MORNING BRIEFING
October 30, 2023

Geopolitics, GDP & Inflation

Check out the accompanying chart collection.

Executive Summary: We recently raised our subjective odds of a US recession before year-end 2024 from 25% to 35% mostly because the geopolitical risks continue to escalate. We see two potential scenarios that could result in a recession, but they don't warrant raising our recession odds at this time. The US economy remains resilient; we review recent areas of strength. … Also: Further escalation of war in the Middle East could bring unsettling uncertainty to the stock market against a backdrop of well known headwinds and a troubled Chinese economy. … And: We review the latest inflation news. We don't expect the Fed to surprise markets with a rate hike this week.

YRI Weekly Webcast. Join Dr. Ed's live webcast with Q&A on Mondays at 11 a.m. EST. You will receive an email with the link one hour before showtime. Replays of the weekly webcasts are available *here*.

Geopolitics: Getting More Dangerous. The S&P 500 is now down 10.3% since it peaked this year at 4588.96 on July 31 (*Fig. 1*). The S&P 500 equal-weighted index is down 13.7% since then. The Nasdaq is down 7.9% from its July 19 high (*Fig. 2*).

This selloff occurred because the 10-year Treasury bond yield spiked from around 4.00% to 5.00% over this short period. It did so because the Treasury announced on July 31 that the government needed to raise $1.0 trillion during Q3. The next day, on August 1, Fitch Ratings downgraded US government debt from AAA to AA+. The economic indicators released since then showed that economic growth was strong, led by better-than-expected consumer spending. In addition, at his September 20 *press conference*, following the latest FOMC meeting, Fed Chair Jerome Powell reiterated that interest rates are likely to stay higher for longer. Indeed, the FOMC's *Summary of Economic Projections* showed that the committee now expects to cut the federal funds rate by 25bps only twice next year rather than four times as was indicated in June's SEP.

However, the bond yield seems to have found buyers at 5.00% last week and dipped to 4.84% by the end of the week. Thursday's real GDP report for Q3 showed an increase of 4.9%, about as expected. Yet last week, the S&P 500 fell 2.5% as the Nasdaq experienced a mini tech wreck, falling 2.6%. The earnings reports issued by Google and Facebook did

disappoint, but those of Microsoft, IBM, Intel, and Amazon beat expectations.

Joe and I think that the stock market was hit hard by unsettling news out of the Middle East suggesting that the war between Israel and Hamas is spreading. On Thursday, October 19, the USS Carney, a guided missile cruiser operating in the Red Sea, shot down four cruise missiles fired by the Iranian-backed Houthi rebels toward Israel. According to an October 24 *WSJ* *article*, a fifth missile was intercepted by Saudi air defense systems, operating to protect Saudi airspace.

The US launched strikes on Iran-linked facilities in Syria on Thursday in retaliation for a series of drone attacks on American military bases in the region, Defense Secretary Lloyd Austin said. From October 17 to Thursday, US and coalition forces were attacked at least 19 separate times in Iraq and Syria by a mix of drones and rockets, according to defense officials. ABC News reported that Austin *said*, “US military forces conducted self-defense strikes on two facilities in eastern Syria used by Iran’s Islamic Revolutionary Guard Corps (IRGC) and affiliated groups. These precision self-defense strikes are a response to a series of ongoing and mostly unsuccessful attacks against U.S. personnel in Iraq and Syria by Iranian-backed militia groups that began on October 17."

The Biden administration is starting to acknowledge publicly that Iran is the head of the terrorist snake. The administration is sending more forces into the Middle East, including two aircraft carrier groups, additional fighter jets, and missile-defense systems. On Friday, in a speech at the United Nations, Iran’s foreign minister threatened that the US will not escape unaffected if the Hamas-Israel war turns into a broader conflict, firing back after the Biden administration said Iran was ultimately to blame for the recent spate of drone attacks on American forces.

