There is little evidence the US Economy is slowing materially or that a recession is imminent

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Background

With the Federal Reserve now firmly on hold awaiting greater clarity from incoming data, attention has shifted to focusing on “separating the signal from the noise,” as analysts attempt to digest the effects of the administration’s proposed policy changes which have elevated uncertainty for economic activity. So far, despite the growing unease, there is little tangible evidence the US economy is slowing materially or that the threat of recession is imminent. In fact, “hard” data shows the overall US economy remains on solid footing, continuing to expand, albeit at a more subdued rate, as job creation continues apace, and unemployment remains low. But “soft” data, gathered from numerous business surveys, tell a different story, contributing to a recession scare.

As for the “hard” economic data, beyond retail sales which grew a tepid 0.2% month-over-month in February, recent reports show relatively benign readings in housing and factory activity. However, numerous business surveys, “soft” data, show a concerning downshift in sentiment. Notably, the pace of activity in manufacturing accelerated in February following months of contraction, whereas data from the Empire State, Philadelphia and Richmond Fed surveys for both February and March came in soft. Similarly, despite high mortgage rates, housing starts, existing home sales and new single family home sales all rose in February, while the March sentiment index from the National Association of Home Builders (NAHB) fell to its lowest level since August. And most recently, the latest S&P Global Flash Composite PMI, which measures manufacturing and services activity, showed that US growth accelerated in March, thanks to an upturn in services which offset a renewed fall in manufacturing output. However, the Flash report also showed business expectations for the year ahead fell to their second lowest reading since October 2022 as companies grew increasingly cautious about the economic outlook, often citing worries over customer demand and the impact of the administration’s trade policies.

In our view, like the FOMC members who, amidst the unusually high degree of uncertainty over tariffs, recently voted to leave monetary policy unchanged, survey respondents are reacting to top of mind trade concerns. Whether their dour expectations translate into

significantly diminished overall economic activity, or just a short-term mood swing subject to reversal, remains to be seen.

As the administration continues to upend policies across multiple fronts including trade, immigration, regulation, taxes and spending, the spreading effect of these increases the probability of an economic slowdown. While several forward-looking economic models we are aware of have signaled a slowdown, and many Wall Street economists have trimmed their GDP forecasts, few are forecasting recession. And, of the metrics used by the National Bureau of Economic Research (NBER) Recession Dating Committee to determine whether the economy has entered recession, none are signaling recession. Meanwhile, our firm's proprietary Economic Model, designed to signal a change in the direction of the US economy six to nine months in advance of an inflection point, remains above-trend, signaling expansion ahead.

US consumer confidence fell in March to the lowest level in four years on uncertainties about higher prices and the economic outlook. The Conference Board's gauge of confidence fell sharply, declining 7.2 points to 92.9, below the consensus forecast of 94.0. Significantly, a measure of expectations for the next six months dropped nearly 10 points to 65.2, the lowest such reading in 12 years, while a measure of present conditions dipped more modestly. Consumer sentiment surveys from both the Conference Board and the University of Michigan have shown weakness as households fear a resurgence of inflation from the President's tariffs as they impact input costs and threaten to interrupt supply chains. Companies have warned at recent conferences and during some earnings calls of higher prices and less demand, coinciding with economists' forecast that suggest a risk of stagnation and the low but rising odds of a recession. Inflation expectations for the coming year increased to the highest level in two years according to the Conference Board, and a similar metric from the Michigan survey early this month rose to the highest level since 2022. Clearly, consumers' optimism, which had held up in the past few months, has been eroded by feared policy changes. Households' expectations for future finances have declined to their lowest level since July 2022, the darkest days of the pandemic.

The most significant theme coming from the March FOMC meeting was uncertainty. Chair Powell cautioned that the trade policy announcements scheduled for April 2 could tilt growth to the downside and inflation to the upside. FOMC participants expressed this concern in the risk weightings to their GDP and core PCE forecasts which showed downward revisions to growth and upward revisions to inflation. And while Fed forecasts continue to point to two additional interest rate cuts this year, the odds the Fed will actually cut rates have fallen, in our view, as the economic uncertainties around inflation have mounted.

Investment Climate

The Keynesian animal spirits nourished by President Trump's election in November have given way to widespread misgivings about the new administration's policies apparently intended to create a new world economic order. Central to those concerns is Trump's negotiating style: Are his tariff proposals merely a huge, risky bluff designed to drive a hard bargain with our trading partners or is he serious about using tariffs as the basis for some new economic system? If the President's first term is any guide to understanding his current intentions, a strong case can be made for the former where hard fought negotiations will be resolved favorably for the US and most of our counterparties. Regardless of the motivation behind these tariff proposals, the threat of their implementation has had a dampening effect on both business and consumer confidence, as well as on our stock market. US equities, faced with a barrage of unsettling, stop-and-go policy announcements, coupled with recession rumblings, have been decidedly weak and unusually volatile this month amidst the chaos. A stream of confusing comments from the White House regarding evolving tariff policy have driven unnerving intraday reversals.

