THOUGHTS OF THE WEEK
Eugenio J. Alemán, PhD, *Chief Economist*
Giampiero Fuentes, CFP®, *Economist*

WEEKLY ECONOMICS

The Pendulum Has Shifted: The Fed has Become Extremely Risk Averse!

Extreme criticism of the Federal Reserve (Fed) over the last year and a half has put Fed officials on the defensive, which means that it went from a highly benign view of inflation (i.e., it is transitory, and we can wait) to a very risk averse stance, which is where we find it today.

This is what we got from the Fed's statement after the Federal Open Market Committee (FOMC) meeting on Wednesday as well as from the press conference given by the Fed Chairman, Jerome Powell. The pendulum has shifted so much that it is purposefully disregarding the better news on inflation we have gotten over the last several months and seems to be willing to overdo its play in terms of monetary policy today. And markets have reacted accordingly after becoming more upbeat in the last couple of months with what they thought was good news and advances on the inflation front.

This section from the Fed's statement gives a clear view of its current extreme risk aversion stance:

> *"In assessing the appropriate stance of monetary policy, the Committee will continue to monitor the implications of incoming information for the economic outlook. The Committee would be prepared to adjust the stance of monetary policy as appropriate if risks emerge that could impede the attainment of the Committee's goals."*
>
> Federal Reserve FOMC statement
> December 14, 2022

This year the Fed had one such event: Russia's invasion of Ukraine and the ensuing war, which sent oil and food prices through the roof and pushed it into the current risk aversion stance. And since almost all petroleum forecasts we have seen lately call for prices of petroleum to go back to $100 or higher, it is clear that the Fed is trying to be ahead of the curve in case this forecast comes to fruition and pushes inflation higher once again.

For this reason, we are including our 'inflation heatmap' in this report so we can see the different inflation paths and the time we will need for the Fed to attain the 2.0% inflation target going forward. Remember that these are very simple scenarios that assume that inflation changes at a constant rate per month in order to observe what would happen to the year-over-year rate of inflation for both the consumer price index (CPI) and the personal consumption expenditures (PCE) price index, which is the favored inflation number targeted by the Fed.

By looking at this 'inflation heatmap' it is clear that what markets are expecting— for the Fed to pivot before the end of 2023—is akin to expecting several monthly deflationary (i.e., negative rates of inflation) readings for both the CPI as well as the PCE price index. Although this is not impossible, it is very unlikely as things stand today. And the reason has to do with, as we indicated above, the possibility for oil prices to, once again, cross the $100 dollar per barrel threshold.

CPI Inflation Heat Map:

	Month-Over-Month CPI Percentage Change							
Year-Over-Year CPI Percentage Change	-0.1%	0.0%	0.1%	0.2%	0.3%	0.4%	0.5%	0.6%
Nov-22	7.1%	7.1%	7.1%	7.1%	7.1%	7.1%	7.1%	7.1%
Dec-22	6.4%	6.5%	6.6%	6.7%	6.8%	6.9%	7.0%	7.1%
Jan-23	5.6%	5.8%	6.0%	6.2%	6.5%	6.7%	6.9%	7.1%
Feb-23	4.7%	5.0%	5.3%	5.6%	5.9%	6.3%	6.6%	6.9%
Mar-23	3.3%	3.7%	4.1%	4.5%	4.9%	5.4%	5.8%	6.2%
Apr-23	2.8%	3.4%	3.9%	4.4%	4.9%	5.4%	6.0%	6.5%
May-23	1.7%	2.4%	3.0%	3.6%	4.2%	4.8%	5.5%	6.1%
Jun-23	0.3%	1.0%	1.7%	2.4%	3.2%	3.9%	4.6%	5.3%
Jul-23	0.2%	1.0%	1.9%	2.7%	3.5%	4.3%	5.2%	5.9%
Aug-23	-0.4%	0.5%	1.4%	2.4%	3.3%	4.2%	5.2%	6.1%
Sep-23	-0.9%	0.1%	1.1%	2.1%	3.1%	4.2%	5.2%	6.3%
Oct-23	-1.1%	0.0%	1.1%	2.2%	3.3%	4.5%	5.6%	6.8%
Nov-23	-1.1%	0.0%	1.1%	2.2%	3.3%	4.5%	5.6%	6.8%
Dec-23	-1.1%	0.0%	1.1%	2.2%	3.3%	4.5%	5.6%	6.8%

