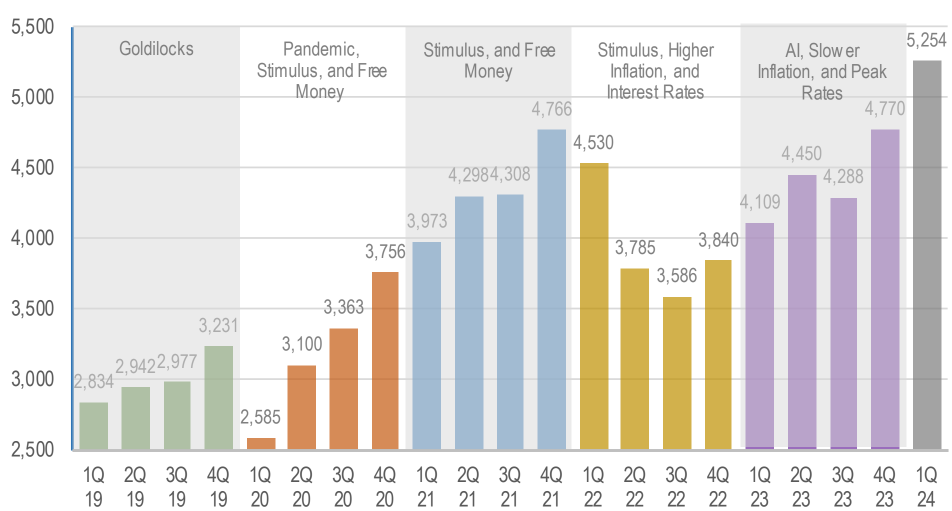
House View

1Q 2024
April 8, 2024

Good morning, and welcome to the House View for the first quarter of 2024. This House View summarizes our sense of the economic, financial, and investment landscape as we look forward to the rest of 2024 and 2025. We are predominantly US investors, although we have limited exposure internationally. Consequently, our House View is purposely US-focused. We conduct a relatively exhaustive quarterly comparison of the global investment opportunity set. There are scant justifications that lead us to reorient our view abroad. When, or if, that changes, we will adjust our allocations.

Equity markets were 10.2% higher for the first quarter than the fourth quarter of 2023, a remarkable quarterly gain. The driving narrative for equity and fixed-income markets was watchful waiting. Convinced that inflation and interest rates were at a cyclical peak, the pressing question was when rates were coming down and by how much. As 2024 burst upon the world, financial markets expected approximately seven rate cuts during the year, resulting in a year-end interest rate of 3.5%. As the quarter wore on, economic data revealed a US economy much more resilient than anyone expected. Consumer and government spending strengthened in the face of higher rates, mainly because the labor market has shrugged off layoff headlines from tech companies by quickly absorbing displaced workers and a flood of new entrants in the labor force.

S&P 500 Index Levels
(Source: Bloomberg)

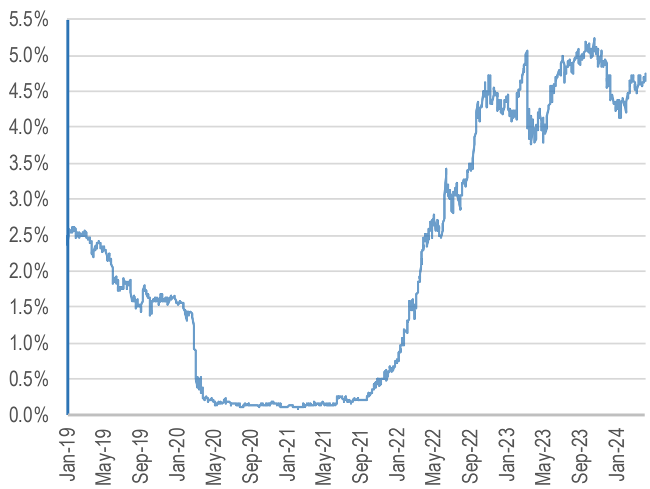


Markets in pre-pandemic 2019 were living the last full year of the Goldilocks era, where rates and inflation were both moderately low, corporate profit was predictable, and the macro environment sanguine. COVID-19 infections were high enough to be countable in January 2020. Government action was swift and decisive, resulting in a stimulus flow and free money through zero-bound accurate interest rates. While the pandemic was essentially in hand by the end of 2020, financial and economic impact propelled profits, markets, and transitory inflation through 2021. By early 2022, transient inflation looked more intransigent, resulting in a mea culpa from government policymakers and an about-face on zero-bound interest rates. With no sense of where things may settle, financial markets spent 2022 wallowing in uncertainty. Artificial intelligence, although far from certain, provided a salve for markets in 2023. Inflation also peaked, as did interest rates.

Forward expectations for interest rates in the United States have increased significantly since yesterday. Economic data for the first quarter continues to come in hotter than expected, while inflation, although still trending lower, is falling slower than expected. On Friday, employment data showed the US economy added 303,000 new jobs for March, approximately one-third more than expected. In response, yields on US government two-year bonds rose to 4.75%, an 11.78% jump from where rates settled at the end of 2023.

US Government Bond 2-Year Yield

January 2, 2019 - April 5, 2024
(Source: Bloomberg)



Our research focuses on one area outside US boundaries—artificial intelligence. US financial markets tend to reward pure-play artificial intelligence investments, while conglomerates are the rage in emerging markets. Reliance Industries, a large petroleum company in India, is developing a ChatGPT-like AI model with capabilities in 22 Indian languages. Local sense makes sense in a country with more than 1.4 billion people.

In addition, as the AI craze rages on in the United States, company values have become hard to justify in some cases. Meanwhile, outside the US, potential leaders look cheap for investors and equally compelling from an acquisition perspective for an AI player wanting to do a cannonball in a large domestic market.

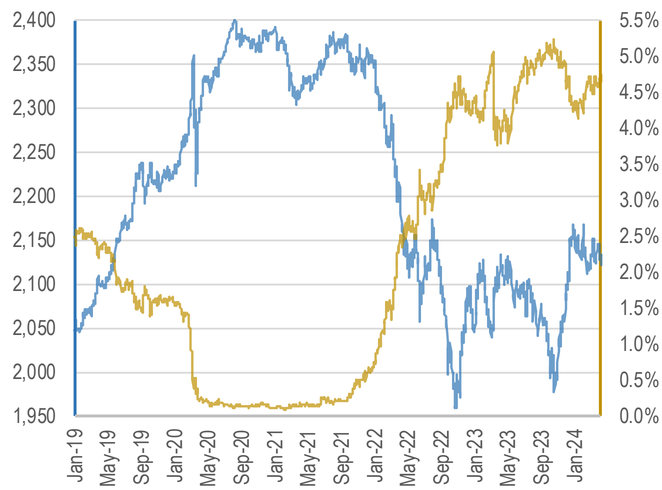
Our Weekender for April 6, 2024, published under a separate cover, summarizes this House View. Fair warning: This publication will use a lot of graphs. Stroke sufferers and candidates like myself should use caution. We suggest you consult a qualified financial advisor before making significant financial decisions.

Market Narrative

Fundamental fixed-income valuation theory and practice suggest that bond values fall as market interest rates rise. This relationship has held relatively steady over the last few years. We believe the Federal Reserve is eager to begin bringing down interest rates. While inflation hasn't yet reached its 2.0% target, it is slowly coming to heel. Interest rates significantly higher than inflation show a monetary restriction uncommon for the last fifty years. Most economists predicted that, given elevated interest rates, economic performance would dramatically moderate. Instead, the consumer, which drives more than 60% of US economic output, remains willing and able to keep spending on products and services. A strong consumer strengthens the foundation of an unexpectedly robust labor market.

