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ECONOMIC UPDATE

Amid growing concerns over liquidity issues at several regional banks and the looming shutdown of the US government, three anxiously awaited, key economic events have come and gone this month without much apparent change to the consensus economic outlook nor did they upset the financial markets.

Early this month we were reminded how resilient the US labor market has been during one of the fastest monetary tightening policy cycles in modern history. The FOMC has raised its policy rate by 500 basis points since March 2022 and yet the labor market has remained very tight by many measures. The Bureau of Labor Statistics *establishments* employment report for May showed payrolls increased by a robust 339,000, easily exceeding the consensus expected 195,000, and prior month's employment growth was revised upward by 93,000. Average monthly gains this year have been 314,000. Overall labor force participation held steady in May at 62.6% but the participation rate among prime-age workers (25 to 54) ticked up slightly to 82.4%, near its highest level over the past two decades. These levels of participation and payrolls gains are consistent with very tight labor markets, an important concern for the Fed. Other signs of labor scarcity were seen in the Job Openings and Labor Turnover Survey (JOLTS) data for April. The declining trend in the job openings numbers we had seen in previous months reports reversed course in April as openings increased to 10.1 million from 9.745 million in March. The ratio of vacancies to unemployed, the V/U ratio, moved up from 1.7 to 1.8; while off the recent highs of 2.0, the V/U remains well above the 1.0-1.2 range that is viewed as consistent with a labor market in balance. However, despite the current tightness in labor conditions, there are signs of a gradual softening. For example, the May *household* survey showed the unemployment rate rising to 3.7% from 3.4% in April. While its too early to tell, one explanation for the dichotomy between the *establishments* and *household* surveys could be that smaller businesses are beginning to pare back their workforces while larger firms can afford to continue to hoard labor.

Last week, the Labor Department reported the Consumer Price Index (CPI) fell in May to about half of last year's 9.1% peak but remains elevated, well above the Fed's 2% target. While the pace of price increases has clearly slowed, investors fear inflation's stickiness could give rise to further Fed tightening. Core consumer prices, which exclude volatile food and energy categories, climbed 5.3% in May from a year earlier, down from 5.5% in

April. Economists see core prices as a better predictor of future inflation. Core prices remain elevated because an earlier surge in housing-rental prices continue to show up in the inflation figures. Apartment-rent growth has since cooled significantly, declining to just under 2% over the 12 months ended in May from double-digit increases a year ago. The weakness in these figures will reduce inflationary pressures but they will take time to impact the core numbers due to the lag in how rent is calculated.

THE FED

The day following the Labor Department's report, Federal Reserve officials voted, as widely expected, to hold interest rates steady following 10 consecutive increases, the most rapid series of rate hikes since the 1980s, but signaled they were prepared to raise rates next month if inflation failed to show further improvement. Fresh economic projections released following the FOMC meeting signaled the Committee was inclined toward slowing its increases rather than ending them. In fact, most of the voting members penciled in two additional rate increases this year, potentially lifting them to a 22 year high, and at the same time boosting their forecasts for both economic growth and inflation. Keep in mind, the Fed's interest rate forecast "dots" are only a forecast, not a promise. Whether that forecast will be realized depends on data the Fed will see over the next month. Of late, Fed officials have slowed their rate increases, lifting the reference rate by a quarter percentage point at their past three meetings. Last Wednesday's decision not to raise rates was a continuation of the slowing process according to Fed Chairman Powell, given how much closer they are to their destination, "It's common-sense to go a little slower."

