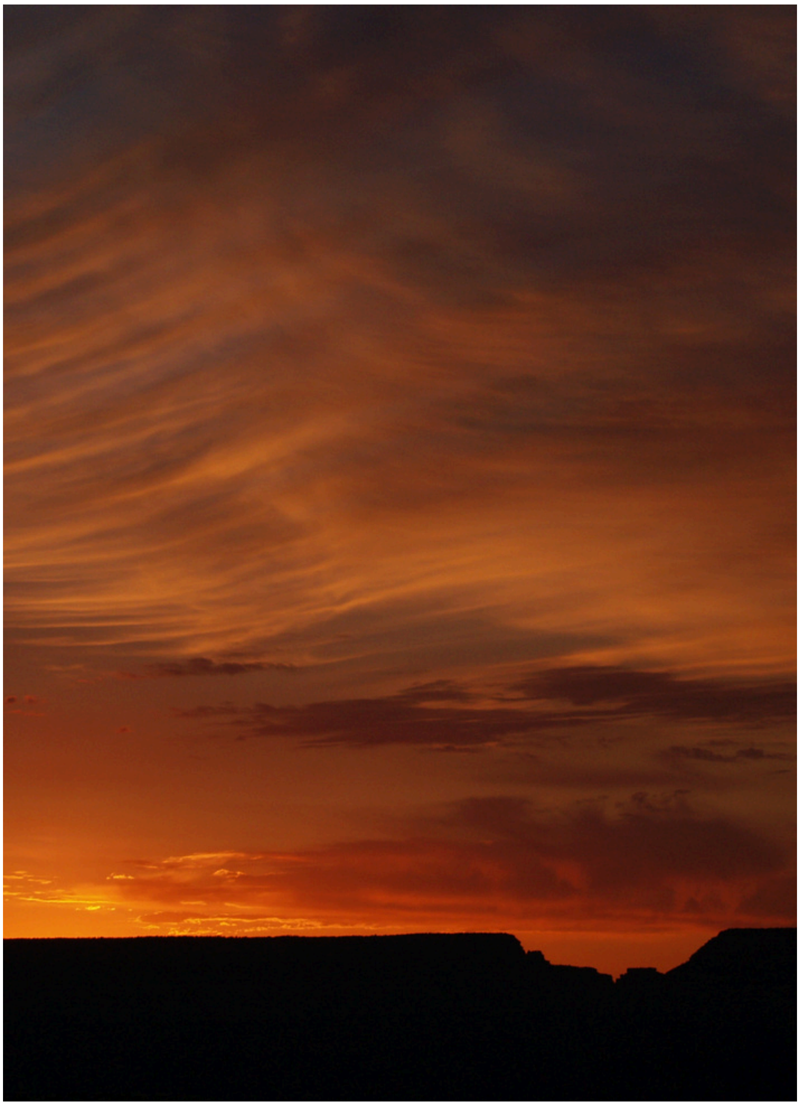
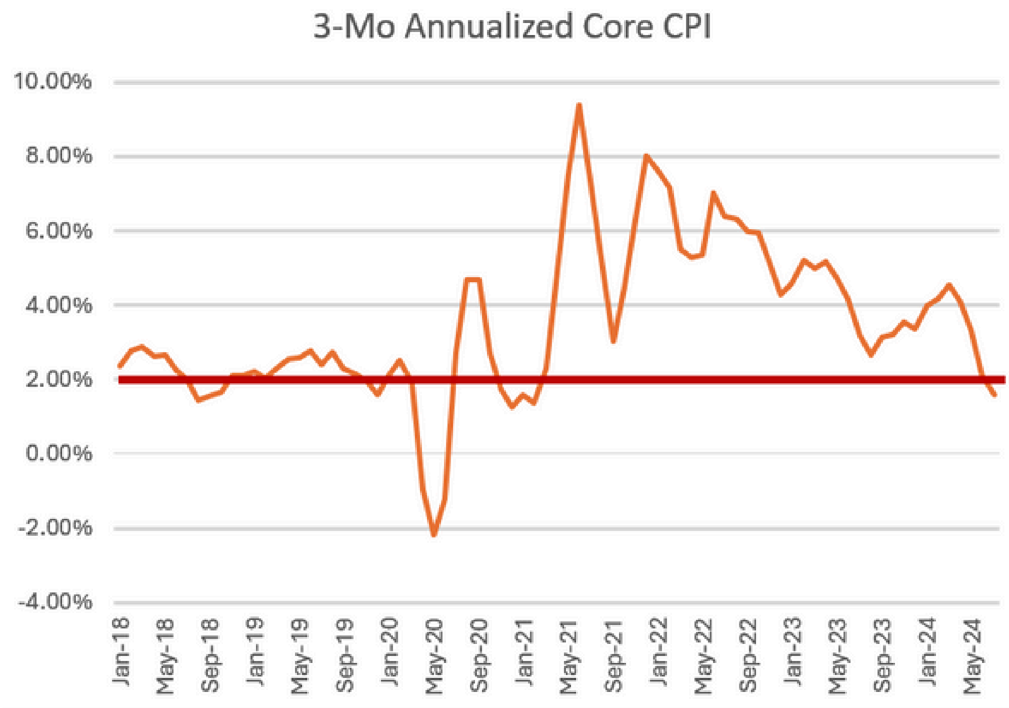
FSA INSIGHTS

HERE COMES THE SUN

Chairman Powell's speech at Jackson Hole signified a noteworthy shift in emphasis from the Federal Reserve. While the attention since 2022 has been mainly focused on doing whatever it takes to bring down inflation, the Chairman has now placed the spotlight on a softening labor market. This single-mindedness approach has implications for the market and how it reacts to economic data. When the Fed was focused on bringing down inflation, then any good economic news was seen as bad for the markets since it would mean the Fed would have to keep rates higher for longer. The eventual consequence would be too high rates hurting U.S. consumption and eventually drive the economy into a recession. Consequently, any bad economic news was good since it meant inflation was coming down and thus we were closer to interest rates falling again. With this recent shift towards focusing on a weakening labor markets means we are now back in the bad economic news is bad for the market. Therefore, it's now even more important to grasp whether the economy is slowing down and moving towards a recession.



