FINANCIAL MARKET OBSERVATIONS

August 2023

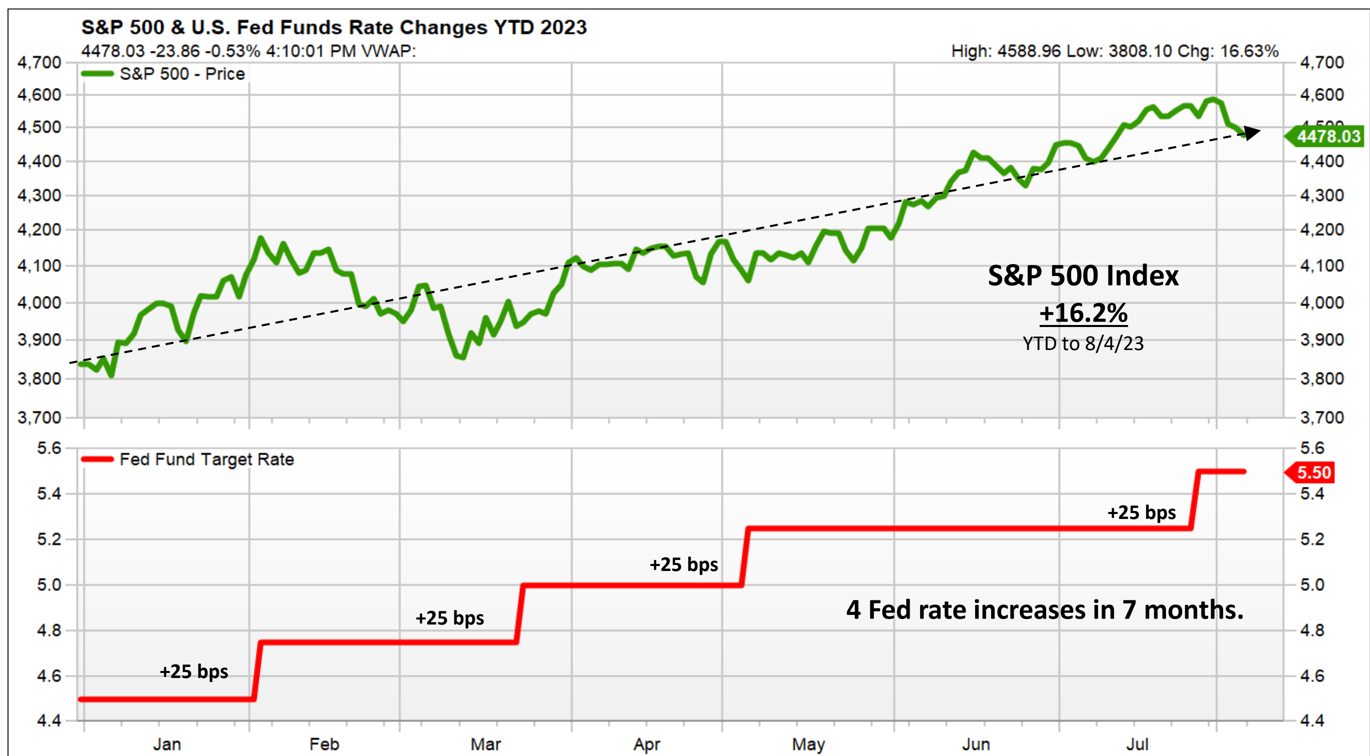
Better Than Expected!

Consensus & Surprises

With the year well past the mid-point, U.S. economic and financial market results have been surprisingly positive. From mid-2022 until recently, the consensus was the Federal Reserve would persist in raising interest rates leading to a recession, declining GDP, rising unemployment and lower inflation. We too expected the Fed to be aggressive in its actions to quell inflation but were optimistic and believed inflation would decline more rapidly than predicted, that the consumer (69% of U.S. GDP)[i] was in better financial condition than anticipated and that the change in the structure of the U.S. economy (more service/less manufacturing) would keep labor markets stronger, longer.

The cautious/less optimistic consensus gradually dissipated as inflation declined more rapidly than it rose, unemployment remained at a half-century low (3.5%)[ii], hourly wages climbed[iii], and the economy, as measured by GDP, grew[iv] (no recession currently), accelerated, and exceeded expectations. In addition, corporate revenues and profits have remained positive and the weaker (relative to other currencies) U.S. dollar[v] has become a positive for companies that export from the U.S. These factors have combined to improve investor and consumer expectations and propel equity markets higher and raise the prospect for a "soft" landing.

