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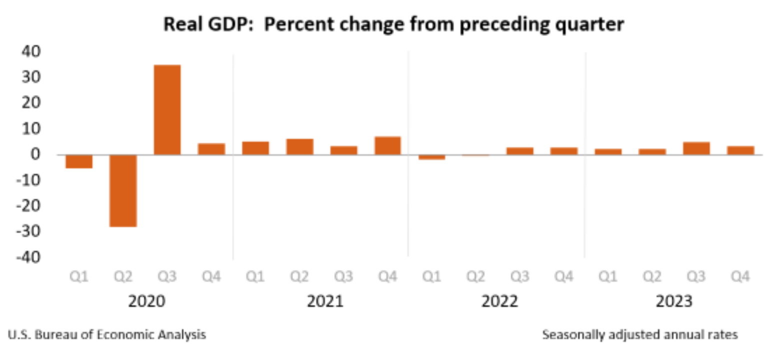
Mitch on the Markets

Portfolio Manager Investing Insights

The Unforeseen Resilience of the U.S. Economy

In a remarkable defiance of consensus expectations, the U.S. economy maintained a solid pace of growth as 2023 progressed—which was the exact opposite of what nearly every economist anticipated at the beginning of the year.[1]

According to the Bureau of Economic Analysis "advance" estimate, U.S. real GDP grew at an annual rate of 3.3% in Q4, following a 4.9% increase in Q3. Now, to be fair, growth slowed from Q3 to Q4, and the "advance" estimate for Q4 is subject to change. But in my view, the exact data points here are less important than the high-level takeaway, which is that the U.S. economy performed better than nearly everyone expected last year.[2]



BEA[3]

The most prevalent concern heading into 2023 was that the U.S. economy was spiraling toward 1970s-style stagflation. Instead, we got about 2.5% full-year real GDP growth, with inflation falling from 5.5% in January 2023 to 2.6% in December 2023 (headline PCE price index). Again, virtually the exact opposite of what many feared.

There is no environment more supportive of stocks, in my view, than one where we see this level of disconnect between expectations and reality. Looking ahead, I think that means more good news for investors in 2024. Americans are still largely unhappy with the economy, and consumer sentiment has only recently rebounded from levels last seen during the 2008 Global Financial Crisis. The calls for a

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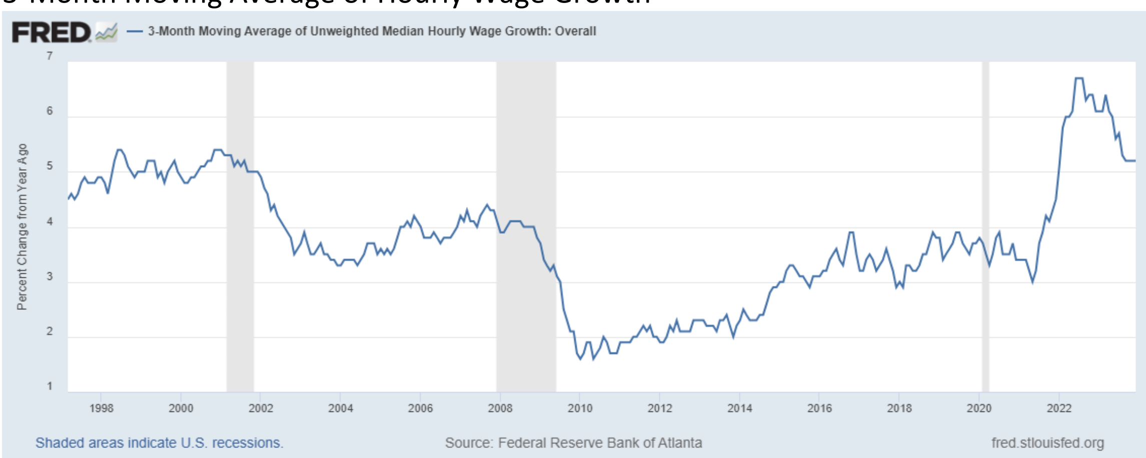
recession have abated, but I think we're still far away from pessimism turning into optimism or euphoria. In other words, the wall of worry remains firmly intact.