Aggregate Bond Prices (Blue) and Yields (Gold)

January 2, 2019 - April 5, 2024
(Source: Bloomberg)



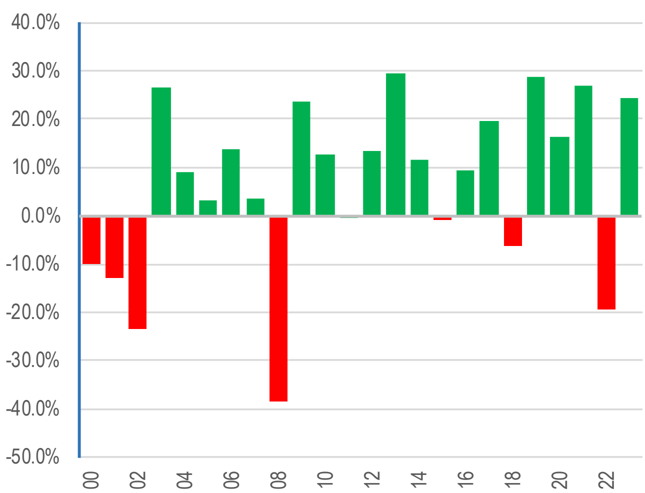
We believe the Federal Reserve is between a financial rock and a hard place. Inflation is slowly falling toward its objective in an environment of relatively strong economic expansion. If the Fed follows market expectations by lowering rates later this year, consumer spending may accelerate, increasing inflation's heat. Anyone with a modicum of economic experience is giving the Fed a bit of "side eye." Usually, rates are lowered to spur the economy toward growth, but the economy is doing just as well; thank you very much.

Financial markets now expect interest rates to fall to 4.7% by the end of the year. There is a significant expectation alteration, and some of the reasons markets have gone sideways for most of March. A dominant narrative for 2024, other than continued expectations of some degree of lower rates, has yet to emerge. Artificial intelligence is still a thing, and its long-term potential must be fully reflected in equity markets. But the end game for AI remains the stuff of science fiction novels, although it's likely to be upon us much faster than anyone expects.

As measured by the S&P 500, annual returns have been solid since the beginning of the millennium. Since the credit crisis in 2008 – 09, equity markets have experienced unprecedented expansion, even when accounting for the pandemic.

S&P 500 Annual Returns

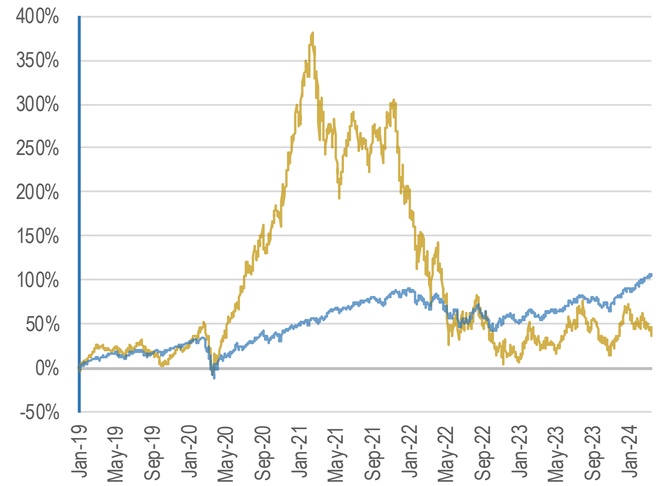
January 2000 - 2023
(Source: Bloomberg)



Focusing on the period from the beginning of 2019 to the present since it captures a bit of the pre-pandemic "normal" period in 2019, the pandemic periods of 2020 and 2021, and the pandemic recovery period from 2022 to the present illustrates some exciting insights. Equities, wildly speculative technology stocks that had yet to generate profits during the pandemic, took financial markets by storm, creating a bubble. This bubble has deflated over the last two years, and the drained equity capital found its way into yielding assets like fixed income and money market instruments.

S&P 500 (Blue) and Money Losing Tech (Gold) Cumulative Return

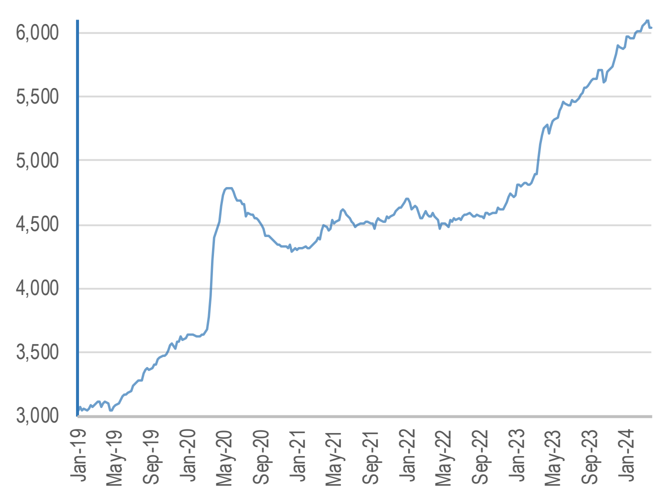
January 2, 2019 - April 5, 2024
(Source: Bloomberg)



Assets held within money market accounts continue to rise as a risk-free alternative to increasingly more expensive equities, yielding almost 5.0%. It's been decades since such an option was available to ordinary investors. The trillions of stored capital in money market accounts will be a cushion against any potentially significant fall in equity markets. If stocks fall, the dry powder in money market accounts will reach into stock markets and snap up values as they present themselves.

Money Market Assets (Billions)

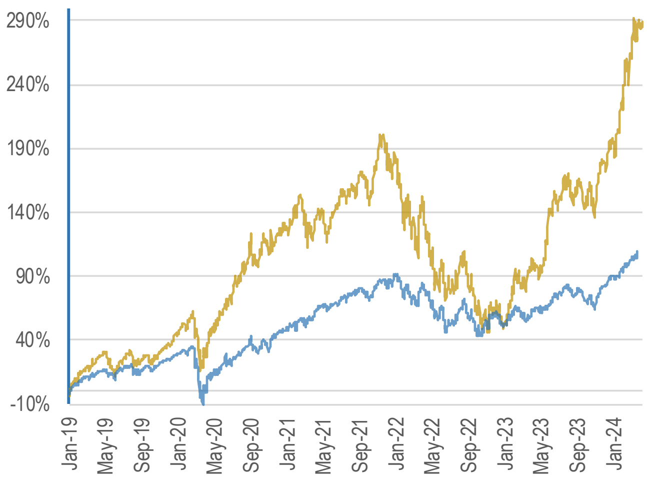
January 2, 2019 - April 7, 2024
(Source: Bloomberg)



While money-losing tech holds too much risk for our appetite, most of the expected early leaders in the artificial intelligence space are already profitable. We expect any expansion of artificial intelligence to expand margins and refine the ability of corporations to target potential customers in a way that will drive operating efficiencies and operating margin growth. The opportunity to invest may have already passed for many companies involved in artificial intelligence. We do not concur. Instead, our view is that the impact of artificial intelligence on markets, corporations, and humanity has only just begun. While some of the hype may be overdone at present, the investment characteristics for the theme are likely to heighten in the months and years ahead.

S&P 500 (Blue) and Artificial Intelligence (Gold) Cumulative Return

January 2, 2019 - April 5, 2024
(Source: Bloomberg)

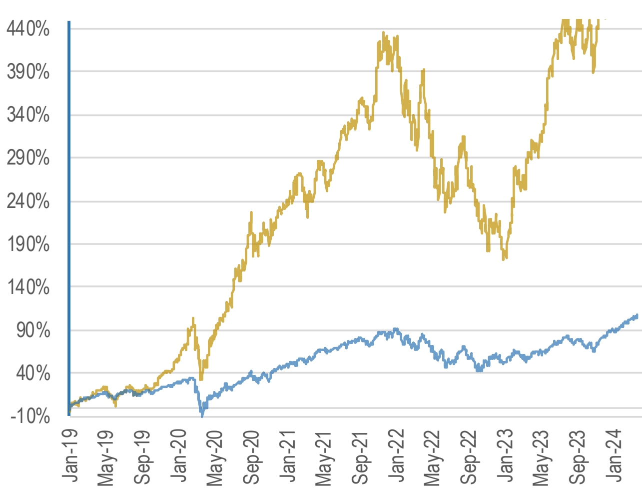


Magnificent Seven (-2)

As artificial intelligence took center stage in financial markets at the beginning of 2023, investment capital looked for the most likely early beneficiaries as a proxy. The usual suspects were the initial leaders, including Amazon, Microsoft, Meta, Tesla, Apple, Alphabet, and Nvidia. Last year, the magnificent seven rose 107.0% and is higher this year on a year-to-date basis at 17.8%.

