Economy gaining momentum

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Background

Data we have seen since our June Economic Update shows the US economy gained momentum this Spring, contrary to many economists' predictions the Fed's unprecedented rate-hike campaign, taking its reference rate to a two-decade high, would trigger a recession beginning in the middle of this year. With inflation falling and a strong labor market, the solid above-trend growth we are experiencing increases the odds of a soft-landing where inflation drifts lower, closer to the Fed's 2% target, averting a recession. Interestingly, talk of a downturn even among perpetual skeptics is petering out, the Fed staff is no longer forecasting a recession, business and consumer surveys taken in July were either stable or higher. And recent readings of our firm's proprietary Economic Model, designed to signal a change in the economy's direction six to nine months in advance of an inflection point, while still inconclusive, are encouraging.

Supporting the soft-landing argument, the Commerce Department reported last Thursday that real GDP grew at a seasonally adjusted above-trend 2.4% rate last quarter, driven by consumption and business spending, exceeding expectations and above what the economy showed in the first quarter. Strength in consumption, which accounts for about 70% of GDP, was supported by strong household balance sheets where just 9.6% of disposable personal income was required to cover household debt service payments, and a robust labor market. Also positive, the economy delivered above-trend growth even as inflation, when measured by the Fed's preferred gauge, the Personal Consumption Expenditures Index (PCE) remained well above its target.

The Fed

The FOMC hiked rates last week by another 25bp to 5.25% - 5.50%, making it clear that while real interest rates are already restrictive and will continue to slow the economy, future rate decisions will hinge on the two CPI and jobs reports it will review prior to its early September meeting. Fed Chair Powell noted that even if there were no further rate increases in this cycle, the Fed was likely to keep borrowing costs elevated for some time. In addition to the favorable PCE report, the latest Employment Cost Index (ECI) reading showed further moderation last quarter rising 1.0%, the slowest quarterly pace in two years. This brings the year-ago growth rate in the ECI to 4.5% from its 4.8% level in March. Should the ECI cool further, it will reinforce the case for the Fed to remain on hold at its upcoming meetings.

Outlook

The negative case for the economy and equity market revolves around the higher-for- longer monetary policy Powell has discussed, the unquantifiable lagged effects of prior Fed tightening and future decisions to be taken, the earlier collapse of M2 money supply growth, negative signaling from the yield curve inversion, possible liquidity headwinds stemming from this winter's regional banking failures, tightening bank lending standards and weaker loan demand, as well as sticky inflation. Nevertheless, the fundamental narrative for the economy and stocks remains positive largely focused on the soft-landing scenario, peak Fed rate policy, disinflation traction, the strong labor market, consumer resilience, housing market improvement, the expected second half earnings recovery, and the emerging AI secular growth tailwind.

Balancing these factors, we are now more inclined to believe that greater-than-expected economic momentum entering the second half of the year and continued disinflation trends that increase the likelihood the Fed's tightening cycle is largely completed, diminish chances of a recession in the next year. Consequently, we have upgraded our outlook for the economy, pegging the chances of a recession at less than 50/50. That said, any downturn is likely to be brief and shallow. Time will tell whether growing confidence a downturn can be avoided translates into business decisions that underpin a shift from protecting profit margins in an uncertain environment to positioning for the next expansion.

Leading economic indicators

Beyond the stronger-than-expected first quarter GDP report, high frequency leading economic indicators we monitor sent mixed-to-improving signals. The July **ISM Manufacturing Index**, which accounts for about 11% of all business activity, ticked up to 46.4, continuing to signal contraction in that sector as post-pandemic consumer demand has shifted from goods to services in short supply during COVID-19. The **ISM NonManufacturing Index** for June, which accounts for nearly 80% of business activity, edged a bit higher, well above 50, signaling further expansion in services. Reflecting the labor market's strength, the four-week average of **Initial Jobless Claims and Continuing Claims** remained steady at near historically low levels. The **M2 measure of money supply** continued its recent turn-around, rising for the second consecutive month, following a year of record contraction. And the **stock market**, in our view a reliable indicator of future business conditions, recorded further across-the-board gains last month.

