

# FRONT BARNETT

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## Economic Update

Economic data shows the US economy continues to slowly decelerate as the restrictive Federal Reserve monetary policy of the past two years gradually gains traction. Softening consumption, less tight labor market conditions, weakness in interest rate sensitive industries including housing, autos and commercial real estate, and recession-like manufacturing sector reports define the slowdown which, when combined with easing inflation, almost guarantee the FOMC will cut its reference rate 25 basis points when it meets in mid-September. We expect additional rate cuts at subsequent FOMC meetings so long as incoming data shows further progress toward hitting Fed official's 2% inflation target.

The current economic moderation has been delayed until recently by a succession of unique circumstances triggered by the unprecedented pandemic lockdowns and the subsequent reopening of the economy, the massive monetary stimulus that preceded the Fed tightening, plus the remarkable expansion of the federal budget in 2023, despite the historically low unemployment rate and more than \$1 trillion of excess savings on the balance sheets of US households.

The surprising uptick in the unemployment rate to 4.3% in July has added to recession fears. Economically sensitive equities, strong relative performers in July, have weakened this month. Several high-profile Wall Street economists have increased the odds of a downturn in their forecasts. Management comments during recently concluded quarterly earnings calls citing high interest rates and growing consumer wariness, came across as more cautious, particularly those from leaders of consumer-oriented business such as McDonald's, Disney, Home Depot and P&G. Our firm's proprietary [Economic Model](#) dipped last month toward its trend line, possibly foreshadowing a further slowdown. And the widely followed **Sahm Rule**, created in early 2019 by former Fed economist Claudia Sahm to act as a rule of thumb for the "early diagnosis" of possible recession, has signaled a downturn.

The Sahm Rule simply says when the three-month average US unemployment rate rises by 0.50% or more from its 12-month low, a recession is underway. The Sahm Rule was triggered on August 9 as the reported unemployment rate surprised to the upside. During postwar US recessions through the 2008 pullback, the unemployment rate initially increased gradually prior to a sharp pick up. The Sahm Rule was meant to establish a threshold at which Fed policy makers should start to respond to the downturn. It has been historically accurate since 1970. In our view, while the odds of a

recession have probably risen and concerns are warranted, today's labor market is significantly different. The July unemployment report did show a slowdown, but it reflected strong growth in the labor force which drove the unemployment rate higher, not layoffs. And, anecdotally, we found few references to job cuts on recent earnings calls. In this economic cycle, the Sahm Rule may be exaggerating the perception of economic weakness, particularly in the labor market, which is its sole focus.

***While without doubt the decrease in jobs being added reinforces the notion the economy is slowing, we believe growing labor market data is pointing toward an economy that is closer to full employment rather than one in recession which is ordinarily characterized by a pick-up in layoffs and a collapse in aggregate demand. In this instance, the rise in unemployment is directly traceable to increased labor supply (i.e. immigrants, young people entering the labor force for the first time and returning retirees who have depleted their savings) not weakening demand for workers, a stark difference from past recessions. We continue to expect the economy to avoid recession.***

## The Fed

After two years of an increasingly restrictive monetary policy, encouraging trends in both the CPI and PPI indices, some of which will feed through positively to the Personal Consumption Expenditures (PCE) index, the Federal Reserve's preferred gauge of inflation expected to be released later this month, allow the Fed to turn its attention from fighting inflation to addressing weakening labor market conditions. Avoiding a serious policy mistake by keeping rates too high for too long has now become a Fed priority and Fed administered rates are headed lower. The question investors will be asking is how much lower? Officials have signaled their intermediate-term goal will be to manage the Fed Funds rate toward the so-called "neutral" interest rate which is defined as the rate that is neither stimulative nor contractionary in a stable economy at full employment. The "neutral" interest rate is thought to be 3.0% or lower, well short of the current 5.25% to 5.50% Fed Funds target range.

## Retail Sales

One bright datapoint which should allay fears of a severe economic slowdown was the July **retail sales** report which showed an increase of 1.0%, more than double expectations, following a revised 0.2% drop in June. The strong, broad-based data showed consumer outlays, which account for close to 70% of GDP, to be resilient and on solid footing, despite higher borrowing costs, consistent with the Fed's "soft landing" objective.