PCE Inflation Heat Map:

	Month-Over-Month PCE % Change							
Year-Over-Year PCE % Change	-0.10%	0.00%	0.10%	0.20%	0.30%	0.40%	0.50%	0.60%
Dec-22	5.4%	5.5%	5.6%	5.7%	5.8%	5.9%	6.0%	6.1%
Jan-23	4.7%	4.9%	5.1%	5.3%	5.5%	5.7%	6.0%	6.2%
Feb-23	4.0%	4.4%	4.7%	5.0%	5.3%	5.6%	5.9%	6.2%
Mar-23	3.3%	3.7%	4.2%	4.6%	5.0%	5.4%	5.8%	6.2%
Apr-23	2.2%	2.8%	3.3%	3.8%	4.3%	4.8%	5.4%	5.9%
May-23	1.9%	2.6%	3.2%	3.8%	4.4%	5.0%	5.7%	6.3%
Jun-23	1.2%	1.9%	2.7%	3.4%	4.1%	4.8%	5.6%	6.3%
Jul-23	0.1%	0.9%	1.7%	2.6%	3.4%	4.2%	5.0%	5.9%
Aug-23	0.2%	1.1%	2.0%	2.9%	3.8%	4.8%	5.7%	6.6%
Sep-23	-0.2%	0.8%	1.8%	2.8%	3.9%	4.9%	5.9%	7.0%
Oct-23	-0.6%	0.5%	1.6%	2.7%	3.8%	5.0%	6.1%	7.3%
Nov-23	-1.2%	0.0%	1.2%	2.4%	3.7%	4.9%	6.2%	7.4%
Dec-23	-1.2%	0.0%	1.2%	2.4%	3.7%	4.9%	6.2%	7.4%
Nov-23	-1.2%	0.0%	1.2%	2.4%	3.7%	4.9%	6.2%	7.4%
Dec-23	-1.2%	0.0%	1.2%	2.4%	3.7%	4.9%	6.2%	7.4%

