

December 12, 2022

Service sector still shows solid growth

The ISM services index continues to suggest solid growth in the services sector, in contrast to the S&P survey which has been in contraction for the last five months. On the inflation front, producer prices in November came in stronger than expected, but wholesale prices continue to cool, while consumer sentiment saw a solid rise but remains at very depressed levels.

Service sector growth surprisingly accelerates

ISM services index climbed in November despite expectations of a decline. At 56.5, November's reading reflected solid growth and was only marginally below the 12-month average. The increased growth in services was mostly a byproduct of a surge in business activity, which climbed to its highest reading since last December. The only other major component to rise was employment which climbed back above the expansion/contraction line. Growth in new orders slowed modestly and registered a six-month low, while price growth also experienced a small decline but remained elevated by historical standards. Supplier deliveries still showed modest delays but improved to its lowest since prior to the pandemic, reflecting the effects of both stabilizing supply chains and falling demand for services — particularly international demand (note that the export orders index fell to its third-lowest reading on record).

The expansion reading for the ISM services index is still at odds with the S&P services PMI, which was in contraction in November for a fifth straight month. According to the S&P survey, the rate of contraction was the fastest since August and faster than all but a few months since the inception of the survey in 2009. The contractionary reading is being driven by weaker domestic and especially foreign demand, which fell to its lowest point in over two years due to weakening global economic conditions.

The ISM and S&P surveys are measured somewhat differently, with the broader ISM survey capturing several industries not measured in the S&P. It's likely this has contributed to the divergent findings in terms of expansion and contraction. Previously, however, the two surveys agreed at least on a downward trend in growth in the services sector; ISM's most recent reading suggests flat — or even slightly upward — trend over the last six months.

Producer price growth is falling, but remains high

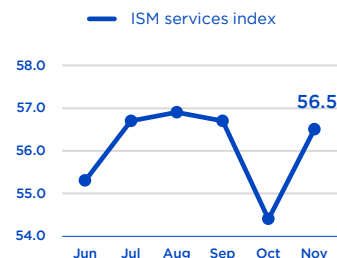
While the monthly change in the producer price index (PPI) moderately outpaced forecasts, the 12-month pace cooled to 7.4 percent while the core rate (the overall rate less food, energy, and trade services) fell to 4.9 percent. Although still very high by any historical standard, the 4.3-percentage-point drop in the PPI between March and November represents the largest deceleration over such a short time period on record (data back to 2010). Lower input prices, while contributing to ongoing disinflation trends, have a long road back to normalcy.

Elsewhere, the University of Michigan's consumer sentiment survey climbed to 59.1 in early December. The growth in sentiment was broad-based, representing gains in sentiment on current economic conditions and short-run expectations — largely driven by hopeful sings that inflation has peaked. December's reading should still be considered very low as it is far below the long-run average.

Consumer survey results continue to be much more dour than actual consumer activity data. Consumer spending got off to solid start to the fourth quarter as strong labor market trends have given households confidence to dip into savings. The inflation fatigue and concern over rising interest rates consistently seen in consumer surveys has not yet filtered into the spending data — and may not do so until there are increased concerns that hiring will roll over.



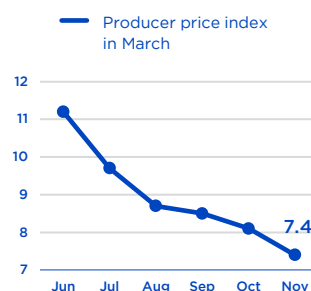
The trend is flat, and growth is solid for services



The ISM services index defied expectations of slower growth, and the trend for growth over the last six months has been little changed.



Producer prices continue sharp decline



The 12-month change in the PPI has fallen in each of the last five months and more than four percentage points since March.