Meanwhile, economic fundamentals within the latest batch of real GDP data look encouraging. We saw less inventory build-up and lower government spending contributions in Q4 relative to Q3. In addition, key components like consumer spending, non-residential fixed investment (business investment), and residential fixed investment made positive contributions. Businesses spent more on intellectual property products, structures, and equipment.

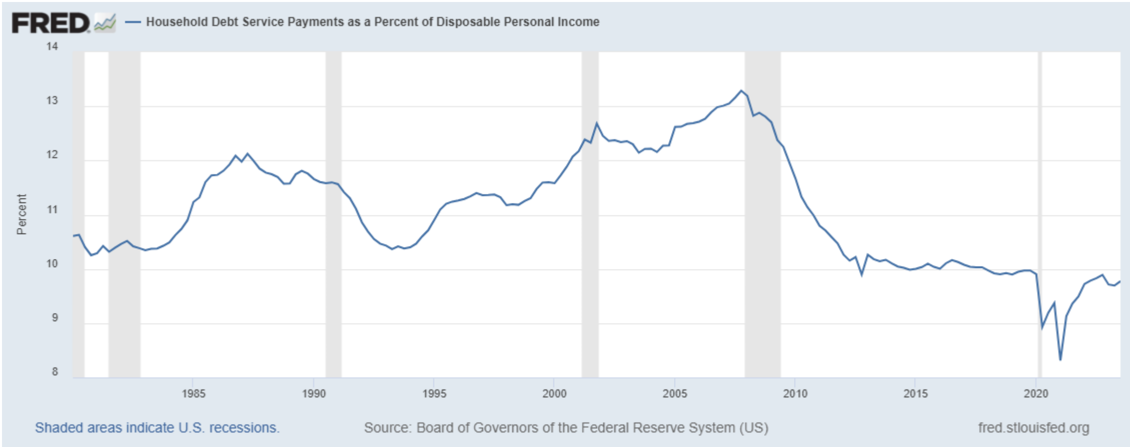
In the critical consumer spending category, we saw increases across both goods and services. In the services realm, Americans traveled more, dined out, and spent more on health care. In the goods category, consumers bought more recreational goods, computer software, and pharmaceutical products. I think there's a clear link connecting solid spending with rising wages and disposable incomes. Real disposable incomes increased 2.5% in Q4, and as seen in the chart below, wage growth continues to outpace inflation.

3-Month Moving Average of Hourly Wage Growth



Source: Federal Reserve Bank of St. Louis[4]

A narrative I saw appear throughout last year was that the U.S. consumer was on the brink of being "tapped out," with stimulus savings gone and the return of student loan repayments serving as a headwind. But this story has yet to show up in the data. As referenced above, wages are growing more quickly than inflation, the unemployment rate remains below 4%, and debt service payments as a percent of disposable personal income are at multi-decade lows (chart below). You wouldn't know it based on most media reporting and sentiment indicators, but American households are arguably better off than they have been in decades.



Source: Federal Reserve Bank of St. Louis[5]

Bottom Line for Investors

Even though most economists have backed off of recession forecasts, expectations for economic growth in 2024 are low. This sets up a relatively low hurdle for the U.S. economy to clear, in my view, and should bolster stock prices if economic growth continues on a better-than-expected track. I see economic outperformance as a distinct possibility as businesses are coming into 2024 leaner than they were in 2023, and with an earnings rebound in the offing. And consumers simply are not as tapped out as many expect them to be. They continue to benefit from higher wages, near full employment, and softening inflation.

And I didn't even mention rate cuts.

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[1] BEA. 2024. https://www.bea.gov/news/2024/gross-domestic-product-fourth-quarter-and-year-2023-advance-estimate

[2] A Wealth of Common Sense. January 26, 2024. https://awealthofcommonsense.com/2024/01/this-is-the-best-u-s-economy-since-the-1990s/

[3] BEA. 2024. https://www.bea.gov/news/2024/gross-domestic-product-fourth-quarter-and-year-2023-advance-estimate

[4] Fred Economic Data. January 10, 2024. https://fred.stlouisfed.org/series/FRBATLWGT3MMAUMHWGO#