We raised our subjective odds of a recession in the US occurring before the end of 2024 from 25% to 30% on October 10 and again to 35% on October 23 mostly because of the war in the Middle East. Should we do so again now? We’ve decided not to, but we can envision two potential narratives unfolding that could increase the odds of a recession in the US. Here is our thinking:

(1) *Recessionary scenario #1: The war in the Middle East spreads, and oil prices soar.* In recent years, we’ve viewed geopolitical crises as short-term events that provided buying opportunities in the stock market. But the current crisis has the potential to be a lengthy one and to widen into a regional war. That could spike the price of oil if Iran’s oil exports are reduced by the toughening of US sanctions or if the country’s oil export facilities are

attacked. Any spike might not last very long since Saudi Arabia is likely to boost its exports in response. The question then would be whether Iran's surrogates in Yemen would send drones or missiles to attack Saudi oil production, as they did in 2019 and again in 2022. So there is that potential oil price catalyst to a US recession to consider.

(2) *Recessionary scenario #2: Biden's guns-and-butter fiscal policies enrage the Bond Vigilantes.* Perhaps a more plausible reason to raise the odds of a recession is that the high federal budget deficit could be pushed even higher by defense spending, causing bond yields to rise to levels that cause a recession. The US military is facing more challenges than usual—fighting a proxy war against Russia in Ukraine and supporting Israel militarily and fending off Iran-backed terrorists in the Middle East. Meanwhile, the US must provide military deterrence to keep China from invading Taiwan. As a result, defense spending will have to increase at a time that the federal budget deficit is the highest ever excluding the pandemic period.

That could worsen the partisan divide not only between Democrats and Republicans in Congress but also the divides between the extreme wings of both parties from their moderate factions. The Bond Vigilantes might then join the fight by pushing up bond yields to levels that cause a recession.

Meanwhile, the backdrop against which those potentialities could take place includes:

(1) *China's property market disaster is depressing the world economy.* The global economic outlook is weighed down by the poor prospects for economic growth in China, as we discussed last week in Tuesday's *Morning Briefing*. China's economic recovery has been weighed down by a slump in its real estate sector, with major property developers China Evergrande Group and Country Garden Holdings Co. saddled with heavy debts. The real estate market accounts for some 30% of China's GDP. Evergrande filed for bankruptcy in a New York court in August. During the first nine months of 2023, investment in real estate development dropped 9.1% y/y.

China's slow-motion property market collapse is likely to depress the country's economy for years.

(2) *The US remains the shining city upon a hill.* The good news is that the US economy remains resilient, inflation is still on a moderating trend, corporate earnings are growing, the Fed is probably done tightening, and the bond market may be stabilizing. The odds of a recession resulting from the current geopolitical mess are still no greater than 35%, in our

opinion, given these positives.

(3) *Nothing to fear but fearful developments.* Nevertheless, any escalation of the war in the Middle East is bound to unsettle the stock market (and us) by generating more uncertainty about the eventual outcome.

The other problems are well known but still unsettling: Fiscal policy is out of control, the US government is dysfunctional, the Bond Vigilantes are riding high, inflation remains above the Fed's target, cracks are showing up in the credit system, and geopolitical analysts are wondering whether the US can handle three wars if China attacks Taiwan. Plus, there are China's property market problems weighing on its economic activity, as discussed above.

So everything is fine with a few notable exceptions.

GDP: No Hard Feelings. Our relatively optimistic economic outlook through the end of 2024 is somewhat less optimistic now that we have lowered its subjective odds to 65% from 75% in early October. While we've been in the optimistic camp on the resilience of the economy since early last year, we certainly didn't expect that real GDP would grow 4.9% during Q3 until the monthly indicators suggested that neither the hard-landers nor the soft-landers had it right.

In his September 20 *press conference* following the latest FOMC meeting, Fed Chair Jerome Powell said: "[T]he economy has been stronger than many expected given what's been happening with interest rates. Why is that? … [H]ousehold balance sheets and business balance sheets have been stronger than we had understood, and so spending has held up. … The savings rate for consumers has come down a lot. The question is whether that's sustainable. [I]t could just mean that the date of [the monetary tightening] effect is later. It could also be that … the neutral rate of interest is higher for various reasons. We don't know that. It could also just be that policy hasn't been restrictive enough for long enough."

Let's review the recent areas of strength and consider whether they might continue to keep the economy remarkably resilient:

(1) *Strong despite rate shock.* The Citigroup Economic Surprise Index has remained higher for longer near previous cyclical peaks this year (*Fig. 3*). This is one of the reasons why the bond yield has risen more than widely expected this year. The question now is whether the US economy can grow with the bond yield at 5.00%, up dramatically from 0.52% during

August 2020 (*Fig. 4*).

