The Advisor

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

Market Update - First Quarter, 2024

HAPPY NEW YEAR – We certainly hope 2024 is off to a good start for everyone. Let's dive right into a few things we are watching as the new year gets underway.

The Economy. Last year, the U.S. economy proved resilient in the face of some slowing, if not contracting, economic data and market signals.

Take, for example, the ISM Manufacturing index remaining in contraction for 14 months, the most extended period of declining activity since 2000-2001.

On the services side of the equation, the ISM Services index fell to 50.6 in December (above 50 is expansion, below is contraction). It was the lowest reading in seven months.

If we look even closer at the new orders data within both ISM surveys the numbers are weak and on par with previous recessionary periods. There would need to be a sustained reversal of trend if the economy plans to avoid a material slowdown.

The Conference Board produces a Leading Economic Index (LEI) comprised of ten components designed to signal turning points in the business cycle. The LEI has been in a state of decline for 20-months, the longest streak since 2008.

If we zoom out a bit and simply look at Gross Domestic Product (GDP) compared to Gross Domestic Income (GDI) we find GDP is outpacing GDI. It's easiest to think of GDP as a measure of spending while GDI is a measure of income. The data suggest consumers are relying more heavily on savings and credit to fuel spending versus income.

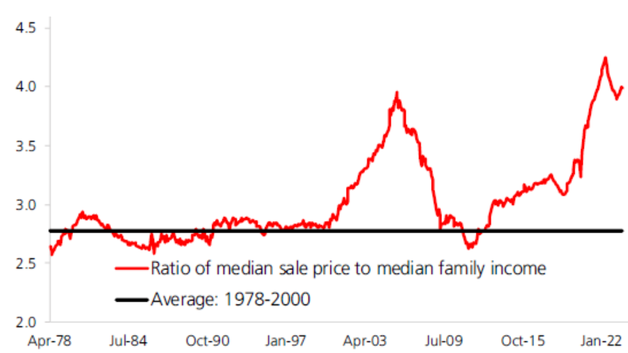
In theory, GDP and GDI data should match-up because every expense is another's income. In reality there are periods when they diverge, like they are now, with GDI (income) falling faster than GDP (expenditures).

Jeremy Nalewaik, an economist with the Fed, wrote a paper titled *Estimating Probabilities of Recession in Real Time Using GDP and GDI*. Inquiring minds can read it ***here*** but spoiler alert; GDI just might be a better indicator of recession and at the least it's a necessary component alongside GDP in measuring the true state of the economy.

The Consumer. Part and parcel of last year's economic strength was household spending. The most recent data show consumer spending at nearly 68% of GDP. The long-term average is roughly 64%. The consumer still appears solid; however, we are watching some signs of stress including:

Household excess savings are shrinking, the personal savings rate as a percentage of disposable income is below pre-Covid levels, lending standards and access to credit have tightened significantly, personal interest payments as a percentage of income have soared alongside credit card balances. Speaking of credit cards, delinquency rates are now above pre-Covid levels. And speaking of delinquency rates, lenders are seeing a rise in late-payments for auto loans as well. Oh, and student-loan payments have resumed.

Housing. Prices and mortgage rates remain elevated making affordability a tough equation for many buyers. The below chart from UBS illustrates the challenge by showing the ratio of median sale price to median family income.



Source: Census Bureau, National Association of Realtors, Haver, UBS

The U.S. Treasury Yield Curve – A Market Signal. We're not going to bury the lede here. The popular measure of the 10-year minus the 3-month U.S. Treasury remains inverted and it has been for longer than any other time in history. All other previous occurrences of 10y / 3m inversions were followed by a recession.

In real terms, a 10y / 3m inversion means an investor is compensated more, on a yield basis, for owning a 3-month treasury than they are for owning a 10-year treasury. We have previously written about the significance of the yield curve and more specifically that inversion is not normal. We stress – an inverted yield curve does not cause a recession. Instead, the inversion is a signal; it's a reflection of underlying economic conditions and the probability that future rates will be lower and the Fed will be forced to adjust their monetary policy accordingly. What is often missed in yield curve analysis is asking the question, why? Why is the market consistently pricing in lower rates? Historically, the answer has been signs of economic weakness.

The Labor Market. The labor market, as defined by the unemployment rate, remains strong. We are beginning to see some normalization evidenced in continuing claims numbers trending higher, workweeks and quit rates are decreasing and the number of job openings are falling.

Keep an eye on the non-farm payroll reports. Final numbers for 2023 are not in yet but the Bureau of Labor Statistics (BLS) have downwardly revised every single payroll report in 2023 – except one. This means fewer jobs have actually been created compared to what was initially reported. If this trend continues and/or if payroll numbers begin to disappoint outright – economic weakness will follow.

Inflation. Headline CPI rose to 3.4% in December from 3.1% in November. Gasoline prices were to blame, declining only slightly compared to the much larger decline in November. Core CPI reached a two-and-a-half year low, falling to 3.9% in December from 4.0% in November.

The Fed's preferred measure of inflation is the personal consumption expenditure index (PCE). The headline number fell to 2.6% for November. Core PCE removes food and energy and it fell to 3.2% in November. December data will be released at the end of this month.

We see meaningful progress on inflation and we expect that progress to continue in 2024. We believe the Fed does too.

The Fed. The Fed released an updated Summary of Economic Projections (SEP) at their December meeting. Therewithin was the pivot that both the stock and bond market absolutely loved – the Fed signaled three rate cuts in 2024. Interestingly, at Chairman Powell's November press conference, when asked by Coby Smith with the *Financial Times* about tightening financial conditions and rate cuts, Powell said, "… the fact is the Committee is not thinking about rate cuts right now at all. We're not talking about rate cuts."

So, what changed in a matter of weeks causing the Fed to pivot from not even thinking about rate cuts and stressing a higher for longer message to signaling rate cuts are coming? We'll never know that answer but we suspect the Fed sees meaningful progress on inflation as economic headwinds build which increases the potential for negative outcomes if real rates remain too restrictive.

In other words, real rates simply refer to inflation adjusted rates derived by subtracting inflation from nominal rates. In our discussion here, the nominal rate would be the fed funds effective rate which is currently 5.3%. Subtracting inflation of 3.4% leaves a real rate of roughly 2%. Presuming inflation continues to soften, and indications are it will, if the Fed does not adjust the overnight rate, it means financial conditions will actually be getting tighter.

Positive real rates are good for savers. If you are earning 4.5% on a bond or CD and inflation is at 3.4% you are increasing your buying power. The flip side of that is also true – if real rates were negative, you would be losing purchasing power.

For the economy and markets (and the Fed) – if positive real rates are too restrictive for too long it is problematic because that means borrowing and financing is more expensive which impacts growth.

We devoted this newsletter to highlight a few things that have our attention because the roadmap in 2024 will likely be quite different than it was in 2023. We are committed to helping our clients navigate the market and economic cycles to achieve long-term financial well-being. We remain focused on managing risk, capitalizing on opportunities in the yield environment and maintaining appropriate equity exposure.

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.

Lastly, follow us on social and let's connect!

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