Winter 2023

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Recent Economic Events

The American economy turned in one of its most impressive quarterly performances in the third quarter. As per usual, the consumer was the star, but all the key players were contributors. Three factors appear to be instrumental: increased household wealth, a strong job market, and fiscal stimulus. The stock market is threatening all-time highs and housing prices continue to ascend. Unemployment has been below 4% for almost two years, the longest such streak since WWII excluding the early 1950s post-war boom and the late 1960s "Guns and Butter" stretch. A trio of Federal bills to improve American competitiveness has showered funding on infrastructure and new technology initiatives. The good news is that the strong economy has not reversed the progress on inflation. In fact, growth appears to be slowing price increases through gains in productivity. The bad news: A rising tide isn't presently lifting all boats. Credit stresses are becoming more noticeable, especially among lower-income households. And lest we forget, while interest rates seem to have peaked, they are still much higher than they were a year or two ago. This will have a significant impact on the future spending mix of the Federal government.

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Real third-quarter GDP clocked in with a remarkable 5.2% increase, the strongest since 2006 except for the Covid recovery quarters. Personal consumption accounted for the lion's share of the growth, but business and residential investment, net exports, and government spending were positive as well. Consumption is now tracking above the pre-pandemic trend, driven by both a $34 trillion jump in household wealth since the end of 2019 and record levels of employment. The former has supported strong spending among the more affluent while the latter has kept workers' income ahead of inflation. The one thing we can always count on is that if Americans have access to cash or credit, consumer spending will power ahead. Spending from accumulated wealth is more contingent than spending from increased income, but so far, consumers have been even more conservative in using wealth gains to fund spending than they were in the past. That bodes well for the future. So do the steady gains in jobs (up 199,000 in November) and average wages (up 4% year-on-year). Median wages, which sidestep the changing mix of workers, have advanced an even stronger 6%+over the past year. Union strikes and fear of unions have been key in the gains workers have achieved.

The relative shift towards labor power might have been expected to lead to increasing inflation. In contrast, booming productivity (up 5.2%) caused labor costs to fall by 1.2% during the third quarter. Maybe technology (AI?) is working its magic. All the different inflation metrics have slowed over the past year. Core PCE inflation, the Federal Reserve's

Recent Economic Events-continued

preferred measure, has decelerated to 3.5%. While this still exceeds the 2% target, the recent monthly figures imply even lower levels.

There are some clouds on the horizon. Lower-income households are feeling the pressure as higher interest rates and the resumption of student loan payments kick in. Banks are tightening credit as a result. Eventually, higher rates will impact a lot more than lower-income households. Top of the list: the Federal government. While deficit spending is now helping the economy, that is because the deficit consists primarily of spending (direct and for social insurance) and incentives for construction. As future expenditures shift toward increased interest on the debt, the stimulative impact will fade.

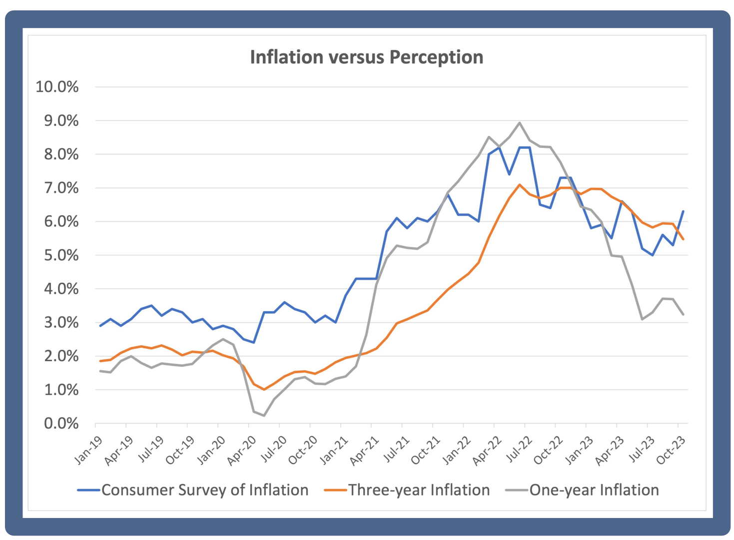
Was "Stranger Things" prescient in its discovery of the "upside down"? It certainly seems so when we try to apply previously reliable economic rules to the post-pandemic economy. Higher rates have not slowed the economy, and a strong economy has not boosted inflation. In this holiday season, perhaps we shouldn't look a gift horse in the mouth.