Source: FactSet, RJ Economics

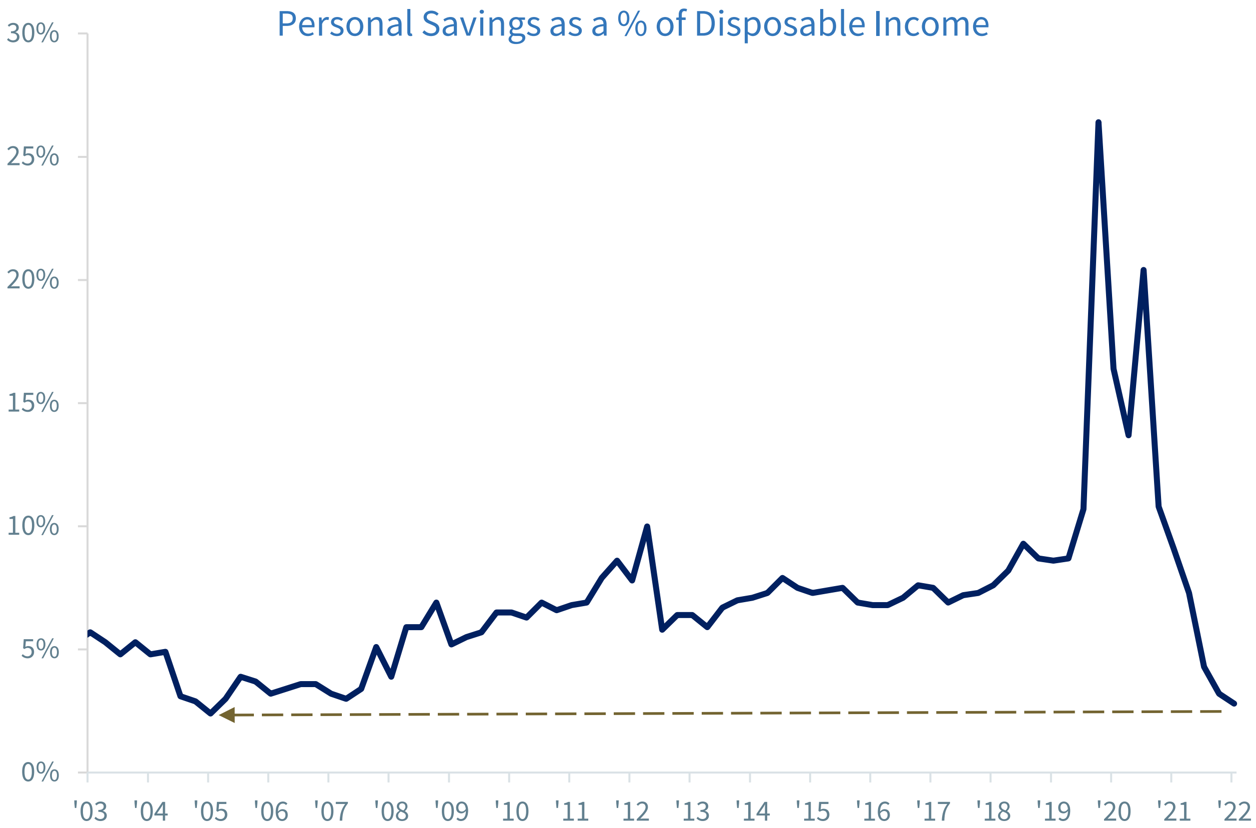
The Federal Reserve's Drive to Affect 'Animal Spirits'

Being at the Fed is probably a very rewarding job in good times, i.e., low inflation and low unemployment, but it is probably very stressful when those two measures are not where everyone expects them to be because the Fed's mandate states that it is responsible for both of these measures to be low at the same time, which is a very difficult feat in normal times, let along during and after a pandemic such as we experienced in 2020.

As we have said on many occasions, the Fed has a very blunt instrument to weaken economic activity, that is, interest rates. As interest rates increase, investment and those sectors that are more sensitive to interest rates, i.e., the housing market, take the lead in weakening. However, there are other sectors that are not that sensitive to interest rates but are much more sensitive to high inflation. That is the case with consumer demand, which is about 70% of the total economy.

Consumer demand is very sensitive to high inflation and less sensitive to interest rates, but that doesn't mean that it is completely immune to higher interest rates. Consumer demand depends on income and income is affected by inflation, i.e., high inflation reduces real income. That is, inflation affects the amount of goods and services we can buy with our income. But consumer demand is also affected by interest rates because, in the end, individuals decide to consume today or to consume tomorrow (i.e., save today) depending on interest rates. If interest rates on savings accounts are too low today, individuals prefer to consume today because the alternative of increasing savings is not an enticing one. However, if interest rates are high today, then they would prefer to save today and increase consumption in the future.

