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Economic Update

By most measures, the performance of the American economy has been exceptionally strong when contrasted with that of China and Europe which continue to struggle in this post pandemic era. US real GDP grew at an above-trend 3.1% year-over-year rate last quarter, well ahead of Japan, the UK and the Eurozone. China, the world's second largest economy, is suffering from a deflating property market built upon massive debt which has led to local deflation, weakened consumer confidence and sluggish consumption. Our 3.9% unemployment rate remains near levels not seen in over a half century; jobs are plentiful. Non-farm productivity is advancing at a healthy 3%+ clip. And the broad-based equity market indices, reliable forward-looking economic indicators, have recently made new all-time highs.

Yet, the mood of the country, as measured by poll-after-poll is glum, dragged down by consumers' downbeat views of their family's current and future financial situations. Conference Board data shows consumers' expectations fell sharply in 2022 as interest rates spiked and, despite a recent uptick in confidence, they remain well below Covid-19 levels. The dour outlook has been driven by the nearly 20% rise in consumer prices since the pandemic lockdowns. And that headline number probably understates the actual increase in the cost of living for many families since their outlays for necessities such as fuel, autos and food have risen more than the overall trend. For example, the price of a gallon of unleaded gasoline has risen more than 80% since May 2020, while the price of car and truck rentals are nearly 70% higher. Electricity costs have increased 30% and dining out is 25% more expensive. At the same time, home prices have risen sharply putting new home ownership beyond reach for many families. Between May 2020 and the end of last year, the selling price of a single-family home is 42% higher, while mortgage rates are near their highest level in over a generation. Meanwhile, growth in disposable personal income has trailed inflation since the outbreak of COVID-19, leading to a decline in the living standard for many. So, persisting in its drive to tame inflation remains top priority for the Federal Reserve.

The Fed

Though incoming economic data shows inflation as measured by the Fed's preferred gauge, the Personal Consumption Expenditures index (PCE), has fallen sharply from a year ago, its stickiness remains a concern. PCE price data for January showed a strong month for both the "core" and "super core" inflation measures. While the 0.4% increase in the "core" PCE index in January represented the largest monthly gain in a year, the year-over-year inflation rate continued to slow, falling to 2.8% and we continue to believe price increases will soften further over the months ahead as consumer spending normalizes and economic activity moderates toward 2% trend-like real GDP growth. Recently reported data for January showing real consumer spending pulled back 0.1% in January following strong gains in prior months, and other survey results consistent with the slower GDP growth we discuss below, support this view.

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Looking beyond monthly inflation data, which viewed in isolation can be misleading, Fed officials have on numerous occasions reaffirmed their belief, which we share, that price increases will move lower allowing for easing later this year. Consistent with this view, the Federal Reserve's **Monetary Policy Report**, released in advance of Federal Reserve Chair Powell's recent testimony before Congress, stated it did not expect "it will be appropriate to reduce the target range until it has gained greater *confidence* that inflation is moving sustainably toward 2 percent." In subsequent testimony before the House Financial Services Committee Powell acknowledged the "notable" slowing in inflation but underscored the need for just "a bit more" evidence inflation was headed lower before officials would commence cutting rates. A day later, he told the Senate Banking Committee there had been, "Widespread slowing across both goods and services prices" and went on to say, "When we do get that *confidence*, and we are not far from it, it will be appropriate to dial back the level of restriction, so we don't drive the economy into recession." The Fed Chair's testimony appears to support the current consensus view the FOMC will begin to lower rates at its June meeting, although that outcome remains dependent upon how the economy plays out over the near term, as officials focus on inflation and the labor market.

Despite the Fed's confidence in its ability to curb inflation without tipping the economy onto recession, lower wage growth and the unemployment rate's recent uptick highlight the risk that the labor market could deteriorate more rapidly than expected before the Fed starts reducing rates. Reducing policy restraint too little or too late could unduly weaken economic activity and employment, risking a not-so-soft landing for the economy.

Jobs

While the February nonfarm payroll report showed strong job growth, downward revisions totaling 167,000 to employment gains reported for the prior two months and an increase in the unemployment rate to 3.9%, a two-year high, suggests a slowing labor market. The report also showed wage growth cooling in February, increasing the odds, in our view, the Federal Reserve will begin to trim its reference rate by June. Interestingly, traders in interest-rate derivatives were pricing in a roughly 60% chance of a June rate cut after the February jobs report last Friday, up from 40% a month ago.