## Outlook

Recent economic data, including a decline in construction, weak durable goods orders, slower job growth and mixed ISM indices, (where manufacturing is signaling contraction while the service sector remains positive) confirm the economy's deceleration. Here is some color on the forward-looking indices.

**ISM Manufacturing Index** declined to 46.8 in July, lagging the consensus expectation of 48.8, falling to an eight-month low. (Levels higher than 50 signal expansion; levels below 50 signal contraction.) Manufacturing activity, which accounts for 11% of GDP, has now contracted for twenty of the last twenty-one months. Just five of the eighteen major manufacturing industries reported growth, with eleven reporting contraction. Both output and demand contributed to the drop in the overall index, as the production index fell to 44.9, the lowest level since the COVID lockdown months, while the new orders index fell further into contraction to 47.4. Given weak demand, companies have turned to reducing their order backlogs seen in the backlogs index which remained deeply depressed at 41.7 and has been below 50 for twenty-two consecutive months. Survey comments have noted dwindling backlogs which are prompting manufacturers to reduce their costs. Consequently, the employment index fell to 43.4, the lowest level since the pandemic shutdowns.

**ISM Non-Manufacturing Index** increased to 51.4 in July, above the consensus expected 51.0. (Levels higher than 50 signal expansion; levels below signal contraction.) Services, which account for about 70% of GDP, bounced back in July following weak readings in two of the past four months, as nearly all major measures of activity rose and are above 50, signaling expansion. The exception was the supplier deliveries index which fell to 47.6, a favorable development as contracting delivery times indicates easing bottlenecks. The downside to the report was that the new orders index is lower than any month in 2023 and the employment index has been showing contraction for six of the last eight months. Meanwhile, inflation remains a major theme in comments from survey respondents. The prices paid index rose to 57.0 in July with eight of the eighteen industries reporting paying higher prices for the month. Trends in inflation are important as the services sector has been the main driver for stubbornly high inflation over the past two years.

**Initial Jobless Claims** for the week of August 10 declined for the second consecutive week to 227,000 from 250,000 two weeks earlier, the highest reading this year. The four-week average edged higher, remaining above where it had been at the end of June. Overall, while claims are higher than the March/April period, they have not moved up significantly since June. This report is good news, arguing against any impending collapse in the labor market. The message from continuing claims was also positive as they fell to 1.86 million. Nevertheless, the rise in continuing claims over the last couple of months could point to the increasing difficulties laid-off workers may be encountering in landing new jobs.

**Front Barnett Proprietary Economic Model**, designed to signal a change in the direction of the US economy six to nine months before an inflection point, fell to its one-year trend line in July. While the Model continues to portend expansion, future below-trend readings would be cause for concern.

***Balancing these and other factors we take into consideration when assessing the outlook, we conclude that despite the risks associated with the economic deceleration we are seeing, heightened concerns over the possibility of a policy mistake on the Fed's part, and the usual political uncertainties present in a presidential election year, conditions for investors remain generally positive.***

## Investment Policy

Recent government reports for July showing a rise in the unemployment rate to 4.3%, a notable slowdown in job growth has shaken confidence in the operative economic soft-landing scenario. Consequently, we have witnessed further sentiment shifts as investors lurch between the extremes of obsessing that the economy is too strong to allow the Federal Reserve to cut rates to worrying that the Fed is being too slow to cut rates as the economy slows, possibly nudging it into recession. Reality, in our view, is probably somewhere between these two extremes. Yes, the economy is widely expected to decelerate for a couple of quarters during which time overall growth could well slip below its 2.0% long-term trend. However, we neither find signs that consumption is about to collapse nor do we expect to see the massive job cuts usually associated with a recession. In fact, we find the US economy fundamentally sound, likely to take a breather for a while further, extremely resilient in the face of two years of high *real* interest rates and the geopolitical shocks it has absorbed over the past few years. Measures of liquidity are more than adequate to support economic growth we foresee, and our banking system is well reserved according to the results of recent Fed stress tests. ***Consequently, portfolios under our supervision are fully invested within their guidelines, broadly diversified between high quality, core domestic growth and value equities, tilted toward growth which is our firm's long-term bias. Our investment platform also allows for allocations to domestic small cap equities as well as investments in developed and emerging markets domiciled abroad.***