On the one hand, the bond yield has normalized to where it was before the Great Financial Crisis from 2002-07, when the economy was expanding. On the other hand, the last time that the yield rose 500bps in such a short time was from 1977 to 1979, which was followed by two recessions in the early 1980s. Then again, both the household and business sectors refinanced quite a bit of their debts at record-low interest rates during the pandemic period.

While real GDP rose 2.9% y/y during Q3, nominal GDP rose 6.3% y/y (*Fig. 5*). So the bond yield at around 5.00% is still below the growth rate of nominal GDP. During their heydays of the 1980s, the Bond Vigilantes forced yields above nominal GDP growth and raised them three times to slow nominal GDP growth. We are expecting that nominal GDP growth will slow along with inflation with the result that the bond yield remains around 5.00%.

(2) *Consumers have several sources of income.* Let's not forget that many households benefit from higher interest rates. Interest income in personal income rose to a record $1.8 trillion during September, up $300 billion from two years ago (*Fig. 6*). Also at record highs in personal income are proprietors' income ($1.9 trillion), dividend income ($1.8 trillion), and rental income ($1.0 trillion). These four sources of income totaled a record $6.5 trillion in August and were equivalent to 54% of wages and salaries income.

A large percentage of all that non-wage income was earned by older American households, including many retiring Baby Boomers. As we've previously discussed, the Baby Boomers are spending lots of their income on labor-intensive services, which explains why the labor market has been so resilient in the face of tightening credit conditions.

(3) *Signs of rolling recovery in consumer goods.* During the pandemic, the ratio of real consumer spending on goods to spending on real services soared from March 2020 through March 2021 (*Fig. 7*). This buying binge for goods fizzled when consumers were able to binge on services, causing the ratio to decline. But the ratio has flattened out in recent months, suggesting that the rolling recession in consumer goods is bottoming and could be turning into a rolling recovery. That's confirmed by the upturn in both the M-PMI through September and the uptrend since early this year in the four regional business surveys available through October (*Fig. 8*). However, both remain in contractionary territory.

(4) *WFH cushions oil price shocks.* By the way, since more consumers are working from home (WFH) now than before the pandemic and fewer commuting, jumps in gasoline prices aren't as taxing on household budgets as they used to be. Consumers also now have more

flexibility to respond quickly to gasoline price increases by driving less in their neighborhoods. That's what happened when gasoline prices jumped this summer, then dropped when demand weakened recently (*Fig. 9*). (Consumers may now be the Oil Vigilantes!)

Inflation: Still Moderating Enough for the Fed? The FOMC meets on Tuesday and Wednesday. Might they surprise the financial markets and raise the federal funds rate after all? Melissa and I doubt it given the significant rise in the bond yield since the last meeting on September 19-20.

At his post-meeting press conference on Wednesday, Powell is likely to remain as hawkish as he was during his *interview* on October 19. He undoubtedly will acknowledge that inflation has been moderating, but he will reiterate that it remains too high and that the Fed needs to maintain a restrictive monetary policy stance. Here is a brief overview of the latest inflation data:

(1) *Expected inflation.* On Friday, the bad news was that the Consumer Sentiment Index survey showed that October's one-year expected inflation rate jumped to 4.2%, up from 3.2% the month before (*Fig. 10*). This series tends to be highly influenced by the price of gasoline, which is starting to come down. The comparable survey conducted by the Federal Reserve Bank of New York earlier this month reported that expected inflation over the coming year was 3.7%.

The five-year-ahead expected inflation rate was 3.0% in both surveys. In the Fed's lexicon, "inflationary expectations remain well anchored."

(2) *PCED inflation.* The headline PCED inflation rate remained at 3.4% y/y during September (*Fig. 11*). The core rate continued to moderate down to 3.7%. Goods inflation has turned out to be transitory after all. It was only 0.9%, with durable goods down 2.3% and nondurable goods inflation up 2.7% (*Fig. 12*).

The inflation rate for housing and utilities peaked at 8.3% in June and fell to 7.2% in September (*Fig. 13*). That's still quite high but is widely expected to continue to fall in coming months, including by Fed officials.