Investment policy

Equity markets continued their surge higher in July extending the longest streak of monthly gains since August 2021. For the year-to-date, the cap weighted S&P 500, dominated by a small group of mega cap technology stocks, has added close to 20%; the tech heavy, more volatile NASDAQ has advanced over 36%. These remarkable returns shine when compared with other stock market indices not dominated by the mega caps. For example, the S&P 500 Equal Weighted Index has risen 9% and the Dow Jones Industrial 30 blue chip stocks has earned only 7% this year. In a reversal of last year's out-performance by *value* stocks, this year the S&P 500 *Growth* Index has gained 24% outpacing the S&P 500 *Value* Index which is ahead 15%. Initially driven by enthusiasm over Artificial Intelligence, investor participation in the market has broadened out over the past couple of months as the softlanding narrative took hold, encompassing sectors of the market that had previously languished including energy, financials, cyclicals and consumer discretionary shares. Both *growth* and *value* equities are well represented in client's equity portfolios which have remained fully invested within portfolio guidelines during the market's recovery since last October.

From a *valuation* perspective, the stock market has gone from being undervalued at the start of this year to fairly valued now given the economic expansion and earnings surge we expect to unfold next year. Currently, the S&P 500 is selling at about 18.5x the consensus of 2024 estimated earnings per share of

$245. *Technically*, the market advance has been feeding on its own momentum for weeks as investors who have remained heavily in cash throughout the advance since the October 2022 lows are throwing in the towel for fear of missing out on future appreciation (FOMO). It remains to be seen whether the market will sustain its gains near term amidst signs of slowing business "higher for longer" interest rates
which are no friend to risk assets and technical signs the market may be temporarily overbought. A mild 5% to 10% sentiment-driven pullback from these levels, cooling investor's animal spirits, would probably be a healthy development.

As long-term investors, we prefer to look beyond the near-term uncertainties to the next business expansion, spurred by easing credit conditions, and sound underlying consumer and business fundamentals, and the investment opportunities it will inevitably present.

The sharp rise in interest rates to more normal levels has made bonds investable once again. Accordingly, we are extending fixed income portfolio durations in clients' laddered, high quality corporate bond portfolios under our supervision toward a 2.5-year target. Lower yielding money market fund investments have been replaced by higher yielding US Treasuries maturing in less than a year. Because we see longer-term rates rising further over the medium term, we have deferred adding further to portfolio duration currently.

Indexes are unmanaged, do not include fees or expenses and are not available for direct investment. Definitions: **Personal Consumption Expenditures Index (PCE)**: A measure of the prices that people living in the United States, or those buying on their behalf, pay for goods and services. The PCE price index is known for capturing inflation (or deflation) across a wide range of consumer expenses and reflecting changes in consumer behavior. **Conference Board's Confidence Index:** The Consumer Confidence Survey® reflects prevailing business conditions and likely developments for the months ahead. **ISM Manufacturing Index**: The ISM manufacturing index or purchasing managers' index is considered a key indicator of the state of the U.S. economy. It indicates the level of demand for products by measuring the amount of ordering activity at the nation's factories. **ISM Non-Manufacturing Index**: The Institute of Supply Management (ISM) Non-Manufacturing Index is an economic index based on surveys of more than 400 non-manufacturing (or services) firms' purchasing and supply executives. **S&P500 Index**: The S&P 500 Index, or Standard & Poor's 500 Index, is a market-capitalization-weighted index of 500 leading publicly traded companies in the U.S. **S&P500 Growth Index**: The S&P 500 Growth Index is a stock index administered by Standard & Poor's-Dow Jones Indices. As its name suggests, the purpose of the index is to serve as a proxy for growth companies included in the S&P 500. **S&P500 Value Index**: The S&P 500 Pure Value Index refers to a score-weighted index developed by Standard and Poor's (S&P). The index uses what it calls a "style-attractiveness-weighting scheme" and only consists of stocks within the S&P 500 Index that exhibit strong value characteristics.