S&P 500 (Blue) and Magnificent Seven (Gold) Cumulative Return

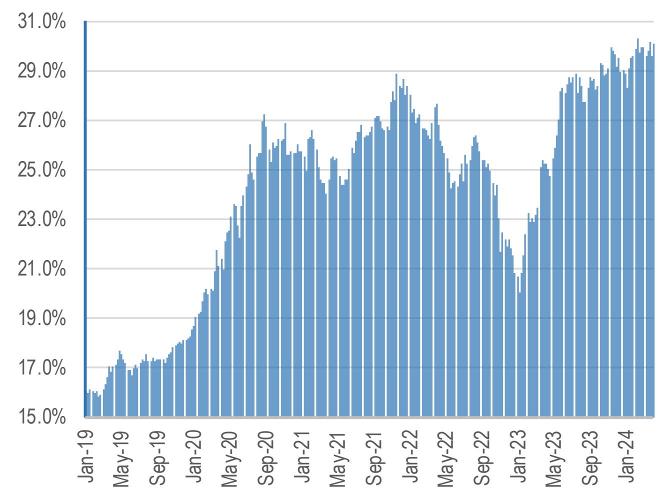
January 2, 2019 - April 5, 2024
(Source: Bloomberg)



Over the past year, the nature and impact of the magnificent seven on the broader market increased. The combined value of these stocks now accounts for 30.1% of the S&P 500 Index's combined market value of $45.4 trillion. More than ever, the fortunes of the magnificent seven will drive broader market outcomes.

Magnificent Seven Value as a Percent of the S&P 500

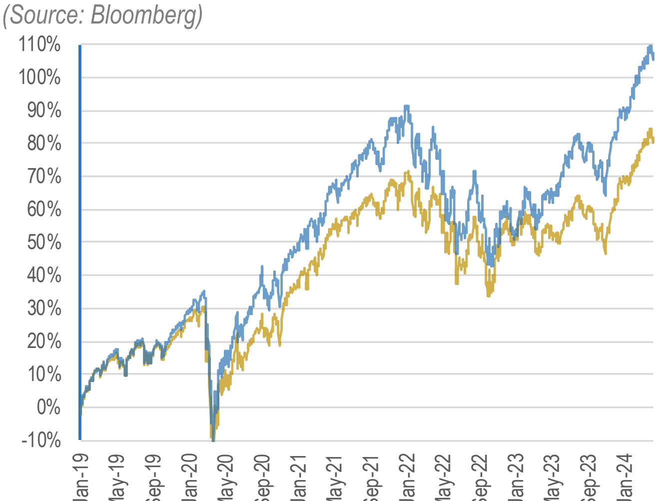
January 2, 2019 - April 5, 2024
(Source: Bloomberg)



When the Magnificent Seven are removed from the S&P 500 Index, the "return of the rest" is still inspiring. Since the beginning of 2019, the S&P 500 Index has been higher by 107.6%, while the S&P 500 Index without the Magnificent Seven is only higher by 81.7%, with a respectable annual return of approx-

S&P 500 (Blue) and S&P 500 without the Magnificent Seven (Gold) Cumulative Return

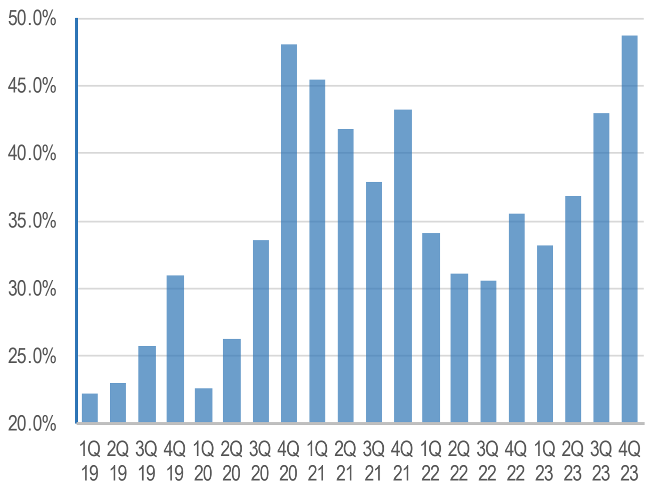
January 2, 2019 - April 5, 2024
(Source: Bloomberg)



imately 15.5%. Magnificent Seven performance is not just about price performance. For the first quarter of 2019, the combined operating cash flow of the Magnificent Seven accounted for 22.2% of the combined cash flow of all 500 members of the S&P 500 Index. At present, the similar contribution has more than doubled to 48.7%.

Magnificent Seven EBITDA as a Percent of the S&P 500

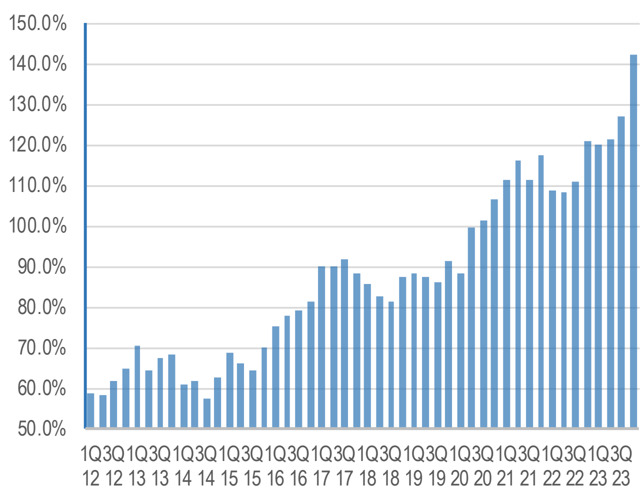
1Q 2019 - 4Q 2023
(Source: Bloomberg)



Looking a little farther back, the contribution of the Magnificent Seven to the combined retained earnings generated by members of the S&P 500 was 58.8%. Today, it is 142.2%, suggesting that many other members of the S&P 500 generate a significant retained earnings deficit.

Magnificent Seven Retained Earnings as a Percent of the S&P 500

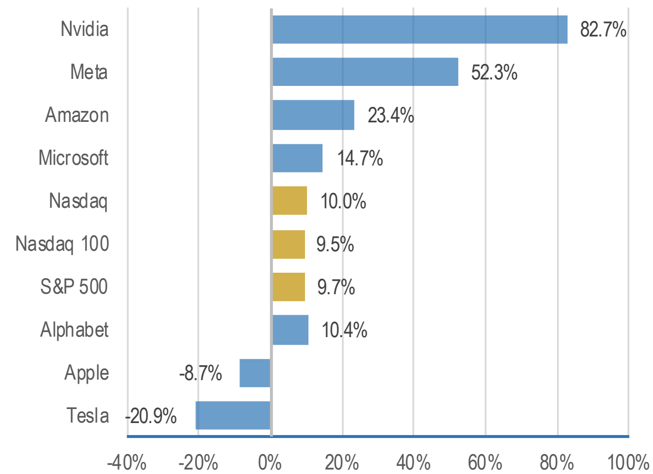
1Q 2012 - 4Q 2023
(Source: Bloomberg)



The Magnificent Seven powerfully manifests changing market dynamics. Companies are getting larger and larger, and their influence on broad markets cannot be underestimated. Investment outperformance is increasingly more accessible in such an environment when one knows and accurately predicts the performance of market whales like the Magnificent Seven. But they are not all magnificent—at least not this year. Nvidia, Meta, Amazon, and Microsoft have generated price returns that exceed the broader market year-to-date, Apple and Tesla less so.