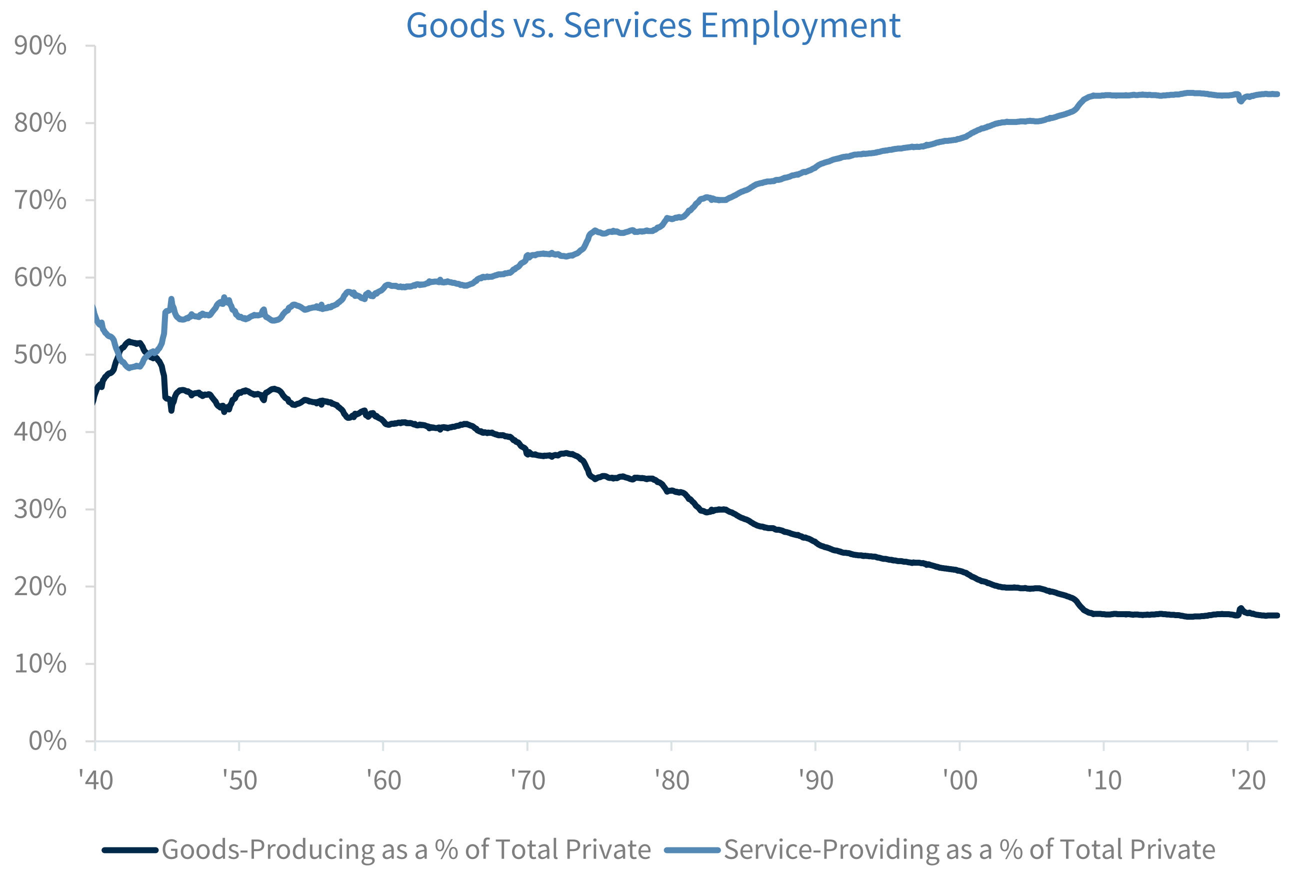
But just by looking at the savings rate today, it is clear that interest rates on savings are still not creating the incentives for Americans to save more today. So, what is the alternative to not saving? To continue to consume. Thus, Americans have continued to consume, even if they have to go into debt to do so.



Source: Federal Reserve Bank of St. Louis, data as of 12/16/2022

This means that the Fed is between a rock and a hard place. It wants to slow down the economy, but the economy is not responding. The goods producing sector is weak, and that is the result of higher interest rates as well as the appreciation of the US dollar. Higher interest rates have slowed the housing market while the appreciation of the US dollar has started to affect exports to the rest of the world. But the goods sector is not tanking, it is, so far, slowing down. However, the service sector is still booming, and it seems it does not care about higher interest rates, at least not yet.

