

Morning Market Tidbits

Let's talk about inflation risks

In focus

A reacceleration of inflation is still the most underpriced risk for an economy where final demand grew at 3% in 2H23. A relatively aggressive easing cycle is priced in, even after the Fed and the blowout payrolls report last week, beyond what the Fed had signaled. In this context, upside risks to inflation could be among the most disruptive for markets and may drive the Fed to be particularly cautious as we approach the start of the easing cycle.

The rapid disinflation is supply rather than demand driven

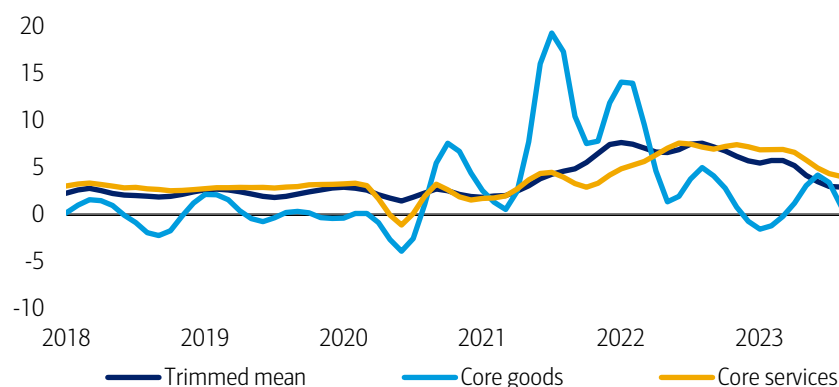
Markets and the Fed cannot claim to have a good record forecasting post-pandemic inflation. However, markets don't seem to have learned the lesson. Immaculate disinflation is taking place with the economy which is growing above potential, but there is no evidence of a productivity boom. This unusual correlation between prices and economic activity hints that most of the disinflation so far was supply driven rather than demand driven, as bottlenecks normalized. As much as the persistence of inflation was underestimated in 2022, the persistence of disinflation could be overestimated now (Exhibit 1).

A two-speed economy is a hard signal-extraction problem

The core upside risks to the inflation outlook are an economy at full employment, a tight labor market, still resilient consumption, fiscal policy that is too pro-cyclical, and that disinflation has been concentrated in goods. Both supply and nominal spending are growing but supply is temporarily growing relatively faster. Once supply normalizes, trend inflation should be mostly demand driven. The US is mostly a services economy. If supply is reaching an upper bound and nominal spending remains robust, inflation can reaccelerate. Geopolitics and fiscal policy are additional risks in an electoral year.

Exhibit 1: Trimmed mean inflation, and core inflation (CPI, 3m/3m saar, %)

Core CPI services inflation remains elevated, as does the trimmed mean measure



Source: BofA Global Research, Haver

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See our full report: [The Global Thinker: Let's talk about inflation risks](#)

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GDP: Gross Domestic Product

FOMC: Federal Open Market Committee

ECB: European Central Bank

BoJ: Bank of Japan

NIRP: Negative Interest Rate Policy

YCC: Yield Curve Control

QT: Quantitative Tightening

CPI: Consumer Price Index

PCE: Personal Consumption Expenditure

SLOOS: Senior Loan Officer Opinion Survey

Market Action

The Asian equity markets that we cover closed mixed overnight. Looking at individual markets, the Korean Kospi and the Nikkei were down 0.6% and 0.5% respectively. On the flipside, the Indian Sensex, the Shanghai Composite and the Hang Seng rose 0.6%, 3.2% and 4.0% respectively.

As of 7:00 am ET, aggregate European stocks are up 0.1% and S&P500 futures are down 0.1%. In the bond markets, 10-year Treasury yields are flat at 4.16% and German Bund yields are up 2bp to 2.34%. The dollar index is flat at \$104.45. WTI crude oil prices are \$0.40 higher at \$73.18/bbl, and gold prices are at \$2026.70/oz.