Year-to-Date Return for Magnificent Seven

January 2 - April 5, 2024
(Source: Bloomberg)

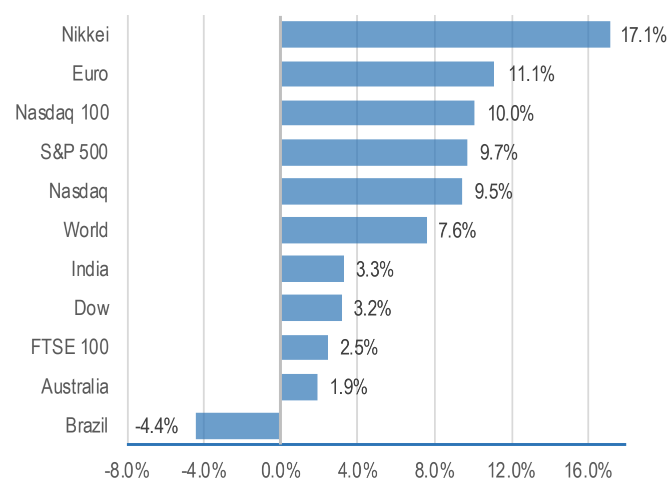


Countries

While our model portfolio remains heavily weighted to the United States, for diversification purposes, positions in international funds provide some diversification. On a year-to-date basis, the Japanese Nikkei is the best performer, higher by 17.1%, but that's in local currency. The Japanese yen has ex-

Year-to-Date Return for Countries

January 2 - April 5, 2024
(Source: Bloomberg)



perienced significant depreciation over the period. On a dollar basis, the index is higher by 8.4%. Europe's return is similar. In Euros, it is higher by 11.1%, but in dollars, only 8.9%.

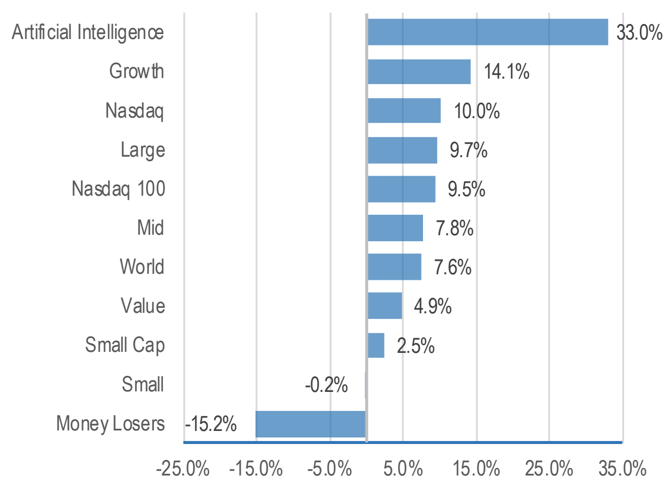
US financial markets are broader and deeper than any global alternatives. However, valuations in most US asset classes are getting a bit stretched. Consequently, if US valuations reach unwarranted extremes, we may look further afield for opportunities.

Instruments

Year-to-date returns by equity class confirm artificial intelligence as a leading investment theme, showing significant follow-through from last year. Semiconductors were the primary driver in the gains for artificial intelligence, and Nvidia was a key driver. So far this year, growth outperformed value by a wide margin, and the future promise of money-losing stocks gave in to the make money now mantra taking over since the pandemic froth blew off by the end of 2022.

Year-to-Date Return for Equities

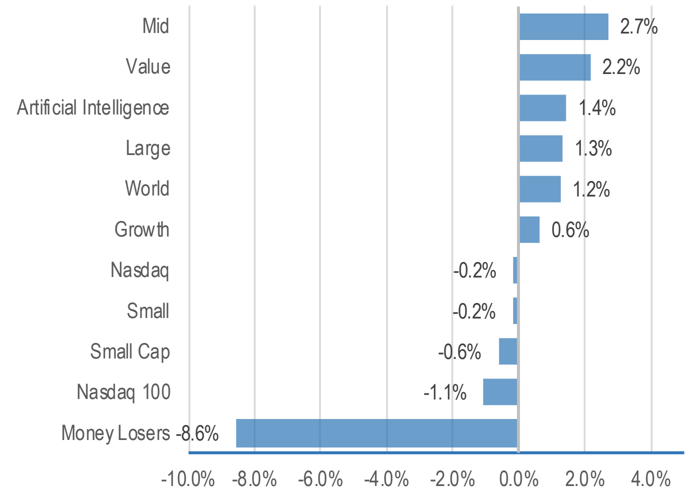
January 2 - April 5, 2024
(Source: Bloomberg)



Tightening down the date range a little to show equity returns from the beginning of March to the present shows the early stages of a rotation. While a return to ultra-low interest rates favors growth stocks, higher for longer is the friend of value names. Investors rewarded value over growth from March 1, 2024, to last Friday.

Month-to-Date Return for Equities

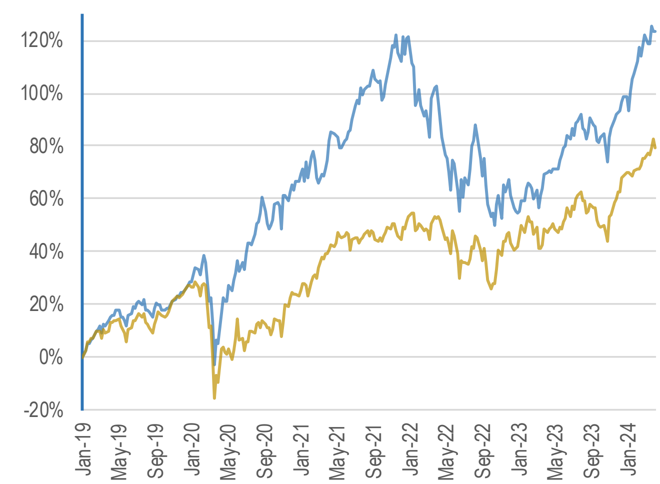
March 1 - April 5, 2024
(Source: Bloomberg)



Since the free money giveaways in 2020, growth and value have separated, with value experiencing dramatic underperformance. We expect the performance gap between development and value to shrink over the next year.

Growth (Blue) and Value(Gold) Cumulative Return

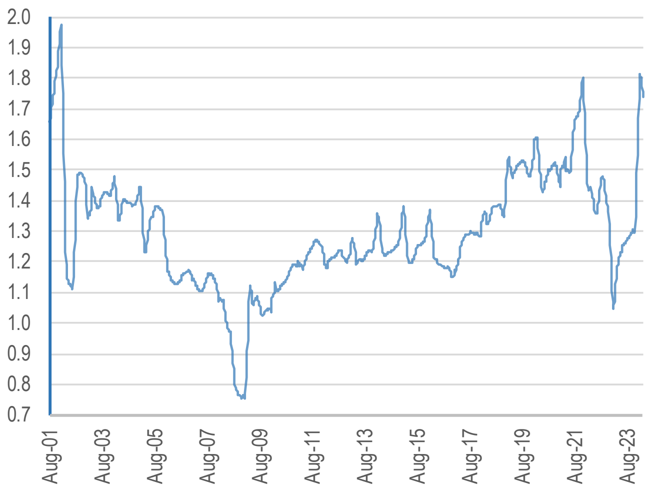
January 2, 2019 - April 5, 2024
(Source: Bloomberg)



A fundamental justification for growth-to-value gap shrinkage is likely to be valuation. The growth ratio to value price-to-earnings ratios is currently close to peak levels. In all previous environments where such a discrepancy exists, a rotation returned to balance, resulting in a drop in growth and a rise in value. Higher interest rates for a more extended period are a typical market catalyst for such a move.

