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ECONOMIC UPDATE

INFLATION

Data released last week by the Labor Department showed the Consumer Price Index (CPI) rose less than expected in October, pushing the annual rate of increase below 8% for the first time in eight months. This was the strongest indication we have seen that headline inflation probably peaked around midyear and is gradually slowing, allowing the Federal Reserve room to scale back its aggressive interest rate hikes should further signs of easing price increases emerge over the next few months. On a year-over-year basis, overall consumer prices rose 0.4% last month, falling short of the consensus expected +0.6% and lowering the year-ago comparison for the fourth consecutive month to 7.7%. Obviously, inflation remains a major problem for the economy as the current rate is still far above the Federal Reserve's long-term 2.0% target. Further Fed tightening, albeit at a less aggressive pace, is, therefore, highly likely despite the risk its restrictive policy could tip the economy into a mild recession next year.

Nevertheless, the October CPI report contained several positive data points. First, the typically volatile energy sector was *not* the reason inflation was relatively tame, as energy prices rose 1.8% last month after falling a combined 11.3% during the three prior months. Excluding energy, consumer prices rose a modest 0.3% in October. Meanwhile, food prices rose 0.6%, the smallest monthly gain in 2022. Stripping out food and energy, "core" prices moderated in October, rising 0.3% versus an expected +0.5%, reducing the year-ago comparison down to 6.3% (from 6.6% in September). Housing rents (for both actual tenants and the rental value of owner-occupied homes) continued to increase at an outsized pace, rising 0.6% for the month, but below the staggering pace of September where both categories posted their largest monthly increases in more than thirty years. Housing rents, which accounted for nearly half of the overall rise in consumer prices, are expected to be a key driver of inflation next year as they amount to more than 30% of the overall CPI and they have a long way to go to catch up to home prices, which skyrocketed during COVID-19. A deep dive into the "core" data shows inflation was held down by several categories including medical care which declined 0.6%, the largest drop in over fifty years, due to a statistical fluke not likely to repeat itself in the months ahead. Other categories that declined in October were prices for used vehicles (-2.4%), airline fares (-1.1%), and apparel (-0.7%) as retailers offered discounts to move unwanted

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inventory. There were also welcome decreases in the prices of furniture and bedding as well as appliances. As a result, core goods prices fell 0.4% after being unchanged in September, as demand slowed, and global supply chain issues eased. While the October CPI report was encouraging, the Fed will require additional evidence of declining prices over the months ahead before it can safely conclude the inflation scare is over and reverse its restrictive policy. Recall prices ebbed in July last year through September, before reaccelerating, a lesson not lost by the Fed.

JOBS

Labor Department data for October shows that despite the tight labor market where there are 1.9 open jobs for each job seeker, employment growth is decelerating following the Fed's aggressive tightening. Nonfarm payroll growth slowed to 261,000 in October compared with an average gain of 407,00 per month so far this year. Another measure of jobs that includes small business start-ups, Civilian Employment, dropped 328,000 resulting in an increase in the unemployment rate to 3.7% from 3.5% in September. Meanwhile, average hourly earnings increased 0.4% in October, up 4.7% in the past year while consumer prices have risen roughly 8% from a year ago implying "real" hourly wages are falling, crimping consumers' purchasing power. We expect a continued slowdown in employment gains in the months ahead as companies trim hiring or implement layoffs in anticipation of slower economic growth and a possible recession next year.

OUTLOOK

Beyond the inflation and jobs data which drive Fed policy decisions, *forward-looking* economic indicators we monitor show the economy growing more slowly than earlier this year but avoiding recession, so far. Below are the key indicators and brief comments on each.

> **INITIAL JOBLESS CLAIMS** rose slightly last week as job cuts have begun to spread across industries most affected by soaring intertest rates, such as housing and technology. Unemployment claims for the week ending November 5 rose by 7,000 to 218,000 the previous week. The four-week moving average, our preferred measure, held steady at 218,000. Applications for jobless claims, which generally track layoffs, have remained historically low this year even as the Fed has aggressively increased its reference rate in its effort to cool the economy to tame inflation.
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> **ISM NON-MANUFACTURING INDEX** declined to 54.4 in October, below the consensus expected 55.3. (Levels above 50 signal expansion, levels below 50 signal contraction.) The major measures of activity moved lower last month but nearly all stand above 50, signaling growth. The new orders index declined to 56.6 from 60.6, while the business activity index dropped to 55.7 from 59.1. The employment index declined to 49.1 from 53.0 while the supplier index rose to 56.2 from 53.9. The prices paid index increased to 70.6 in October from 68.7 in September.

