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Economic & Market Summary
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Despite headlines of layoffs, job creation has been surprisingly strong and the labor market remains tight. The quit rate is still above pre-pandemic levels and job openings are plentiful. However, other data show a mixed view of the economy. Manufacturing activity is slowing, inflation is impacting consumer spending, and the housing market is weak. Inflation is trending downwards but remains at an unhealthy level around 5%.

With data softening and the Federal Reserve restricting monetary policy, many economists anticipate a recession. Economic forecasts are notoriously inaccurate and irrelevant for successful long-term stock investing. We don't know if a downturn is coming, but a period of slow or possibly negative growth seems probable. First, it takes six months or more for changes in monetary policy to fully impact the economy which implies more than a third of the Fed's cumulative rate hikes have yet to be felt. Second, lending standards are tightening and will probably tighten further given the recent high-profile collapse of several banks. This reduces the flow of money into the economy thus tempering growth. Finally, monetary policy will likely remain restrictive longer than expected. Prices on Fed Funds futures imply expectations of interest rate cuts later this year, but this seems premature in our view. Chair Jerome Powell persistently warns about the risk of easing policy before inflation is controlled and has suggested the bar for rate cuts is high. This has negative implications for growth. Notably, elected officials are making the Fed's job harder with aggressive spending and needless bickering over the debt ceiling.

While the economy may be slowing, we think rate hikes are ending. The Fed has raised interest rates twice this year but in smaller increments than the large hikes of last year. Projections from the Fed suggest one more small increase before pausing. On another positive note, several economic headwinds have reversed which could help offset restrictive monetary policy. Supply chain pressures have broadly lessened which reduces inflation. China has finally lifted its harsh COVID-19 restrictions which will benefit the global economy. So far, the economic fallout from the Ukraine/Russia war has been less than feared. Europe avoided an energy crisis over the winter and many commodity prices that spiked early in the war have dropped. Also, the dollar has weakened which will help US companies with large overseas businesses.

A softening economy seems only partially reflected in stock prices. Earnings estimates for S&P 500 companies have come down but still reflect expectations for positive year-over-year growth. This seems aspirational if the economy slows further. The price-to-earnings (PE) ratio for the S&P 500 is 18x this year's earnings which is close to historical norms and doesn't imply much pessimism. We think this is explained by expectations for rate cuts and the strong performance of a few high PE technology stocks that make up a significant weighting of the index. Consequently, stocks could see more volatility which is uncomfortable to experience but a gift to long-term investors. Stock prices overreact to bad news in the short-term allowing patient investors to buy great companies at bargain prices. Strong long-term fundamentals ultimately drive shareholder value creation and allow companies to manage through challenging times.

Mark J. Sprtel, CFA

If your financial situation has materially changed or you would like to discuss your accounts in detail, please contact your investment manager. To request our SEC Form ADV Part II, please contact Mark J. Sprtel, Chief Compliance Officer, at the address above.