The so-called "super-core" inflation rate remains sticky. This is the PCED core services inflation rate excluding housing-related items (*Fig. 14*). It did edge down to 4.3% in September. It too is likely to fall in coming months, as suggested by the CPI services less

rent of shelter inflation rate.

Calendars

US: Mon: Dallas Fed Manufacturing Index. **Tues:** Consumer Confidence Index 100.0; Employment Cost Index 1/0%q.q; S&P/CS HPI Composite 1.6%y/y; Chicago PMI 45.0. (FXStreet estimates)

Global: Mon: Eurozone Business & Consumer Survey 93.3; Eurozone Consumer Confidence -17.9; Germany GDP -0.3%q/q; Germany CPI 0.2%m/m/3.6%y/y; Spain CPI 0.4%m/m/3.7%y/y; BoJ Interest Rate Decision -0.10%; Japan Industrial Production 2.5%; Japan Unemployment Rate 2.6%; China M-PMI & NM-0MI 50.4/51.8De Guindos; Enria; Rogers. **Tues:** Eurozone GDP -0.1%q/q/0.2%y/y; Eurozone Headline & Core CPI 3.2%/4.2%y/y; Germany Retail Sales 0.5%m/m/-1.2%y/y; Germany Import Price Index 0.4%; France GDP 0.1%q/q; France CPI 0.2%m/m/4.6%y/y; France Consumer Spending 0.4%; Italy GDP 0.1%; Italy CPI 0.6%m/m/2.6%y/y; Japan Household Confidence 35.1; Japan Housing Stats -4.7%; China Caixin M-PMI 50.8; BoJ Press Conference; De Guindos; Wuermeling; Nagel. (FXStreet estimates)

Strategy Indicators

Global Stock Markets Performance (*link*): The US MSCI index fell 2.6% in its sixth weekly drop of the last eight weeks and slipped deeper into a correction at 15.3% below its record high on December 27, 2021. The US MSCI ranked 41st of the 48 global stock markets that we follow in a week when 18 of the 48 countries rose in US dollar terms. The AC World ex-US index outperformed the US MSCI, but fell 0.9% for the week and slipped deeper into bear market territory at 22.9% below its June 15, 2021 record high. Most regions fell w/w. EM Eastern Europe was the best performer with a gain of 2.6%, ahead of EM Latin America (2.0%), BIC (0.8), EMU (-0.4), EAFE (-0.8), and EM Asia (-0.8). EMEA was the worst performing region last week with a 1.6% decline. Portugal was the best-performing country last week, with a gain of 3.8%, followed by Poland (3.6), Chile (3.4), Mexico (3.1), and China (2.5). Among the 21 countries that underperformed the AC World ex-US MSCI last week, the 3.8% decline for Argentina was the biggest, followed by those of Korea (-3.6), the Philippines (-3.2), and Canada (-3.2). Looking at 2023’s performance so far, the US MSCI is up 7.5%, as its ytd ranking dropped one place w/w to 14/48. The AC World ex-US’s ytd

decline of 1.4% is trailing the US's, with 22/48 countries in positive territory. EM Eastern Europe is the best regional performer ytd with a gain of 20.9%, followed by EM Latin America (4.4), EMU (2.1), and EAFE (0.1). The regional laggards so far in 2023: BIC (-5.9), EMEA (-5.1), and EM Asia (-4.1). This year's best ytd country performers: Greece (29.4), Sri Lanka (29.3), Hungary (27.2), Poland (19.8), and the Czech Republic (18.0). Here are the worst-performing countries of the year so far: Pakistan (-21.9), Hong Kong (-21.1), Finland (-20.0), Thailand (-18.9), and New Zealand (-15.4).

