2023 | The Outook

January 2, 2023

Financial markets are coming off their worst year since the great financial crisis in 2008. Last year, fixed income investments suffered their worst year on record as interest rates broke their four-decade downtrend, and stocks suffered their longest prolonged decline in thirteen years. Global financial markets have now shed nearly $40 trillion of their market value.

Policymakers, professional forecasters, and investors remain generally cautious headed into the new year. Nevertheless, the consensus outlook is also the best case scenario where inflation declines steadily, but the economy doesn't slip into a recession (or at least only suffers a very mild one if it does). Inflation that failed to retreat as expected and/or a recession deep enough to weigh on corporate profits would likely make 2023 another tough year for investors.

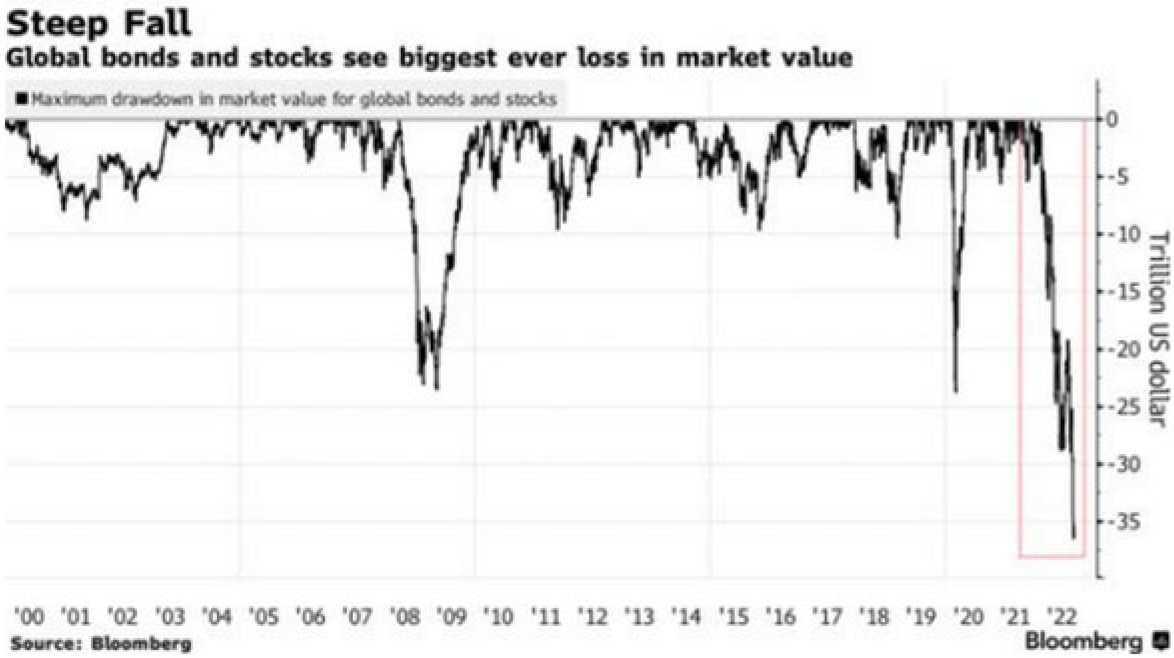
With margins still at historically high levels and earnings growth expected to remain strong despite the slowing economy, the potential for disappointing earnings appears to be the biggest risk for the market at the turn of the calendar year.

Projections for 2023 by Policymakers, Forecasters and Investors

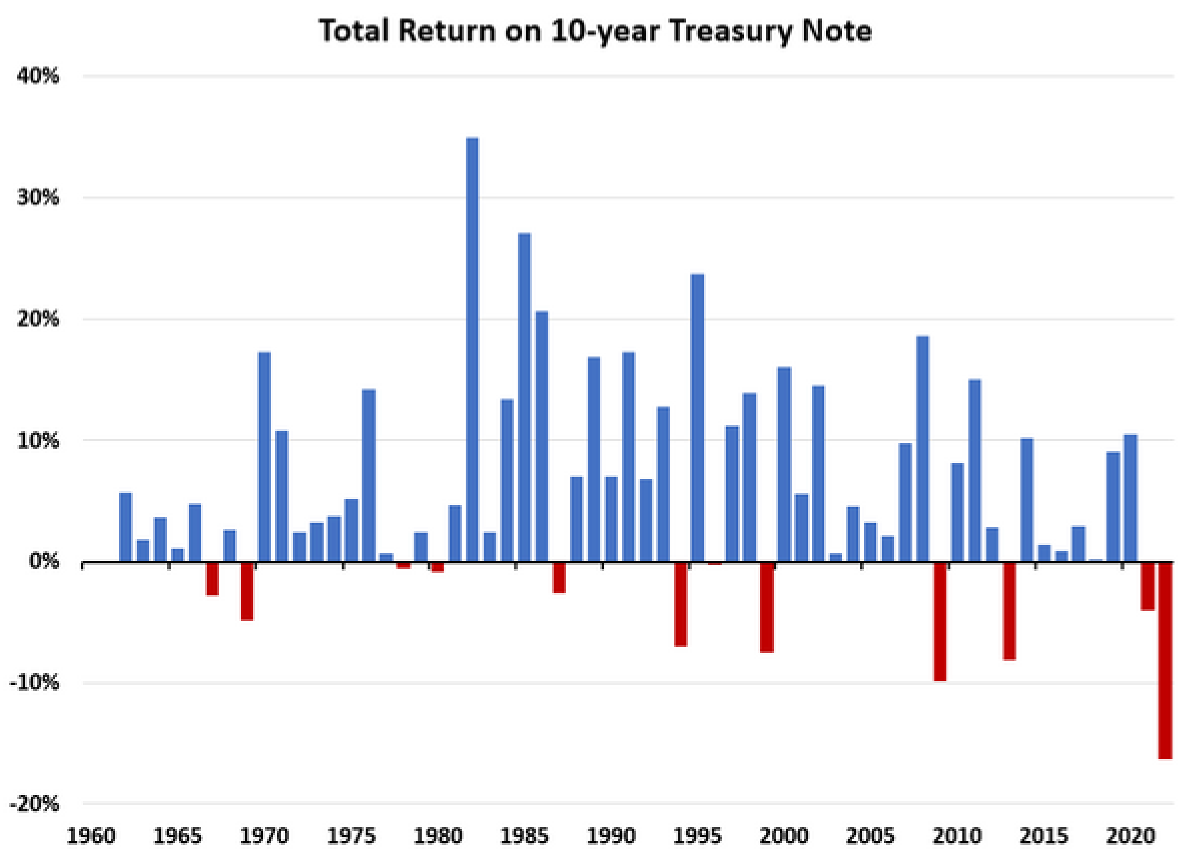
	Fed Policymakers	Professional Forecasters	Investors
GDP Growth	0.4%-1.0%	0.70%	N/A
Recession	No	Maybe, ~50% probability	Yes based on yield curve; Maybe based on the stock market
Inflation	~3.1% PCE	~3.4% CPI ~2.9% PCE	~2.6% CPI based on TIPS
Fed Funds Rate	5.00%-5.25%	4.3% (3-month T-bill)	4.50%-4.75% based on Fed Funds futures
S&P 500 Index	N/A	N/A	Down 11% to Up 17% based on market strategists' range of projections
S&P 500 Earnings	N/A	N/A	Up ~13% based on consensus of research analysts

Professional Forecasters projections from Philadelphia Fed's November Survey of Professional Forecasters.

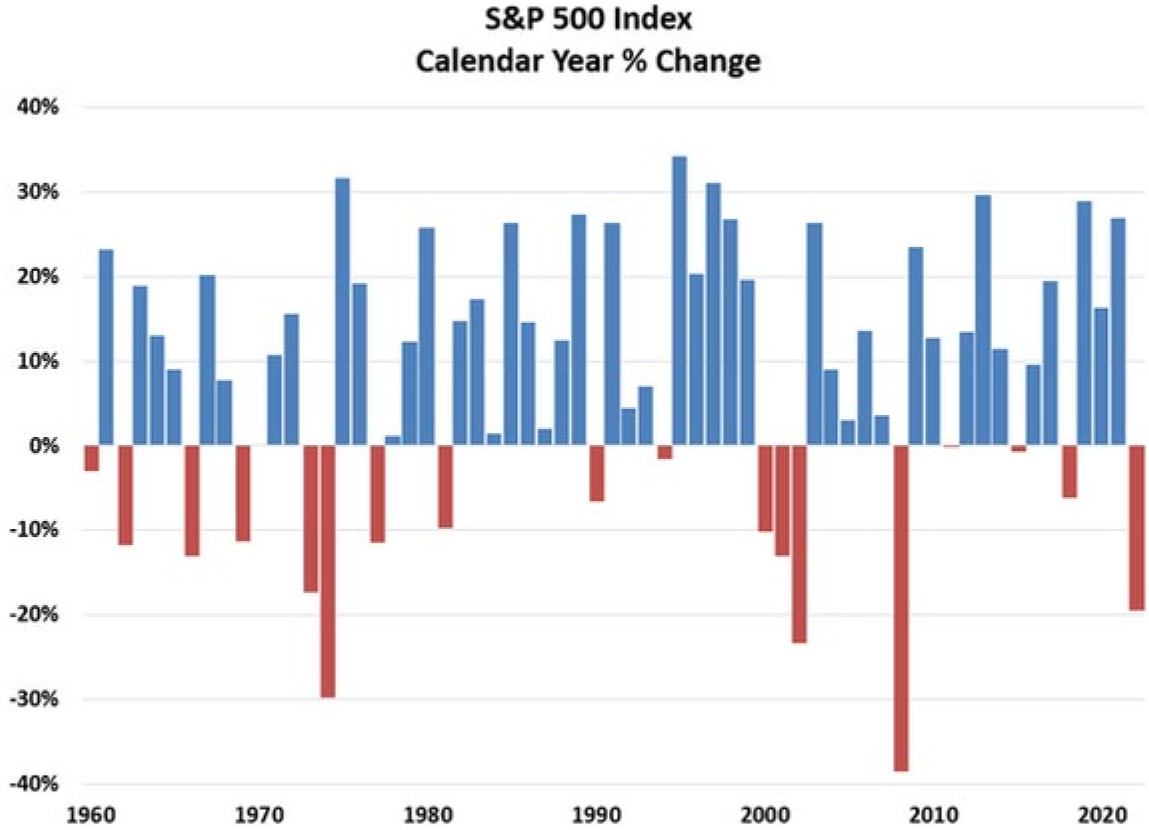
Steep decline in market value for bonds and stocks from historically extreme valuations.



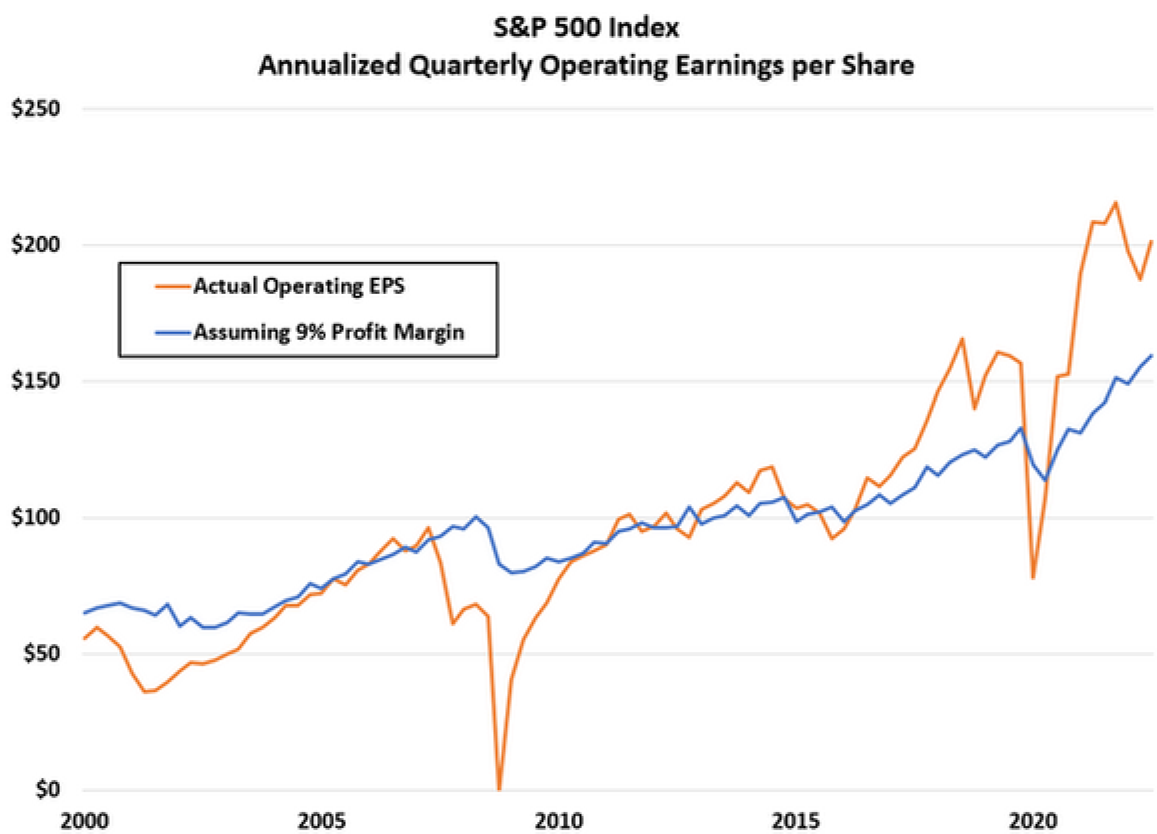
Long-term fixed income investments had their worst year in 2022.



It would be unusual but not unprecedented for stocks to decline in back-to-back years.



A big question for the stock market: how permanent are recent high profit margins?



Sources: https://fred.stlouisfed.org/, Federal Reserve, Bloomberg, YCharts, AOWM calculations

Labor Market | Strong employment, weak wages

January 9, 2023

The labor market remained generally strong in December with the unemployment rate falling to 3.5%. Instead of raising fears that the good jobs report might keep the Fed raising interest rates, investors seized on a slowdown in wage growth as a sign that inflation will continue to abate. While a potentially good sign for inflation, slowing wage growth is likely to add an additional headwind for the economy as wages fail to keep up with rising prices, hurting consumption.

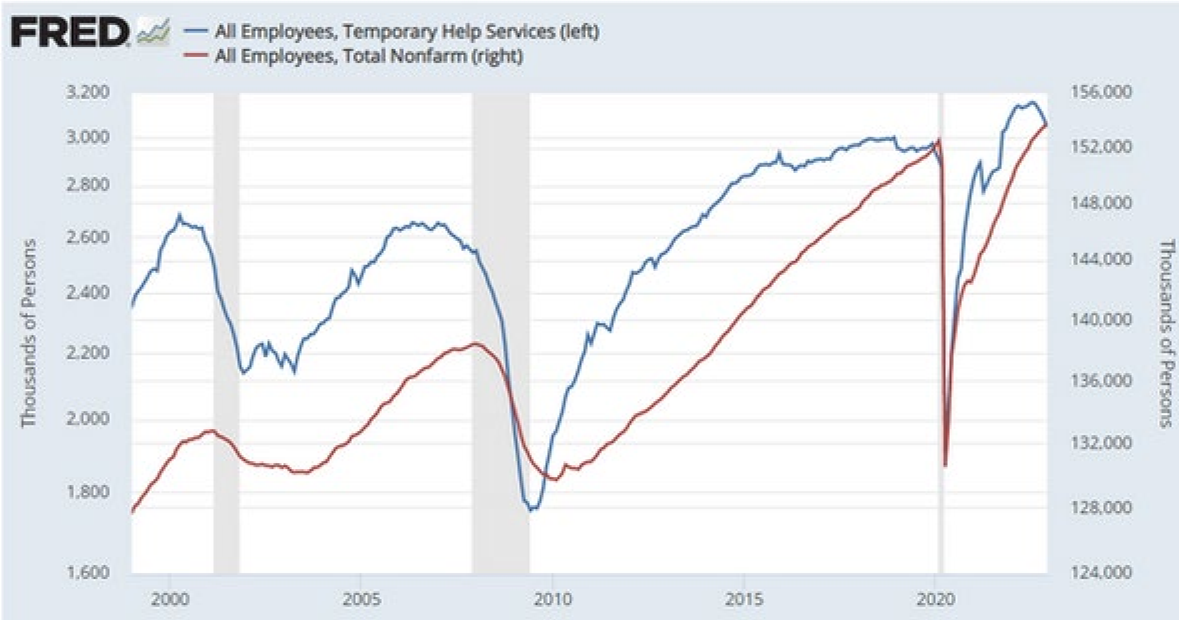
There were also signs under the surface that the Fed is being successful in slowing the economy. The number of new jobs added continued to decline to the lowest level in two years. In addition, the number of employees in temporary help services fell further which has historically been a canary in the coal mine for the broader labor market.

Investors are holding out hope that inflation will subside without a recession. However, state level data through November indicates that more than half the states are already experiencing negative labor market conditions which has historically implied a pending downturn for the national economy. Despite the positive market response to the jobs report on Friday, the odds of inflation retreating peacefully still don't appear high.

Labor market remained strong in December with unemployment falling to 3.5%.

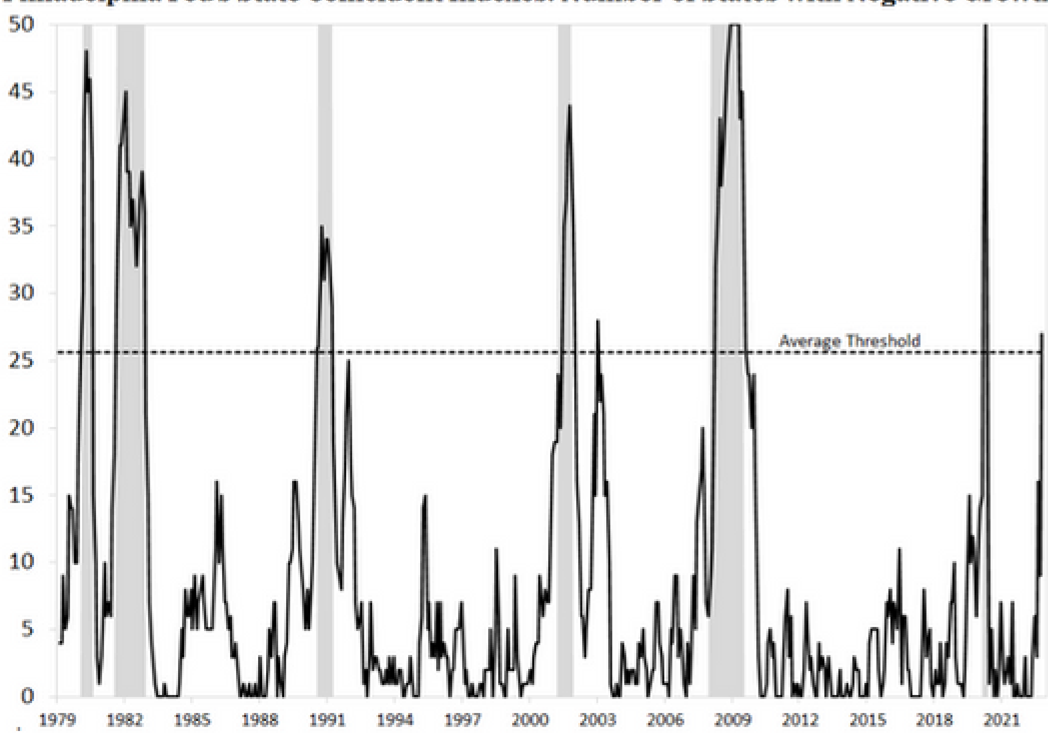
Slowing growth in average hourly earnings is a hopeful sign inflation will continue to abate.

A decline in temporary employees often proceeds broader weakness in the labor market.



More than half the states are experiencing negative labor market conditions.

Philadelphia Fed's State Coincident Indexes: Number of States with Negative Growth



Sources: https://fred.stlouisfed.org/, Federal Reserve, Philadelphia Fed, https://www.stlouisfed.org/on-the-economy/2022/dec/are-state-economic-conditions-harbinger-national-recession

Inflation | Mission accomplished?

January 16, 2023

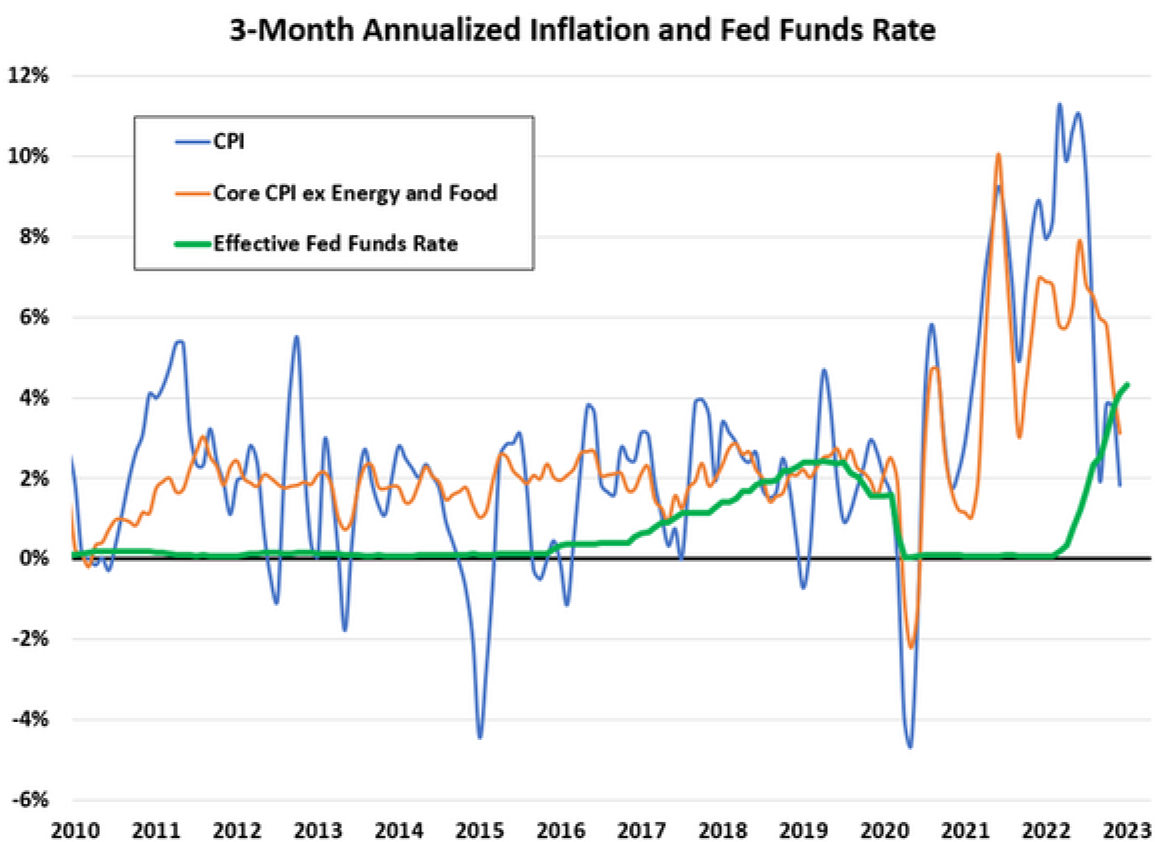
Annual inflation as measured by the Consumer Price Index (CPI) declined for the sixth straight month in December, down to 6.4%. Annual core inflation excluding energy and food also improved, declining to 5.7%.

Over the past three months, inflation has been running below 2% on an annualized basis, and core inflation has been close to 3%. As a result of declining inflation and the rapid increases in the fed funds rate by the Federal Reserve, real short-term interest rates based on core CPI eked backed into positive territory in the last quarter of 2022 after being deeply negative to start the year.

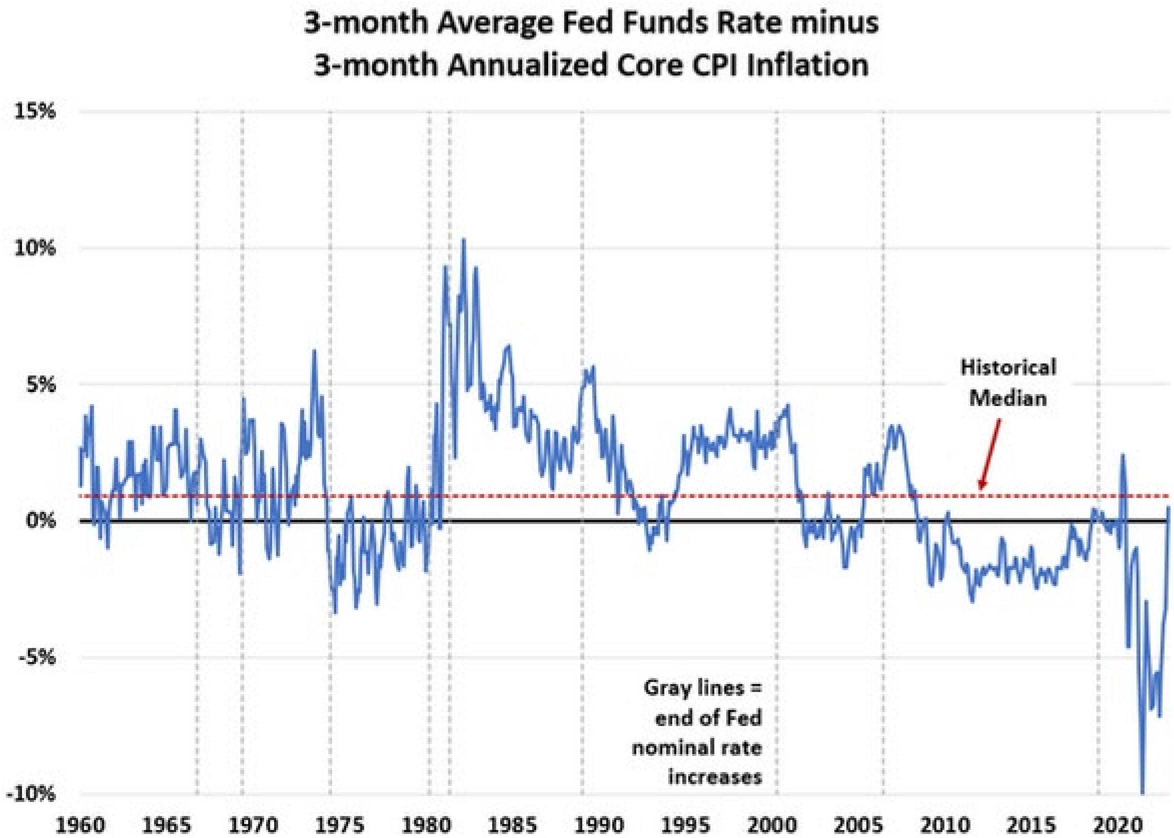
Inflation is unlikely to take a straight elevator back down to 2%, but it is definitely moving in an encouraging direction which has alleviated a lot of investors' concerns even if they remain overly optimistic about how quickly the Fed will stop raising rates and reverse course.

The past few years have highlighted how little is understood about how inflation works, so policymakers are likely to stick to their plans for raising the fed funds rate above 5% for an extend period to ensure that the stake has been thoroughly run through the heart of inflation. If the markets and economy continue to motor along without any great unhappiness, there will be even less incentive for them to do otherwise.

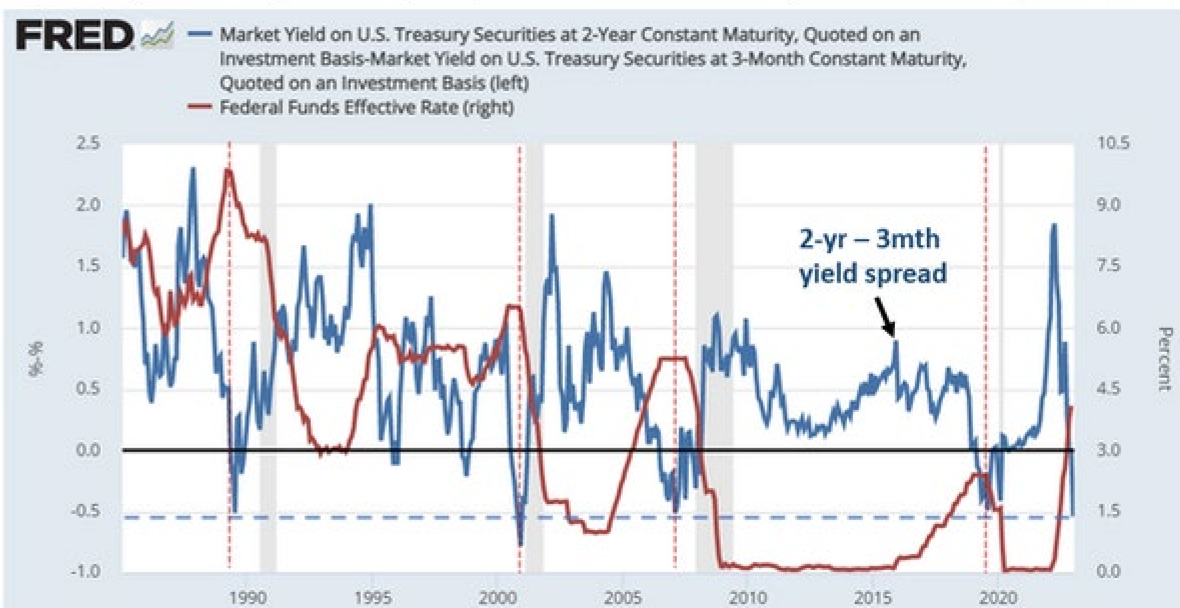
Inflation over the past three months is now below the fed funds rate.



The real fed funds rate has often been higher at the end of a Fed tightening cycle.



Historically when the front end of the yield curve is this inverted, the Fed is done tightening.



Sources: https://fred.stlouisfed.org/, AOWM calculations

Mortgage rates | Lower but still high

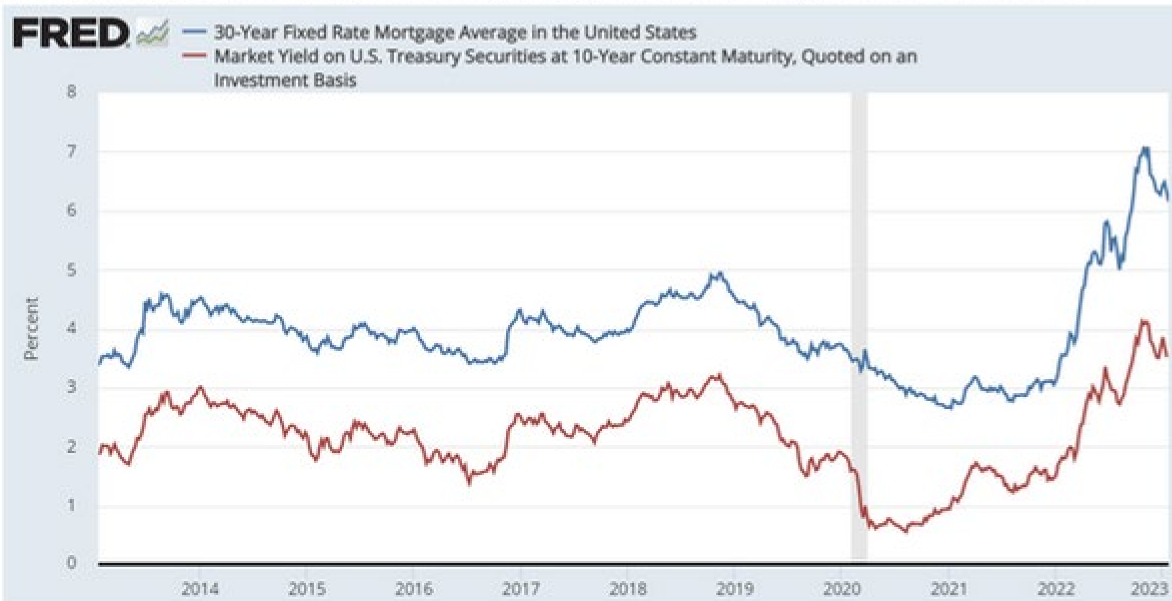
January 23, 2023

Last year mortgage rates spiked from around 3% to over 7%, significantly decreasing the affordability and sale of homes. The past few months have offered a slight reprieve as mortgage rates have retreated towards 6% and may have further to fall as they remain at a historically wide spread to the 10-year Treasury rate; however, high mortgage rates are likely to remain a headwind for the sector.

The Federal Reserve is clearly being successful in slowing the economy when it comes to the housing market. In addition, data released last week on industrial production and retail sales in December showed other areas of the economy are weakening as well.

Given the growing signs that the economy and inflation are slowing, investors expect the Fed will increase its target fed funds rate by just 0.25% at its meeting next week and stop raising rates at its following meeting in March.

Mortgage rates have declined recently along with other long-term interest rates.

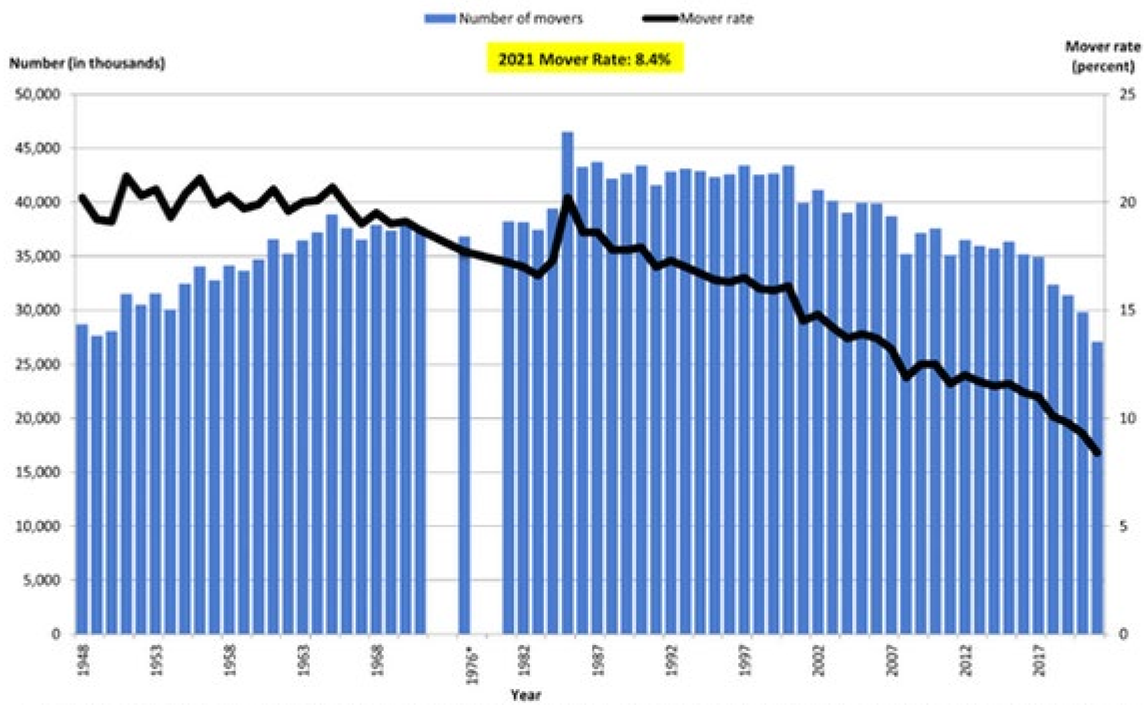


The spread between mortgage rates and 10-year Treasurys remains higher than normal, perhaps offering mortgage rates further room to decline.

High mortgage rates have slowed the sale of existing homes significantly.

The percent of individuals who move each year has been declining for decades; the increase in mortgage rates likely helped to continue that trend last year.

Figure A-1.1 Number of Movers and Mover Rate: 1948-2021

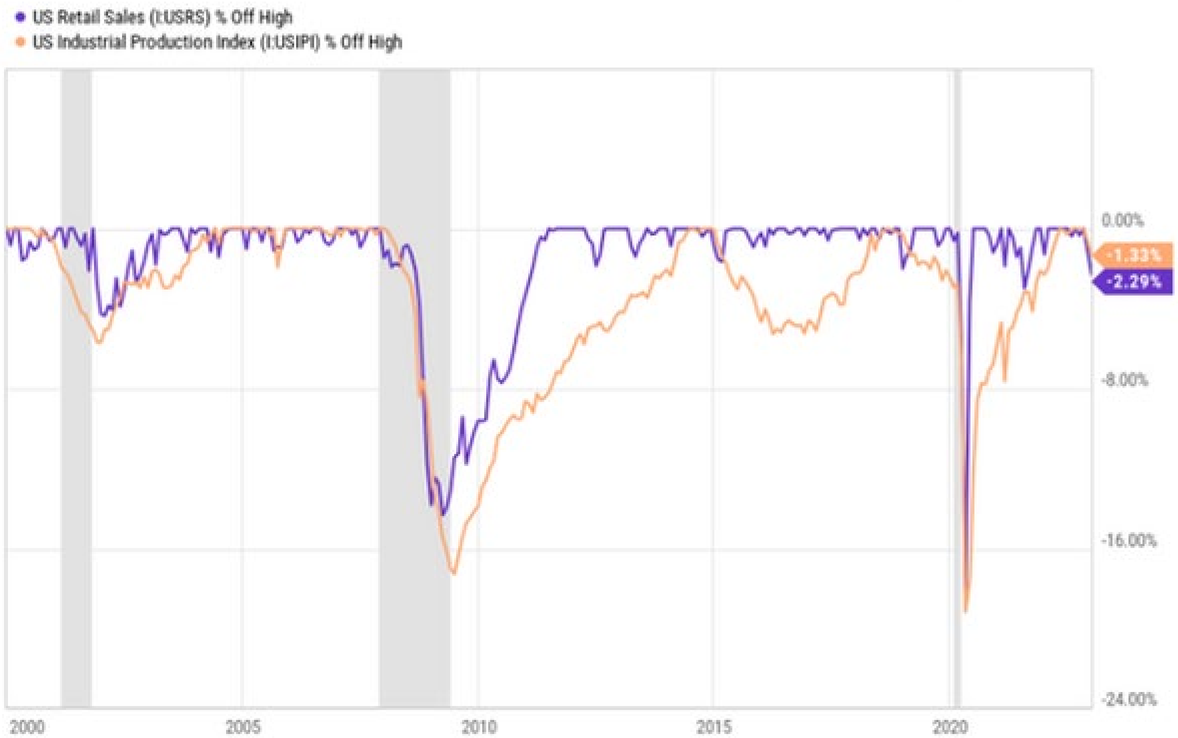


Notes: The CPS sample design was generally updated in years ending in "5" based on previous decennial censuses. Data for the following years are: 2011 (2000 controls), 2010 (2000 controls), 2001 (SCHIP, 2000 controls), 1993 (1990 controls). For more information on confidentiality protection, sampling error, nonsampling error, and definitions, see https://www.census.gov/programs-surveys/cps/technical-documentation/complete.html.

* The migration question was asked differently between 1971 and 1980. Only 1971 and 1976 have a 1-year estimate comparable to all other years.

Source: U.S. Census Bureau, Current Population Survey, Annual Social and Economic Supplement 1948-2021

Industrial production and retail sales weakened at the end of last year.



Sources: https://fred.stlouisfed.org/, YCharts, https://www.census.gov/library/stories/2022/03/united-states-migration-continued-decline-from-2020-to-2021.html

The Market | Fighting the tide

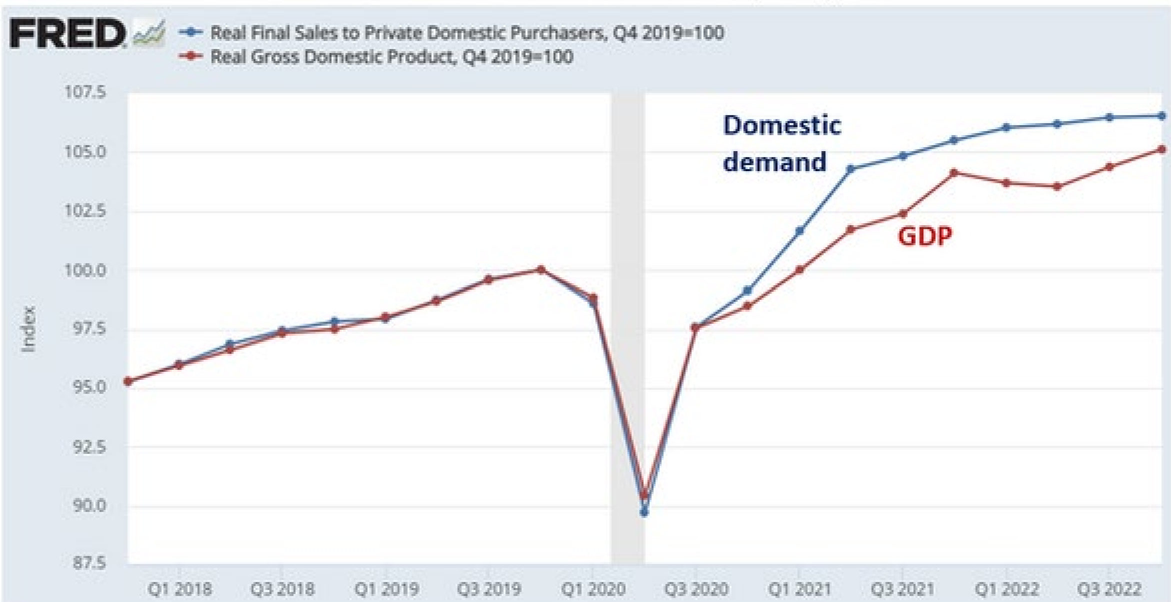
January 30, 2023

The markets have gotten off to a good start in the new year. The S&P 500 index is up over 6%, and the Bloomberg US Aggregate Bond Index is up 3%. To the extent these short-term price moves are indicative of a coherent outlook by investors, it would imply a growing view that inflation will quickly fall to 2%, the Fed will swiftly pivot to lowering rates, and the economy will avoid a recession.

That goldilocks chain of events would be a historical anomaly. It also may not be sufficient to push the stock market much higher. Improving expectations for corporate profits and growing risk appetites fuel strong bull markets; the tide for both is still going out at the moment.

Even if the Fed was inclined to pivot towards lowering rates, it is far from guaranteed that would improve the short-term outlook for the market. But the potential effect of lower rates is likely moot as the Fed is poised to affirm yet again this week its plans to take short-term interest rates higher for longer.

Growth in domestic demand slowed to a crawl at the end of last year.

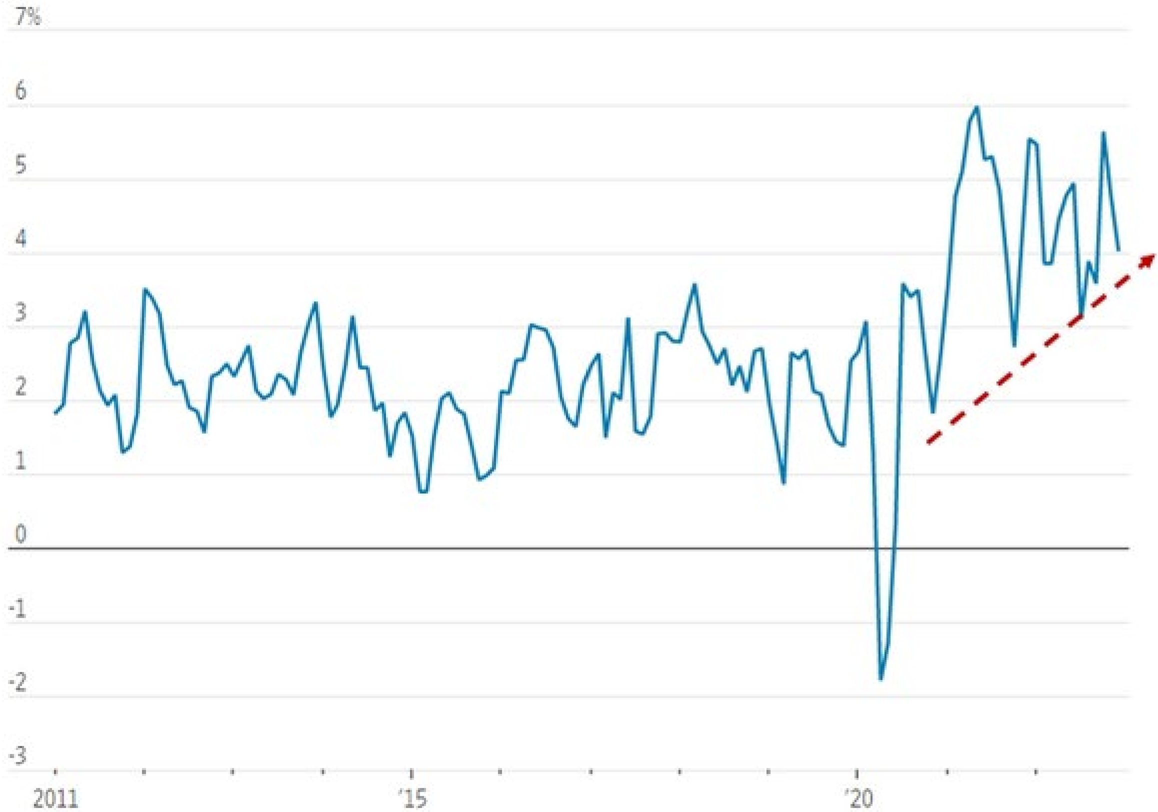


Margin debt has continued to decline even as the market has rallied.

As seen in '00-'03 and '07-'09, margin debt typically increases after a market bottom, and a Fed pivot to rate cuts does not necessarily revive animal spirits.

The inflation metric policymakers are most focused on has not slowed as much as others and has yet to exhibit a persistent downtrend.

Three-month annualized inflation, services excluding energy and housing



Sources: https://fred.stlouisfed.org/, YCharts, BEA, PCE inflation, Wall Street Journal

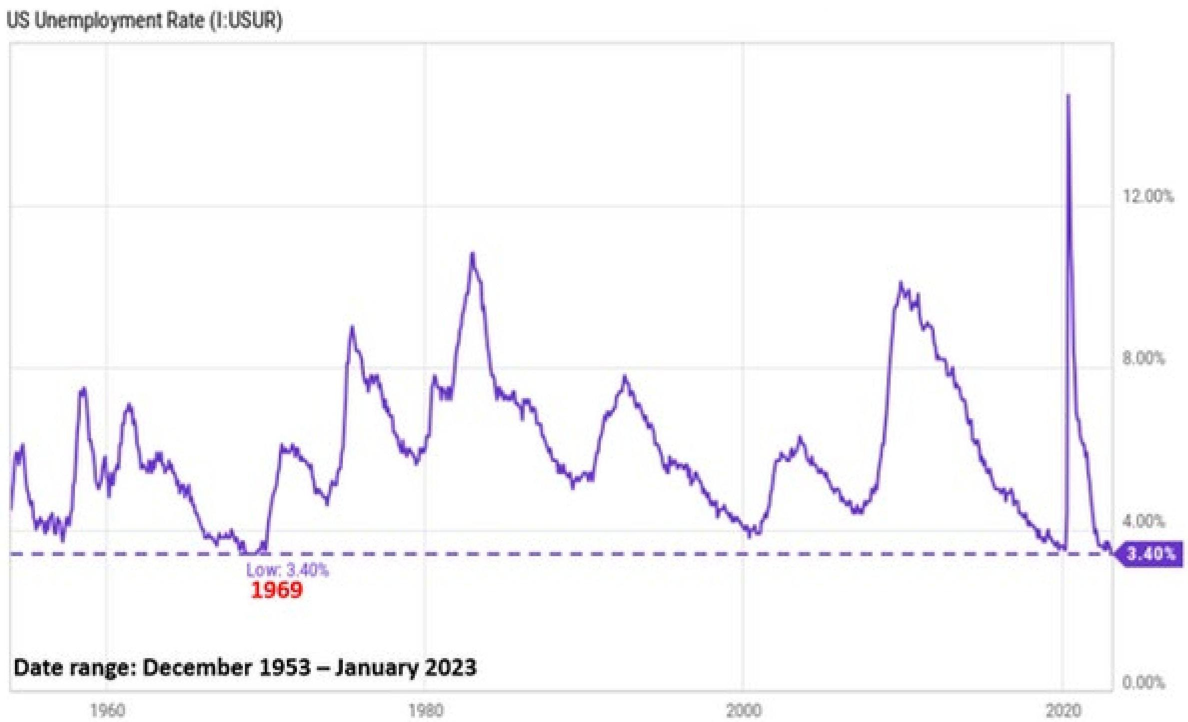
Labor Market | Still beating expectations
February 6, 2023

The jobs report last week was once again better than expected as the labor market continues to hold up well in the face of rising interest rates and a slowing economy. The unemployment rate fell to its lowest level over the past 69 years, and employers were estimated to have add 517,000 new jobs.

January's employment numbers took a little steam out of the stock market which has charged higher through its 200-day moving average and last year's downtrend line. Investors took a breath from their recent bullish run as the strong jobs report makes it more likely that the Fed actually will take interest rates higher for longer.

The strong labor market unfortunately cannot be taken as a sign that the Fed will succeed in pulling off a soft landing of taming inflation without a recession – which would be the best news for investors. There have been a lot of historical outliers over the past few years; however, it would be the historical norm for employment to remain strong past when the Fed plans to finish raising rates in a few months and then turn south with the economy a few months thereafter.

The unemployment rate is the lowest it has ever been over past 69 year.



Unemployment often remains low until after the Fed stops raising rates.

S&P 500 has broken through its 200-day moving average and last year's downtrend line. The 50-day moving average above the 200-day is another bullish indicator.

Sources: https://fred.stlouisfed.org/, YCharts

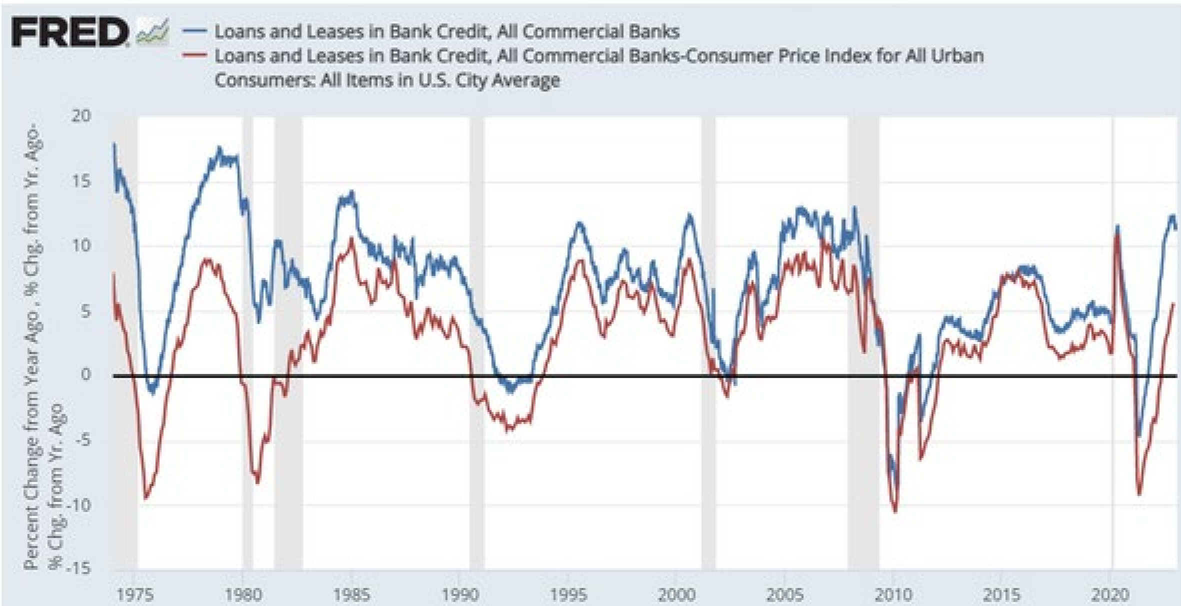
Banks | Beginning to batten down the hatches

February 13, 2023

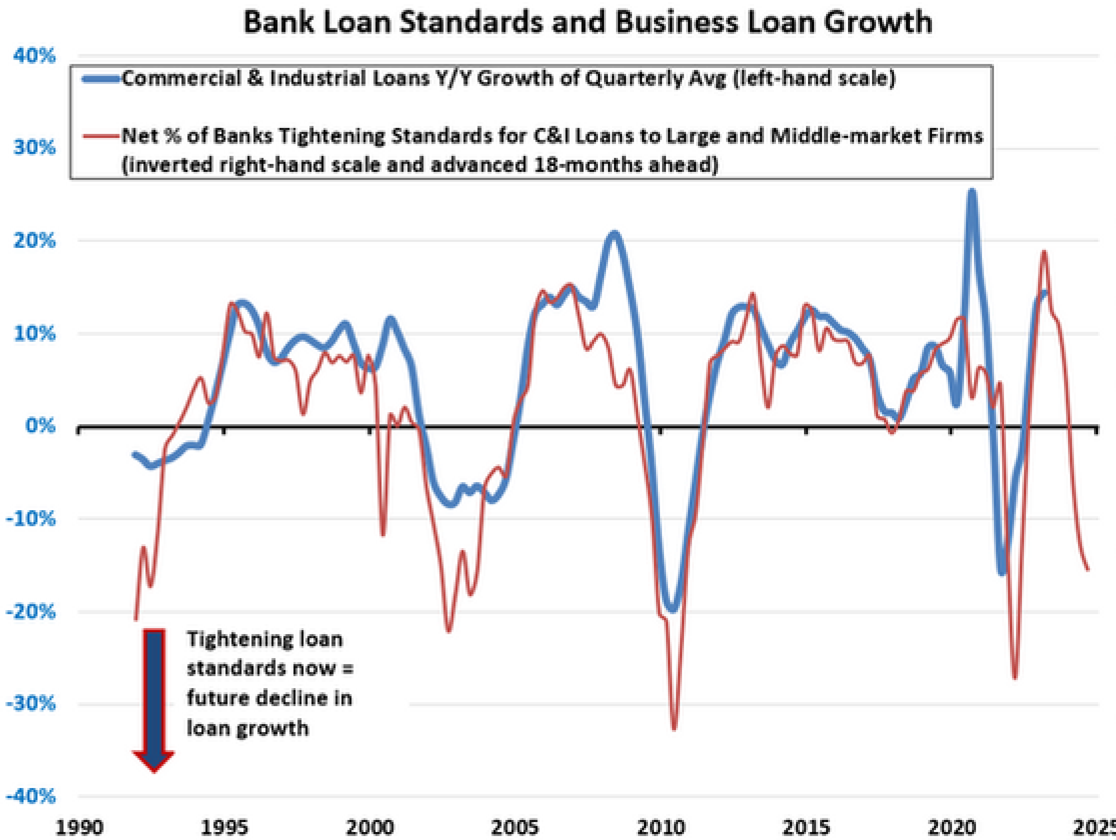
Bank lending has remained strong despite the slowing economy, but the number of banks tightening lending standards continues to grow which does not bode well for future loan growth. The demand for loans is also declining as the Fed continues to raise interest rates.

A retrenchment in available credit could be one of the things that helps to tip the economy into a recession later in the year. And in turn a recession would also likely lead to a de-leveraging of corporate balance sheets. Corporate debt outstanding has grown to a historically high level relative to GDP (~50%). After the recessions in 2001 and 2007-2009, corporate debt as a percent of GDP fell to around 40%.

