ALTMAN
INVESTMENT MANAGEMENT

MARKET PERSPECTIVE

SEPTEMBER, 2024

IN FOCUS:

Since the yield curve inverted 2 years ago, the economy has been successful in avoiding a recession. The Fed responded aggressively, raising its key interest rates 11 times. Inflation has since settled below 3%, down from its most recent high of over 9%. Additionally, the idiosyncratic banking failures of 2023 quickly stabilized and a widespread banking system failure was averted. Banks are now in stronger positions since the 2008 financial crisis, having rebuilt their balance sheets while maintaining higher liquidity standards. Like prior tightening cycles, it is no surprise that the yield curve inverted by over 100 basis points. The main difference thus far has been the strength in economic data that continues to support a soft landing for the U.S. economy. The next phase depends on how effectively the Fed can unwind its restrictive policies at a pace that allows inflation to continue to moderate while staying on track for a soft economic landing.

Growth in July payrolls was weaker than expected, but was mostly due to short-term weather-related headwinds impacting employment data. The level of payroll employment remains at a record high in step with upward trending corporate forward earnings. New concerns of a softening labor market after this employment read were quickly offset by a better-than-expected jobless claims report. Overall, the trend in labor appears to be cooling at a pace consistent with a soft landing. The recent unemployment claims have yet to clarify if weather-related factors did in fact have a short-term impact on employment or if the labor market is at risk of stalling.

Consumer prices (CPI) moved down closer to the Fed's target rate in July registering at 2.9%. Housing costs continue to be a headwind as any improvements in price levels have a lagged impact on overall CPI. Shelter costs increased 5.1% in July down slightly from the prior month and down from the most recent high of 8.2% in Q1 of last year. Researchers at the Minneapolis Federal Reserve Bank forecast shelter inflation to fall to 4.8% in December - but then to stay above pre-pandemic levels through 2025. Excluding shelter, the CPI grew at a rate of only 1.7%. Since the pandemic began, average hourly earnings advanced 22.3% as compared to the CPI of 20.8%. The faster rate of growth in wages over the CPI tells us that despite higher prices, consumers purchasing power has been sustainable.

The labor market came in a bit weaker than expected as reflected in the July confidence survey and the August initial unemployment claims. We expected a stronger bounce back from the depressed weather-related economic activity in July. The market continues to expect that inflation will approach the Fed's 2.0% target by the fourth quarter. We anticipate the decline in the 30-year fixed mortgage rate to 6.76% (down from 7.89% this time last year) should begin to spur home buying activity as the market adjusts to the lower borrowing rates.

The Fed's recent tightening round will unlikely trigger a recession. This cycle doesn't have the usual ingredients of an energy crisis, or a bursting speculative bubble in companies that aren't delivering on earnings expectations. Currently the bulls have characterized that Fed funds rate is in the process of normalizing after reaching a level of 5.25-5.50% off the near zero policy for far too long. So far, there has not been a credit crunch and inflation appears to be moderating without a recession this time around. One explanation for this soft landing could be the rolling recessions that hit different sectors of the economy at different times staving off an outright economic downturn.