Sources:
Institute for Supply Management;
Bureau of Labor Statistics

The Week Ahead

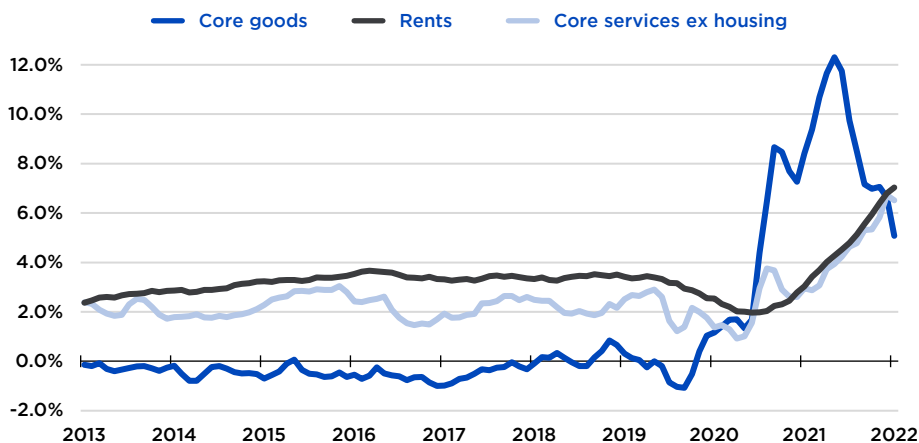
Here's what we are watching this week, including the FOMC's meeting: (see next page for more)

CPI MoM &
CPI Ex Food
and Energy
MoM



Consumer prices expected to advance at a firm pace

We predict that both overall and core CPI will increase a firm 0.4 percent month-over-month in November, despite a 3.4 percent decline in gasoline prices. The monthly advance indicates minimal slowing for the year-on-year pace. The overall CPI will gradually slow to 7.4 percent from 7.7 percent and the core CPI annual rate will fall modestly to 6.2 percent from 6.3 percent. In the mix, we expect core services prices to remain near their 40-year high annual rate of 6.7 percent, while core goods prices should continue to decelerate from the 5.1 percent rate posted in October.



Sources: Bureau of Labor Statistics

Retail Sales
Advance MoM



Retail sales projected to pull back in November

Due to the 3.4 percent decline in gasoline prices and the large 6.1 percent drop in auto sales heavily weighing on the headline reading, retail sales likely fell 0.4 percent overall. Excluding auto sales, we estimate that sales were flat. Despite the weak monthly reading, consumer spending is still on course to rise over 3 percent (annualized) in the fourth quarter lifting GDP growth slightly above 3 percent.

Industrial
production



Industrial production to post modest increase

Total industrial production likely increases just 0.1 percent in November, following a 0.1 percent decline in October, boosting the capacity utilization rate to 79.9 percent — a high rate for utilization. However, due to the headwinds from slower global economic activity and reduced domestic order books, the manufacturing sector is cooling. We have seen high inventory levels at the wholesale and retail sectors relative to sales to weight on production activity.

FOMC's December Meeting

FOMC
Meeting



Dialing back, but terminal rate higher

- The Federal Open Market Committee (FOMC) is poised to reduce the size of its rate hike to 50bps on December 14, raising the target on the fed funds target range to 4.25 – 4.5 percent. This marks a new phase of the rate tightening cycle as the Fed looks to calibrate the level of the policy rate now that it is within the range considered restrictive.
- We forecast a terminal rate range of 5 - 5.25 percent that will be reached in early 2023. The FOMC likely holds that level throughout 2023. We expect Chairman Powell's comments in the press conference to support our view. The FOMC's median rate forecast for year-end 2023 should be revised similarly, up from the 4.6 percent forecast in September.
- Contrary to the Fed's aim, real GDP growth — powered by buoyant consumer spending — continues to run strong at around a 3 percent (annualized) pace in Q4, following a near-3 percent pace in Q3. Labor demand remains strong and amid a taut employment market wage gains re-accelerated in November. The resilience of consumer spending and the labor market places upward pressure on inflation and as a result heightens the upside risks to our terminal rate forecast.
- In our view, restrictive monetary policy, a diminution in the excess pandemic-related household savings, and an expected contraction in corporate profits will lead companies to shed workers and pull back on capital expenditures in 2023. This should lead to a moderate recession starting in mid-2023.

Federal Reserve officials have widely telegraphed that the size of the rate hike at the December 14 policy meeting will be dialed back to 50bps after raising the fed funds rate by 75bps at each of the prior four policy meetings. This would lift the fed funds target range to 4.25 – 4.5 percent, further within what officials believe is a restrictive range.

