**The Economy**

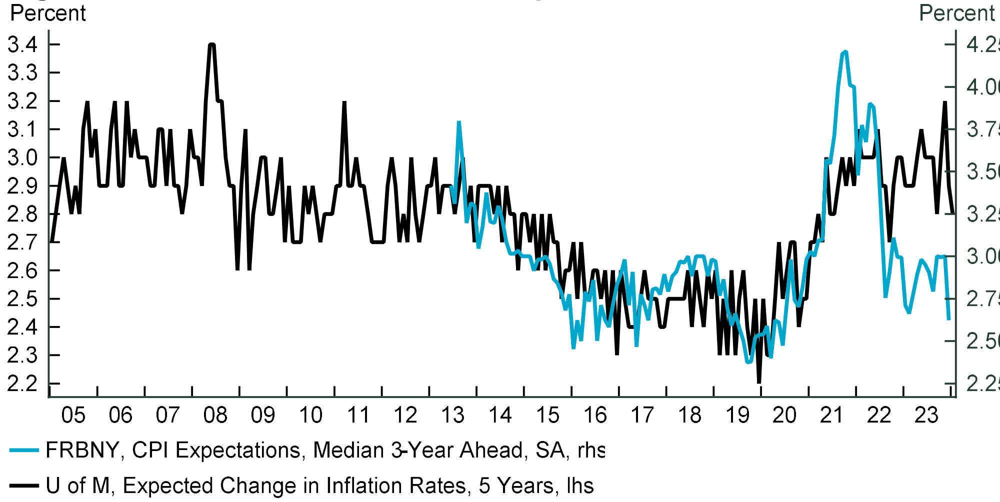
Mixed data as investors scale back expectations of near-term rate cuts.

US

People love disinflation! The surge in the **Michigan consumer confidence index** (up 9.1 points in January to the highest level since July 2021) was all about disinflation. The Michigan survey is much more sensitive to inflation, whereas the Conference Board is more sensitive to labor market. The two surveys had been worlds apart as inflation was high and the labor market tight over the last couple of years, but they are now re-converging (from both ends). One year inflation expectations dropped two tenths to 2.9%, the lowest since December 2020. In reality, this was the delayed response to the decline in gas and food prices we've already seen. And as a reminder of the extent to which all these monthly data need to be taken with caution, recall that the 1-year inflation expectation number in November was 4.5%!...It was that print that we had highlighted at the time as not making much sense because gas prices were already falling…Medium term expectations ticked down a tenth to 2.8% and show no evidence of expectations de-anchoring.

One interesting observation in regard to the drift up in 5-year median inflation expectation in the post-Covid era is that it has been driven less by more people expecting high inflation (5%+) and more by fewer people expecting very low inflation (1-2%). We will argue this change is a good thing if the Fed hopes to avoid zero-lower-bound constraints in the next recession.

**Figure 1: US Consumers' Inflation Expectations Normalize**




*Sources: Macrobond, SSGA Economics, University of Michigan, New York Fed*
*Updated as of 1/19/2024*

Disinflation is also supporting real incomes and that is supporting consumer spending. **Retail sales** surprised positively in December, with total nominal sales up 0.6% m/m and control sales (excluding food services, building materials, autos dealers and gas stations) up 0.8% m/m. The latter was the strongest since January 2023, which seems a little too good to hold up, especially given the reported surge in consumer credit in November. Is that what helped finance the December retail sales?

Both the Empire and the Philly Fed manufacturing surveys undershot expectations in January. The **Empire index** plunged for a second consecutive month to its lowest level since May 2020. We had seen huge single month declines several times over the intervening period, but the sort of back to back retrenchment we got in December and January is unusual. We'll have to see the February data before concluding this is a definitive trend break lower since it could still end up being part of the outsized volatility that has characterized this metric since Covid.

The **Philly Fed index** improved slightly in January, but this followed a downward revision to the December reading; at -10.6, the index remains on the weak side. Notably, new orders cratered to a nine-month low and the second lowest level since the Covid recovery began. We've seen large single month declines in this metric before, but they had previously followed outsized gains. The January order decline follows a modest retreat in December, so the signal appears a bit more ominous. The prices paid measure moved higher in both surveys, whereas the prices received rose modestly in the Philly survey and declined modestly in the Empire survey.