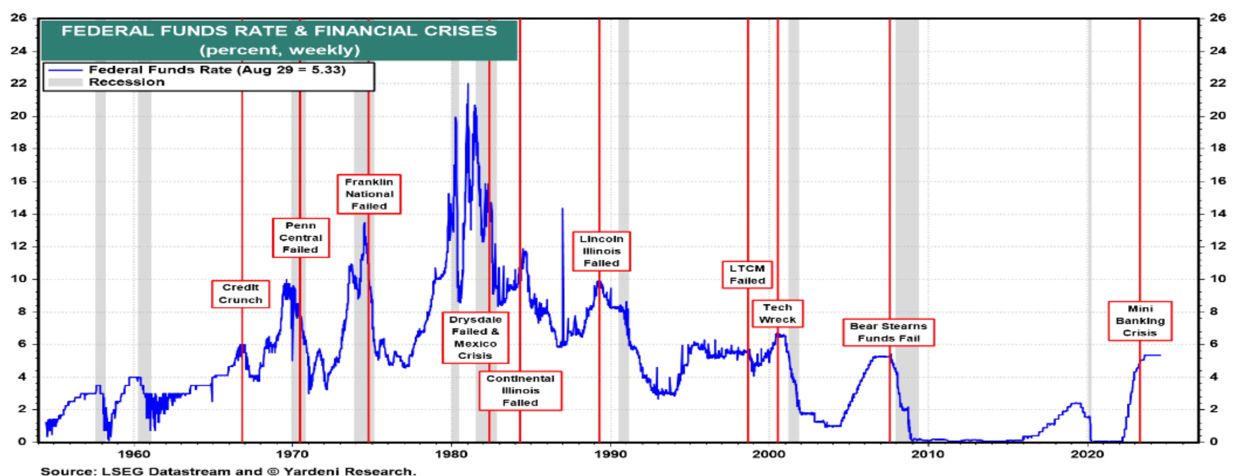
Business capital spending and the wealth effect of the Baby Boomers living on their retirement income has helped lengthen the business cycle. Despite weakness in employment and industrial production, nominal and real consumer spending continues to rise to record levels (while the personal savings rate falls). As wages increase faster than consumer prices, the productivity argument remains intact at least for the time being. Keep in mind that recessions on average last less than a year - and there have been only 13 recessions since 1945 and this has only been 14.2% of the time.

A Retrospective: *Fed Policy and Recessions*

Recessions don't happen very often, and they don't last very long. Most of the nine recessions since 1960 were caused by the tightening of monetary policy, which triggered a financial crisis and a credit crunch that caused a recession. On four occasions since then, the recessions were precipitated by an energy crisis, which caused the prices of crude oil and gasoline to spike. On a few occasions, recessions resulted from the bursting of speculative bubbles.

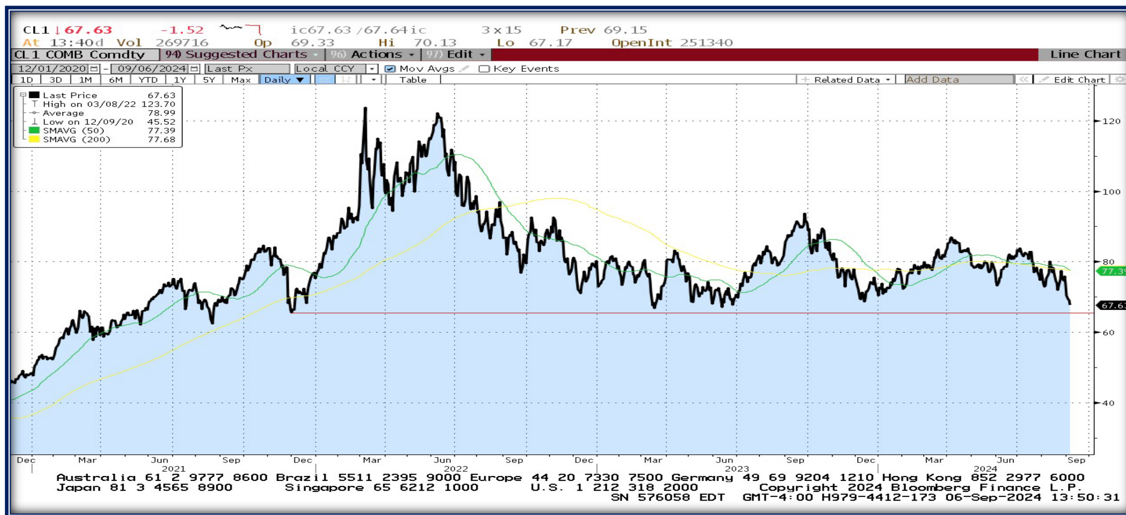
In the past, the Fed almost always responded immediately to financial crises by lowering the federal funds rate significantly. That helped to mitigate the credit crunch and shorten the recession. There was an exception in 2023. The Fed responded to a banking crisis by rapidly creating an emergency bank liquidity facility, providing income support through the unemployment insurance system to help moderate the downturn. In retrospect, fiscal policy is often late to the game, using tax cuts and other stimulative measures that help boost recoveries.