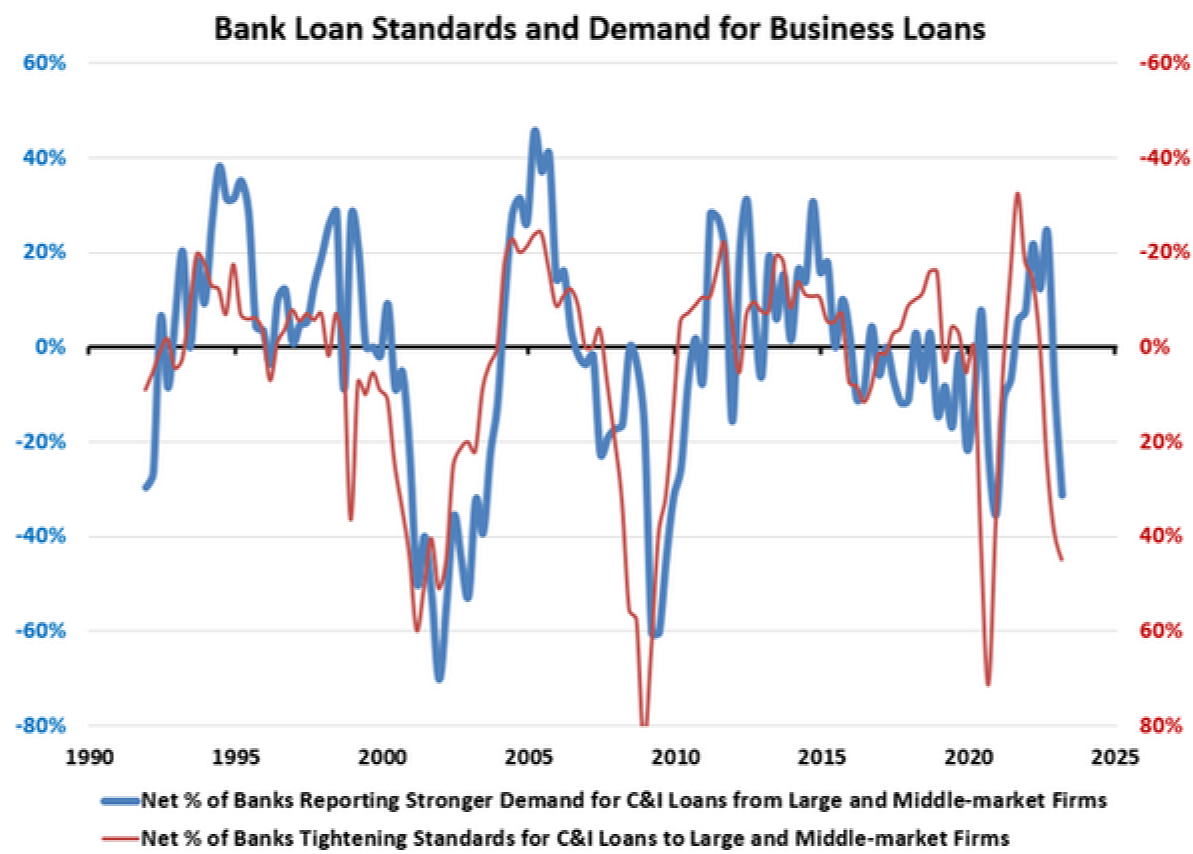
Bank loan growth has remained strong so far.
Nominal growth (blue line) and inflation-adjusted growth (red line)



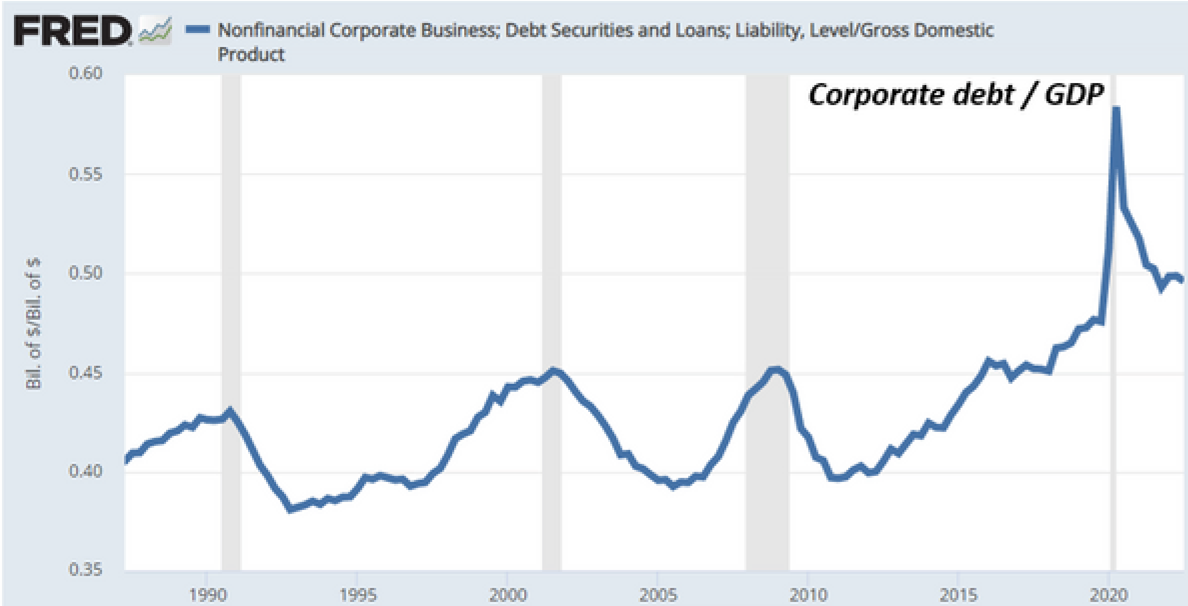
Banks continued to tighten leading standards for all types of loans, which suggests bank lending is likely to decline over the next year.



Demand for loans also began to decline at the end of last year.



Corporate debt remains at a historically high level relative to GDP. A recession would likely force companies to de-lever, especially if corporate profits decline significantly.



Sources: https://fred.stlouisfed.org/, https://www.federalreserve.gov/data/sloos.htm, AOWM calculations

Rising Rates | How high and how long?

February 20, 2023

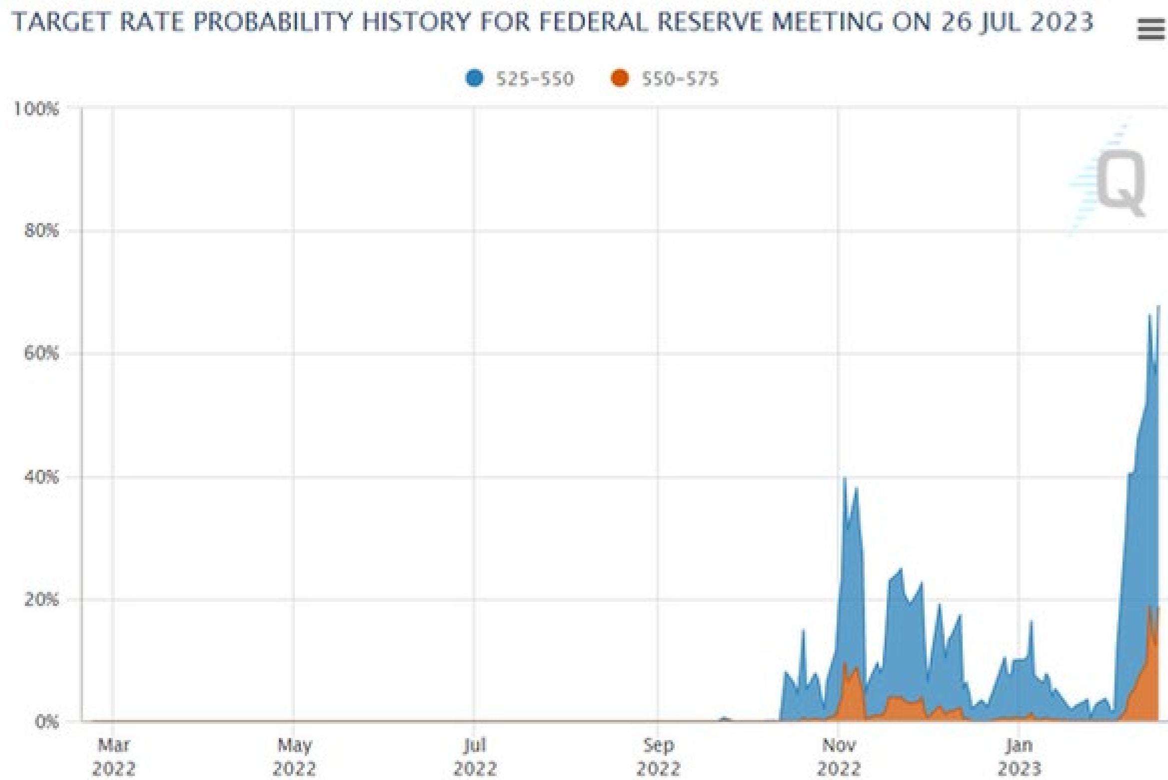
Recent economic data has suggested inflation may be more stubborn than hoped.   As a result, investors have once again shifted their expectations for how high the Fed will raise interest rates.

Over the past two weeks, expectations for the peak fed funds rate have moved from below 5% towards 5.5%. Long-term interest rates have increased by a similar amount but remain below the levels they reached last fall.

Is it time to shift from fixed income securities with short-term maturities and lock in long-term interest rates? History suggests investors can be patient as long-term rates, especially for corporate debt, haven't typically begun to decline significantly until the Fed is done raising rates. And if the markets are in the process of slowly adjusting to a new normal of higher interest rates, short-term debt may continue to offer better returns for a while as it did in the 1960s and 1970s.

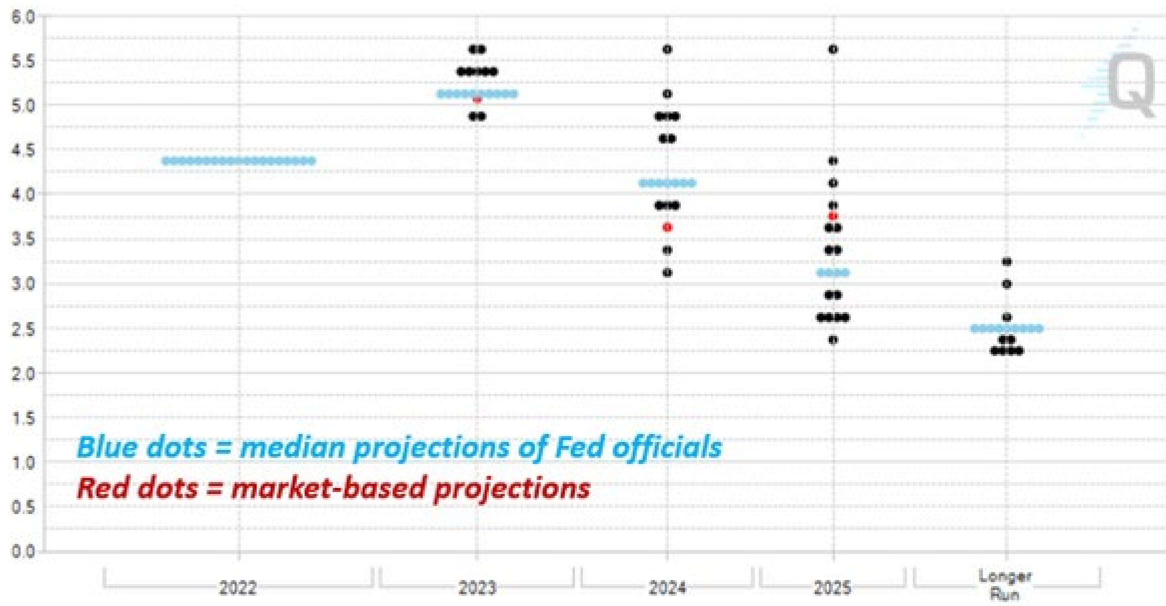
How much higher and longer the Fed will raise rates is hard to predict, but investors are likely still best served by tilting their fixed income investments towards high quality, short-term debt.

Expectations for how high the Fed will raise rates has jumped higher recently. Investors now expect the Fed to raise rates towards at least 5.5% by the middle of the year.



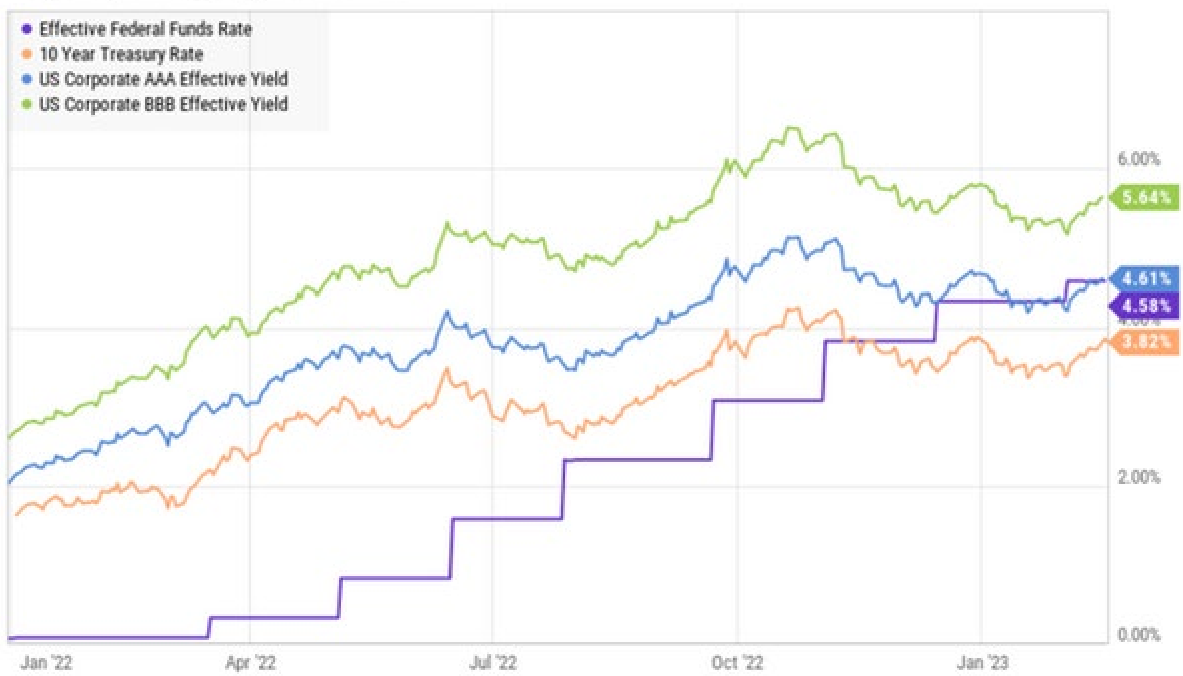
Market expectations for where the fed funds rate will be at year end are now in line with the Fed's own projections released in December.

FOMC PARTICIPANTS' ASSESSMENTS OF APPROPRIATE MONETARY POLICY : "DOT-PLOT"

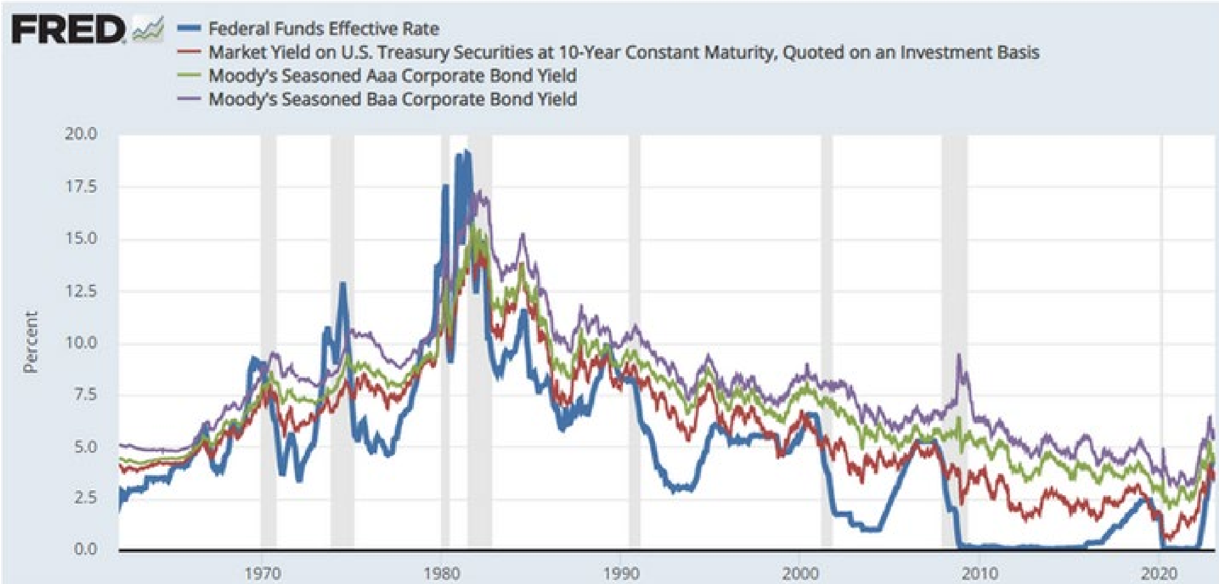


Blue dots indicate the median projection. Data is based on the economic projections published on December 14, 2022.
Red dots indicate the effective rate implied by the year-end FedFund future price.

Long-term interest rates have moved higher along with expectations for a higher peak fed funds rate.



Long-term rates haven't typically declined significantly until the end of a Fed tightening cycle, especially corporate debt which faces widening credit spreads during the usual subsequent recession.



Rolling short-term debt offered investors better returns than long-term debt as interest rates and inflation increased in the 1960s and 1970s.

Sources: https://fred.stlouisfed.org/, Ycharts, https://www.cmegroup.com/markets/interest-rates/cme-fedwatch-tool.html, AOWM calculations

Corporate Profits | Normalizing as stimulus wanes

February 27, 2023

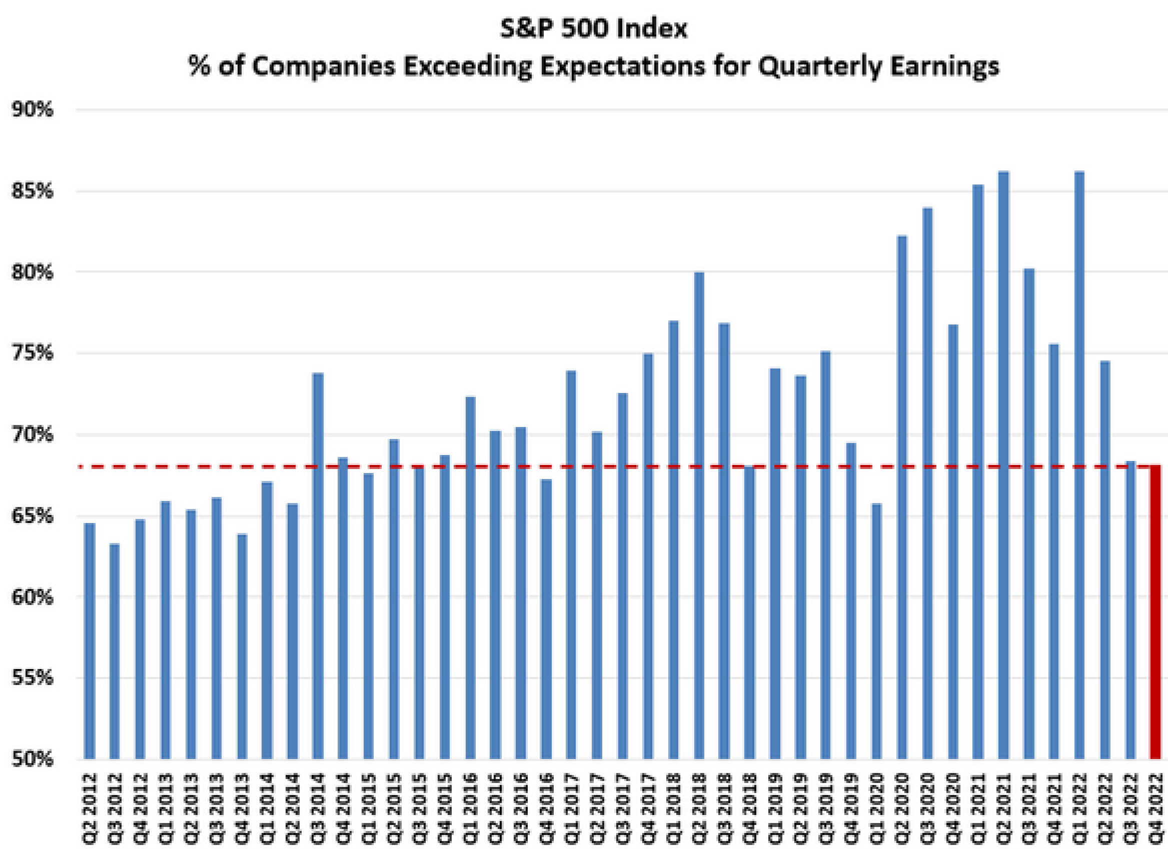
With most of the companies in the S&P 500 having reported earnings for the fourth quarter of last year, "only" 68% have exceeded the well-managed earnings expectations of analysts. Over the past few of years, that number has often been greater than 80%.

During 2022, corporate profitability began to normalize after benefiting greatly from the sizable government stimulus injected into the economy to counteract the effects of the pandemic. Even after retreating slightly, profit margins remain high by historical standards; and yet the consensus expectation is they will rebound higher again this year despite the Fed's efforts to slow the economy with higher interest rates.

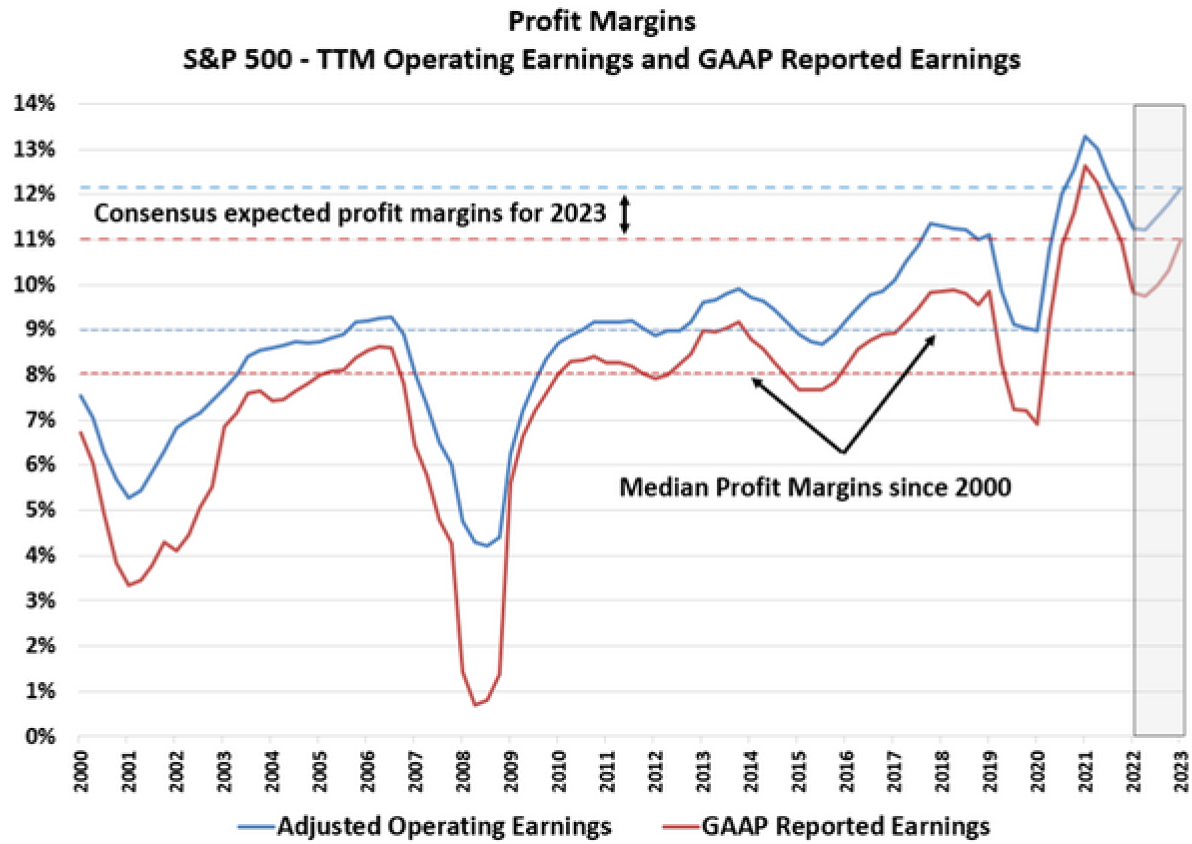
Those higher interest rates in themselves cast doubt on expectations for higher margins. Over the past couple of decades profit margins and corporate bond yields have often moved together with interest rates leading the inverse change in margins by a few months. The most direct link between the two is the fact that lower interest rates ultimately reduce companies' borrowing costs and vice versa. Indirectly, corporate bond yields are also an indicator of investors' general confidence in future corporate profitability.

Current corporate bond yields, which still reflect tight credit spreads to US Treasury debt and thus a high confidence in future corporate profitability, nevertheless suggest that profit margins may continue to decline back towards a more historical level even without a recession.

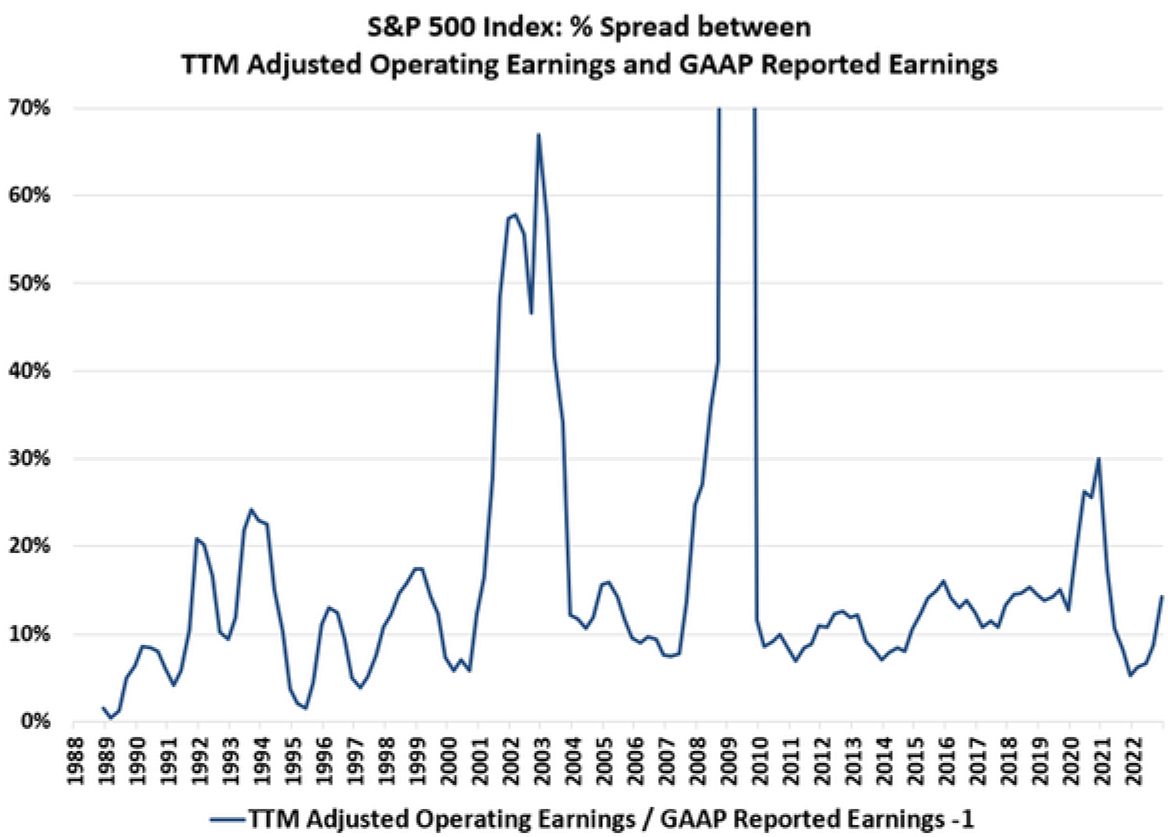
The percent of companies beating earnings expectations in Q4 was below the high level of recent years and the 72% historical average of the past decade.



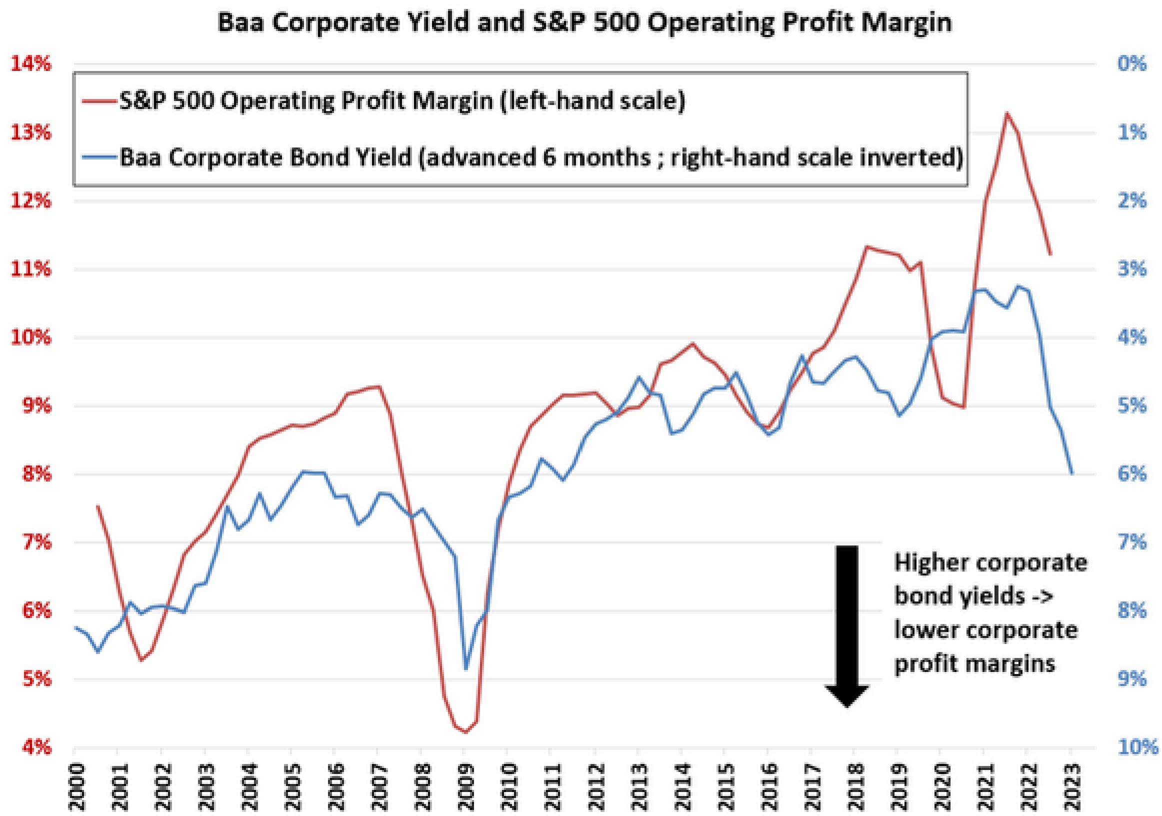
Profit margins are down from the pandemic high but are still elevated with a consensus expectation they will rebound higher this year.



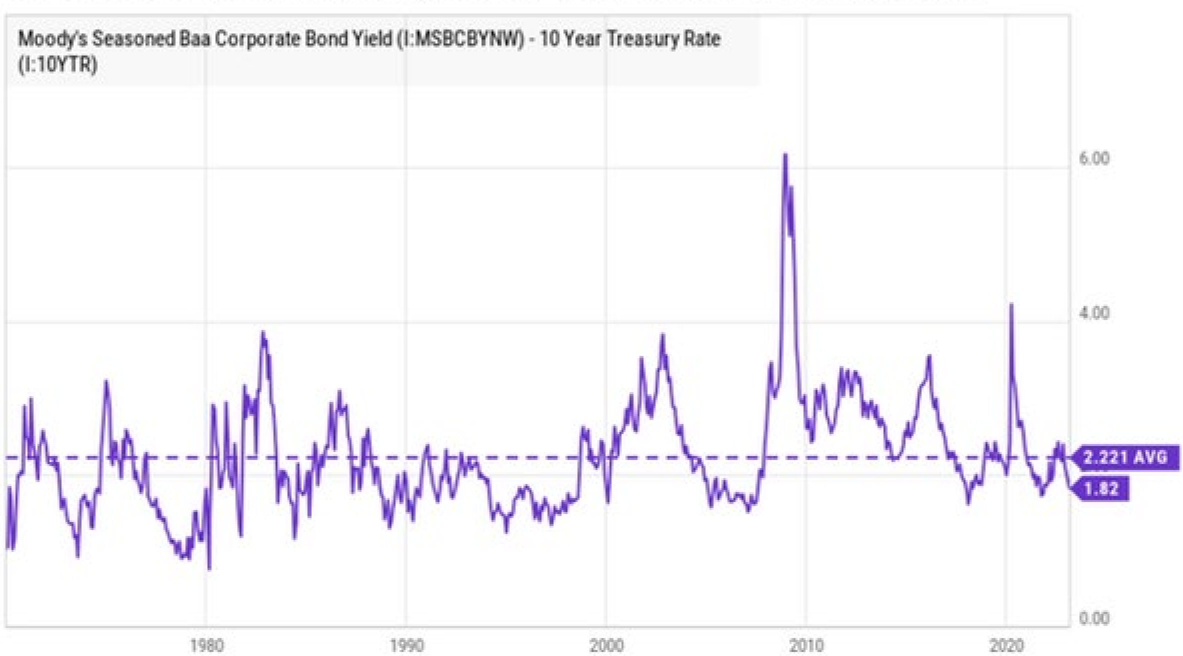
The growing spread between adjusted operating earnings and reported GAAP earnings could be an early sign of future weakness in corporate profits.



The last time corporate bond yields were this high, the S&P 500's operating profit margin was about 2 percentage points lower.



Higher corporate bond yields may indicate a further decline in profit margins due to higher interest expenses, but so far they are not an indicator of general concerns about corporate profitability as credit spreads remain tight.



Sources: https://fred.stlouisfed.org/, Ycharts, Federal Reserve, Moody's Seasoned Baa Corporate Bond Yield, https://www.spglobal.com/spdji/en/indices/equity/sp-500/#overview, AOWM calculations

Federal Debt | Snowballing

March 6, 2023

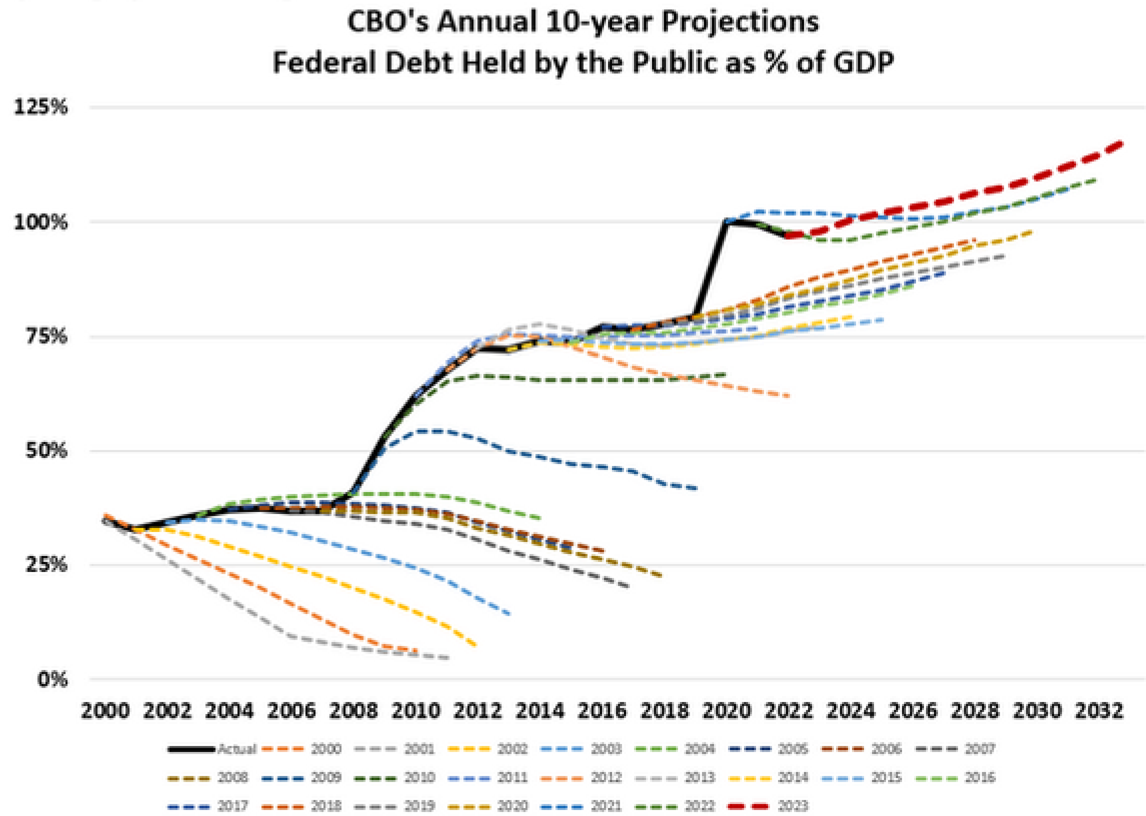
As Congress marches towards a showdown this summer over raising the federal debt limit, the Congressional Budget Office (CBO) has highlighted the long-term fiscal challenges facing the federal government with its latest 10-year budget projection.

The CBO makes these forecasts each year assuming current laws remain in place and smooth sailing for the US economy. Not surprisingly these estimates have significantly underestimated how much debt the federal government would accumulate over the coming decade.

In the past fifteen years, the US has experienced a financial crisis and a pandemic – rough seas that led to significant outlays by the federal government. The federal debt held by the public has already topped 100% of GDP, and the CBO projects it is headed towards 200% over the next thirty years. Market-imposed fiscal limits may prevent that forecast from being another underestimate.

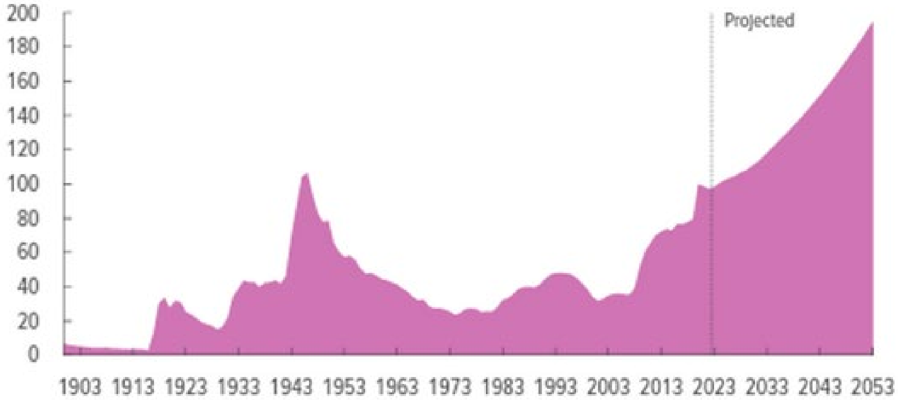
The powers-that-be have been able to increase the federal debt with no apparent downside as the Federal Reserve has pegged interest rates at abnormally low levels for most of the past two decades. With interest rates returning to more normal levels, Congress likely won't be able to kick the hard decisions down the road for much longer.

The CBO's annual projections of the federal budget, based on the prevailing laws at the time of the forecast, have consistently underestimated the future debt burden by a significant margin.



The CBO's long-term debt projections are hardly optimistic, however, as the federal debt held by the public is projected to double to 200% of GDP over the next 30 years.

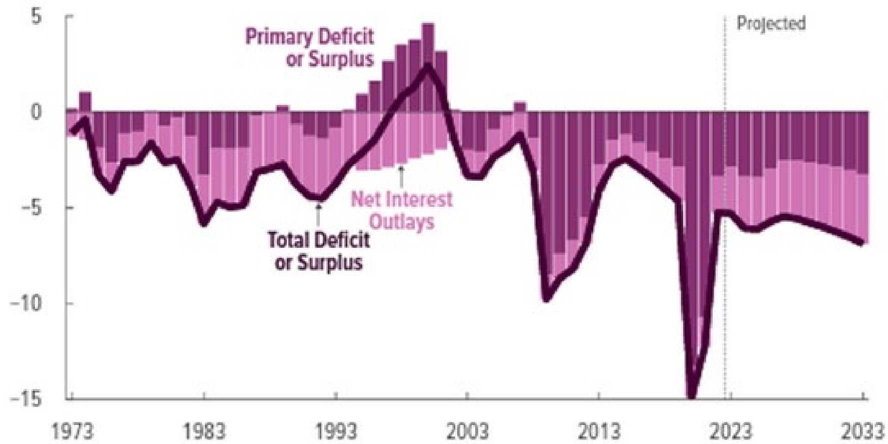
Federal Debt Held by the Public, 1900 to 2053
Percentage of Gross Domestic Product



Debt is projected to rise in relation to GDP, mainly because of increasing interest costs and the growth of spending on major health care programs and Social Security.

Budget deficits (i.e., the annual amount added to the federal debt each year) are expected to grow as a percentage of GDP thanks to increasing interest expenses on the federal debt.

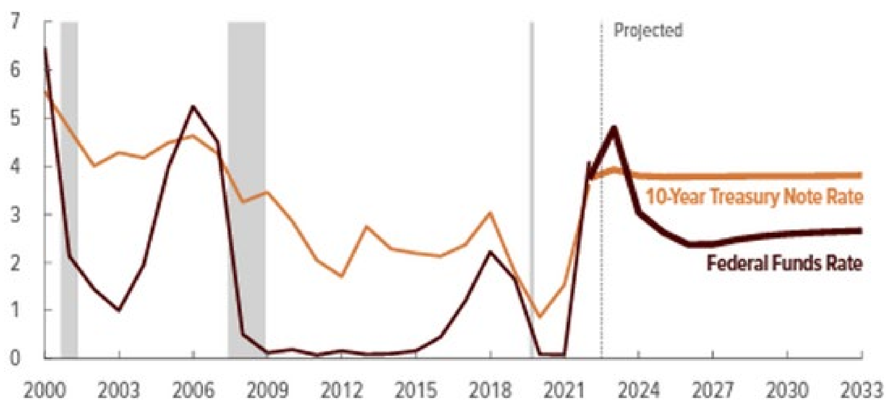
Total Deficits, Primary Deficits, and Net Interest Outlays
Percentage of Gross Domestic Product



In CBO's projections, net interest outlays increase by 1.2 percent of GDP from 2023 to 2033 and are a major contributor to the growth of total deficits. Primary deficits (that is, revenues minus noninterest outlays) increase by 0.4 percent of GDP over that period.

The CBO's interest rate assumptions driving the higher interest expense assume inflation is brought under control relatively quickly without a recession.

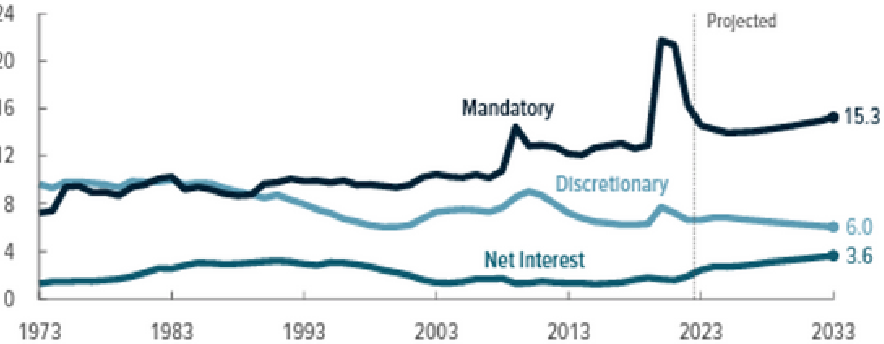
Interest Rates
Percent



In CBO's projections, the Federal Reserve further increases the target range for the federal funds rate in early 2023 to reduce inflationary pressures in the economy. That rate is projected to fall in 2024 as inflation slows and unemployment rises. The interest rate on 10-year Treasury notes, however, remains at 3.8 percent from 2024 to the end of the projection period.

Increasing mandatory outlays for Social Security and Medicare along with increasing interest expenses will squeeze other discretionary federal spending in the coming decade.

Outlays, by Category
Percentage of Gross Domestic Product



In CBO's projections, rising spending on Social Security and Medicare boosts mandatory outlays, but total discretionary spending falls in relation to GDP. As the cost of financing the nation's debt grows, net outlays for interest increase substantially and, beginning in 2030, exceed their previous peak.

Revenue as a percentage of GDP has remained relatively stable over the past 50 years. Congress will ultimately have to make some politically unpopular decisions about spending and/or taxes.

Total Outlays and Revenues
Percentage of Gross Domestic Product

Measured as a percentage of GDP, outlays exceed their 50-year average each year of the projection period. Revenues fall to their 50-year average in 2025 but then exceed it in each subsequent year because of scheduled changes in tax law.

Sources: CBO, https://www.cbo.gov/publication/58848, AOWM calculations

Bank Failures | Changing investors' outlook for rates

March 13, 2023

The past week has been eventful. The Fed Chair, Jay Powell, first led investors to believe that the central bank would push interest rates higher for longer to combat inflation. Then the 16th and 29th largest banks in the US quickly failed leading investors to wonder if the Fed is about to pivot in dramatic fashion towards lowering rates and once again injecting large sums of money into the system.

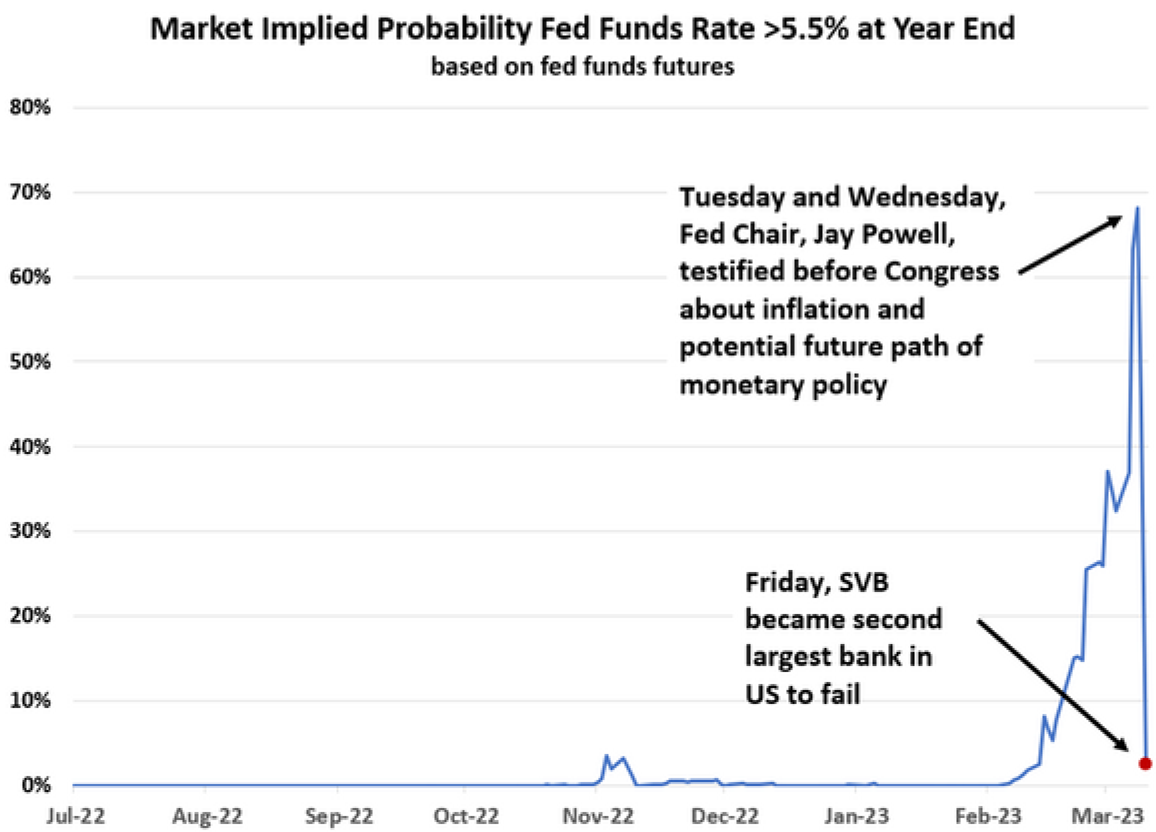
The two banks that failed, Silicon Valley Bank and Signature Bank, rode the large wave of monetary stimulus during the pandemic with their market capitalizations surging to over $43 billion and $22 billion, respectively, just 14 short months ago. However, they both fell victim to an old fashion bank run over the past week.

Banking by its very nature depends on the confidence of depositors – only about half of all bank deposits are insured by the FDIC, and banks on average only keep about 10% of the deposits they hold in cash. Thus if there is a loss of faith in an institution, it can quickly get into trouble even in the best of situations, and a rising rate environment is less than an ideal environment to be forced to sell off fixed income investments.

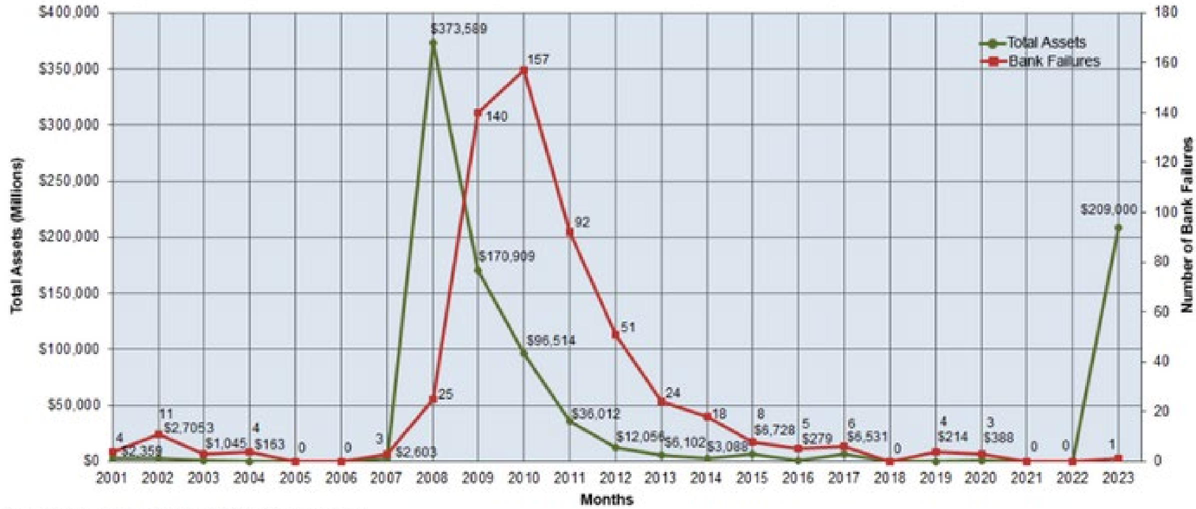
During the pandemic, banks were flooded with deposits as a result of the unprecedented government stimulus, and they invested a lot of those deposits into fixed income securities when interest rates were pegged to the floor by the Fed. As interest rates have risen, that has pushed down the value of those securities. Much like with an investor who buys a bond with the intention to hold it to maturity, the day-to-day change in value shouldn't matter as long as the security can be held to maturity – which for banks depends on avoiding having a wave of depositors ask for their money back all at once.

Policymakers at the Fed and the Treasury have hopefully forestalled further panic about the safety of deposits with their response to the recent bank failures. Nevertheless, the events of the past week are still likely to dampen the animal spirits of investors with a renewed appreciation for the risks they are taking.

Last week saw a wild swing in expectations for what the Fed will do this year.



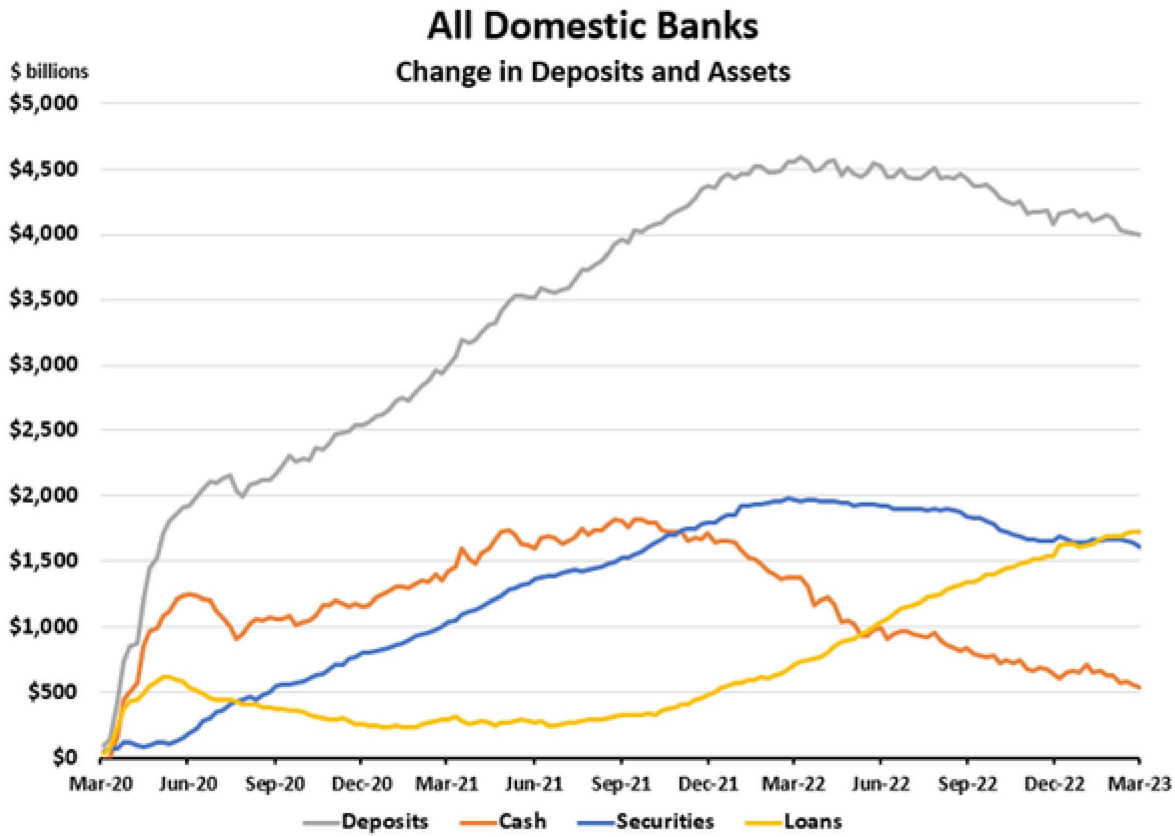
The banking industry had been relatively calm in recent years with few bank failures…



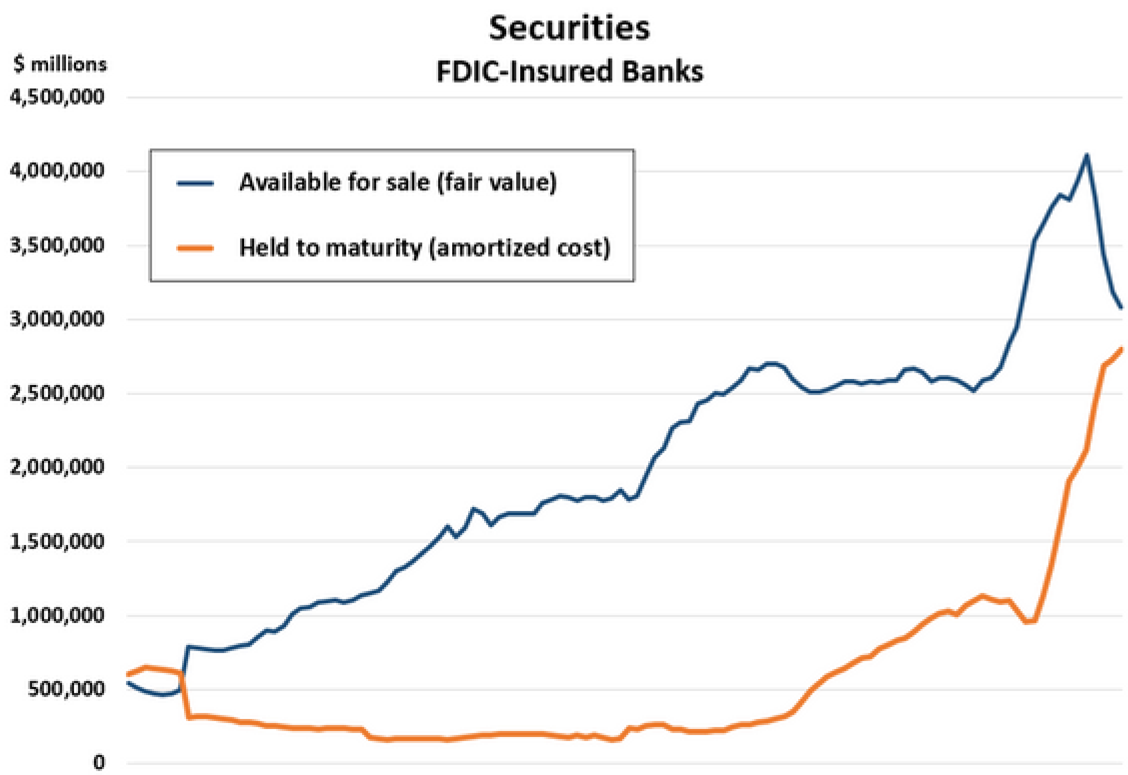
https://www.fdic.gov/bank/historical/bank/

Banks rely on the confidence of depositors. The largest 25 banks have less than 12% of deposits in cash while smaller banks have less than 8% of deposits in cash (though a higher percentage of small bank deposits are typically FDIC insured).