**Industrial production** itself ticked 0.1% higher in December, aided by a 0.1% uptick in manufacturing and a 0.9% increase in mining that offset a 1.0% drop in utilities output. Still, production is up a mere 1.0% y/y, reflecting a broad slowdown in goods demand globally.

The one area of the economy that is unmistakably reviving is housing. Last year, we used to say that "housing is in recession but not in crisis". Now, it is fairer to say that housing *was* in recession. **Housing permits** were up 6.1% y/y in December, while **housing starts** increased 7.6% y/y. These were the best y/y comparisons since March and April 2022, respectively. To be fair, there is a lot of nuance under the surface. As rates rose, activity shifted towards cheaper multi-family units. Now with mortgage rates easing back and likely to decline further as the Fed cuts rates in 2024, the single-family housing segment is gearing up again while multi-family activity softens. Housing permits are a good illustration of this: single-family permits rose 32.9% y/y in December, even as multi-family permits declined 24.2% y/y. There is a similar dynamic with housing starts: single-family starts up 15.8% y/y, multi-family starts down 7.9% y/y.

Homebuilder sentiment is rapidly improving as lower mortgage rates and expectations of further declines one the Fed starts cutting rates later this year help improve affordability. The **NAHB (National Association of Homebuilders) index** surged 7.0 points in January, the twin largest monthly gain since the summer of 2020. There were big improvements across all subcomponents, but especially in future sales expectations, which jumped 12.0 points (the most since June 2020).

**Existing home sales** are the one part of housing that's not yet rebounding as inventory is still extremely limited. Existing home sales declined 1.0% in December and were 6.2% lower than in December 2022. The limited inventory is sustaining high prices (up 4.4% y/y) and perpetuating the affordability challenge.

Canada

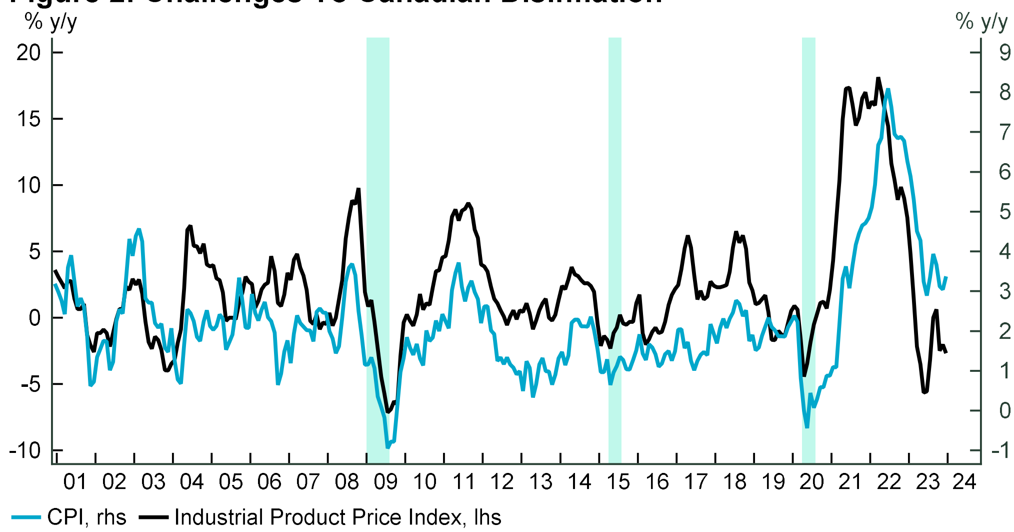
**Consumer price inflation** seems to be a bull fighting back the taming. Sizeable disinflation in a few categories is balanced by deteriorating base-effects in others. Consumer prices rose 0.3% m/m, lifting inflation by three tenths to 3.4% y/y in

December. Goods prices declined 0.8% m/m, but base effects lifted the annual rise by a full percentage point to 2.4% y/y. Meanwhile, service prices were flat m/m but rose 4.3% y/y. Overall, the data reduced the chances of an interest rate cut in the near-term meetings, in line with our expectations.