The services sector continued to expand in October but at a slower rate than the previous month, with sixteen of the eighteen industries reporting growth. Respondents reported resilient sales despite being partially held back by the uncertain economic environment surrounding concerns of a future recession. Business activity and new orders, the two most forward-looking indicators in the report, both declined in October but remain comfortably above 50 as businesses and consumers continue to shift resources from goods to the still-reopening services sector. Recall that pre-pandemic, services made up roughly 69% of consumption spending. That number fell to 65% during the depths of COVID-19 as people avoided concerts, theaters and restaurants. Third quarter GDP data show that number has risen to 66%. We expect continued growth in the services sector as spending continues to shift back to pre-pandemic levels.

ISM MANUFACTURING INDEX declined to 50.2 in October, narrowly beating the consensus expectation of 50.0. (Levels above 50 signal expansion, levels below signal contraction.) The major measures of activity were mixed in October. The production index rose to 52.3 from 50.6 in September, while the new orders index rose to 49.2 from 47.1. The supplier index declined to 46.8 from 52.4 in September and the employment index rose to 50.0 from 48.7 the prior month. The prices paid index declined to 46.6 in October from 51.7 in September.

The manufacturing sector continued to expand in October, but at the slowest pace since the pandemic recovery commenced, with only eight of the eighteen industries reporting growth. Respondent's comments were mainly focused on worries about the pace of future activity with some customers pulling back on new orders due to worries about an economic slowdown. Most notable was the lack of comments related to supply chain issues which have plagued the manufacturing sector over the past few years. Meanwhile, the employment index rebounded to 50.0 in October, signaling neither expansion nor contraction.

Finally, 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 below trend, pointing to the possibility of a recession next year.

Other data we have seen since our September Economic Update show income, spending and inflation continuing to rise, albeit unevenly, as the economy transitions from a stimulus-fueled rebound from COVID toward a slower path of growth. The economy is shifting from the shutdown-induced measures that mainly supported the goods side of the economy, back to the services side, which was discouraged (or outright prohibited) during the pandemic. Consider that from February 2020 to December of that year, spending on goods rose by more than $300 billion, while outlays for services fell by over $500 billion. This government-induced shift caused a massive reallocation of resources. Now, as we return to more normal spending patterns, the goods side of the economy is slowing bringing with it some layoffs, supply side issues and other economic misallocations. Looking back, the stimulus checks, PPP loans, and extra unemployment benefits of 2020 dramatically boosted consumer spending power, more than replacing lost wages. That economic stimulus, meant to dull the pain of shutdowns, led to multi-decade high inflation and the current economic pain that now comes with trying to get that inflation in check. No, we are not in recession yet, but the Fed, trying to undo the effects of fiscal and monetary policy decisions made over the last three years, may well cause one.

THE FED

The FOMC delivered its fourth consecutive 75bp interest rate hike at its November meeting, underscoring the need for further increases. The Fed's policy rate remains well below the consensus peak rate currently forecast by economists to occur in January at 4.625%, well below the 5.0%+ rate expected just a few weeks ago. However, the Fed added language to its most recent statement indicating the pace of future rate increases will depend on "the cumulative tightening of monetary policy, the lags with which monetary policy affects economic activity, and economic and financial developments". During the post FOMC news conference, Fed Chair Powell did say smaller sized increases may come as soon as December, but "it would be very premature to be thinking about pausing rate hikes". According to the FOMC statement, the Fed anticipates that ongoing rate increases will be appropriate until there is a clear trend that inflation will be declining to 2% over time. Nevertheless, this shift in monetary policy can be described as a *very soft pivot* and does signal that the Fed is entering the final stages of its aggressive rate hiking campaign.

EQUITY INVESTMENT POLICY

Equity investment policy remains unchanged. Stock portfolios under our supervision are well-diversified, fully invested in high quality companies, balanced between *growth* and *value* investments, tilted toward *value*. *Value* has outperformed *growth* by about 20 percentage points this year as rapidly rising interest rates negatively impacted *growth* stock valuations. Our equity investment platform also includes companies domiciled abroad in both *emerging* and *developed* markets as well as domestic small cap common stocks.

We remain focused on fundamental equity research avoiding the temptation to "time" the market's eventual recovery, recognizing we have no demonstrated ability to take advantage of the ebbs and flows of investors sentiment. The recent nearly 15% rebound in the broad stock market indices from their September-end lows likely reflects a combination of investors' growing confidence we have seen peak inflation, giving the Fed room to moderate its very aggressive tightening campaign early next year, and the extreme oversold condition of the market. Because monetary policy is so key to the current economic outlook, stock market volatility is likely to remain elevated around future Fed meeting dates, the release of various inflation readings and Fed speak. Fundamentally, high quality, large cap domestic equities are fairly valued at about 16.5 times forward earnings, the average multiple of the past 20 years.

FIXED INCOME INVESTMENT POLICY

In the fixed income portion of portfolios under our supervision, seeking preservation of principal has served us well during the period of rising interest rates. Now, with interest rates cresting we have begun to extend maturities, using the proceeds of bond maturities to capture the higher interest rates available in investment grade corporate obligations maturing in late 2023 through 2024.

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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 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.