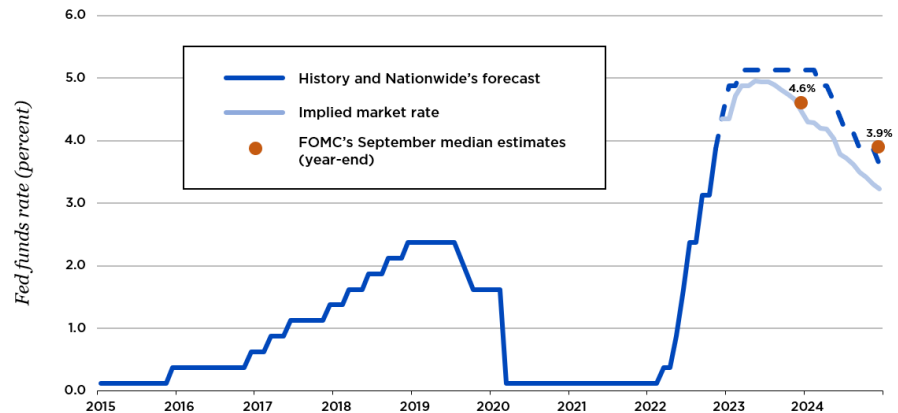
As such, the key focus for investors and business leaders will be the forward guidance the FOMC provides via its policy statement, the revised economic and interest rate (dot plot) estimates, and Chairman Powell's press conference. Most importantly financial market participants will be eager to see the updated terminal rate forecast for the fed funds rate and the path for rates beyond that peak.

At the September FOMC meeting, the FOMC's median dot plot estimate showed a 4.6 percent rate for the fed funds rate for year-end 2023. However, we expect the Fed's estimate to be increased to 5.13 percent. The strength of the economic data since the September meeting, the still elevated pace of inflation, and Chairman Powell's recent comments signal an upgrade to the fed funds rate forecast. The bond market is pricing in a terminal rate of around 5 percent, but also expects the Fed to be cutting rates about 50bps in the second half of 2023. We believe that such easing is premature and requires a surprise downside performance for inflation. Instead, we look for the policy rate to be held at 5.13 percent throughout 2023. The Fed likely waits until 2024 to engineer rate cuts, when inflation is securely on its way towards the 2 percent target level. In addition to the specific median interest rate forecast, market participants will keenly watch the range of the rate forecasts for next year and beyond to gauge rate possibilities and how united the FOMC members are. (continued)

FOMC's December Meeting (continued)

Chart 1
Fed fund rate

We anticipate that as the bond market starts to price in a steady 5.13 percent path for the funds rate for 2023, it should trigger a renewed rise in Treasury yields across the curve – with the 10-year yield rising back towards 4 percent. The higher bond yields should introduce further downside pressure on equity prices. Though the key headwind for stock prices will be a slowing and eventual contraction in corporate earnings next year.



Source: Federal Reserve, Bloomberg, Nationwide

Fourth-quarter real GDP growth is running around 3 percent, propelled by a surge in real consumer spending. This is well above the economy's projected long-run potential growth rate of 1.8 percent. Fed officials are aiming to temper activity below the potential rate to help slowdown inflation and ease resource constraints particularly in the labor market.

However, the labor market remains very tight with the unemployment rate remaining at 3.7 percent, just slightly above the cycle and pre-pandemic low of 3.5 percent. The highly watched jobs openings to unemployed ratio remains very high at 1.7, just off the record high of 2 and far above the pre-pandemic average of just 1.1 in 2017-2019. The combination of robust labor demand amid a short supply of available workers continues to fuel wage gains. The Fed is concerned this could result in a wage-price spiral that prolongs the elevated pace of inflation. Specifically, policy makers are worried that that rapid rise in wages will make it harder to dampen core services inflation excluding housing which measured by the PCE price indicators is running 4.1 percent. The reason is that services activity is highly labor intensive and as such rising worker compensation costs can drive up the input costs for services and prevent or significantly delay the desired slowing in consumer services inflation.