PE of Growth Divided by Value

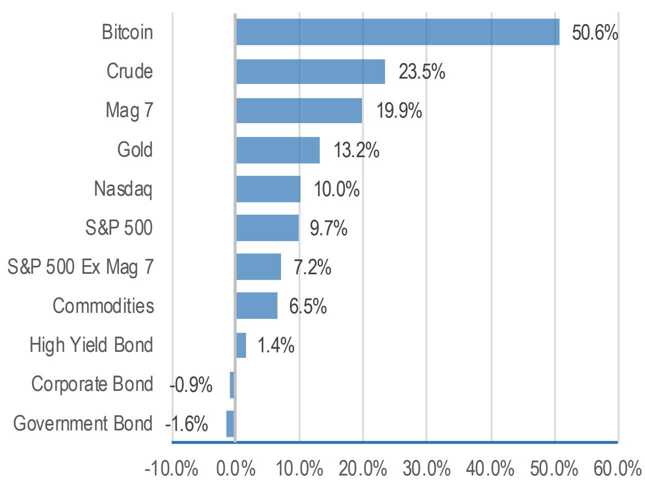
August 2001 - April 2024
(Source: Bloomberg)



Looking at instruments year-to-date, bitcoin was the undisputed leader by a wide margin. A broader acceptance of cryptocurrencies as an asset class and the recent introduction of several traded crypto-oriented exchange-traded funds (ETFs) also had an impact. True believers suggest that crypto, in general, and bitcoin, in particular, are exerting their legitimacy as an asset class. They contend that with government spending out of control and tenuous global monetary structures, the superiority of crypto is increasingly apparent.

Year-to-Date Return for Instruments

January 2 - April 5, 2024
(Source: Bloomberg)

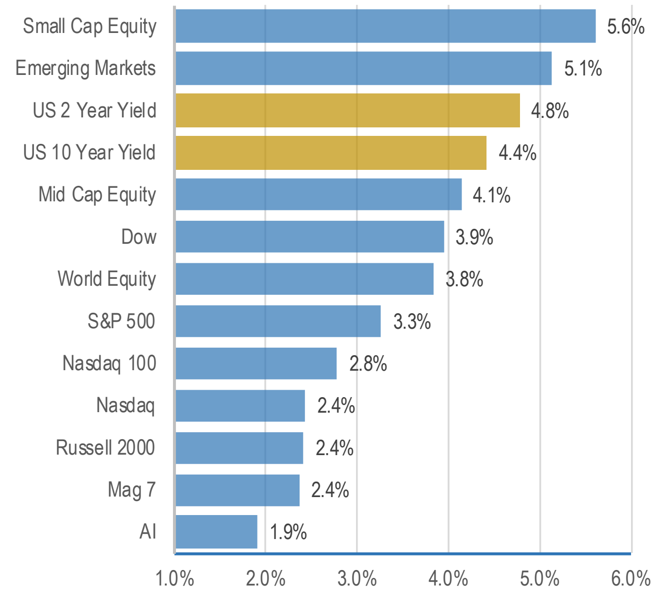


We contend that cryptocurrency is a legitimate asset for long-term investors, as a pet rock is a heritage gift. No government will permit a group of villains, wells, and conspiracy theorists to dictate its monetary system. China has already outlawed crypto. Most other nations or sovereign groups will develop their digital currency within the next few years to preserve the integrity of their monetary tools.

On valuation grounds, we are beginning to see some cracks in the market. Consider the free cash flow yield of significant equity indices compared to risk-free government bond yields. At present, investors are not adequately compensated for taking on equity risk, but that's acceptable if interest rates fall significantly shortly. However, if rates remain higher for longer, the near-term fundamental justification for equities versus debt is harder to justify.

Free Cash Flow Yield

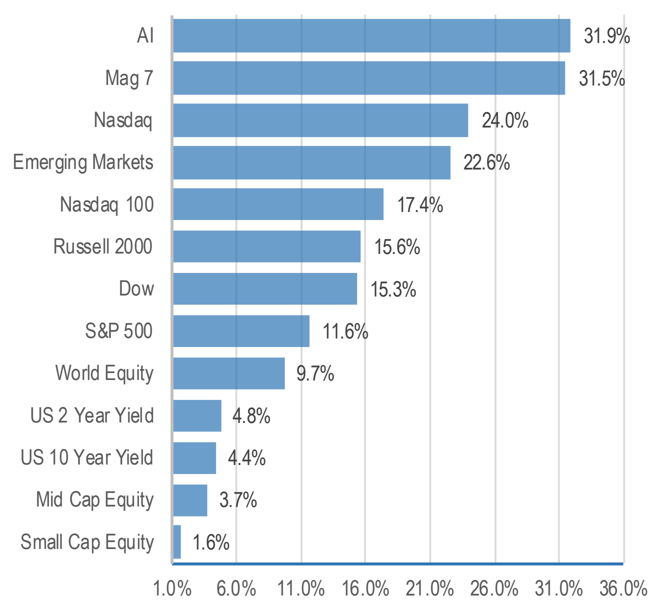
April 5, 2024
(Source: Bloomberg)



While the income from fixed-income securities does not grow, the market value of the bonds will likely increase as mar-

Free Cash Flow Yield plus Growth

April 5, 2024
(Source: Bloomberg)



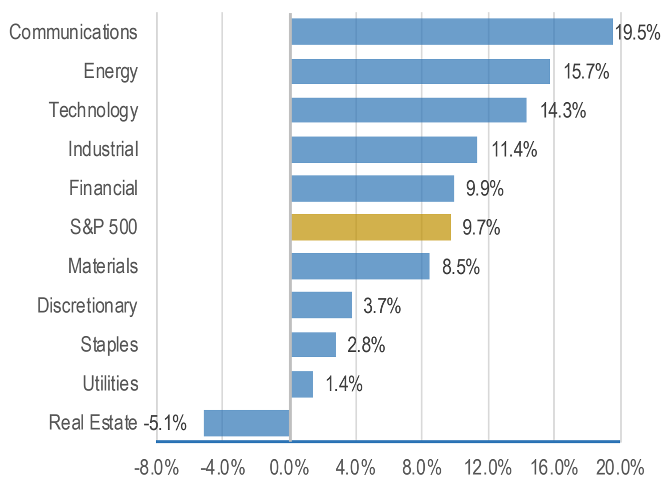
ket rates fall. A lower interest rate in the future is also favorable for growth stocks, of which artificial intelligence names rank highly. Taking the free cash flow yield and adding the expected growth in free cash flow over the next year, a projected total return, assuming valuation multiples remain constant, suggests an AI-driven market still has some legs.

Sectors

Most sectors are solidly higher on a year-to-date basis. Given higher mortgage rates, giving real estate a pass is fair. Builders are still doing well, given the insatiate demand for new homes in almost every part of the United States. Commercial real estate is another ball of worms. While some companies have "insisted" employees return to work at least a few days per week, office space still shows a level of vacancy that will take a couple of decades of consistent growth to overcome. Office towers in some cities are being sold at prices that recently cleared markets twenty years ago.

Year-to-Date Return for Sectors

January 2 - April 5, 2024
(Source: Bloomberg)

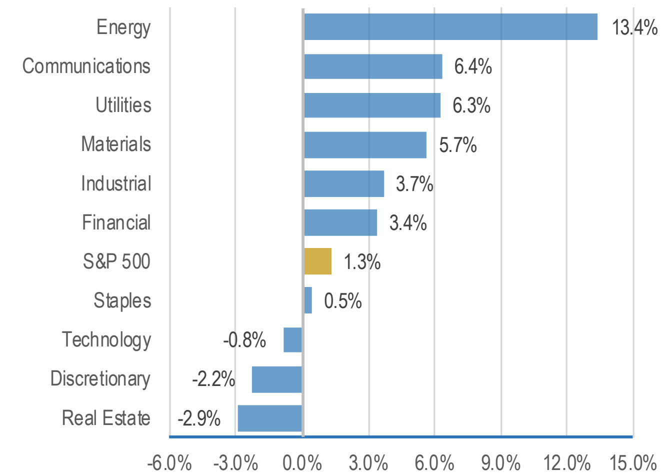


Communications' outperformance is driven primarily by the AI names classified in the sector. Energy is one of the sectors most likely to be heavily impacted by artificial intelligence. AI data models already provide vastly better predictions of pipeline outages and repairs, routing, and well completions. But none of that is driving energy. Energy's relative outperformance comes from higher oil prices and a stronger-than-expected global economic backdrop. West Texas Intermediate (WTI) closed at $86.91 per barrel on Friday. Brent was at $91.17.

Over the last month, a powerful rotation has shown deference to the regular economy. Since the beginning of March, energy is higher by %13.4%, by far the best-performing sector.