The Fed's mission has been to push interest rates high enough to drive inflation down from its current 4%-to-5% range to its 2% target despite the risk its actions might tip the economy into recession and increase unemployment. Higher rates inevitably tighten financial conditions, increase borrowing costs, pressure stock prices and strengthen the dollar. In recent weeks, Fed officials have displayed growing disagreement over whether to continue raising rates. Some FOMC members expressed reservations following the Silicon Valley Bank failure which led to the demise of three regional banks. In their view, the resulting increase in funding costs for many other banks raised the risks of a credit crunch that would limit their ability to raise rates as much as they would otherwise. Other Fed members, concerned that inflation, hiring and consumption have remained too strong, have favored hiking rates further. Last week's decision to forego a rate increase this month appears to have been a compromise, offering a way to unite hawkish Fed officials who would have favored lifting rates this week and those who were more dovish, including Powell, who we believe wanted to wait, leaving open the prospect of an additional 25 basis point increase when the FOMC meets late next month. It may be hard for Powell to convince the FOMC in July to forego an increase for two consecutive meetings, so one final 25 basis point rate bump is likely next month.

In our view, the Fed, while initially failing to recognize the seriousness of the inflation problem, calling it "transitory", has now raised *real* interest rates to where they are close to being sufficiently restrictive to curb inflation. Based upon the 5.3% increase in core consumer prices (excluding food and energy) over the past 12 months, the current *real* interest rate is around zero. Using inflation-protected US Treasury bond yields as a proxy for investors' estimates of future inflation, the *real* rate is now 1.4%. The Fed considers a *real* rate of 0.5% neutral, meaning it neither stimulates nor slows the pace of economic activity. A rate above 0.5% is seen as restrictive enough to push unemployment higher and inflation lower. That said, the current *real* rate is still not overly restrictive. In fact, *real* rates were much higher prior to every recession since 1960.

From the foregoing we conclude the data dependent Fed is close to finishing the job of bringing real interest rates to its desired restrictive level, particularly if the current slowing pace of inflation persists, and that there remains a pathway, albeit a narrow one, to skirting the recession many economists and our firm's proprietary Economic Model have been forecasting for months.

ECONOMIC INDICATORS

The US economy remains captive to both the excessively stimulative impact of fiscal and monetary policies of 2020-2021, which are still being worked off, and pressures from the Fed and US Treasury which are raising real interest rates and pulling money out of the system to curb price increases. Manufacturing activity has clearly slowed, jobs continue to rise but gains have been offset by a slowdown in hours worked, and retail sales are down from a year ago when adjusted for inflation. Economic growth overall remains positive as the service sector, which accounts for nearly 80% of business activity, continues to recover from the pandemic shutdowns.

High frequency *leading* economic indicators we monitor continue to send decidedly mixed signals but are clearly pointing to a further slowdown in business activity. Recent readings of these and other measures, as well as our brief comments on each, follow.

LEADING ECONOMIC INDICATORS

ISM MANUFACTURING INDEX declined to 46.9 in May narrowly missing the consensus of 47.0, signaling contraction. (Levels higher than 50 signal expansion; levels below 50 signal contraction.) The major measures of activity were mixed in May. The new orders index declined to 42.6 from 45.7 in April, while the production index rose to 51.1 from 48.9. The supplier deliveries index fell to 43.5 from 44.6 in April and the employment index increased to 51.4 from 50.2. The report showed the overall index remained in contraction for the seventh consecutive month as only four of the eighteen industries surveyed reported growth in May. Survey respondents

noted worries about slowing demand from customers as the new orders index fell to a near post-pandemic low. In fact, the customer inventories index rose to 51.4 in May, the second consecutive reading above 50. The combination of less demand from customers and built-up inventories at retailers means factory output is likely to remain sluggish. On a positive note, fewer new orders and the improvement in supply chains has allowed factories to catch up on backlogs, with that index falling to 37.5 in May, the lowest reading for this index since the 2008 financial crisis. Finally, on the inflation front, the prices index fell to 44.2 in May, disrupting the recent upward trend.