Most of the reacceleration came from transportation, whose annual inflation jumped 3.3 percentage points to 3.2% y/y (nsa). We see three reasons: base effects in gasoline prices (-4.3% m/m, but +1.4% y/y), seasonal travel (rail & bus transportation +4.3% & 5.4%) and also, strong automobile demand. These factors were balanced somewhat by opposite base effects in air transport (+31.1% & -9.7%), but the category ended up overall contributing 0.54 ppts to the annual inflation, up from being stalled in November.

StatCan also noted that the launching of new 2024 model automobiles had an impact, in line with our note from June 2023 about strong auto demand in Canada. Recovery in the housing sector could also add headwinds to disinflation; in December, rents climbed 7.7% y/y after rising similarly in November. As such, the overall contribution from shelter remained high at 1.8 ppts. The next bout of disinflation will have challenges and would need to be aided by cooling demand.

**Figure 2: Challenges To Canadian Disinflation**




*Sources: SSGA Economics, StatCan, Macrobond*

**Retail sales** declined -0.2% m/m against expectations of having stalled, which is encouraging for the view of cooling aggregate demand. The sales of the control group (excluding gas & auto sales) declined a massive -0.5% m/m (vs. -0.1% consensus). Motor vehicle & parts dealers' sales registered a large 0.5% jump, validating our view of elevated automobile demand. Other categories were quite weak; food sales declined -1.4%, while general merchandise sales were down -1.8%.

Prices of produced manufactured goods and also their raw material prices continued to ease. The **industrial product price** declined -1.5% m/m month or -2.7% y/y annually in December. The fall is led by energy and petrol products, whose industrial product prices fell -8.5% m/m (or -14.2% y/y), the largest decline since a year. Low expectations of future oil demand and oversupply internationally had a role.

Intermediate food products and other categories too declined and was partly balanced by rises in the prices of light-duty trucks & SUVs some precious metal groups. Overall in 2023, industrial product prices declined 1.8%, the second largest decline in history following 2009's 3.5% decline. However, StatCan noted that 14 or the 21 sub-groups saw price increases in 2023, which aligns with our view the next chapter of disinflation in CPI will come with challenges. Separately, **raw materials price index** declined -4.9% m/m which translated into -7.9% y/y annually, after a similar sequential deceleration last month, so there are active forces for disinflation.

All this reinforces our softer than consensus view that the Bank of Canada will stand pat next week and may even push back against market expectations of cuts starting sooner than their liking. We still expect the BoC to cut interest rates by a full percentage point this year, but may begin later than markets expect.

UK

**Headline inflation** unexpectedly rose by one tenth to 4.0% in December, bucking expectations of a decline to 3.8%. However, the increase was primarily due to a rise in tobacco duty and seasonal air fares. Meanwhile, food and non-alcoholic beverages were the largest detractor to the y/y CPI rate, easing 1.2% to 8.0%. Core inflation was stable at 5.1% y/y. Services inflation edged up to 6.4% y/y, which is a bit concerning. This week CPI data has very limited impact on the outlook, and we continue to look for the first rate cut to happen by August at the latest.

The latest data showed a sharp drop in wage pressures. The **growth in average total pay** (including bonuses) eased 0.7 percentage points to 6.5% y/y for the three months to November. Growth in regular pay (excluding bonuses) also eased sharply, down 0.6 percentage points to 6.6% y/y. Labor demand continues easing: vacancies in the three months to December moderated for the 18th consecutive month with declines in 12 out of 18 sectors. Meanwhile, the unemployment rate for the quarter ending November was largely unchanged at 4.2%.