Month-to-Date Return for Sectors

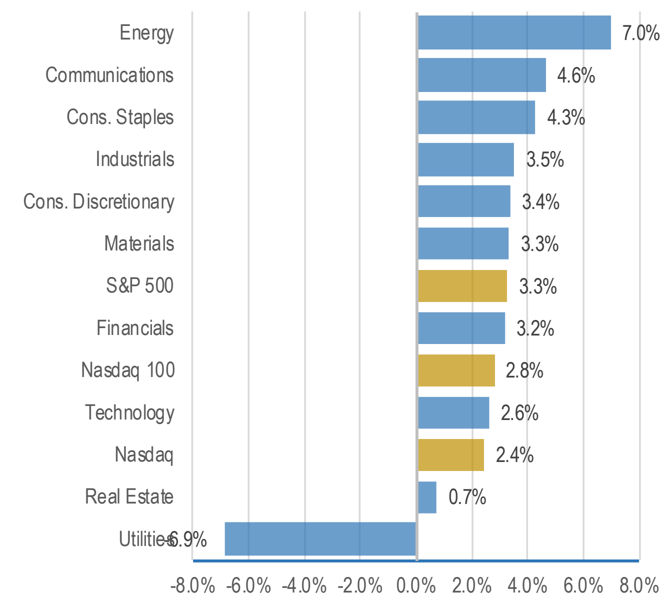
March 1 - April 5, 2024
(Source: Bloomberg)



Considering where opportunities still exist, energy is still the most undervalued in free cash flow yield. Utilities almost always have negative free cash flow due to their capital—and investment-intensive business models.

Free Cash Flow Yield

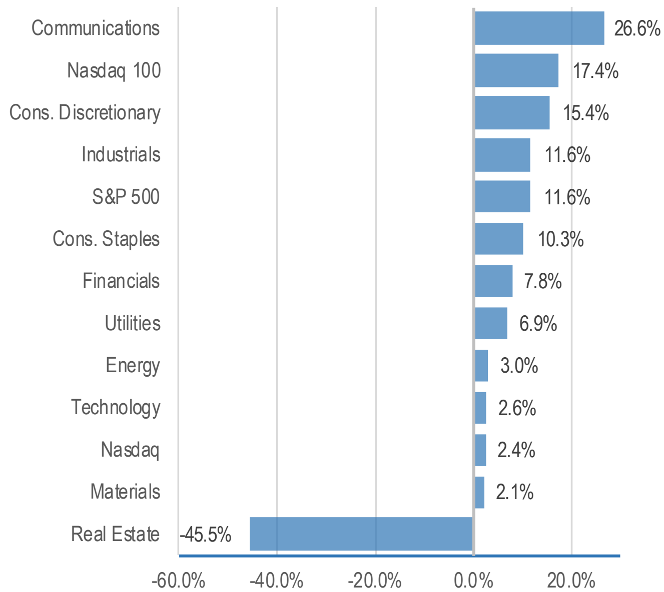
April 5, 2024
(Source: Bloomberg)



Providing a growth overlay on sector-free cash flow yields as we did with investment instruments confirms the previous insights.

Free Cash Flow Yield plus Growth

April 5, 2024
(Source: Bloomberg)



In broad strokes, we believe the data suggests a continuation of our investment thesis from last year. AI-related growth will move from trinketry applications like ChatGPT to fully integrated applications for consumers and corporations. However, we continue seeking lesser-known names likely to benefit from the expected economic landscape. We expect rates to remain higher than expected for the rest of the year. Having been far more robust than expected, consumers will be forced to begin slowly retrenching, driven by the realities of spent stimulus, peak debt loads, exhausted savings, and falling but still too high inflation.

Economic Narrative

We have argued that the economy would slow but not suffer a typical recession without a significant break in the labor market, and we continue to hold that view. From an investment perspective, we suggest dancing with the partner who brought us to the ball. This view presupposes a particular economic background, which we will describe in this section of the House View.

Unlike our previous House View publications, this one will start by answering a few questions from friends, colleagues, and clients. We will then examine the six factors essential to understanding where the economy is headed. These include: 1. Consumer strength; 2. Inflation; 3. Interest rates; 4. Labor; 5. Geopolitics; and 6. Corporate profits.

Questions

A year ago, pundits and experts predicted an imminent economic recession. Why hasn't it happened? Is it still coming?

As the pandemic broke upon the world in the closing days of 2019, infection and death rates went from being inconsequential to catastrophic within thirty days. Governments around the world took drastic and immediate action. Forced to stay home from work, the unemployment rate shot up to 14.8%, higher than at any period since the great depression. Body bags piled up in morgues around the world, and in larger cities, refrigerated trucks were brought as temporary storage for the deceased. No one knew when or if it would end.

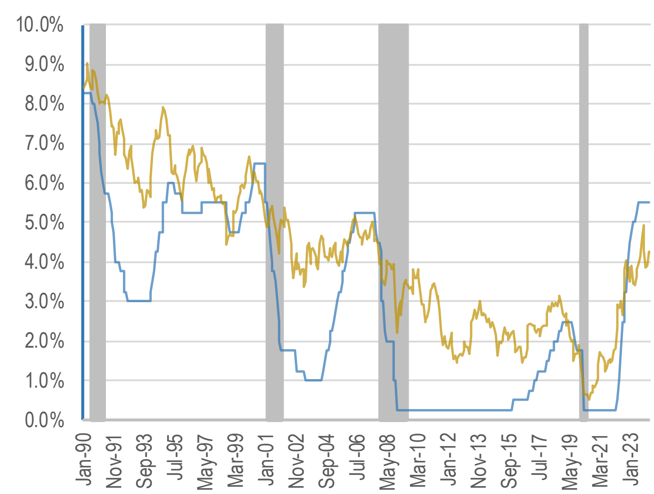
Monetary authorities worldwide pushed policy interest rates to some of the lowest rates in history while increasing the size of their balance sheets by buying government securities and flooding their financial systems with unprecedented liquidity. On the fiscal front, stimulus payments were granted to almost every sector of the economy to attempt to keep the wheels on the bus.

What we did not know then but seems beyond obvious now is that too much liquidity, stimulation, and generosity was injected into the economy and pockets. From the comfort of their couches, consumers spent the ill-gotten booty on products, stocks, and eventually premium travel experiences, all of which combined to push prices for products and services higher as too much money chased too few goods.

During regular economic cycles, periods of economic

Fed Rate (Blue) and US Government 10-Year Bond Yield

January 1980 - March 2024
(Source: Bloomberg)



growth and expansion are characterized by a fully employed labor market, access to capital and debt, and a willingness of individuals, corporations, and governments to spend. As the cycle peaks and begins to contract, governments typically pursue similar actions to those in the pandemic economy. The difference is that government intervention begins after a recessionary downturn is assured in most economic cycles. These actions are designed to cushion the economy from a hard landing and increase aggregate demand to shorten recessionary periods.

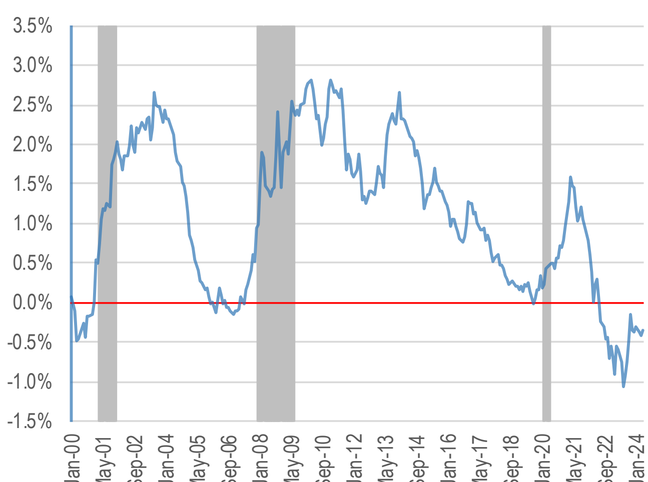
In the case of the pandemic economy, the remedy (stimulus and low interest rates) was applied before the recession caught hold. The US and global economies are still working through the stimulus funds provided during the pandemic. Trillions of dollars in approved stimulus remain unspent by government departments. While interest rates have fully recovered and appear restrictive, significant amounts of the unprecedented cash stimulus remain and continue to support the economy above its standard run rate, making a proximate recession unlikely.

