FLORIDA PRIME™

Weekly Commentary

JANUARY 30, 2023

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Cooling down

The Personal Consumption Expenditures Index (PCE) doesn't get the press time the Consumer Price Index wields, but the Federal Reserve watches it closely. In fact most economists say the Fed staff prefers PCE to CPI, though that's splitting hairs. In any case, both of these measures of inflation have been declining lately—or more accurately rising at a slower pace. Friday, the Bureau of Economic Analysis reported the latest PCE index decelerated to an annualized growth rate of 4.4% in December, lower than November's 4.7% and well below the peak of 5.4% in February 2022 (a 39-year high).

Announced Thursday of last week, the initial measure of fourth quarter 2022 gross domestic product was a better-than-expected increase of 2.9%. Despite that, the recent lower inflation figures probably lock the Fed into a quarter percentage-point increase of the federal funds target rate at Wednesday's Federal Open Market Committee meeting. Policymakers are walking a tightrope here—not wanting to push the economy into a rough recession but leaving inflation little chance to rise again if either index reaches around 2%.

The problem, of course, is that the punishing impact of rate hikes are not immediately felt in the broad economy—only certain aspects such as mortgages and loans respond quickly. By the time other measures, like inventory growth, take longer to be impacted. The latter is a case in point as inventory restocking surged in the fourth quarter. Presumably, it will trail off as consumer demand slows—but nothing is certain. So, a 25 basis-point hike is probably the best route. At the very least, it gives the Fed some room to maneuver before it pauses hikes completely, which we think will happen in the second half of this year.

G40461-19 (1/23)