

# WEEKLY

## Economic Commentary

JANUARY 12, 2024

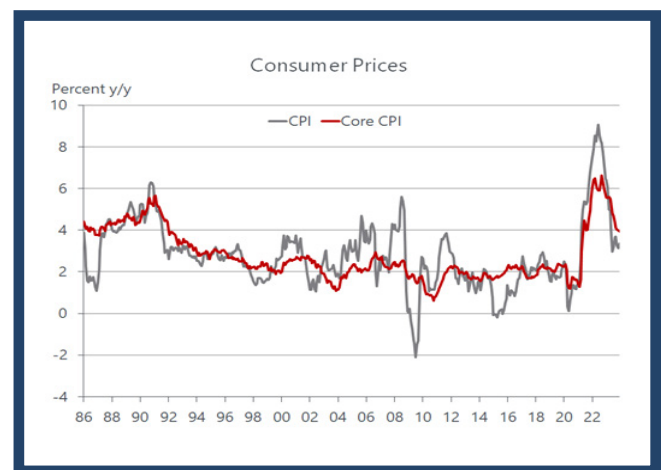


**Millennium**  
CORPORATE CREDIT UNION

**Following a mildly hotter than expected employment report last week, the Labor Department doubled down against the disinflation narrative by issuing a slightly hotter than expected consumer inflation report this week.** The reports, however, were not particularly alarming, nor did they derail the trends that were well entrenched prior to their release. The job market is softening, and inflation is easing; at most, the latest pay-roll and CPI data for December bend the curve rather than alter its direction. Nor did they affect expectations regarding monetary policy. The financial markets are still pricing in more rate cuts this year than the Fed is signaling, although the bets of a move as early as March have been shaved a bit.

The biggest upside surprise came from the headline CPI, which increased 0.3 percent in December, the fastest in three months following a 0.1 percent advance in November and no change in October. That lifted the gain over the past year to 3.4 percent from 3.1 percent. However, excluding the volatile food and energy items, the core CPI came in much as expected. The core index rose 0.3 percent, the same as November but, importantly, slipped to 3.9 percent compared to a year ago, the first time the year-over-year rate fell below the 4 percent threshold since May 2021. There is always a lot of noise in the monthly data, so looking at a broader perspective gives a better idea of underlying trends. Both the headline and core price indexes remain firmly on a downward path; last December, the headline and core inflation rates were running at 6.5 percent and 5.7 percent compared to year earlier levels.

That said, the dramatic slide in inflation in 2023 is now in the rear-view mirror and the road ahead will be bumpier. The question is whether more of a nudge from the Fed is needed to get inflation down to the 2 percent target. Policy makers have not taken another rate increase off the table, if needed, although they are more inclined to keep rates higher for longer rather than pull the hiking trigger again. Both options risk imparting more damage to the economy than justified. However, cutting rates too early poses the opposite risk of reigniting the inflation embers and prompting an embarrassing reversal down the road. From our lens, a rate reduction is in the cards, but the Fed will likely wait a few more months than investors expect to assess unfolding developments. We expect the first rate cut to take place in May unless some confidence-shattering event, such as a dramatic escalation of geopolitical tensions, forces the Fed to act earlier.



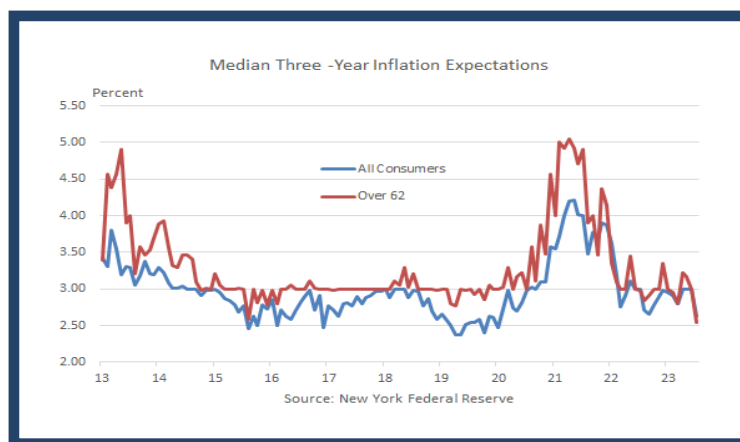
The good news for the economy is that worker pay rose 0.1 percent faster than the 0.3 percent increase in consumer prices last month, lifting real earnings over year-earlier levels for the third consecutive month. Still, while workers are catching up to inflation, they are not there yet, as there is still a ways to go before they recoup the losses caused by the inflationary spiral in 2021 and 2022. Real earnings are still almost 3 percent below the level of December 2020. That shortfall explains why households view high prices as their number one complaint despite the rapid slowdown in inflation. Prices do not have to fall back to prepandemic levels — and they won't -- but if real earnings recoup the losses of the past three years, households will put the inflation scourge in the real view mirror.