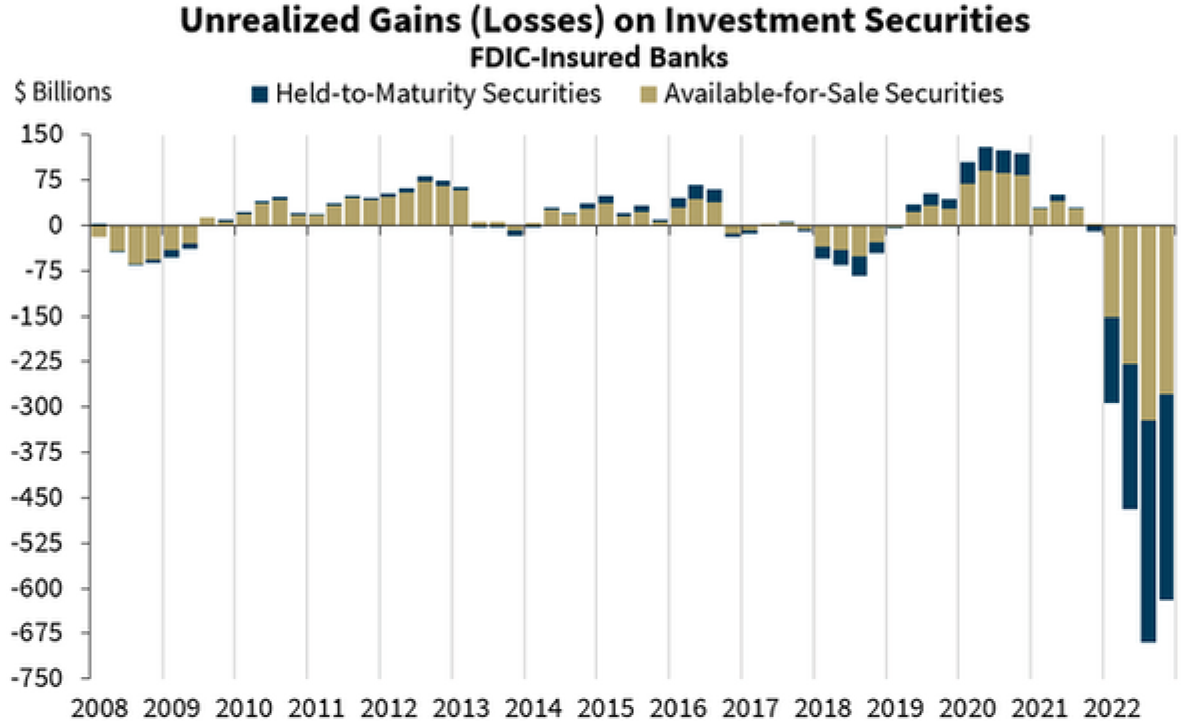
Banks placed a lot of the deposits that flooded the system during the pandemic into fixed income securities when interest rates were extremely low.



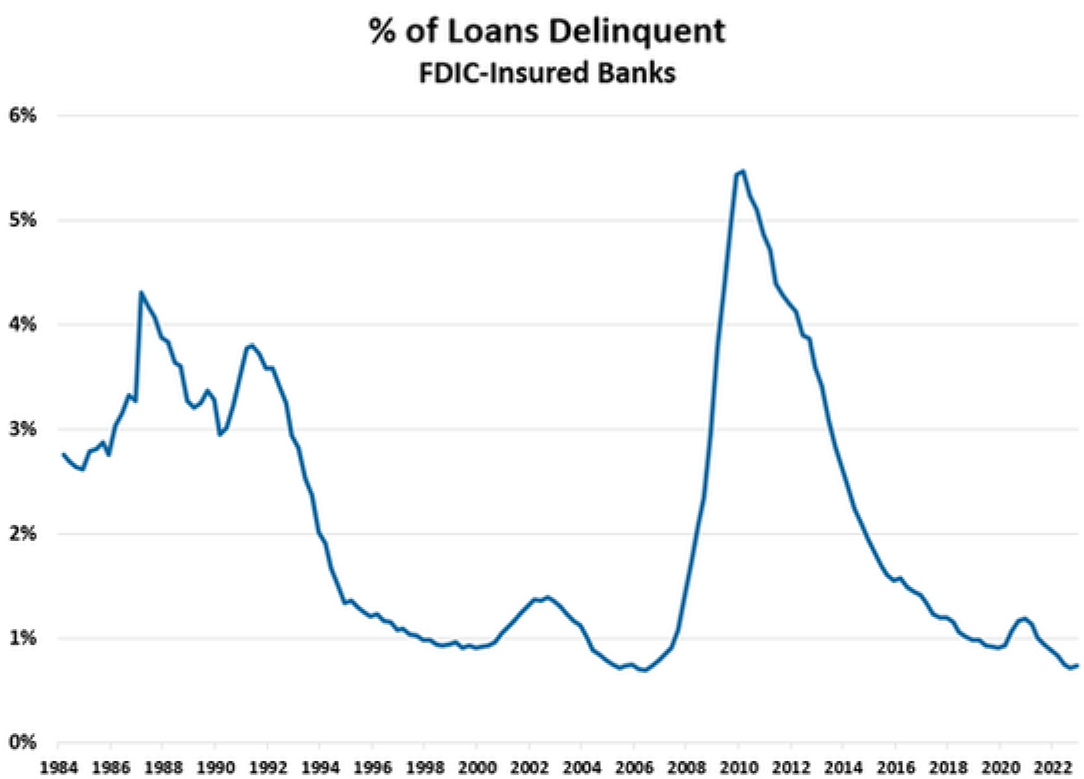
Banks have classified many of the securities they have added over the past three years as "held to maturity" so they don't have to record changes in the securities' market value similar to the accounting for the loans they originate and hold.



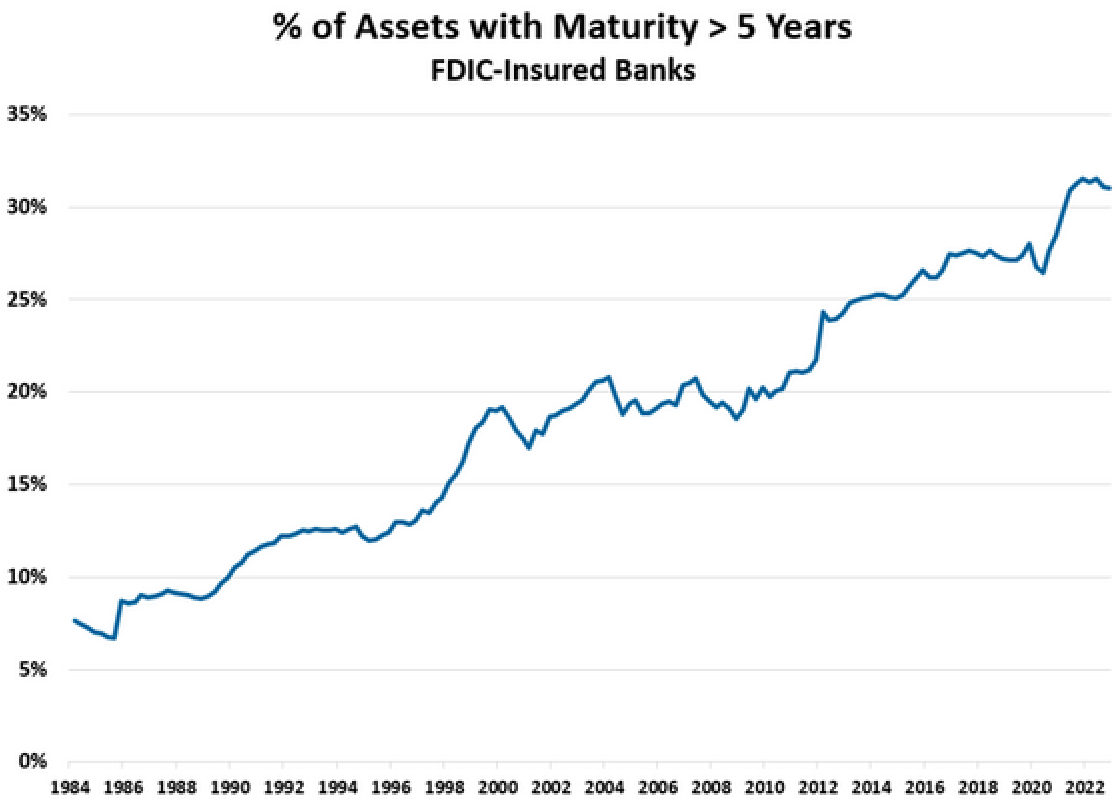
Unrealized losses are likely only an issue for banks if they are forced to sell the securities at a loss to meet deposit withdrawals.



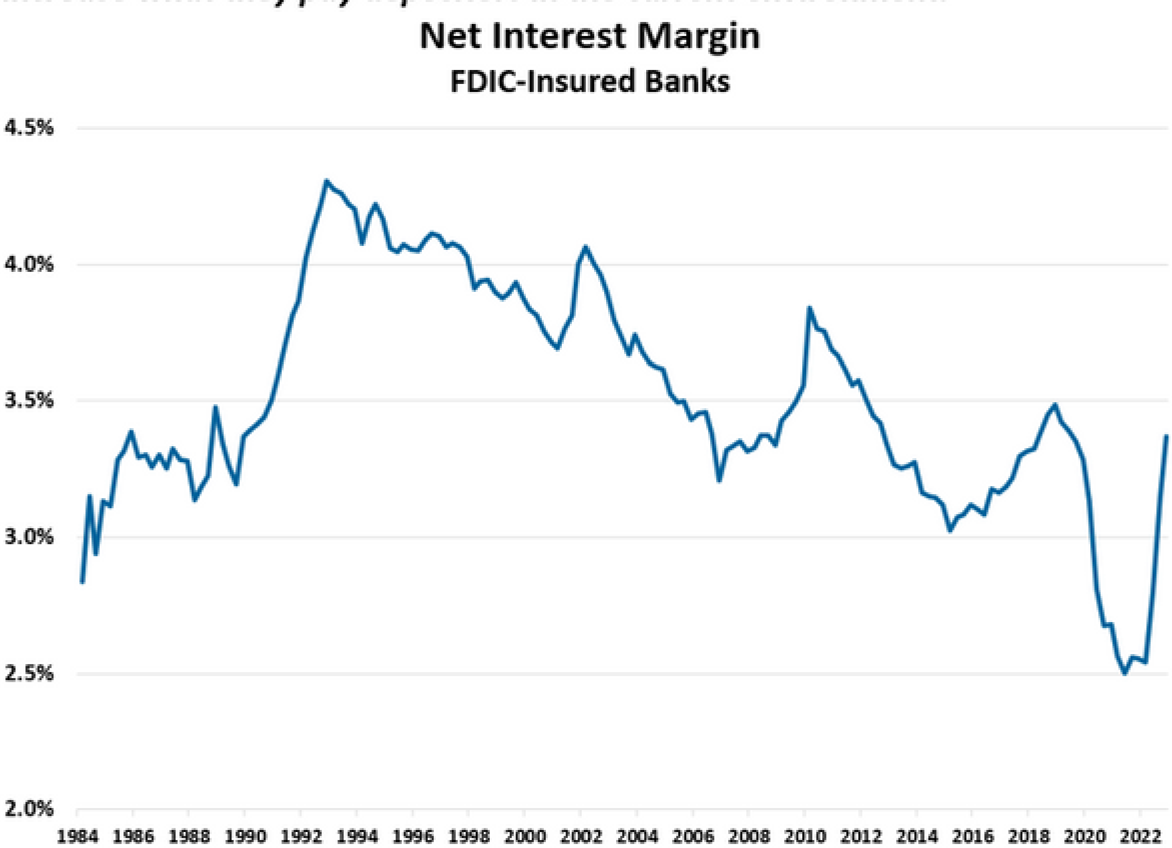
Unlike in 2008, banks remain generally healthy and have yet to see a decline in the asset quality of their loans despite the growing concerns about a potential recession.



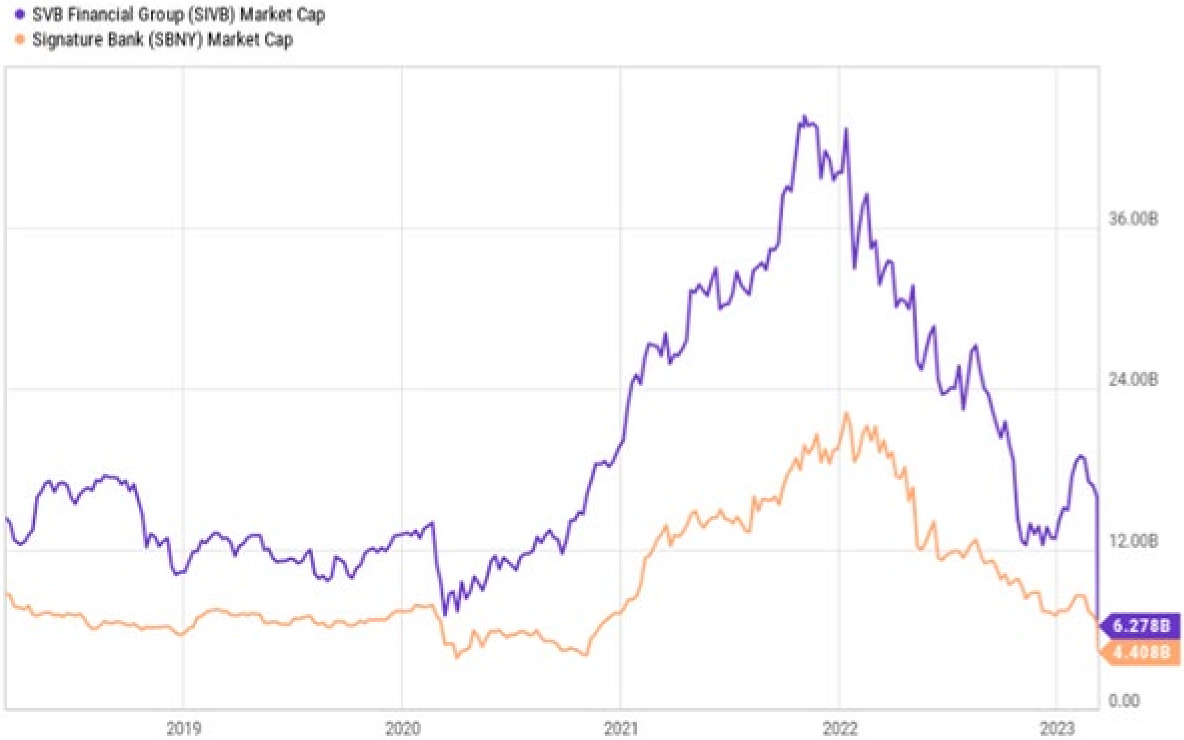
Banks have increased the maturity of their assets. While most hedge the inherent interest rate risk of longer maturities, the unrealized losses generated in a rising rate environment can still shake investors' confidence.



Banks have benefit from the increasing interest rates as their assets have repriced faster than their liabilities. They will likely come under pressure to increase what they pay depositors in the current environment.



SVB and Signature Bank represent the boom and bust of the pandemic market.



Sources: FDIC, https://www.fdic.gov/bank/historical/bank, https://www.fdic.gov/news/press-releases/2023/pr23013.html, YCharts, https://fred.stlouisfed.org/, https://www.cmegroup.com/markets/interest-rates/cme-fedwatch-tool.html, AOWM calculations

The Fed | Stuck between a rock and a hard place

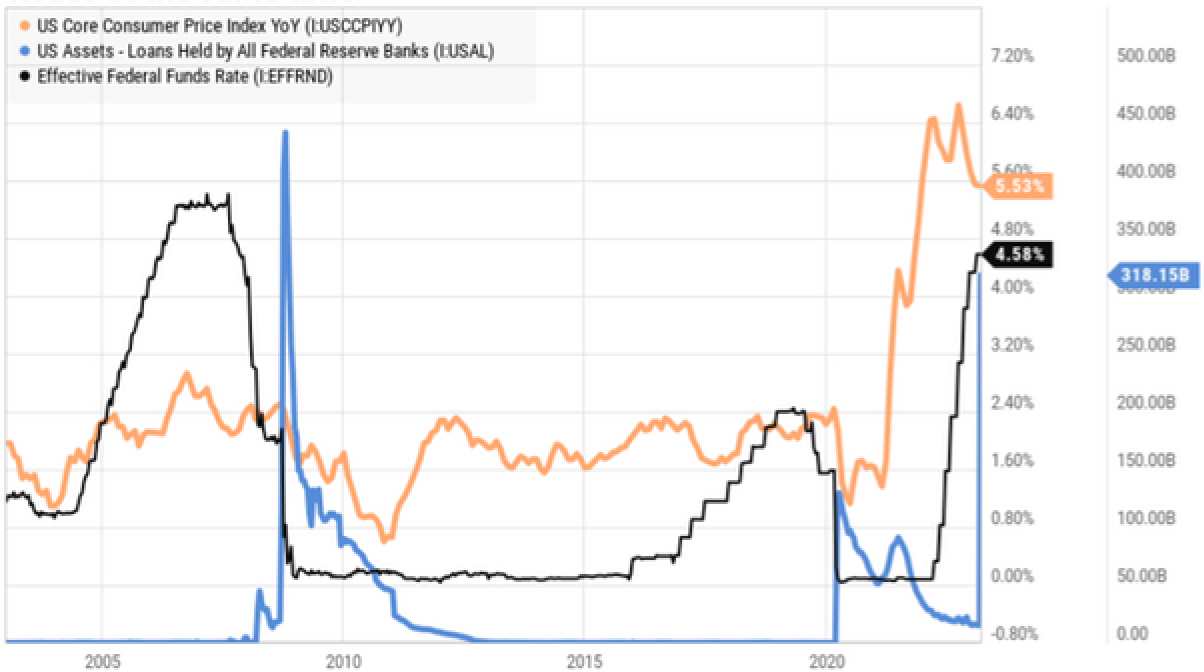
March 20, 2023

Policymakers at the Federal Reserve meet this week to decide their next step in their battle against inflation, which is declining but remains well above the Fed's 2% inflation target. The Fed's next step was highly anticipated to be another rate increase of 0.25% or 0.50%, but the recent turmoil in the banking industry has complicated things.

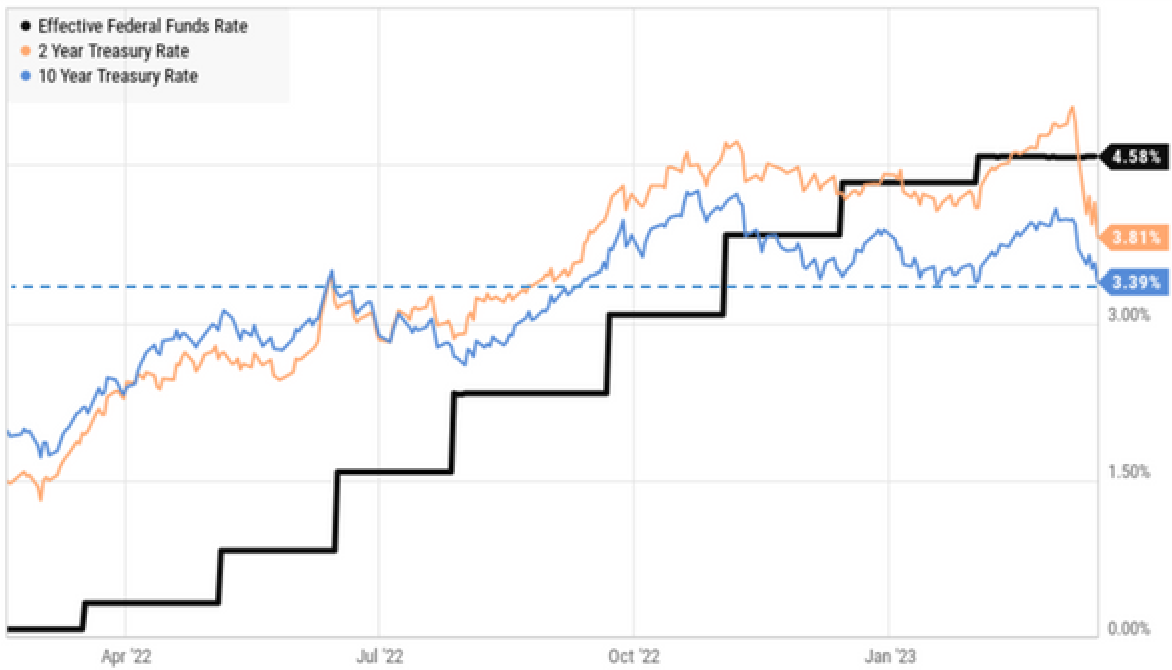
Based on the market for fed fund futures, investors still view it as more probable than not that the Fed will raise its target fed funds rate to between 4.75% and 5%. Last week the European Central Bank raised its target interest rate by 0.50% despite the banking issues rattling the Old World. Given regulators' reassurances about the soundness of the US banking industry and the persistence of high inflation, it will be hard for policymakers to pause their rate hikes now.

If the Fed does raise rates this week, we will enter a strange world in which the Fed is increasing interest rates while simultaneously loaning hundreds of billions of dollars directly to banks to calm nervous depositors concerned about rising interest rates. But we live in strange times, and policymakers may be stuck with no better options.

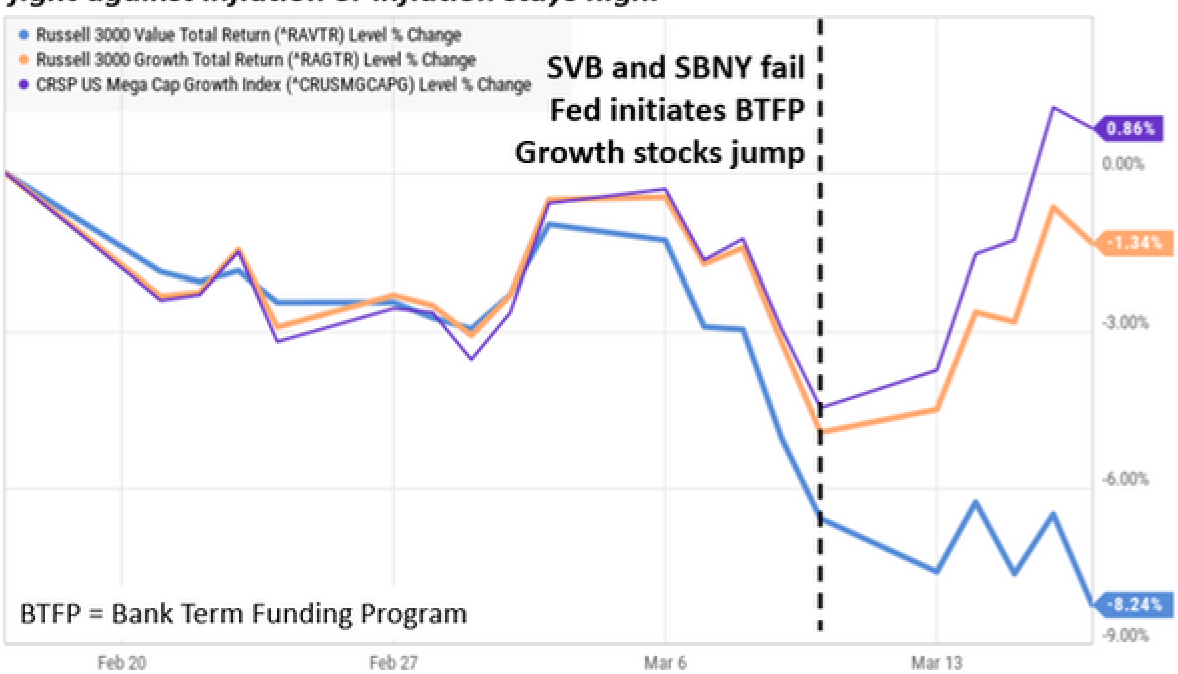
The Fed is stuck between high inflation (orange line of core CPI inflation) and a banking crisis (blue line of Fed loans to banks). The central bank will likely continue to raise rates to battle inflation while also continuing to act as a lender of last resort for the banking industry in an attempt to address both issues at the same time.



The recent bank failures and concerns around unrealized losses hiding on bank balance sheets have sent long-term interest rates back toward their recent lows, even as the Fed prepares to potentially increase short-term rates once more to fight inflation.



Investors betting on a replay of growth stocks outperforming again because of extreme monetary stimulus will likely be disappointed if the Fed keeps up its fight against inflation or inflation stays high.



Sources: YCharts

Interest Rates | Future path increasingly uncertain

March 27, 2023

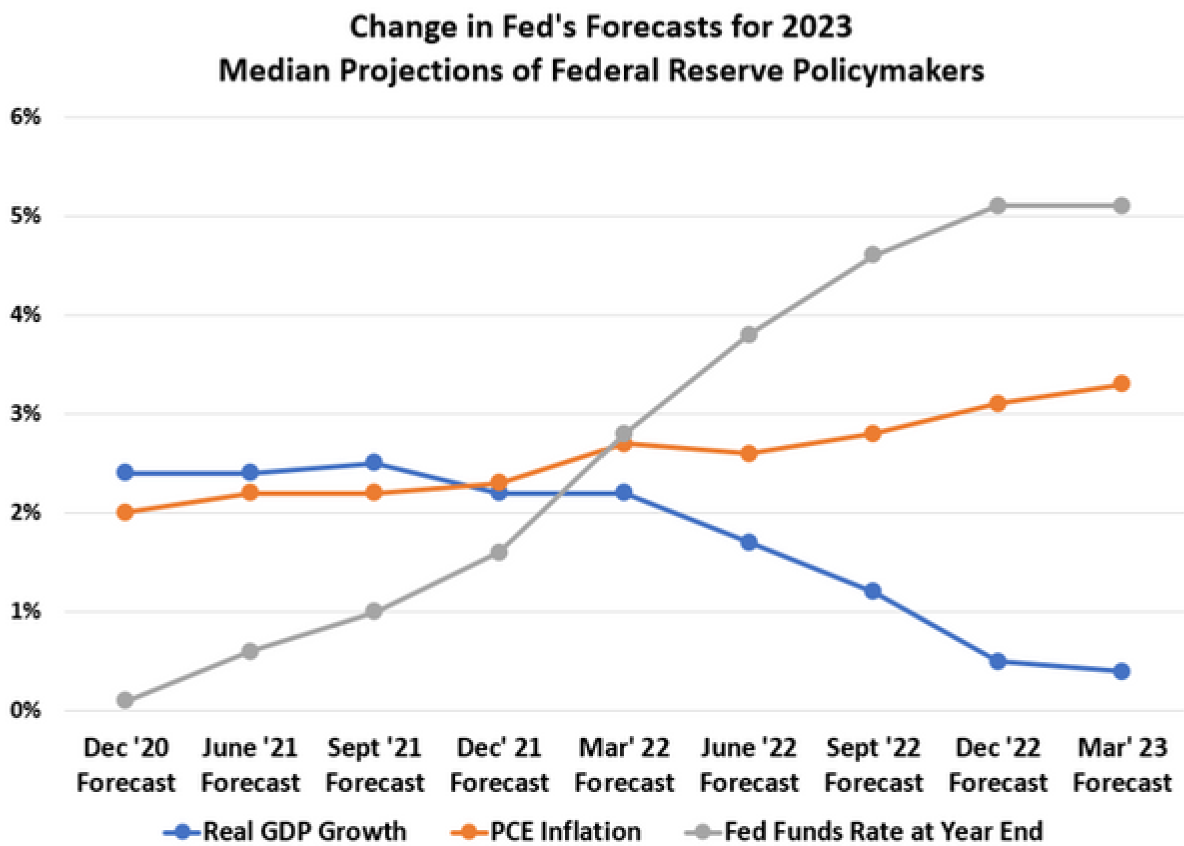
Fed policymakers once again raised the fed funds rate by 0.25% last week while once again increasing their projections for inflation and lowering their outlook for economic growth; however, for the first time since they started tightening monetary policy, they did not raise their forecast for the peak fed funds rate.

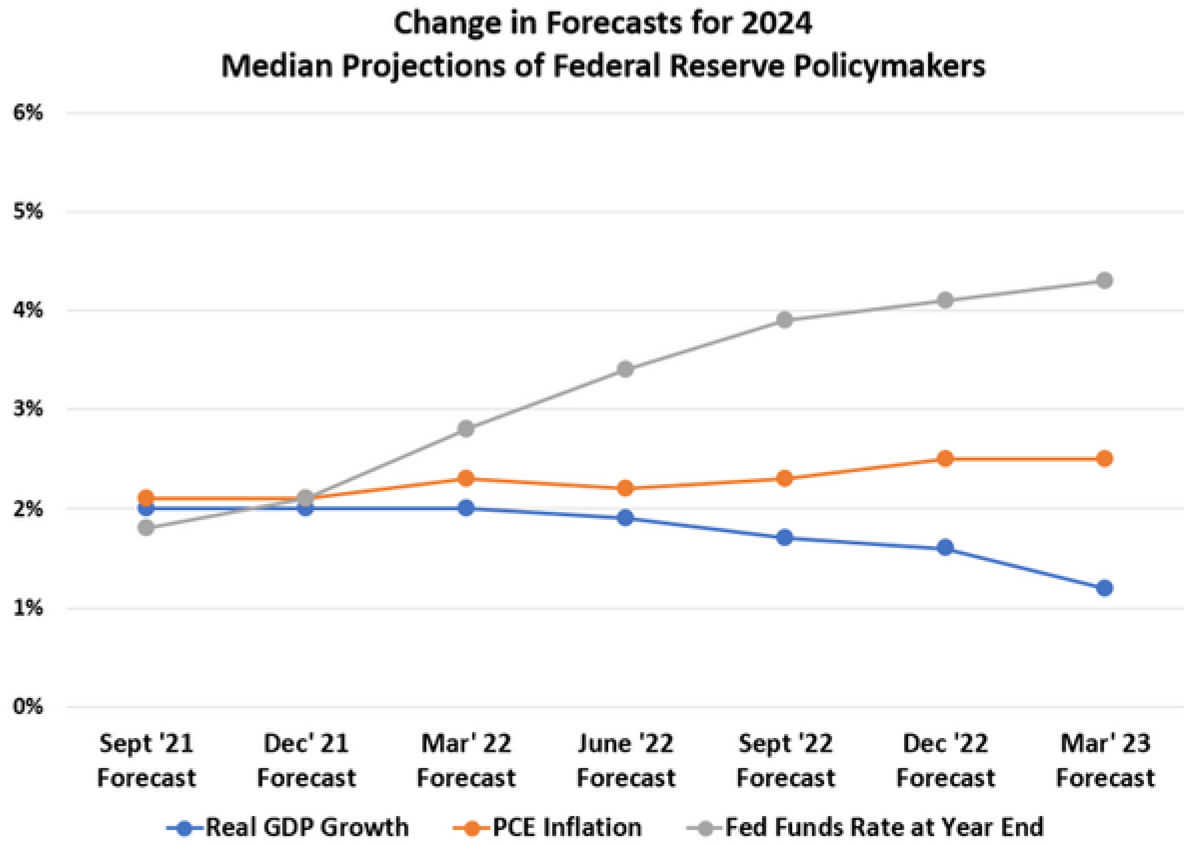
Policymakers still expect to raise the fed funds rate one more time by 0.25% to over 5% and then keep it at that level through at least the end of the year. Fixed income investors, on the other hand, think rates have peaked and that the Fed will be cutting interest rates by July.

Everyone anticipates the recent turmoil in the banking industry will tighten the availability of credit and slow the economy. The disconnect between policymakers and investors is that market participants think more things are likely to break causing the Fed to reverse course to maintain financial stability.

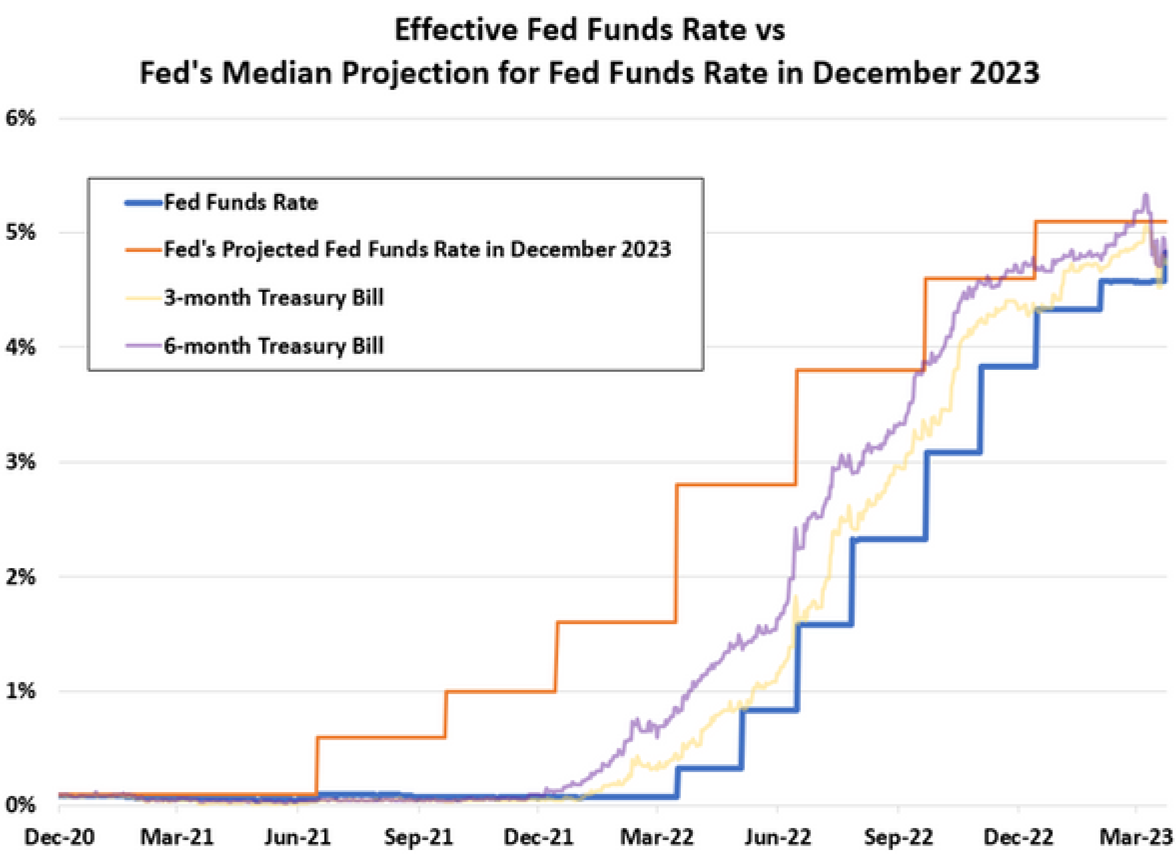
If fixed income investors are right, the economy will soon be in a recession, which has not been priced into the equity markets. If the Fed is right, interest rates will be higher for longer than either the fixed income or equity markets are currently expecting. In either case, markets will remain volatile given the heightened level of uncertainty.

For the first time since the start of the tightening cycle, Fed policymakers did not raise their median projection for how high the fed funds rate will be at the end of 2023.





Fed policymakers indicate they will likely raise rates one more time, but investors are betting rates have peaked.

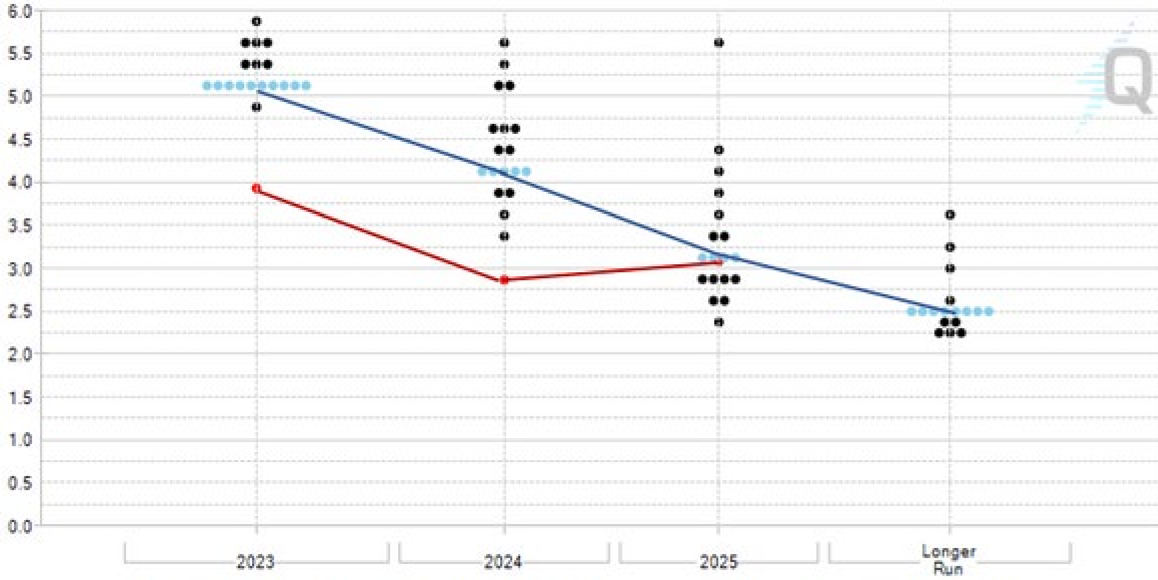


Investors expect that the Fed will start cutting interest rates in July and will have reduced the fed funds rate below 4% by the end of the year.

FOMC PARTICIPANTS' ASSESSMENTS OF APPROPRIATE MONETARY POLICY : "DOT-PLOT"

Blue dots and line = median Fed official forecast

Red dots and line = investors' expectations based on fed fund futures



Blue dots indicate the median projection. Data is based on the economic projections published on March 22, 2023.
Red dots indicate the effective rate implied by the year-end FedFund future price.

Sources: Federal Reserve, Ycharts, https://www.cmegroup.com/markets/interest-rates/cme-fedwatch-tool.html?redirect=/trading/interest-rates/countdown-to-fomc.html

Fed Remittances | No longer supporting Uncle Sam

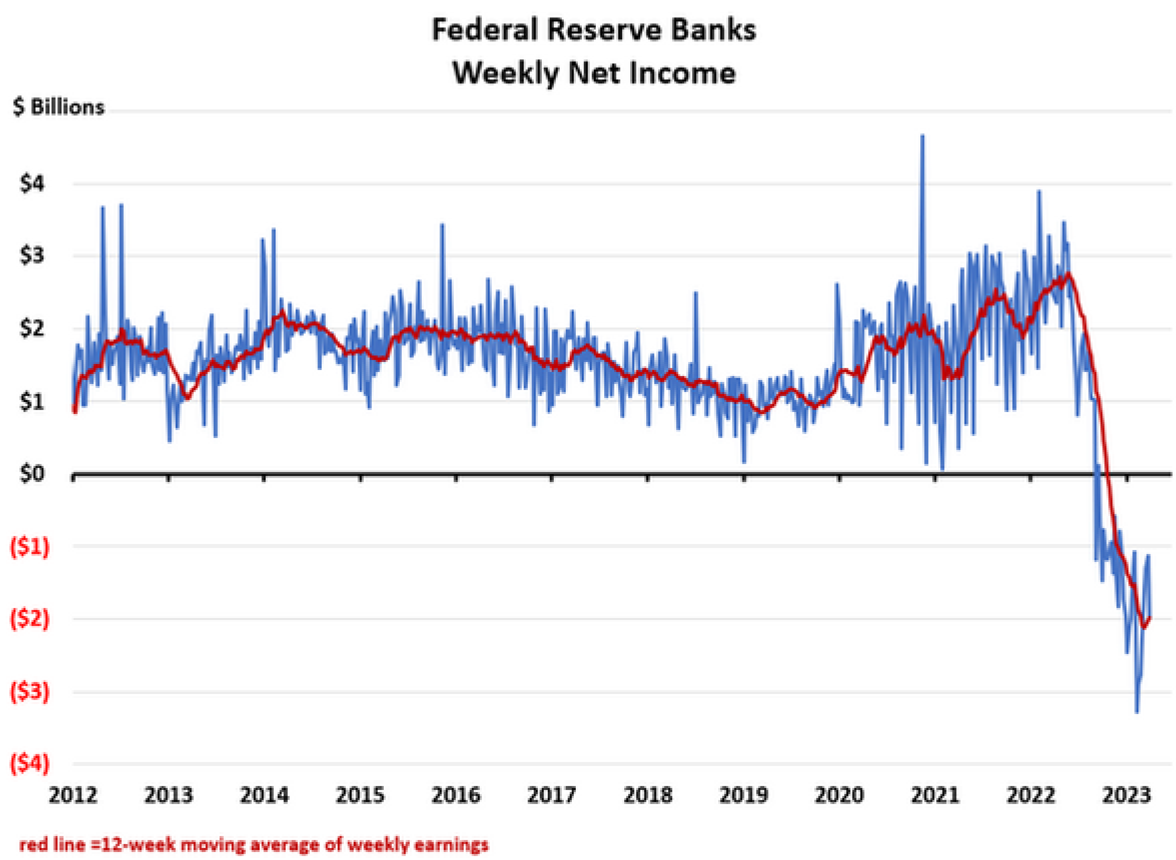
April 3, 2023

During the era of Quantitative Easing, the Federal Reserve greatly expanded its balance sheet and made a lot of money. Last week the Fed released its audited financial statements for 2022 and reported net income of $60.7 billion. Over the past decade, the Fed's annual earnings have averaged over $80 billion. This has been a wonderful free lunch for the federal government as the benefactor of the Fed's earnings, but that free lunch has come to an end.

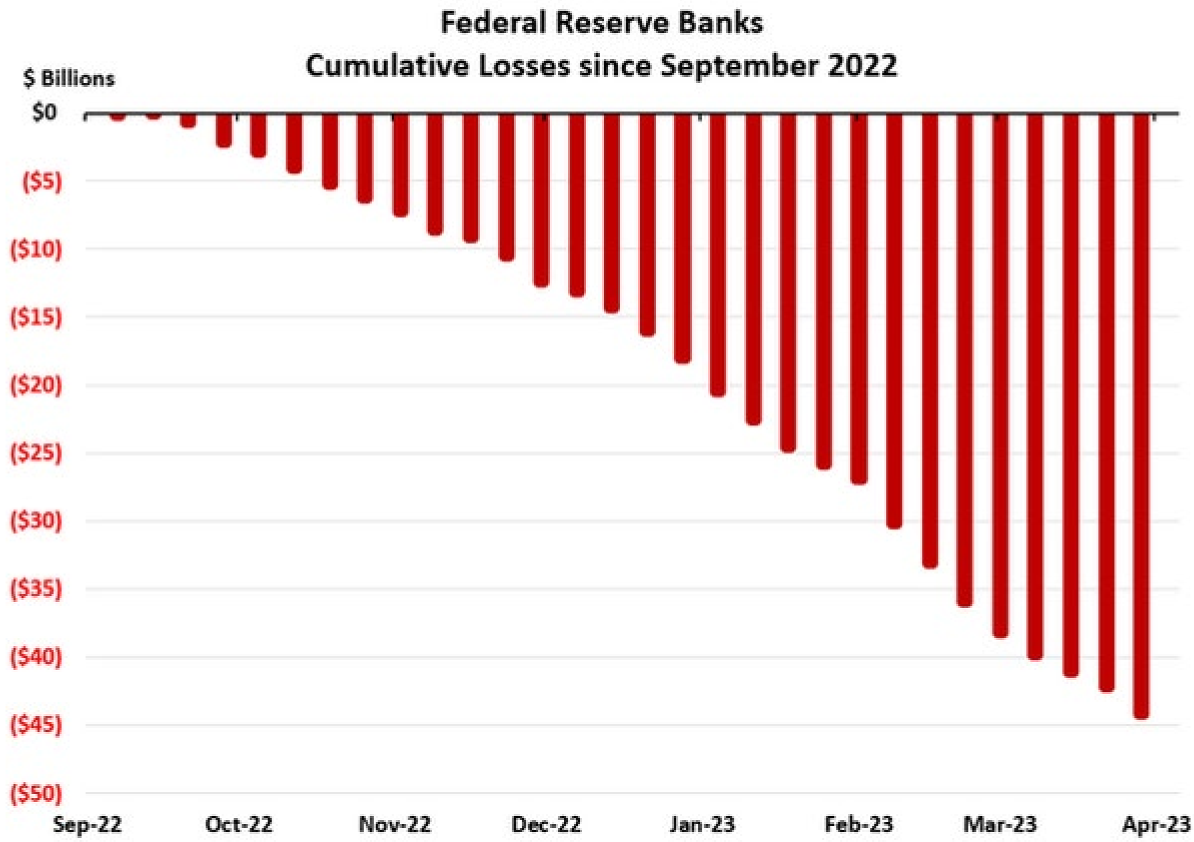
The Fed started losing money in September as it began to pay out more in interest than it was earning on its portfolio of fixed income securities. It is now losing about $2 billion each week and has accumulated losses of $44.2 billion over the past seven months. Unlike some of the banks which have also been squeezed by low yields on long-term assets and rising rates on short-term liabilities, the Fed doesn't have to worry about its solvency. It can effectively print money to meet its commitments and nicely gets to book its losses as a deferred asset because the losses reduce what it must remit to the Treasury in the future.

That through-the-looking-glass accounting unfortunately does not eliminate the reality that the federal government is losing what amounted to nearly $1 trillion in revenue over the past twelve years. Whether it was ever wise for the Fed to create that income stream will be long debated, but its loss will clearly add to the burgeoning federal debt which seems headed towards a day of reckoning that will force the powers-that-be to raise taxes and/or lower spending.

The Fed started losing money last September, and it is currently paying out about $2 billion more per week than it earns in interest on the fixed income securities that it acquired during the era of Quantitative Easing.



The Fed has accumulated losses of over $44 billion since September, which it books as a "deferred asset" because it does not have to remit any earnings to the US Treasury until the losses have been recouped.



The Fed is required to send the US Treasury its earnings. Last year that amounted to $76 billion before the Fed suspended remittances when it started to lose money.

	System total			
	2022		2021	
Reserve Bank and consolidated variable interest entity net income before providing for remittances to the Treasury	$	58,836	$	107,928
Other comprehensive income		1,819		1,640
Total comprehensive income - available for distribution	$	60,655	$	109,568
Distribution of comprehensive income (loss):				
Transfer from surplus	$	–	$	(40)
Dividends		1,209		583
Remittances transferred to the Treasury [1, 2]		76,031		109,025
Deferred asset increase		(16,585)		–
Earnings remittances to the Treasury, net		59,446		109,025
Total distribution of comprehensive income	$	60,655	$	109,568

[1] Represents cumulative excess earnings remittances transferred to the Treasury during the period prior to entering a period of a shortfall of earnings and suspending remittances.

[2] Inclusive of a lump-sum payment of $40 million that was remitted to the Treasury on February 5, 2021 as required by the National Defense Authorization Act of 2021. As a result, aggregate surplus limitation in the FRA was reduced from $6.825 billion to $6.785 billion.

Remittances from the Fed to the Treasury, which have been a nice boost to the federal budget in recent years, are likely over for the foreseeable future unless there is a fifth iteration of Quantitative Easing.

Sources: Federal Reserve, https://www.federalreserve.gov/aboutthefed/audited-annual-financial-statements.htm, https://fred.stlouisfed.org/

Jobs Report | Bad good news?

April 10, 2023

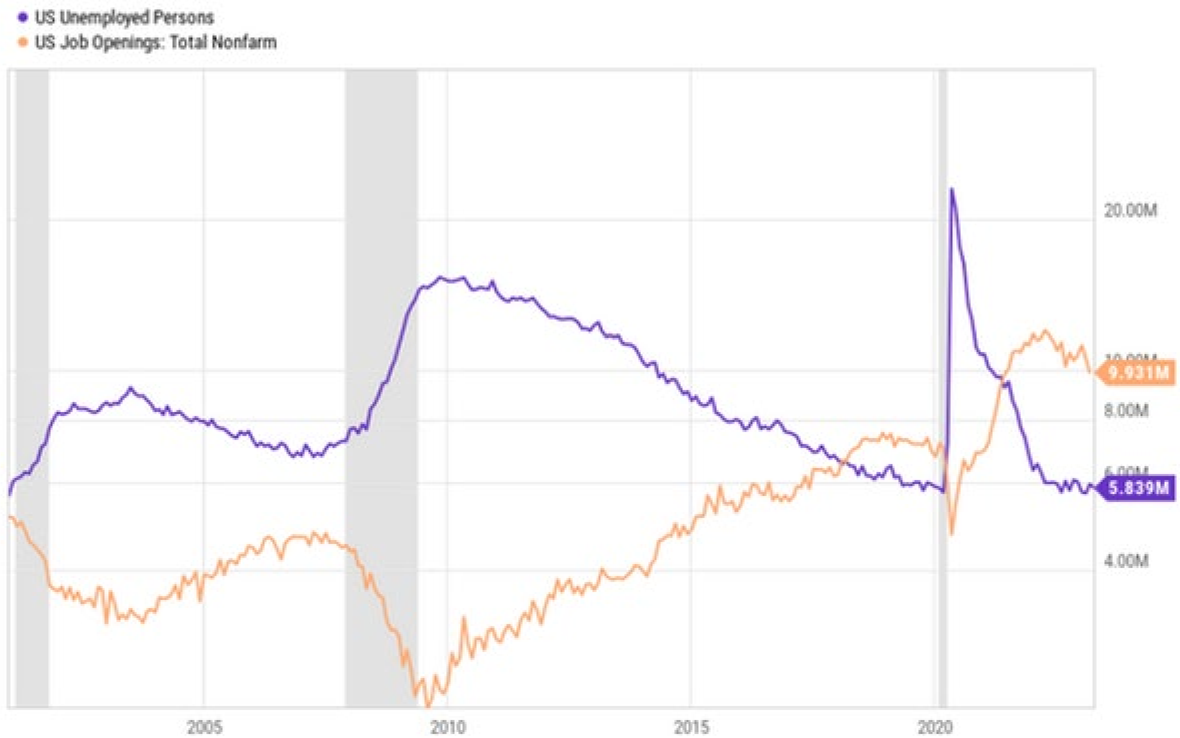
The labor market remained strong in March with an estimated 236,000 jobs added and the unemployment rate ticking lower to 3.5%. The good jobs report has increased the odds that the Fed will raise rates at least one more time; however, the news was not all bad for policymakers striving to bring down inflation.

The size of the labor force continued to grow at a healthy pace for the fourth month in a row as the labor force participation rate increased to its highest level since March 2020. The possibility of a soft landing always depended in part on drawing back into the workforce the individuals who left during the pandemic.

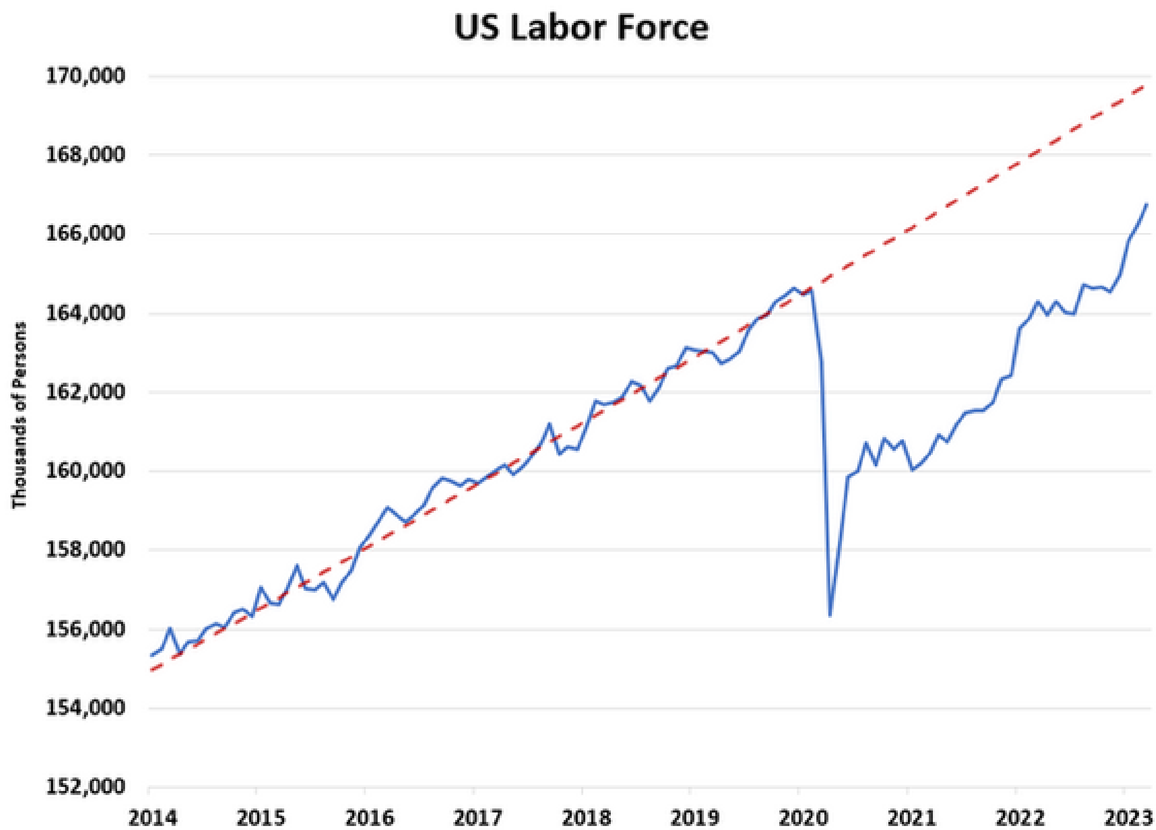
Policymakers could also look past the good headline numbers and see signs of weakening in the labor market if they wanted a reason to pause their rate hikes. Private payrolls increased by the lowest level since 2020, and the number of temporary workers continued to decline compared to last year.

Fixed income investors certainly seem to think the labor market is about to weaken substantially as the negative spread between the 10-year Treasury yield and 3-month Treasury yield reached a historic level of inversion last week.

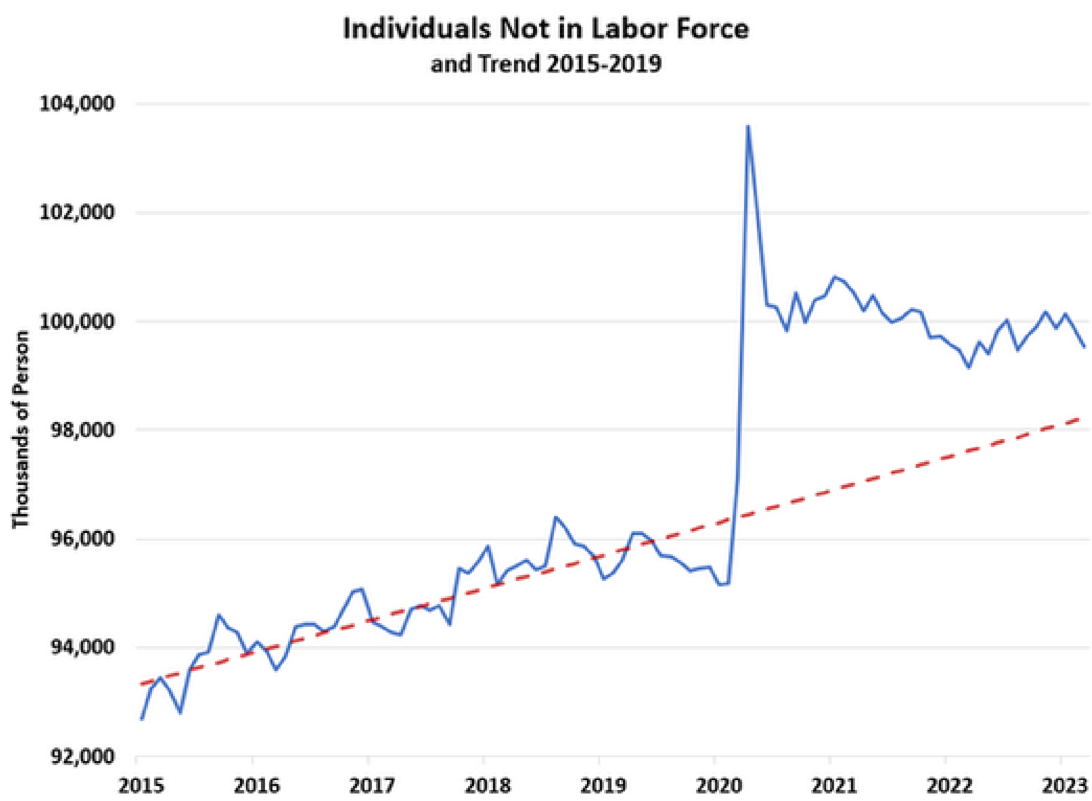
The labor market remained tight in March. The number of job openings still exceeds the number of unemployed by a large margin.