Despite An Aggressive Fed, Equity Markets See Light at The End of The Tunnel



Unfortunately, not everyone is "on the same page." Atlanta Federal Reserve President, Bostic recently stated that he believes the Fed no longer needs to increase interest rates. That statement is a positive for stock market investors and a further indication that the Fed is winning its battle against inflation. On the other hand, Kansas City Fed President Bowman indicates that she believes additional hikes may be required to bring inflation down to the 2% annual rate established by the Fed as the inflation target.

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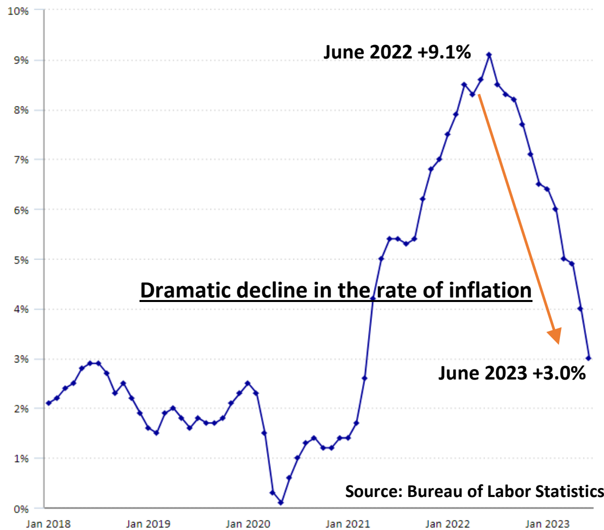
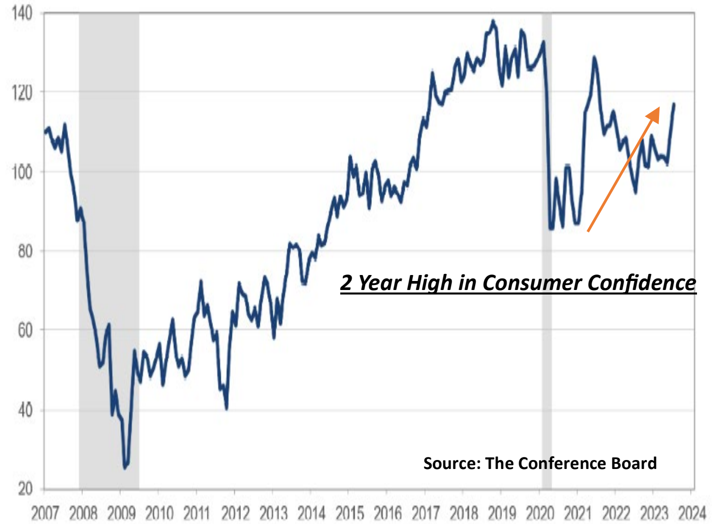
A Picture (s) Rather Than a Thousand Words

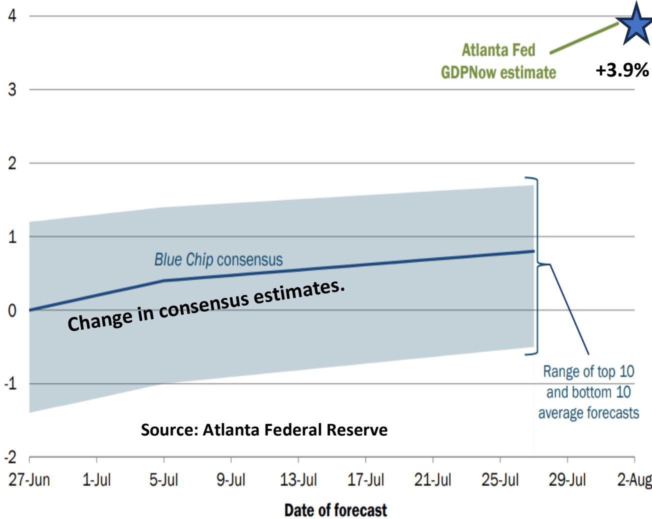
12-Month Change, U.S. Consumer Price Index



Consumer Confidence



Atlanta Fed Estimate of 3rd Qtr. Real U.S. GDP Growth



The Atlanta Fed GDPNow forecast is a running estimate of real U.S. GDP growth based upon available economic data for the current calendar quarter. There are no subjective adjustments.