The bad news for the Fed is that the catching up process means that prices will continue to come under pressure from rising labor costs. This is a particular issue in the service sector, where sticky prices are more directly linked to wages. However, wage gains are slowing, and that slowing trend should continue as the demand and supply of labor come into better balance. What's more, nonlabor costs are moving into deflationary territory, as prices on the wholesale level fell for the third consecutive month in December. Weak energy prices weighed on this measure, but the core producer price index that excludes volatile food, energy, and trade services is also decelerating at a more rapid pace than prices on the retail level. There is some question as to how much pricing power businesses retain. But the wide spread between retail and producer price inflation offsets some of the squeeze from labor costs, providing businesses with leeway to restrain price increases while cushioning the hit to the bottom line.

Although the Fed would like to see the disinflation process speed up, it has to be encouraged by the ongoing retreat in inflation expectations. A nascent signal of this trend has been appearing in recent surveys by the Conference Board and University of Michigan. But the most significant improvement was reported this week by the New York Fed. In its latest survey of consumer expectations, the median expectation for inflation over the next three years fell to the lowest level since June 2021, falling to 2.62 percent in December from 3.00 percent in November. This drop, one of the largest for a month on record for this survey, gives the Fed confidence that lowered inflation expectations will restrain consumer spending and wage demands, making the job of wrestling inflation down to the 2 percent target easier.

Interestingly, the sharpest retreat in inflation expectations was reported for the older segment of the population. Consumers over the age of 62 expect inflation to fall to 2.54 percent over the next three years, the lowest expected inflation rate since this survey began in 2013. It's unclear why older consumers expect such a dramatic reduction in inflation, although they tend to spend more heavily than the general population on household goods and rent, where prices and rents on new leases have recently been slowing more sharply than overall prices. In any event, this segment of the population was around during the virulent inflationary cycle of the 1970s and may remember how effectively the Fed vanquished inflation the last time it raised rates so aggressively. They may also remember the severe recessions that followed in the 1980s, which may influence their spending propensities as they opt to put aside more savings in the face of possible adversity.

So far, the economy has held up surprisingly well amidst the sharpest Fed rate increases in more than forty years. One reason is that the effects of the rate hikes have not impacted a large swath of borrowers carrying loans that are locked in with the lower rates obtained in the years leading up to and following the pandemic recession. However, many businesses will need to refinance those loans at the higher prevailing rates, and the lagged effects of the Fed's policy are poised to kick in this year. Also important is that as inflation recedes in coming months, the prevailing rates will bite even deeper as the real cost of borrowing increases. We believe that the Fed will respond to this confluence of forces and start following the inflation slowdown with a series of rate cuts starting in May.



# economic COMMENTARY JANUARY 12

## KEY FINANCIAL INDICATORS

INTEREST RATES	January 12	Week Ago	Month Ago	Year Ago
3-month Treasury bill	5.35%	5.38%	5.38%	4.61%
6-month Treasury bill	5.19	5.24	5.33	4.79
2-year Treasury note	4.14	4.40	4.43	4.22
5-year Treasury note	3.83	4.02	3.92	3.54
10-year Treasury note	3.94	4.05	3.91	3.51
30-year Treasury bond	4.18	4.20	4.01	3.61
30-year fixed mortgage rate	6.66	6.62	6.95	6.33
15-year fixed mortgage rate	5.87	5.89	6.38	5.52
STOCK MARKET				
Dow Jones Industrial Index	37592.98	37466.40	37305.16	34302.61
S&P 500	4783.83	4697.20	4719.19	3999.09
NASDAQ	14972.76	14524.10	14813.92	11079.16
COMMODITIES				
Gold (\$ per troy ounce)	2053.50	2052.60	2033.80	1923.00
Oil (\$ per barrel) - Crude Futures (WTI)	72.76	74.00	71.78	80.06

## KEY ECONOMIC INDICATORS

	Latest Month/Quarter	Previous Month/Quarter	Two-Months/ Quarters Ago	Average-Past 6 Months or Quarters
Consumer Price Index (December) - % change	0.3	0.1	0.0	0.3
Core CPI (December) - % change	0.3	0.2	0.3	0.3
Producer Price Index (December) - % change	-0.1	-0.1	-0.4	0.2

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