S&P 500/400/600 Performance (*link*): All three of these indexes fell w/w as LargeCap and MidCap posted their biggest drops in five weeks. SmallCap's 2.3% decline was slightly less than the 2.5% and 2.8% drops recorded by LargeCap and MidCap. At Friday's close, LargeCap was in a deeper 14.2% correction from its record high on January 3, 2022, MidCap fell back into a 20.1% bear market from its record high on November 16, 2021, and SmallCap slipped further into bear market territory at 27.1% from its November 8, 2021 record high. Just two of the 33 LargeCap and SMidCap sectors moved higher for the week, compared to seven rising a week earlier. LargeCap Utilities was the best performer with a gain of 1.2%, followed by SmallCap Utilities (0.3), MidCap Consumer Staples (-0.1), SmallCap Consumer Staples (-0.1), and LargeCap Materials (-0.4). Among the biggest underperformers for the week were LargeCap Communication Services (-6.3), LargeCap Energy (-6.2), MidCap Communication Services (-5.1), SmallCap Energy (-4.2), and MidCap Health Care (-4.1). Looking at performances so far in 2023, LargeCap, with a gain of 7.2%, remains well ahead of MidCap (-4.3) and SmallCap (-7.7); nine of the 33 sectors are higher ytd compared to 19 at the beginning of the month. The top sector performers in 2023: LargeCap Communication Services (33.6), LargeCap Tech (31.4), LargeCap Consumer Discretionary (17.7), MidCap Energy (9.5), MidCap Industrials (6.3), and SmallCap Energy (6.1). Here are 2023's biggest laggards: MidCap Utilities (-24.5), MidCap Communication Services (-22.2), SmallCap Health Care (-20.8), SmallCap Financials (-20.4), and SmallCap Utilities (-19.3).

S&P 500 Sectors and Industries Performance (*link*): Just one of the 11 S&P 500 sectors rose last week, but eight outperformed the composite index's 2.5% decline. That compares to a 2.4% decline for the S&P 500 a week earlier, when two sectors rose and five outperformed the index. Utilities was the best performer with a gain of 1.2%, followed by Materials (-0.4%), Consumer Staples (-1.0), Consumer Discretionary (-1.1), Real Estate (-1.2), Tech (-1.7), Industrials (-2.3), and Financials (-2.4). Communication Services was the worst performer, with a drop of 6.3%, followed by Energy (-6.2) and Health Care (-3.9). Looking at 2023's performance so far, the S&P 500 is up 7.2% ytd, with just three sectors still outperforming the index and three higher for the year. The best ytd performers:

Communication Services (33.6), Tech (31.4), and Consumer Discretionary (17.7). These are 2023's worst performers: Utilities (-16.8), Real Estate (-12.7), Consumer Staples (-9.7), Health Care (-9.5), Financials (-8.2), Materials (-3.6), Energy (-3.5), and Industrials (-1.9).

S&P 500 Technical Indicators (*link*): The S&P 500 fell 2.5% last week and weakened considerably relative to its 50-day moving average (50-dma) and its 200-day moving average (200-dma). The index remained below its 50-dma for an eighth week, and dropped further below its 200-dma after being above for 30 weeks. As for what the dmas themselves have been doing, the 50-dma moved lower for a sixth week, but the 200-dma rose for a 22nd week in its longest positive streak since March 2022. Here are the details of where the S&P 500 is trading relative to its 50-dma: The index fell last week to a 53-week low of 5.5% below its falling 50-dma from 3.3% below a week earlier. For perspective, the latest reading is down from a 20-week high of 5.4% above its (rising) 50-dma in mid-June. Other comparison points include: a four-month low of 10.6% below its (falling) 50-dma at the end of September 2022, a 23-month high of 8.7% above its (rising) 50-dma in August 2022, and a 27-month low of 11.1% below its (falling) 50-dma in June 2022. The index had been trading above its 50-dma from most of late April 2020 to early April 2022; in June 2020, it was 11.7% above, which was the highest since its record high of 14.0% in May 2009. That compares to 27.7% below on March 23, 2020—its lowest reading since it was 29.7% below on Black Monday, October 19, 1987. Turning to the 200-dma, the price index dropped to a 42-week low of 3.1% below its (rising) 200-dma from 0.5% below a week earlier. That compares to a 24-month high of 12.4% above its (rising) 200-dma in mid-July. The S&P 500 is well above its 26-month low of 17.1% below its (falling) 200-dma in June 2022 and compares to 17.0% above in December 2020, which was the highest since November 2009 and up from the 26.6% below registered during the Great Virus Crisis on March 23, 2020—the lowest reading since March 2009. At its worst level of the Great Financial Crisis following the failure of Lehman Brothers, the S&P 500 index was 39.6% below its 200-dma on November 11, 2008.