ISM NON-MANUFACTURING INDEX declined to 50.3 in May, well below the consensus 52.4, barely growing last month but still signaling expansion. (Levels above 50 signal expansion; levels below 50 signal contraction.) The major measures of activity were all lower in May. The new orders index fell to 52.6 from 52.9, while the business activity index declined to 51.5 from 52.0. The employment index fell to 49.2 from 50.8, while the supplier delivery index declined to 47.7. from 48.6. The report showed a pullback in the rate of growth in the services sector, as the headline index declined to 50.3, below the most pessimistic forecast. The two most forward-looking pieces of the report, new orders and business activity, both fell in May. While both remain in expansion mode, business activity fell to a new low for 2023 and new orders remain just a fraction above its low for the year. The general softening shown by these two categories was also echoed in the respondents' comments which revealed that some companies are starting to pause hiring until they have greater clarity regarding the direction of the economy. The highest reading of any index in May once again came from prices paid, which fell to a still elevated 56.2. This index has been trending down since its peak of 84.5 at the end of 2021.

INITIAL JOBLESS CLAIMS remain near the highest level in almost two years at 262,000. The four-week moving average rose to 246,750, the highest level since the week ended November 20, 2021, pointing to some softness in the otherwise strong US labor market. Unemployment claims typically begin to rise when the economy is slowing, and a recession is approaching. Claims have increased since the beginning of the year but are still extremely low by historical standards. Since the mid-1970s, a sustained rise in jobless claims has led recessions by 39 weeks on average.

M2 MONEY SUPPLY soared in the first two years of COVID-19, up 40.4% from February 2020 to February 2022. In a major reversal, through April of this year, the M2 measure of money supply has dropped for nine consecutive months and is down 4.1% from a year ago. Recall that M2 money supply growth has averaged about 6% annually. Other credit conditions are also showing tightening. Bank credit at commercial banks as well as their commercial and industrial loans are both down. It remains to be seen how quickly these reductions in money supply, combined with the Fed's 10 rate increases since mid-2022, translate into inflation falling toward the Fed's 2% target.

CONSUMER INFLATION EXPECTATIONS fell in early June to a more than two-year low, driving consumer sentiment higher. Americans see prices climbing at an annual rate of 3.3% over the next year, down from 4.2% expected in May according to the preliminary June reading from the University of Michigan. The overall sentiment index increased to a four-month high of 63.9, well above the median estimate of 60. Despite the sentiment increase, the report showed consumers

grew more concerned about their incomes. The labor market, which supports consumer spending, has come more into balance in recent months which means workers are no longer seeing the robust wage gains to which they had become accustomed post-COVID. This is good news for those who feared a wage/price spiral would prolong the Fed's fight to bring inflation down. It is not good news for workers whose buying power is being sapped by rising prices.

OTHER ECONOMIC INDICATORS

RETAIL SALES rose 0.3% in May, beating the consensus expected decline of 0.2%, a sign of economic resilience in the face of mounting economic challenges. The May report was roughly in line with expectations, showing a further slowing in consumer outlays, but not a sharp deterioration. Retail sales were up 1.6% versus a year ago. The largest increases were surprisingly for autos and building materials, which could help to support the economy this quarter. The largest declines were at gas stations, where, due to lower seasonal prices, sales were down 20.5%. In the last twelve months, overall retail sales are up only 1.6%, clearly lagging inflation. Sales at restaurants and bars rose 0.4% in May and are up a robust 8.0% from a year ago as consumers continue to shift more of their purchases to services from goods, a trend we see continuing as the availability of credit weighs on economic activity and the labor market.

CPI INFLATION continues to trend positively, albeit more gradually than Fed officials would like. As noted earlier, consumer prices increased only 0.1% in May and 4.0% when compared with the same month last year. Last month's modest increase was driven by a decline in gasoline prices and the ex-food and energy "core" CPI was up a firmer 0.4%, or 5.3% over a year ago. Meanwhile, Powell's "super core", which strips out goods and rent, was up only 0.2%.

