Weekly Market Flash

A Very Good Inflation Number

December 22, 2023

As the year winds to a close, one of the big stories has been something that didn't happen. That, of course, is the much-predicted Recession of 2023. It seems increasingly likely (though by no means a guarantee) that the economic downturn that did not happen this year will also not happen next year, putting Jay Powell in pole position to pull off what very few of his predecessors have – the "soft landing" at the end of a monetary tightening program. Here's what that soft landing looks like in numbers: unemployment close to its recent lows at 3.7 percent, monthly job creation at a modest but still positive rate, Q3 real gross domestic product growth at 4.9 percent (a pace not likely to be repeated any time soon) and a holiday shopping season that so far seems to be exceeding expectations.

The test for Powell and his Fed colleagues was to accomplish this while at the same time bringing inflation down. On that front, today's Personal Consumption Expenditure report was one of the best inflation prints to date. The PCE is less well known than the Consumer Price index, but it is the measure the Fed pays closest attention to as a gauge of consumer price trends (as usual, the Fed focuses on core inflation without the volatile categories of food and energy). The annualized core PCE reading for November was 3.2 percent, the lowest level since May 2021.

Even better, the month-on-month change in the core PCE was just 0.06 percent, well below the 0.2 percent predicted by economists. The month-on-month number is important because it tells us what has been happening with prices most recently. The answer seems to be: not going up by very much. In fact, the headline PCE number (which includes food and energy) actually fell by minus 0.07 percent month-on-month, bringing annualized headline PCE down to 2.6 percent. If this trend continues, it might actually start registering with Americans dissatisfied about the economy that, well, things are not all that bad (according to a number of surveys, a healthy plurality of our fellow citizens are firmly convinced that we are already in a recession, all the evidence to the contrary notwithstanding).

We will get a more realistic read on overall economic growth when the Q4 GDP report comes out in late January. The 4.9 percent number for Q3 (based on the third revision) was driven by consumer spending and inventory investment, and the latter number in particular is not likely to put in another barnstormer in Q4. But economists have been slowly revising their assumptions upward over the course of the past several months, and the median Blue Chip Consensus estimate is now just around 1.2 percent. The GDPNow tracker run by the Atlanta Fed predicts that Q4 GDP will come in at 2.7 percent, largely due to an expected increase in private business investment.

There are still plenty of unknowns in the mix. One of the challenges, in fact, is how businesses will adjust to weaker pricing power as inflation continues to come down. This morning Nike, a useful benchmark for consumer discretionary trends, gave a downbeat estimate for future macro conditions as weaker demand and less ability to raise prices implies flat or negative sales growth. The company is focusing on cost controls and improved efficiencies to shore up profit margins in response to weaker sales.

Then again, a downbeat macro demand outlook may be the excuse the Fed needs for the rate cuts the market (and, as of last week's FOMC meeting, the Fed itself) expects to see next year. If month-on-month inflation numbers continue coming in at or below 0.1 percent, as with today's PCE report, the central bank will have some leeway to soften its interest rate policy without worrying about another spike in consumer prices. That would be about as smooth a soft landing as possible, were it to come to pass.

For those of you who are celebrating Christmas this weekend, may it be a very merry one full of joy and laughter with friends and loved ones.

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