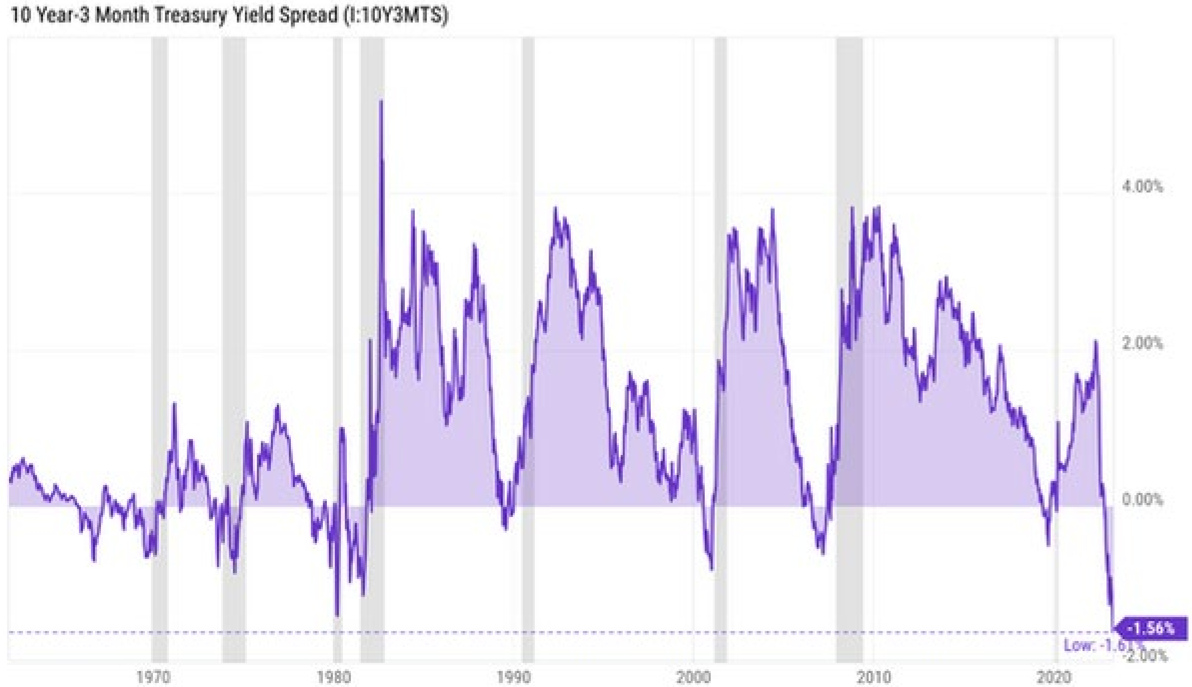
The gap between the size of the US labor force and its pre-pandemic trend level continues to narrow.



Even accounting for an aging population, there are still more than a million workers missing from the labor force who likely would be there absent the pandemic.



The yield curve is at a historic level of inversion, which is another leading indicator of a recession. If this time is different, it will be very different.



The number of temporary workers continued to decline which has historically been a leading indicator of a pending recession.

Sources: BLS, YCharts, https://fred.stlouisfed.org/, AOWM calculations

After Rate Hikes End | Flip a coin?

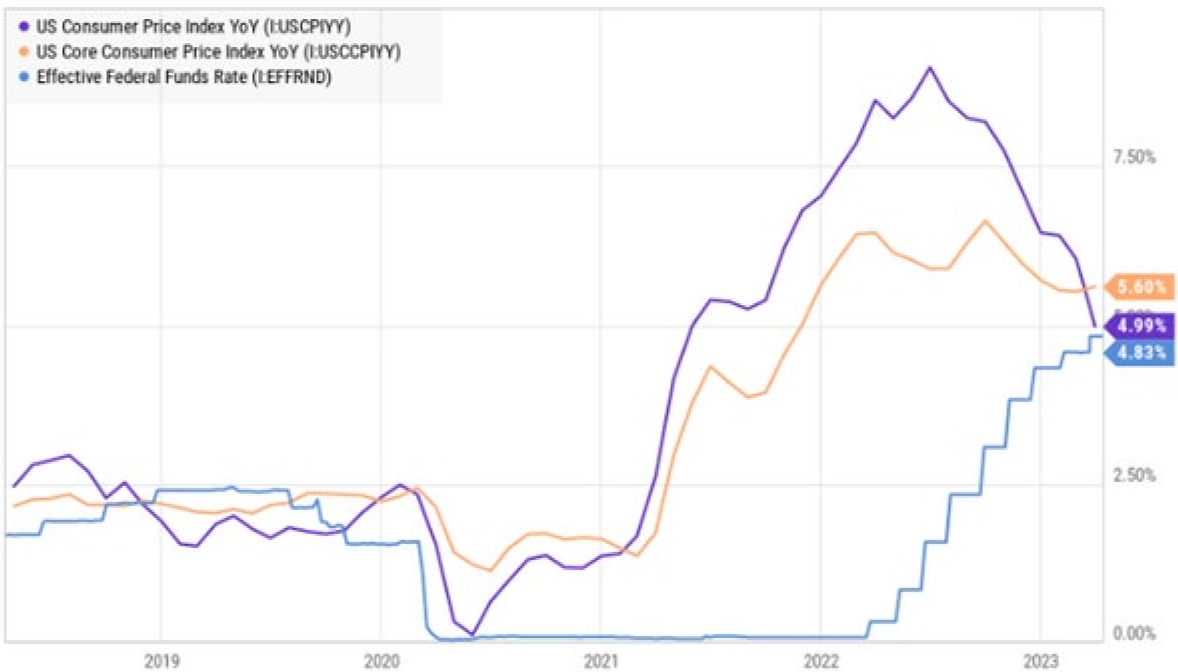
April 17, 2023

Inflation continued to improve in March with the headline number falling to 5%. The Fed may still hike rates one more time next month as core inflation excluding food and energy is showing less progress, but the end of Fed rate increases seems imminent.

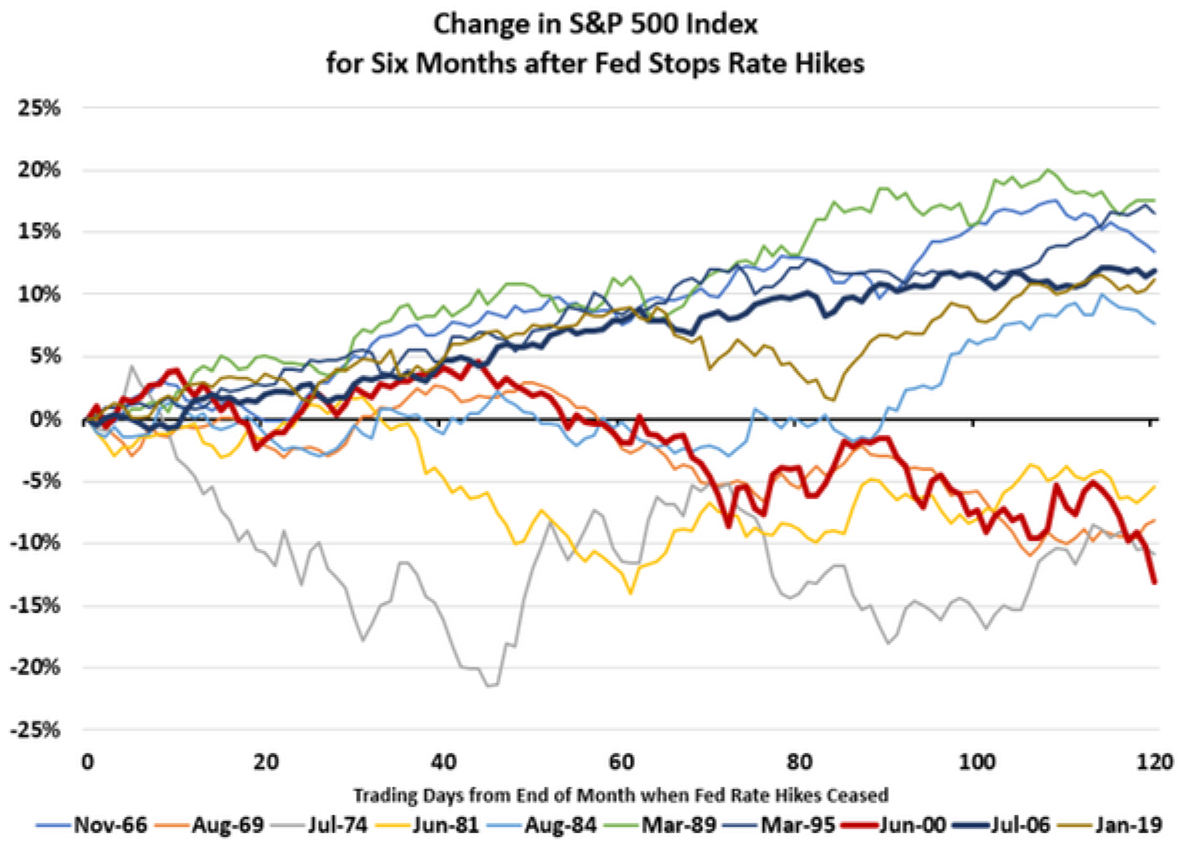
What happens after the Fed stops raising rates? History tells us the stock market may go up – or it may go down. At the end of the past ten Fed tightening cycles, the market reacted positively six times over the subsequent six months. Half the time, however, significant market declines were still to come, including the false dawn in 2006 when the market sailed to new all-time highs in 2007 before the financial crisis struck.

When policymakers finally do indicate that they think they've done enough, the decreased uncertainty around how high the Fed will raise rates may very well generate a momentary rally in the stock market. How long such a rally lasts will likely depend on corporate profits and investors' risk appetites remaining robust. Stubborn inflation and/or a deep recession would dent both.

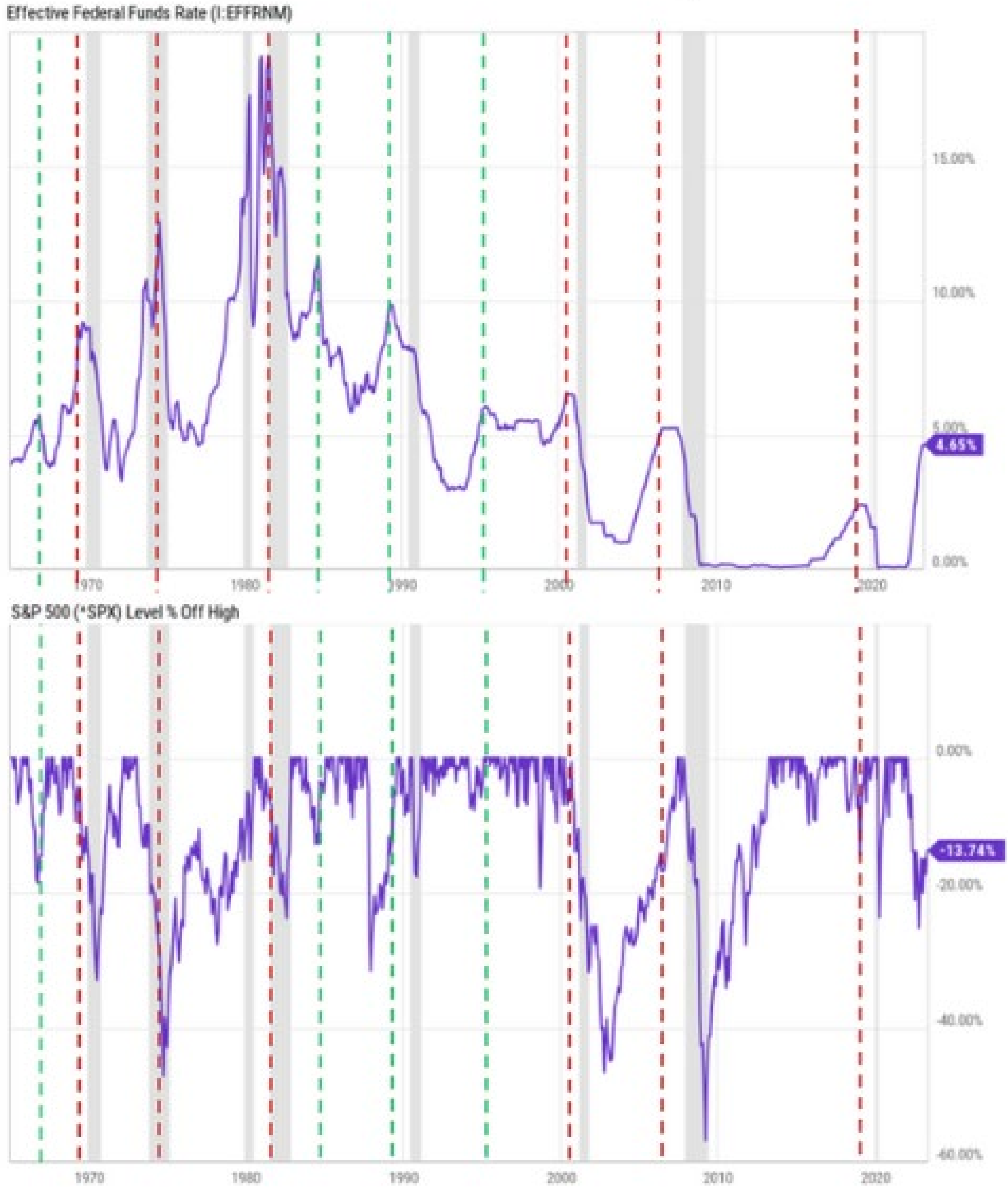
Headline CPI inflation fell in March to its lowest level since May 2021.



The end of Fed rate hikes may give the stock market a boost, but it may only be temporary if the economy slips into a recession.



Tightening monetary policy usually increases market volatility, but sometimes the bottom is when the rate hikes stop.



Sources: YCharts, https://fred.stlouisfed.org/, AOWM calculations

The Markets | Unsettled quiet

April 24, 2023

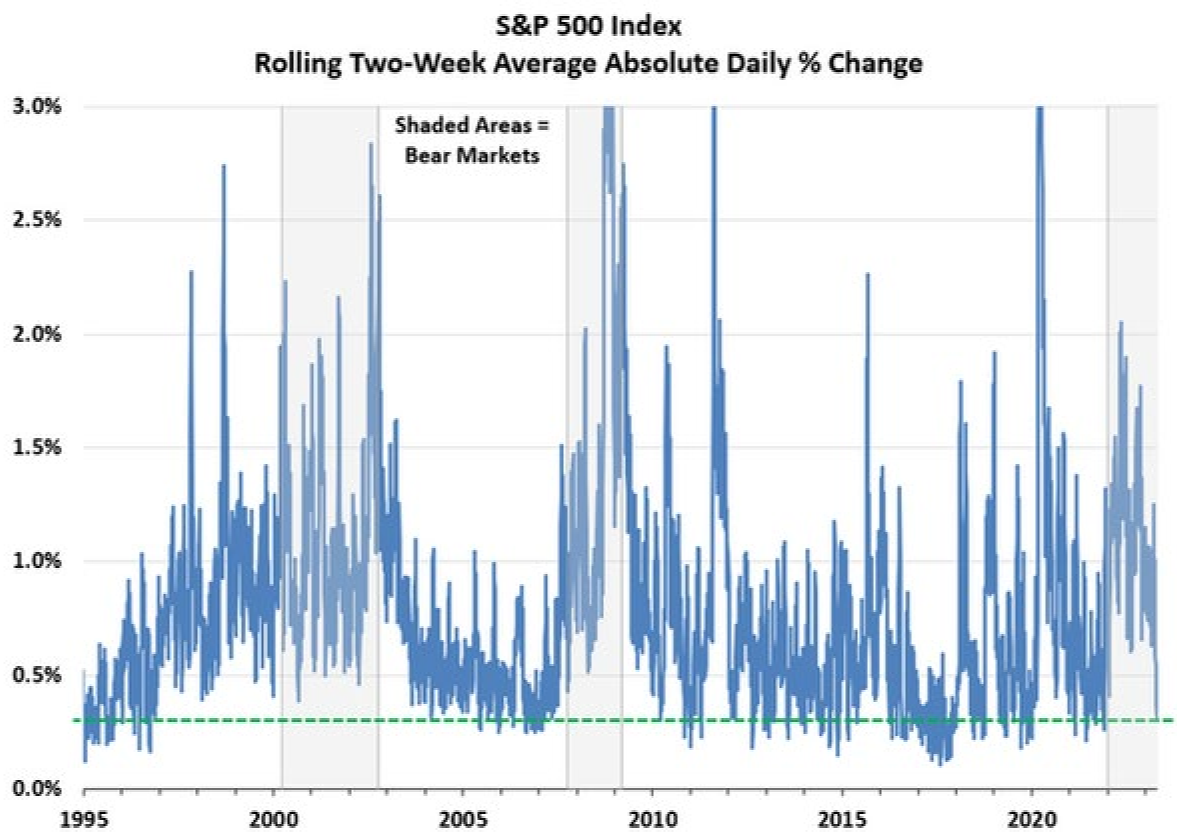
The stock market has had a quiet start to the earnings season during which companies report their first quarter profits. Over the past two weeks, the realized and expected future volatility of the S&P 500 Index has fallen back to where it was at the market peak in January 2022. The seas have calmed quickly after the recent rattling storm of two large bank failures.

It is unusual for the market's daily swings to be this subdued during a bear market -- or the early stages of a new bull market if that is where we are. But the stock market has been anything but normal over the past three years.

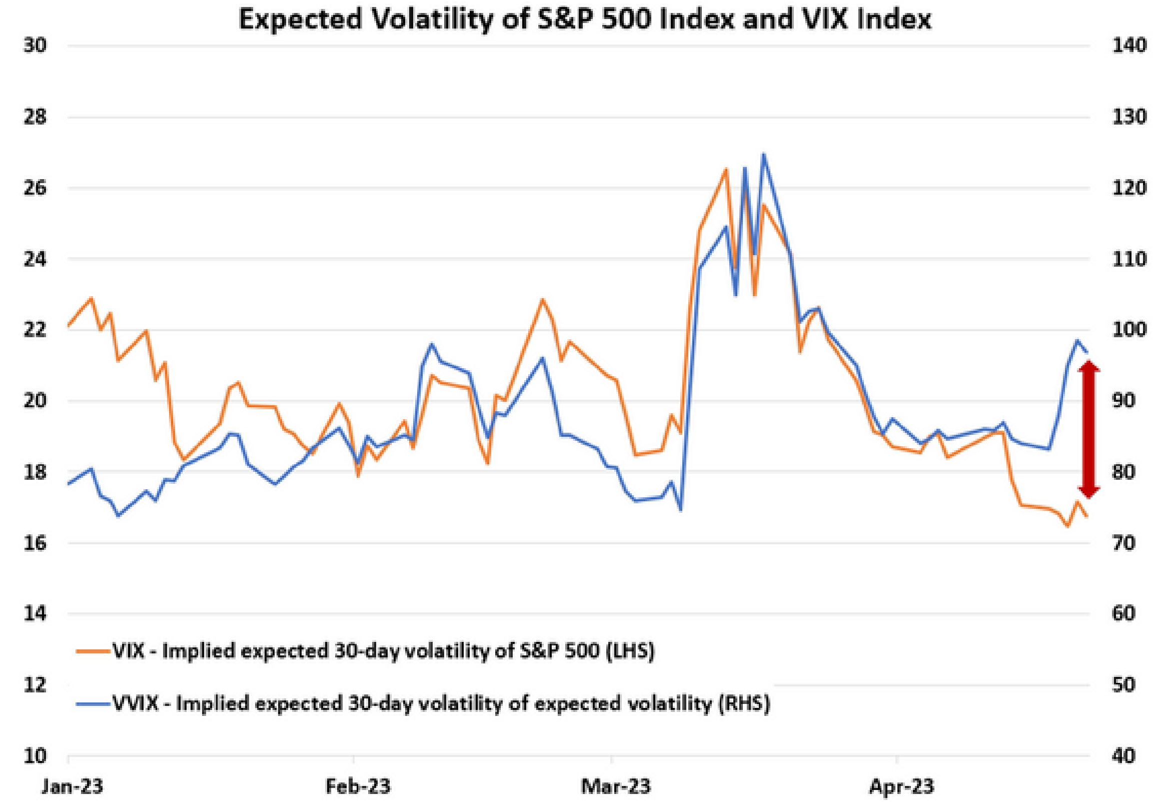
Adding to the eerie stillness of the stock market is the strange activity in the Treasury market where the yield on the one-month Treasury bill has cratered to 3.36% over the past few weeks even while expectations have increased for the Fed to raise its target overnight rate above 5% next week. It is unclear why the most liquid market in the world is behaving so oddly, though it may have something to do with concerns about the looming debt ceiling battle in Congress.

Even without the potential for a brewing debacle in the nation's capital, the next two weeks are likely to make all financial markets livelier as two-thirds of the companies in the S&P 500 Index are scheduled to report their first quarter earnings and the Fed will announce its next interest rate decision. If the stock market sleeps through all that without at least a few characteristically erratic swings, something peculiar is afoot.

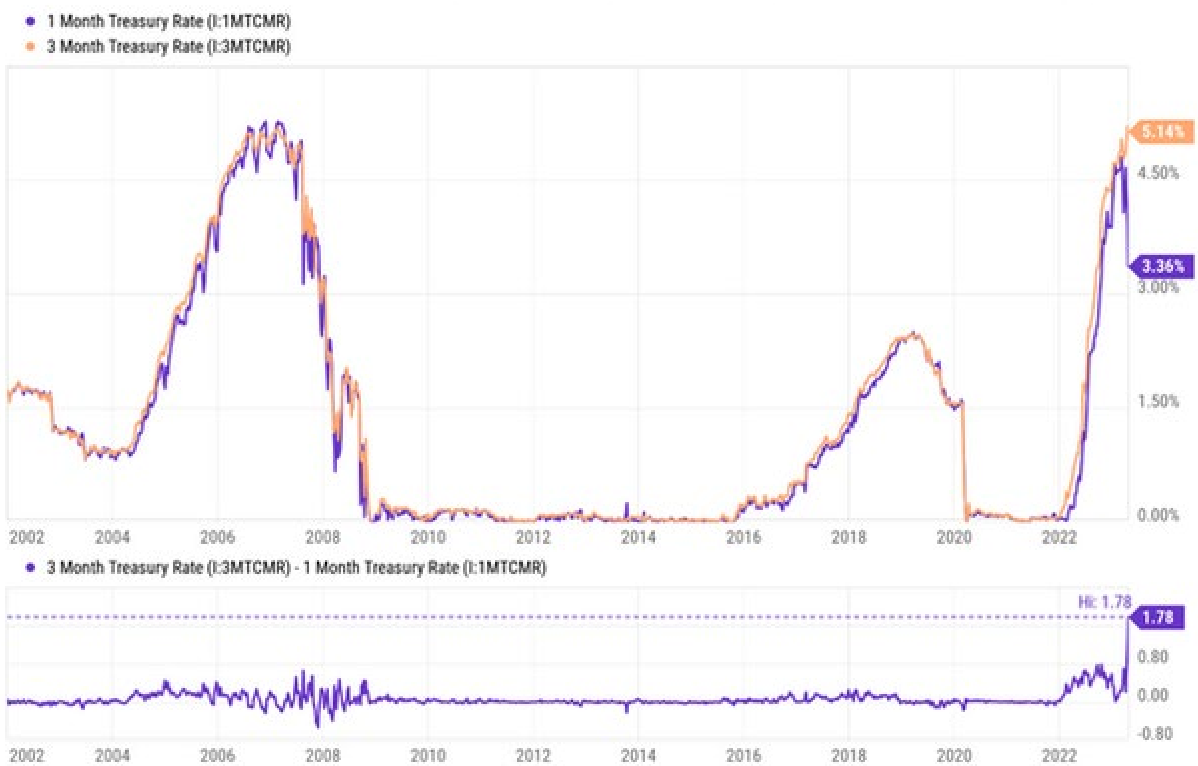
Realized volatility in the stock market has been unusually low over the past few weeks for a bear market or a new bull market.



Expected volatility in the S&P 500 Index based on option prices has fallen back to where it was at the market peak in January 2022, but investors are simultaneously not betting for that to last.



While the stock market is strangely calm, the Treasury market is strangely not.



Sources: YCharts, finance.yahoo.com, AOWM calculations

The Consumer | Still spending

May 1, 2023

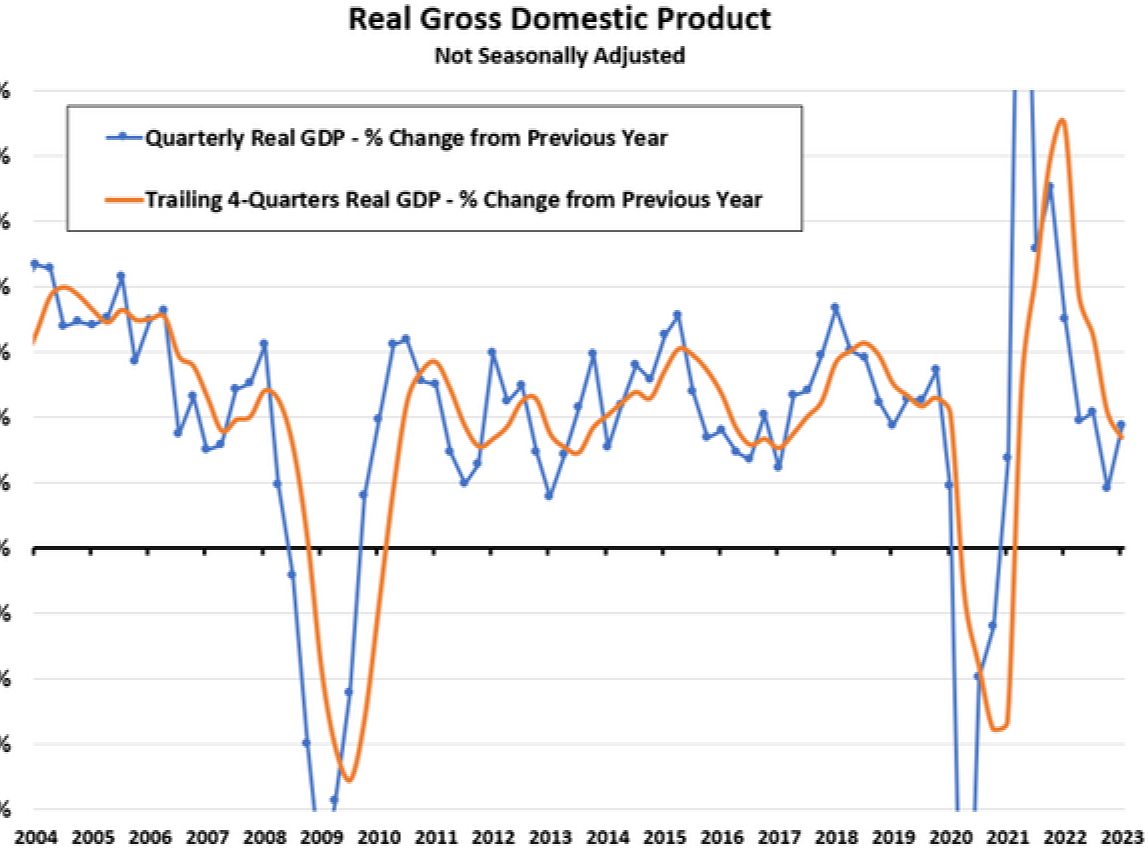
Economic growth in the first quarter was weaker than forecasters had expected with the economy growing just 1.1% during the quarter at a seasonally adjusted annual rate. Quarter-over-quarter growth has been choppy over the past eighteen months, but the economy does seem to be trending towards slower growth, if not a recession.

To the extent the economy is growing, the consumer is primarily to thank. Businesses drew down inventories in the first quarter, which weighed on growth, but the consumption of goods and services continued to head higher. The economy has leaned heavily on personal consumption over the past few years as it has grown to represent nearly 71% of real GDP.

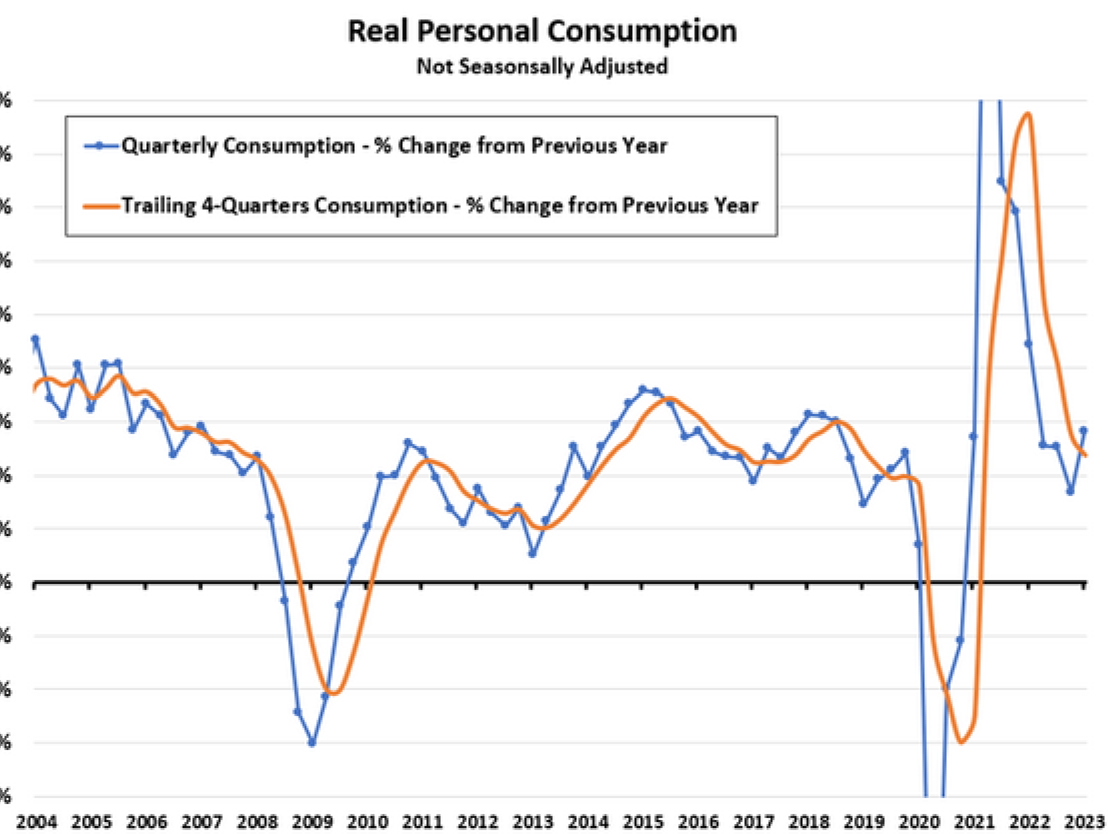
The enormous stimulus doled out during the pandemic has fueled consumer spending. Consumers are likely still sitting on over $1 trillion more in savings than they otherwise would have had. That stockpile is being slowly whittled down but should continue to support the economy for the remainder of the year. Once it is gone, the economy will be more vulnerable to the Fed's tightening monetary policy which is expected to go another rung higher this week.

Quarter-over-quarter growth has been up and down, but real GDP for the recent quarter looked better when compared to the weak first quarter last year.

Despite the bounce in YoY growth, the economy still seems to be slowing.



Year-over-year personal consumption was up a healthy 2.8% in the first quarter.



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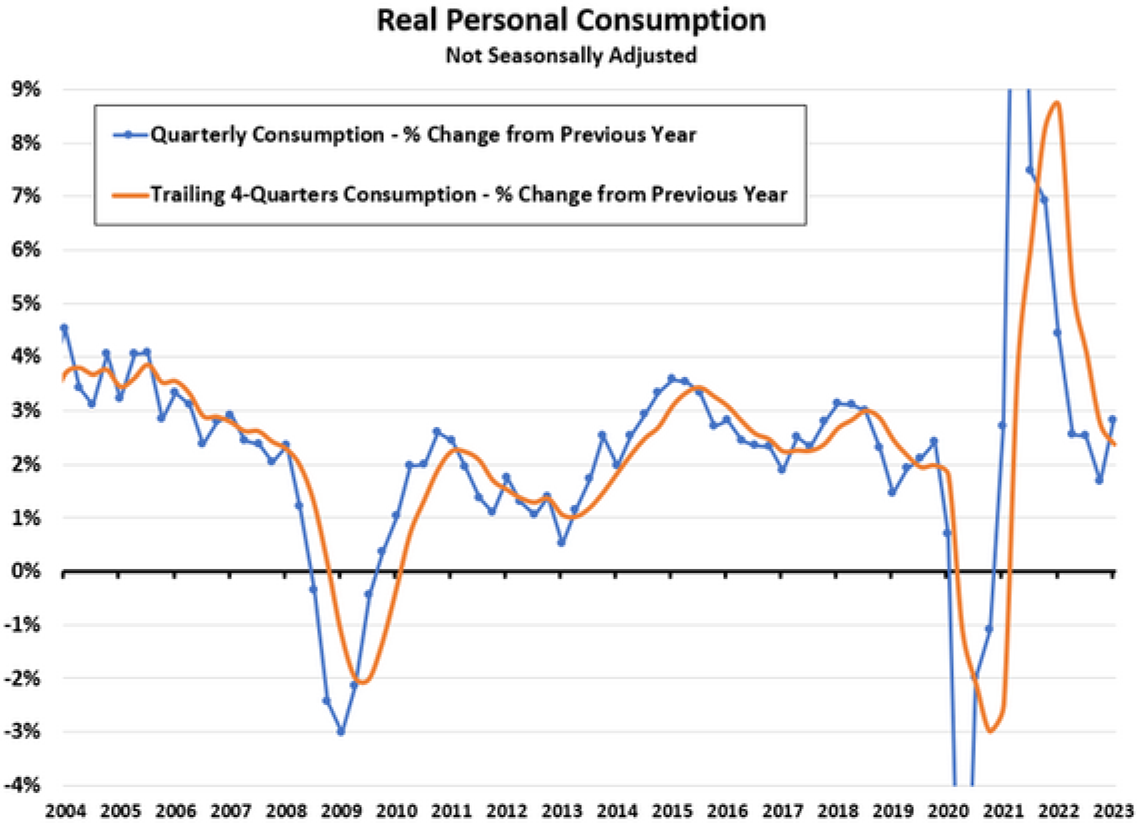
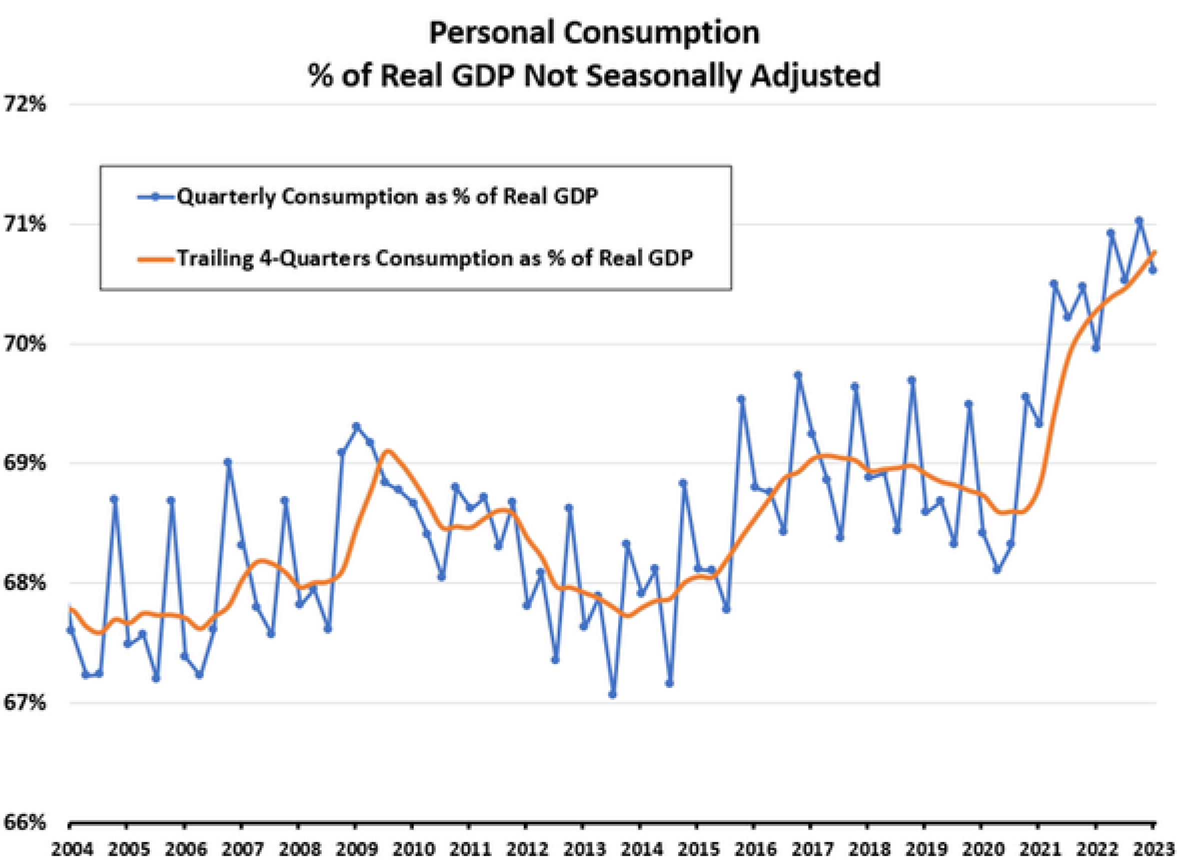
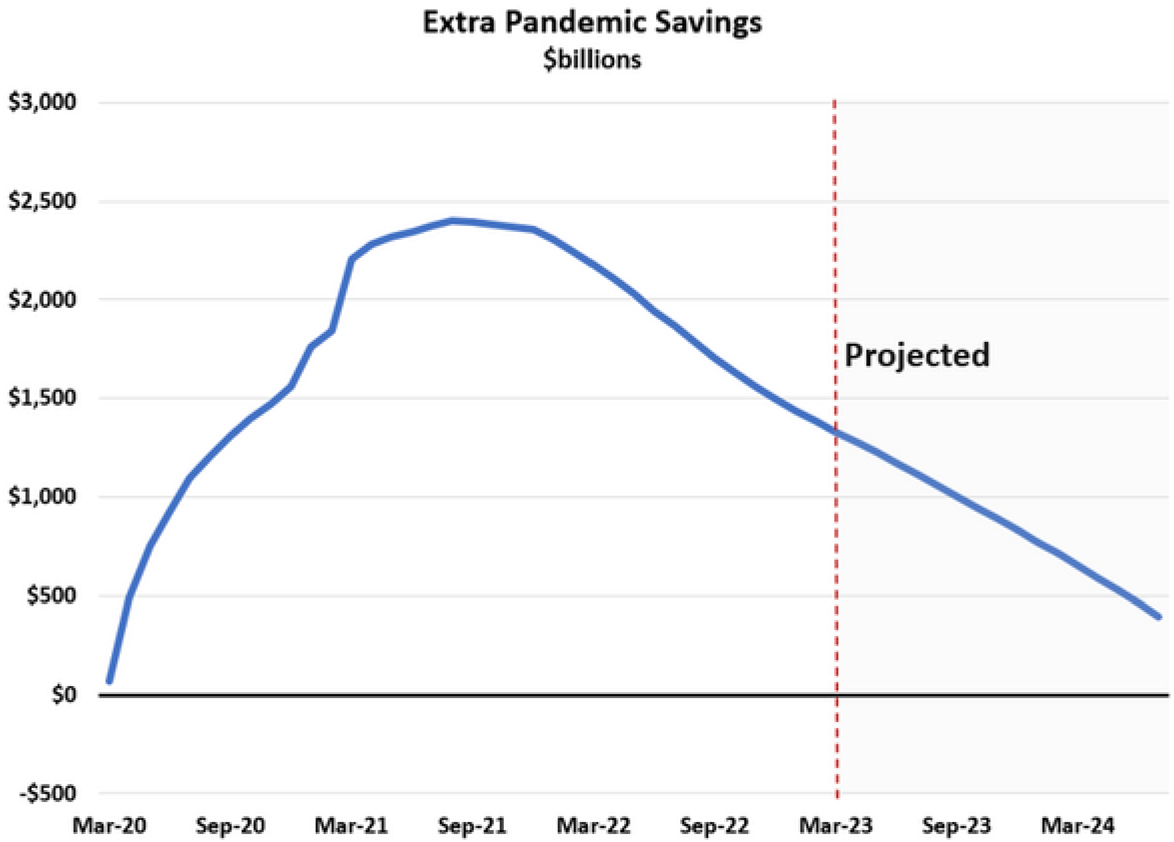


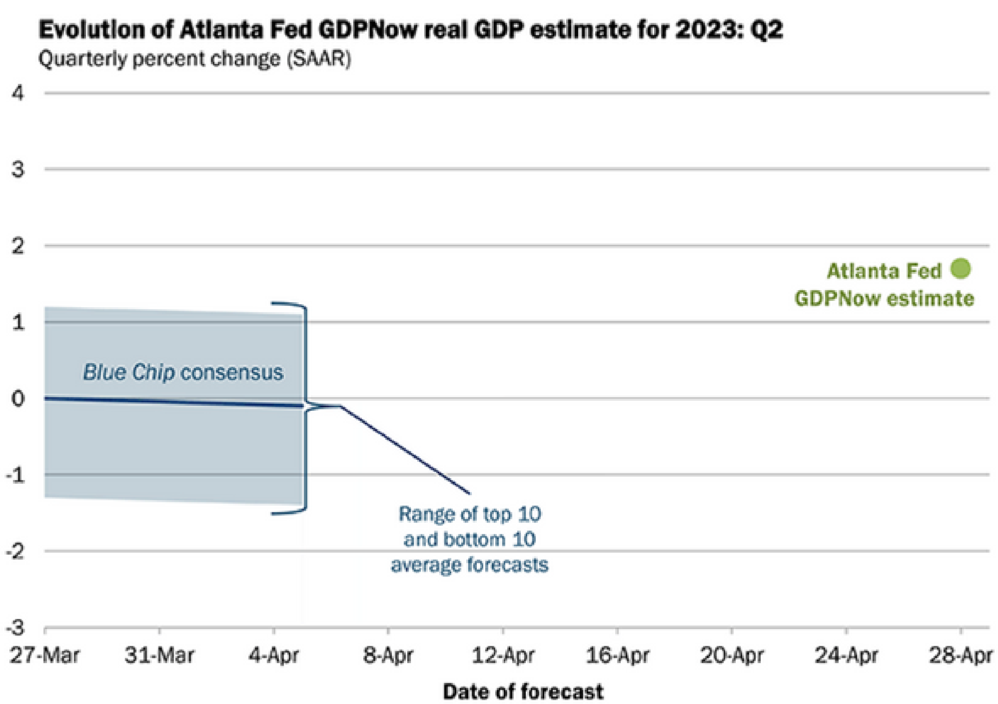
Personal consumption has grown in importance as a driver of economic growth over the past three years.



The stockpile of extra pandemic savings continues to decline, although it is shrinking at a slower pace than last year as individuals have increased their savings in recent months.



Economic growth is expected to remain weak in the second quarter.



Sources: *Blue Chip Economic Indicators* and *Blue Chip Financial Forecasts*
Note: The top (bottom) 10 average forecast is an average of the highest (lowest) 10 forecasts in the *Blue Chip* survey.

Sources: YCharts, https://fred.stlouisfed.org/, https://www.atlantafed.org/cqer/research/gdpnow.aspx, AOWM calculations

Peak Fed Funds | Wait and see

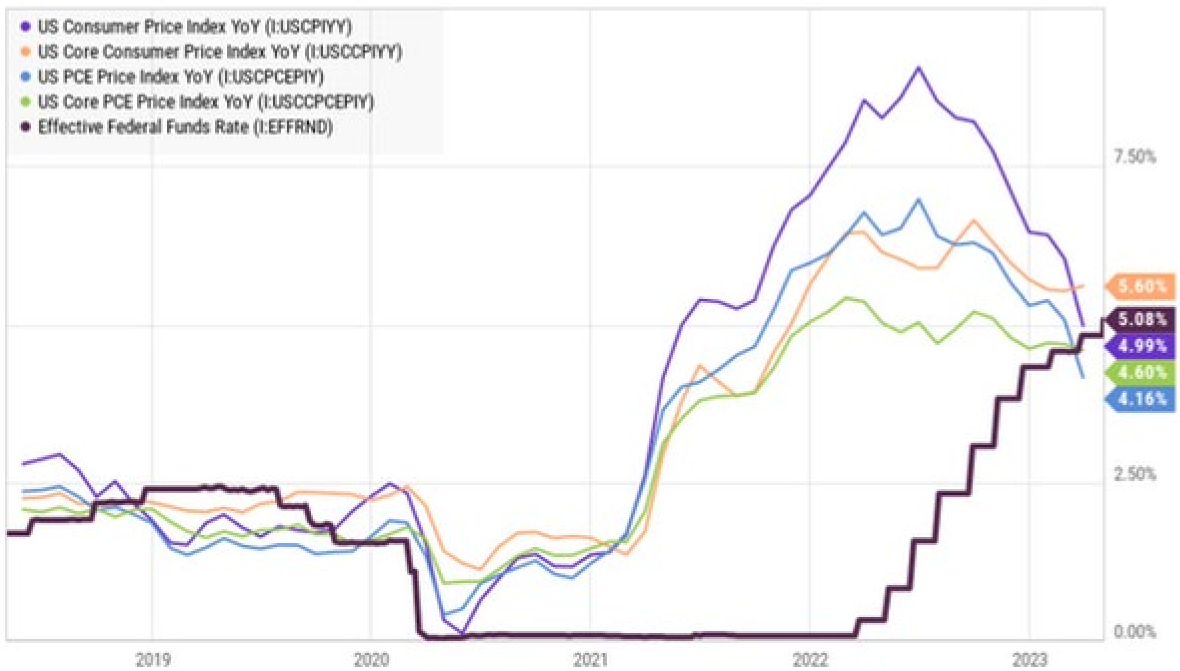
May 8, 2023

Policymakers at the Federal Reserve increased their target overnight interest rate to over 5% last week and indicated they will take a wait-and-see approach from here to evaluate whether they have done enough to bring inflation under control. The fed funds rate is now above most measures of inflation for the first time since 2019; however, in real, inflation-adjusted terms, the Fed's target rate remains historically low unless inflation continues to fall relatively swiftly in the coming months.

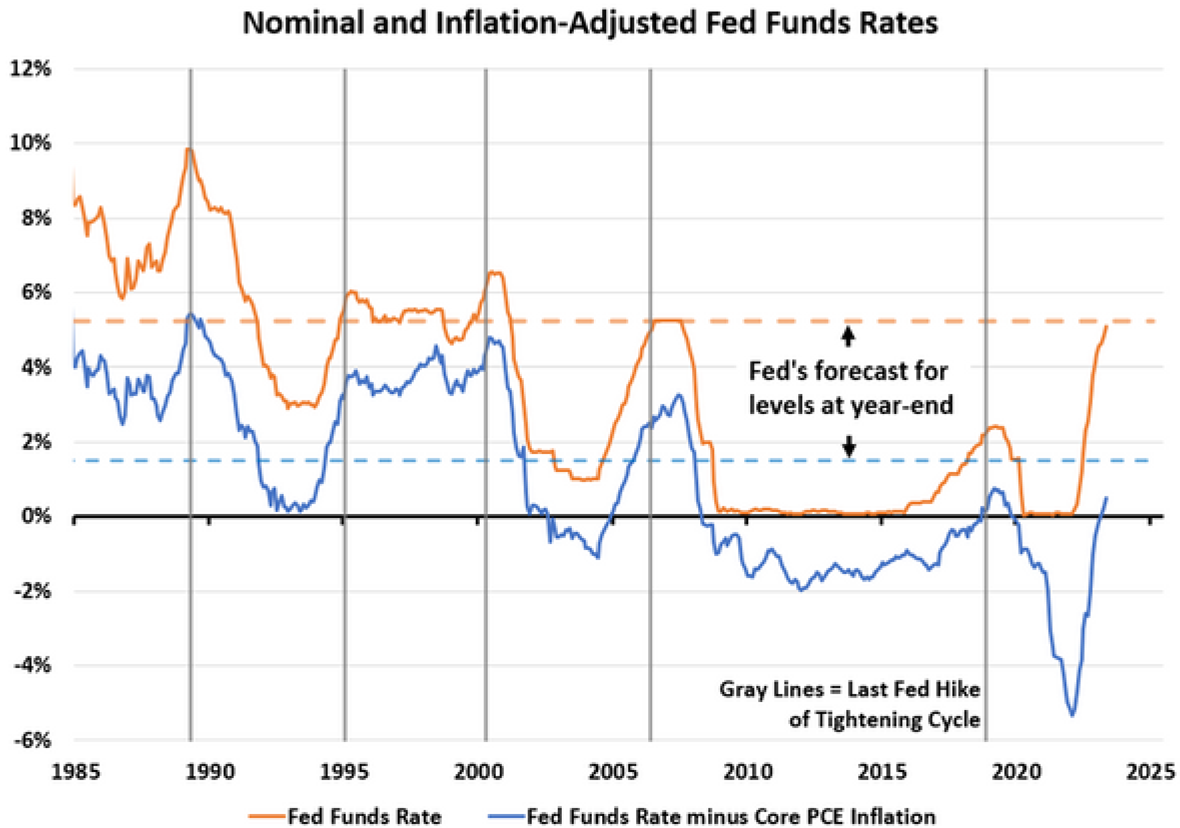
The Fed is looking for financial conditions to tighten further naturally from here with policymakers expecting the fed funds rate to be about 1.5% above falling core PCE inflation by the end of the year (which would still be well below where the real fed funds rate peaked in 2000 or 2007). If inflation does not fall as forecasted, nominal rates will likely not have peaked after all.

The strong labor market may complicate the Fed's contemplative pause. The unemployment rate fell back to the multi-decade low of 3.4% in April and has been below 4% for more than a year which has added to inflationary pressures. Unemployment often does not start to increase until several months after the Fed has stopped raising rates. But for policymakers hoping to be done with rate increases, it would be helpful for the imbalances in the labor market to start moderating sooner rather than later (ideally via a glorious soft landing of more folks joining the workforce than a big decline in employment).

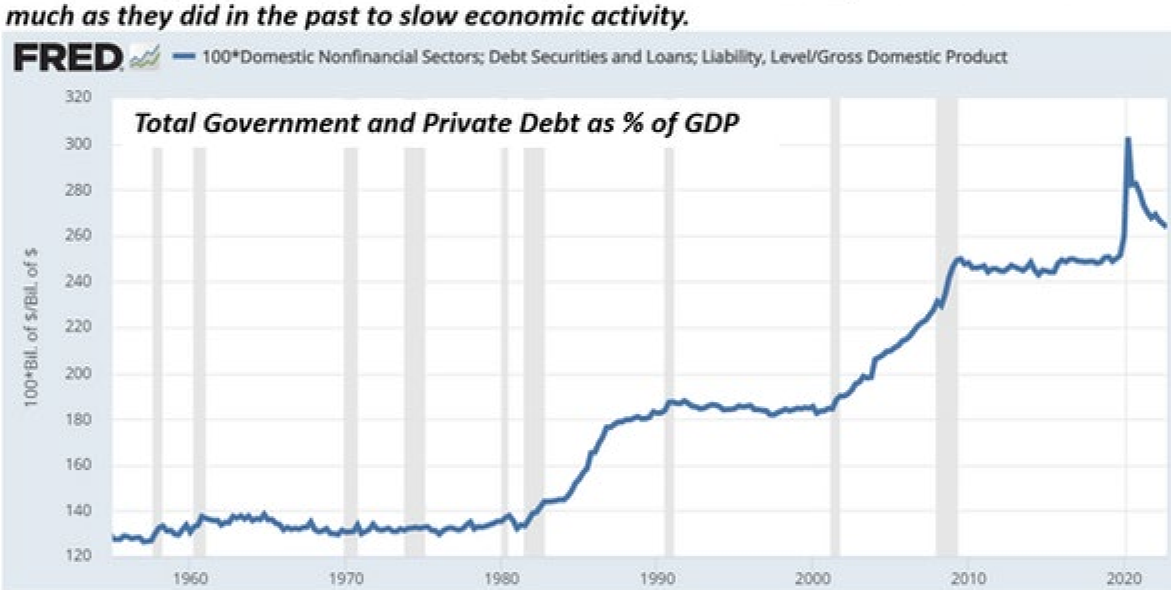
The fed funds rate is now back above most measures of trailing inflation for the first time in four years.



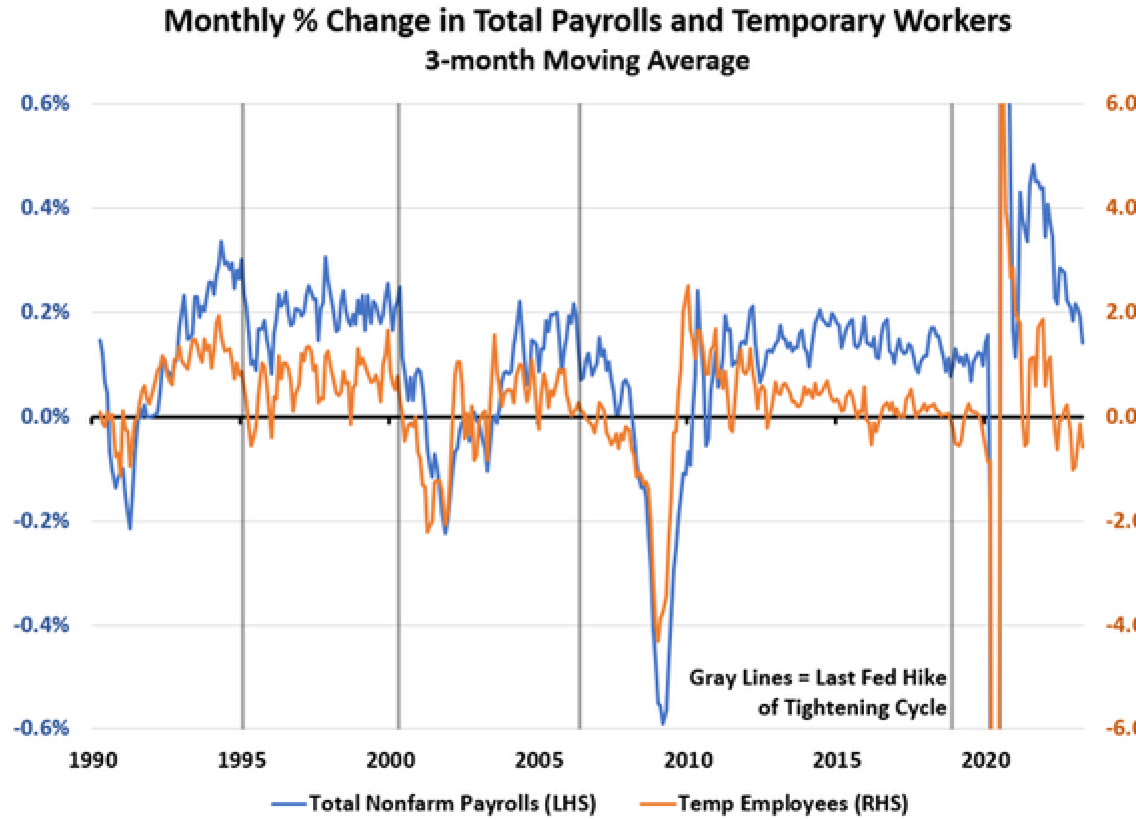
The real fed funds rate may be back above zero, but it remains at what historically would have been viewed as a stimulative, low level.



Given the large amount of debt outstanding, real interest rates may not have to rise as much as they did in the past to slow economic activity.



The labor market remained strong in April but continued to slow. The number of temp workers declined for the sixth straight month, which may be a leading indicator for the broader jobs market.



In some cases, the unemployment rate has remained low for more than year after the Fed stopped increasing interest rates.

Sources: YCharts, https://fred.stlouisfed.org/, AOWM calculations

Small Caps | Not feeling very bullish

May 15, 2023

The stock market continues to trend sideways, held up primarily by the stocks with the largest market valuations. While seemingly going nowhere fast, the S&P 500 Index still remains more than 15% above the low reached last October. Small cap stocks, on the other hand, have traded back toward the lows with the Russell 2000 Index down nearly 29% from its all-time high.

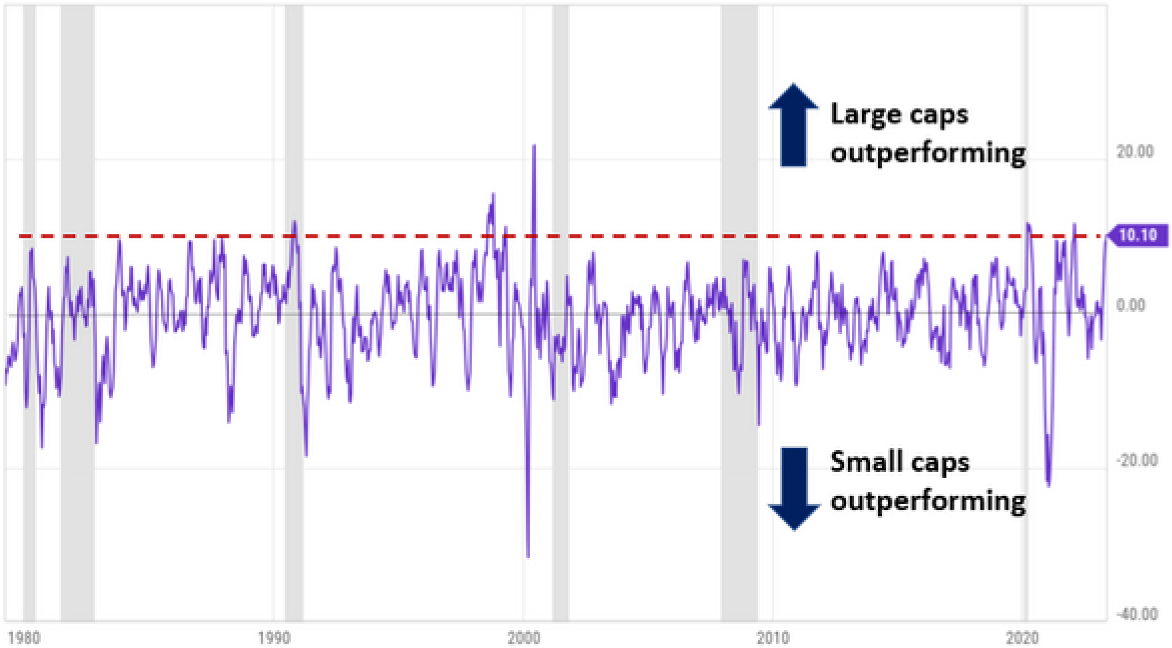
Small cap stocks typically lead the market coming out of a downturn (or at least keep pace). They are clearly not doing that now. Thus if last October was the low, the market is defying its historical pattern, which it has frequently done over the past three years.

