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Economic Update

Consumer spending, inflation, and the job market have shown notable cooling in recent weeks, moving the US economy closer to the Federal Reserve's preferred glide path toward a "soft landing." This overall moderation, shown in both hard data and forward-looking surveys we monitor, likely closes the door to any further rate increases during this cycle, setting the stage for a Fed pivot to rate cuts by mid-2024. In fact, should inflation continue its rapid descent along with slower economic growth now anticipated, the Fed may find itself under growing election year pressures to ease sooner than the middle of next year as signs of stress in parts of the economy most exposed to higher rates emerge. ***Failure of the central bank to jawbone against the 75-basis point decline in intermediate and longer-term bond yields since late October itself suggests the Fed has capitulated on higher-for-longer rates and may be inclined to reverse its restrictive policy sooner than is generally expected.***

Consumption

Surging 5.2% third quarter real GDP, driven largely by a spurt in consumption, has given way to a period of sharply slower growth we now estimate to be in a more sustainable 1.50% to 2.00% range. Households, particularly those at the lower end of the wage spectrum, have curbed their outlays for both goods and services in response to declining income growth, high interest rates and elevated prices, shrinking excess COVID-19 savings and the reinstatement of student loan payments, which are eroding their ability to maintain their spending increases. Consumer spending rose 0.2% in October, down notably from a 0.7% rise in September. The October reading marked the slowest increase since May. Spending on services in October rose 0.4% and is up 6.8% in the past year (2.3% when adjusted for inflation). Goods spending declined 0.2% in October but remains 2.4% higher in the past year, while "real" inflation-adjusted spending on goods is up 2.1%. Elsewhere, we find other early signals of deceleration in the current quarter in the form of weaker-than-expected data on trade and inventories, declines in new and pending existing home sales, sluggish EV demand, and softening services sector surveys. And the M2 measure of the money supply for October showed a 0.1% decline and is down 3.3% from a year ago. Recall that monetary policy operates with a lag, so the economy is likely to feel the negative effects of these M2 declines over the months ahead.

Inflation

The Federal Reserve's preferred inflation gauge, the Personal Consumption Expenditures price index (PCE) has cooled rapidly this year, remaining mild in October, fostering expectations the 2021-2022 inflation spike can be unwound without too much additional pain in the form of lost jobs. Core PCE prices, which exclude volatile food and energy items, were higher by 3.5% from a year ago after peaking at 5.6% in early 2022 due largely to impaired supply. Core PCE rose 2.5% at a six-month annualized rate, down from 4.5% in the six months through April, a major improvement. The three- and six-month annualized increases in the core PCE price measure are 2.4% and 2.5%, respectively, still above the Fed's 2% target, but not hugely so. The Fed has also highlighted a subset of inflation known as the "Super Core" which includes services only, excluding food, energy, and housing. That measure rose 0.1% in October and is up 3.9% versus a year ago, down from the 5.2% peak in October of last year. As job growth slowed last month, pay increases have also stalled, according to ADP's National Employment Report for November. The median annual pay increase for employees remaining in their same roles was 5.6% last month, the lowest rate since September 2021, while workers who switched jobs experienced an 8.3% median pay increase, the weakest since June 2021, easing wage driven inflation pressures. Inflation expectations, which weigh heavily in FOMC policy deliberations, have fallen sharply this month. The University of Michigan's preliminary December consumer sentiment survey released last week showed the one-year outlook for the inflation rate slid to 3.1%, down sharply from 4.5% in November and the lowest reading since March 2021. The five-year outlook also moved lower to 2.8% from 3.2% the previous month, indicating inflation expectations to be well anchored and providing policymakers with support for their current stance of keeping rates on hold.

Jobs

The gradual cooling of the still-strong labor market extended into November, renewing optimism the economy will avoid recession. While headline *nonfarm payrolls* increased a healthy 199,000 last month, slightly above consensus expectations according to the Bureau of Labor Statistics' (BLS), last month marked only the fourth time in the last 36 months when job gains dipped below 200,000. Last month's increase in Civilian employment, an alternative measure of jobs that includes small business start-ups, amounted to 747,000, helping push the unemployment rate down to 3.7% from 3.9% in October. Meanwhile, the number of people looking for work jumped 532,000, a positive development following the hand wringing over the shrinking labor pool, and the share of the population aged 16+ with jobs rose to 60.5%, the highest such reading since the onset of COVID. Nevertheless, behind these strong headline numbers there continue to be signs of weakening in the jobs market. For example, private payrolls rose 150,000 in November while revisions to prior months' gains reduced private payrolls by 61,000 bringing the net gain to 89,000, hardly the robust job growth the headline implies. However, that modest gain included about 38,000 fewer workers on strike. Absent the strike effect, net private gains would have amounted to a disappointing 51,000 for the month. The BLS also reported average hourly earnings rose a healthy 0.4% in November which was likely affected by the return to work of relatively higher wage-earning auto workers and screen writers. Average hourly earnings are up 4.0% from a year ago versus a gain of 5.0% in the year ended November 2022.

