



Inflation pressures moderating

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Background

For the better part of a year, the US economy has been dogged by too much money chasing too few goods, driving consumer inflation to heights not seen since the 1980s. The root causes of this inflationary burst, excessively stimulative fiscal and monetary policies, skyrocketing energy prices, the war in Ukraine, and supply chain bottlenecks caused by shuttering and then reopening the economy in response to perceived COVID risks, are gradually running off. In recent months, inflation pressures have clearly moderated along with consumer spending which declined in both November and December. Consumer prices rose 5% in the year through December according to the Federal Reserve's preferred measure, the *Personal Consumption Expenditures* price index (PCE). While still well above the Fed's 2% target, the December PCE reading fell to the slowest pace in more than a year, marking considerable progress in curbing runaway prices. Taken together, these trends paint a picture of an economy finally coming off the boil. Policy makers at the Fed have aggressively tightened credit conditions to force consumers and businesses to curtail their outlays which, with a lag, should result in slower price increases. Data now shows the Fed's efforts have begun to bear fruit.

Surveys also show that over 60% of economists responding believe a recession is likely this year, doubting the Fed will be able to achieve its inflation goal without causing an economic pullback. Indeed, the January reading of our firm's proprietary [Economic Model](#), designed to signal an inflection point in the economy six to nine months in advance of a change in its direction, has for months been pointing to a possible downturn. The Leading Economic Indicators (LEI) are also trending lower, signaling recession. *While there may be a narrow, though improving, path to the Fed's hope for a "soft landing," an examination of their past record in credit tightening is not encouraging.*

Inflation

Recently released reports underscore slowing inflation trends traceable to tightening credit conditions. The PCE rose only 0.1% in December for the second straight month, and was up 5.0% from a year earlier, a notable annual decline from the 5.5% November rate, and a continuation of a six-month downward trend. After stripping out food and fuel, the "core" PCE rose 4.4% from a year earlier, a slowdown from the 4.7% rate in November. Another closely followed report on nonfarm productivity showed the slowing rate of inflation in the fourth quarter contributed positively to a 1% inflation-adjusted wage increase, the first such *real* gain in workers' pay of the year. Meanwhile, consumer spending fell 0.2% in December and spending in November, initially reported as an increase, was revised to show a small decline, easing demand-driven pressures on prices.

Elsewhere, incomes continued to rise in December reflecting the strong job market. Average hourly earnings increased 0.3% from December, and 4.4% year-over-year, an indication that some of the

pressure to lure employees back to work with inflation-fueling pay raises may be easing. Available data also shows that rather than spend their extra earnings, many workers have elected to increase their savings, a further sign people may be becoming a bit more cautious with their outlays, cooling demand, amid announced layoffs and recession talk. Keep in mind, households in the aggregate, still have over \$1 trillion in excess savings built up during the pandemic, indicating strong balance sheets and their ability to continue spending.

Employment

Fed officials, who believe robust job gains fuel inflation, are now particularly focused on labor market conditions as they try to determine how many more policy adjustments will be needed, and for how long rates should be held at a high level, before changing policy. Last week's blowout January nonfarm payrolls report, following months of steady declines in job growth, will complicate the Fed's job. The report showed a startling 517,000 jobs increase, on a seasonally adjusted basis, three times greater than expectations, and an impressive surge of 1.2% in hours worked. Underscoring the labor market vibrancy was the unemployment rate which fell to 3.4%, the lowest level since 1969. Other newly available data detailing a surprising jump in job openings (JOLTS), and a further decline in initial jobless claims confirm tight and still out-of-balance labor market conditions. In addition, the unanticipated sharp increase in the January ISM Non-Manufacturing index signaling expansion in the services sector, casts the economy as stronger than previously thought even though retail sales have fallen for two consecutive months, housing continues to take a hit from elevated interest rates, and the forward looking manufacturing PMI is signaling contraction. Balancing these and other data points, we must conclude last month's much better-than-expected employment data and the sharp rebound in the services sector, which accounts for over 70% of our economy and employs 80% of US workers, paints the picture of a very resilient economy.

Given the strong labor market and recent FOMC statements, Fed policy is likely to remain tighter for a while longer than previously expected, suggesting additional quarter point rate increases are in the cards for March and May. Incoming data, which has been volatile, will have a major impact on future Fed decisions. But in view of the overall resiliency of the economy to date, a "soft landing" cannot be ruled out.

Investment policy

Following a dismal 2022, during which equity and bond investors suffered outsized losses, stocks have registered gains from the opening bell in January amid rising confidence the Fed will soon conclude its tightening cycle and that, given the economy's resilience, a serious recession can be avoided. In addition, rampant fears in some quarters last year, that the Fed's aggressive withdrawal of liquidity would trigger a financial hiccup somewhere in the global economy have largely disappeared. The S&P500, representative of large cap US stocks, has risen about 9%, following a near 19% loss last year, the worst year since the 2008 financial crisis. The tech-heavy NASDAQ is now about 15% above last year's close after a 33% decline in 2022. And the Morgan Stanley All Country World Index, a measure of the combined equity market performance of developed and emerging markets countries, has advanced over 8% this year after declining more than 18% in 2022. Aside from energy and related stocks (accounting for about 5% of the S&P500), which benefited from rising oil prices, no equity sector was spared a sharp rerating. Bonds have also recovered a meaningful fraction of their steep 2022 losses; The Barclays US Aggregate Bond Index, down 13% last year, has bounced about 3% in 2023 as investors' worst inflation fears have receded and the prospects for Fed moderation have taken hold. In retrospect,

negative sentiment, year-end tax selling, the bursting of the 2021 tech stock bubble, huge declines in crypto-related shares, SPACs and other highly speculative vehicles, and the bearish positioning of many traders left stocks deeply over-sold and less than fairly valued, setting the stage at the end of last year for this year's surge.