[5] Fred Economic Data. December 15, 2023. https://fred.stlouisfed.org/series/TDSP#

STEADY INVESTOR WEEK

- **An update on the Fed and rate cuts**
- **Rising consumer confidence**
- **The status of tax cuts**

The Fed Disappoints Markets

The Federal Reserve ended its first policy meeting of 2024 last week, and investors weren't too happy with the outcome. As expected, the Federal Reserve held rates steady in a range of 5.25% to 5.5%. This decision came as no surprise. What markets did not appreciate, however, was the central bank's suggestion that rate cuts were not imminent in the spring, which goes squarely against the market's 50% odds that the first-rate cut would come at the March 19-20 meeting. To date, the Federal Reserve has largely tried to remain cautious in setting expectations for rate cuts. But what was unique and arguably disconcerting for markets last week was Chairman Jerome Powell explicitly stating that a March cut did not seem likely. The market wants to hear that the door is still open to a cut, especially considering the expectation for five rate cuts to 2024 versus the Fed's projection of three. Investors looking ahead in 2024 might reasonably consider this tension to continue playing out, with the market wanting one thing and the Fed delivering another. Chairman Powell stated that the Fed is not necessarily looking for further improvement in the data, but rather that inflation does not show any signs of picking back up. In our view, there is not a very strong rationale for keeping the Fed funds rate above 5% when inflation is below 3%. This level of restrictive policy is appropriate when the Fed is trying to push inflation down, but today the central bank just needs to keep it from going up.[1]

Consumer Confidence is Picking Up

American households held a dismal view of the U.S. economy last year, even as 2.7 million new jobs were created and as wages rose faster than inflation. Higher prices arguably outweigh everything when it comes to sentiment, and mortgage rates above 7% – accompanied by a tight housing market – also had many folks feeling dour about their economic prospects. It is early days, but things may be looking up in 2024. The Conference Board's consumer confidence index rose by 6.8% in January from the month before, with feelings about the business environment and jobs market hitting their highest level since the pandemic. Consumers no longer believe that jobs are "hard to get," and inflation expectations fell to their lowest level since March 2020. American households are also looking ahead and seeing the possibility, or even likelihood, of lower interest rates, which should reduce borrowing costs and bring home purchases back within reach. Gains in the Conference Board's measure of confidence was seen across all age groups, particularly the older cohort. Making plans for big purchases dipped a bit in January, but consumers also said they held favorable views on the outlook for their incomes and personal finances over the next six months.[2]

Could More Tax Cuts Be on the Way?

A new proposal delivering tax cuts for businesses and families has cleared a key hurdle in the House of Representatives, making its way out of committee with a 40-3 vote in favor. Some readers may be wondering: *Tax cuts? Aren't* *deficits and debt a growing concern in the U.S. today?* The answer is that this set of tax cuts is being funded by the proposed end of another tax credit, known as the employee retention tax credit, which was a pandemic-era tax credit that has been costing the federal government tens of billions of dollars – often becomes of claims made in bad faith or that were outright fraudulent. Ending that program would free up approximately $79 billion, enough to fund the newly proposed tax cuts through 2025. The new tax cuts would be ones many Americans are familiar with. On the business side, the bill would reverse a provision in the 2017 Tax Cuts and Jobs Act which said that businesses had to spread deductions for domestic research costs over five years, versus having the ability to take them immediately. The bill would also bring back full immediate deductions for equipment purchases, and ease a limit on deductions for interest costs. For American families, the bill focuses on the child tax credit, which is currently for $2,000 a child but is not all refundable. In the bill, the amount of the credit available as a refund would be raised to $1,800 for 2023 tax returns, $1,900 in 2024, and $2,000 for 2025.[3]

[1] Wall Street Journal. January 31, 2024. https://www.wsj.com/economy/central-banking/fed-leaves-rates-steady-and-opens-door-wider-to-cuts-d10a107d?mod=djemRTE_h

[2] Conference Board. 2024. https://www.conference-board.org/topics/consumer-confidence

[3] Wall Street Journal. January 30, 2024. https://www.wsj.com/politics/policy/tax-cut-loving-republicans-grumble-at-78-billion-in-bipartisan-tax-cuts-95f45132?mod=djemRTE_h

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