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The economy is showing signs of weakness

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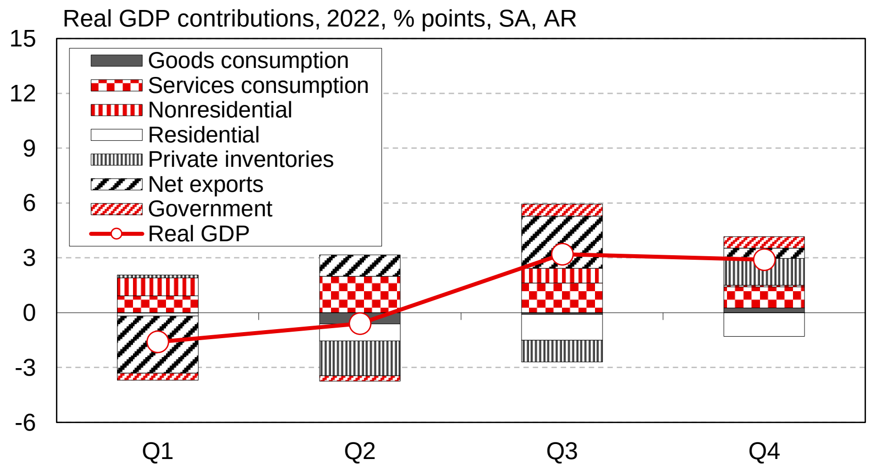
The economy expanded at an annual rate of 2.9 percent in Q4 and core inflation rose 4.4 percent annually in December, in line with most expectations. On a positive note, annual inflation is easing, driven largely by durable goods, but the economy is showing signs of weakness. Personal savings are rising and outlays are falling, signalling consumer pessimism. The rise in private inventories in Q4 does not reflect growing demand with new orders for durable goods entering negative territory in December. Additionally, the growth in services spending is largely non-discretionary. The US economy will likely begin to shed its positive veneer in 2023 as economic output slows.

Consumers have no choice but to spend on services

Services consumption was positive again in Q4, contributing 1.16 percentage points to real GDP. Though strong, sustained services consumption is largely on non-discretionary spending categories and is not a positive sign. The fourth quarter saw increased consumption in health care, housing, and personal care services, most of which lack substitution. All the while, labor shortages continue to be pronounced in health care and in in-person services, driving strong wage growth in these industries. The dangers of services inflation and its relation to wages was discussed in a previous report, with these latest Q4 consumption figures only confirming the growing risk.

Consumer pessimism is indeed growing, with personal savings growing by 16 percent for two consecutive months ending in December, the largest growth since the start of the pandemic. This is a result of both increases in personal income from wages and salaries and decreased spending. Personal outlays (consumption, interest, and transfer payments) declined in November and December, signalling that consumers are bracing for potential hardship. Durable goods industries and those in discretionary spending categories are likely to face the strongest headwinds in 2023.