S&P 500 Sectors Technical Indicators (*link*): All 11 S&P 500 sectors trade below their 50-dmas now for the first time since early October, as Communication Services and Energy turned negative again last week. That compares to all 11 S&P 500 sectors above their 50-dmas in the three weeks before the end of July. All 11 sectors also have a falling 50-dma now as Communication Services and Energy turned down in the latest week. Looking at the more stable longer-term 200-dmas, the positive club dropped to two members w/w from three as Energy exited that club. The two sectors still trading above their 200-dmas are Communication Services and Information Technology. The rising 200-dma club shrunk w/w to three sectors, as Energy turned down w/w. Still in the rising 200-dma club are

Communication Services, Consumer Discretionary, and Information Technology.

US Economic Indicators

GDP (*link*): *Real GDP* for Q3 exceeded expectations, expanding 4.9% (saar), stronger than the 4.3% expected gain and more than double the increases of 2.1% and 2.2% the prior two quarters; on a y/y basis, it climbed 2.9% to a new record high. There's no recession indicated in these numbers. Q3 growth was once again led by consumer spending, with inventory investment and exports also adding to the gain. *Real consumer spending*, which accounts for two-thirds of real GDP, increased a larger-than-expected 4.0% (saar), the strongest since Q4-2021, which was also at 4.0%. *Services* consumption advanced 3.6% (saar) after gains of 1.0% and 3.1% the prior two quarters, while *goods* consumption picked up to 4.8% (saar) from Q2's 0.5%. Within goods consumption, durable goods spending accelerated 7.6% (saar) following a 0.3% downtick during Q2, while *nondurable goods* consumption rose 3.3% (saar)—the strongest since Q2-2021. Meanwhile, *real gross private domestic investment* expanded 8.4% (saar) following a 5.2% gain and a 9.0% loss the prior two quarters. *Real inventory investment* increased a whopping $65.7 billion (to $80.6 billion from $14.9 billion) during Q3, while *real residential investment* rebounded 3.9% (saar) after a nine-quarter slump. Meanwhile, *real nonresidential investment* was flat last quarter, ticking up 0.1% (saar) following gains of 7.4% and 5.7% the prior two quarters, as gains in intellectual property products (2.6%, saar) and structures (1.6) were offset by a decline in equipment (-3.8) spending. *Real government spending* advanced for the fifth successive quarter, with the growth rate accelerating 4.6% (saar) from 3.3% during Q2. Federal (to 6.2% from 1.1%) spending picked up during Q3, while growth in state & local (3.7 from 4.7) government spending slowed. Turning to trade, it had little impact on Q2's real GDP, subtracting just 0.08ppts, with the gain in exports (6.2%, saar) virtually offset by the rise in imports (5.7). (Imports are subtracted in the calculation of GDP, so Q3 imports contributed negatively.)

Contributions to GDP Growth (*link*): *Consumer* spending (2.69ppts) was the biggest positive contributor to real GDP growth during Q3, led by *services* (1.62), though *goods* (1.1) spending also was notable, with both durable (0.60) and nondurable (0.48) goods consumption contributing. *Inventory investment* (1.32) moved up to the number two spot, virtually all nonfarm (1.28) inventories, after being a drag on growth the prior two quarters. *Government* spending (0.79) was the third biggest contributor to GDP growth during Q3, with both state & local (0.40) and federal (0.39) governments equal contributors. *Residential investment* (0.15) was a positive contributor to real GDP for the first time in 10 quarters (Q1-

2021). *Nonresidential* (0.0 ppts) investment's contribution was neutral, as gains in intellectual property products (0.14) and structures (0.05) offset the decline in equipment (-0.19) spending. Within equipment spending, information processing (-0.09), other (-0.05), industrial (-0.04), and transportation (-0.01) equipment all contributed to the decline. *Trade* (-0.08) subtracted from growth for the first time in six quarters, as the positive contribution in exports (0.68) was more than offset by the negative contribution from imports (-0.75). (Imports, which are a subtraction in the calculation of GDP increased.)

Personal Income & Consumption (*link*): Spending has been rising at a faster pace than income in recent months, as consumers have dipped into savings. *Personal income* rose 0.3% in September and 1.2% the past four months, while disposable income was up 0.3% and 0.6% over the comparable periods. Meanwhile, *personal consumption expenditures* rose 0.7% in September and 2.4% over the four months through September. *Personal saving* is down $385.7 billion the past four months to $687.7 billion—the lowest level so far this year—with the personal saving rate down from 5.3% in May to a low for this year of 3.4% in September. In *real terms*, consumer spending in September rose 0.4%, with spending on goods up 0.5% and on services up 0.3%. Over the past four months, real goods consumption climbed 1.5%, while real services consumption was up 1.2%; compared to a year ago, both were up 2.4%. *Real disposable income* fell 0.1% in September and 0.5% during the four months through September.