US *job openings* fell in October to the lowest level since March 2021 according to the Bureau of Labor Statistics' Job Openings and Labor Turnover Survey (JOLTS). Fed officials are looking for a cooling in the labor market, ideally through less demand for workers rather than outright job losses. Open positions surprisingly declined to 8.73 million, a decline of 617,000 or 6.6%, from 9.4 million in September and well below their peak of 12 million last year. Hiring edged lower. Layoffs were little changed. The JOLTS openings figure, which was below all estimates, was broad-based across all sectors with significant drops in health care, financial activities and accommodations, and food services. The so-called quits rate, which measures voluntary job-leavers as a share of total employment, held steady for the fourth consecutive month at the lowest level since early 2021. A moderation in quits implies workers are feeling less confident in their ability to find other jobs in the current market or it may reflect a smaller wage premium for switching. The ratio of openings to unemployed people slid to 1.3, the lowest level since mid-2021. While still somewhat indicative of a tight labor market, that ratio has eased substantially over the last year. At its peak in 2022, the ratio was two-to-one.

Forward-looking *Initial jobless claims* data which can be choppy from week to week, especially around the holidays, rose to 220,000 in the week ended December 2 from 219,000 the previous week. The four-week moving average of claims, our preferred measure of this indicator, rose slightly to 220,000, continuing its upward drift as labor market conditions ease. The 1.86 million four-week moving average of continuing claims is the highest in two years.

Fed officials have appeared pleased in their recent statements with their progress in dampening inflation. FOMC members have emphasized the trajectory of the labor market will inform their future rate decisions. While the current labor market remains strong on balance, we find signs of deceleration worth noting. Officials seem to be content with current interest rate policy, signaling the end to rate hikes for this cycle. What they are unwilling to do now is to encourage financial market speculation around rate cut expectations for the first half of next year, saying they intend to maintain interest rates at their currently restrictive level for some time.

As the body of data confirming slowing GDP has grown, so have the risks to the “soft landing” scenario. Whether consumers, still armed with as much as \$900 billion of excess savings, will maintain their spending momentum counts heavily toward avoiding recession. Looking ahead, the lagged effects of past rate hikes and reduced fiscal stimulus, will align to curb future growth. To counter these headwinds, Fed policy may need to become less restrictive sooner than expected or risk tipping the economy into recession.

Forward-Looking Economic Indicators

High frequency, forward-looking economic indicators we monitor signal a slowdown ahead. Below are some of the recently released figures and their implications.

ISM Manufacturing Index remained at 46.7 in November, falling below the consensus estimate expected 47.8. (Recall readings of this diffusion index below 50 signal contraction; readings above 50 signal expansion). The major measures of activity were mostly lower last month, although the measure of new orders increased to 48.5 from 45.5. The production index fell to 48.5 from 50.4 in October. The employment index dropped to 45.8 from 46.8 the prior month and the supplier

deliveries index declined to 46.2 from 47.7 one month earlier. Manufacturing, which accounts for about 12% of US GDP, continued its downtrend for the thirteenth consecutive month, the longest streak since the 2000-2001 recession. During COVID, a combination of shelter-in-place orders and extra fiscal stimulus in the form of stimulus checks and large unemployment benefits artificially boosted goods-related demand. Then, as the economy reopened and consumers' preferences shifted toward services not available during the pandemic, spending normalized. The ISM Manufacturing Index peaked in March 2021, the last month of the Federal stimulus checks, and has been on a downward trajectory since then. Just three of the eighteen major industries reported growth in November. The new orders index has signaled contraction for fifteen consecutive months. Meanwhile, on the inflation front, the prices paid index remained below 50 having signaled contraction for the last seven months, a sign restrictive Fed policies since 2022 have gained traction against inflation.

ISM Non-Manufacturing Index rose to 52.7 in November, exceeding the consensus expected 52.3. (Recall readings of this diffusion index below 50 signal contraction; readings above 50 signal expansion). The major measures of activity were mostly higher in November. The business index rose to 55.1 from 54.1 in October. New orders were unchanged at 55.5. The unemployment index edged higher to 50.7 from 50.2 the prior month, while the supplier deliveries index increased to 49.6 from 47.5. Prices paid fell to 58.3 from 58.6 in October. Economic activity in the services sector, which amounts to nearly 80% of GDP, continued to expand with fifteen of eighteen major industries reporting growth in November. Consumers have continued their return to purchasing services following the COVID-era when goods-related activity was artificially boosted by government policies. The highest reading came from the prices paid index which remains elevated, a sign inflation remains a problem in the services sector. We expect services to weaken in the next few quarters as the impact of shrinking fiscal stimulus and declines in the M2 measure of the money supply work their way through the economy.