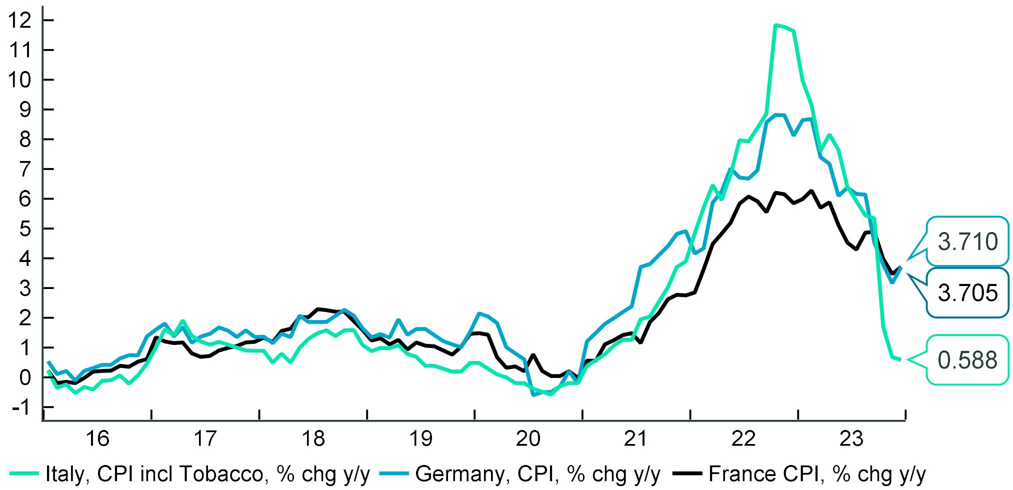
We anticipated a decline in December **retail sales** following strong Black Friday sales in November, but the outcome was far worse than we expected. Retail sales plunged 3.2% m/m (consensus was -0.5% m/m), with declines across all categories. Non-food store sales volumes fell by 3.9%, while food store sales volumes dropped by 3.1%. Non-store retailing and automotive fuel sales contracted 2.1% and 1.9%, respectively. This marks the largest monthly drop since January 2021, when the pandemic affected sales. Consumer spending is likely to continue to struggle in the next few months. However, easing inflation and lower interest rates should provide a boost to real consumer spending in the latter part of the year.

Eurozone

After an extraordinary descent over the last six months, **CPI inflation** metrics across some (but not all) large eurozone economies ticked higher in December. We do not take this to mean the end of eurozone disinflation, but it does suggest that the lowest hanging fruit has already been harvested. This is not really a surprise. In fact, this is precisely why we had been arguing that prior market expectations of 150 bp worth of rate cuts by the ECB this year may be a little too much; we've been favoring 4-5. Market perceptions are now shifting in our direction, though it is so early in the year that one can be sure of plenty oscillations from here on.

**Figure 3: European Disinflation To Slow, Not End**

Percent




*Sources: SSGA Economics, INSEE, DESTATIS, Istat*

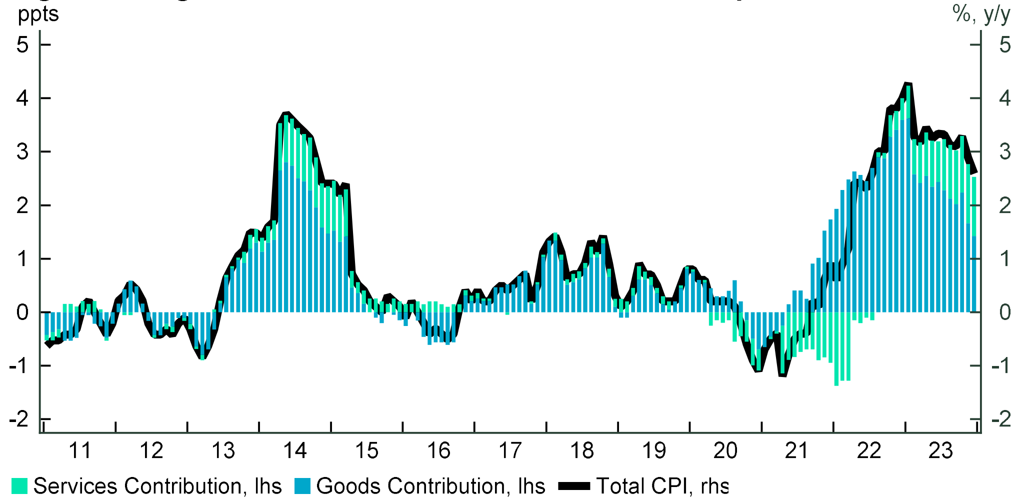
***Eurozone* inflation** ticked up to 2.9% y/y in December from 2.4% y/y in November; ***German*** inflation accelerated half a percentage point to 3.7% y/y, ***French*** inflation rose two tenths to 3.7% also, while ***Italian*** inflation eased a tenth to 0.6% y/y. The ECB should hold steady at the January 25 meeting and emphasize data dependence as a means to push back on near-term rate cuts expectations.