Commentary

Economists tend to get enthralled by their data. Because we are generally adept at math, we believe in numbers and their manipulations more than we should. This explains the disconnect between the general public's view of prices and that of economists and financial market participants. Inflation is the change in prices from some previous period. However, the choice of the previous period is entirely arbitrary. While media reports will focus on the one-year inflation rate, there is no psychological reason to expect that one year fits with human perception of things. The chart below shows both the three-year and one-year inflation rate compared to the consumer survey of inflation.

As you will note, the one-year rate moves much quicker than perception while the three-year average seems to track inflation expectations quite well.

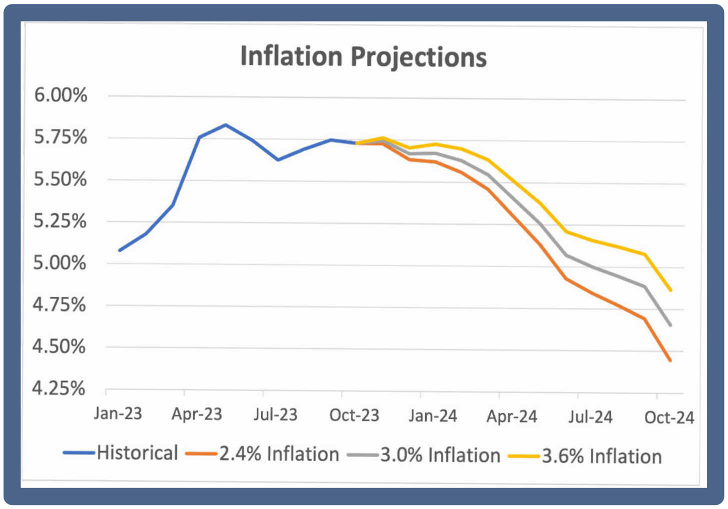
Market professionals use calculus, while everyday folks react to prices today versus those that they remember. For example, if I buy a car every three years, I will compare my last trip to the dealer to what I am seeing now. On the other hand, I buy gasoline at least weekly. Inflation statistics try to address the different time frames by considering an average market basket of consumer purchases. So, a car's price is phased in monthly rather than once every three years. Gasoline shows up each month. This results in a disconnect between the statistics and what consumers experience.



Commentary-continued

The annual time frame allows economists to talk about slowing inflation. Remembrance of things past helps explain why the local coffee klatch can bemoan the jump in the breakfast special price that took place two years ago when the diner reopened after Covid with a skeleton crew of servers

Now look at the second chart. It shows what happens to the three-year inflation rate assuming