Consumer Sentiment Index (*link*): *Sentiment* dropped for the third month, from a 21-month high of 71.5 in July to a five-month low of 63.8 in October (above its mid-month reading of 63.0). The *present situation* component sank for the third month, to 70.6 in October, after climbing five of the prior seven months by 16.9 points to 76.5 in July—which the highest level since October 2021. The *expectations* component in October dropped to a five-month low of 59.3 from July's 19-month high of 68.3. According to the survey, October's decline in sentiment was driven by higher-income consumers and those with sizable stock holdings. Expected business condition dropped 16% in October, while consumers' personal finances are expected to fall 8% over the year ahead due to inflation and concerns over negative news both domestically and from abroad. Turning to inflation, the *one-year expected inflation rate* shot up from 3.2% in September to 4.2% in October—the highest since May's 4.2%. It remains well above the 2.3%-3.0% range in the two years prior to the pandemic. The *five-year expected inflation rate* edged up from 2.8% to 3.0%, again staying within the narrow 2.9%-3.1% range that it has been in for 25 of the last 27 months. However, long-run inflation remains elevated relative to the 2.2%-2.6% range seen in the two years just before the pandemic.

Personal Consumption Deflator (*link*): September's PCED increased 0.4%, matching August's gain, which was the highest monthly increase since January (0.6%). Meanwhile, core prices rose 0.3%, after edging up 0.1% in August, which was smallest monthly gain since November 2020. The yearly headline rate was at 3.4% again in September, matching the August and July gains. It was at 3.2% in June, which was the lowest since March 2021, though easing from a peak of 7.1% last June—which was the highest since the end of 1981. The yearly core rate eased for the second month to 3.7% y/y from 4.3% in both July and June; it was at a recent peak of 5.6% during February and March of last year. On a *three-month annualized* basis, the *core rate* accelerated 2.5% (saar) in September, after easing the prior sixth months from 5.0% in February to 2.0% in August, remaining below its yearly rate of 3.7%. The three-month rate for *durable goods* has been negative every month but one since November, falling 4.6% (saar) in September, while the three-month rate for *core nondurable goods* prices dipped just below zero in August and remained there in September at -0.5% (saar). Meanwhile, *services prices ex energy* picked up to 4.3% (saar) in September after slowing to 3.7% in August, though remained below its recent peak of 6.2% at the start of this year. The three-month annual rates for consumer services ex energy (4.3%, saar & 5.0% y/y), core nondurable goods (-0.5 & 4.2), and consumer durable goods (-4.6 & -2.3) all were below their yearly rates, with both measures below zero in the latter. *PCED components for which three-month rates lag yearly rates*: used motor vehicles (-20.2 & -8.0), motor vehicles parts (-6.4 & -0.2), furniture & home furnishings (-3.6 & -2.9), lodging away from home (-0.3 & 8.0), prescription drugs (-1.1 & 2.2), clothing & footwear (-1.3 & 2.4), sports & recreational vehicles (0.2 & 2.0), new motor vehicles (1.9 & 2.6), hospitals (1.9 & 2.5), education services (1.9 & 2.3), personal care products (4.7 & 5.6), tenant rent (5.6 & 7.4), and owner-occupied rent (5.7 & 7.1). *PCED components for which three-month rates exceed yearly rates*: gasoline & other energy products (51.8 & 2.1), professional & other services (11.6 & 9.9), airfares (10.0 & 3.5), transportation services (8.6 & 5.4), recreation services (6.2 & 5.9), food & nonalcoholic beverages purchased for off-premise consumption (3.1 & 2.6), physician services (1.5 & 0.6), household appliances (-0.6 & -6.4), and video audio & information processing (-6.4 & -7.1). *PCED components for which three-month rates & yearly rates are comparable*: tobacco (5.5 & 5.6) and alcoholic beverages purchased for off-premise consumptions (3.3 & 3.2).