Why is the yield curve still inverted if the economy is doing fine? Should we be worried?

An inverted yield curve is a common early predictor or manifestation of economic recession. It exists when longer-dated government bonds generate a yield lower than similar bonds mature earlier. When longer-dated bonds have a lower yield than near bonds, it's a sign that markets expect interest rates to be lower, suggesting a recession may be on the horizon.

US 10-Year Minus 2-Year Yield

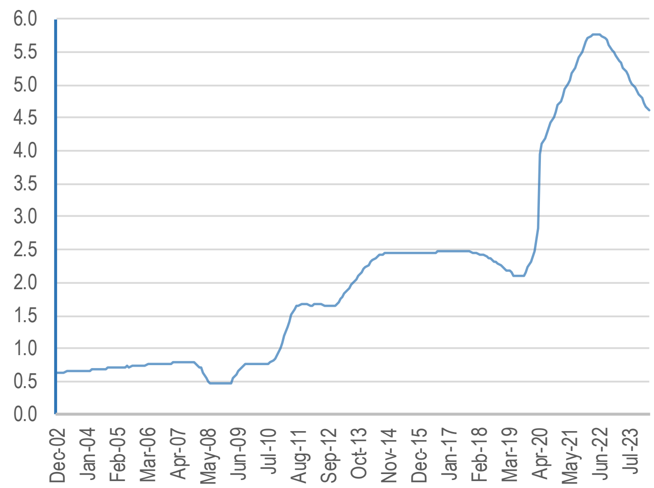
January 2000 - March 2024
(Source: Bloomberg)



In the graph, the blue line shows the difference between the US government's two-year bond yield and the ten-year bond. Using this measure in isolation suggests a recession may be imminent. Out of isolation, something interesting is happening that provides a bit of perspective.

US Treasuries Held by the Federal Reserve

December 2002 - March 2024
(Source: Bloomberg)



Leading up to the credit crisis, Federal Reserve holdings of US government bonds rose as the requirements of a modestly growing economy demanded. As a partial remedy to the challenges of the credit crisis, ownership of government securities rose dramatically but pale compared to their intervention during the pandemic. Since mid-2022, the Fed has been reducing the size of its balance sheet by selling government securities. This flood of sales combined with the unprecedented increase of bond issuance from the US Treasury. Increased supply of bonds tends to push their price lower, which increases yields. Since most of the securities sold by the Fed were shorter in maturity, the short end of the yield curve has been persistently high compared to its longer-dated peers, making the yield curve inverted.

Actions by the Federal Reserve shift the signal power of an inverted yield curve, leaving more noise than is typical of the tool. As the Fed continues to sell off securities from its balance sheet, the noise in this once-useful determinant of recession has lost some of its value.

Are we at risk of a similar credit crisis that occurred during 2008 – 09?

No, or at least not yet. At its most profound level, the credit crisis was caused by an inappropriate movement of mortgages from the bank lending channel into the capital markets.

This mispricing of mortgages and related securities knocked on liquidity and solvency, reverberating throughout the US economy.

Regulators are always fighting the last war, which means a repeat of the credit crisis is unlikely, although it's certainly possible a different type of crisis may emerge. Large banks are very well-capitalized and pose no meaningful risk to the financial system.

Smaller banks, sometimes called regional banks, tend to hold a disproportionate amount of commercial real estate loans, which will be increasingly problematic. Higher interest rates for longer will also hurt the value of bond holdings at banks. More notable is that credit card delinquencies at small banks are rising rapidly. Typically, credit card delinquencies rise during periods of economic distress. This time, they are increasing due to remarkable economic strength.

However, the likelihood of another credit crisis similar to 2008 – 09 is low, and potential red flags have not yet become visible.

Is now a good time to buy a house?

No idea is the easy answer. An answer requiring a little more introspection is also a bit more nuanced. Residential real estate expresses remarkable regional phenomena. Areas with net inward migration and strong regional economies continue to record upward solid housing pricing. Higher mortgage rates, tight inventory, and higher prices currently remove the most pressing interest in relocating. A strong labor market also makes relocation less urgent.

Waiting for a residential real estate downturn or collapse to provide an easy entry point may be long. Mortgage rates, which could significantly impact monthly payments, will likely moderate over the coming years.

Many economists predicted and expected a recession in the United States by now. Economists and analysts are known for always being certain but rarely being accurate.

Consumer

Consumer strength is bounded by a combination of willingness and ability to spend. Getting the consumer right is critical to predicting the future of the US economy since approximately 70% of US economic growth comes from consumer demand.

Cumulative household savings, which includes total holding of checking and savings deposits and money market investments, has come down significantly, suggesting the consumer has blown a lot of their dry spending powder. Consumers save almost nothing on each marginal dollar earned while consumer credit is at all-time highs. We believe stimulating the consumer before the pandemic continues to support consumer spending on services and products. As savings continue to erode and credit becomes increasingly heavy, the consumer will begin to pull back.

Willingness is a function of how the consumer envisions their future. Consumer sentiment is generally a valuable indicator of willingness to spend, and it had been rising from a multi-cycle low in June 2022. The primary reason for the low was inflation, which had not been heard of since 1980. But now, as inflation softens, sentiment is rising.

A strong labor market with little angst about the future of one's employment options unlocks consumer wallets. Unemployment is close to all-time lows but rising modestly to 3.9%, suggesting most people have jobs. In the main, those who do not have jobs are transitioning from one to another or don't want one. JOLTS data suggest 1.4 job openings for every unemployed person. While this ratio has come down significantly from its peak while pandemic shortages were being filled and revenge travel was at its peak, it is still well above its pre-pandemic levels.

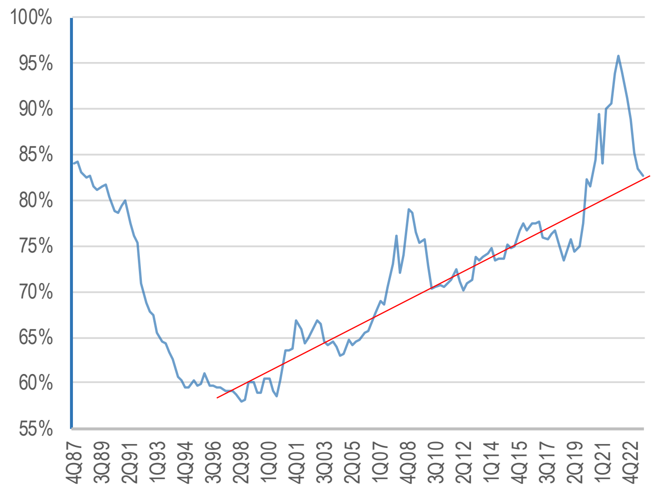
An ability to spend, meaning having the money or access to it, starts with having an income that grows faster than inflation, which was negative in the post-pandemic period when inflation was rising fast but has turned positive since May 2023. In short, the foundation of economic strength is a consumer with a job and many alternatives, with higher incomes than inflation.

The impact of government stimulus programs continues to support the consumer and is likely to do so through at least the rest of 2024. The income-to-spending ratio remains uncharacteristically low, suggesting consumers spend most of their earnings and put very little into savings. However, the consumer war chest that has been tucked away remains formidable.

Consumer savings, including checking accounts, savings accounts, and money markets, are indeed being spent down. Household savings as a percentage of disposable income have now fallen to the trend.

Cumulative Household Savings Percent of Disposable Income

4Q 1987 - 4Q 2023
(Source: Bloomberg)



We don't know where the economy would be sans the pandemic-era government largess, but we will find out. As consumer liquidity continues to erode, consumer spending will tighten.

As further confirmation, the growth in consumer credit continues to fall in the face of higher interest rates and tighter lending standards. The kindness of strangers will not keep the consumer afloat.