On the positive side for small cap stocks is their relative valuation. The Russell 2000 is trading at less than 13 times expected earnings while the S&P 500 is over 19. Even if estimates for future earnings remain too optimistic and have further to fall, investors seem to have built some margin of safety into small cap valuations.

Small caps have lagged since the Silicon Valley Bank failed in early March.

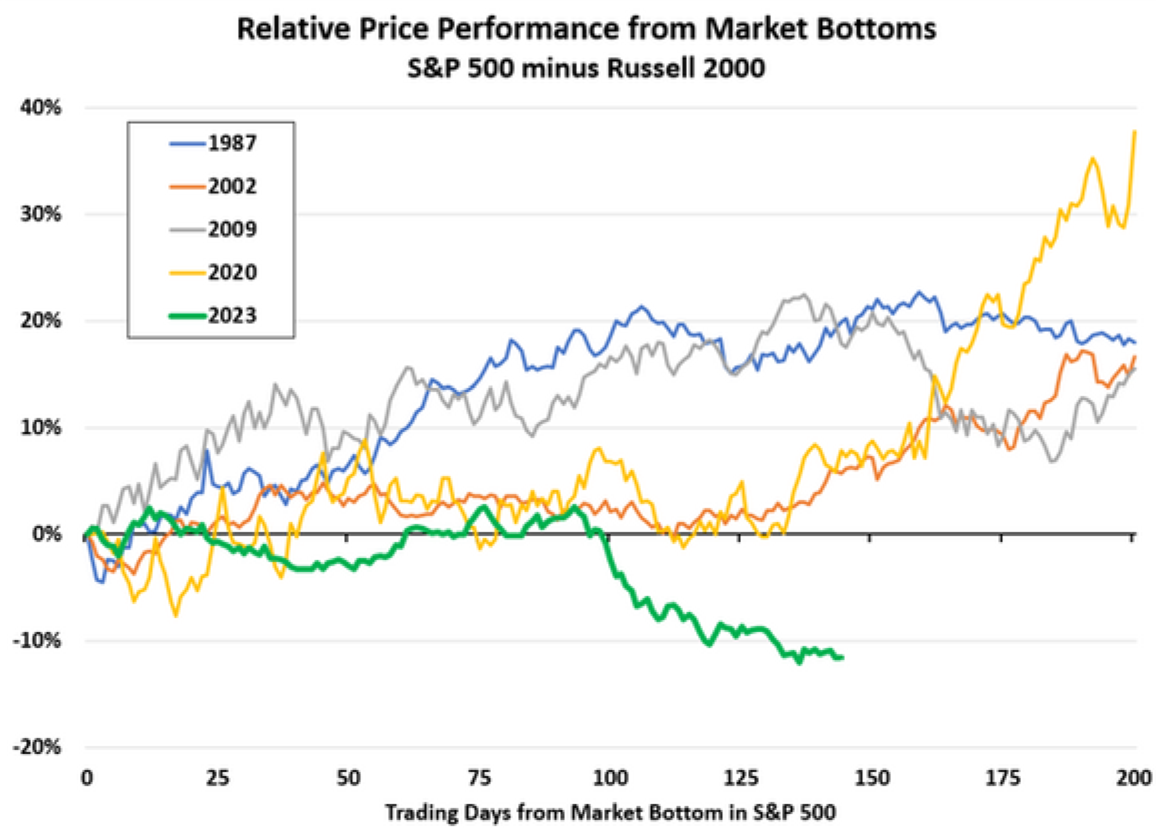
Large caps have been outperforming recently, but history suggests the wheel will turn in small caps favor before long at least on a relative basis.

Rolling 3-month Relative Price Returns: S&P 500 vs Russell 2000

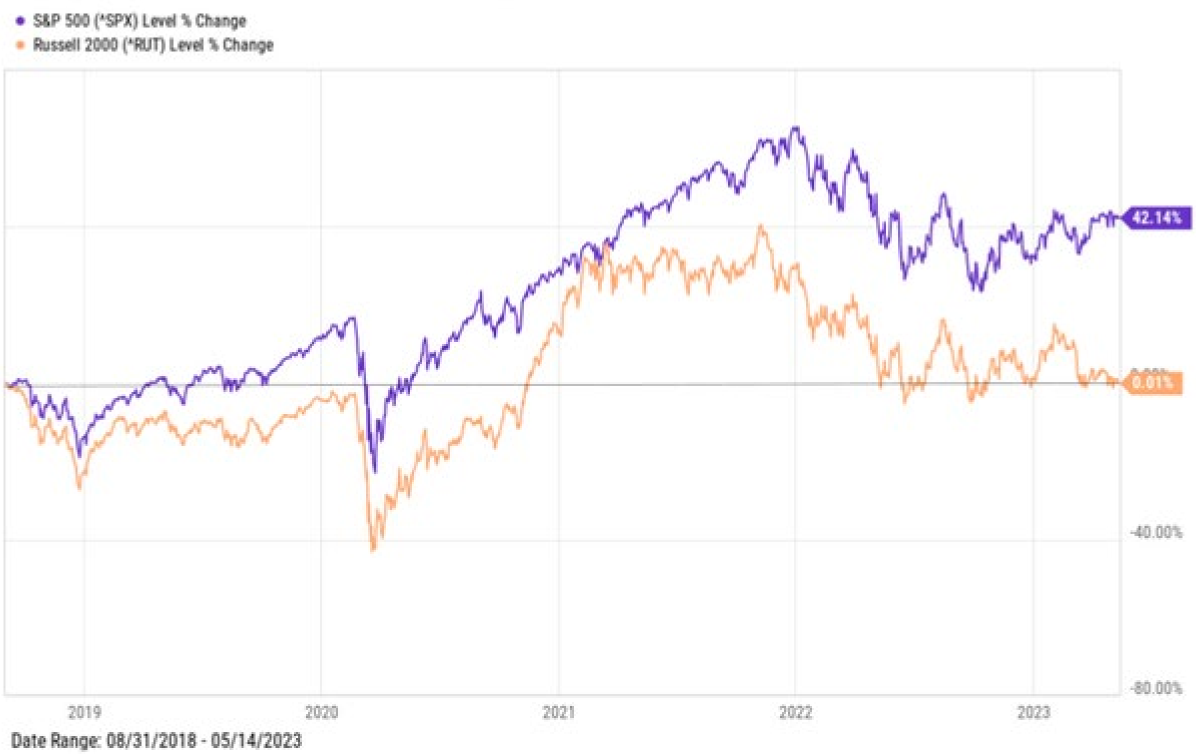


Small caps are trading near their lows since the bear market began.

Small caps typically outperform large cap stocks coming out of a bear market.



Small cap stocks have traded sideways for nearly five years and thus trade at a significant valuation discount to large cap stocks, which are still up over 40%.



Sources: YCharts, AOWM calculations

Debt Ceiling | Fiscal fig leaf

May 22, 2023

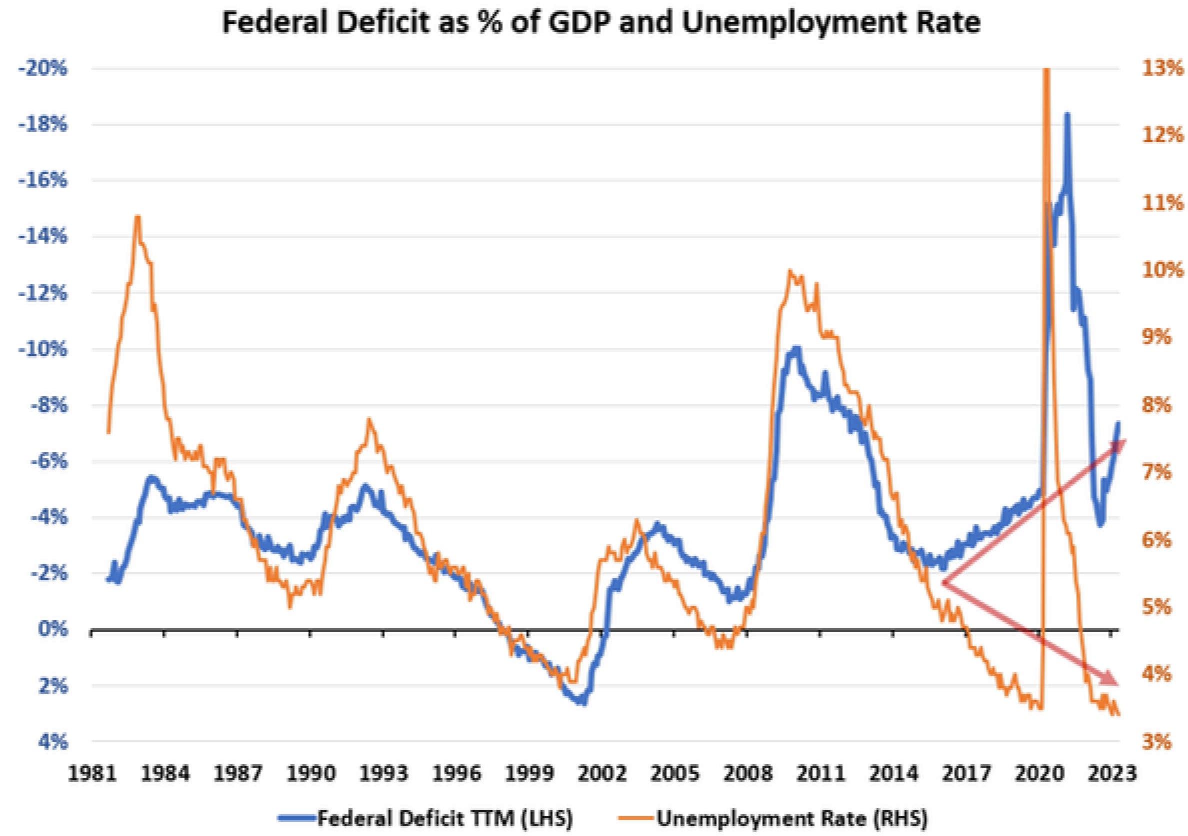
The cash reserves of the federal government are running low as the powers-that-be continue to negotiate an increase to the statutory debt limit. It is generally viewed as unimaginable that the historically meaningless debt ceiling won't be raised as it has been 78 times since 1960. Accordingly, financial markets have largely shrugged off the drama. Nevertheless, the nation's growing fiscal imbalances will ultimately require more than a fig leaf of attention, potentially sooner rather than later since the pandemic increased the federal debt held by the public to around 100% of GDP.

Even with the pandemic in the rearview mirror, the government is still running a nearly $2 trillion deficit which equates to more than 7% of GDP. That is half of what the deficit was at its pandemic peak, but it remains historically elevated especially considering that the unemployment rate is at its lowest level in 70 years. If there is a recession in the next year, the deficit will naturally widen even more and further exacerbate the long-run fiscal challenges facing the country.

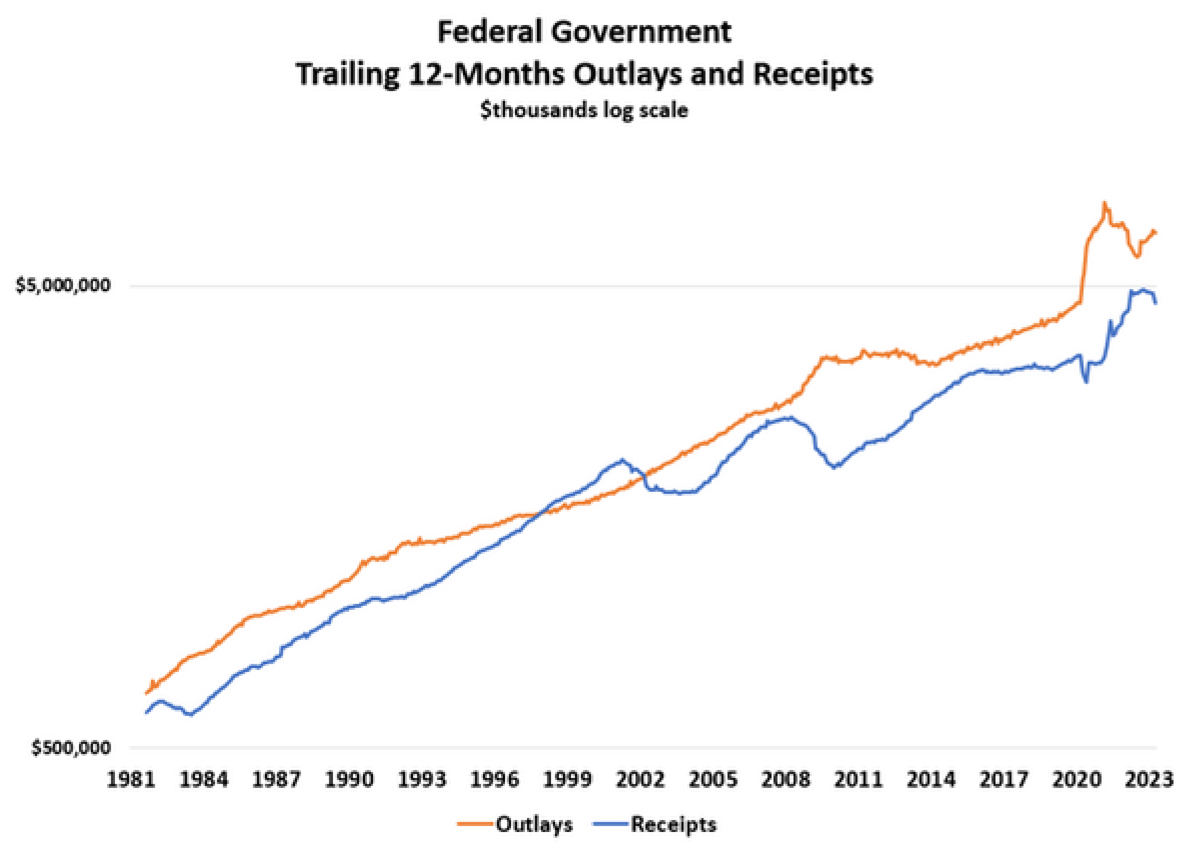
Some combination of lower discretionary spending by Congress, higher taxes and higher inflation seems a likely result of the growing gap between federal receipts and outlays -- barring a technological miracle that dramatically lowers health care costs or accelerates economic growth, which the political class may hold out hope for as long as possible until events force them to do otherwise.

The Treasury was down to just $57 billion in its account at the Fed last Thursday.

The size of the budget deficit has diverged from the general strength of the economy over the past six years (excluding the pandemic years).

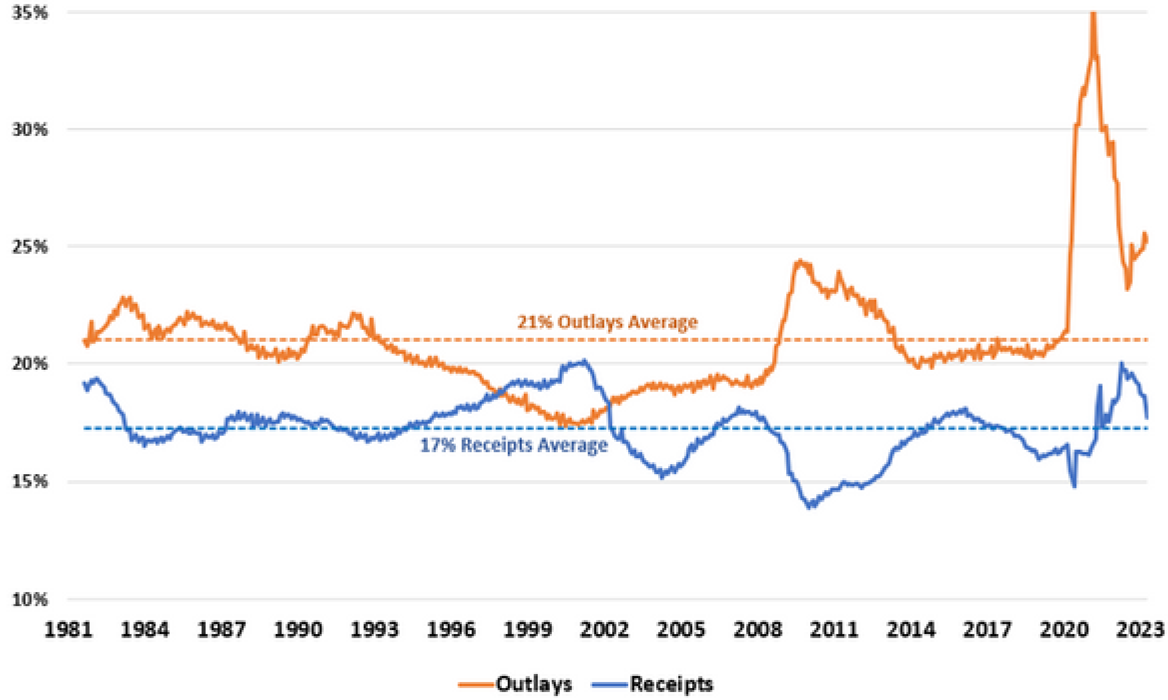


Federal outlays remain more than 40% above their level before the pandemic while receipts are about 30% higher. The economy is about 23% bigger in nominal terms.

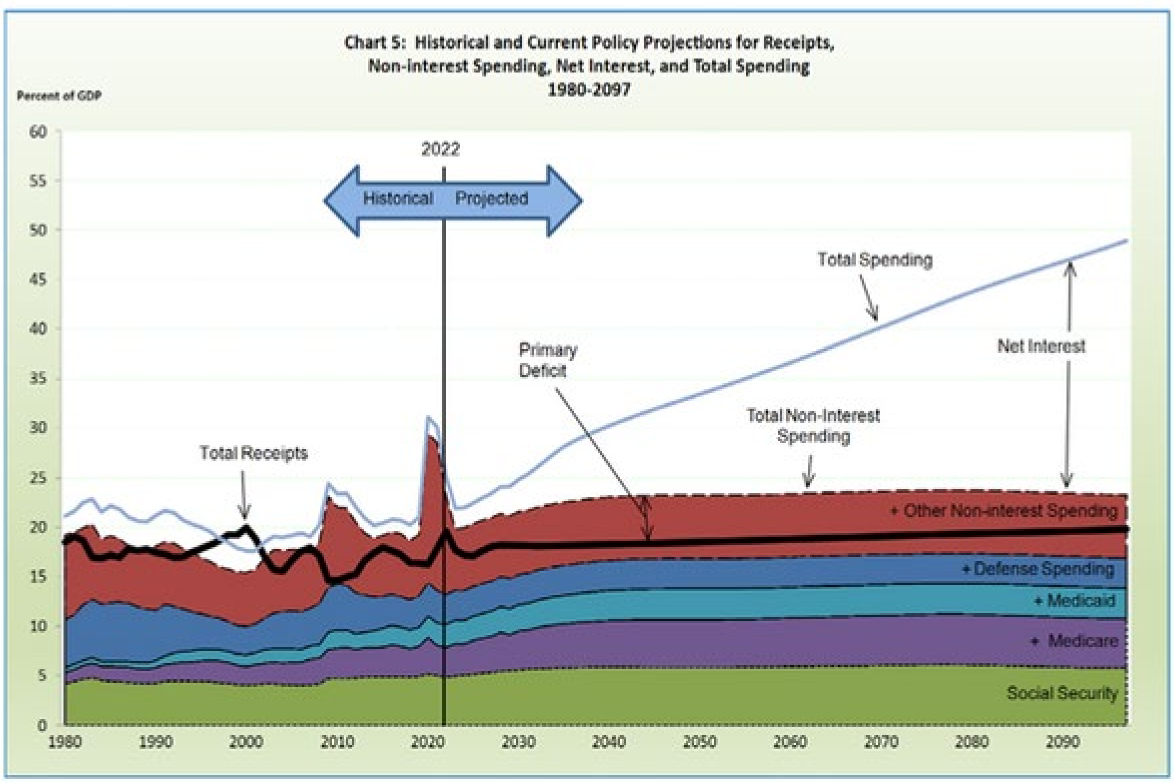


Federal receipts have trended back towards their long-run average as a percent of GDP, but outlays remain well above their long-run average. Increasing interest expense on the federal debt and growing Social Security, Medicare and Medicaid costs will continue to push spending higher.

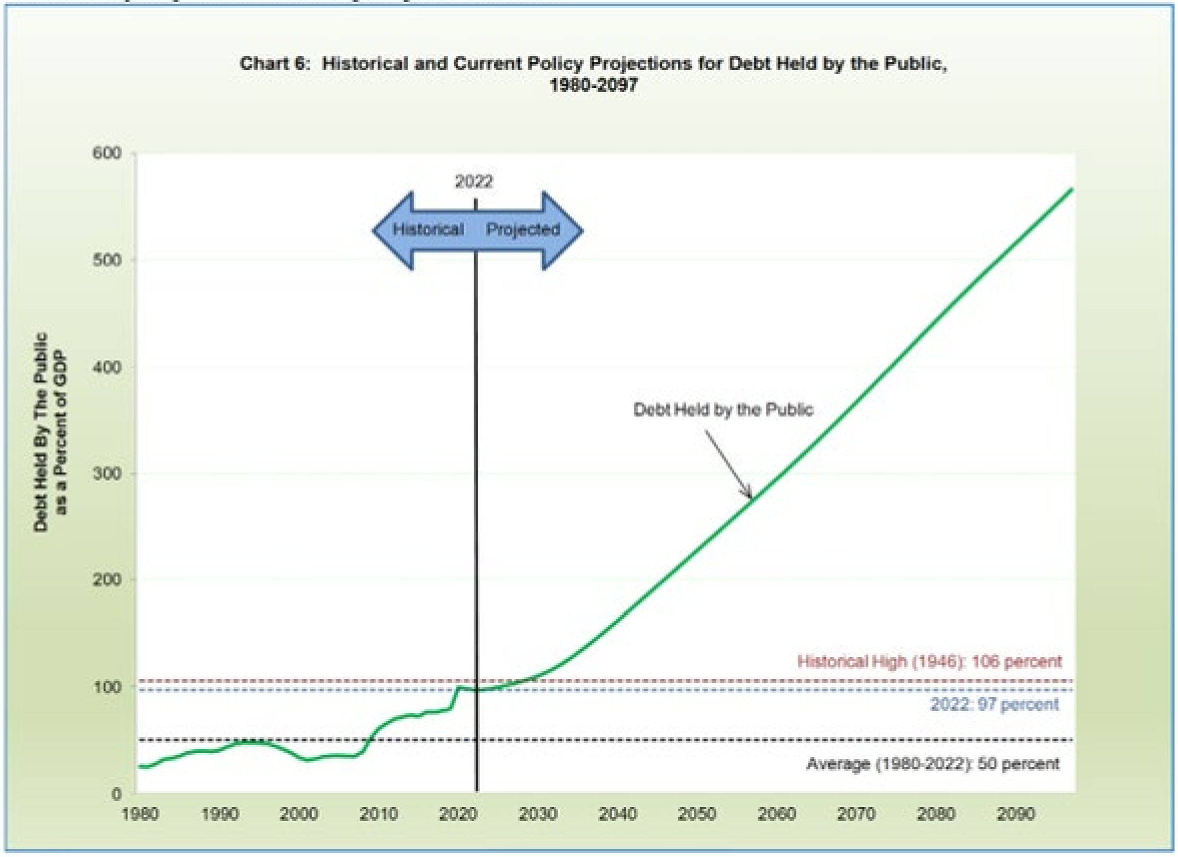
Federal Government
Trailing 12-Months Outlays and Receipts
as % of GDP



The Treasury Department's latest annual Financial Report projected that the federal government is on an unsustainable fiscal path.



A sustainable fiscal policy is defined as one where the ratio of debt held by the public to GDP (the debt-to-GDP ratio) is stable or declining over the long term. Current projections are far from that.



Sources: https://fred.stlouisfed.org/, https://fiscal.treasury.gov/reports-statements/financial-report/current-report.html, AOWM calculations

AI | Blowing bubbles?

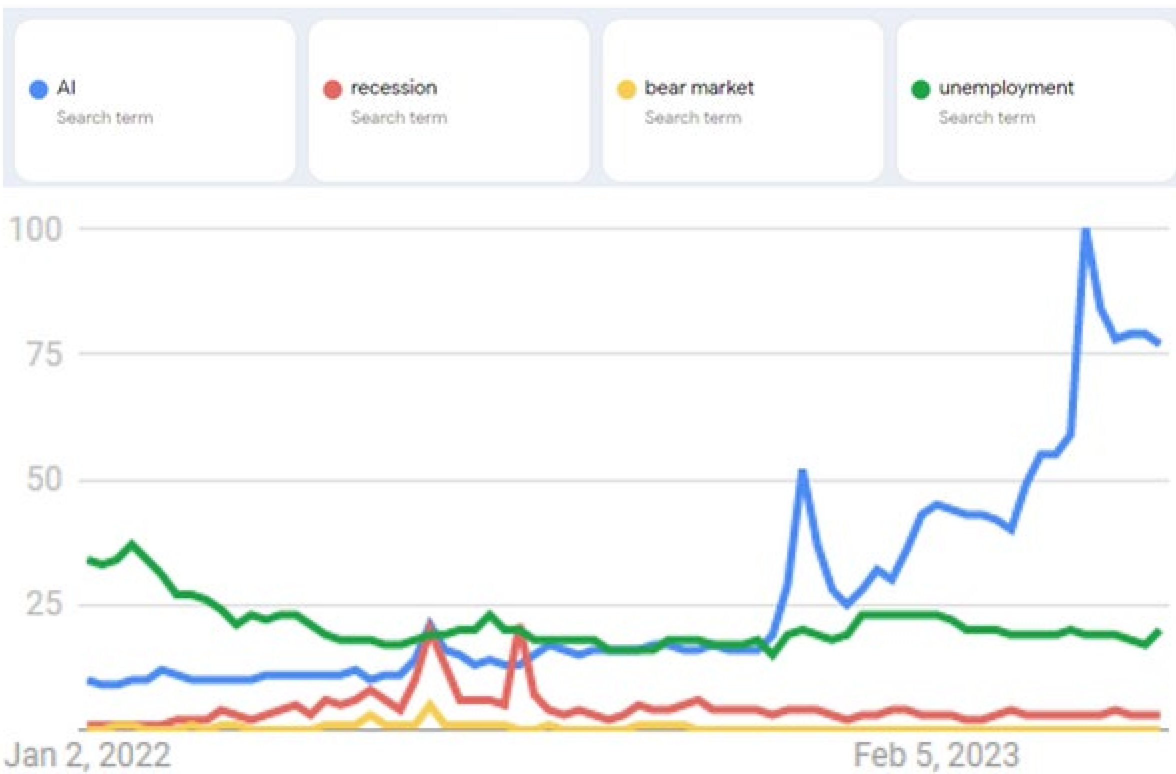
May 29, 2023

Since the artificial intelligence (AI) chatbot ChatGPT was released last November, interest in AI has exploded, offering growth technology stocks another shot of adrenaline. The AI story is largely holding up the broader market indexes so far this year with some valuations starting to look rather bubblish again after briefly retreating from such levels in 2022. But can the run in AI stocks continue in the current economic environment?

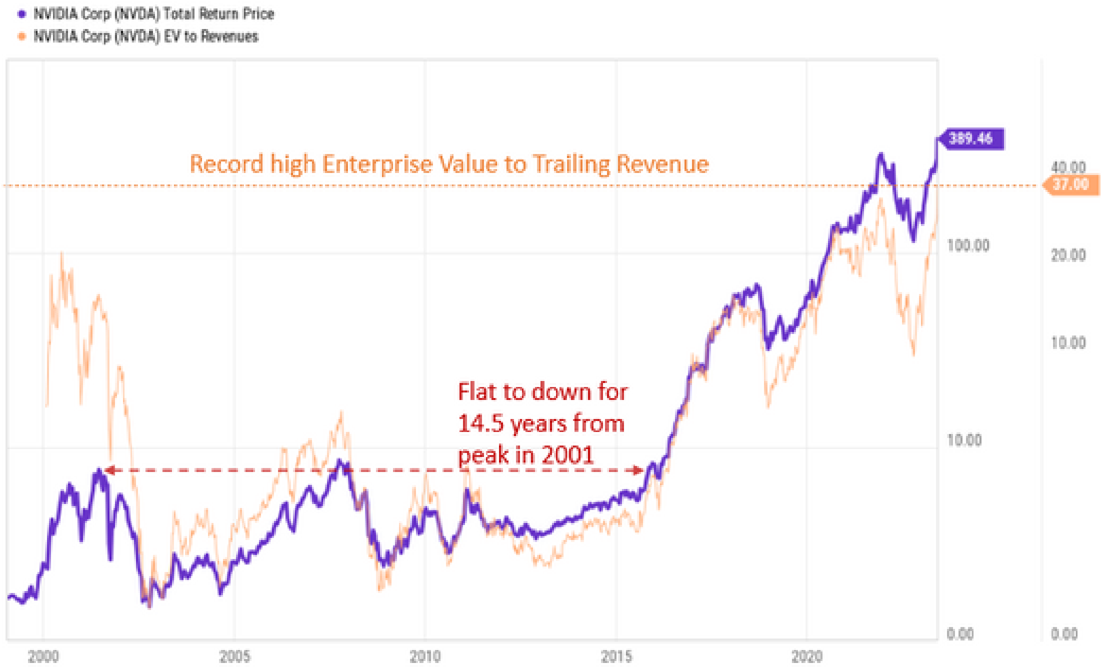
Speculative bubbles typically thrive on two things: a narrative about a glorious future that goes viral and easy credit. AI has the first part in spades as the technology has the potential to be truly revolutionary and has clearly caught the public's imagination. However, the AI bubble will have to overcome a tightening credit cycle if it is to continue to inflate. That said, there may still be enough juice left in the system from all the pandemic stimulus to let the AI stocks run for a while.

From a long-term perspective, bubbles generally look ridiculously irrational, but in the moment it can be perfectly rational to buy a stock that the herd seems determined to push higher. The challenge is getting out of the herd's way when it changes direction.

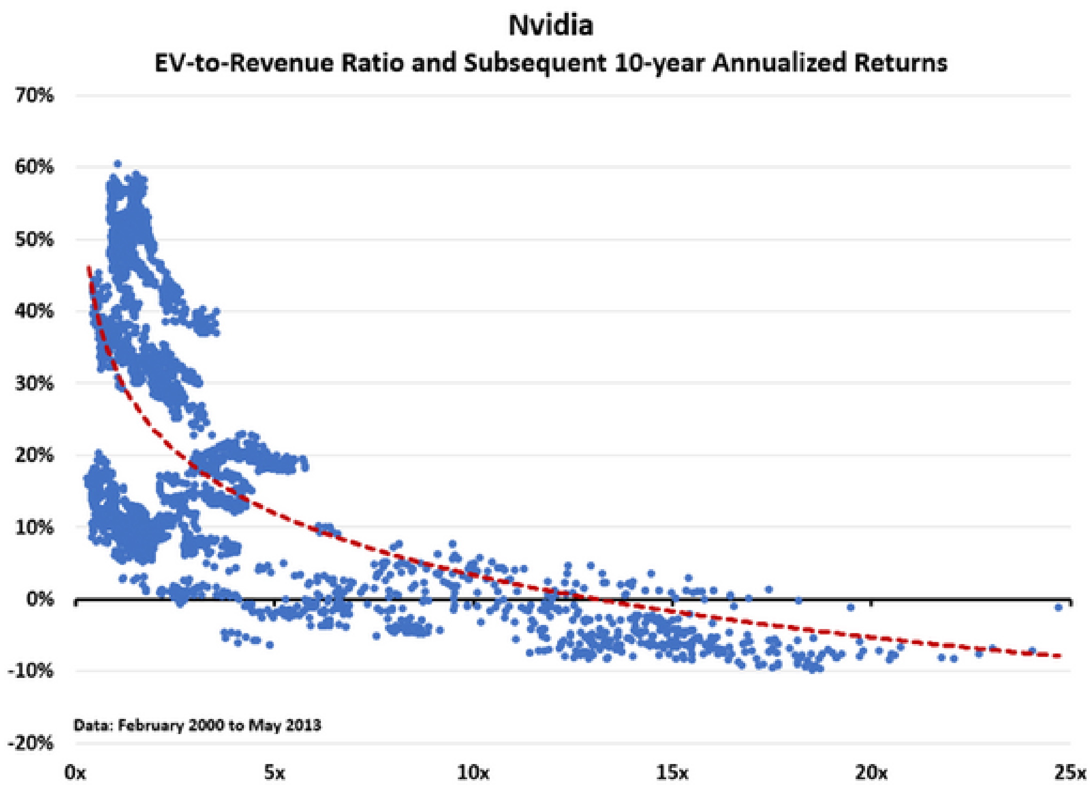
Interest in AI is surging and swamping any economic concerns at the moment – at least in terms of Google searches.



Nvidia is now the fifth largest stock by market cap and one of the darlings of the AI revolution. The stock is up 167% so far this year, supercharged last week by a very positive outlook by management. History would suggest long-term returns from here are likely to be subpar, but how far it will run in the short run is anyone's guess.

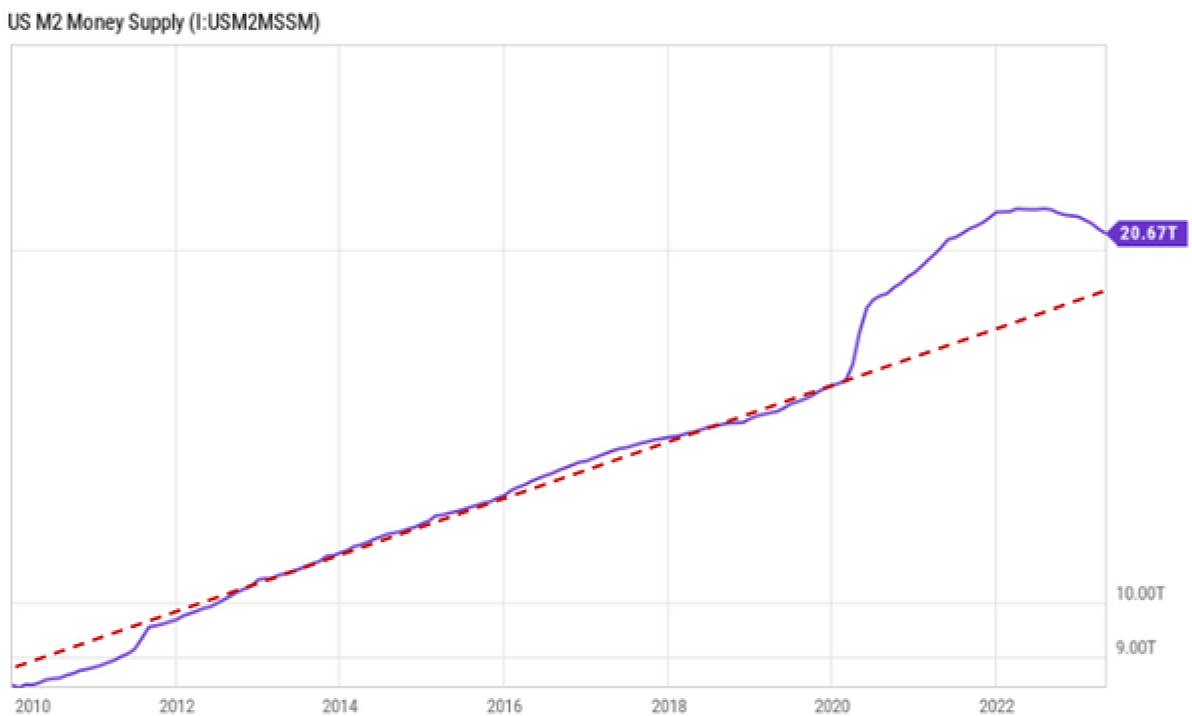


It is difficult for a stock to generate good returns from overly lofty valuations. Even more so the larger the company is as the sustained high growth required to generate equity-like returns is harder to achieve.



Speculative bubbles usually thrive on easy credit, but margin debt has flatlined and banks are tightening lending standards as the Fed has raised interest rates.

The US money supply is declining but remains about 15% larger than it likely would have been without the extraordinary measures taken during the pandemic. Perhaps just enough juice to feed another bubble for a while.



Sources: YCharts, https://trends.google.com/, AOWM calculations

Labor Market | Strong but slowing

June 5, 2023

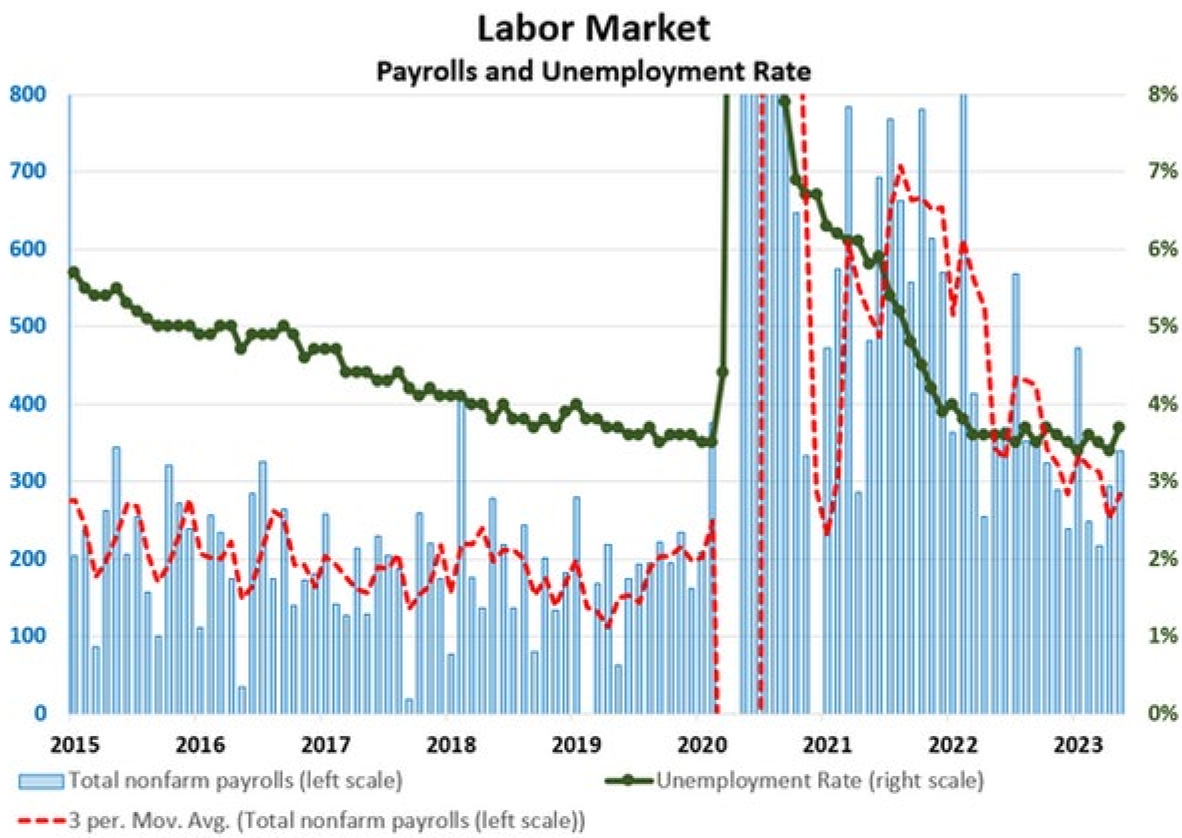
The labor market remained strong in May with employers initially estimated to have added 339,000 jobs and the unemployment rate remaining low at 3.7%. Even though there were indications of further softening in the data, the jobs report increased the odds that the Fed will raise rates again later this summer.

Employment is a lagging indicator of the economy's strength as employers generally avoid letting workers go as long as possible. That may be even more true in the current environment after workers were so hard to find coming out of the pandemic. The decline in average hours worked and weak productivity data suggests employers may indeed be holding on to workers even as demand begins to weaken.

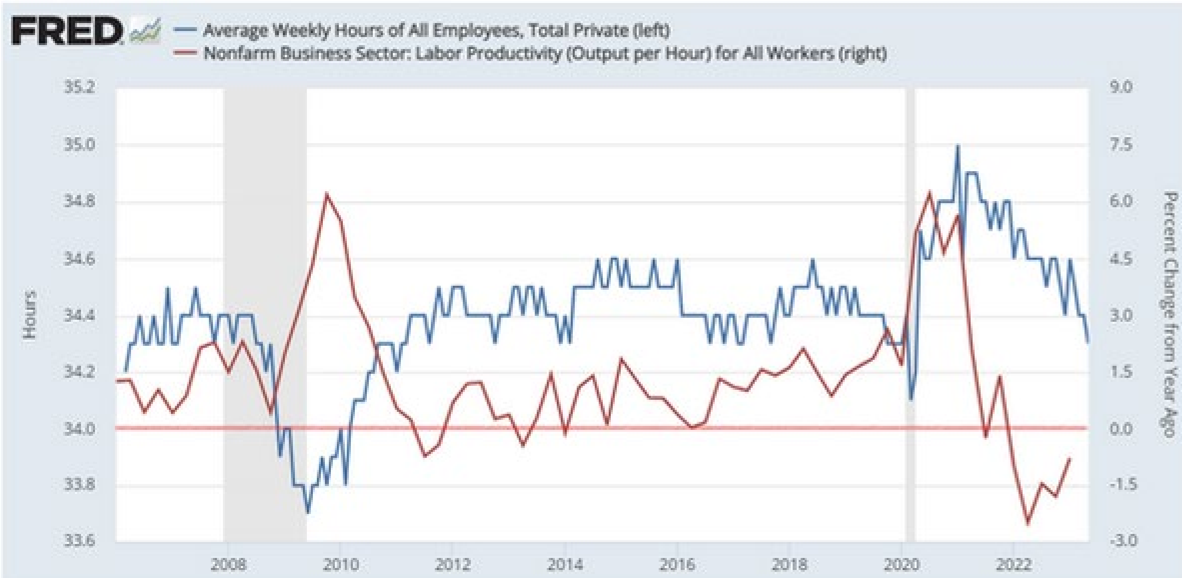
The unemployment rate also increased 0.3 percentage points in May as the household survey continues to show weaker employment growth than the payroll survey. In addition, while estimates of payroll gains in March and April were revised higher, initial payroll estimates have been ultimately revised lower more often than not over the past year which may be another indicator that we are in the midst of a turning point for the labor market.

The current strength in the employment data is not overly surprising based on previous Fed tightening cycles. If it remains strong in the face of the headwinds confronting the economy in the latter half of the year, that will be unexpected and perhaps a complication for the Fed's efforts to tame inflation.

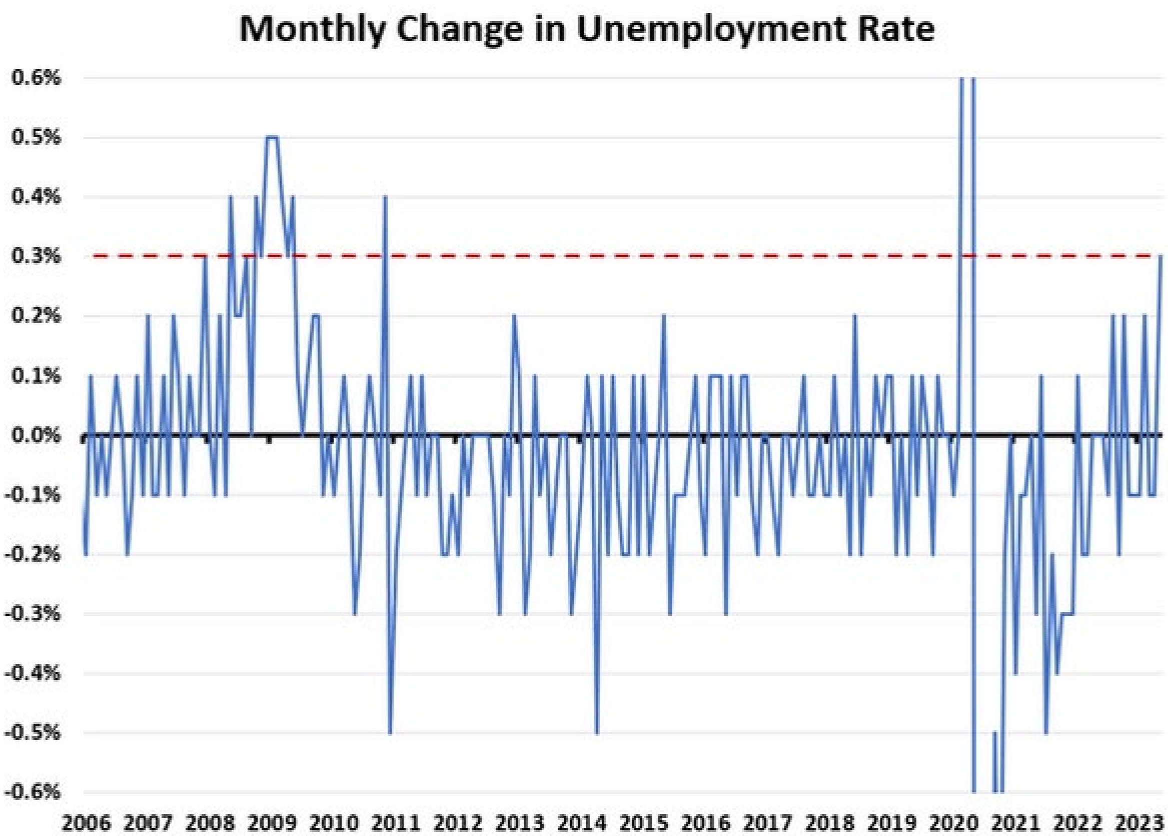
The labor market remained strong in May but continues to decelerate.



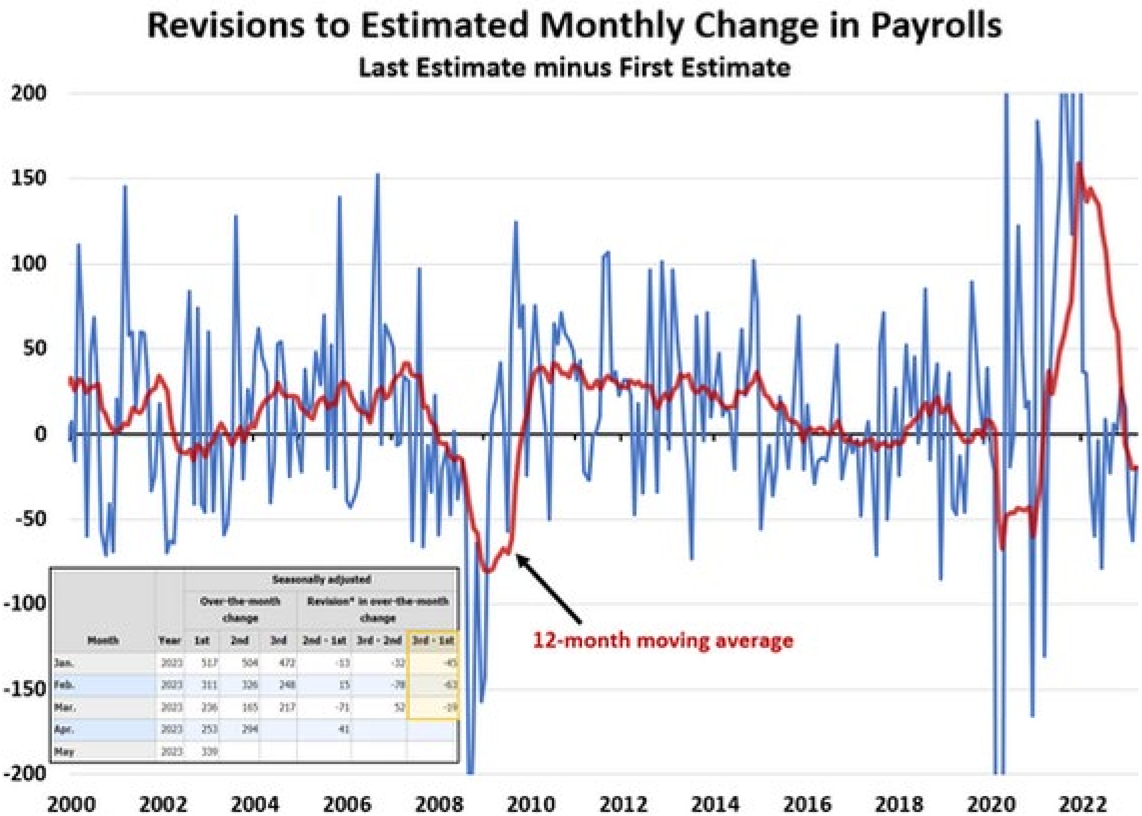
The decline in average weekly hours worked and weak productivity data suggests that businesses may be holding on to workers even as demand weakens.



The unemployment rate increased to 3.7%. The 0.3% increase was the largest month-over-month increase since 2010 excluding the large swings during the early months of the pandemic.

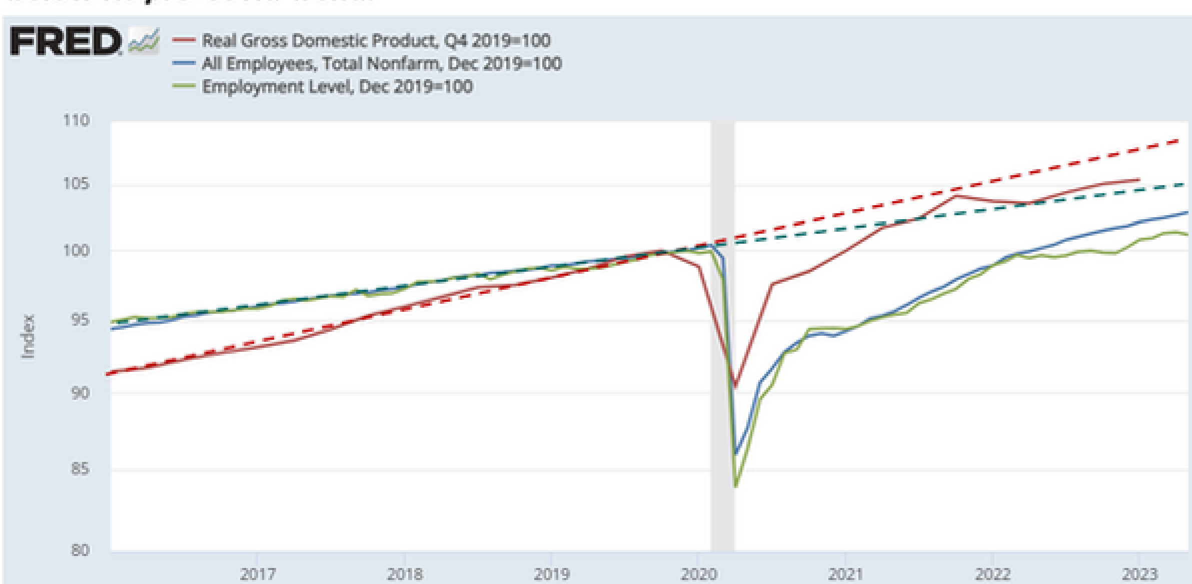


Revisions to the estimate of total payrolls is indicative of a softening job market even amidst low unemployment and strong payroll gains.



Month	Year	Seasonally adjusted: Over-the-month change 1st	2nd	3rd	Revision* in over-the-month change 2nd - 1st	3rd - 2nd	3rd - 1st
Jan.	2023	517	504	472	-13	-32	-45
Feb.	2023	311	326	248	15	-78	-63
Mar.	2023	236	165	217	-71	52	-19
Apr.	2023	253	294		41		
May	2023	339					

Employment remains 2% to 4% below its pre-Covid growth trend. The household survey of employment has shown weaker growth than the business survey of payrolls over the past year. Overall economic growth also remains below its pre-Covid trend.



Sources: YCharts, https://fred.stlouisfed.org/, BLS, https://www.bls.gov/web/empsit/cesnaicsrev.htm, AOWM calculations

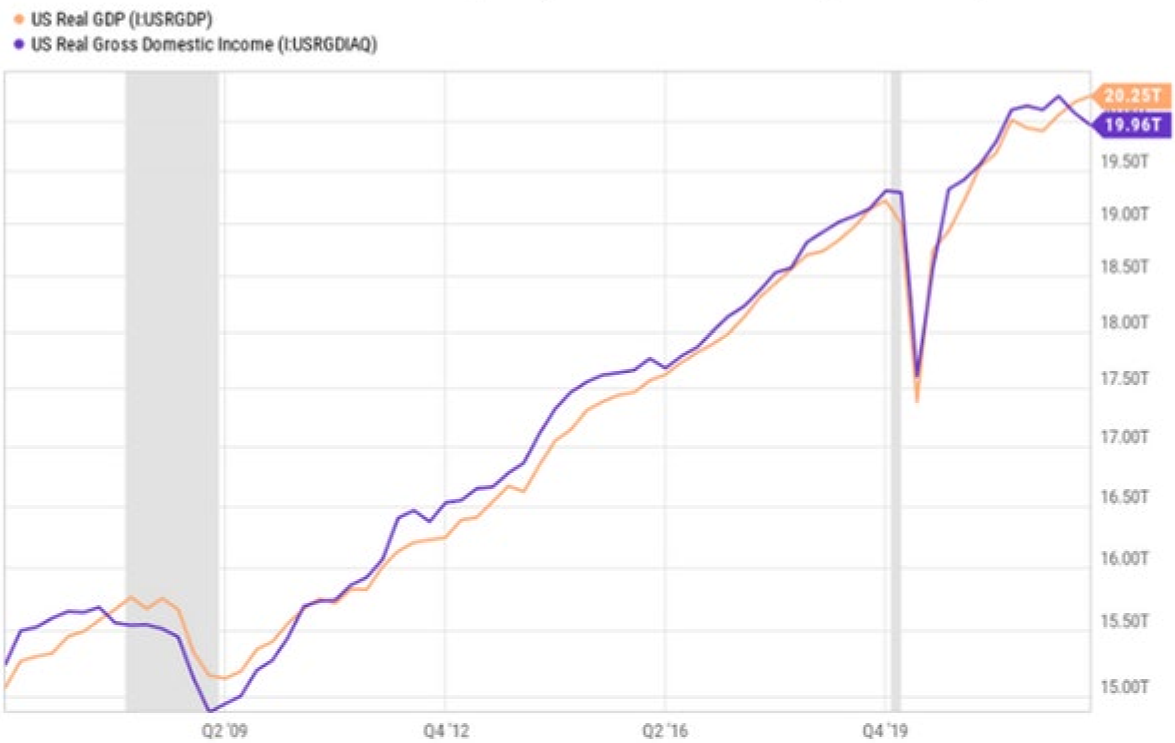
GDI | Already a hard landing?
June 12, 2023

With the S&P 500 up 20% from its October low and the financial press cheering a new bull market, investors seem to be increasingly pricing in the expectation that the economy will avoid a recession and profits will quickly rebound higher. Meanwhile the economic data remains mixed but still seems consistent with the forecast for the economy to slip into reverse around the end of the year. One measure that is incongruent with the market's outlook is the government's estimate of inflation-adjusted Gross Domestic Income (GDI), which has declined the past two quarters and is currently below the level reached at the end of 2021.

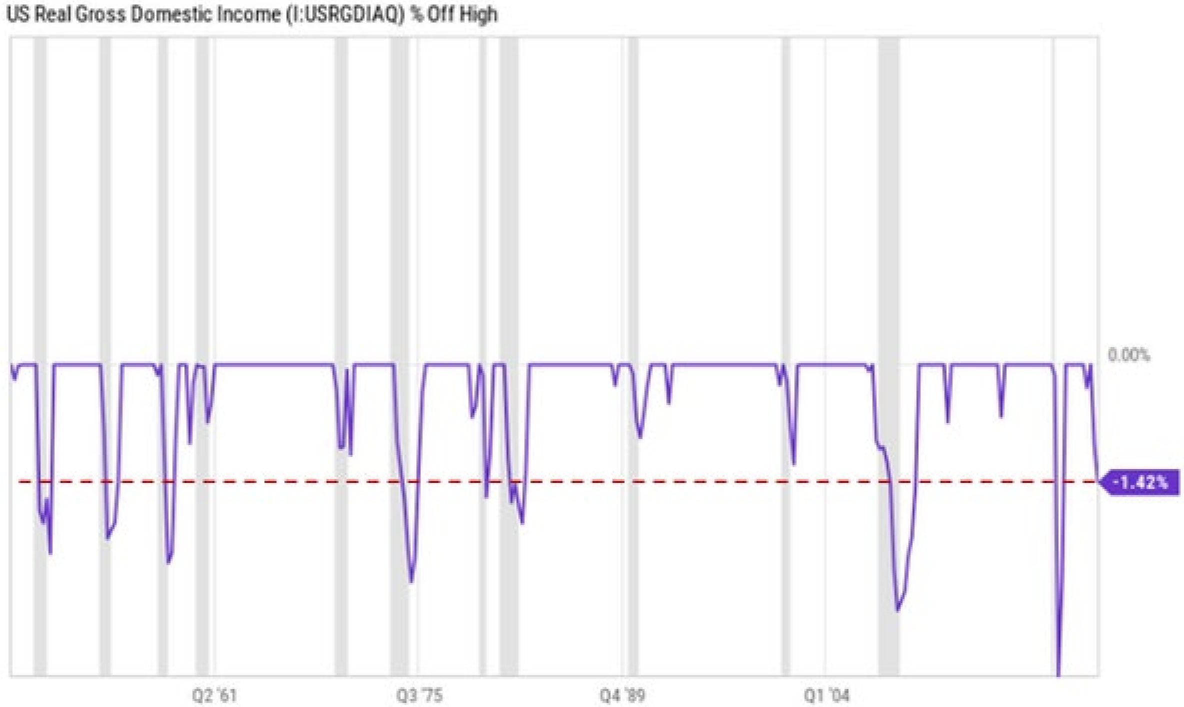
In theory, GDI should equal the Gross Domestic Product (GDP) as an equivalent but different measure of the size of the economy. GDI is estimated by collecting income data, and GDP by collecting expenditure data. There is always some statistical difference between the two, but the twin measures have not painted such a different picture of the economy since 2007 when GDI indicated the economy was sliding into a recession while GDP showed it was still growing.