PRODUCER PRICE INDEX declined by 0.3% in May following a 0.2% increase in April. From a year ago, the PPI rose 1.1%, the smallest advance since the end of 2020. Energy prices plunged 6.8% in the month, while food prices fell 3.3%. Core PPI rose 2.8% year-over-year, slower than the April rate. The core measure, excluding food and energy, is a measure of underlying inflation. The pace of wholesale price increases has slowed markedly since the middle of last year amid normalizing supply chains, shifting consumer spending preferences toward services, amid a broader cooling in costs of key commodities.

On balance, data shows economic growth continuing to slow under the weight of tightening credit conditions, the significant though declining impact of inflation on consumer's real purchasing power, and continued weakness in manufacturing as consumers migrate their outlays from goods to services. Still, surveys show consumers, whose spending accounts for over 70% of GDP, to be well financed and eager to spend. So, should we enter a recession, it is likely to be a mild, short-lived affair. *Whether the lagged effects of earlier Fed measures to aggressively tighten credit conditions and decisions yet to be taken cause a more prolonged, deeper downturn remains to be seen. But the odds of a pullback have clearly risen beyond better than even.*

EQUITY INVESTMENT POLICY

Despite the economic and policy headwinds facing equities, year-to-date performance of the broad, cap-weighted stock market indices, dominated by a narrow group of mega cap tech stocks, has been exceptional. Through last Friday, the S&P 500 has returned 15.8% and the NASDAQ is higher by 31.3%. These eye-popping returns stand in contrast to the more modest gains of other indices, those not dominated by the mega caps (e.g., Apple Inc. (+42.3%), Amazon (+49.4%), Alphabet (+40.1%), Microsoft (+42.1%) and Nvidia (+192.0%). By comparison, the S&P 500 Equal Weighted Index has risen only 4.9% and the "blue chip" Dow Jones Industrial Average 30 has gained a mere 4.6%. In a reversal of last year's out-performance by *value* stocks, this year the Russell 1000 Growth Index (+27.6) has outpaced the Russell 1000 Value Index (+4.3%) by a wide margin. Initially driven by Artificial Intelligence enthusiasm, market participation now seems to be broadening out to other sectors as some investors are wagering the Fed will soon end its tightening cycle and that the economy will avoid recession. Recently, lagging cyclicals, financials and consumer discretionary shares have shown signs of relative out-performance. We see this improvement in market breadth, should it persist, to be an important development supporting further market recovery.

On a technical basis, the market is feeding on its momentum. The S&P has now closed above 4400 for 6 straight days, its longest streak of gains since March 2021 and the NASDAQ hit its highest level since March 2022. It remains to be seen whether the market can sustain these gains amidst signs of slowing economic activity, "higher for longer" interest rates which are no friend to risk assets, rising bond yields offering greater competition to the expected returns from equities, and signs the market may be overbought from a very short-term perspective. A mild pullback from these levels, cooling investor enthusiasm, would probably be healthy.

Some market skeptics, focusing on the near term, believe a long-awaited stock market correction, testing last October's lows, is around the corner, a necessary development as they see it before the start of the next sustained bull market. They expect a meaningful earnings recession this year that, in their view, has yet to be priced into share valuations. At the same time, they see a sharp rebound in S&P 500 earnings in 2024 propelling the market higher. While stocks are not cheap currently, we share their view regarding next year's substantial earnings recovery. We, therefore, prefer to look beyond the near-term uncertainties to the next expansion, spurred by easing credit conditions and sound underlying consumer and business fundamentals, to the investment opportunities it will inevitably present. *Equity portfolios under our supervision are, therefore, fully invested, well balanced between growth and value investments, tilted slightly toward growth, which is our long-term bias.*

FIXED INCOME INVESTMENT POLICY

The sharp rise in interest rates to more normal levels has made bonds investable once again. Accordingly, we have extended fixed income portfolio durations in clients' laddered, high quality corporate bond portfolios, selectively deploying funds generated by maturing bond holdings, and increasing yields materially. Lower yielding money market fund investments have been replaced with higher yielding US Treasury bills maturing in less than a year. We see longer term rates drifting higher over the intermediate term presenting a possible future opportunity to increase portfolio durations further.

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