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Economic Update

Economic indicators through mid-April remained surprisingly strong, exceeding forecasts, dashing earlier hopes for a Federal Reserve interest rate cut as early as June. However, the late April employment report, as well as other data released recently, have fallen short of expectations raising the possibility that if there are additional signs of cooling, the central bank may move sooner than September, the current consensus, to reduce its reference rate.

Jobs

Job growth, wage gains and hours worked were all surprisingly soft in April, a rare occurrence in recent months, while the unemployment rate unexpectedly ticked higher, to 3.9% from 3.8% in March. While the latest jobs data cannot be categorized as weak and, taken alone, are not likely to cause Fed policy makers to change their expected path for monetary policy, they do ease fears of an overheating economy, keeping hopes alive for a late-summer rate cut. Payrolls increased 175,000, lagging the consensus expected 240,000 and at the slowest pace since last October. Core payrolls, which exclude government, education & health services, and leisure & hospitality, rose a modest 67,000 in April, at the slowest pace of this year. Meanwhile civilian employment, an alternative measure of jobs that includes small-business startups, increased only 25,000. **Often, a general trend of slower employment growth has foreshadowed an inflection point toward slower economic growth.**

Other signs of an easing in the labor market, welcome news for the Fed, included a 0.1% decline in hours worked, and a small 0.2% increase in average hourly earnings, which have increased 3.9% versus a year ago, the smallest gain since 2021. And the average workweek for production and non-supervisory workers also ticked down. Clearly, the problem for workers, as well as the overall economy, is that inflation is running well above 0.2% per month, so the reported gain in wages translates into a decline in inflation-adjusted purchasing power in the sector that accounts for well over two thirds of real GDP.

The Job Opening (JOLTS) report last month also contained signs of cooling labor demand and hiring as job openings fell to 8.488 million, the lowest level since 2021, but evidenced no signs of rising separations. The so-called quits rate, which measures the percentage of people who voluntarily leave their job, fell to 2.1%, the lowest since August 2020. The recent decline in this metric suggests that people are holding onto their current positions as they are less confident in their ability to land new jobs that may pay more.

An unwelcome surprise early this month was the hotter-than-expected Employment Cost Index (ECI) reading for the first quarter which rose 1.2%, above the 0.9% gain of the previous quarter and well above the forecast consensus 1.0% gain, illustrating persistent wage pressures that are keeping inflation elevated. However, the ECI report was later overshadowed by new data showing the moderating employment conditions noted earlier.

Forward Looking Indicators

The softer momentum in economic activity signaled by the April employment report was echoed in weaker, forward-looking business survey readings and other data last month.

The ISM Manufacturing Index declined to 49.2 in April, lagging the consensus expected 50.0. (Levels higher than 50.0 signal expansion; levels below 50.0 signal contraction.) The major measures of manufacturing activity, which accounts for about 11% of GDP, were mostly lower in April. The new orders index declined to 49.1 from 51.4 in March and the production index fell to 51.3 from 54.6. The employment index rose to 48.6 from 47.4 the prior month, while the supplier deliveries index declined to 48.9 from 49.9. Manufacturing activity in the US manufacturing sector has now contracted for seventeen of the last eighteen months. Both demand and production were responsible for the drop in the overall index, with the index for production softening to 51.3 and the new orders index falling back into contraction territory at 49.1. This marks the eighteenth month in the last twenty when the new orders index has been below 50. With production moving along and demand dragging, companies have been reducing their order backlogs. That index, which now stands at 45.4, has been in contraction for nineteen consecutive months. In retrospect, demand for goods during the COVID lockdown was artificially boosted, but as the economy reopened consumers shifted their spending preferences back to services, away from goods. The ISM manufacturing index peaked in the last month federal stimulus checks were mailed and has since been weak.

The ISM Non-Manufacturing Index also showed weakness in April, declining to 49.4, well below the consensus expected 52.0, signaling contraction in the services sector, which accounts for nearly 80% of GDP, for the first time in sixteen months. (Levels above 50 signal expansion; levels below 50 signal contraction.) The major measures of activity were mostly lower last month. The business activity index dropped sharply to 50.9 from 57.4, while the new orders index fell to 52.2 from 54.4. The employment index fell to 45.9 from 48.5, while the supplier deliveries index rose to 48.5 from 45.4. The drop in the overall index was a result of lower growth in business activity and new orders, with those indices declining to 50.9 and 52.2, respectively. Survey comments noted muted activity coming in part from slowing markets and soft business activity, and in part from concerns over inflation and geopolitical impacts on supply chains. Hiring also appears to be cooling, as the index moved deeper into contraction territory in April, now below 50 for four of the last five months. A further slowdown in services is expected as excess savings accumulated during the COVID era are worked off and the impact of the recent reductions in the M2 measure of the money supply works its way through the economy.

While the loss of momentum in both the manufacturing and services sectors is significant, it is important to recognize that the ISMs do not track closely with key economic activity measures.

Consumer confidence took a hit in April as The Conference Board's measure of consumer confidence fell to 97.0 last month from a downwardly revised index of 103.1 in March, below a reading of 104.0 expected, reaching its lowest level since July 2022 as consumers became less positive about the current labor market situation, and more concerned about future business conditions, job availability and incomes. The present situation reading also fell to 142.9 from 146.9.