Given the imperfections of both estimates and the inevitable future revisions to those estimates, some insight about the true state of the economy may be gleamed by taking the average of the two. Doing so suggests the economy has basically been trending sideways since the end of 2021. The economy may yet turn up without a recession as investors are expecting. Weighing against that bet are several factors including inflation that has yet to be completely subdued, higher interest rates, tightening credit, and the end of the last vestiges of pandemic stimulus, all of which may continue to decrease the aggregate demand for goods and services as the year wears on.

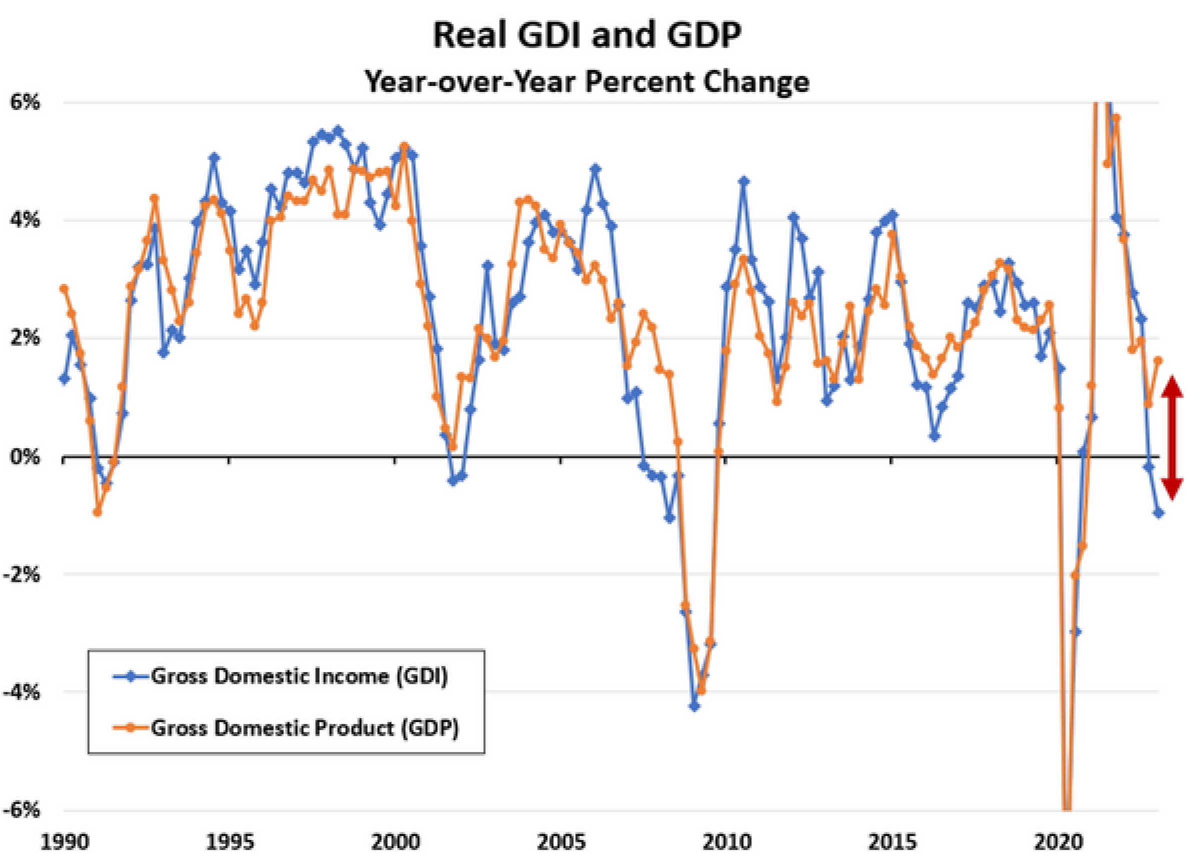
Gross Domestic Income (GDI) has fallen below where it was at the end of 2021 even as Gross Domestic Product (GDP) has continued to grow slowly.



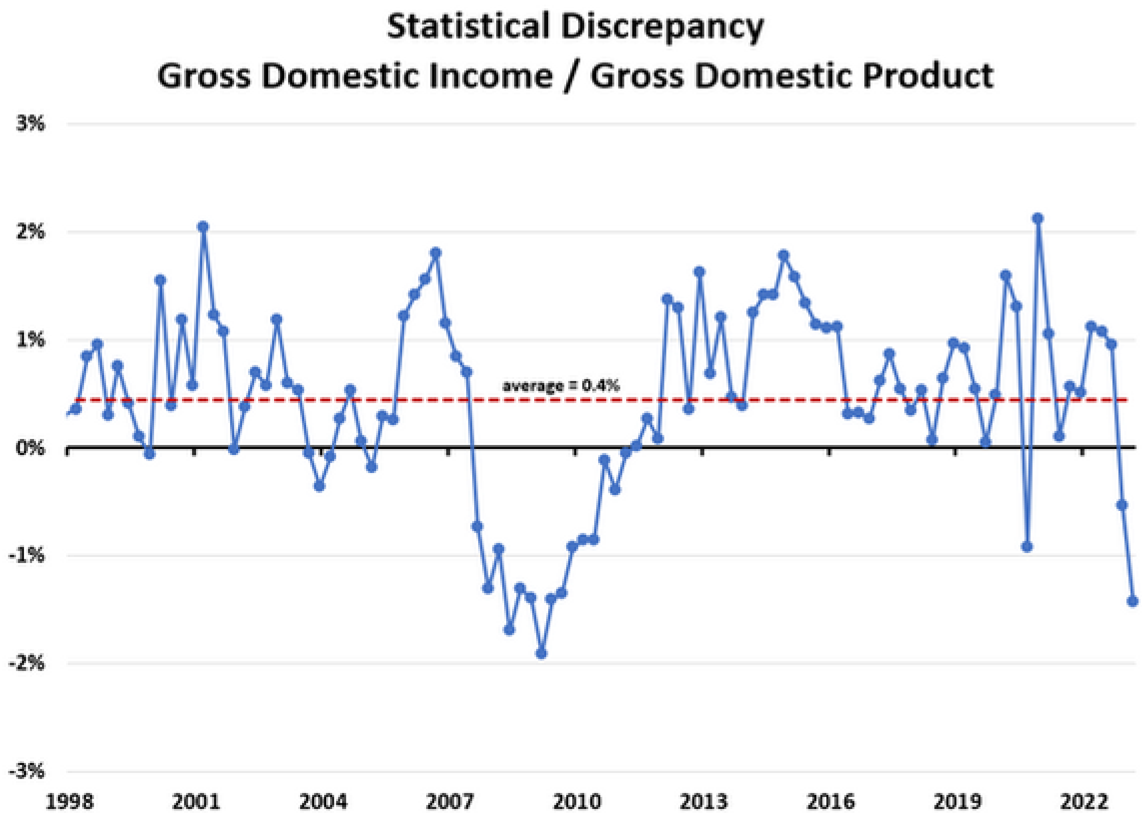
Current estimates of GDI are 1.4% below its high reached in the third quarter of last year. GDI has not historically declined this much until well into a recession.



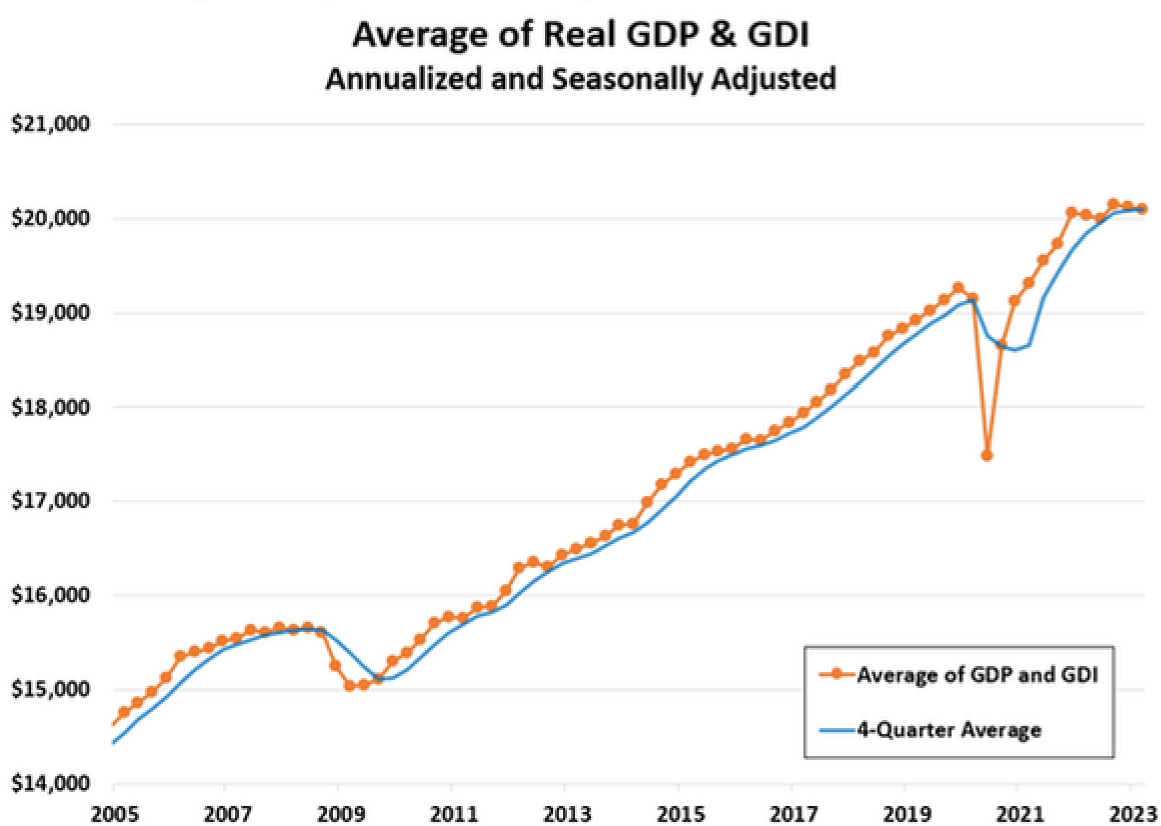
The last time the estimates for GDI and GDP diverged this much was in 2007.



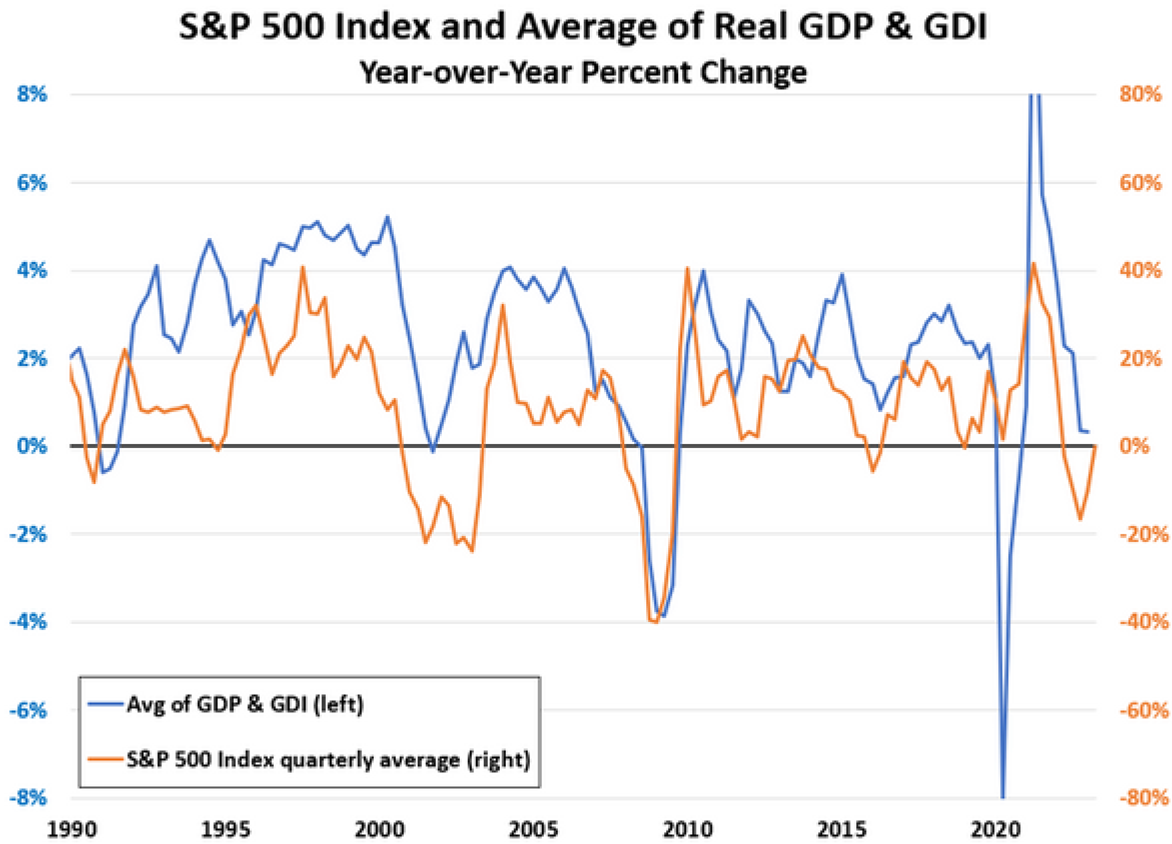
Over the past 25 years, the statistical discrepancy between the two measures of the economy has favored GDI except during economic rough patches.



The average of GDP and GDI paints a picture of an economy that has basically been trending sideways since the end of 2021.



The stock market is betting that the economy will avoid a recession.



Sources: YCharts, https://fred.stlouisfed.org/, AOWM calculations

The Fed | Just catching its breath

June 19, 2023

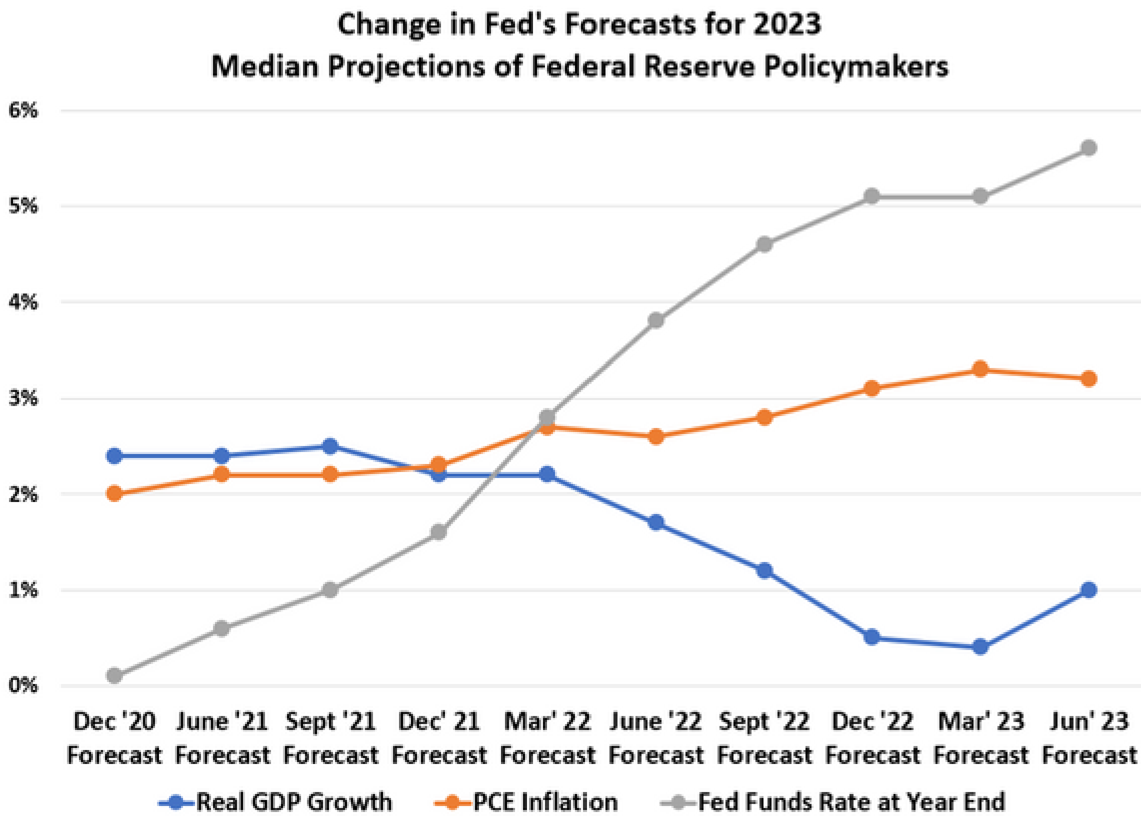
At their meeting in May, policymakers at the Federal Reserve raised interest rates for the tenth straight time but suggested the May rate hike might be their last for this tightening cycle. At their meeting last week, they did not raise rates but indicated further hikes are now likely before the end of the year.

The Fed's preferred inflation metrics have improved but at a slower pace than policymakers had expected which led to the forecast for further increases in their target fed funds rate - the overnight interest rate for interbank lending. One way or another, either through rising rates or falling inflation, policymakers anticipate financial conditions will continue to tighten over the next eighteen months as the real fed funds rate adjusted for inflation rises towards 2%.

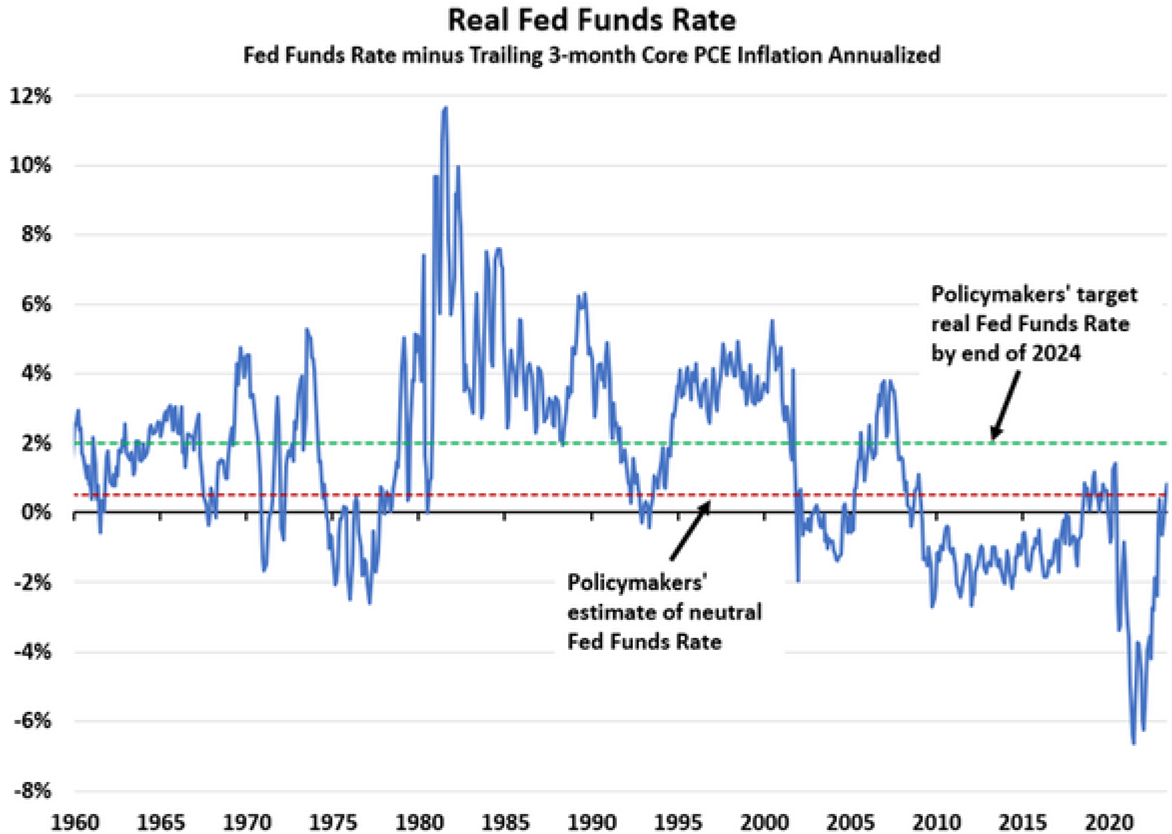
The economy and the markets have so far held up well in the face of the Fed's blitz of rate increases from basically 0% to over 5%; however, that may be partly because monetary policy has remained relatively accommodative over the past year as the Fed has been working to drain an unprecedented amount of stimulus from the system. Even now monetary policy can only be seen as restrictive when viewed through the lens of the past fourteen years of negative real interest rates and ever-expanding asset purchases by the central bank.

The true test will come over the next year as monetary policy continues to tighten to levels not seen since before the Great Recession and its lagged effects on the economy are fully felt.

Policymakers did not raise rates at their meeting last week but did raise their expectation for the terminal fed funds rate.

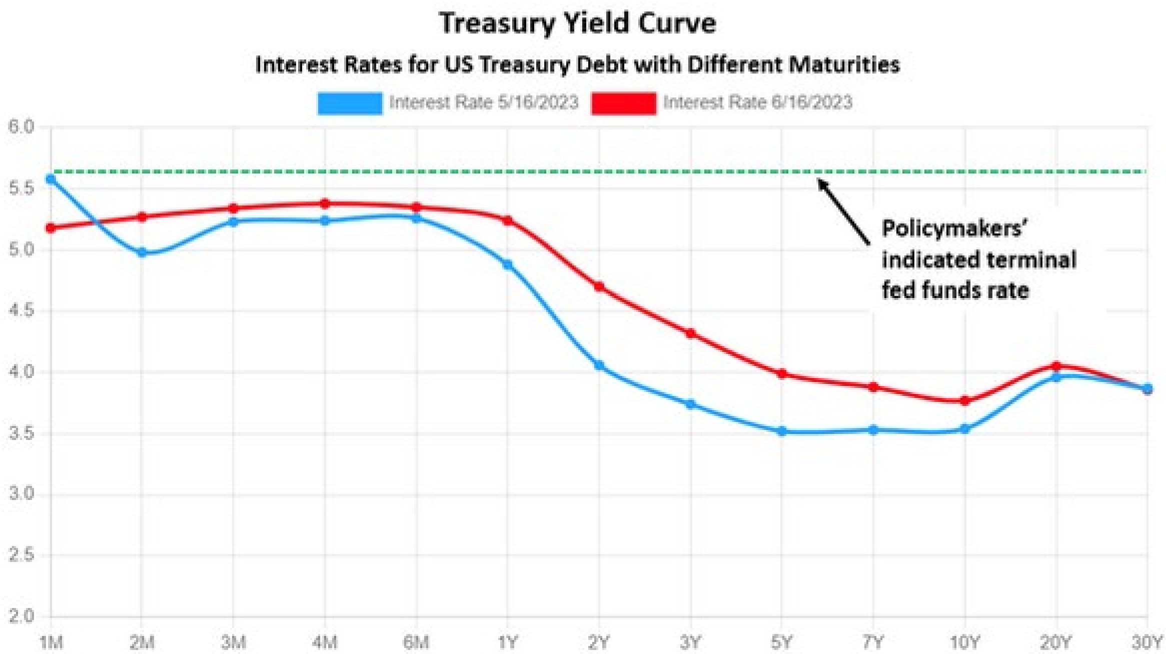


Despite all the monetary tightening the Fed has done, the real fed funds rate adjusted for inflation remains at a low level by historical standards. Low real interest rates have supported the economy and asset valuations, but they are expected to continue increasing over the next year.



The Fed's balance sheet relative to the size of the economy is also still significantly larger than it has historically been. At the current pace of "Quantitative Tightening" it would likely take five to six years to return the Fed's balance sheet to the same size it was as a percent of GDP before the era of "Quantitative Easing" began in '09.

Interest rates have increased across the yield curve over the past month, but investors still doubt the Fed will raise rates as much as they have indicated.



Sources: Federal Reserve, https://fred.stlouisfed.org/, https://www.ustreasuryyieldcurve.com/, AOWM calculations

Leading Indicators | Still mostly negative

June 26, 2023

Except for the stock market, most leading indicators continue to signal a recession is likely on the horizon. The Conference Board's Leading Economic Index® has now declined for fourteen straight months and has been flashing a pending recession warning for several months. And yet with each passing month that the labor market remains strong and inflation inches lower, the hopes that this time will be different grow.

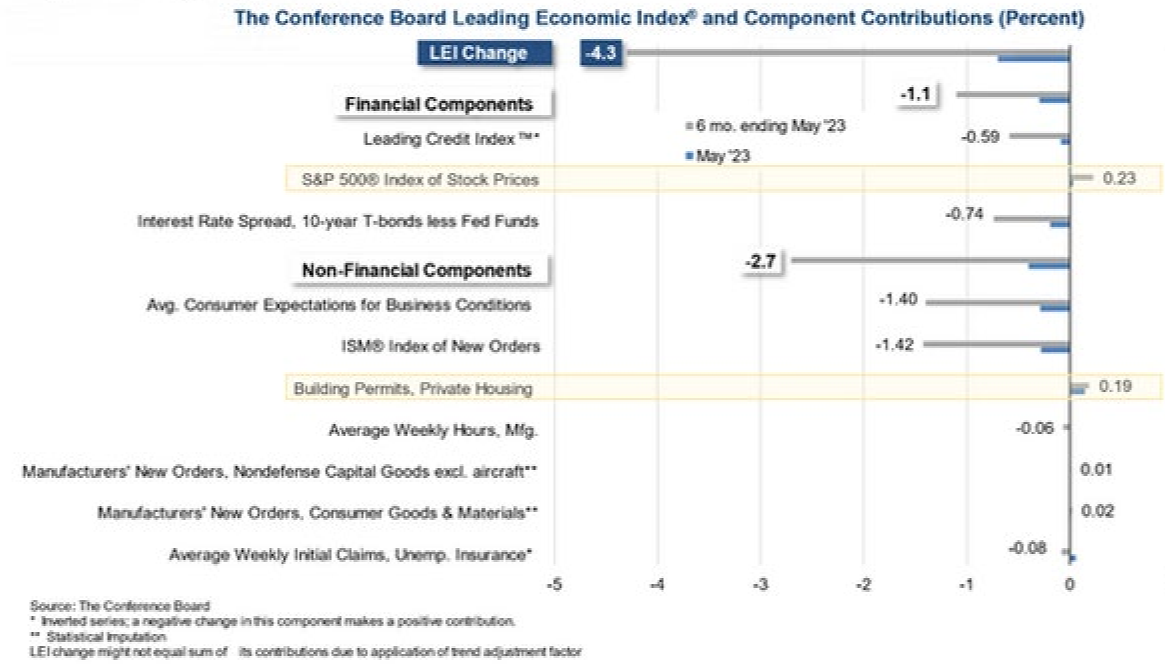
One area of the economy that seems to be rebounding quickly from a brief slowdown is residential investment as building permits and housing starts have ticked higher this year. Higher mortgage rates have decreased the affordability of houses, but they have also constrained the supply of existing homes for sale which has buoyed the market for new homes.

The experience in the housing market has raised the notion that we will have a rolling recession that hits sectors at different times but is sufficiently spread out that the overall economy never experiences a widespread retrenchment in employment or output. The Composite of Leading Indicators published by the Organization of Economic Cooperation and Development (OECD) offers this theory some support as it continues to point to sub-par growth over the next year, but not yet a recession.

The one leading indicator that continues to toll the bell loudly for a pending recession is the yield curve which is deeply inverted with the 10-year Treasury 1.67 percentage points below the 3-month Treasury as of Friday. The bond market seems to be completely at odds with the stock market, which isn't particularly unusual. Over the past few decades, however, the bond market has been the wiser of the two in foreseeing trouble as the stock market would trade near all-time highs while an inverted yield curve rightly urged caution.

The Conference Board's Leading Economic Index® (LEI) continues to signal a recession is likely within the next 12 months.

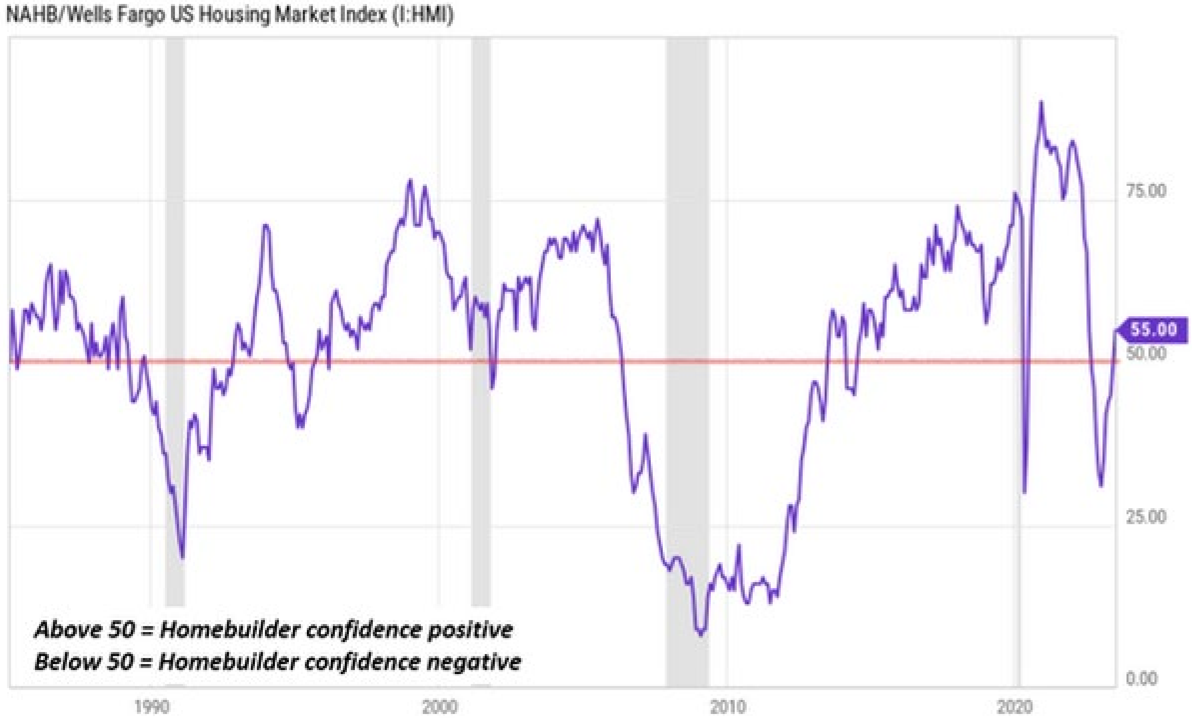
The uptick in stocks and residential construction over the past six months are the only true bright spots among the LEI components.



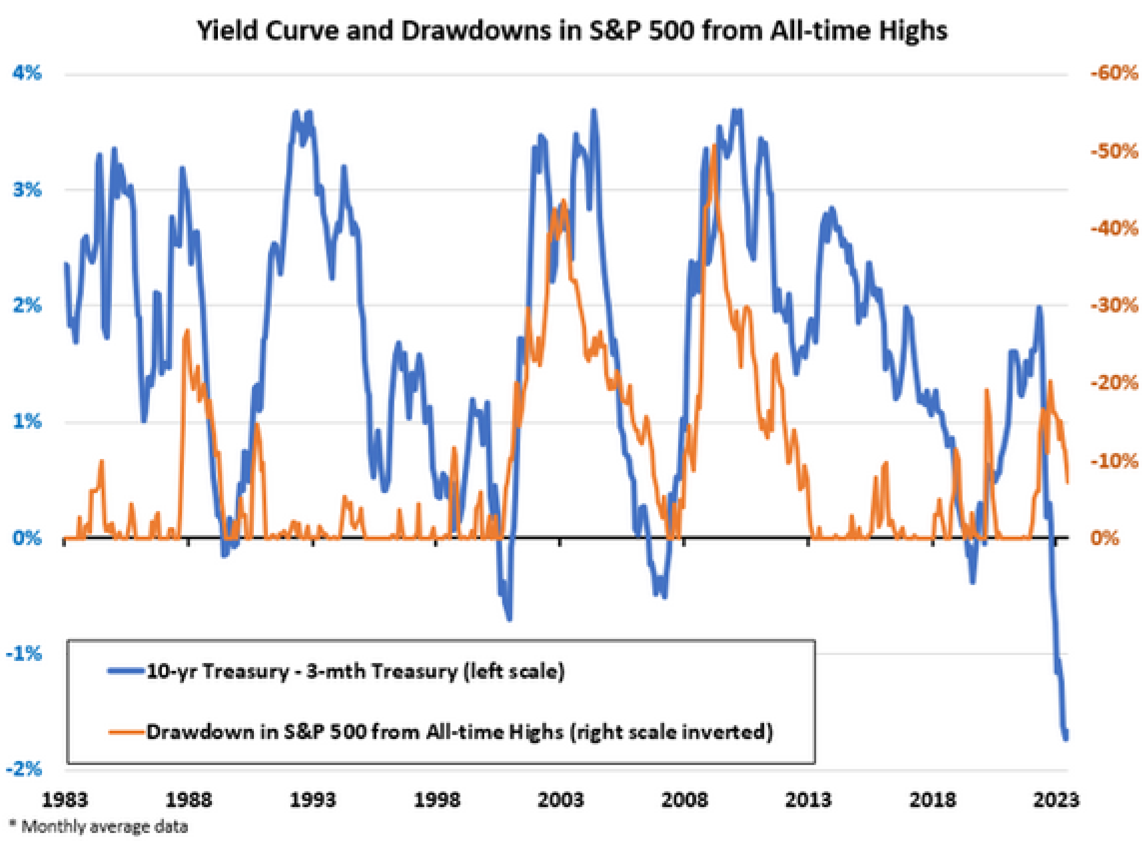
The OECD's Composite Leading Indicators Index indicates growth will remain slow, but it has not yet fallen to a level that is necessarily associated with a recession.

Component Series (Unit)	*Source*
Work started for dwellings sa (number)	Bureau of the Census
Net new orders - durable goods sa (USD)	Bureau of the Census
Share prices: NYSE composite (2015=100)	New York Stock Exchange
Consumer survey - confidence indicator sa (normal = 100)	Survey of consumers – University of Michigan
Weekly hours worked: manufacturing sa (hours)	Bureau of Labor Statistics
Manufacturing survey - confidence indicator (% balance)	US Institute of Supply Management
Spread of interest rates (% p.a.)	Federal Reserve

The outlook of homebuilders has rebounded strongly this year despite higher mortgage rates as the supply of existing homes for sale remains constrained.



In 2000 and 2007 the yield curve inverted, but the stock market paid little attention to the warning. Also true in 2019, but it is hard to know what would have occurred without the Covid-19 pandemic.



Sources: https://www.conference-board.org/topics/us-leading-indicators, https://www.oecd.org/sdd/leading-indicators/, https://fred.stlouisfed.org/, https://www.nahb.org/news-and-economics/housing-economics/indices/housing-market-index, Ycharts, AOWM calculations

Corporate Profits | Pause or pivot?

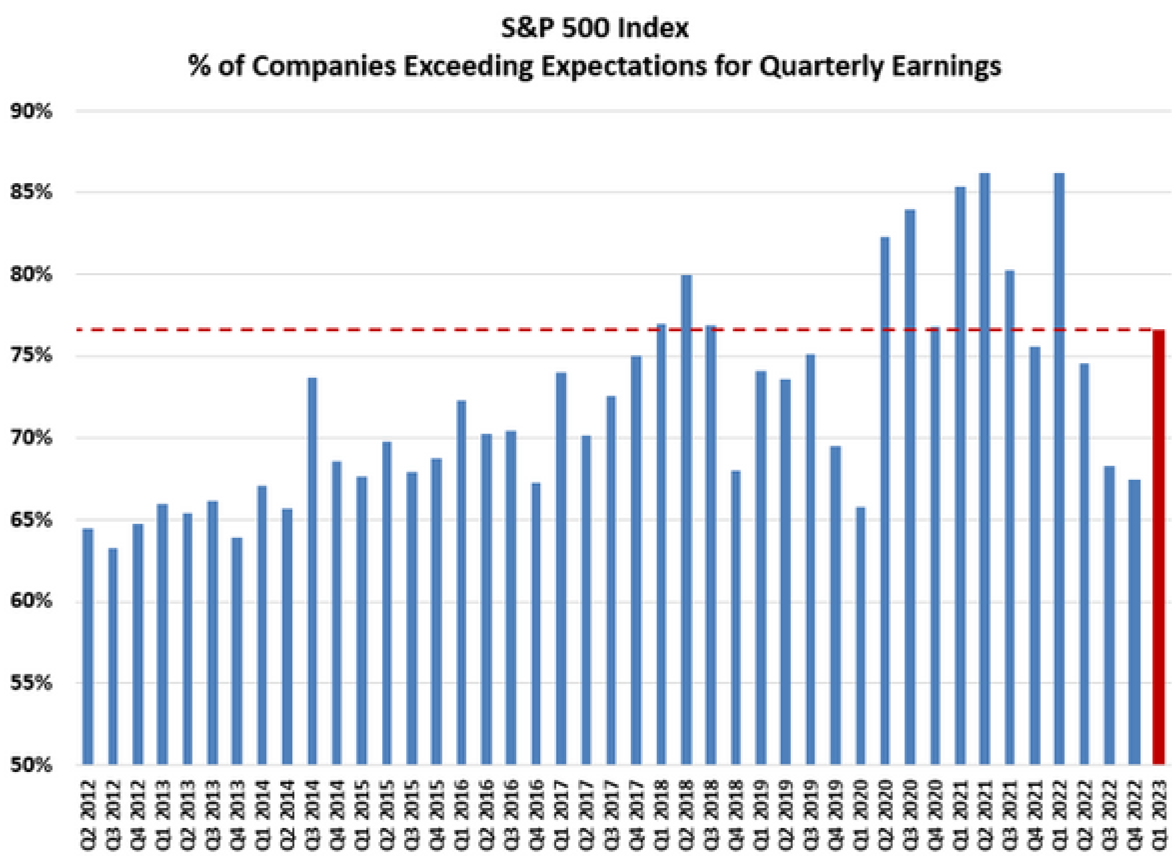
July 3, 2023

Much of the market narrative in the first half of the year centered around whether and when the Fed would pause rate hikes or even pivot to cutting interest rates -- and how investors would meet that moment with exuberance. And yet investors now seem unbothered by the prospect of interest rates likely heading higher for longer. Turns out the pause-or-pivot question more important to the market so far this year may have centered around profits, not monetary policy.

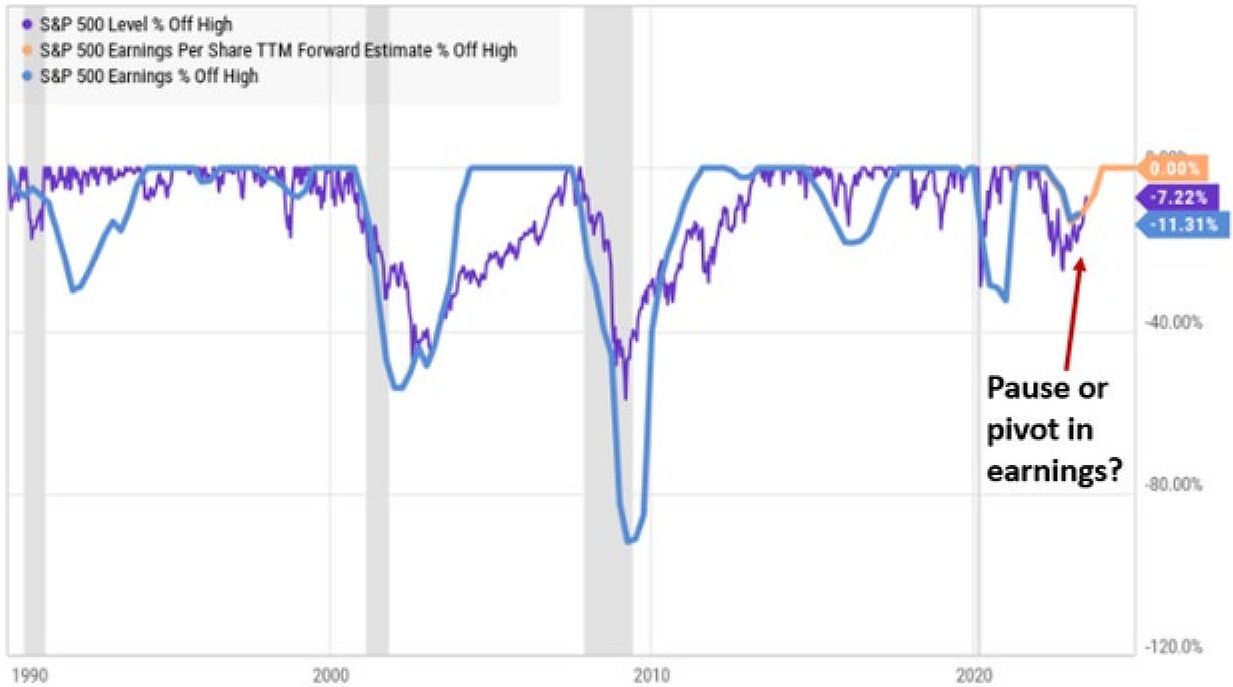
At the end of the day, fundamentals drive stock returns. In 2022, it appeared that corporate profitability had begun a potentially long hangover from the pandemic high. However, first-quarter profits broke the downtrend and fed a growing bullish sentiment. The pause in the expected earnings recession has investors hoping it will turn into a full pivot towards renewed strong earnings growth that will keep stocks moving higher.

The Fed's actions will still play a role in where the economy and profits go from here, so investors may return their attention to that pause-or-pivot question before long.

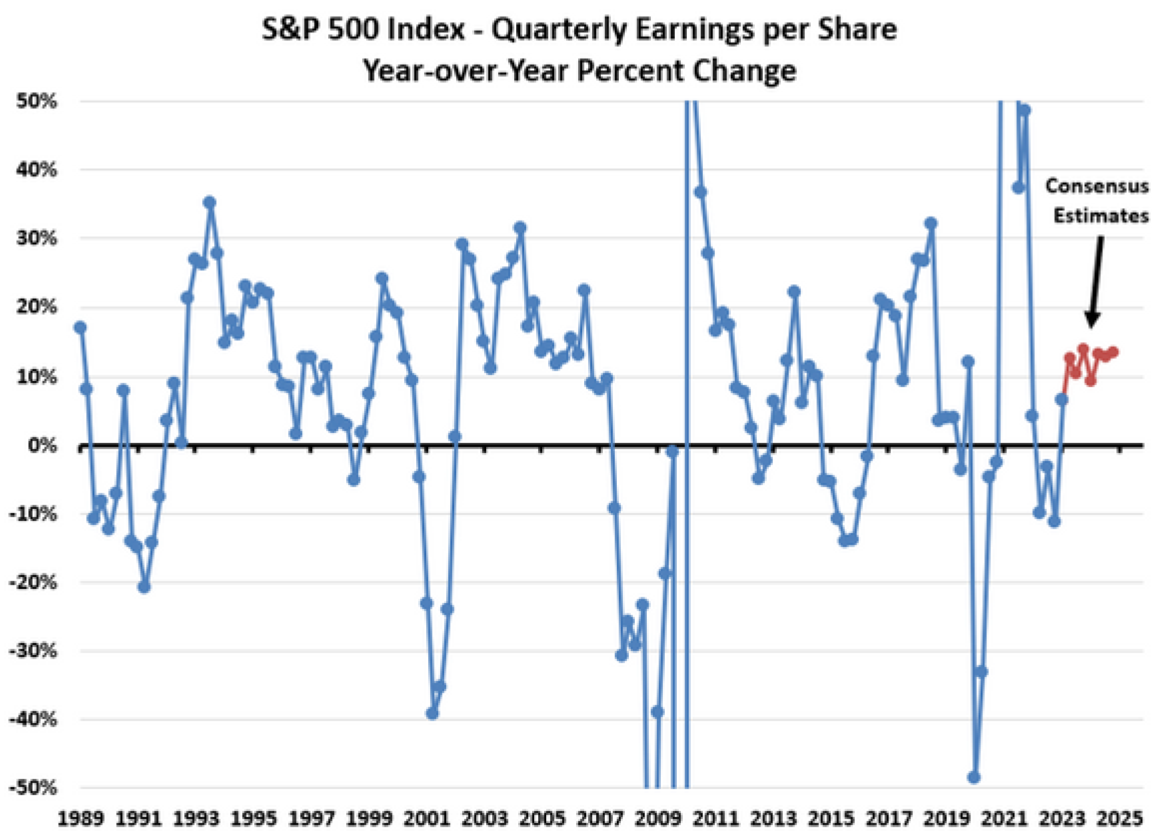
The number of companies in the S&P 500 Index beating earnings expectations increased in the first quarter as profits rebounded higher.

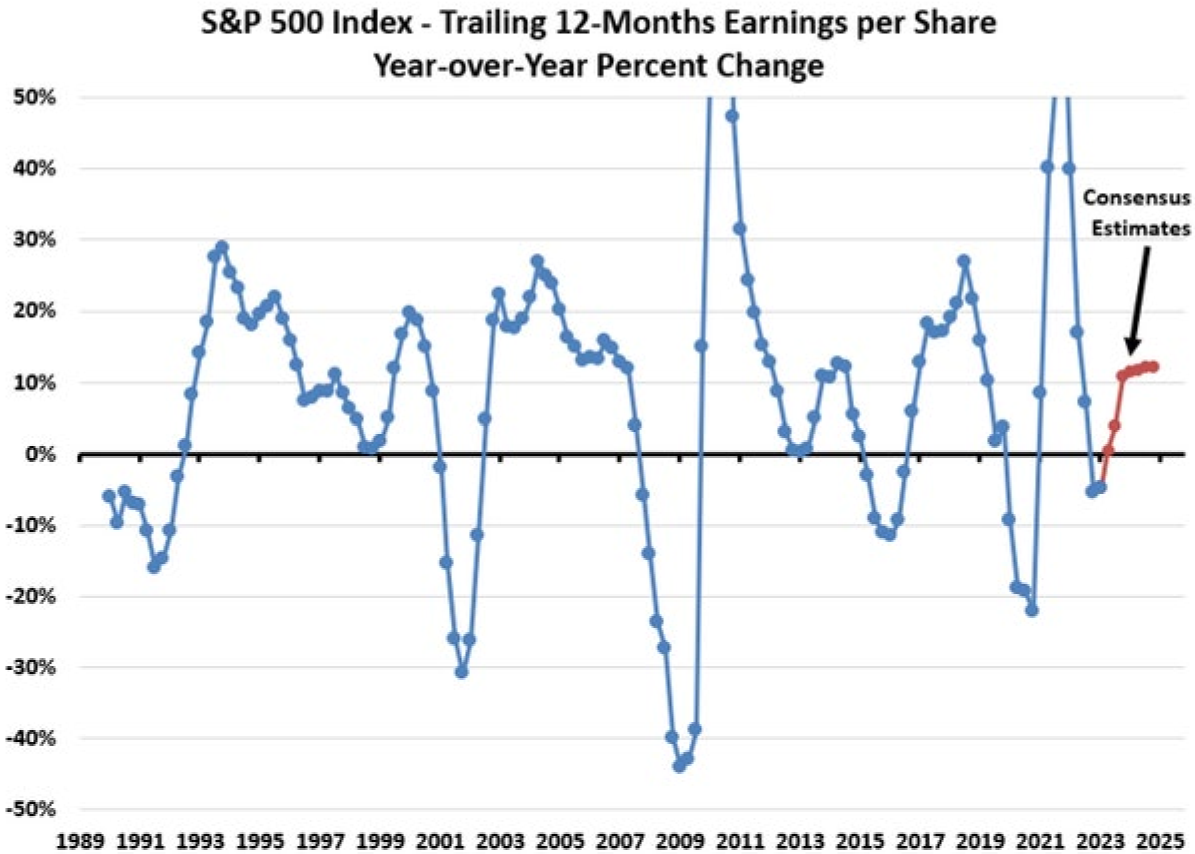


Earnings don't usually pause mid-retreat, providing hope that profits are quickly pivoting back towards growth.



Earnings are expected to remain strong leading into the second half of the year. Without a pickup in economic growth such expectations may still be optimistic.





Sources: Ycharts, https://www.spglobal.com/spdji/en/indices/equity/sp-500/#overview, AOWM calculations

Bond Market | Mixed messages

July 17, 2023

The bond market is often cast as the dour sidekick to the sunny stock market. To be sure, the source of many recession fears is the deeply inverted yield curve which is a classic indicator of a pending downturn. However, bond investors are optimistic on a couple of fronts, which don't fully jive with a recession prediction.

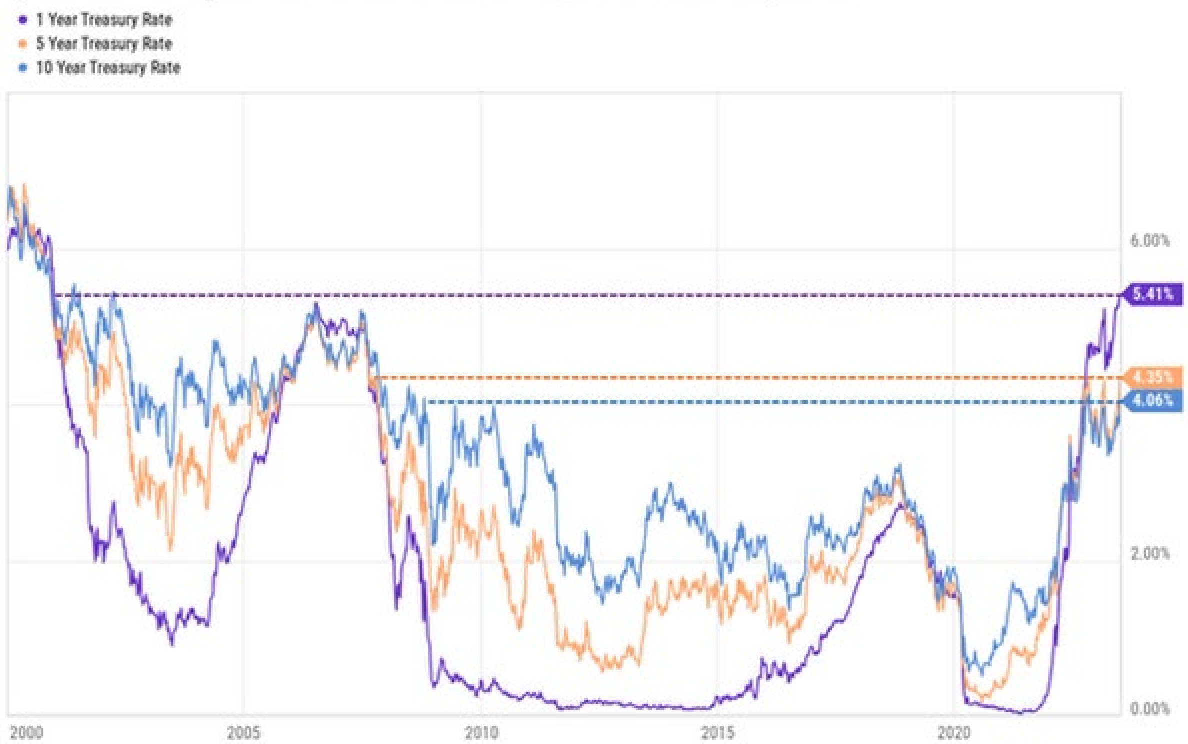
Over the past two months, interest rates across the yield curve have moved higher as strong economic data and fading concerns about bank failures have led investors to believe that the Fed will indeed keep short-term rates higher for longer. At the same time, bond investors remain sanguine about the outlook for inflation and the credit quality of corporate debt – a combo that would imply a successful soft landing for the economy and not a recession.

While real, inflation-adjusted rates have increased significantly as a result of the Fed's response to surging inflation, investors' expectations for inflation in the market for Treasury Inflation Protected Securities (TIPS) have remained well anchored near the Fed's 2% target. At present, investors appear confident that the Fed will get inflation back under control relatively quickly and not adjust its target higher in response to intransigent inflation.

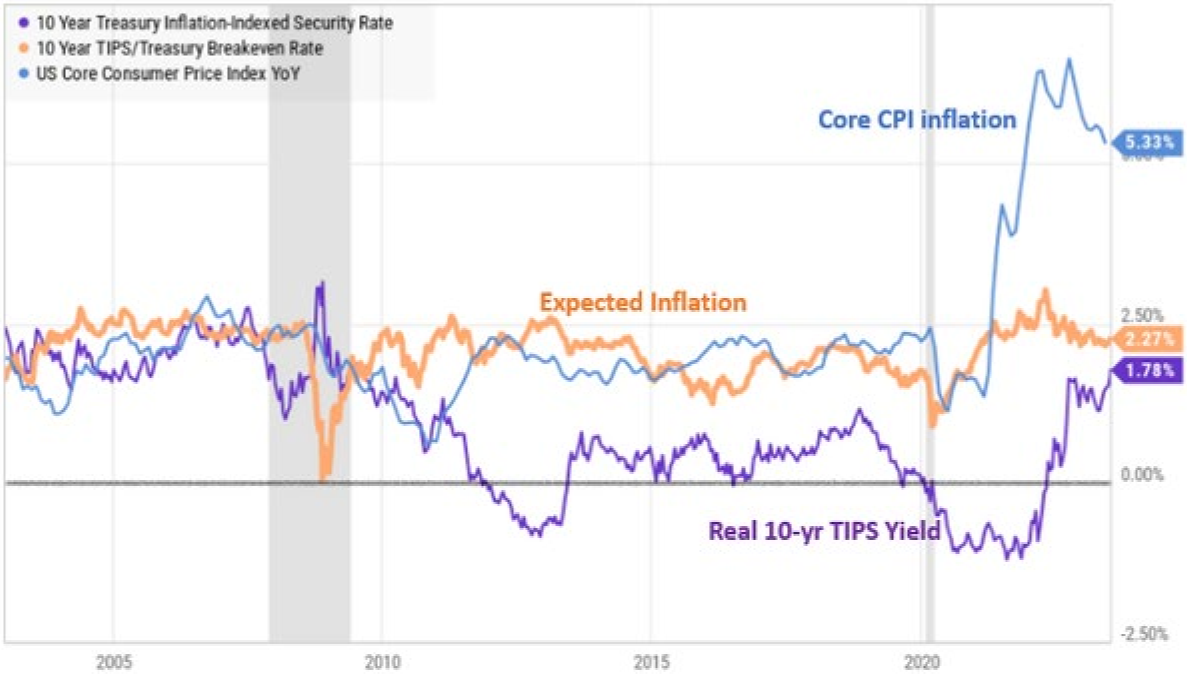
There also seems to be little concern about the effect of those higher real interest rates in the corporate bond market where investors are not demanding much additional return to invest in corporate debt versus US Treasury debt. If recession fears were running rampant, credit spreads would likely be widening, not trending lower.

Maybe this time is different for the yield curve as a predictor of a recession – or maybe bond investors are just as torn between hopes and fears as everybody else.