Despite numerous signs of slowing, the US economy has proven resilient. Forecasters' recession predictions have gone unrealized. A growing consensus now expects a cooling rather than a sharp pullback in activity. Our firm's proprietary [Economic Model](#), designed to portend a change in the direction of the economy six to nine months in advance of an inflection point, remains above-trend, having signaled expansion in four of its last five monthly readings, increasing the odds the US economy will avoid recession.

Equity Investment Policy

Entering this year, investor confidence was tempered by expectations for declining growth and fears of recession. In fact, several high-profile economists and market savants opined in January that the US had entered a downturn. However, China's reopening, large fiscal stimulus and strong consumer outlays stabilized growth which has been above-trend. Investors' Keynesian "animal spirits" were rekindled by excitement over prospects for ChatGPT, booming luxury goods sales, expectations for Fed rate cuts and several very successful movies and concerts over the summer. The economic expansion and stock market rise have persisted despite the largest interest rate

increases in decades, wars in Ukraine and Israel, an energy crisis which drove WTI crude to near \$100 a barrel, last winter's regional banking crisis and some very early signs of consumer credit deterioration.

Stock market data shows that most of this year's S&P 500 gains, amounting to about 20%, have come from a small number of high-priced mega cap tech *growth* stocks, the so-called Magnificent Seven, that earlier rallied around themes of Artificial Intelligence and bullet proof balance sheets. Their rise ignored the significant rise in interest rates and increases in the price/earnings multiples of these market-leading stocks. Beyond the Magnificent Seven, S&P 500 stocks have largely marked time this year, uncertain of the prospects for the economy. This has led to a high concentration of index weight in a handful of the most richly capitalized stocks, a condition not seen in over a half century. While mega cap tech has outperformed for much of this year, the most recent rally in stock prices which began in late October, driving the S&P 500 up about 9% in November, has shown broadening leadership where for the first time in over a year, more than 90% are above their 20-day moving averages. Interestingly, since 1990, whenever this many individual stocks have been above their 20-day moving averages, the index was, on average, more than 15% higher a year later and was higher more than 95% of the time. Another measure of improving market breadth is the percentage of S&P 500 stocks above their 200-day moving averages which has increased from 26.7% to 67.1% over the last month. Beneath the surface of the overall market, we have seen since Thanksgiving the beginning of a notable shift in investors' preferences, away from the former mega cap tech leaders to a broader list of companies positioned to benefit from the coming Fed pivot. In that time, the S&P 500 is up 0.83%, and the S&P 500 *value* index is 3.1% higher.

Consensus forecasts call for both inflation and economic demand to soften in 2024, allowing the Fed to commence easing by midyear. In our view, a Fed pivot will set the stage for the next broad-based economic expansion and the gradual emergence of new economically sensitive market leaders whose earnings will benefit from a prolonged cyclical expansion. *Growth* shares have outpaced *value* in 2023 by a wide margin. To date, the S&P 500 *growth* stock index has risen 23.7% while the S&P 500 *value* index is higher by just 13.9%. The S&P 500, a cap weighted index dominated by mega cap tech shares, has risen 19.4% this year while the S&P 500 equal weighted index has advanced only 5.8%. Looking ahead to next year, we expect stock market leadership to broaden out further, narrowing the performance gap between *growth* and *value* investments.

Equity portfolios under our supervision remain fully invested within their guidelines, well diversified and balanced between high quality large cap *growth* and *value* shares, tilted toward *growth* which is our long-term bias. Our platform allows for modest allocations to small cap equities and companies domiciled abroad in both developed and emerging markets. From a P/E perspective, while the S&P 500 is currently selling at about 18.6x 2024 estimated per share earnings of \$245.75, a full valuation in our view, it is more attractively priced at only 15.5x when its component mega cap tech stocks are excluded.

As long-term investors, we prefer to look beyond near-term economic uncertainties and short-term investor preferences to the coming business expansion, spurred by easing credit conditions and sound underlying business and consumer basics, to the investment opportunities it will inevitably present. We pay scant attention to market timing or

technically driven trading strategies, instead focusing our energies on the fundamental equity research that has driven our wealth building strategy over the past thirty years.

Fixed Income Investment Policy

Investors have been presented for the first time in over a decade with attractive fixed income investment opportunities as the Fed has increased interest rates to fight inflation. Accordingly, we have increased bond portfolio durations toward a target of 2.5 years. Maturing obligations have been replaced in client's laddered corporate bond portfolios with other high-quality, marketable issues maturing over the intermediate term where yields of 5.5%-6.0% have become available.

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The entire Front Barnett Team sends its warmest holiday greetings and best wishes for the New Year to you, our valued clients and friends.

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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&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 U.S. **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.