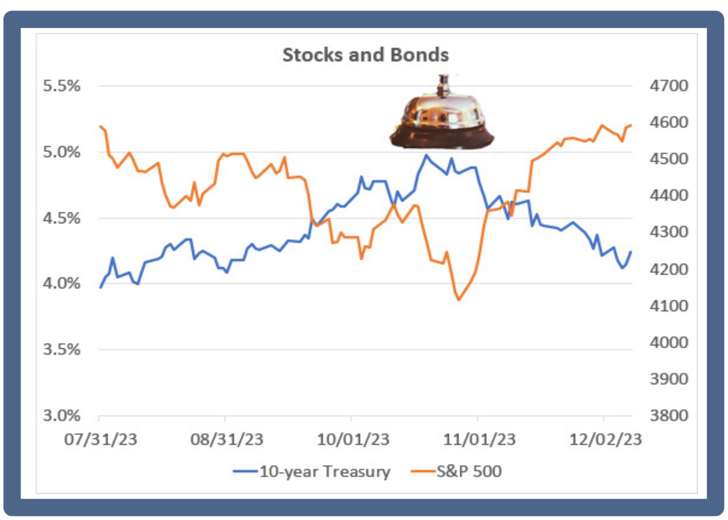


that inflation runs 2.4%, 3.0% or 3.6% over the next year. All show some moderation, but none get to even the current annual rate over the time frame. It's this persistence of memory that has put the man on the street at odds with the markets, the Fed, and the economic profession when it comes to the perception of inflation.

Market View

They say that they don't ring a bell at the top or bottom of the market, but the unsuccessful push by the ten-year Treasury to exceed 5% in October was as close as they come.

Since then, Treasury rates have done a complete about-face, dropping by as much as 75 basis points. The stock market has jumped to levels last seen in late 2021, mostly erasing the painful 2022 drop. Gold is trading at an all-time high, and even Bitcoin has popped.



That's enough history for now. The question before us is, "What will the future hold?". To get at this, it is important to try to determine why the markets have changed course. The most obvious answer is that the successful defense of the 5% rate level has solidified the belief that we have seen the peak in both longer-term rates and the overnight rate set by the Federal Reserve. Known as the "Fed Pivot", it promises a turn to easier

Market View-continued

monetary policy with lower interest rates. While I agree that the high points for rates are now behind us, I am wary of the holiday euphoria that has gripped the markets. Given the dusting of snow that I see out my window, I might observe that financial prices have gotten out ahead of their skis.

Since I am skeptical of the speed of market movement, I would argue for a measured approach to investing at present. The last few weeks of the year are characterized by tax-loss selling and window-dressing. The former tends to further beat down those stocks with year-to-date price declines while the latter will boost those that have performed well. January normally sees some reversal of these movements. That suggests paring some winners before the ball falls in Times Square while looking for some beaten down but well-run companies to buy. Of course, it is easier to take gains if you can do so in a retirement account rather than setting yourself up for capital gains taxes.

I clearly think that the fixed income market is ahead of itself, but current rates in the two to three-year range seem high enough to protect against price declines were rates to go back up some. For those with a higher risk tolerance, mortgage-backed securities offer elevated spreads versus historical averages. Rather than purchase individual securities, I would lean towards mutual funds or ETFs for these items. Both Money Market Funds and bank CDs currently offer rates above 5%. That is an attractive low-risk option.

Commodity markets have been buffeted by both supply/demand swings and by geopolitical events. This makes them especially treacherous at present. Who would have thought that oil prices would be falling in the face of the Israel-Hamas war and OPEC supply cuts? While I am generally loath to venture into the realm of precious metals and crypto-currencies, both have broken out to higher prices recently. A small (no more than 2%-3% of your portfolio) commitment probably is warranted given the level of uncertainty in the world today. Remember that these are investments with no real intrinsic value. They only profit when things are going badly elsewhere.

My September recommendation of REITs and MLPs has worked well enough in to generating income rather than price appreciation. I continue to believe that it will do so. Green energy stocks haven't bounced much; however, they fit into the profile of beaten-down companies.

Editor's Notes

Since my last newsletter, I have experienced two life events. First, and most importantly, Susan and I are now grandparents. Our granddaughter was born in early October and is charming us with her gurgles and smiles. On the other end of the age spectrum, I celebrated my 70th birthday in November. I say celebrated because I have been about as lucky as one can be in getting to this age in good health. Susan contends my hearing isn't so good, but I don't notice that. After paying Social Security taxes for over 50 years, I will now become a drag on the system. Now that the page has turned, I find myself less inclined to increasing the Social Security retirement age and more inclined to higher payroll taxes. If the war of generations heats up, I plan to take my walker into battle.

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