Senior Loan Officer Opinion Survey on Bank Lending Practices (SLOOS) conducted by the Fed quarterly in advance of FOMC meetings, showed, on balance, tighter lending standards and weaker demand for commercial and industrial loans to firms of all sizes over the first quarter. Meanwhile, banks reported tighter lending conditions and weaker demand for all commercial real estate (CRE) loan categories. ***Tightening lending standards and shrinking loan demands have often been precursors of slowing business activity.***

Initial Jobless Claims for US unemployment benefits rose last week to the highest level since August, consistent with the other signs of gradual cooling in the labor market noted above. Initial claims rose 22,000 to 231,000 in the week ended May 4. Until the latest week, claims had been confined to a range of 200,000-222,000 applications for the last three months. The four-week moving average of claims, our preferred gauge, increased to 215,000, the highest since February.

Beyond these forward-looking indicators, first quarter real GDP increased at a 1.6% pace, well below the forecast 2.5% forecast, the slowest growth rate in almost two years. Putting the seemingly weak headline number aside, underlying data shows real domestic demand increased at a 2.8% pace last quarter, and while also below expectations and slower than the second half of last year, it still reflects solid growth. Consumers accounted for most of the strong results with a 2.5% increase in their outlays, but slower than the 3.3% gain in the previous quarter. Spending gained momentum as the quarter progressed so expectations for the pace of real GDP growth in the current quarter have been rising. Should this momentum be sustained, the first quarter GDP shortfall will likely be largely offset by the improved second quarter outcome. Underscoring the strength and momentum in the economy, over 75% of the S&P500 component companies reported first quarter earnings exceeded expectations and analyst's estimates of earnings for the current quarter and second half are being adjusted upward.

Inflation

The latest available reading of the Federal Reserve's preferred inflation gauge, the Personal Consumption Expenditures index (PCE), rose 2.7% in March from a year earlier, showing price growth remains stubbornly above the central bank's 2% target and that there has been little further progress so far this year in bringing the inflation rate down. Closely watched core PCE inflation, which strips out volatile food and energy prices, rose 2.8% in March, compared with a year earlier, above the 2.6% expected by economists. The higher-than-expected PCE number and the elevated ECI reported with first quarter GDP figures stemmed mostly from an upward revision to January's inflation reading.

Outlook

In summary, the US economy appears to be fundamentally sound and financially stable, albeit showing some signs of weakening at the margin. Our firm's proprietary [Economic Model](#), designed to signal a change in the direction of our economy six to nine months in advance of an inflection point remains above trend, continuing to show expansion ahead. The Model does not attempt to predict the rate of economic growth, only its direction. While showing some signs of slowing, recent data suggests economic activity has continued to expand at a solid pace. Although GDP moderated from 3.4% in the fourth quarter of last year to 1.6% in the first quarter, Private Domestic Final Purchases, a metric closely followed by the Fed, grew 3.1% in the first quarter sending a clearer signal that underlying demand was as strong last quarter as it was in the second half of 2023. Consumer spending has been robust over the past several quarters, even as restrictive interest rates have weighed on housing, autos, and equipment investment. Improving supply conditions have supported resilient demand. The labor market remains relatively tight, but supply and demand conditions are now better balanced. Payroll job gains averaged 276,000 per month in the first quarter, while the unemployment rate remains low at 3.9%. Strong job creation over the past year has been accompanied by an increase in the supply of workers, reflecting increases in participation among individuals aged 25 to 54 and the continued strong pace of immigration. Nominal wage growth has eased over the past year and the jobs gap has narrowed, but labor demand still exceeds the supply of available workers. Inflation, while sticky, has eased notably over the past year but remains above the Fed's longer-run goal of 2%. Although some measures of short-term inflation expectations have increased in recent months, longer-term inflation expectations appear to remain well anchored, as reflected in a broad range of surveys of households, businesses, and forecasters, as well as financial market measures.

Investment Policy

There is much discussion about how richly valued equities are given the stock market's roughly 30% rise from its low point last year. Following its 5% correction from late March through the end of April and partial rebound this month-to-date, the S&P500, a capitalization-weighted index, looks expensive, selling at about 21.3 times forward earnings of \$245 per share. However, most of its

overvaluation is concentrated in a handful of heavily weighted, high-quality, mega-cap technology *growth* companies, many of which are likely beneficiaries of artificial intelligence and the stock market's excitement around AI shares. Another stock market measure, the S&P500 Equal Weight index, which, as the name implies, weights its components equally, stripping out the distorting impact of the mega caps, provides a more accurate measure of the market's valuation. This index is currently priced at about 17 times forward earnings, closer to the stock market's historical average over the past 25 years. In our view, valuation is only one of many factors (including business conditions, the likely direction of corporate profitability, changes in fiscal and monetary policy, measures of liquidity, sentiment, and momentum) we find valuable in determining the attractiveness of the stock market. With these factors in mind, we see the stock market to be fully valued currently, with many *value* stocks statistically more attractive than pricey *growth* shares. Accordingly, in recent months, we have favored adding to clients' *value* investments in sectors such as energy, financials, industrials, and communications while maintaining clients' growth stock investments, trimming significant over weights as appropriate.

Our April 8 [Statement of Investment Policy](#) warned of the possibility of a long-overdue 5% to 10% stock market correction, driven by a change in market sentiment or an exogenous shock, noting a pullback, washing out the speculative excesses that were built up during the market's bull run since last October, would be a welcome development. Despite the market's recent rebound from its April correction, we would not rule out further sentiment-driven pullbacks given the market's full valuation.

As for fixed income, we continue to use bond maturities and cash in clients' accounts to extend laddered corporate bond portfolio durations toward our desired 2.5+-year target duration. Yields to maturity on the newest purchases have exceeded 5.25%.

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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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