The Advisor

A quarterly publication from Ables, Iannone, Moore & Associates, Inc.

Market Update - Third Quarter, 2023

HURRICANE SEASON. If you live near the Atlantic or Gulf Coast, hurricane season is a normal part of life. Every June through November, attention turns to the season of the year when conditions become favorable for storms to develop. Yet, for coastal residents and even visitors, day-to-day life is not burdened with worry or fear of a storm's potential impact. This is not to say locals are dismissive of what could happen just that probabilities suggest the best course of action is to plan for nothing but prepare for the worst.

It takes quite the cocktail of ingredients to even produce a hurricane. According to the National Oceanic and Atmospheric Administration (NOAA) the recipe for a hurricane consists of four ingredients:

- Pre-existing weather disturbance such as a tropical wave – a low pressure system that moves through the warm tropics enhancing shower and thunderstorm activity.
- Warm water of at least 80 degrees Fahrenheit over depths of 150 feet.
- Thunderstorm activity turning ocean heat into hurricane fuel.
- Low wind shear: differing wind speeds and directions around the storm can weaken it.

As the initial disturbance moves across the warm tropical waters, warm air rises, forming an area of low pressure. This is a reinforcing loop causing more air from surrounding high pressure areas to rush in, rise and cool, forming clouds and thunderstorms which create more heat and fuel for the storm.

NOAA goes on to say, however, that even with the abovementioned conditions a hurricane does not always develop. In other words, these are necessary conditions but not sufficient. Below are the stages of storm development:
- Tropical Disruption
- Tropical Depression
- Tropical Storm
- Hurricane
- Major Hurricane

We can use this analogy and framework around hurricane season to look at where things stand economically for the second half of 2023. Are conditions favorable for a slowdown, if not recession?

Pre-existing disturbance? Inflation and shifts in demand that complicated the supply side response coming out of Covid shutdowns and into reopening certainly checks the box as an economic disturbance. Now mix in a war, commodity price volatility and geopolitics, to boot.

Warm water? The Fed. Just as a hurricane needs warm moist air rising from the ocean water - an economic slowdown and/or recession needs restrictive financial conditions. Enter the Fed raising the benchmark overnight rate 500 basis points (5%) since last March. For those keeping score at home, that is a torrid pace. Moreover, the Fed has signaled additional rate hikes are needed as well as a higher for longer policy stance.

Thunderstorm activity? We'll highlight commercial real estate (CRE). According to the St. Louis Fed, the office sector of commercial real estate accounts for 15% of the $21 trillion CRE market. The national vacancy rate in the office sector was 17% with rates 20%+ in certain markets such as San Francisco, Austin and Houston. Real estate data firm Trepp reports $270 billion in bank-held commercial mortgages will mature in 2023, of which $80 billion are backed by office properties. The bulk of this debt was financed when rates were lower. Today, rates are much higher and valuations potentially lower which may present refinancing challenges.

Low wind shear? Less bank lending and tighter financial conditions. Although the banking crisis headlines have faded away, the impacts and fallout are evident. Credit conditions have become stricter and there is generally less appetite on the part of lenders. Little to no wind shear allows a hurricane to organize and stabilize. Little to no lending allows recession-like conditions to develop.

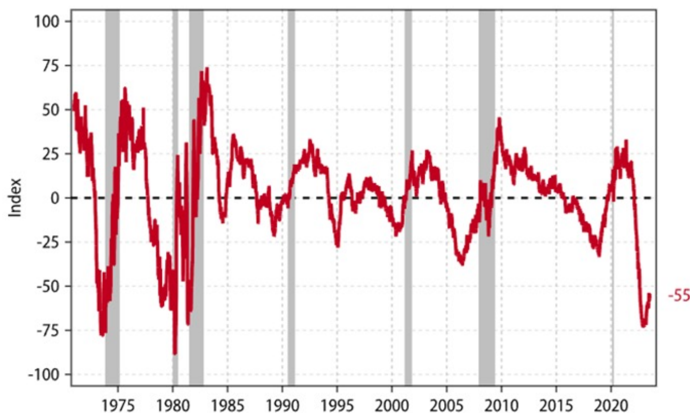
In our view, the conditions to produce a recession are present. When, if at all, and to what degree is in many respects a matter of technicality for the National Bureau of Economic Research to determine. What is more important, and our focus, is recessionary behavior. In other words, tighter credit conditions, less spending, less demand, less production and less investment.

The Fed's belief that more rate hikes are needed to bring inflation down poses a risk. Inflation was running at 3% in June and has clearly rolled over from its 9% peak one year ago. Will there be a sustained reacceleration? Maybe, but not likely, so call us skeptical that 25 or 50 basis-points higher from current levels is the precise, if not magical, Fed Funds Rate needed.

Further evidence that pricing pressures are alleviating is in the Producer Price Index (PPI) which fell to 0.1% in June. In June 2022, it was 11.2%.

Financial conditions are tight as we mentioned above. Below, the chart from Gavekal Research helps put current conditions into context:

U.S. True Financial Conditions Index



Specific examples of tighter credit conditions can be found in a recent report from the New York Fed regarding credit access. The report stated the overall rejection rate for credit applicants increased to 21.8%, the highest level since June 2018. Such rejections included auto loans, credit card applications, credit limit increase as well as mortgage applications.

Manufacturing Production decreased 0.34% year-over-year in June, marking the fourth consecutive month of contraction.

Industrial Production also fell into contraction in June, decreasing 0.43%. This was the first annual decline since February 2021.

It's not all grey skies, however. The labor market has held up and by extension that means the consumer has as well. The reality is, jobs and spending are the engine that powers the economy. Keep in mind consumer spending makes up about 2/3 of GDP.

We've highlighted the overarching economic conditions which appear favorable for recession. Even so, from our perspective, there continues to be attractive opportunity in capitalizing on the yield environment while maintaining prudent equity exposure with an eye towards preservation. This blueprint has worked well in 2023 and we remain committed to helping our clients navigate the market and economic cycles to achieve long-term financial well-being.

To our clients, thank you for the opportunity to serve your investment needs and please do not hesitate to contact us if you experience any material changes in your personal situation or would like to discuss any specific matters.

To our other readers, if you would like a complimentary review of your investment accounts or any other financial matters, please do not hesitate to contact us. As fiduciaries, we will happily provide you with an unbiased opinion based on your specific situation.

AIM & Associates

Ables, Iannone, Moore & Associates, Inc.

A Registered Investment Advisory Firm

419 Montgomery Street
Savannah, Georgia 31401
Phone: 912-777-4128 • Fax: 912-777-5943
Toll Free: 866-815-6004, www.aimainc.com