Data review

ISM Services

ISM services improved in January to 53.4 from 50.4, in line with consensus but a touch stronger than expected. Looking at the details, strength seen across the board- new orders up to 55.0 from 53.3, employment was also up to 50.5 from 43.8, and prices paid increased to 64.0 from 56.7. We have been highlighting that healthy consumer spending has continued to support the service sector and expect it to help the sector remain in expansionary territory.

The prices paid component is not a good reading, no question about that. Readings below 55 are rare on the subcomponent, mainly due to the fact that services prices rarely fall. We had viewed the decline in services prices paid since 2021 as suggesting it had "normalized" so some of the usual volatility should start to show through. We'll see whether this is (1) continued, (2) is a margin/earnings problem, or (3) becomes a consumer price problem. So far, the CPI/PCE data would say that inflation is not reaccelerating.

Senior Loan Officer Opinion Survey (SLOOS)

Standards and terms tightened further on C&I (commercial and industrial) loans, but the net percentage of banks tightening standards fell vis a vis the July and October 2023 surveys. Demand for C&I loans also fell, but the net percentage of banks reporting weaker demand fell relative to recent survey outcomes. This suggests we could be past the peak of net tightening in C&I loans and past the trough in net demand. A similar pattern held for CRE (corporate real estate) loans. For consumers, the picture is similar to that in C&I loans: the net percentage of banks reporting tighter standards fell, but standards tightened further. Bank willingness to lend to consumers improved marginally but remains in negative territory.

The bottom line is that there was an incremental net tightening in standards and terms in 4Q, though to a lesser degree.

US GDP Tracking

Exhibit 2: BofA US GDP tracking estimate (% q/q saar)

4Q US GDP tracking is up two-tenths to 3.5% q/q saar largely due to the higher-than-expected construction spending print in December along with the upward revision to November

Date	Data release	GDP	Final Sales	PCE	Res. Inv.	Struct	Equip	IPP	Gov.	Exports	Imports	Net exports (level)	CIPI (level)
1/12/24	PPI	1.3	2.0	1.9	-0.2	3.6	2.8	2.5	2.3	2.2	2.2	-935.5	27.0
1/17/24	Retail Sales	1.4	2.1	2.0	0.2	3.6	2.8	2.5	2.3	2.2	2.2	-935.5	27.0
1/17/24	Industrial Production, Business Inventories	1.3	2.1	2.0	0.2	3.5	2.5	2.5	2.3	2.2	2.2	-935.5	26.3
1/17/24	Import and Export Prices	1.4	2.1	2.0	0.2	3.5	2.5	2.5	2.3	2.4	1.8	-930.8	26.3
1/18/24	Housing Starts and Permits	1.5	2.1	2.0	0.6	3.5	2.5	2.5	2.3	2.4	1.8	-930.8	26.3
1/25/24	4Q (A) GDP	3.3	2.7	2.8	1.1	3.2	1.0	2.1	3.3	6.3	1.9	-908.2	82.7
2/1/24	Construction Spending	3.5	3.0	2.8	1.5	5.8	1.0	2.1	4.1	6.3	1.9	-908.2	82.7
	GDP tracking	3.5	3.0	2.8	1.5	5.8	1.0	2.1	4.1	6.3	1.9	-908.2	82.7
	Contribution to GDP growth (pp)			1.9	0.1	0.2	0.1	0.1	0.7			0.4	0.1
	BofA official GDP forecast	1.5	2.5	2.0	1.0	3.5	2.5	2.5	2.0	2.5	2.0	-929.0	29.5

Source: BofA Global Research. Our GDP tracking estimate reflects the mechanical aggregation of incoming data that directly informs the BEA's GDP calculations. The process is distinct from our official published GDP forecast. Boldface cells indicate where data have implications for tracking estimates.

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Net exports **CIPI**

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Overseas data**Italy**

January's final services PMI print came in at 48.4, in line with the flash print, while both January economic sentiment came in at 98.1, from 97.3 in December, while manufacturing confidence and consumer sentiment increased to 88.3 and 96.4 respectively.

Our Europe economists note that the faster disinflation has helped supporting sentiment amid expectations of better real purchasing power. However, is clear that despite the perceived general economic outlook, consumers are now anticipating increased saving capacity, indicating that uncertainty continues to drive precautionary saving motives.



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