Digging into the *establishments* survey provides evidence of the labor market's slowdown. Nonfarm payrolls rose 275,000 in February, exceeding the consensus expected 200,000 and higher than the average gain of 229,990 in the past year. However, adjustments for revisions reduced payroll gains to a moderate 108,000 last month. More important, after net revisions to another measure of jobs, *private* payrolls, employment barely rose in February, increasing only 19,000. Elsewhere, *civilian* employment, yet another alternative measure of jobs that includes small business startups, declined 184,000 last month. In the past, changes in the direction of *civilian* unemployment have signaled a likely change in the direction of the overall labor market. And when full-time employment has declined while part-time employment has risen, as was the case last month, it has foreshadowed weakness in the general economy.

Meanwhile, the *household survey* showed the unemployment rate increased by 0.2% to 3.9% last month, the highest level in just over two years and 0.5% above the cycle low. Total hours worked in the private sector increased 0.4% in February, reversing January's decline which may have been impacted by weather. Meanwhile, average hourly earnings rose only 0.1% after a 0.5% surge in January. Average hourly earnings increases have slowed, now up only 4.3% versus the 4.7% gain in the year ending in February 2023, music to the Fed's ears. And consumers will cheer the 4.3% wage gain which was ahead of the rise in consumer prices over the last twelve months. More generally, many *household survey* indicators were on the softer side.

Below are comments on the latest Institute for Supply Management (ISM) surveys which cover over 80% of the US economy.

> **ISM Manufacturing Index,** which accounts for about 11% of real GDP, declined to 47.8 in February, lagging the consensus expected 49.5. (Recall that readings of this diffusion index above 50 signal expansion; readings below 50 signal contraction.) The major measures of activity were mostly lower in February. The new orders index fell to 49.2 from 52.5 in January and the production index declined to 48.4 from 50.4. The employment index declined to 45.9 from 47.1 in January, while supplier deliveries increased to 50.1 from 49.1. The prices paid index eased to 52.5 in February from 52.9 the prior month. Unlike the overall economy, which is driven by consumer outlays, manufacturing contracted for the sixteenth consecutive month in February, and at a more rapid pace than the previous month. Most industries reported contraction or no change for the month. Demand softened as the new orders index fell back into contraction following a brief one-month of expansion. Previously, new orders had contracted for sixteen consecutive months. Meanwhile, output also slowed last month, as the production index fell back into contraction despite sanguine survey comments from manufacturers regarding demand. More problematic, the backlog of orders continues to contract, now for the seventeenth consecutive month and hiring activity contracted for the fifth consecutive month in February as companies continued to reduce headcounts, anticipating further weakening ahead. In retrospect, one of the major distortions created by the pandemic was that goods-related activity was artificially boosted during the COVID-19 lockdowns. However, as the economy reopened, consumers began shifting their spending preferences back to a more normal mix, away from goods toward services. The ISM Manufacturing Index peaked in March 2021, the last month government stimulus checks were mailed, and has since declined.

> **ISM Non-Manufacturing Index**, which accounts for about 70% of real GDP, eased a bit in February, declining to 52.6, lagging the consensus expected 53.0. (Recall that readings of this diffusion index above 50 signal expansion; readings below 50 signal contraction.) A measure of new orders increased to a six-month high of 56.1 from 55.0 in January pointing to underlying strength in the sector. The major measures of activity were mixed in February. The business activity index rose to 57.2 from 55.8 while supplier deliveries dropped to 48.9 from 52.4. The prices paid index declined to 58.6 in February from 64.0 in the previous month. Services activity continued to expand in February though not as fast as in January. The indices for business activity and new orders, the two forward-looking pieces of the report, both rose and remain at multi month highs. And the employment index fell below 50. Hiring activity in the services sector has cooled recently and is below 50 for the second time in three months, while more industries reported a decline in employment in February versus an increase.