Among the concerns for the equity market is the growing caution of stock analysts who have been trimming their earnings estimates for the current quarter. S&P500 forecasts for the first quarter of 2025 have fallen by 4.5 percentage points since January 1, the largest downward revision to earnings estimates since the fourth quarter of 2023. Earnings growth for the S&P500 companies for the current quarter is now expected to come in at about 7.7% year-over-year, the lowest since 2023's third quarter, and to show a large decline from the 17.1% increase in the last quarter of 2024.

By the middle of March, the S&P500 had experienced a 10% pullback from its February 16 high of 6128 in just 16 trading days, wiping out all its post-election gains, before bouncing at mid-month. That decline, which we had been expecting, and we view as a favorable speculation-clearing event, amounted to the quickest about-face into a correction in five years and the eleventh quickest in the last half century. Whether the March low will hold remains to be seen; a retest of the S&P500's 5500 level is likely, in our view, given the "technical" damage done to the market by the severity of its correction and soured investor sentiment. Meanwhile, short-term interest rates have eased, the yield curve has steepened as longer-term rates have backed up, and bond prices have risen as capital has flowed to the relative safety of fixed income investments from risk assets. The loss of stock market leadership from the small group of richly priced, AI-related mega-caps whose gains had accounted for as much as 35% of the S&P500's 25% return last year, and the even greater declines experienced by speculative, lower quality tech stocks and crypto currencies are possible precursors to the broadening in stock market leadership we have forecast. Abroad, relatively cheap developed and emerging market equities have rallied this year, delivering their strongest comparative performance in years, aided by a weaker dollar. And, gold, viewed by many to be a safe haven in uncertain times, reached a record high, topping $3,000 for the first time.

Equity Investment Policy

There has been no change in equity investment policy. Equity portfolios under our supervision remain fully invested. Despite the near-term uncertainties around trade policies, we find the US economy to be fundamentally sound, resilient in the face of its near-term, man-made challenges. While the odds of a recession have risen, they remain low. The administration has signaled its intention to reduce taxes and the regulatory burden on US firms, major positives for profit margins. We see the direction of short-term interest rates as lower. While rates are currently on hold pending further progress on inflation, real interest rates remain restrictive. Fed officials would like to cut rates, but the timing of additional easing has been delayed, made more difficult by the possible impact on prices of the administration's tariff and immigration policies. Lower rates are a tailwind for risk assets. Corporate profits are growing, though the rate of increase is forecast to moderate over the near-term. The US banking system is extremely well-reserved and expected to benefit from a more friendly regulatory regime under the current administration. An expected wave of consolidation will further strengthen the banking industry's financial position. Corporate balance sheets are strong. The society remains awash with cash and lenders abound. Growing corporate profits are eventually reflected in rising stock prices. And, most important, the benefits of innovative technologies, including AI, have begun to filter through to the broader economy, enhancing productivity.

As long-term investors, so long as corporate profits are expected to rise, we look beyond near-term political and economic uncertainties, as well as the short-term volatility inherent in equity investment. Pullbacks of 5-10%+ should be expected to occur regularly, correcting speculative excesses, as sentiment ebbs and flows.

Clients' portfolios are well-diversified, balanced between *growth and value* investments. Our investment platform includes small cap domestic equities as well as modest allocations to developed and emerging market investments. Recall that Front Barnett management uniquely blends core, high quality, large cap *growth and value* investments in a single portfolio, positioning it to grow over the course of market cycles during which the broader market will rotate favoring either the *growth or value* style for a time. This portfolio management strategy seeks to smooth returns over the longer-term.

Despite the still-elevated valuations of formerly high-flying mega cap AI-related tech stocks which drove the cap weighted stock market indices to new highs this winter, following the recent market correction, the stock market as a whole is now more fairly valued when measured by the S&P500 equal weighted index, currently selling at 16x forward earnings, its long-term average, down from 18x earnings prior to the pullback.

Fixed Income Investment Policy

Turning to fixed income, bond yields, as measured by the benchmark 10-year US Treasury, have risen from their low point of 4.18% this year to 4.35% currently. The recent backup in yields is largely attributable to rising inflation expectations and has provided us with opportunities to add to the shorter end of clients laddered corporate bond portfolios. Should rates rise further over the near term toward their recent 4.80% peak, we expect to add to bonds maturing toward the longer end of the bond ladder where yields would exceed 5% again. We target portfolio durations of 2.75 years.

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MBF

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.