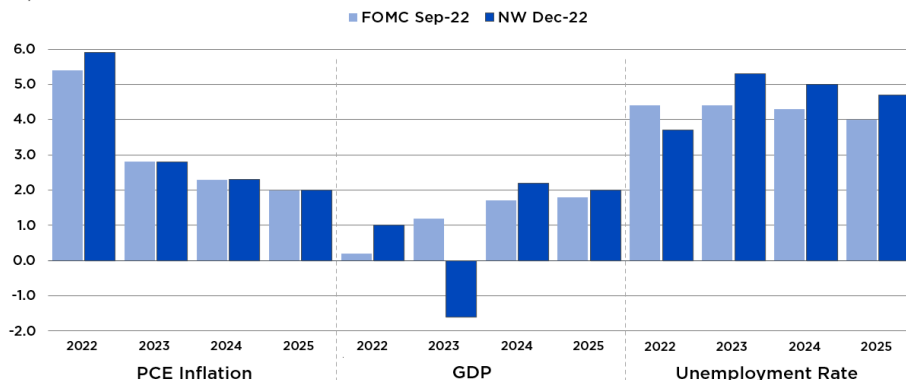
Given the 3+ percent pace of growth in Q4, that builds upon a near-3 percent advance in Q3, the FOMC's median forecast for real GDP growth Q4/Q4 2022 should be revised up significantly from the modest 0.2 percent forecast in September – our current forecast is one percent. However, we do not anticipate much change to the FOMC's forecasts for 2023 – 2025. FOMC members are likely to continue forecasting below-potential growth in 2023 (in September they forecast 1.2 percent), followed by a rebound to around potential growth in 2024 and 2025 (Chart 2, next page).

FOMC's December Meeting (continued)

Chart 2
GDP Economic
Forecasts

US: Economic Projections

% Q4/Q4



Source: Federal Reserve, Nationwide

In our view, the FOMC's forecast for 2023 will remain too optimistic since restrictive monetary policy, a diminution in the excess pandemic-related household savings, and an expected contraction in corporate profits will lead to a slowing in consumer spending and prompt companies to shed workers and pull back on capital expenditures in 2023. This results in a moderate recession starting in mid-2023.

The FOMC's updated inflation forecasts will be closely scrutinized, since the path for inflation dictates the path for rates. We do not look for big changes to the Fed's median inflation forecasts. In fact, their September forecasts line up closely with our forecast for a meaningful deceleration in inflation throughout 2023, driving the year-on-year rate for PCE prices to a bit below 3 percent from nearly 6 percent at the end of 2022 (Chart 2). The anticipated deceleration in inflation in large part is due to the restrictive stance of policy so it does not augur for policymakers to cut rates, in our opinion.

Within the policy statement, we look for an upgrade to the description of current economic conditions in the first paragraph reflecting the pickup in economic activity and acknowledgement that inflation remains elevated though easing somewhat.

The FOMC most likely retains the forward guidance that it included in the November policy statement: "In determining the pace of future increases in the target range, the Committee will take into account the cumulative tightening of monetary policy, the lags with which monetary policy affects economic activity and inflation, and economic and financial developments." The guidance signaled the scaling back of the size of rate hikes and suggests that while the Fed has more tightening to do, it is taking into consideration the rapid 375bps increase (as of November) in the fed funds rate from March. We believe the inclusion of this guidance was driven by Fed Gov. Brainard a nod to other less hawkish members.

Additional Economic Indicators

Previous Week's Indicators

	Period	Actual	Previous
Factory Orders	October	1.0%	0.3%
ISM Services Index	November	56.5	54.4
Trade Balance	October	-78.2 b	-73.3 b
Consumer Credit	October	\$27.08 b	24.98 b
Initial Jobless Claims	Week ending December 3	230k	225k
PPI Final Demand MoM	November	0.3%	0.2%
PPI Ex Food and Energy MoM	November	0.4%	0.0%
U. of Mich. Sentiment	December	59.1	56.8

This Week's Indicators

	Release Date	Period	Forecast*	Previous
Monthly Budget Statement	Monday	November	-200 b	-191.3 b
NFIB Small Business Optimism	Monday	November	91.0	91.3
CPI MoM	Tuesday	November	0.4%	0.4%
CPI Ex Food and Energy MoM	Tuesday	November	0.4%	0.3%
Import Price Index MoM	Wednesday	November	-0.6%	-0.2%
FOMC Rate Decision (Lower Bound)	Wednesday	Week ending December 14	4.25%	3.75%
Empire Manufacturing	Thursday	December	-3.0	4.5
Retail Sales Advance MoM	Thursday	November	-0.4%	1.3%
Retail Sales Ex Auto and Gas	Thursday	November	0.0%	0.9%
Initial Jobless Claims	Thursday	Week ending December 10	235,000	-19.4
Philadelphia Fed Business Outlook	Thursday	December	-12.0	-19.4
Industrial Production MoM	Thursday	November	0.10%	-0.10%
Capacity Utilization	Thursday	November	79.9%	79.9%
Business Inventories	Thursday	October	0.40%	0.4%



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