According to many economists, the Fed was normalizing rather than tightening monetary policy during 2022-2023 when they raised rates 11 times for a total of 525 basis points. That was certainly one of the biggest increases in monetary policy tightening cycles in history. However, the federal funds rate was raised from zero so one can conclude that the increase in the federal funds rate was only normalizing rather than tightening monetary policy.



Oil is deeply oversold hitting the lows experienced in the winter of 2021. Despite geopolitical concerns, the price of oil has fallen sharply in recent weeks. OPEC may delay production increases scheduled to start next month, as a result of weaker Chinese oil demand. In addition, energy traders appear to be betting that a direct war between Israel and Iran is less likely. This suggests that oil's geopolitical risk premium is falling creating a negative near-term view of the commodity. This could relieve any downside pressure for bonds prices - lowering potential yields in the shorter term.

Brent Crude (Current Dollars/Barrel)



Protectionist Policies on Borrowing Rates:

In retrospect, the U.S. policy stance on progressive globalization over the past several decades has resulted in significant labor displacement on its borders. The benefits are highly concentrated at the top of the socioeconomic ladder in the form of corporate compensation favoring stock ownership. This has resulted in a substantial backlash and is being addressed by both political parties this fall. However, increased global trade has also supported economic and profit growth, while creating disinflation and lower borrowing rates. The adoption of protectionist policies by both parties in this year's election could threaten to unwind these net positives, and the use of tariffs would cause stagflation. Protectionist policies are in aggregate not good for equities and other risk assets and could materially lift government bond yields and private sector borrowing rates – it's worth watching.

Earnings Growth Broadening:

Q3 earnings for the S&P 500 benchmark grew at a rate of 12.7% year-over-year, compared to only 8.2% the prior quarter. Notable however was the slower pace of earnings growth in the Mega 8 concentrated sectors such as Technology, Communication Services, and Consumer Discretionary. Financials and Healthcare modestly outpaced Technology. Currently Mega 8 stocks represent 21% of the forward earnings growth for the S&P 500 index. A narrowing margin between the growth in earnings for these growth sectors versus the rest of the market is paving the way for broader market participation. Given the current environment, we continue to emphasize banking to capitalize on improving interest rate spreads, healthcare for the free cash flow and energy for yield.

IN CONCLUSION:

Although unemployment has risen, it's still closer to the Fed's long run target rate. Powell's bullish comments following the last FOMC meeting suggest that the Fed is moving forward on lowering rates by 25 basis points at the next meeting in September, despite the fairly bullish jobs report with payrolls normalizing**.** The August jobs report came in at +142,000 versus the street expectation of +165,000 - and the unemployment rate fell to 4.2% from 4.3% last month. In our view, this is a reasonable "in the middle" jobs report, showing improvement versus last month. Neither are too strong or weak to drive a shift in the economic view. We are expecting only one rate cut this year, with food prices continuing to cool. Although energy prices are under pressure, this sector provides a hedge in portfolios against potential inflation. This suggests that inflation will support equity prices into year-end.

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No gross performance returns that are referenced that are calculated after brokerage commissions but before investment counsel fees are presented without the comparable net performance figures after both commissions, investment counseling fees and other custodial charges. The net counseling fees are the actual average counseling fee calculated across all the portfolios included in the composite. All performance figures are presented on a time-weighted total return basis and assume all income is reinvested. The investment advisory fees are disclosed in Part II-A of the Investment Form ADV. Some clients may benefit from available discounting in the management fee schedule associated with the overall size of the portfolio. Management fees will reduce overall returns to the client.

The composites were created in 2001 and the inception dates start on August 17th, 2001.The composites include only discretionary fee-paying accounts managed in the strategies, and additional information associated with the composites are available such as: dispersion in individual portfolio results as well as the % of the firms AUM in the strategy. All performance calculations are presented within the GIPS® guidelines of the CFA Institute. The CFA institute does not endorse or promote this organization nor does it warrant the accuracy of the content herein.

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