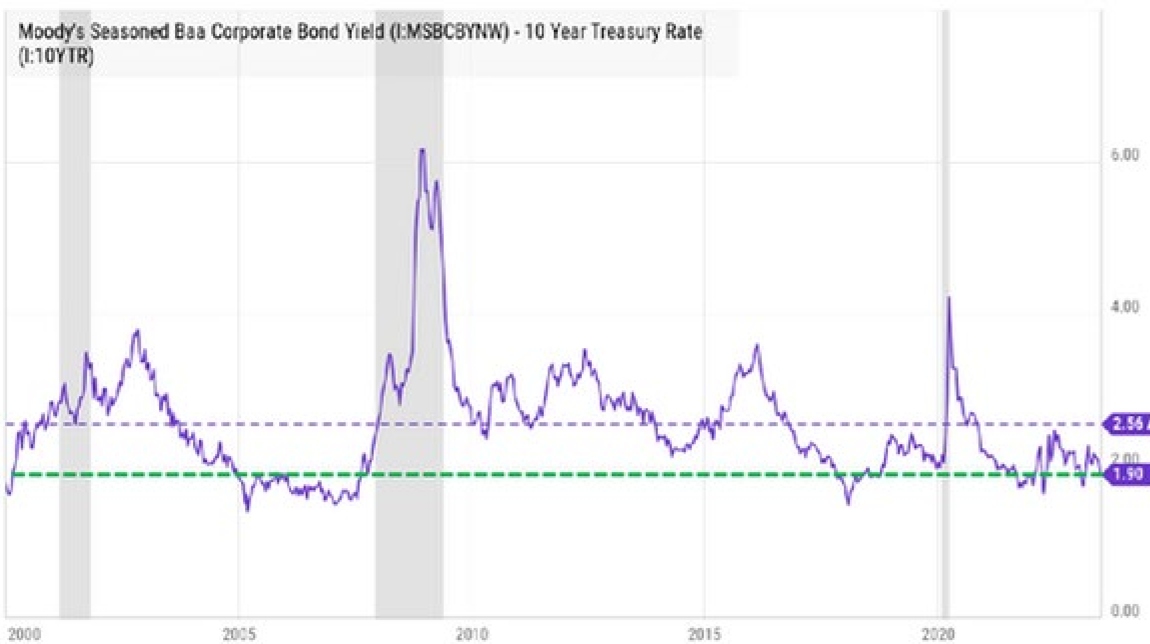
Recent economic data and a hawkish Fed have pushed interest rates across the yield curve higher towards levels not seen in several years.



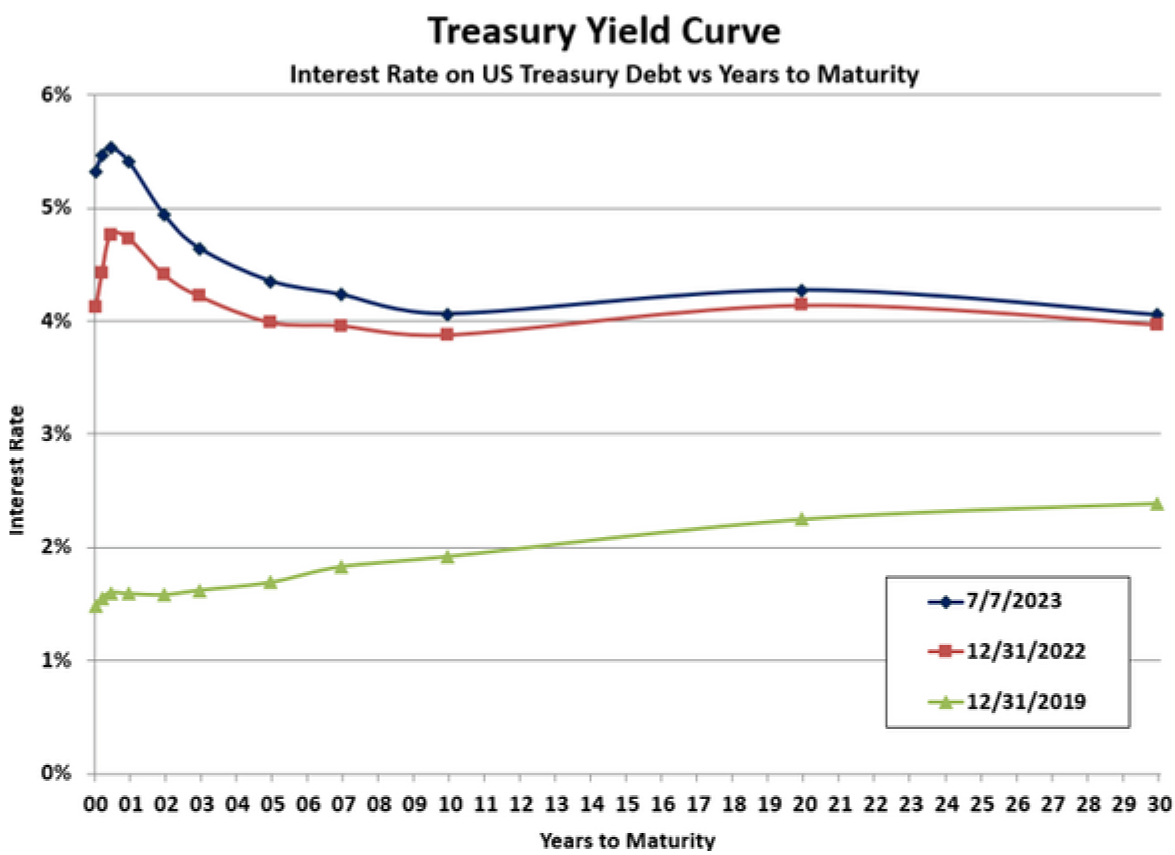
No inflation concerns: Bond investors remain confident the Fed will get inflation under control with inflation expectations for 10-yr TIPS well anchored near 2%.



No credit concerns: Bond investors don't appear worried about the credit quality of corporate debt as credit spreads have come down and remain relatively tight.



Recession concerns: The yield curve remains deeply inverted which is a leading indicator of a downturn, but it also often rights itself before a recession begins.



Sources: Ycharts

Inflation | Mission Accomplished?

July 17, 2023

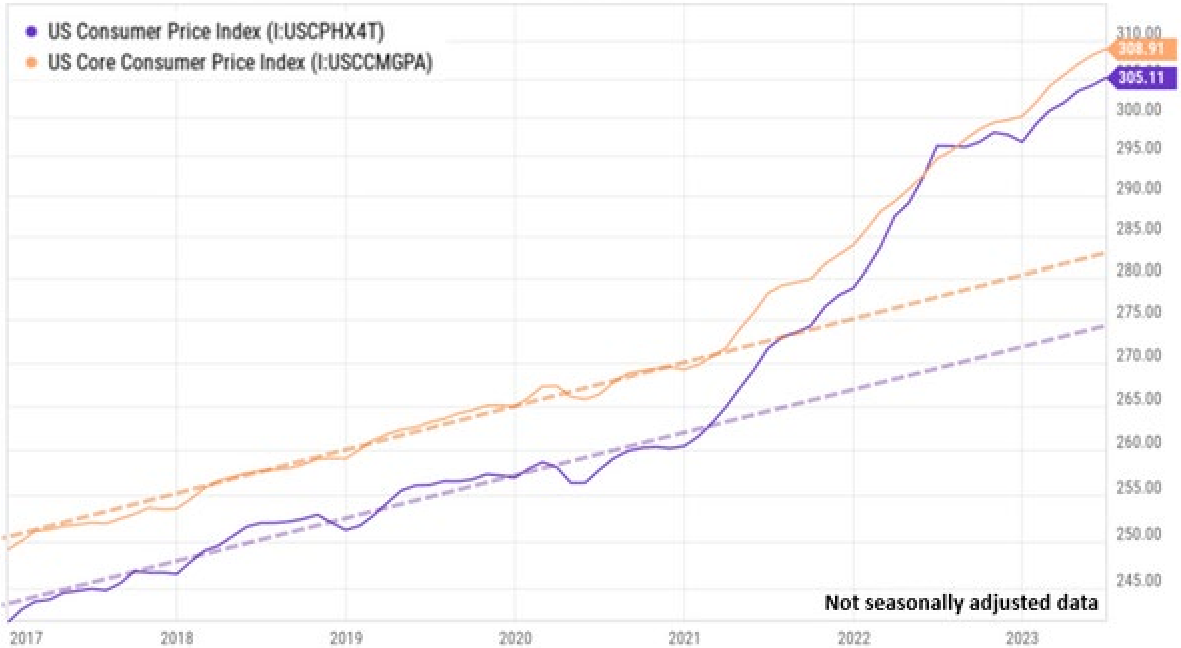
Annual inflation fell for the twelfth consecutive month in June, declining from 9.1% to 3.0% over the past year as measured by the year-over-year change in the Consumer Price Index (not seasonally adjusted). The unusually rapid, consistent disinflation has buoyed investor sentiment and hopes that the Fed will not have to push the economy into a recession to bring inflation back to its 2% target.

Despite the good news, policymakers are wary of declaring "Mission Accomplished" too soon. Indeed, quite the opposite, as the Fed is poised to resume raising short-term interest rates again this month. Core inflation excluding food and energy prices has not declined as swiftly as policymakers would like, and headline inflation is unlikely to continue declining in the coming months.

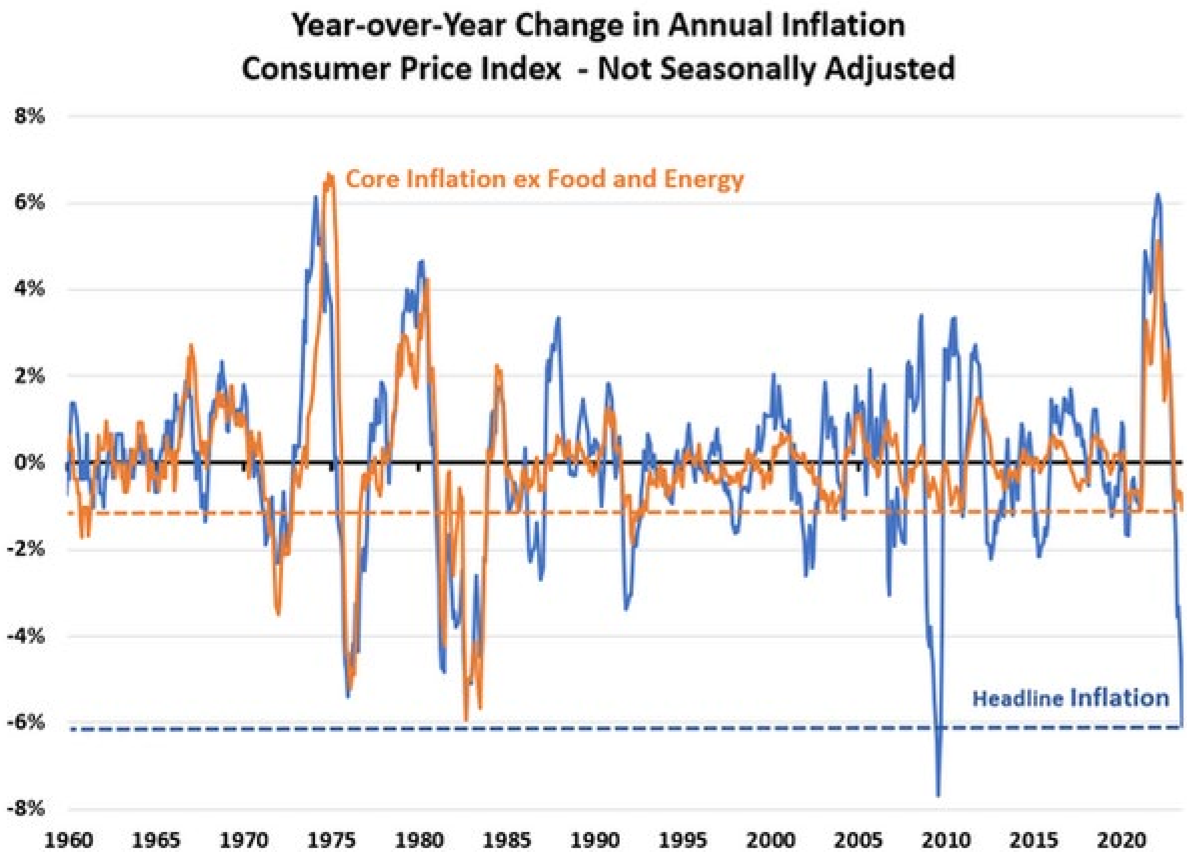
Seasonally most of the increase in the aggregate price index occurs in the first half of the year, while there is typically minimal measured inflation in the latter half. For the first six months of 2023, the Consumer Price Index (not seasonally adjusted) is already up 2.8% (5.7% annualized), so any incremental price increases in the coming months will push inflation up from its current level of 3% and potentially keep the Fed raising rates higher for longer than investors expect.

Headline inflation declined to 3% from 9.1% a year ago while core inflation excluding Food and Energy fell below 5% for the first time since November 2021.

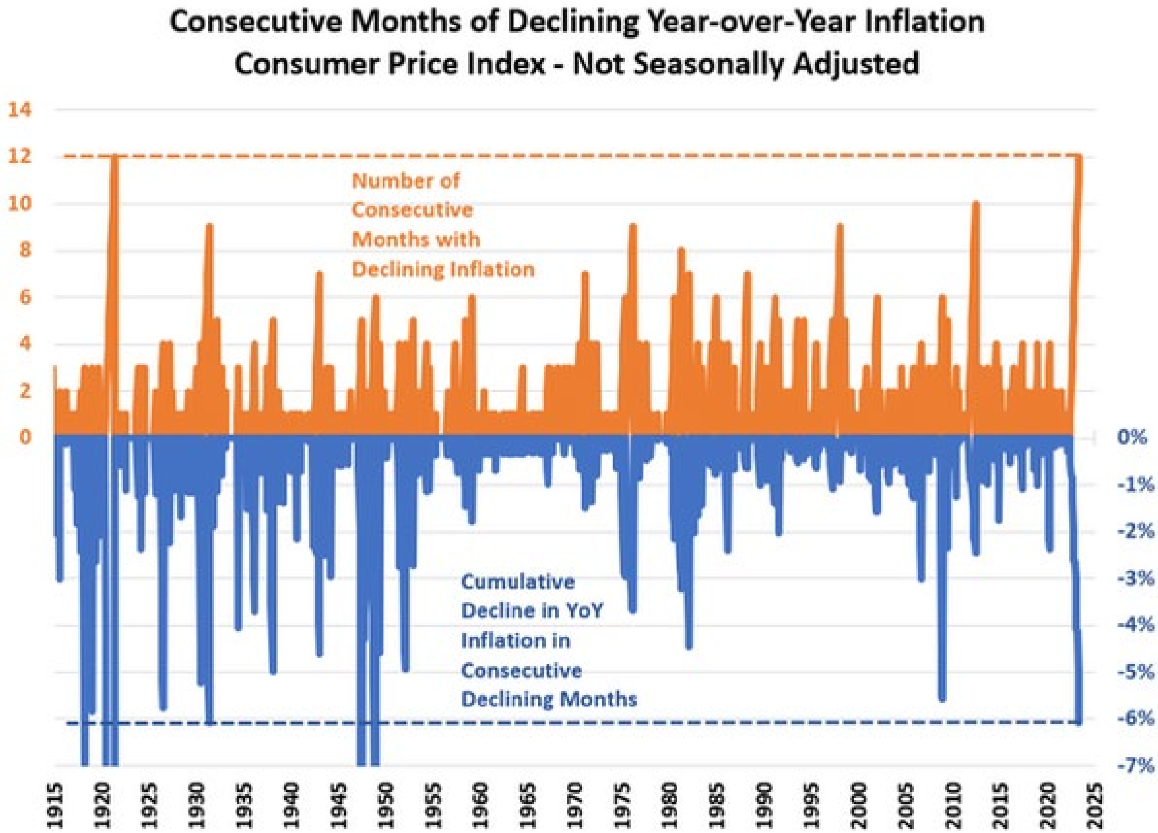
Prices are still trending higher faster than they were before the pandemic. Future changes to Fed policy will hinge on whether price increases take their usual seasonal pause in the second half of the year.



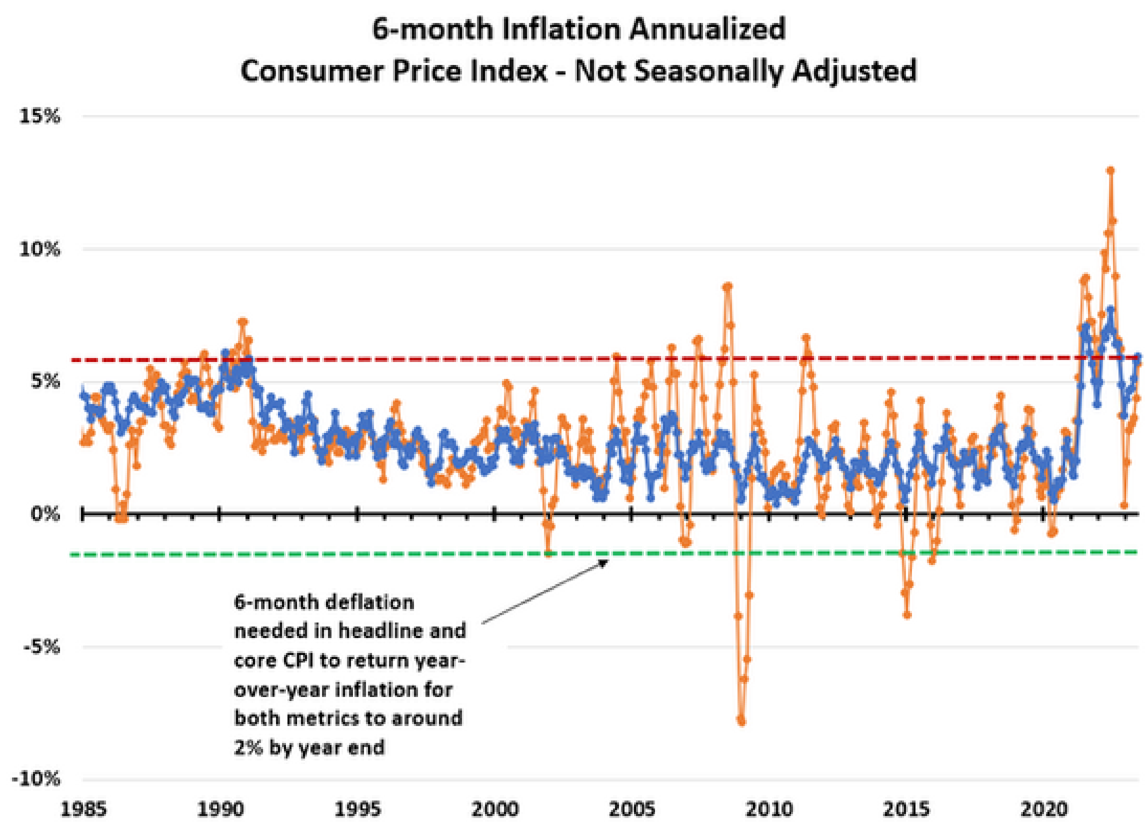
The decline in headline inflation was a historical outlier, while the decline in core inflation was large but more in line with past experience.



Twelve consecutive months of declining year-over-year inflation has only occurred once before in the 110 years of not seasonally adjusted CPI data.



Inflation remained higher than desired in the first half of the year. Further declines in annual inflation will be tougher to achieve over the next six months.



Sources: Ycharts, https://fred.stlouisfed.org/, BLS, AOWM calculations

Expectations | Change slowly

July 24, 2023

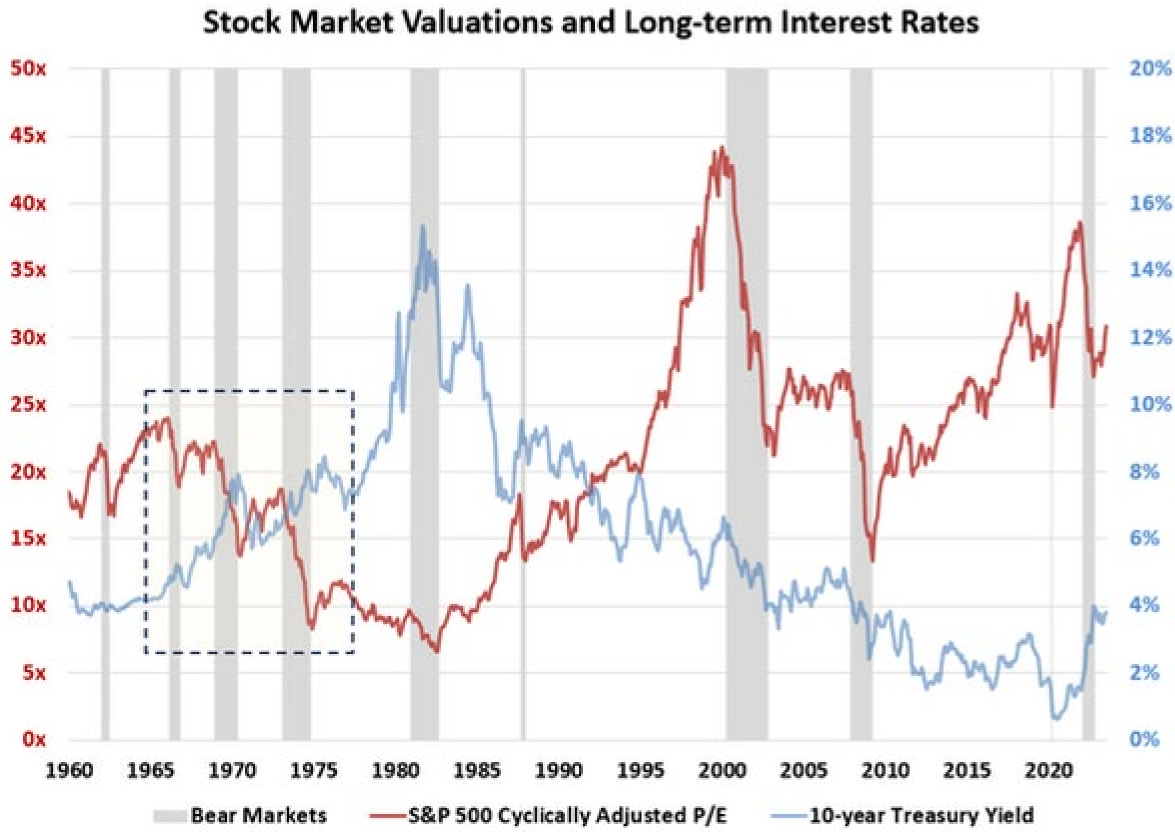
Investors continue to push the stock market closer and closer to new all-time highs even as valuations creep higher and the short-term economic outlook at best seems to be indicating slow growth.

Investors also appear to be disregarding the high probability that falling interest rates and declining corporate tax rates will no longer bolster long-run profit growth as has been the case for the past several decades. An economist at the Federal Reserve recently estimated that "lower interest expenses and corporate tax rates mechanically explain over 40 percent of the real growth in corporate profits from 1989 to 2019."

People are prone to project the recent past into the future. And declining interest rates, expanding profit margins and fast earnings growth has been the recent experience. Even if interest rates retreat to their pandemic lows, tax rates don't change and profit margins remain high, future long-run earnings growth is likely to be significantly slower than it has been in recent decades. Nevertheless, given our human bias to overweight the recent past, it may take a few bear markets for investors' expectations to change – or AI may just change everything.

Inflation seems unlikely to spiral out of control like in the 1970s, but we still may be on track to repeat the stock market of the late 1960s and 1970s with higher highs and lower lows until a solid bottom is found as investors acclimate to a new normal.

It took over eight years and three bear markets for investors to adjust valuations to the reality of higher inflation and interest rates in the late 60s and early 70s.



Investors have enjoyed the tailwind of falling interest rates and declining tax rates for decades. However, these profit drivers have reached their limits and may turn into headwinds in the coming years. The environment investors have grown accustomed to is changing; history suggests they will be slow to adjust.

Figure 2: Corporate interest rates

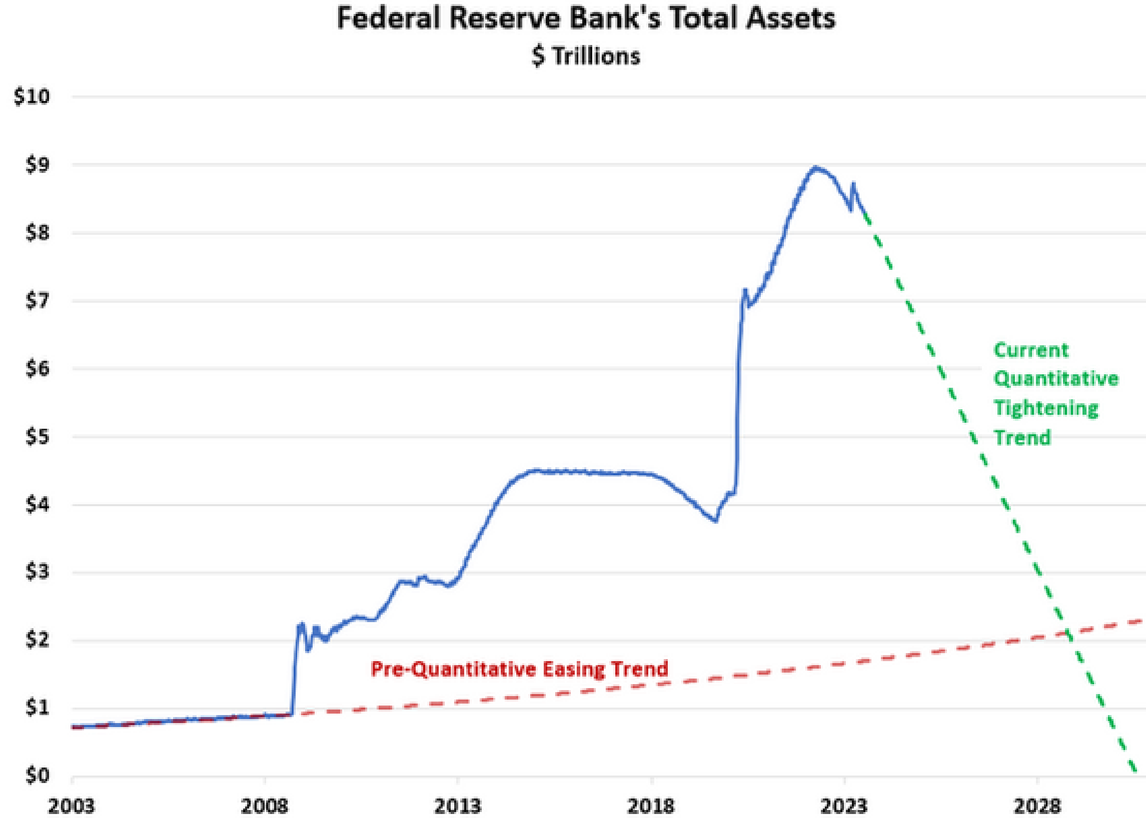
Note: Aggregate values for S&P 500 nonfinancial firms, 1962 to 2022.
Source: Compustat.

Figure 5: Effective corporate tax rates

Note: Aggregate values for S&P 500 nonfinancial firms, 1962 to 2022.
Source: Compustat.

Source: ***End of an era: The coming long-run slowdown in corporate profit growth and stock returns*** **by Michael Smolyansky (June 2023)**
https://www.federalreserve.gov/econres/feds/files/2023041pap.pdf

Long-term interest rates could remain under sustained upward pressure as the Fed continues to decrease the size of its balance sheet. But it will take several years to undo the era of Quantitative Easing; investors may reasonably doubt that policymakers will ever get there given the Fed's recent track record.



Policymakers face tough choices in the coming years that will require tradeoffs affecting interest rates and taxes – and in turn the stock market.

Option 1 - The federal deficit is brought under control which is likely the most politically challenging option.

Option 2 - The Fed contains inflation with higher interest rates which may also prove politically challenging before long.

Option 3 - The Fed resumes Quantitative Easing to help finance high budget deficits even if inflation remains higher than desired which seems like the path of least resistance.

Option 4 - Some combination of all three may be the ultimate outcome which would imply higher taxes, higher interest rates and higher inflation than has been the experience for most of the past two decades.

Policy Options	Option 1	Option 2	Option 3
High budget deficits	NO	YES	YES
Low interest rates	YES	NO	YES
Low inflation	YES	YES	NO

Sources: Ycharts, *End of an Era* by Michael Smolyansky - https://www.federalreserve.gov/econres/feds/files/2023041pap.pdf, http://www.econ.yale.edu/~shiller/data.htm, AOWM calculations

Residential Investment | Buoyed by golden handcuffs

July 31, 2023

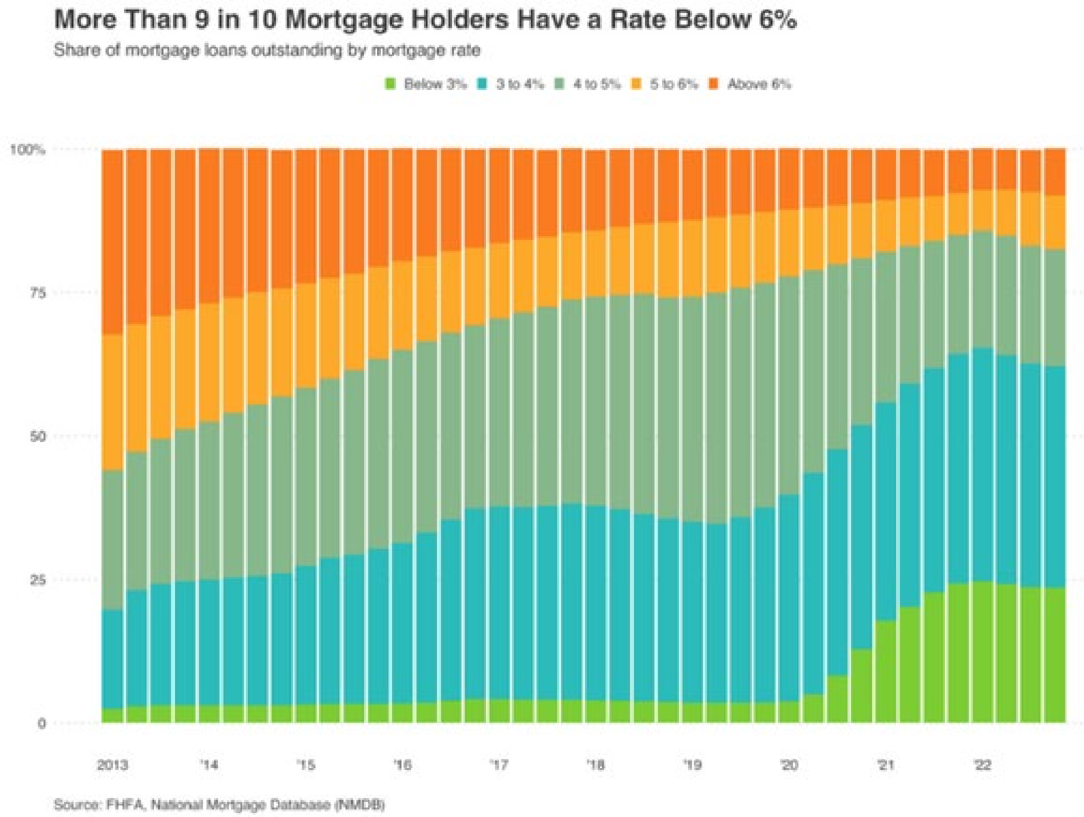
The preliminary estimate by the Bureau of Economic Analysis indicates that the US economy continued to chug along in the second quarter with real growth bouncing around 2% year-over-year. Residential investment has not been a source of growth over the past year, but it has bolstered the economy by not being as big a drag as feared.

When mortgage rates spiked to 7%, residential investment did slow as expected; however, it didn't crater as the Fed has unintendedly created a squeeze in the housing market. One side effect of the Fed pushing interest rates to ultra-low levels during the pandemic was that it locked many homeowners into mortgages with very low rates, making them far less inclined to move. At the end of last year, 62% of outstanding home mortgages had a rate below 4%. As a result, the number of existing homes on the market is at an extremely low level, which has so far kept new home construction from falling as much as it has in previous downcycles.

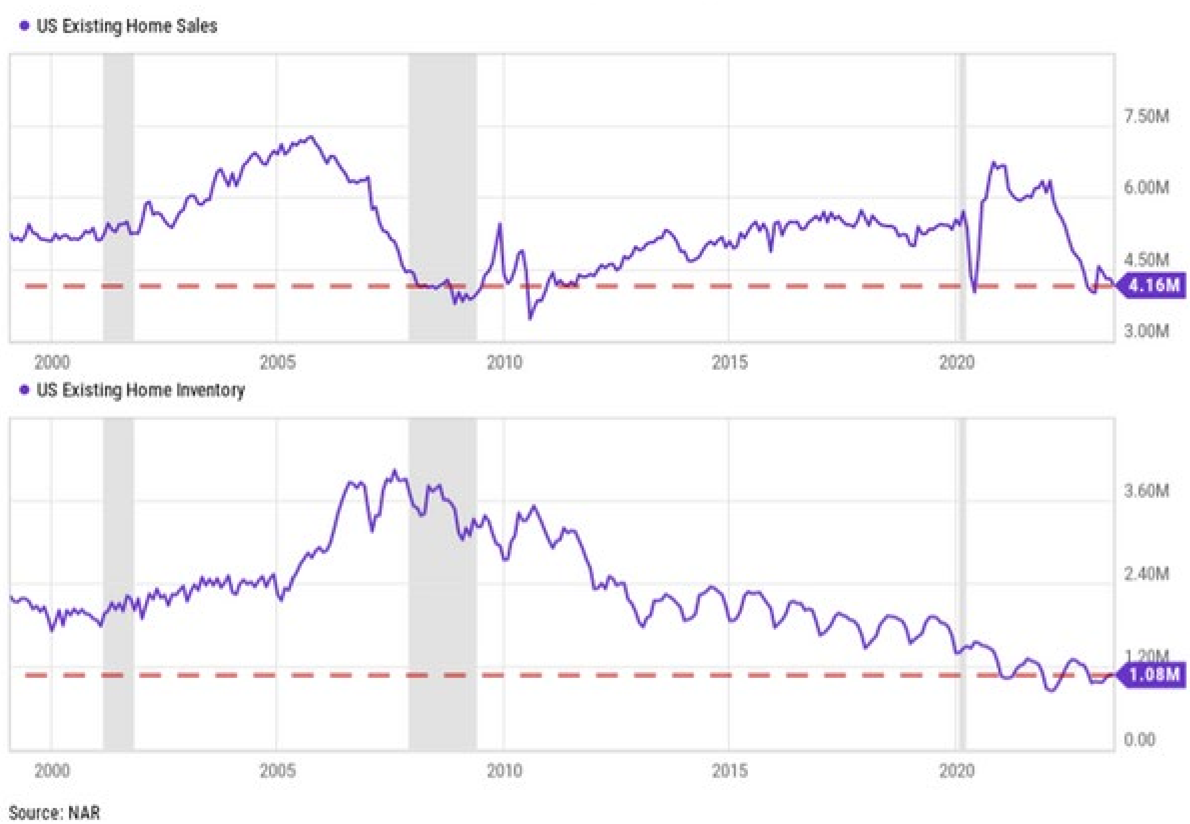
Whether the current uptick for homebuilders is a momentary pause before a recession hits or what will happen when mortgage rates come back down (assuming they do) is anyone's guess. The wild pandemic stimulus will likely continue to have unexpected consequences for years to come.

Mortgage rates have spiked towards 7% since the Fed started raising interest rates. The 30-year mortgage rate is at an unusually large spread to the 10-year Treasury as new mortgages are being priced as short-term debt with the assumption that they will be quickly refinanced when rates (hopefully) decline.

Most homeowners with a mortgage have locked in a rate below 4%, making them less inclined to move and take on a mortgage with a rate close to 7%.



Existing home sales and the number of existing homes on the market are around the lowest levels seen over the past 25 years.



The lack of existing homes for sale appears to have kept the new housing market from cratering into recession territory with recent data even showing an uptick in activity.

US New Single Family Houses Sold

• US Housing Starts

• US New Housing Permits: 1 Unit

Sources: Ycharts, NAR, Census Bureau, Redfin, https://www.redfin.com/news/high-mortgage-rates-lock-in-homeowners-2023/, AOWM calculations

Yield Curve | Long end rising

August 7, 2023

Last week, investors were reminded of the federal government's poor fiscal health when one of the credit rating agencies downgraded US Treasury debt to one notch below the highest AAA rating. While the downgrade is unlikely to have any direct practical implications, it still helped to push the yields on long-term Treasurys higher.

Over the past several months, long-term interest rates have risen primarily on growing economic optimism. The 10-year Treasury yield is now back above 4% and near the level it reached both last fall and this spring before the bank failures. The yield curve remains deeply inverted with short-term rates well above long-term rates, but it is flatter than it was a couple of months ago. Typically the yield curve regains its normal shape from an inversion as the Fed lowers short-term rates to bolster a slowing economy.

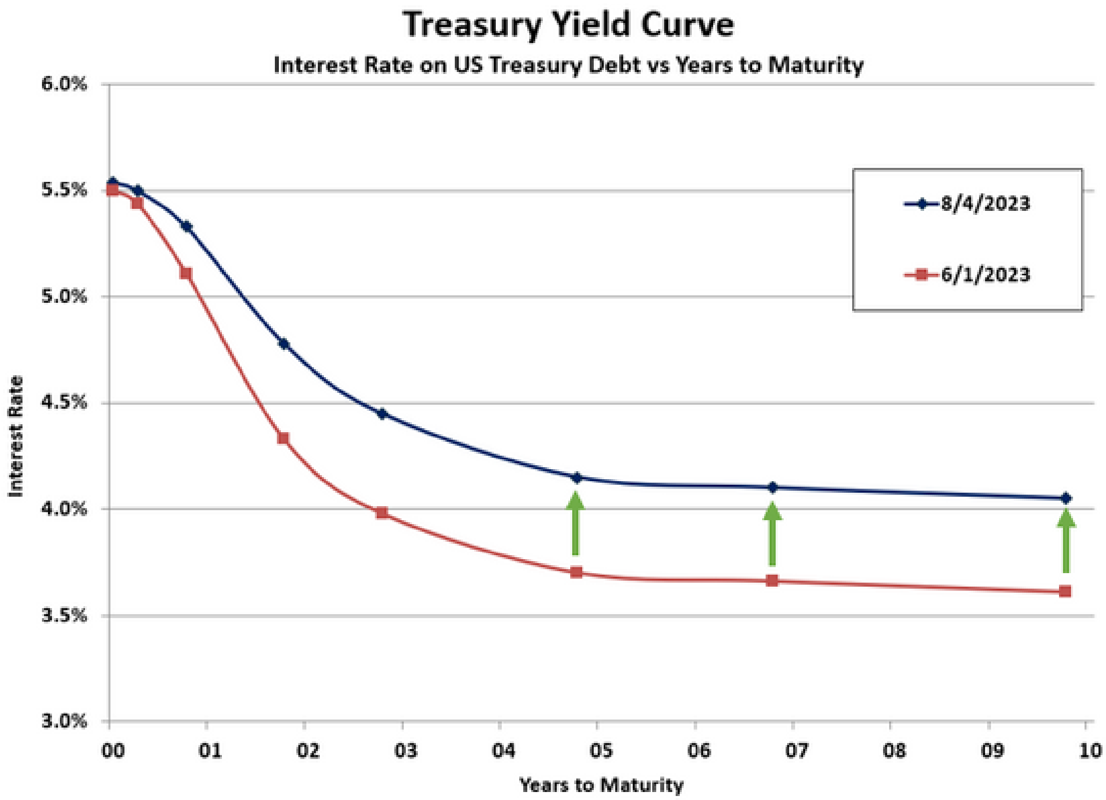
Whether anticipating a recession or not, investors generally agree the yield curve will again right itself as the result of Fed rate cuts starting next spring. If long-term rates stay roughly where they are now, the yield curve could be returned to its normal upward-sloping shape by the end of 2024 based on investors' current outlook for monetary policy.

A scenario that would catch many investors by surprise is if long-term rates rise to meet current short-term rates. While it would be a deviation from the experience of recent decades, it is not a far-fetched possibility if inflation remains sticky, the Fed remains resolute, the economy remains above water, and the Federal government remains profligate. Wilder things have happened in recent years.

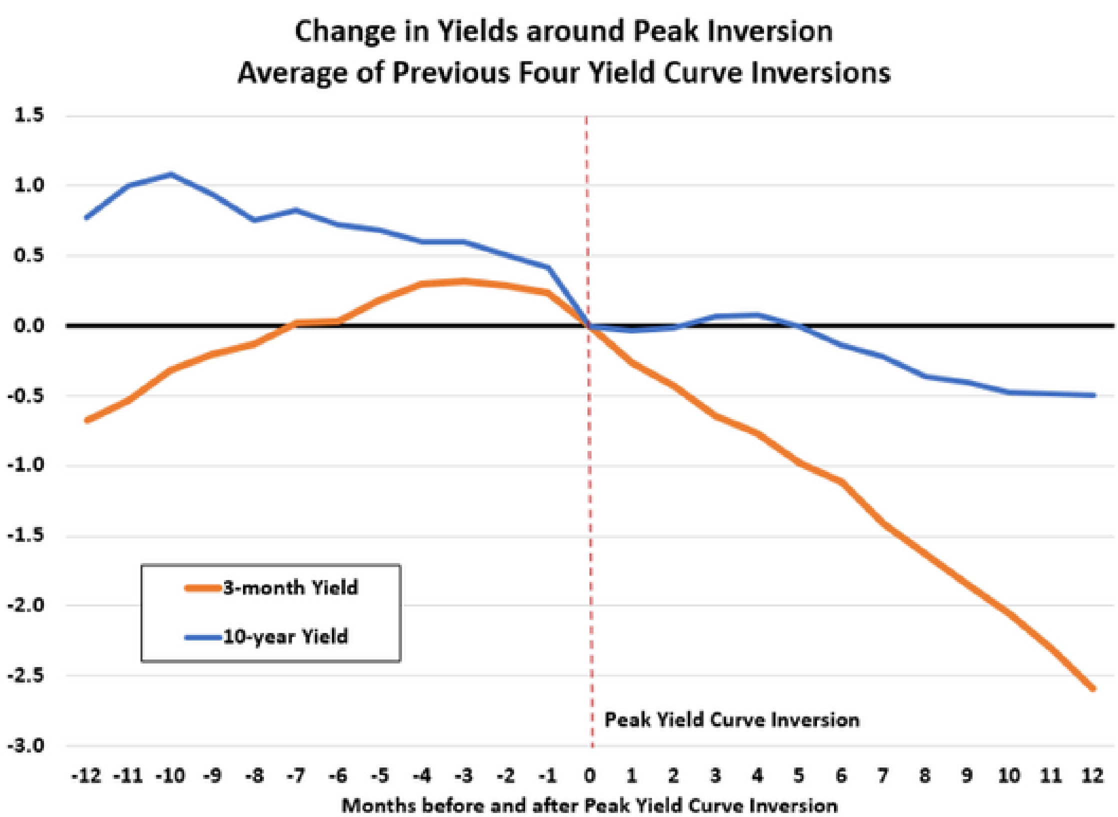
The deep yield curve inversion appears to have bottomed a couple of months ago and has trended back since then as the long end of the curve has risen.

10 Year-3 Month Treasury Yield Spread (I:10Y3MTS)

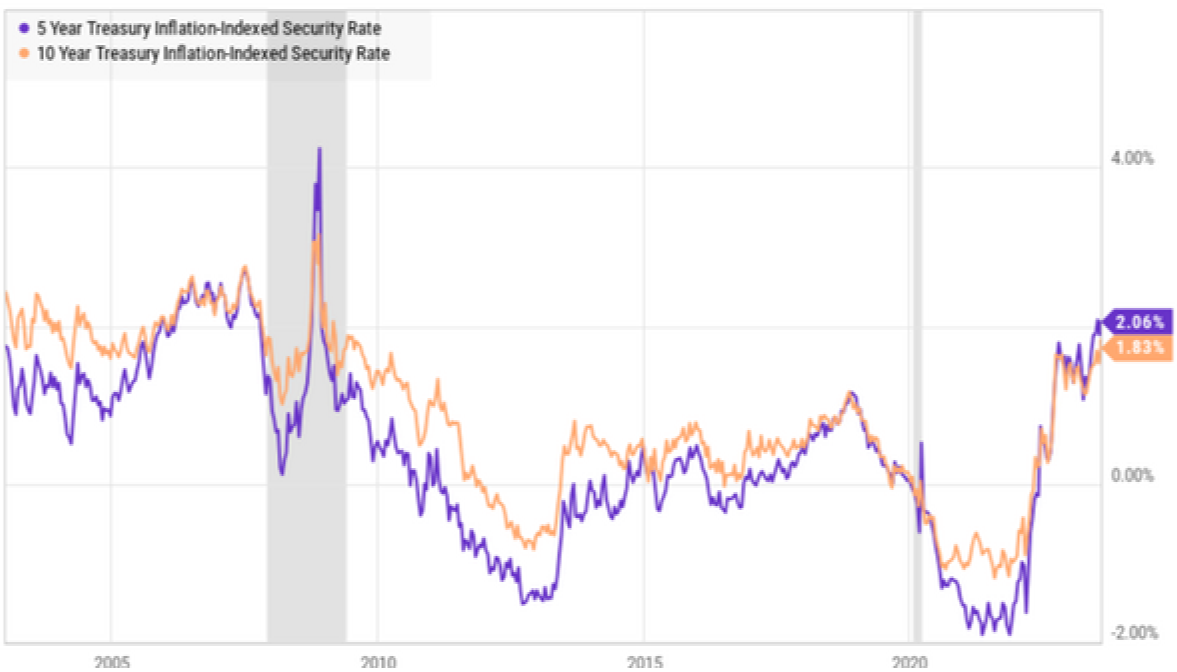
Long-term rates have trended higher over the past two months on a combination of hopes about the economy, expectations that the Fed will keep rates higher for longer, and bubbling concerns about fiscal deficits.



Yield curve inversions have typically corrected by the Fed lowering short-term interest rates in response to a slowing economy.



Real, inflation-adjusted long-term interest rates are trending higher towards 2%. If inflation proves persistent above 3% and the economy avoids a recession, the yield curve could right itself via the long end of the curve rising as opposed to the usual decline in short-term rates.



Sources: Ycharts, https://fred.stlouisfed.org/, US Treasury, AOWM calculations

Inflation | Historic run comes to an end

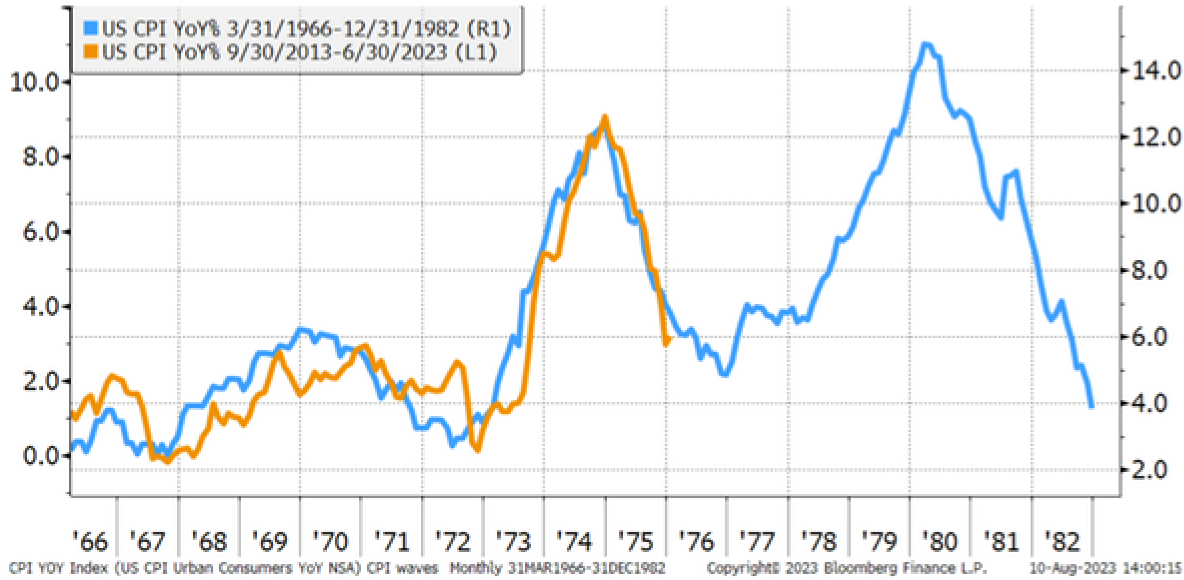
August 14, 2023

Annual inflation, as measured by the Consumer Price Index, ticked higher in July to 3.2% after declining for a record twelve straight months. Underlying inflation trends remained generally positive, but year-over-year headline inflation is still likely to remain sticky in the 3% to 4% range for the remainder of the year thanks in large part to the estimate for shelter inflation which is expected to moderate slowly.

While an uptick in annual inflation was anticipated, the stock and bond markets still sold off slightly last week as expectations for another potential Fed rate hike in November increased and the projected start date for rate cuts was pushed back to May. Inflation was never going to retreat to 2% in a straight line; however, the inevitable hiccup raises the specter of another inflation wave à la the 1970s.

The ghost of the 70s is what will likely keep the Fed pushing interest rates higher for longer and in turn keep the risk of a recession elevated.

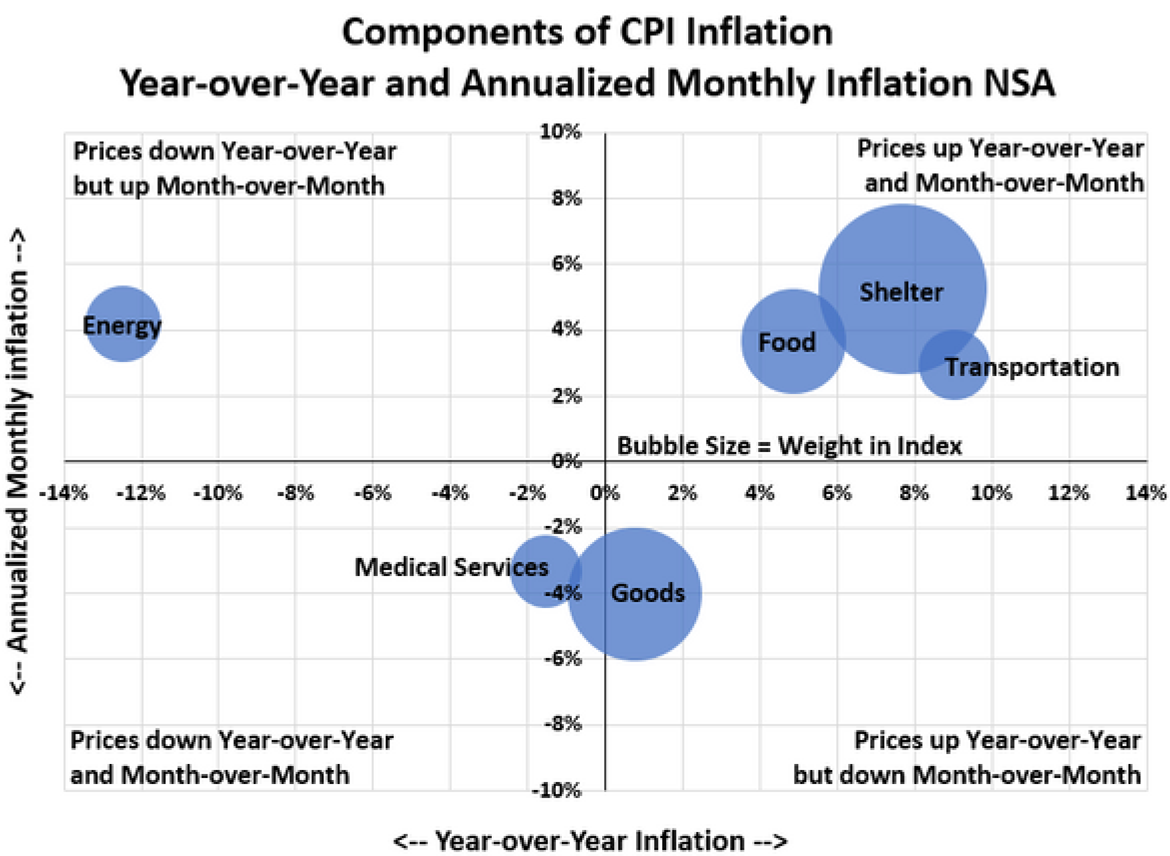
Annual inflation ticked up slightly in July after a historic 12-month streak of declining inflation. Worrisome comparisons were made with the 1970s when inflation retreated only to rebound even higher. It is that history lesson that is likely to keep the Fed from lowering interest rates anytime soon.

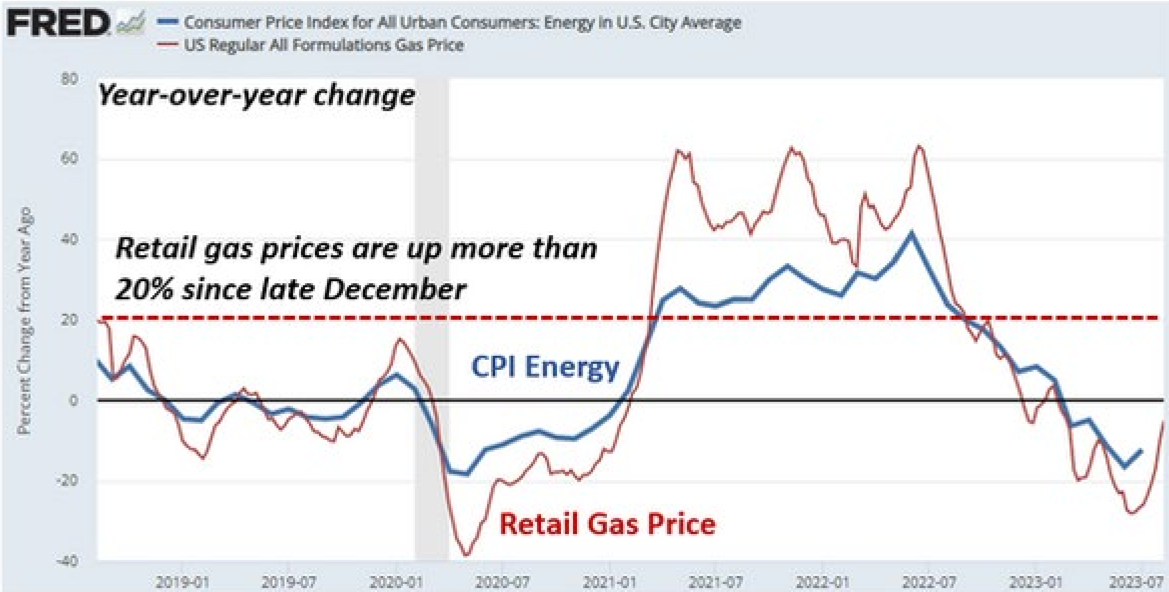


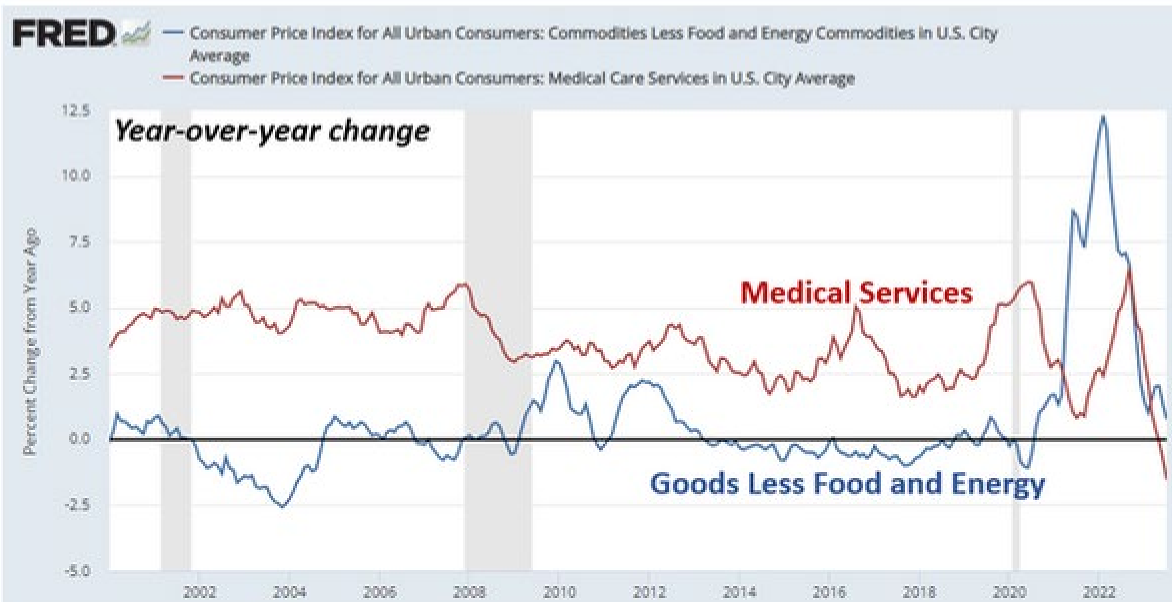
https://twitter.com/JeffreyKleintop/status/1689698973139738624

Excluding shelter inflation which should continue to moderate, the rest of the Consumer Price Index (CPI) was up just 1% over the past year.

Energy prices have helped to bring down headline inflation over the past year but may pressure inflation higher in the coming months. Goods and medical services have also offset the surge in shelter inflation.







Sources: Ycharts, https://fred.stlouisfed.org/, BLS, AOWM calculations

The Consumer | Facing new hurdles

August 21, 2023

While most investors aren't thrilled with the idea that interest rates may stay higher for longer, fears of a recession are receding as the economy continues to grow, inflation has come well off its high, and unemployment remains low. The picture remains far from clear, however, and it is still too early to gauge the ultimate effect of the Fed's tightening monetary policy.