## Surprising Volatility

Equity markets were roiled earlier this month by a surprise confluence of two factors which drove the broad market indices 8% to 12% lower: Weaker-than-expected economic data, which fueled recession fears, and the unwinding of the so-called carry trade. In its simplest form, the carry trade is borrowing in a low yielding currency (known as the funding currency) and investing the borrowed funds in a higher yielding currency (known as the asset currency). Investors have traditionally borrowed in currencies such as the Yen or Swiss franc and invested in higher yielding currencies like the US dollar or Mexican peso. The objective is to, at

a minimum, earn the difference in interest rates between the two currencies. Investors can also use leverage to enhance their returns, and many speculate in equities and other asset classes with the borrowed funds. The carry trade works best in low volatility environments and can unravel quickly when volatility spikes. When the funding currency appreciates investors can be forced to sell the asset currency to cover their losses. In this case, the carry trade with Japanese yen positions began to unwind on July 10 when the Bank of Japan intervened in currency markets and accelerated on July 31, adding to the downward pressure on US stocks which speculators were forced to unload. Stocks have since rebounded, retracing about 50% of their early August losses from what now appears to have been a “technical correction” rather than a systemic pullback driven by worries about the viability of the financial system.

## **Bifurcated Market**

The early August market volatility did little to realign the bifurcation we have seen in the stock market this year. The same small group of speculative, richly priced mega cap tech stocks, driven by high expectations for their AI businesses, continue to account for about 35% of this year’s gain in the S&P500, a cap weighted index, which has gained 14.4% year-to-date. Meanwhile, the S&P Equal Weight index, which treats the returns of smaller capitalized stocks the same as those of larger ones, has returned just 6.4% in 2024. This narrow market advance creates challenges for active fund managers who are charged with protecting their investors from the excessive risks associated with highly concentrated portfolios, and who are also constrained by diversification requirements and other risk-mitigating practices.

***In view of the disproportionate impact of these few mega cap stocks on the S&P500, where only 10 stocks account for about 35% of the index, it is not at all surprising that broadly diversified equity portfolios such as those we manage have generally failed to keep pace this year with the Cap Weighted index, performing more in line with the Equal Weighted index.***

Another feature of this year’s equity market has been the disparity in performance between *growth* and *value* shares, where *growth* stocks have gained 20.4% and *value* 7.3%. Such a huge differential in performance is rare and, in our view, is likely to narrow sharply as confidence the economy, supported by easing credit conditions, is not likely to enter a recession any time soon, is restored.

Stock market valuation measures show the S&P500 to be richly valued at near 21x forward earnings, near its highest reading since 2021, when interest rates were zero, suggesting the S&P500 is significantly overvalued. The top tech stocks are even more expensive, showing an average P/E of over 30x. However, the forward valuation of the average stock as measured by the S&P500 Equal Weight index, is only about 17x, a valuation closer to fair value, leaving room for a further overall market advance.

As long-term investors, looking beyond near-term uncertainties, equity portfolios under our supervision are fully invested within portfolio guidelines, broadly diversified between *growth* and *value* shares, tilted slightly toward *growth* which is our firm's bias. Front Barnett combines high quality, large cap *growth* and *value* investments in clients' portfolios in the belief that our investment style allows portfolios to potentially gain throughout economic cycles in which the broader market favors either the *growth* or *value* style, smoothing returns over time. In addition, opportunistically, our investment platform allows for small cap domestic investments as well as investments in developed and emerging markets domiciled abroad.

Clients' high quality, highly marketable, laddered corporate bond portfolios have a target duration of 2.5+years. Yields-to-maturity on most holdings exceeded 5.0% when purchased. The proceeds of future bond maturities will be invested to fill out the aforementioned ladders.

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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 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.

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