Today, only 16.3% of total nonfarm employment is in the goods-producing sector. This sector of employment is still not weakening even though the industrial sector has weakened over the last several months. Furthermore, the rest, that is 87.7% of nonfarm employment, is in the service sector which is still booming.



Source: Federal Reserve Bank of St. Louis, data as of 12/16/2022

So, the only recourse the Fed has today is to ‘scare’ companies that a recession is coming so they start to dial back in terms of employment today as well as employment projections for the coming months. In ‘Fed speak’ this is what it calls ‘guidance.’ Since the Fed has no other way of pushing companies to slowdown or even shred employment, it is letting them know that it is going to be even tougher than it has been in the past in order to make companies change their expectations about the future. That is, they are trying to change expectations in order to affect what John Maynard Keynes called ‘animal spirits’

According to investopedia.com: *“Animal spirits represent the emotions of confidence, hope, fear, and pessimism that can affect financial decision-making, which in turn can fuel or hamper economic growth. If spirits are low, then confidence levels will be low, which will drive down a promising market—even if the market or economy fundamentals are strong. Likewise, if spirits are high, confidence among participants in the economy will be high, and market prices will soar.”*

So, this is where we are today. The Fed is trying to ‘scare the bejesus’ out of the financial markets as well as other economic actors like firms and consumers, so the economy goes into recession. However, firms, but particularly small firms, are saying: why would we not keep increasing employment if we are still understaffed for the amount of business we have today? Meanwhile, consumers argue that since interest rates on savings are so low, they will continue to consume even if they have to continue to borrow because, so far, employment is very strong, and we expect to pay back these debts in the future.

Summary of the week:

CPI: What the November CPI report showed is that this is no longer a “one datapoint doesn’t make a trend” story and that inflation is now on a clear disinflation trajectory. This disinflationary trajectory will probably cement itself in the coming quarters as we expect shelter prices, which represent about a third of the weight on the CPI index, to start weakening. This CPI report will not change this week’s Federal Reserve (Fed) decision to increase the federal funds rate by 50 basis points, but it may help keep the Fed from overtightening monetary policy. We remain in the camp that the Fed will end its tightening campaign at 5.0% for the terminal fed funds rate during this cycle, but we will have more confirmation about this once the Fed ends this week’s Federal Open Market Committee meeting on Wednesday. The consumer price index (CPI) increased by a less-than-expected 0.1% in November on a seasonally adjusted basis after increasing 0.4% in October, according to the US Bureau of Labor Statistics. The year-over-year CPI was down to 7.1% in November, non-seasonally adjusted. The core CPI (that is, all items less food and energy) also increased a less-than-expected 0.2% as used car and truck prices declined 2.9% after declining 2.4% in October. Shelter prices increased 0.6% during the month while transportation services prices declined 0.1%. Meanwhile, medical care services prices dropped 0.7% after declining 0.6% in October. Food prices increased 0.5% during the month while energy prices declined 1.6% as gasoline prices dropped 2.0%. Energy services prices declined by 1.1% in November after declining 1.2% in October as utility (piped) gas services declined 3.5% after previously declining 4.6% in October. This was a very good CPI report and will help cement the view that inflation has peaked and prices are now on a disinflationary path. Perhaps the better news is that inflation was very low even as shelter prices continued to increase, this time by 0.6% after increasing by 0.8% in October. We expect shelter prices to start weakening in the coming quarters, which will add to the disinflationary pressures going forward.