Regional M-PMIs (***link***): Four Fed districts so far have reported on manufacturing activity for October—New York, Philadelphia, Richmond, and Kansas City—and collectively they show a contraction in manufacturing during the month. *Manufacturing activity* (to -4.7 from -3.7) continued to decline at a fairly steady pace, as the New York (-4.6 from 1.9) measure moved from expansion to contraction, while Philadelphia's (-9.0 from -13.5) declined at a slower pace, and Richmond's (3.0 from 5.0) rose at a slightly slower pace; Kansas City's

was unchanged at -8.0. *New orders* (-6.5 from –4.0) contracted at a slightly faster pace in October, as billings in the Philadelphia (4.4 from -10.2) area posted a 14.6-point swing back into expansionary territory, while the New York (-4.2 from 5.1) and Richmond (-4.0 from 3.0) measures recorded negative 9.3-point and negative 7.0-point swings, respectively, back into contractionary territory. The Kansas City (-22.0 from -14.0) measure fell deeper into negative territory. *Employment* (2.5 from 0.2) showed factories are slow to hire, bouncing around zero for the past few months, as factories in the New York (3.1 from -2.7), Philadelphia (4.0 from -5.7), and Richmond (unchanged at 7.0) regions all hired at a sluggish pace, while Kansas City's (-4.0 from 2.0) showed a slight shortfall. Looking at *prices-paid* indexes, the Philadelphia (23.1 from 25.7) measure held steady in October, though is up from April's 8.2 reading—which was its lowest since mid-2020—while New York's (25.5 from 25.8) measure also showed little change. The Richmond (30.2 from 40.6) measure continued to ease from its record high of 152.9 last May, while Kansas City's (-2.0 from 7.0) dipped into negative territory from its record high of 84.0 during October and May of 2021. *Prices-received* indexes saw New York's (11.7 from 19.6) gauge slow a bit, though was up from July's three-year low of 3.9, while Philadelphia's (14.6 from 14.8) measure barely budged again during October, though did ease from May's 23.0. Meanwhile, Richmond's (20.7 from 30.6) gauge continued to ease from its record high of 106.3 last June. Kansas City's (0.0 from 2.0) measure continued to hover around zero, up from July and August readings of -7.0 and -6.0, respectively. It was at a record high of 60.0 during August 2021. New York's gauge was at a record high of 56.1 in March 2022, while Philadelphia's reached its record high of 65.8 in November 2021. (Note: The New York, Philadelphia, and Kansas City measures are diffusion indexes, while Richmond's measures are average annualized inflation rates—which we multiply by 10 for easier comparison to the other regional measures.)

Durable Goods Orders & Shipments (*link*): *Durable goods orders* soared more than expected in September, as orders for nondefense aircraft skyrocketed. Orders for durable goods rose for the first time in three months, spiking 4.7% (vs 1.5% expected) to within 1.3% of June's record high, as orders for nondefense aircraft & parts shot up 92.5% after plummeting in August. *Excluding transportation*, durable goods orders expanded for the eighth time this year, by 0.5% in September and 2.0% ytd. Meanwhile, *nondefense capital goods orders excluding aircraft* (a proxy for future business investment) climbed 1.6% during the two months through September to a new record high, while *nondefense capital goods shipments excluding aircraft* (used in calculating GDP) was little changed (-0.1%) at August's record high. In September, electrical equipment, appliances & components and machinery orders climbed to new record highs, while orders for motor vehicle & parts was only a percentage point below August's record high. Meanwhile, orders for both primary

metal and fabricated metals remained in record-high territory.

Contact us by *email* or call 480-664-1333.

Ed Yardeni, President & Chief Investment Strategist, 516-972-7683
Debbie Johnson, Chief Economist, 480-664-1333
Joe Abbott, Chief Quantitative Strategist, 732-497-5306
Melissa Tagg, Director of Research Projects & Operations, 516-782-9967
Mali Quintana, Senior Economist, 480-664-1333
Jackie Doherty, Contributing Editor, 917-328-6848
Valerie de la Rue, Director of Institutional Sales, 516-277-2432
Mary Fanslau, Manager of Client Services, 480-664-1333
Sandy Cohan, Senior Editor, 570-228-9102

Copyright (c) Yardeni Research, Inc. Please read complete copyright and hedge clause.