The current estimate for the 3rd quarter, ending 9/30/23, is meaningfully higher than the Blue Chip consensus (poll of top business economists) and even the highest single estimate. The GDPNow forecast may not be correct, but its historical absolute error is only 0.82% points since the model's inception in 2011.

An interesting aspect of the chart displayed on the left is how much consensus estimates have change just since the end of June. The Atlanta Fed is obviously not suggesting a recession soon.

A final "picture" of an economy stronger than many had expected when interest rates were rising, inflation was rampant, and supply-chain bottlenecks held the economy hostage is the unemployment rate.

A more typical path for the Unemployment Rate is to rise as the Fed increases interest rates to slow demand for goods and services. As demand slows, companies react by producing less and reducing its labor force. That has not been the case during the past two years.

U.S. Unemployment Rate

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Not a Perfect Picture Though

Notwithstanding the positive trends described on the previous page in addition to consumer resilience, positive corporate earnings reports, and the changing narrative (more positive) regarding recession and the Fed's aggressive tightening policy (not likely to continue), there are numerous factors that require close scrutiny.

They include:

- Consumer spending due to the increasing cost (cards, cars, and mortgages) and diminishing availability (tightening standards) of consumer credit, the required resumption of Federal educational loan payments, and the waning excess savings from government stimulus payments.
- Upward pressure on interest rates due to the downgrade of U.S. credit and large increases in federal funding.
- The likelihood that disinflation will not continue in a "straight" line.
- The strength of regional banks due to the uncertainty of commercial real estate loan values.
- The inverted yield curve (yield on short maturity debt exceeds yield on longer maturity debt) and negative Leading Economic Indicator Index (15 consecutive months[vi]) as predictors of impending recessions.
- The spike in crude oil prices. We watch this price change intently due to its impact on gasoline prices.
- Geopolitical conflict and political divisiveness.

Looking Ahead

The uncertain economic outlook during the first two-thirds of the year has not delayed or interrupted investment action. As mentioned previously, we find that periods of uncertainty often provide the best time to be opportunistic and make decisions that will further increase the quality, growth, diversification, or stability of client portfolios. This period has been no exception. We have continued to further diversify and enhance stock portfolios by initiating or adding to high-quality, consistent growth companies. With respect to investment action relating to the bond portion of client portfolios, we positioned portfolios to have short average maturities, benefit from rising interest rates, and to concentrate in AAA rated U.S. government securities.

We remain optimistic in our outlook particularly as we think about the next five years and the positive impact that onshoring/reshoring, infrastructure upgrading and spending on Artificial Intelligence will have on the creation of jobs and income for American workers and opportunities for investors. With respect to the remainder of 2023 and the first half of 2024, we do not anticipate a recession. Although the U.S. experienced two consecutive calendar quarters of negative growth during the 1st and 2nd quarters (-1.6% & -0.6% respectively)[vii] of 2022, the Bureau of Economic Analysis did not determine that period to be a recession. We suspect that it was *the* recession.

We are conscious of the need to closely monitor factors that we discussed above as well as others that may impact the "health" of the economy and valuation of the financial markets.

The investment actions we take are always with the objective of achieving positive, real (inflation adjusted) returns for clients. We continue to emphasize active management, tax minimization, diversification, and investment in high quality bonds, and consistent growth companies. Most important though is to maintain a reasonable investment time horizon and avoid reacting to what may be short-term "noise."

Please do not hesitate to contact us if you have any questions, comments, or critique. We highly value the relationship we have with you and look forward to the next time we speak or meet.

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There is no guarantee a diversified portfolio will enhance overall returns or outperform a non-diversified portfolio.

Diversification and asset allocation do not protect against market risk. International investing involves special risks such as currency fluctuation and political instability and may not be suitable for all investors.

Bonds are subject to market and interest rate risk if sold prior to maturity. Bond values will decline as interest rates rise and bonds are subject to availability and change in price. Bond yields are subject to change. Certain call or special redemption features may exist which could impact yield.

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[i] The World Bank Open Data, August 2023
[ii] U.S. Bureau of Labor Statistics, July 2023 monthly report
[iii] Bureau of Labor Statistics, June 2023 monthly report
[iv] Bureau of Economic Analysis, July 2023 monthly report
[v] FactSet, August 2023
[vi] The Conference Board, July 2023
[vii] Bureau of Economic Analysis, August 2023