Import/Export Prices : Both US import and export prices declined for the fourth consecutive month in October as lower fuel prices, softer global growth, and a strong dollar continued to put pressure on prices. In fact, while both import and export prices are higher than they were in October 2021, both are now increasing at the lowest year-over-year rate since February 2021. Going forward, additional declines will likely provide further relief to supply chains. US import prices declined for the fourth consecutive month in October by 0.2%, but they are still 4.2% higher than they were a year ago. Fuel prices declined once again, but this time only by 1.3% compared to a cumulative decline of 20.8% over the previous three months. Despite increasing by 0.4% in September, foods, feeds, and beverages resumed the decline that started in April of 2022 and decreased by 0.8% in October. Lastly, automotive vehicles prices experienced the largest monthly increase since January 2022, mostly due to passenger car prices. US export prices declined by 0.3% in October, making it the fourth consecutive monthly decline, and bringing the year-over-year change to 6.9%. Agricultural exports declined the most by 1.0%, mostly due to a 6.6% decline in soybean prices that more than offset higher prices for wheat, fruit, and vegetables. Nonagricultural industrial supplies and materials continued to decline, while capital goods prices increased by 0.2%. Both import and export prices were lower for the fourth consecutive month in October. Excluding energy and food, import and export prices declined by 0.1% and 0.8%, respectively. Along with the recently released inflation data, both declines are good news for the Federal Reserve’s goal of bringing inflation down.

Jobless Claims: After a marginal increase the week prior, initial jobless claims during the week ending December 10 showed that the labor market continued to show signs of strength. Initial claims were down 20,000 and this is the biggest decrease since July of this year. Overall, such tightness in the labor market is not what the Federal Reserve (Fed) wants to see in its fight against inflation. The advance figure for seasonally adjusted initial claims was 211,000, down 20,000 from the previous week’s revised level, according to the Department of Labor. FactSet consensus expectation was for claims of 234,000 during the week. The previous week’s level was revised slightly upward, from 230,000 to 231,000. The four-week moving average, a better measure that reduces week-to-week volatility, was 227,250, reversing last week’s increase and down 3,000. The advance seasonally adjusted insured unemployment rate remained unchanged at 1.2%. The total number of continued claims for the week ending December 3 was 1.671 million, an increase of 1,000 compared to last week’s revised level.

Retail Sales: November's retail and food services sales report was very weak across the board with only a few sectors, mostly services related, avoiding a decline in sales. This report helps to explain the weaker-than-expected consumer price index (CPI) report for November as almost all the sectors had trouble posting higher sales during the month. This means that we could see higher discounting during the month of December as retail firms try to get rid of inventories as the year ends. This will probably help weaken inflation readings at the end of the year. However, as we learned yesterday with the Federal Reserve (Fed) chairman's comments and statement, do not expect any change in Fed monetary policy due to weaker consumer demand and weaker inflation readings. Retail and food services sales declined by a larger-than-expected 0.6% in November after surging 1.3% in October, according to the US Census Bureau. Still, retail and food services sales were up 6.5% in November of this year compared to the same month a year earlier. Control group sales, a proxy used for personal consumption expenditures, declined 0.2% during the month but is up 5.5% compared to November of last year. Retail trade sales were down a larger 0.8% compared to October but were 5.4% higher than in November of last year. Total retail and food services sales excluding sales of motor vehicles and parts were down 0.2%, while sales excluding gasoline station sales were down 0.6%. Motor vehicle and parts dealers' sales declined 2.3%, while furniture and home furnishing stores sales were down 2.6%. Sales at electronics and appliance stores were down 1.5%, while sales at building material and garden equipment and supplier dealers' stores were down 2.5%. Sales at food and beverage stores were up 0.8%, while sales at health and personal care stores were up 0.7%. Gasoline stations sales were down 0.1%, while sales at clothing and clothing accessories stores were down 0.2%. Sales at sporting goods, hobby, musical instruments and bookstores were down 0.6%, while sales at general merchandise stores were down 0.1%. Within this last category, sales at department stores declined 2.9%. Sales at miscellaneous stores retailers were up 0.5%, while sales at nonstore retailers dropped 0.9% during the month. However, sales at food services and drinking places were up 0.9%. November's retail and food services report was weak across the board with almost all categories of goods sales down during the month compared to October. The only bright spots were those sectors related to the service side of the economy like food services and drinking places, in addition to a few good sectors like food and beverage stores sales as well as health and personal care stores sales.