We expect the consumer to remain relatively strong while labor markets are robust. However, as government stimulus funds are exhausted and credit cards maxed, consumer spending will slow at lower income levels, leading to lower demand, increased layoffs, softer prices, and lower interest rates.

Inflation

Inflation is generally measured at the producer and consumer levels. Producer inflation is a function of commodity prices, labor, imports, and housing.

Inflation data was released this week, including consumer, producer, import, and export prices. All the data showed stubborn resistance. While the inflation rate is well off the highs from 2022, the prospect of getting the rate of inflation close to the Federal Reserve's target of 2.0% is looking remote in 2024. As we have mentioned numerous times, the last mile of the fight against inflation will be hard fought. Consumers expect inflation to be approximately 3.0% a year still ahead. The "higher for longer" interest rate mantra is directly tied to stubborn inflation expectations. Even so, we do not expect rates to stay at their current level.

Despite significant round trips in many construction-related commodities, like lumber, commodity prices are still 28% higher than before the pandemic. We do not anticipate commodity prices will fall considerably from here without a significant deterioration in the crude oil complex, which is unlikely given the disruptions in the Middle East and Ukraine and the pricing incentives of OPEC nations.

The price of labor, as manifest through real wage increases, continues to put upward pressure on product prices. We expect this to continue. We discuss work in more detail below.

Import prices are influenced by several factors, including shipping, the relative strength of importing countries, and the domestic demand for products. Whenever we look at import prices, we are, in effect, looking at China. During the pandemic, container prices from Shanghai to Los Angeles exceeded $12,000. As demand fell, prices also fell, although they have recently increased due to global uncertainties in the Middle East. In the leading, import prices have been contracting, not just rising less than previously. Domestic demand in China continues to weaken in the face of a potential residential real estate bubble that dwarfs the mortgage crisis in the United States by many orders of magnitude. Most of Europe is on the edge of an economic recession, especially Germany, the largest exporter.

At the consumer level, inflation is similar to a tax on spending. The US consumer price index continues to moderate, but the early easy drops have been taken. Getting consumer inflation closer to the Federal Reserve's 2.0% target will take time and patience. Used car prices continue to fall from their peak during the pandemic. We expect this to continue as new car inventory continues to build. On the stickier side, home prices are moving in the wrong direction, primarily driven by a relatively low inventory of single-family dwellings.

US government bond break evens suggest that inflation in the coming year will likely trade closer to 3.0% than the Fed's target).

Interest Rates

Expectations of higher inflation follow higher interest rates. At the beginning of the year, markets were convinced that a drumbeat of lower interest rates would begin in March. More robust economic growth and hotter inflation suggest there will be no interest rate race lower. The Fed will likely lower rates by Summer, but if the economy and labor markets remain robust, they will likely step back and survey their handiwork for the rest of the year. Interest rate markets are already trading toward our expected outcome.

Higher rates will keep mortgages high, and increasing defaults will pressure the spread of the 30-year mortgage versus the 10-year government bond yield, which is currently close to an all-time high. Higher mortgage rates have all but eliminated demand for equity-out refinancing. Most remaining mortgages are for new home sales, bringing mortgage demand back to the level of the late 1990s.

Over the medium term, interest rate levels will be driven by prospective inflation, which continues to moderate, and economic strength, which remains strong. A year ago, inflation was coming down, and the consensus was that the economy was slowing. This duopoly had the Fed on its toes, ready to goose the economy to keep it from recession. Today, inflation is falling, but not nearly as precipitously, and the economy shows no signs of slowing down. Current conditions are both providential and paradoxical for the Fed. They now have more time to decide to lower rates, but they don't know why or when they should do so. If the economy is doing just fine, thank you very much; lower rates could send inflation higher in a higher-rate environment. Their secondary mandate for keeping the labor market taut seems secure, confirming that things are okay.

Even so, government yields remain inverted, although by much less than they were. Several odd dynamics suggest that this time is different. Partial liquidation of the Federal Reserve's government bond holdings artificially keeps the curve's short-end high. In addition, altering capital requirements from banks has them holding more than they otherwise would.

Labor

By any estimation, the labor market is strong. Unemployment is close to an all-time low, although it ticked up to 3.9% in February, which is a meaningful move higher. There are still significantly more job openings than unemployed. One data point suggests the labor market may soon soften if only a little. The quit rate is decreasing, suggesting employees are less likely to leave one job for another. Now, from the book "This Time is Different." Tight labor markets put employees in the driver's seat.

Economists often discuss the long and variable lags that follow monetary and fiscal policy changes. In honesty, people are still determining when the full effects of pandemic stimulus will end or when the full restrictive power of higher rates will be fully felt. Some data suggest that things are getting closer to their pre-pandemic normal. For example, small businesses' assessment of whether difficulty hiring people is a prominent concern has fallen significantly and is now within the trend.

Working remotely continues to be a thing, and attempts to force employees back into the office have met with mixed success. Employees will likely keep the upper hand while maintaining labor conditions. However, the side hustle has become a powerful personal income accelerant since the pandemic. Business formations increased stepwise as soon as the pandemic lockdowns emerged and continue to hold higher than before the pandemic. A side hustle is more complicated to manage if employees work under the all-seeing eyes of managers in an office. For many, the side hustle brings in enough additional income to be more open regarding the demands of their day job.

On the labor inflation front, average hourly earnings rose 4.3% in February, year over year, showing that labor inflationary forces are not softening. Notably, wages are now growing more than inflation.

We believe the Fed's target interest rate of 5.5% is economically restrictive, although not enough to tip the economy into recession. As more evidence of softening demand manifests, the Fed can lower rates while keeping them in restrictive territory. Residential mortgage demand has fallen to levels not seen since the 1980s. A large part of the drop comes from equity withdrawal refinancings, which have gone from plentiful during the low rates of the pandemic to endangered today. Its spread above the inflation rate is 2.3%, which, in historical terms, is very restrictive. By the same metric, interest rates were more restrictive before the internet bubble recession and the credit crisis.

We believe the labor market will remain tight for the rest of this year. We expect a continuation of tech layoffs as they reconcile and size their labor components correctly after the pandemic hiring bloat.

Geopolitical

The global Woodstock moment of openness is over, and countries around the world are increasingly assembling in opposite corners of the ring, preparing for what will undoubtedly be increased conflict and the dismantling of the global trade apparatus. While this is not a positive outcome, it would be foolhardy to ignore it, and positive vibes and wishes were never anecdotes to tragedy. World War II is such a great example.

We believe the global political landscape will continue deteriorating, putting pressure on international trade agreements and relationships. The likely outcome will be an increase in reshoring and friend sharing. More manufacturing will return to North America.

Profits

A three-quarter earnings recession is now over, and payments are beginning to grow. Future earnings growth will result from reduced bloated inventories and a return to average margins, which have increased significantly since the pandemic.

Inventories rose to record levels during the pandemic's frenzy of stressed supply chains. We expected a well-endowed consumer to spend enough to eventually pull inventories down to more normal levels. That has not happened. Business inventories continue to hover at record levels.

We believe that as consumer demand softens, businesses must sluff off excess inventories, especially as holiday products arrive at the end of summer. Discounts will lead to slender margins and reduced profit expectations. We sense that earnings estimates have been and will continue to be adjusted downward, eventually leveling off at an earnings growth percent roughly in line with the inflation rate.

Conclusion

We believe the consumer is full. Savings are spent down, debt is at its peak, but the labor market remains strong. Retailers find that consumers are pushing away from premium brands in favor of value. Meanwhile, credit card delinquencies are rising. We think consumption growth will taper below the rate of inflation. Inflation is moving down but very slowly. The last mile will take longer and cost more; therefore, interest rates will need to be higher for longer. Stagflation increasingly looks like the likely outcome. The labor market will be key to whether the economy pulls off a soft, no, or hard landing. Currently, it defies gravity, and while there are signs of some weakness, it's not enough to cause concern. Geopolitics are a huge X-factor, but they don't tend to move the needle for economic growth or corporate profits, and profits are slowing in most sectors, except AI.

Disclosure Statement