Volatility has been a hallmark of the markets in recent years, yet many investors attempting to take advantage of the short-term price swings by "timing" the market have stumbled. For example, an investor who missed the best five days in the stock market last year achieved a return 13.11% less than someone who remained in the S&P500 throughout the year; another indication that timing the market is a fruitless endeavor. And, while it's too soon to conclude the bear market for stocks that began last year is over, investors who acted on the advice of several widely followed chartists to exit the market in advance of what they predicted would be a market crash this year, have missed a notable rally.

Interestingly, for all of 2022, the M2 measure of money supply growth was essentially flat, reversing the explosive M2 increases seen during the prior year. This can be seen in our [Economic Model](#). Now, with the Fed-driven rise in interest rates, investors have been aggressively pulling money from lower yielding bank savings accounts, reinvesting the funds in US Treasuries and other higher yielding vehicles. (While this process, known as disintermediation, is not new, it was not seen nor warranted during the earlier, long period of near zero interest rates). For their part, banks, seeking to maintain their reserves, have turned to the Fed to improve their liquidity and to satisfy their regulatory requirements. As a result, Fed Funds, the benchmark for borrowing costs across the economy, hit \$120 billion on January 27, the highest one-day total since 2016. One impact of these money flows will be to contribute to an increase money supply growth and consequently, over time, underpin the demand for equities.

Near term, we expect equities to remain volatile, particularly around the release of key inflation and employment data, Fed decision dates, and Fed speak. Changing expectations regarding the likely course of Fed interest rate decisions and the likelihood of a recession will drive sharp market swings. A dwindling group of sell side market strategists, remain worried that 2023 earnings estimates are still too high, predict the S&P500, now 4,136, will either revisit its early October 2022 lows near 3,600 or undercut them, before stocks finally bottom, setting the stage for a sustainable advance. Others, with longer-term time horizons, including our firm, will stay-the-course, avoiding the temptation to time the market's inevitable sentiment swings.

As to current market valuation, assuming S&P earnings of \$226 per share this year forecast by Wall Street analysts, stocks, which discount future profits, are currently selling at 18.1x earnings, about two turns above their historical 16x average multiple. While not statistically cheap at today's prices, stocks are close to fair value. Looking further out to 2024, when S&P500 earnings are forecast by some to recover toward \$260 per share, equities are attractively priced at 15.8x earnings. Clearly, should it become apparent the Fed is succeeding in engineering its desired "soft landing", stocks are expected to rally substantially, further recouping in short order much of the remaining ground they gave up last year. Delays in curbing inflation will trigger periods of market weakness of as much as 5-10% before equities stabilize.

In our view, we've seen about 80% of the likely Fed tightening cycle, rapidly approaching its end, setting the stage for the next economic expansion and the onset of a new bull market. Absent another exogenous shock, we believe the coming expansion will be vigorous and prolonged, supported by sound fundamentals including falling interest rates, easing credit conditions, sticky but gradually receding inflation, a well reserved US banking system and underpinned by strong consumer and corporate balance

sheets. While there is currently no end in sight to the carnage in Ukraine, the war will eventually wind down and, a sizeable investment will be required to rebuild that country's infrastructure, and to strengthen defenses in Western Europe and elsewhere, creating new jobs and, in general, stimulating global growth in the private sector. And, lastly, the coming end to China's zero COVID tolerance policies will further support the nascent expansion.

Equity portfolios under our supervision remain close to fully invested despite the short-term market risks noted above. They are broadly diversified between high quality large cap *growth* and *value* investments, still tilted toward *value*. *Value* stocks continued their outperformance off the December 2022 market lows. However, as expected, when the pressures of rising interest rates abated more recently, *growth* shares, which have become more reasonably priced relative to their long-term earnings growth prospects, began to out-perform the averages following a period of almost 18 months of subpar performance. Our investment platform also includes modest allocations to small cap US stocks as well as investments in equities domiciled abroad in both *developed* and *emerging* markets. Portfolio turnover remains low, consistent with our long-term investment horizon and our focus on producing competitive after-tax returns.

Fixed income

The sharp rise in interest rates over the past year has made bonds investable once again. Accordingly, we have been gradually extending fixed income durations in clients' laddered bond portfolios, selectively deploying the funds generated by maturing holdings returning less than 1% into new, high quality corporate obligations yielding as much as 5%, maturing in about two years. We have also been active replacing clients' lower yielding money market fund holdings with riskless, higher yielding US Treasury bills maturing later this year. The bills yield close to 5%. The cumulative increases in income generated by these strategic shifts, are expected to enhance portfolio total returns over next few years.

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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.

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