been stopped in its tracks. Both the overall and core CPI came in hotter than expected last month, advancing 0.3 and 4 percent, respectively, from December, sending stock prices reeling on the day of the report's release and bond yields sharply higher. The downbeat mood in the markets continued into Friday, stoked in part by another hotter than expected rise in the producer price index. The repricing by traders reflected heightened expectations that the Fed will keep rates higher for longer, dashing all hopes that a March rate cut was in the offing.

The headline CPI, which was suppressed by a fall in gasoline prices, did continue its downward trajectory from year-earlier levels, slipping to 3.1 percent from 3.4 percent in December. However, the disinflation trend in the core index, which excludes volatile food and energy prices, hit a roadblock, rising by the same 3.9 percent from a year ago as the previous month, only the second time in sixteen months that the core index failed to record a year-over-year decline. The current plateau, however, is significantly below last January, when the core CPI stood 5.6 percent above its year-earlier level. The peak of the current inflation cycle was struck just four months earlier, hitting 6.6 percent in September 2022. The peak-to-trough decline (so far) in the overall consumer price index has been much more dramatic, plunging from 9.1 percent in June 2022 to the current 3.1 percent, thanks to the swift unwinding of goods prices that surged amid the pandemic-era supply disruptions and the onset of the war in Ukraine.

As unsettling to investors as the latest inflation data might be, the Federal Reserve is not likely to alter its policy stance from the guidance provided at the last FOMC meeting or from recent comments by Fed officials. Chair Powell and his colleagues have pushed back on a March rate cut for several weeks, even as they expect to pivot towards ease at some point this year. The question is one of timing, which remains a moving target. A lot depends on the path of sticky service prices, which continue to run far above the Fed's comfort level and has an outsize influence on the inflation gauges. Core service prices are up 5.4 percent from a year ago, even as core goods prices have declined by 0.3 percent over the past year.



Importantly, much of the heat stoking the consumer price index is coming from a source that is widely believed to be unrepresentative of current conditions. Notably the shelter component, which carries a 40 percent weight in the core CPI and more than 30 percent in the overall index, had an outsize impact on the January reading. Indeed, the rise in shelter prices, particularly the 0.7 percent spike in the Owners Equivalent Rent (OER), accounted for fully two-thirds of the increase in the overall index in January. Stripped of that component the headline CPI would have increased by a slim 0.1 percent last month instead of 0.3 percent. But this measure of housing costs includes all rents negotiated over the past year and does not reflect real time developments. According to Zillow and other industry yardsticks, rents on new leases have been cooling significantly; a new alternative measure by the Labor Department, the New Tenant Repeat Rent Index, reveals an even sharper retreat in rental inflation.



That said, service inflation remains a stubborn problem for the Fed. Indeed, prices of services, excluding shelter, leaped by 0.6 percent in January, the fastest since September 2022, and by an annual rate of 6.5 percent over the past three months. While components other than shelter have staged larger than expected increases in January, most notably prices for medical care and financial services that were likely one-time events, above-trend service inflation is broader and slower to unwind. These prices, in turn, are heavily linked to labor costs, which is why the Fed is laser focused on the job market for signs that wage increases are slowing.

The good news is that it is, notwithstanding the aberrational increase in hourly earnings contained in the January employment report. Other, more reliable measures, show a cooling in wage growth that we believe will continue as job growth slows in coming months and the labor force strikes more of a balance between the demand for and supply of workers. To be sure, businesses continue to hoard labor, as reflected in the low number of new applications for unemployment benefits. But that should soon change as the wave of high-profile job losers in recent months find it more difficult to land new positions while their lucrative severance packages as well as the savings cushion from unspent funds during the pandemic runs out. Recent Federal Reserve data indicate that savings among wealthier individuals are depleting faster than for lower income groups.

To be sure, the bargaining position of workers ebbs and flows with the demand for the goods and services they help produce. On this score, consumer demand suffered a setback in January, which softened the blow from the surprisingly hot inflation data and had a steadying influence on the stock market, which recovered on Thursday and Friday. Retail sales turned in the weakest performance in almost a year, slumping 0.8 percent in January. As was the case with the CPI report, there was a lot of noise in data, reflecting harsh weather that kept some consumers home and may have impeded purchases of building materials used for renovation projects. But the setback was broadly based and will weigh on the economy's main growth engine, personal consumption, in the first quarter. The control group of sales, which excludes food, building materials, gasoline and auto sales, and feeds directly into the personal spending component of GDP fell by 0.4 percent, the first decline since last March. What's more, sales data for the previous two months were revised down, indicating that consumer spending is losing momentum. The control group of sales is up 2.5 percent from a year ago, the weakest annual advance since the pandemic shut down the economy in April 2020.

The weaker reading on consumer spending has prompted many to downgrade their estimates for economic growth in the first quarter. The Federal Reserve of Atlanta shaved a half-percent from its GDPNow tracking model following the retail sales report, pegging it at 2.9 percent; at the start of the month, the model was tracking a 4.2 percent growth rate. Our estimates were never as high, but we also see growth coming in at a modestly slower pace than our previous estimate of 2.5 percent. Importantly, while the hotter than expected inflation report dashes the prospect of a March rate cut, the surprisingly soft retail sales report keeps the door open for a Fed move later this spring or summer. That said, consumers are probably not as frugal as the retail sales report suggest nor is inflation as hot as the CPI report indicates. We expect that sturdy spending on services, which is under weighed in the retail sales report, to bolster the more comprehensive personal consumption data to be released later this month. Likewise, the Fed's preferred inflation gauge, the personal consumption deflator, is likely to show less vigor than the shelter-laden consumer price index.

KEY FINANCIAL INDICATORS

INTEREST RATES	February 16	Week Ago	Month Ago	Year Ago
3-month Treasury bill	5.37%	5.38%	5.22%	4.70%
6-month Treasury bill	5.32	5.28	5.03	4.84
2-year Treasury note	4.64	4.48	4.39	4.60
5-year Treasury note	4.28	4.14	4.08	4.03
10-year Treasury note	4.28	4.17	4.15	3.82
30-year Treasury bond	4.43	4.37	4.36	3.88
30-year fixed mortgage rate	6.77	6.64	6.60	6.32
15-year fixed mortgage rate	6.12	5.90	5.76	5.51
STOCK MARKET				
Dow Jones Industrial Index	38627.99	38671.69	37863.80	33826.69
S&P 500	5005.57	5026.61	4839.81	4079.09
NASDAQ	15775.65	15990.70	15310.97	11787.27
COMMODITIES				
Gold ($ per troy ounce)	2025.40	2039.60	2085.20	1902.30
Oil ($ per barrel) - Crude Futures (WTI)	79.22	76.60	73.36	78.51

KEY ECONOMIC INDICATORS

	Latest Month/Quarter	Previous Month/Quarter	Two-Months/ Quarters Ago	Average-Past 6 Months or Quarters
Consumer Price Index (January) % change	0.3	0.2	0.2	0.3
Core CPI (January) - % change	0.4	0.3	0.3	0.3
Retail Sales (January) - % change	-0.8	0.4	0.0	0.1
Industrial Production (January) - % change	-0.1	0.0	0.3	-0.1

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