Michigan Consumer Sentiment: Industrial production continued to slow in November with both industrial as well as manufacturing production posting negative rates of growth while capacity utilization came down, reflecting weaker production in both sectors. The only sector that escaped the weakening trend was utilities production, which increased for the first time since July of this year as lower temperatures across the country pushed consumers to increase consumption of utilities. Industrial production declined 0.2% during November compared to the previous month but increased by 2.5% compared to November of 2021, according to the Federal Reserve. Industrial production declined by 0.1% in October but posted a 0.4% increase in September. A decline in manufacturing production of 0.6% during November and a 0.7% decline in mining production were the major culprits for November's decline in industrial production. An increase in the production of utilities, up a strong 3.6%, prevented a larger decline in the index in November. All major market groups saw a deterioration in production during the month with final products declining 0.4%, consumer goods production also declined 0.4% and business equipment production was down 0.8%. Nonindustrial supplies production was down 0.2%, construction was also down 0.2% and the production of materials was down 0.1%. Capacity utilization came down again in November, declining from 79.9% in October to 79.7% in November, the second consecutive monthly decline in this index. Industrial production declined 0.2% during November compared to the previous month but increased by 2.5% compared to November of 2021, according to the Federal Reserve. Industrial production declined by 0.1% in October but posted a 0.4% increase in September. A decline in manufacturing production of 0.6% during November and a 0.7% decline in mining production were the major culprits for November's decline in industrial production. An increase in the production of utilities, up a strong 3.6%, prevented a larger decline in the index in November. All major market groups saw a deterioration in production during the month with final products declining 0.4%, consumer goods production also declined 0.4% and business equipment production was down 0.8%. Nonindustrial supplies production was down 0.2%, construction was also down 0.2% and the production of materials was down 0.1%. Capacity utilization came down again in November, declining from 79.9% in October to 79.7% in November, the second consecutive monthly decline in this index.

Economic Forecasts:

	Quarterly Historical			Quarterly Forecast									Annual	Annual Forecast		
	1Q22	2Q22	3Q22	4Q22	1Q23	2Q23	3Q23	4Q23	1Q24	2Q24	3Q24	4Q24	2021	2022	2023	2024
GDP (annual rate)	**-1.6**	**-0.6**	**3.0**	**1.2**	**0.3**	**-1.8**	**-1.4**	**-0.3**	**1.6**	**1.9**	**2.1**	**2.2**	**5.9**	**1.9**	**0.0**	**0.8**
Year-over-year	3.7	1.9	1.9	0.5	1.0	0.6	-0.4	-0.8	-0.5	0.4	1.3	1.9				
Private Domestic Final Purchases	**2.1**	**0.5**	**0.1**	**-1.0**	**-0.6**	**-2.4**	**-2.1**	**-0.8**	**1.5**	**1.8**	**2.0**	**2.0**	**8.1**	**1.9**	**-1.1**	**0.5**
Year-over-year	4.3	1.8	1.3	0.4	-0.3	-1.0	-1.5	-1.5	-1.0	0.1	1.1	1.8				
CPI (y/y)	**8.0**	**8.6**	**8.3**	**7.2**	**5.5**	**3.5**	**2.7**	**2.4**	**2.4**	**2.4**	**2.4**	**2.4**	**4.7**	**8.0**	**3.5**	**2.4**
Ex-food & energy	6.3	6.0	6.3	6.0	5.2	4.4	3.4	2.9	2.6	2.4	2.4	2.4	3.6	6.1	4.0	2.5
PCE Price Index (y/y)	**6.3**	**6.6**	**6.4**	**5.6**	**4.4**	**3.1**	**2.6**	**2.4**	**2.4**	**2.4**	**2.4**	**2.4**	**3.9**	**6.2**	**3.1**	**2.4**

Fed Funds Target Rate:

	Fed Meeting	Fed Funds Target Rate
2023	Current	4.25-4.50
	January 31-February 1	4.50-4.75
	March 21-22	4.75-5.00
	May 2-3	4.75-5.00
	June 13-14	4.75-5.00
	July 25-26	4.75-5.00
	September 19-20	4.75-5.00
	October 31-November 1	4.75-5.00
	December 12-13	4.75-5.00

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Economic and market conditions are subject to change.

