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By Hubert Marleau

Rational Expectations and Explanations:

The Bureau of Economic Analysis (BEA) reported 2 days before Christmas that the PCE price index had decreased 0.1% m/m in November for the first time since 2020, and excluding food and energy, had increased only 0.1%. On a year-over-year basis, these indices rose 2.6% and 3.2% respectively. What is particularly remarkable, however, is that over the past 6 months, inflation is where the Fed wants it - 2%. Indeed, core PCE inflation - the preferred inflation measure of the Fed - is plummeting, running at an annualised rate of 1.9% and 1.2% over the past 6 and 3 months respectively. Using a more conservative annualised 3-month moving average, the core PCE deflator has grown 2.2%. This, however, is bound to go lower still, because daily real-time indicators from over 30 data sources, encompassing more than 13 million data points, are dropping like flies. The USA Daily Truflation is up 2.56% from a year ago and falling from 6.5%.

This report raises the question as to why the monetary stance needs to be as restrictive as it currently is, which the smart guys that trade the bond market believe. The yield curve inversion is still wide; the policy rate towers over the neutral rate; the money supply is falling; and nominal bond yields, particularly those of short duration, are substantially above inflation. Meanwhile, the market is waging big money that inflation in one year's time will run near 2.0%. Thus, the insurance the Fed insists it needs to ensure that it has killed high inflation expectations is becoming unnecessary.

In the meantime, consumers are adopting a sunnier outlook themselves. A measure of consumer sentiment from the University of Michigan rose no less than 14% to a 5-month high in December, as households brought down their expectations for inflation next year. It has become clearer that the Fed may now be behind the curve, even though the real GDP growth for Q4 is chugging along at the annual rate of 2.3%. There will be a slowdown in economic growth in the first half of 2024, but a pick-up in the second half can be expected because by then the Fed's monetary stance will have completely changed for the better. Thus, the glide to lower interest rates may start sooner than expected, allowing the economy to cruise to a so-called soft landing in which inflation returns to 2% as the swap market predicts, and without a recession as real rates are suggesting. A separate gauge from the Conference Board showed confidence had risen and that expectations for a recession over the next 12 months had fallen to their lowest level of 2023.

P.S. A WSJ story last week showed we've broken out to new all-time highs in the number of households that own stocks. The share of households that own stocks has gone from 53% in 2019 to 58% by the end of 2022, reflecting an uptick in the middle and lower income range, creating a whole generation of new investors. Only a third of households owned stocks in some form in 1989. (In the early-1980s it was less than one-fifth.) The American penchant for stocks is distinct: U.S. households held about 39% of their financial assets in equities, considerably higher than any other westernised

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country including Japan. What is extraordinary is the U.S. has seen its share of the global stock market rise to incredible proportions. The combined market capitalisation of Tesla, Meta, Alphabet, NVIDIA, Amazon.com, Microsoft and Apple is bigger than that of the U.K., China, France and Japan put together. Is this big shift the new normal? Perhaps, if the promising diffusion of AI, robotics and digitalisation brings the productivity that many anticipate. And guess what? The players are all based in North America.

I wish all my readers a happy, healthy and prosperous new year.

Huber Marleau's Macro View

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