Comparisons of the ISM Non-Manufacturing and Manufacturing data which have signaled contraction for sixteen consecutive months, show a sharp divergence. Services underpinned the economic recovery in 2023 and remain strong year-to-date while manufacturing has been in recession. Looking ahead, as the unprecedented fiscal stimulus applied to the economy during COVID finally runs its course, Fed policy remains restrictive and the lagged impact of reductions in the M2 measure of the money supply work their way through the system, we are likely to see a downshift in overall economic activity, with real GDP growth slowing for a couple of quarters. The slowdown will bring with it further progress in the Fed's effort to reach its 2% inflation goal. Fed interest rate cuts, should they commence by midyear as expected, will cushion the slowdown, increasing the odds of a "soft landing" for the economy.

It's worth noting that readings of our Firm's proprietary Economic Model, designed to signal a change in the direction of the US economy six to nine months ahead of an inflection point, and which inform our research process, have been pointing to expansion for eight months while the Leading Economic Indicators (LEI) finally appear to be bottoming.

Equity Investment Strategy

Since year-end, equities have extended an historic advance which began late last October, making new all-time highs on multiple occasions, as continued disinflation, strong consumer spending and the growing likelihood of a "soft landing" supported by expected cuts to the Federal Reserve's reference rate, have functioned as catalysts for the advance. Year-to-date, the tech-heavy Nasdaq 100, driven in part by sustained excitement over the potential impact of Artificial Intelligence (AI), has returned 7.25%, the S&P 500 Index with a 30%+ weighting in tech shares has shown a 7.50% gain, the S&P 500 Equal Weight Index has returned 4.55%, and the Russell 2000 has increased 2.76%. S&P *Growth* stocks have outpaced *value* shares again this year, with growth advancing 11.56% while S&P *Value* shares have gained 4.66%. Returns from equities over the 12 months through February have been remarkable given the headwinds the economy has faced: Nasdaq 100 +51.11%, S&P 500 +30.43% and Russell 2000 +10.00%. Given the exuberance surrounding AI, and stronger than expected earnings and revenue growth among the companies that comprise the S&P 500 Index, it is not surprising that returns from large cap equities have been strong, exceeding most expectations. In fact, almost all the S&P 500 companies have now reported fourth-quarter results, showing earnings jumped 9.8% from last year, 6.2% above consensus.

Equity portfolios under our supervision have been fully invested within established guidelines, well diversified, tilted toward *growth* which is our long-term bias. Our investment platform includes large cap *growth* and *value* shares and allows for modest allocations to domestic small cap equities and companies domiciled abroad in both developed and emerging markets. For months we have emphasized selective additions to depressed *value* shares versus *growth* stocks given their statistical cheapness, in the anticipation of a broadening out in stock market leadership as investors begin to discount easing credit conditions. So far, this expected change in investor preferences has been elusive. We have also marginally increased portfolio exposure to domestic small cap equities, which have trailed large caps by a wide margin for an extended period, expecting improved relative performance from this asset class as interest rates come down. ***Nevertheless, with equity price/earnings multiples stretched at better than 21X estimated forward S&P 500 earnings, a sentiment-driven pullback of 5-10%+ following the recent period of outperformance is increasingly likely and should not be ruled out. In fact, a washout in high-priced, speculative tech shares, many of which have shown parabolic advances this year, would probably be beneficial to the health of the overall stock market. That said, earnings and revenue growth have been compelling and could be the anchor equity markets need to ride out a brief rough patch.***

As long-term investors, we prefer to look beyond the ever-present, near-term uncertainties and short-term investor preferences, to the opportunities the coming economic cycle, spurred by easing credit conditions, sound underlying business and consumer fundamentals, and new productivity enhancing technologies, will present. We intentionally pay scant attention to market timing, momentum-based trading strategies or to questionable, technically driven approaches which can be expensive, detracting from our goal: competitive after-tax returns. Instead, we focus our energies on the same conservative, time-tested fundamental equity research which has been basic to our wealth building strategy over the past thirty years.

Fixed Income Investment Strategy

The Federal Reserve's restrictive credit policy over the past eighteen months has for the first time in a generation made bonds investable. Accordingly, we have used the recent period of higher interest rates to extend fixed income portfolio durations toward a target of 2.5 years from durations short of one year.

Maturing obligations, as well as some bonds nearing maturity have been replaced among clients laddered bond holdings with other highly marketable investment grade corporate bonds maturing over the intermediate term where yields-to-maturity of 5.0%+ became available. New bond purchases have generally been limited to maturities of five years or less.

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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.

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