The US economy can continue to expand without fanning inflation

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Background

While incoming data last month provided confirmation the US economy can continue to expand without fanning inflation, it also suggests Federal Reserve interest rate cuts may be delayed. We received good news for the economy from the Department of Labor's *establishments* survey which showed nonfarm payrolls grew a surprising 303,000 in March, 50% above expectations, the largest increase in ten months. Payrolls for prior months were revised higher by 22,000. Meanwhile, civilian employment, a measure that includes small business start-ups, grew a robust 498,000 last month. The labor force, spurred by immigration, increased 469,000 last month, pushing the participation rate back up to 62.7%. Average weekly hours worked increased to 34.4 from 34.3 in February, and total hours worked rose 0.5% for the month. The *households* survey showed unemployment slipped 0.10% to 3.8% in March. Most important, average hourly earnings increases have slowed, increasing only 0.3% last month and are up 4.1% over the last year, generally in line with inflation. ***While this data promises diminishing pressure on inflation due to the slowing rate of wage increases, given the strength in headline payrolls and the economy's resilience, Fed officials are justified in questioning whether monetary policy is really too tight given that inflation remains stubbornly above their 2% target.***

Outlook

Clearly, the outlook for the economy has improved in recent weeks as reflected in the buoyant stock market and the recent move higher in open market interest rates. Behind the brightening outlook has been the surprising strength in the incoming data noted above, positive reports on labor supply and tentative signs of a recovery in manufacturing as orders for long-lasting goods increased more than expected in February while business spending on equipment in the first quarter outpaced expectations. And there are currently few signs of a meaningful retrenchment in consumer spending which accounts for about two thirds of real GDP.

Looking ahead, both the ISM Manufacturing and ISM Non-Manufacturing indices for March are above 50, pointing toward expansion. And the readings of our firm's proprietary **Economic Model** have signaled expansion for eight consecutive months through March.

Despite the current economic strength, the consensus forecast calls for a cooling in economic growth in the months ahead. This slowdown will result in less tight labor market conditions which are expected to ease inflation pressures further, allowing the Fed to begin loosening credit conditions, possibly by midyear, if incoming economic data shows further progress in bringing price increases down toward its 2% target. Important to the Fed's future deliberations will be readings of its preferred inflation gauge, the

Personal Consumption Expenditures index (PCE). For February, the year-over-year core PCE, which excludes volatile food and energy prices, was 2.8%, in line with expectations, down from 2.9% in January. Core PCE prices rose 0.3% from January to February, also meeting expectations and down from 0.5% the previous month. While a broader array of early first quarter inflation figures showed a modest reversal in the trend of price increases, casting some doubt on the timing of the first rate cut, it has not changed forecasts regarding the downward direction of rates over the intermediate term. We now expect two or three rate cuts this year, commencing this Summer.

Investment Policy

Lower interest rates will, in our view, usher in both the beginning of a broader economic expansion and the change in stock market leadership we have been expecting. For much of 2023 and, to a degree, the first quarter of this year, a handful of highly priced mega cap tech stocks have dominated the broad market indices, leading them to new all-time highs. Now, several factors including stretched valuations, regulatory/legal threats and insider selling present serious questions about the prospects for these stocks over the next year. At the same time, easier financing, fueled by Fed rate cuts, will set the stage for broader stock market leadership. ***The dominance of the "Magnificent Seven" faded as shares of two of its members suffered steep pullbacks while the rest of the market powered ahead, marking the likely coda to their period of extreme market dominance.***

For the March quarter, influenced by its 30%+ weighting in mega cap tech stocks, the S&P gained 10.3%. The tech heavy Nasdaq ended the quarter 9.1% higher. Well-diversified equity portfolios likely trailed these tech-dominated indices last quarter. The 30-stock Dow Jones Industrials advanced 5.6% during the first quarter, its strongest first quarter gain since 2021 when it jumped 7.4%.

The equity market has staged an impressive rally since late October 2023 with the S&P 500 companies rising over 30%, gaining over $9 trillion in market value. It is also no secret that stocks are currently richly valued. The S&P 500 is now priced at roughly 21.5 times estimated 2024 earnings per share. A 16 times price/earnings multiple is average for that index. Overall, sentiment is quite bullish despite day-to-day choppiness. Equities have shown unrelenting upward momentum. The few downturns we have experienced since the October lows have been limited to two percent or less. As we see it, a pullback, driven by a shift in investor sentiment due, for example, to a change in expectations for Fed easing or to an exogenous shock, could trigger a long overdue 5% to 10%+ correction without a meaningful change in the favorable economic fundamentals. A pullback, washing out growing speculative stock market excesses, would be a constructive development.

As long-term investors, we pay scant attention to short-term market gyrations. Instead, we dedicate our research effort to searching for investment opportunities the market will present as the coming economic cycle unfolds. Equity portfolios under our supervision are accordingly fully invested, well diversified between growth and value shares, within their respective guidelines. We maintain portfolio allocations to small cap domestic equities as well as emerging and developed market investments, underperformers for an extended period, as they should be beneficiaries of the easing credit conditions and the weakening US dollar we expect. As for fixed income investments, we have significantly extended the duration of the high quality, laddered, corporate bond investments we manage for clients toward the 2.5-year target we established last year, locking-in yields-to-maturity of 5% or better.

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 US 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&P 500 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 US. S&P 500 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&P 500 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.