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Consumer Price Index is a measure of inflation compiled by the US Bureau of Labor Statistics. Currencies investing is generally considered speculative because of the significant potential for investment loss. Their markets are likely to be volatile and there may be sharp price fluctuations even during periods when prices overall are rising.

Consumer Sentiment is a consumer confidence index published monthly by the University of Michigan. The index is normalized to have a value of 100 in the first quarter of 1966. Each month at least 500 telephone interviews are conducted of a contiguous United States sample.

Personal Consumption Expenditures Price Index (PCE): The PCE is a measure of the prices that people living in the United States, or those buying on their behalf, pay for goods and services. The change in the PCE price index is known for capturing inflation (or deflation) across a wide range of consumer expenses and reflecting changes in consumer behavior.

The Consumer Confidence Index (CCI) is a survey, administered by The Conference Board, that measures how optimistic or pessimistic consumers are regarding their expected financial situation. A value above 100 signals a boost in the consumers' confidence towards the future economic situation, as a consequence of which they are less prone to save, and more inclined to consume. The opposite applies to values under 100.

Leading Economic Index: The Conference Board Leading Economic Index is an American economic leading indicator intended to forecast future economic activity. It is calculated by The Conference Board, a non-governmental organization, which determines the value of the index from the values of ten key variables

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GDP Price Index: A measure of inflation in the prices of goods and services produced in the United States. The gross domestic product price index includes the prices of U.S. goods and services exported to other countries. The prices that Americans pay for imports aren't part of this index.

FHFA House Price Index: The FHFA House Price Index is the nation's only collection of public, freely available house price indexes that measure changes in single-family home values based on data from all 50 states and over 400 American cities that extend back to the mid-1970s.

Expectations Index: The Expectations Index is a component of the Consumer Confidence Index® (CCI), which is published each month by the Conference Board. The CCI reflects consumers' short-term—that is, six-month—outlook for, and sentiment about, the performance of the overall economy as it affects them.

Present Situation Index: The Present Situation Index is an indicator of consumer sentiment about current business and job market conditions. Combined with the Expectations Index, the Present Situation Index makes up the monthly Consumer Confidence Index.

Pending Home Sales Index: The Pending Home Sales Index (PHS), a leading indicator of housing activity, measures housing contract activity, and is based on signed real estate contracts for existing single-family homes, condos, and co-ops. Because a home goes under contract a month or two before it is sold, the Pending Home Sales Index generally leads Existing-Home Sales by a month or two.

DISCLOSURES

Import Price Index: The import price index measure price changes in goods or services purchased from abroad by U.S. residents (imports) and sold to foreign buyers (exports). The indexes are updated once a month by the Bureau of Labor Statistics (BLS) International Price Program (IPP).

ISM New Orders Index: ISM New Order Index shows the number of new orders from customers of manufacturing firms reported by survey respondents compared to the previous month.ISM Employment Index: The ISM Manufacturing Employment Index is a component of the Manufacturing Purchasing Managers Index and reflects employment changes from industrial companies.

ISM Inventories Index: The ISM manufacturing index is a composite index that gives equal weighting to new orders, production, employment, supplier deliveries, and inventories.

ISM Production Index: The ISM manufacturing index or PMI measures the change in production levels across the U.S. economy from month to month.

ISM Services PMI Index: The Institute of Supply Management (ISM) Non-Manufacturing Purchasing Managers' Index (PMI) (also known as the ISM Services PMI) report on Business, a composite index is calculated as an indicator of the overall economic condition for the non-manufacturing sector.

Source: FactSet, data as of 12/16/2022

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INTERNATIONAL HEADQUARTERS: THE RAYMOND JAMES FINANCIAL CENTER

880 CARILLON PARKWAY // ST. PETERSBURG, FL 33716 // 800.248.8863

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