Japan

**Consumer price inflation** is getting entrenched in the Japanese economy, even if the headline metric has come down three-tenths to 2.6% y/y in December. The contribution from goods moderated to 1.42 ppts, the lowest since October 2021, while services contribution remained at its historic high of 1.10 ppts. Considering that services have a 49.5% weightage in the overall basket, we like their strong momentum. Core services (excluding imputed rent) remained robust at 3.3% y/y, down just a tenth from November, but otherwise highest in 33 years.

Disinflation in utilities is the major detractor, bringing the headline down -1.1 ppts, two-tenths more than in November. We expect this to however turn from February, as the lagged effects of declined energy imports (which already seem to have turned around) will wane. Interestingly, recreation and transportation services added 0.70 ppts & 0.40 ppts respectively, highlighting that inflation has spread well into services.

**Figure 4: Highest Contribution From Services to Japan's CPI**




*Sources: SSGA Economics, SBJ, Macrobond*
*Updated as of 1/19/2024*

The official core (excluding fresh food) rose 2.3%, the lowest since July 2022. Still, underlying price pressures are firming up; the global core CPI (excluding food & energy) rose 2.8% y/y, its cyclical high yet. Furthermore, the BoJ's preferred core measure (excluding fresh food and energy) rose 3.7% y/y, down only a tenth from November. Finally on a cautionary note, only three subcategories have accelerated sequentially, the lowest since January 2021, so we advocate some caution in interpreting the strength, given our expectation that consumption may have slowed. Inflation expectations remain near historic highs; a BoJ survey recently found that households expect inflation to rise 7.6% on average in five years.

We have long held the view that **machinery orders** are actually in good shape and that the prevailing narrative of weak orders was incorrect. The reason is the headline core machinery orders exclude the volatile items (ships & electric utilities) from the total that make up nearly 65% of total orders and have been rising historically. In the event, core machinery orders were reported to have declined nearly -5% both sequentially and annually in November. However, the total orders are still robust and still signal strong capital expenditure ahead. The month recorded 2.6 trillion yen worth of sales, which is near historic high. However, the high backlogs have us worried, but also signal a potential rise in production later.

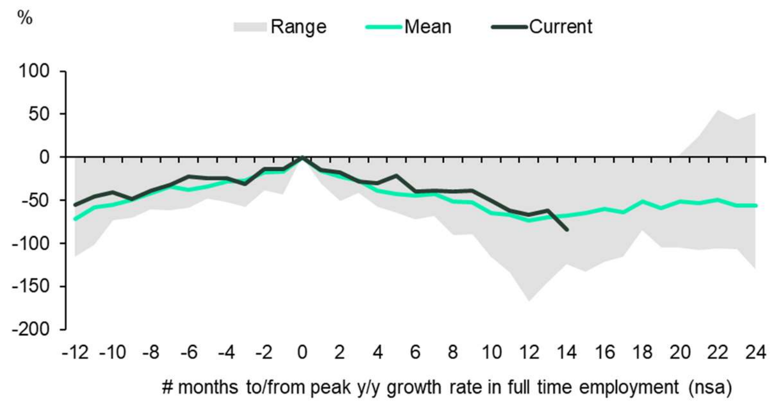
We expect the BoJ to hold its existing policy but we will look for any changes to the forward guidance or hints about how the bank communicates its much anticipated exit from negative interest rates. We also look for reductions to inflation forecasts to accommodate the recently resumed energy subsidies. The BoJ could also increase its funds supplying operation in light of the recent Noto Peninsula Earthquake.