GDP GROWTH REMAINED POSITIVE IN Q4, BUT WEAKNESS LOOMS

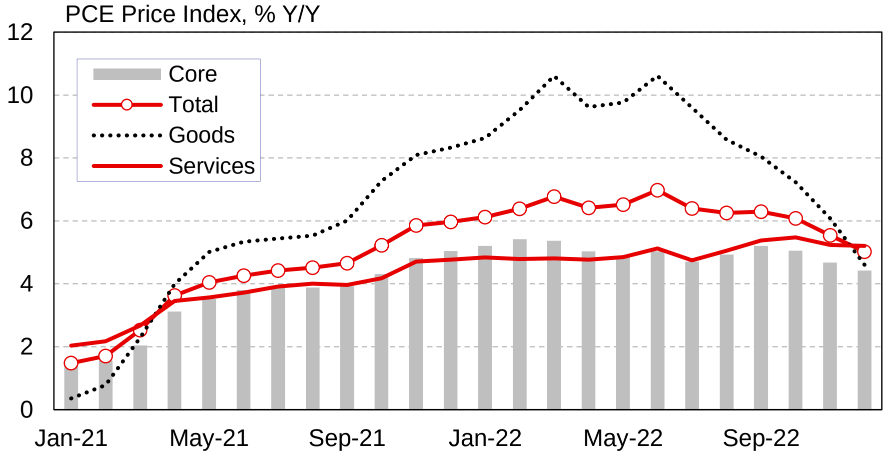


Source: BEA, MUFG Bank Economic Research

Goods industries will be the first to suffer

For those that view inflation as largely transitory, easing consumption (rather than plummeting) along with a strong labor market and falling core inflation are signs of a potential soft landing. This notion, however, may be misplaced. Indeed, disinflation is evident with the core PCE Price Index rising 4.4 percent annually in December, down from 5.1 percent in October and 4.7 percent in November. Disinflation is even more drastic in goods, with prices rising 4.6 percent annually in December compared to 6.1 percent in November.

INFLATION IS CONTINUING TO DECLINE, MOSTLY FOR GOODS



Source: BEA, MUFG Bank Economic Research

However, the appetite for goods may see drastic declines in 2023, a change from the gradual declines up until now. The latest Q4 GDP figures on consumption and inventories are misleading and are projecting more optimism for durable goods industries.

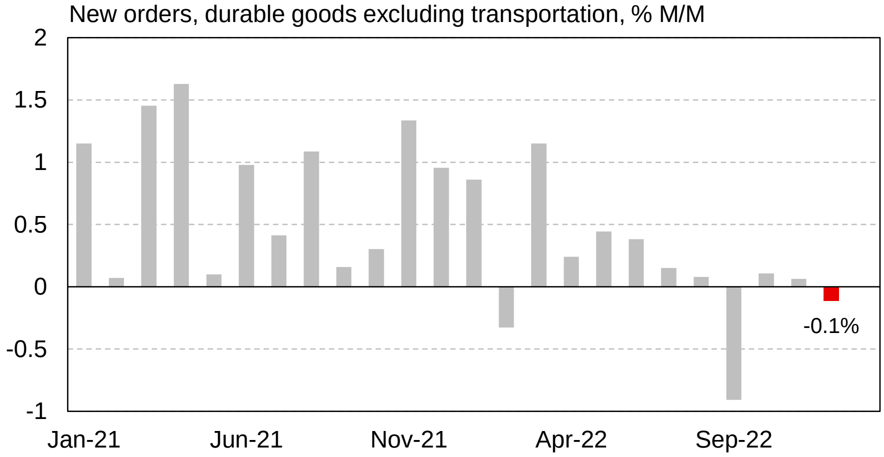
Goods consumption was positive in Q4 (+0.26 percentage points), a reversal from previous quarters of negative growth. This is not necessarily reflective of growing demand since most item categories saw decreasing consumption. Real growth was almost entirely driven by motor vehicles and parts. Unit auto sales rose in October and remained high in November for both total and domestic autos, but this is consistent with normal seasonal patterns (even when seasonally adjusting the data series). Seasonality helped push goods consumption into positive territory in Q4.

Additionally, the fourth quarter saw a rebound in private inventories, contributing 1.46 percentage points to real GDP. Changes in inventories are largely stationary over time, characterized by periods of acute shortages and gluts, especially in volatile industries. Earlier in 2022, businesses experienced large inventory gluts as consumption of goods slowed and supply-chain bottlenecks eased. In the following two quarters of the year, inventories fell to compensate for the oversupply and have now rebounded again. Final sales of domestic product (GDP less change in private inventories) show a much slower Q4.

New orders for durable goods, excluding volatile transportation, present a much more pessimistic view. In December, new orders fell by 0.1 percent, following 2 months of very slow growth in October and November (+0.11 and +0.06 percent respectively) and a significant decline in September (-0.91 percent). The last 6 months of new orders, excluding transportation, are not reflective of acute shortages and gluts, but rather consistent declines in expected demand.

Goods disinflation has been promising, but there exists a looming crash in consumption that is more than just gradual for these industries. The durable goods industry appears to be bracing for a tough 2023 that has much less demand.

FALLING NEW ORDERS SINGALS MORE BUSINESS PESSIMISM



Source: Census Bureau, MUFG Bank Economic Research

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