"THE BEATTLE'S SONG, 'HERE COMES THE SUN,' COMES TO MIND AS WE SEE THESE RATES CUTS AS THE FIRST RAYS OF SUNLIGHT AFTER A LONG WINTER, AND SIGNS OF A BRIGHTER OUTLOOK IN THE RATE ENVIRONMENT."



Sources: BLS, FSA-IG, as of July 31, 2024

Nevertheless, we begin preparing for the first of many Federal Reserve rate cuts beginning this month. The Beattle's song "Here Comes the Sun" comes to mind as we see these rates cuts as the first rays of sunlight after a long winter, and signs of a brighter outlook in the rate environment. Inflation, which had cast a long shadow over the market, is finally showing a steady decline. Over the course of 2024, the core Consumer Price Index (CPI) has been decelerating, with the most recent data coming in near the Fed's 2% target. This decline, fueled by the easing of supply chain disruptions, has reshaped expectations around interest rates. By the end of 2025, markets are anticipating a reduction of 175 to 200 basis points, suggesting a gradual shift away from the aggressive tightening policies of the Federal Reserve.

The labor market, while complex, offers a more nuanced perspective. Though the unemployment rate has been ticking up, this is primarily driven by a rise in labor force participation rather than a collapse in demand for workers. More individuals are re-entering the workforce, which pushes up the unemployment rate but does not yet indicate significant weakness. However, revised job figures showing 800,000 fewer positions than initially reported raise a cautious flag. While we don't foresee a sharp drop in employment, these numbers warrant close attention for further signs of softening in the months ahead. We are watching other indicators such as the Prime-Age Employment to Population ratio which is still rising before we start distressing about a decline in labor.

The broader economic picture, reflected through a mix of hard and soft data, continues to send mixed signals. Survey-based indicators, such as the ISM Manufacturing Index, have pointed to a prolonged contraction, with manufacturing activity in negative territory for 21 of the last 22 months. The services sector, on the other hand, has remained more resilient, with expansion noted in 19 of the past 22 months. This suggests a slowdown in economic growth, though not a full-blown downturn, as services keep the broader economy on a modest upward trajectory.

THE BROADER ECONOMIC PICTURE, REFLECTED THROUGH A MIX OF HARD AND SOFT DATA, CONTINUES TO SEND MIXED SIGNALS.

Several non-traditional, real-time indicators point to ongoing economic resilience. Withheld income tax receipts remain strong, indicating a relatively stable labor market. Furthermore, TSA checkpoint data shows increased air travel, particularly international, thanks to a strong U.S. dollar. Other indicators, such as retail sales, hotel bookings, and restaurant activity, further underscore the strength of consumer spending, even in an environment of rising interest rates. Additionally, jobless claims are holding steady, and credit markets show no signs of stress, with bankruptcy rates and lending trends remaining stable.

On the manufacturing front, U.S. capacity is on the rise, reversing a decades-long trend of decline. Legislation like the CHIPS Act, Inflation Reduction Act, and Infrastructure Act is fueling a new wave of industrial growth, especially in sectors such as artificial intelligence and renewable energy. This resurgence in manufacturing capacity is also driving productivity gains, which historically have supported robust earnings growth. As we've seen in previous periods of technological innovation, higher productivity tends to lead to sustained capital expenditures, which ultimately flow through to corporate earnings.

Looking ahead, these productivity gains should contribute to strong earnings growth, particularly in technology and related sectors. Although recent earnings strength has been concentrated among the largest companies, consensus forecasts expect more widespread growth in the coming quarters. Historically, higher productivity has coincided with higher equity valuations, suggesting that corporate profits may continue to support the stock market even in the face of slower economic growth.

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As we evaluate the investment landscape, it's clear that while economic growth is moderating, there is little evidence to suggest an imminent recession. Inflation is cooling, and the market is now pricing in up to six rate cuts by the end of 2025. Additionally, fiscal stimulus from recent legislation will likely continue to support economic growth while exerting some upward pressure on inflation over the medium term. However, we know these types of situations can change quickly and we will be monitoring for any cracks in the economy that would shift our mindset.

Historically, stocks and bonds have outperformed cash once the Federal Reserve stops raising rates. With September 2023 marking what appears to be the peak in interest rates, a diversified portfolio may offer better returns compared to short-term cash investments. Although equity valuations remain stretched, particularly in tech and communications, continued earnings growth will be essential to bringing these valuations back to more sustainable levels.

As the economy shifts from darker days into a brighter phase, we remain cautiously optimistic. While we expect the markets to be volatile, we see any declines to be a correction in a bull market, and thus we would be buyers. The risks may still be present, but the data suggests that, like the sun breaking through the clouds, the interest rate outlook is improving. As long as the business cycle continues to show growth, we believe a diversified portfolio of high-quality equities and fixed-income investments can help investors capture the sunshine on the horizon.

Respectfully,

Andy Webb
Chief Investment Officer

Brett Akers
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