Australia

Total employment declined -65.1k in December against expectations of a rise of 17.6k, after an upwardly revised 72.6k. Full-time, seasonally adjusted (sa) employment registered its **largest decline outside Covid in the 45-years** of -106.5k. However, the non-seasonally adjusted (nsa) data shows that employment improved 9.9k. So, which data is to be believed?

As we highlighted in our November 20 report, seasonality turned to disfavor the sa data over the nsa data. And because they had favored the headline sa data up to now, neither the consensus nor the markets seemed to notice that the labor market was actually cooling. Nonetheless, we suspect if this cooling accelerated. Regular readers are well introduced to the chart below, which showed that the 'cooling' was in line with historic standards until last month. In the November report we wrote specifically, that *"the annual growth in coming months should be significantly slower than its peak in October 2022. Simply put, the dark blue line in the below chart needs to fall below the green line."* The blue line now is indeed below the green line and the medium term developments have high importance for the RBA.

**Full Time Employment Is Cooling Faster Than Ever In Australia**




Source: SSGA Macro Research, ABS, Macrobond

The data issues are quite real; simply put, it overstated the rise in October & November and understated the December data. Still, the **unemployment rate** remained at 3.9% as the participation rate unwound its record jump in November and is now down 0.5 ppts to 66.8%. Furthermore, the participation rate of those aged 15-19 years declined 2.2 ppts and the employment-to-population ratio of those aged between 15-24 (usually seen as a bellwether of slowing labor market) declined to 63.5% from 66.7% in July 2022.

Earlier in the week, the Westpac-Melbourne Institute **consumer sentiment** declined 1.3% m/m to 81.0 in January and remains nearly 20% under its historic average. Home price expectations ticked up (+0.5%) and were more than offset by the decline in family finances (-7.6%).

## Week in Review (Jan 15 – Jan 19)

| Country | Release (Date, format) | Consensus | Actual | Last | Comments |
|---|---|---|---|---|---|
| **Monday, Jan 15** | | | | | |
| CA | Manufacturing Sales (Nov, m/m) | 1.0% | 1.2% | -2.8% | Good. |
| CA | Existing Home Sales (Dec, m/m) | na | 8.7% | -0.9% | Careful, mortgage interest costs in CPI can rise. |
| EC | Industrial Production (Nov, m/m) | -0.3% | -0.3% | -0.7% | Under pressure. |
| JN | PPI (Dec, y/y) | -0.3% | 0.0% | 0.3% | Good. |
| AU | Westpac Consumer Confidence Index (Jan) | na | 81.0 | 82.1 | Weak. |
| **Tuesday, Jan 16** | | | | | |
| US | Empire Manufacturing (Jan) | -5.0 | -43.7 | -14.5 | Big back to back declines! |
| CA | Housing Starts (Dec, thous) | 250.0 | 249.3 | 210.9 (↓) | OK. |
| CA | CPI (Dec, y/y) | 3.4% | 3.4% | 3.1% | Remain sticky. |
| UK | Average Weekly Earnings (Nov, y/y, 3m) | 6.8% | 6.5% | 7.2% | Sharp drop. |
| GE | CPI (Dec, y/y, final) | 3.7% (p) | 3.7% | 3.2% | Recent disinflation pace could not continue. |
| GE | ZEW Survey Expectations (Jan) | 11.7 | 15.2 | 12.8 | Improving. |
| **Wednesday, Jan 17** | | | | | |
| US | Retail Sales Advance (Dec, m/m) | 0.4% | 0.6% | 0.3% | Impressive resilience. Is it debt-fueled? |
| US | Import Price Index (Dec, y/y) | -2.0% | -1.6% | -1.5% (↓) | China exports disinflation. |
| US | Industrial Production (Dec, m/m) | -0.1% | 0.1% | 0.0% (↓) | Up 1.0% y/y. |
| US | Business Inventories (Nov, m/m) | -0.1% | -0.1% | -0.1% | Modest changes. |
| US | NAHB Housing Market Index (Jan) | 39.0 | 44.0 | 37.0 | Better outlook on rate cut expectations. |
| CA | Industrial Product Price (Dec, m/m) | -0.5% | -1.5% | -0.3% (↑) | Strong disinflation forces |
| CA | Raw Materials Price Index (Dec, m/m) | -1.6% | -4.9% | -4.2% | Strong disinflation forces |
| UK | CPI (Dec, y/y) | 3.8% | 4.0% | 3.9% | Unexpected increase. |
| EC | CPI (Dec, y/y, final) | 2.9% (p) | 2.9% | 2.4% | Disinflaiton slowing. |
| JN | Core Machine Orders (Nov, m/m) | -0.8% | -4.9% | 0.7% | Overall orders are robust. |
| JN | Industrial Production (Nov, m/m, final) | -0.9% (p) | -0.9% | 1.5% | Caution needed. |
| JN | Capacity Utilization (Nov, m/m) | na | 0.3% | 1.5% | Caution needed. |
| AU | Employment (Dec, m/m) | 17.6 | -65.1 | 72.6 (↑) | Labor market is now cooling faster. |
| AU | Unemployment Rate (Dec) | 3.9% | 3.9% | 3.9% | Slip in participation rate. |
| **Thursday, Jan 18** | | | | | |
| US | Housing Starts (Dec, thous) | 1,425 | 1,460 | 1,525 (↓) | Demand shifting back to single-family. |
| US | Building Permits (Dec, thous) | 1,477 | 1,495 | 1,467 | Demand shifting back to single-family. |
| US | Philadelphia Fed Business Outlook (Jan) | -6.5 | -10.6 | -12.8 (↓) | New orders plunged. |
| US | Initial Jobless Claims (Jan 13, thous) | 205 | 187 | 203 (↑) | Extremely low. |
| US | Continuing Claims (Jan 06, thous) | 1,840 | 1,806 | 1,832 (↓) | Very low. |
| JN | National CPI (Dec, y/y) | 2.5% | 2.6% | 2.8% | Underlying price pressure are still strong. |
| JN | Tertiary Industry Index (Nov, m/m) | 0.2% | -0.7% | -0.2% (↑) | Caution needed, but no worries. |
| **Friday, Jan 19** | | | | | |
| US | U. of Mich. Sentiment (Jan, prelim) | 70.1 | 78.8 | 69.7 | People love disinflation! |
| US | Existing Home Sales (Dec, m/m) | 0.3% | -1.0% | 0.8% | Pretty much a frozen market still. |
| CA | Retail Sales (Nov, m/m) | 0.0% | -0.2% | 0.5% (↓) | Great data print. |
| UK | Retail Sales Inc Auto Fuel (Dec, m/m) | -0.5% | -3.2% | 1.4% (↑) | Concerning. |
| GE | PPI (Dec, y/y) | -8.0% | -8.6% | -7.9% | Pipeline disinflation. |

Source: for data, Bloomberg®; for commentary, SSGA Economics.

**About State Street Global Advisors**

Our clients are the world's governments, institutions and financial advisors. To help them achieve their financial goals we live our guiding principles each and every day:

- Start with rigor
- Build from breadth
- Invest as stewards
- Invent the future

For four decades, these principles have helped us be the quiet power in a tumultuous investing world. Helping millions of people secure their financial futures. This takes each of our employees in 29 offices around the world, and a firm-wide conviction that we can always do it better. As a result, we have become the world's fourth-largest asset manager* with US $3.8 trillion† under our care.

* Pensions & Investments Research Center, as of December 31, 2022.

† This figure is presented as of June 30, 2023, and includes approximately $63 billion of assets with respect to SPDR products for which State Street Global Advisors Funds Distributors, LLC (SSGA FD) acts solely as the marketing agent. SSGA FD and State Street Global Advisors are affiliated. Please note all AUM is unaudited.