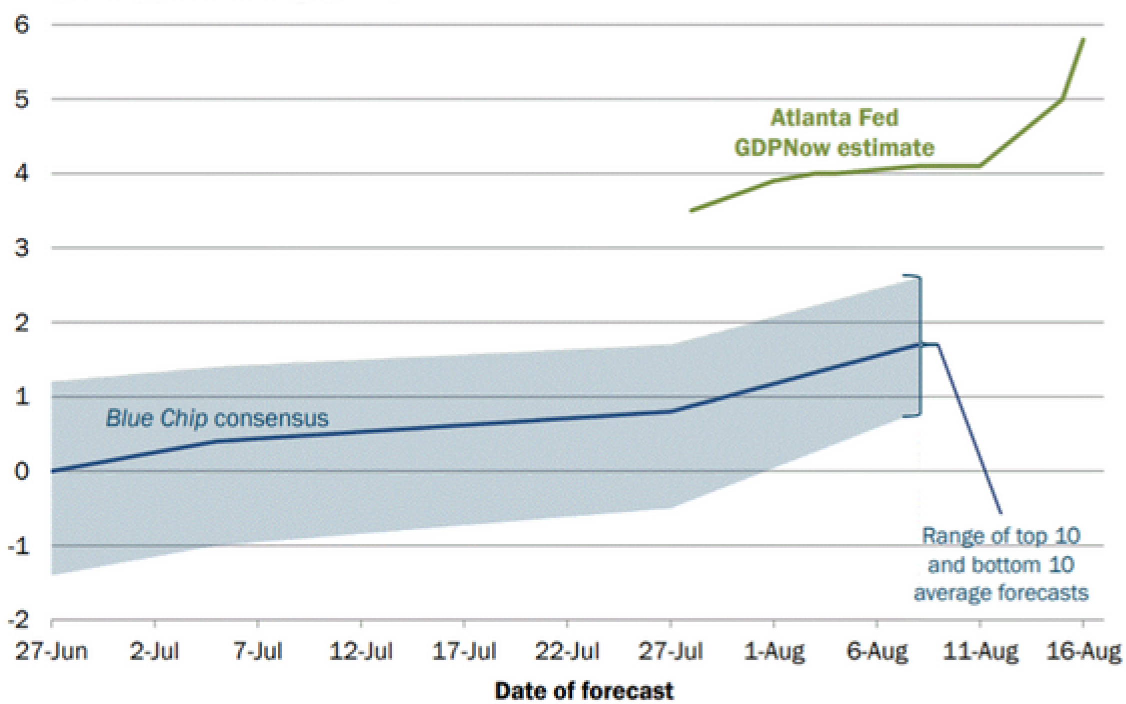
In addition to higher interest rates, the fabled American consumer - whose spending accounts for over two-thirds of the economy - also faces new hurdles in the coming months that may yet trip the economy into a recession. First, over $1 trillion of federal student loans will no longer be in pandemic forbearance starting in September, leaving nearly 27 million individuals with a monthly bill they haven't had to worry about for the past three years. Second, the excess savings that individuals built up during the pandemic is almost gone. If the savings rate returns to levels seen before the pandemic, that could be a further headwind for personal consumption.

Economic activity doesn't grind to a halt in a downturn. Recessions happen at the margin, and the current economy faces an elevated risk that the marginal purchase or investment may not be made in the coming quarters.

Recent economic data has sent some real-time estimates of economic growth shooting higher. The Atlanta Fed's estimate of quarterly GDP growth is now close to 6% annualized. Professional forecasters still expect annualized growth to be less than 2% this quarter.

Evolution of Atlanta Fed GDPNow real GDP estimate for 2023: Q3

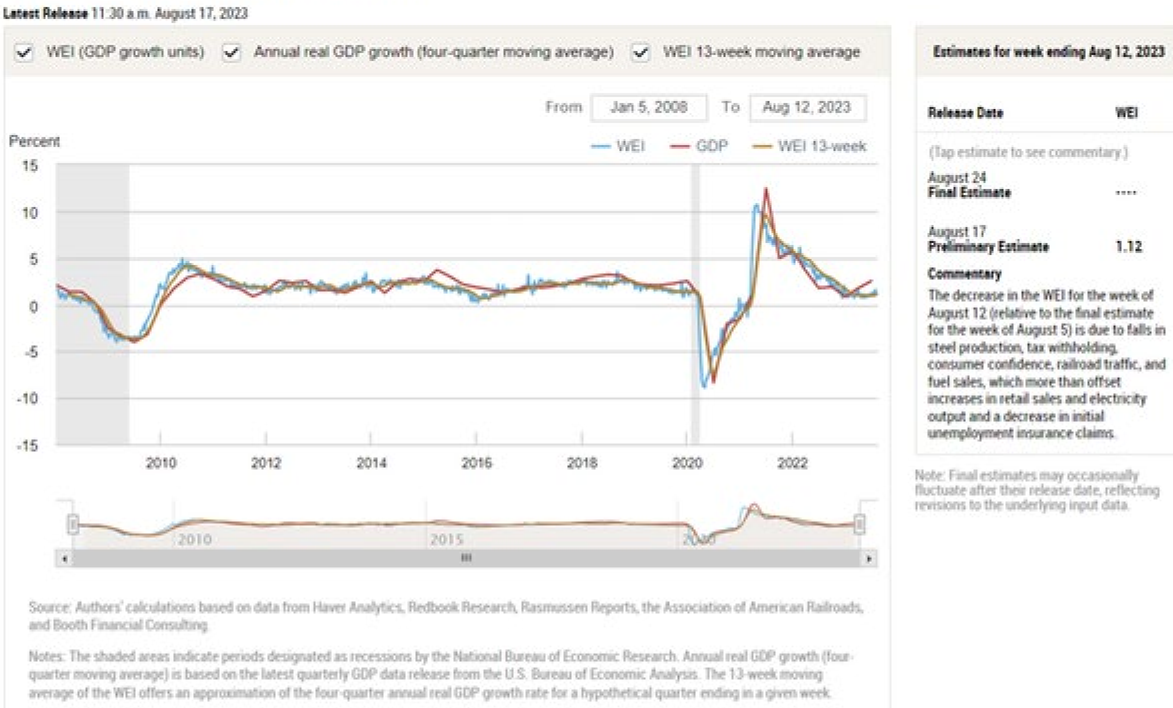
Quarterly percent change (SAAR)



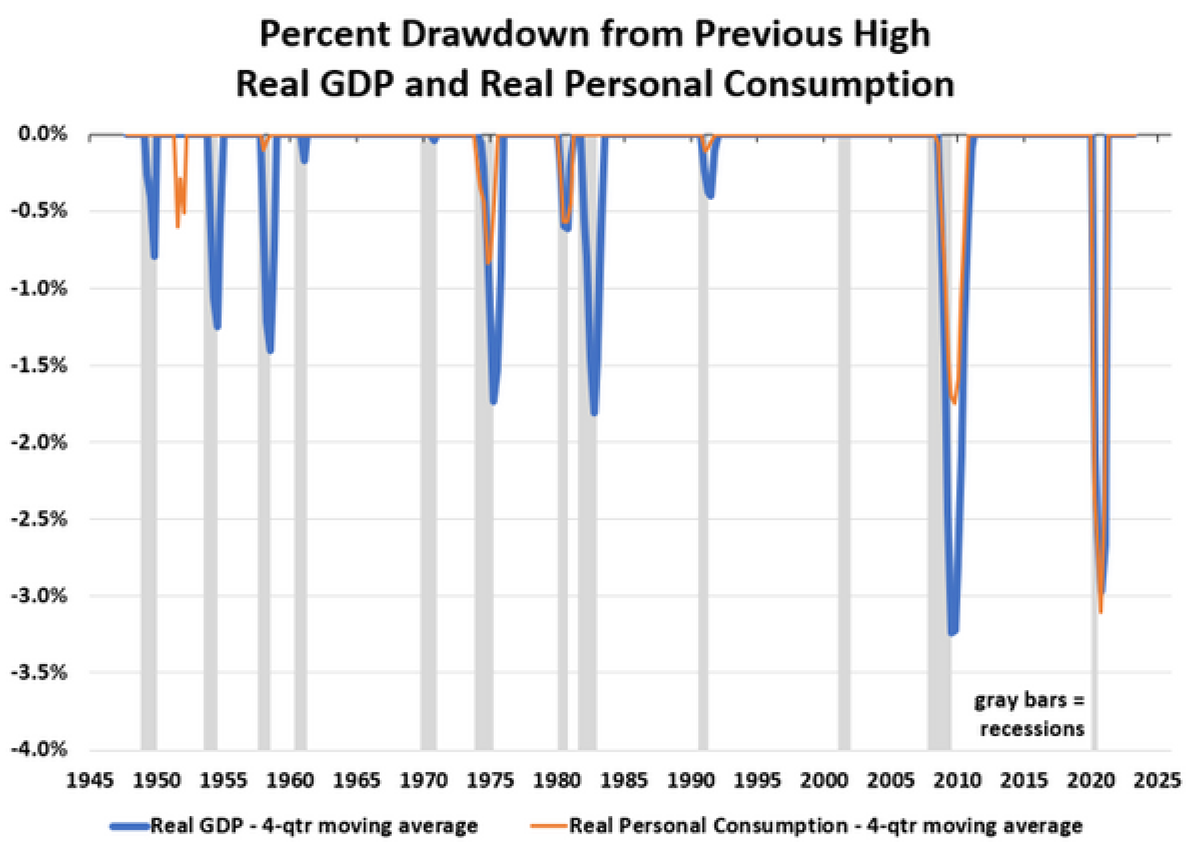
Sources: *Blue Chip Economic Indicators* and *Blue Chip Financial Forecasts*
Note: The top (bottom) 10 average forecast is an average of the highest (lowest) 10 forecasts in the *Blue Chip* survey.

The New York Fed has a Weekly Economic Index that estimates GDP growth year-over-year as opposed to quarter-over-quarter like the Atlanta Fed's estimate. It continues to estimate more tepid annual growth of just slightly more than 1%.

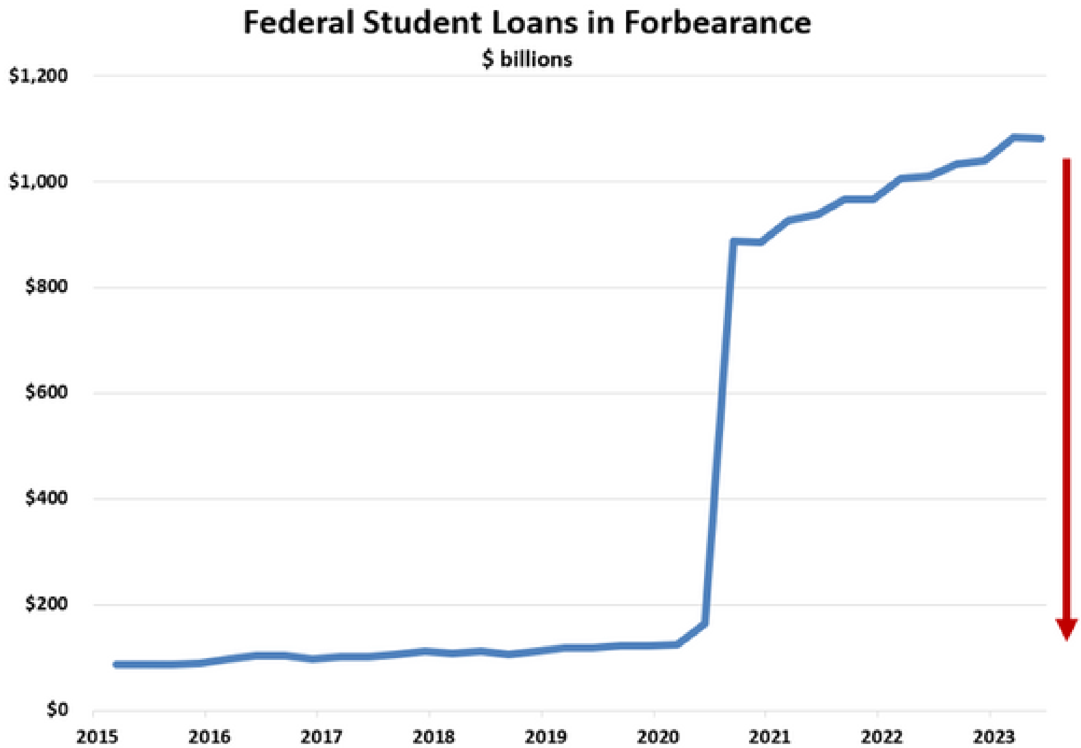
Weekly Economic Index (WEI)



Recessions happen at the margin. Even in deep recessions, annual real GDP and personal consumption have not historically fallen by much more than three percent in the modern era.

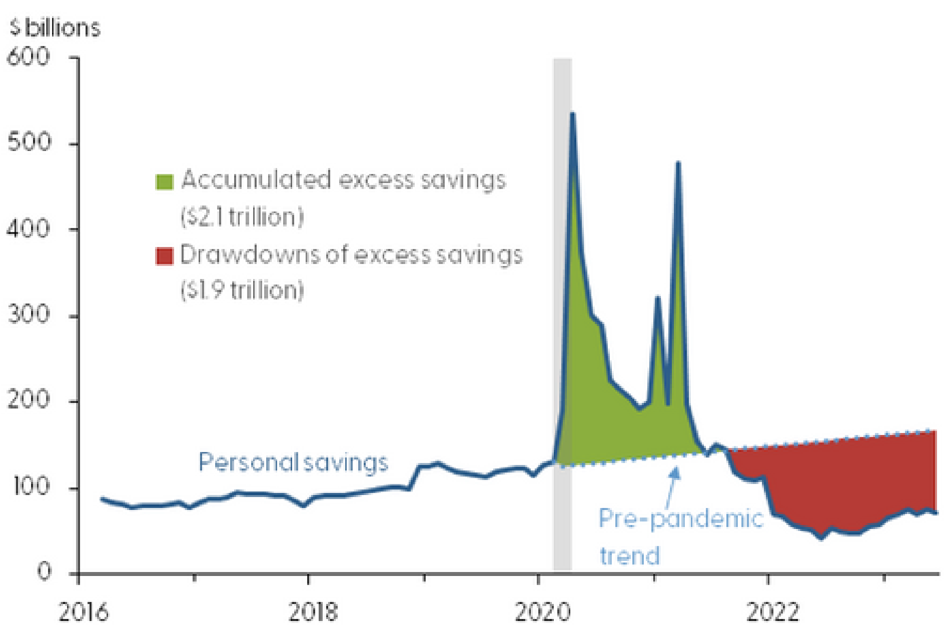


Over a trillion dollars in student loans will no longer be in forbearance starting next month, leaving over 26.7 million individuals with a bill they haven't had to worry about for the past three years.



Pandemic savings is dwindling and will likely be gone in the coming quarters if not this quarter as two economists at the Fed estimated last week.

Figure 1: Aggregate personal savings versus the pre-pandemic trend

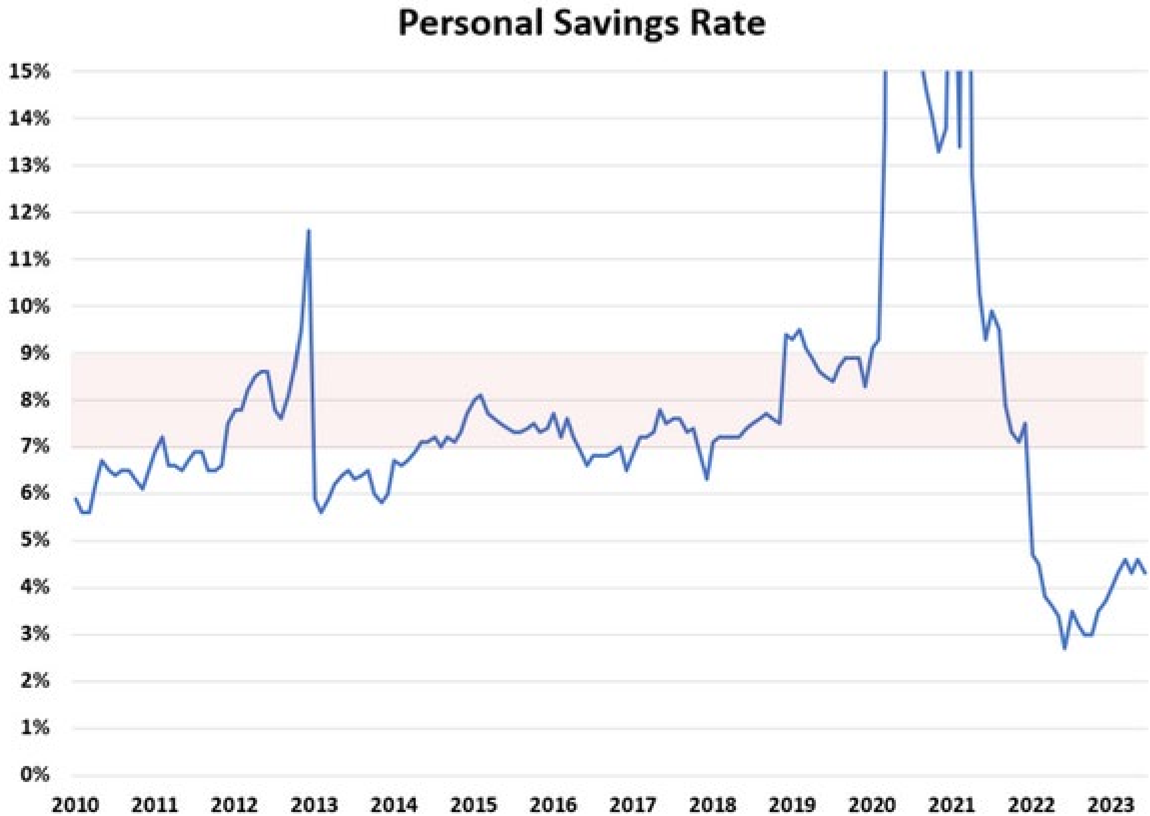


Source: Bureau of Economic Analysis and authors' calculations.

Note: Excess savings calculated as the accumulated difference in actual de-annualized personal savings and the trend implied by data for the 48 months leading up to the first month of the 2020 recession as defined by the National Bureau of Economic Research.

https://www.frbsf.org/our-district/about/sf-fed-blog/excess-no-more-dwindling-pandemic-savings/

If the personal savings rate returns to 7% or greater after the pandemic savings is spent, it could be a drag on future personal consumption.



Sources: Ycharts, https://fred.stlouisfed.org/, BLS, Department of Education, https://www.atlantafed.org/cqer/research/gdpnow.aspx, https://www.newyorkfed.org/research/policy/weekly-economic-index#/, https://studentaid.gov/data-center/student/portfolio, AOWM calculations

The Fed | Navigating by the stars under cloudy skies

August 28, 2023

The Chair of the Federal Reserve, Jerome Powell, reiterated last week the Fed's commitment to bringing inflation back to 2% and the likely need to keep interest rates higher for longer to achieve that goal. He also highlighted the uncertainty plaguing policymakers and ended his speech at the Jackson Hole Economic Symposium by noting that the Fed was "navigating by the stars under cloudy skies."

The labor market is one example of the cloudy outlook confronting the Fed and investors. On the one hand, the unemployment rate remains low, unaffected so far by the increase in interest rates over the past eighteen months. On the other hand, the estimates of new jobs created are being consistently revised lower, job openings are declining, and continued claims for unemployment insurance are increasing. The labor market is the ultimate lagging indicator of the economy's strength, and thus signs that it is weakening are also at odds with other data suggesting the economy is reaccelerating towards faster growth.

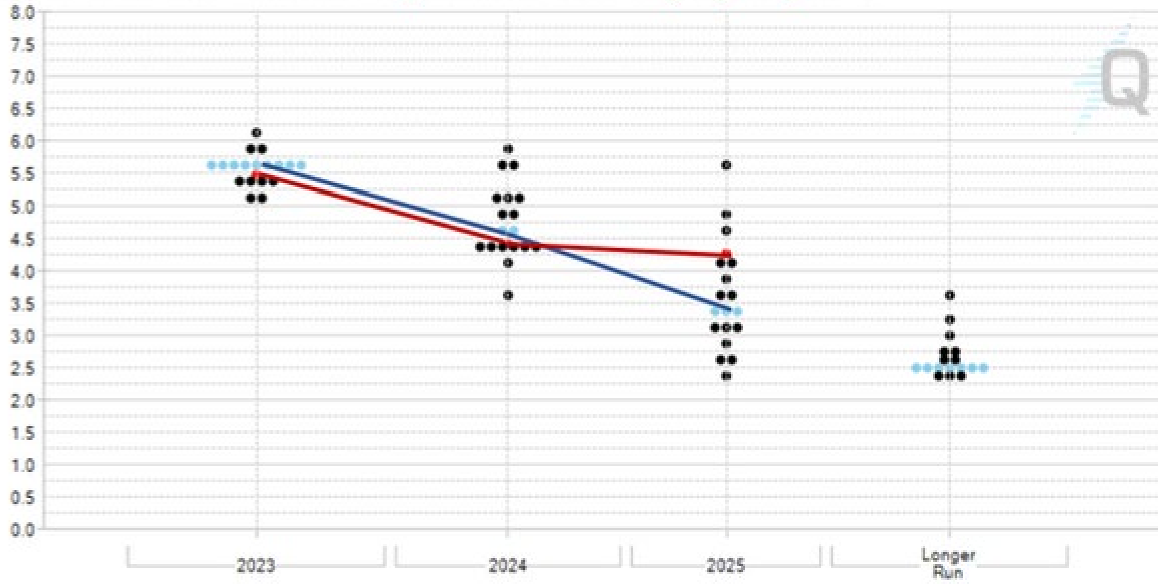
Given the lack of clarity and policymakers' repeatedly stated commitment to reducing inflation, the Fed seems inclined to risk keeping interest rates a little too high for a little too long.

Investors have finally come around to believe that the Fed will keep interest rates higher for longer. Indeed, market expectations are now for rates to stay relatively high for even longer than policymakers have projected.

FOMC PARTICIPANTS' ASSESSMENTS OF APPROPRIATE MONETARY POLICY : "DOT-PLOT"

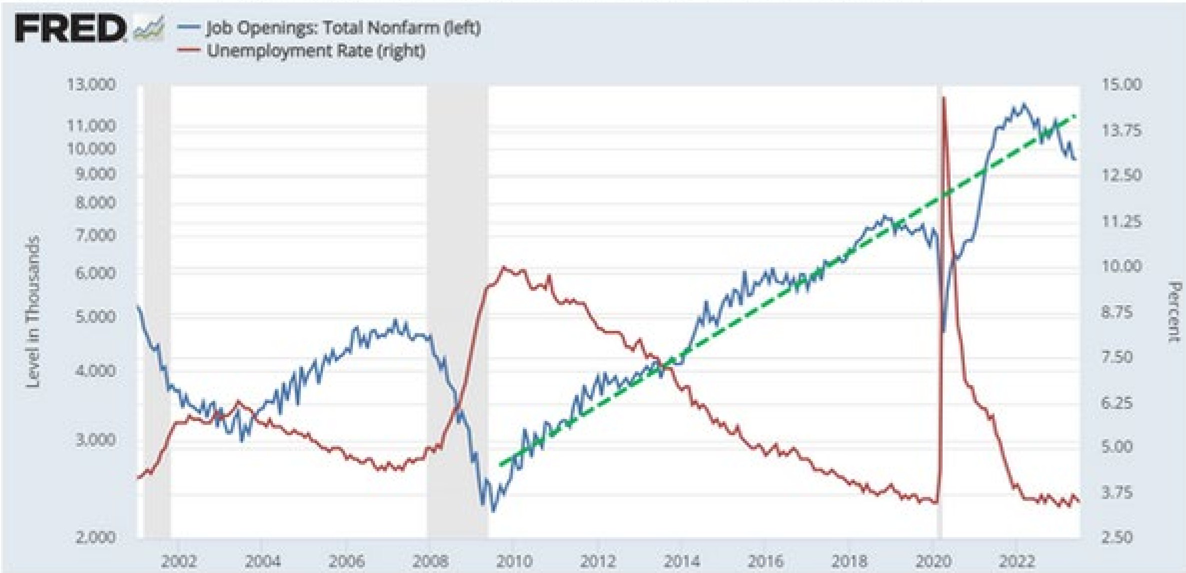
Blue dots and line = median Fed official forecast

Red dots and line = investors' expectations based on fed fund futures



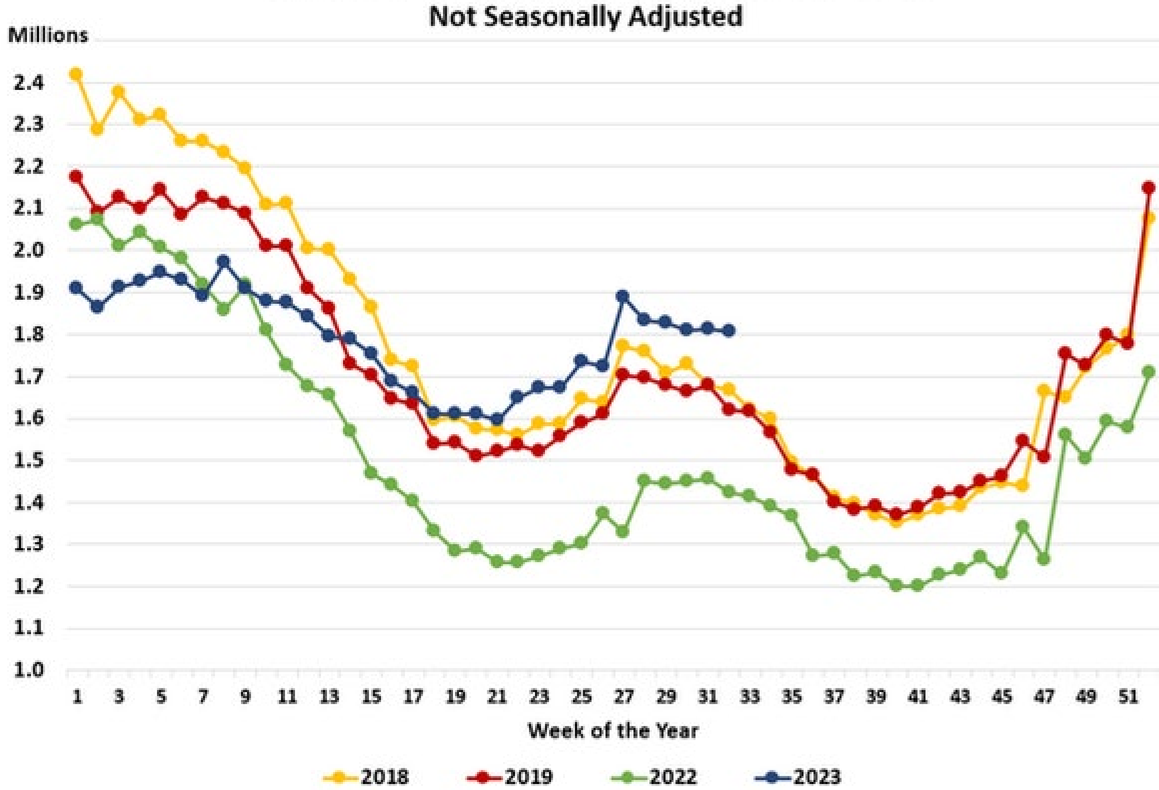
Blue dots indicate the median projection. Data is based on the economic projections published on June 14, 2023.
Red dots indicate the effective rate implied by the year-end FedFund future price.

Deciphering the current strength of the economy is a challenge for investors and the Fed. For instance, the labor market appears to remain strong with the unemployment rate very low and unchanged over the past year. However, job openings are declining and have fallen below the pre-Covid trend.

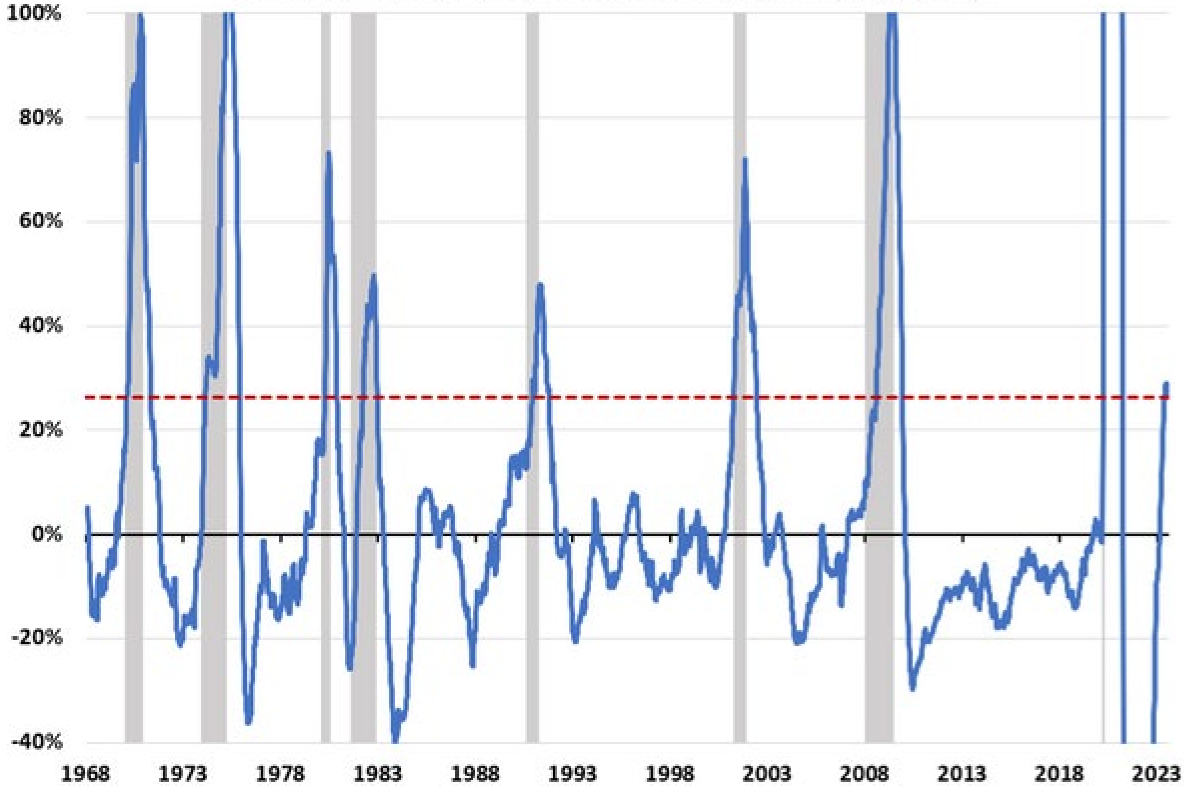


Continued claims for unemployment insurance also remain low in absolute terms; however, they are rising relative to recent non-pandemic years, and the year-over-year percent change is at recessionary levels.

Continued Claims for Unemployment Insurance
Not Seasonally Adjusted



Continued Claims for Unemployment Insurance
Year-over-Year Percent Change in 4-week Moving Average



Sources: Ycharts, https://fred.stlouisfed.org/, https://www.cmegroup.com/markets/interest-rates/cme-fedwatch-tool.html?redirect=/trading/interest-rates/countdown-to-fomc.html, AOWM calculations

The Economy | Approaching a critical juncture

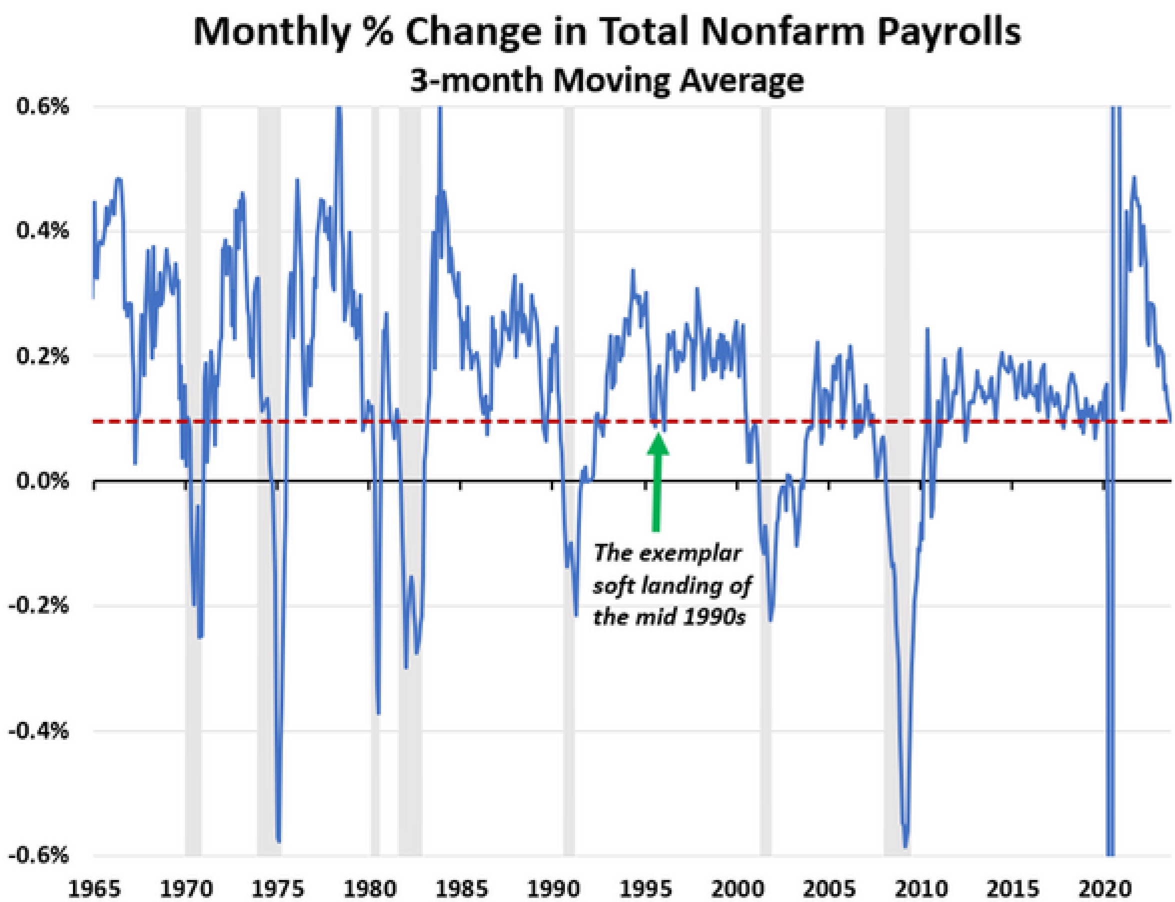
September 4, 2023

Investors took a bad-news-is-good-news approach to much of the economic data released last week with the hope that weaker economic data means the economy is coming in for a soft landing and the Fed will not have to raise interest rates any higher.

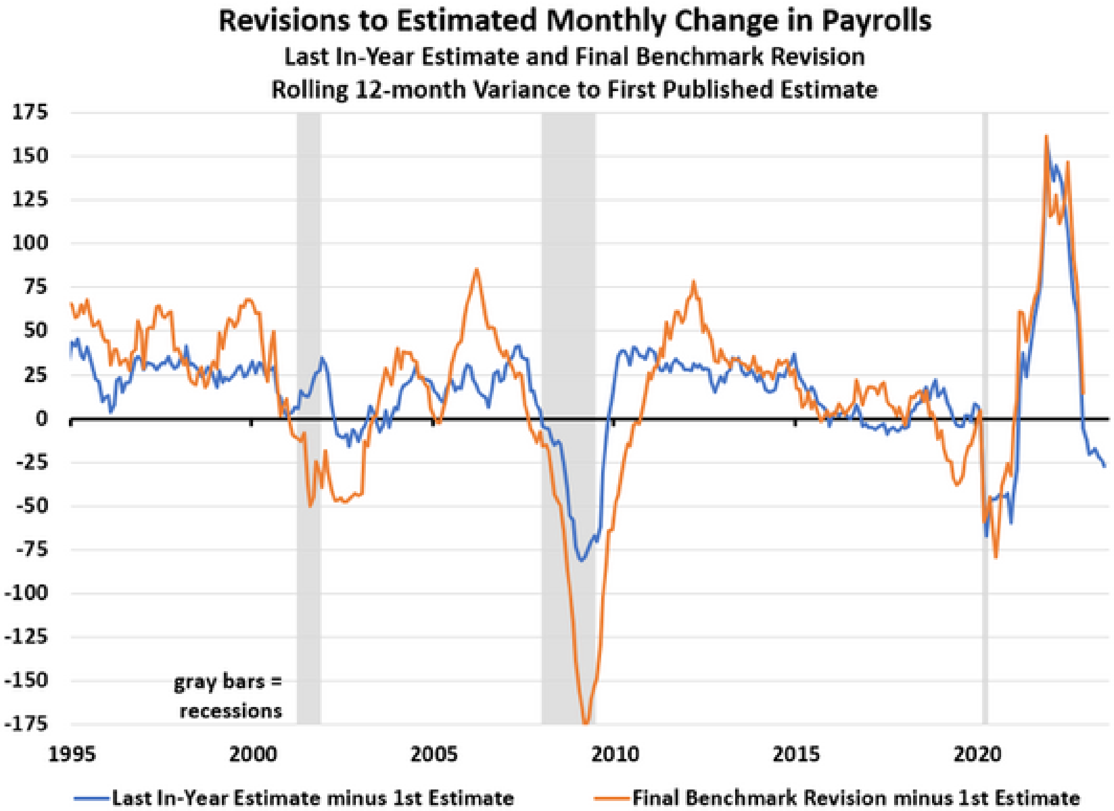
While 187,000 new jobs were estimated to have been created last month, the data for previous months continues to be revised lower and the pace of job growth has continued to slow. The growth in Gross Domestic Product for the second quarter was also revised lower, and its twin measure, Gross Domestic Income, continued to paint an incongruent picture of a much weaker economy.

If the economy is to avoid a recession, the next few months will be a critical test. And, given the data revisions and statistical discrepancies inevitable in trying to measure a $27 trillion economy, we will likely not confidently know the answer for some time thereafter.

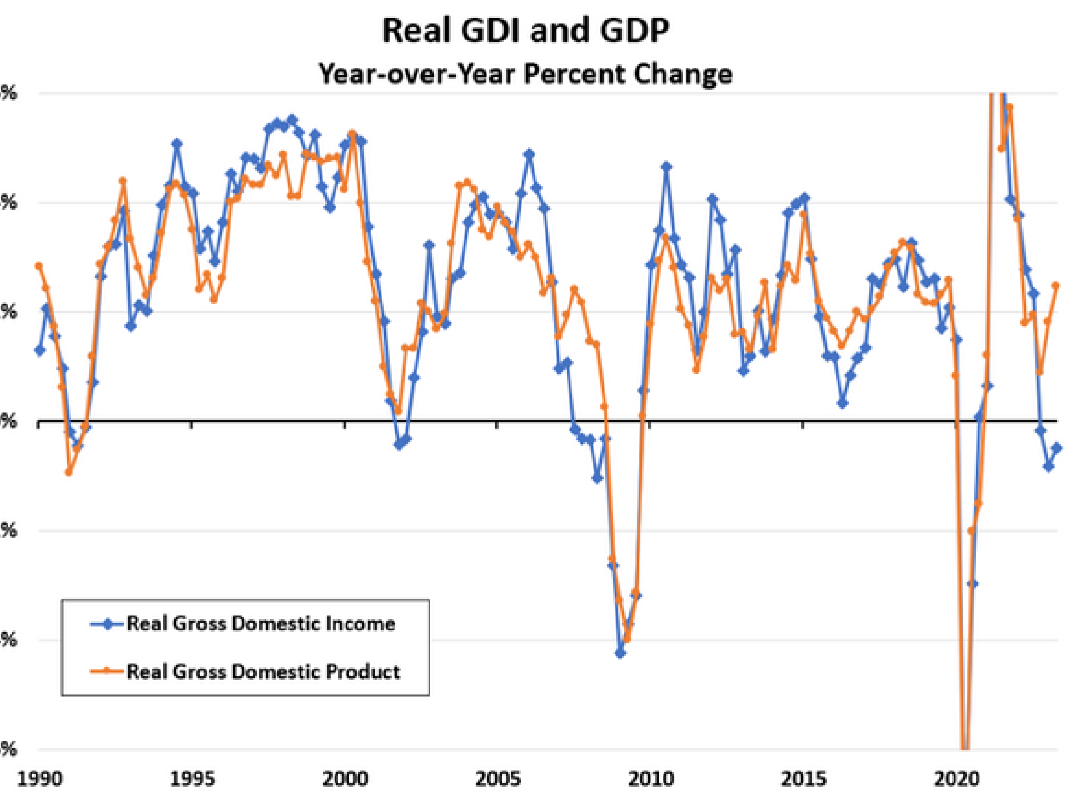
One of the main indicators of a recession is a decline in employment. Payrolls are still increasing, but the downtrend has reached a critical juncture.



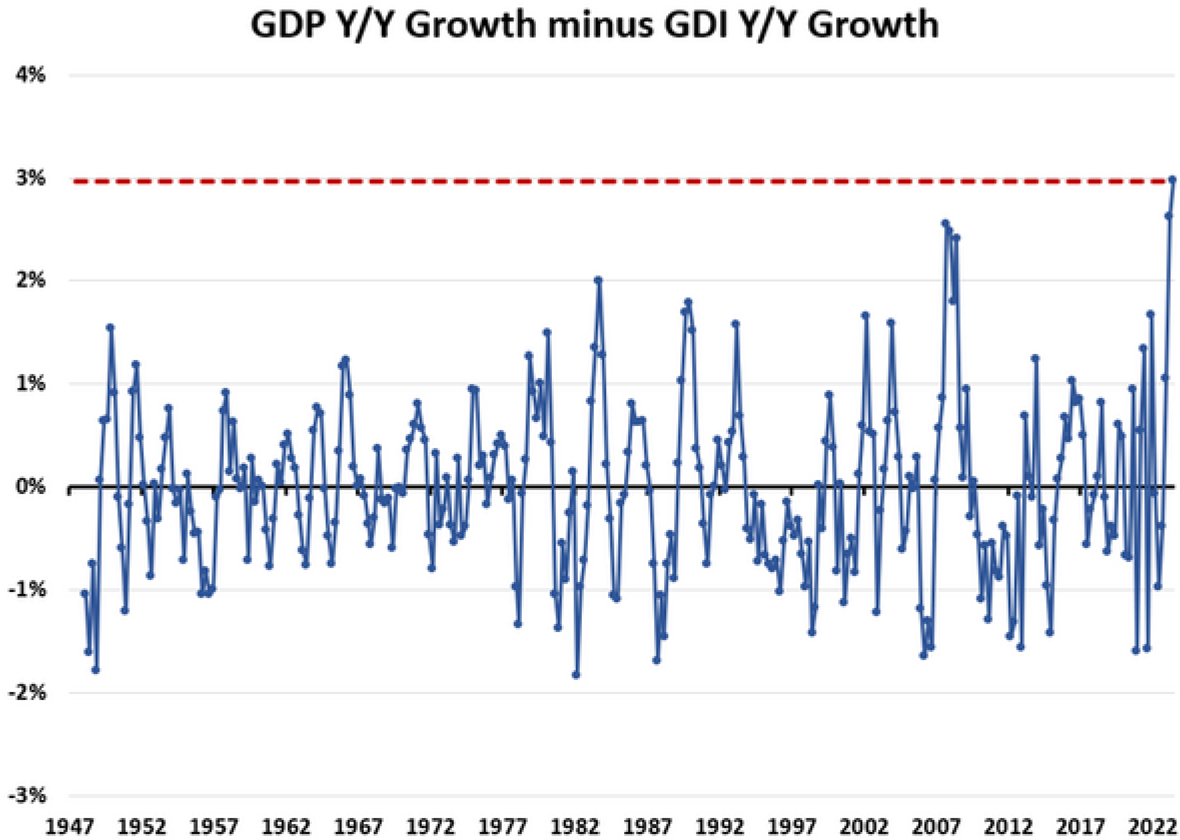
Another indicator of the weakening labor market is the downward revisions to estimated payrolls, which are likely to be revised even lower when the annual benchmark revision is completed next year.



Gross Domestic Income continued to paint a very different picture of the economy in the second quarter than Gross Domestic Product.



Unless changed by future revisions to the data, the second quarter was the greatest statistical discrepancy in year-over-year growth between the two measures of the economy.



Sources: Ycharts, https://fred.stlouisfed.org/, https://www.bls.gov/web/empsit/cesnaicsrev.htm, AOWM calculations

Corporate Profits | Another positive quarter

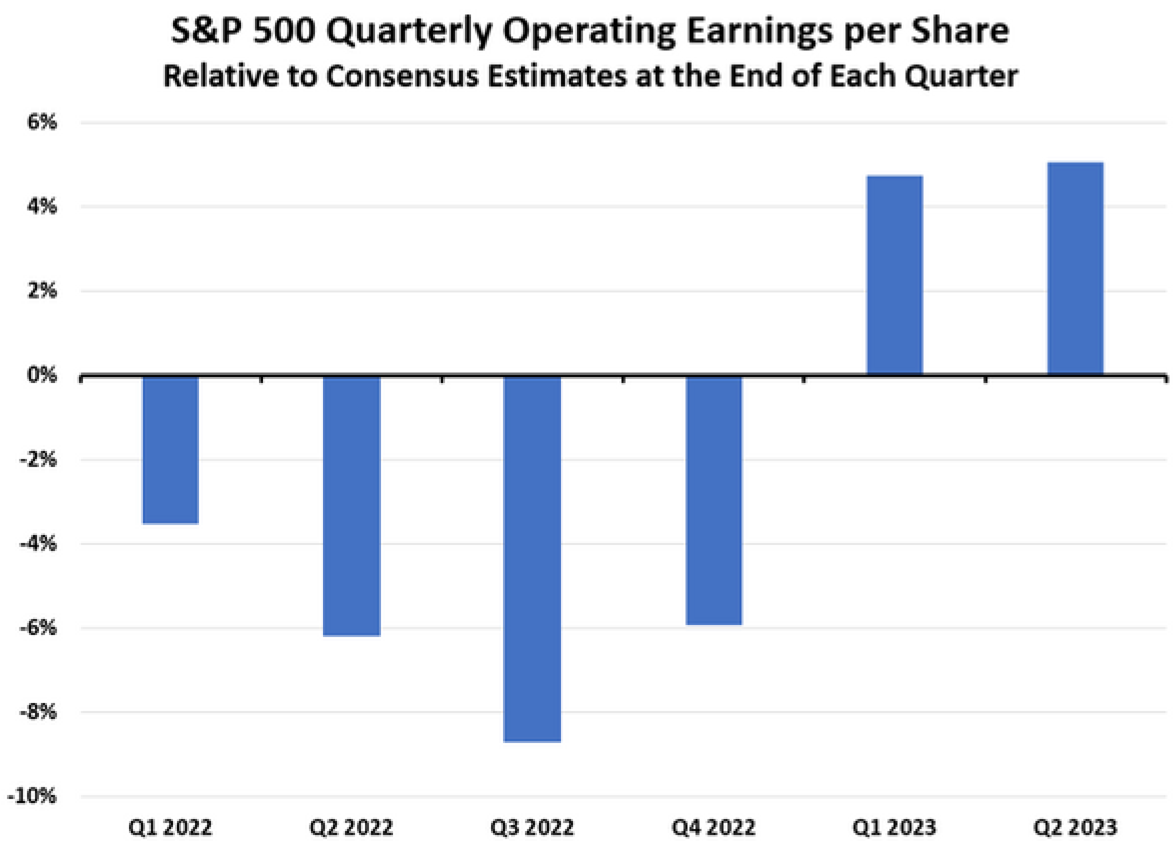
September 11, 2023

Corporate profits in the second quarter continued to surprise pleasantly to the high side for most companies. The generally positive earnings jive with the GDP data which seem to indicate the economy is chugging along at a solid pace despite numerous leading indicators flashing red.

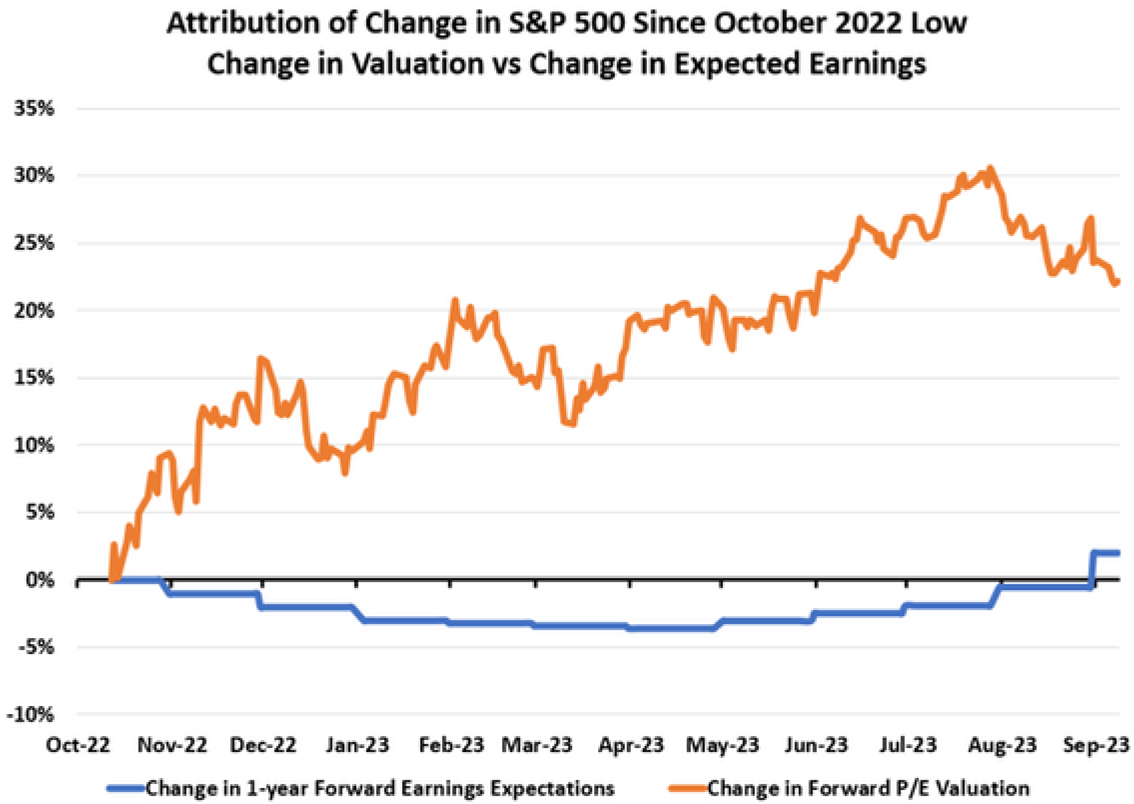
While earnings have come in better than expected in recent quarters, most of the rally in the market has been a function of investors bidding up the valuation for stocks as forward earning expectations have not changed much since last October.

However, if current expectations hold, that will begin to change in the coming months with the consensus outlook calling for earnings to return to double digit growth over the next year. It will likely take more than a soft landing for earnings to gallop ahead at that rate, but investors have been rewarded in recent years for assuming the best.

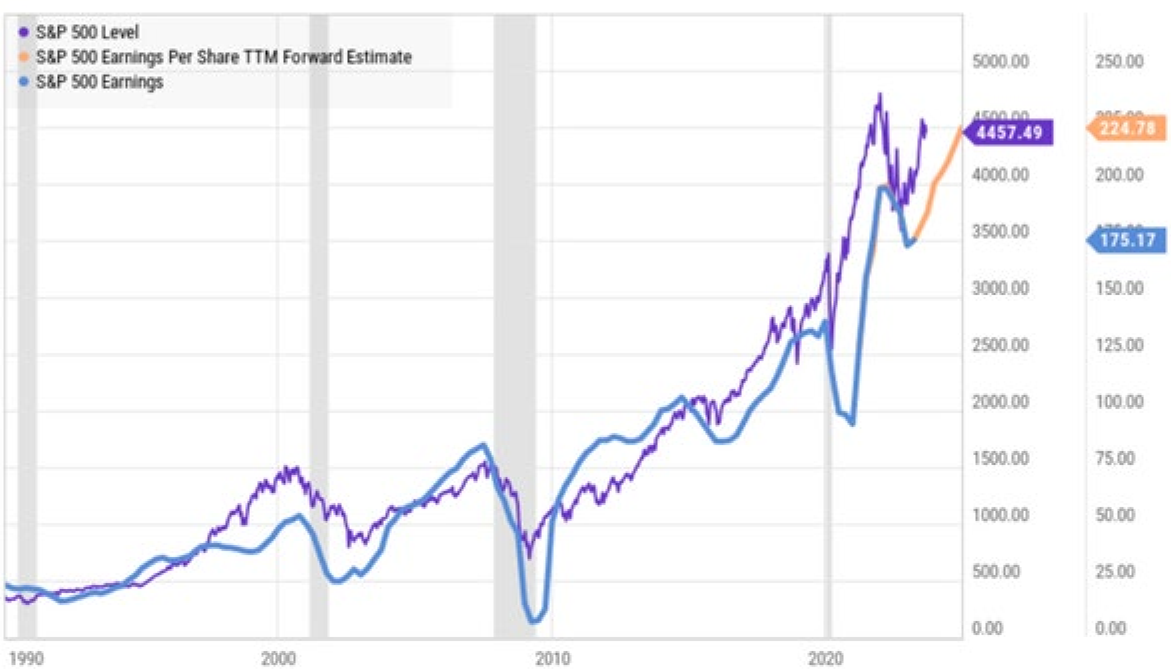
After repeatedly surprising to the downside last year, earnings have come in better than expected for the first two quarters of this year.



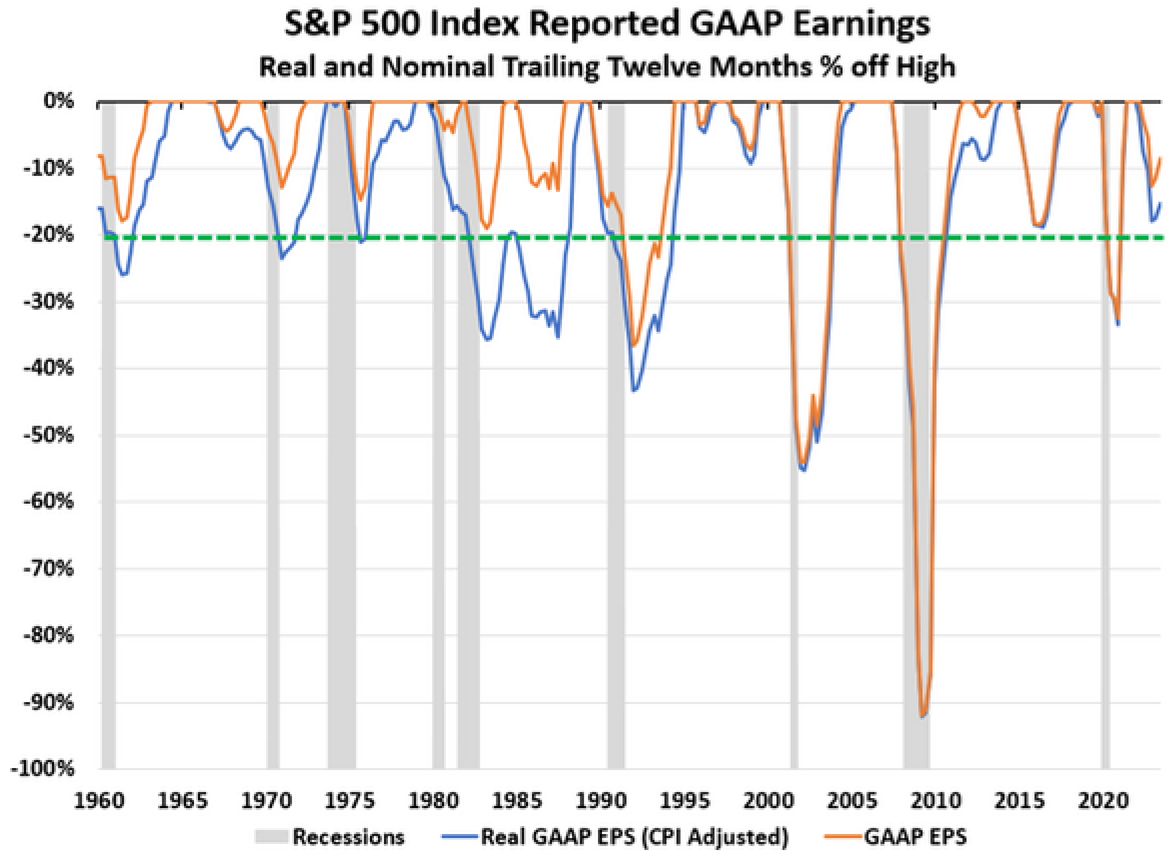
While earnings expectations have started to trend higher again, most of the rally in the market over the past eleven months has been the result of an expansion in valuations as expected forward earnings have barely changed.



The turnaround in earnings is helping to fuel hopes for a soft landing for the economy. However, even a soft landing may not be sufficient to fuel the expected return to double digit earnings growth over the next year.



In a recession, inflation-adjusted earnings have historically fallen at least 20%. If a recession is avoided, corporate profits may have bottomed. If not, the strength of the past two quarters will likely have offered false hope.



Sources: Ycharts, https://fred.stlouisfed.org/, https://www.spglobal.com/spdji/en/indices/equity/sp-500/#overview, http://www.econ.yale.edu/~shiller/data.htm, AOWM calculations

Monetary Policy | Long and variable lags

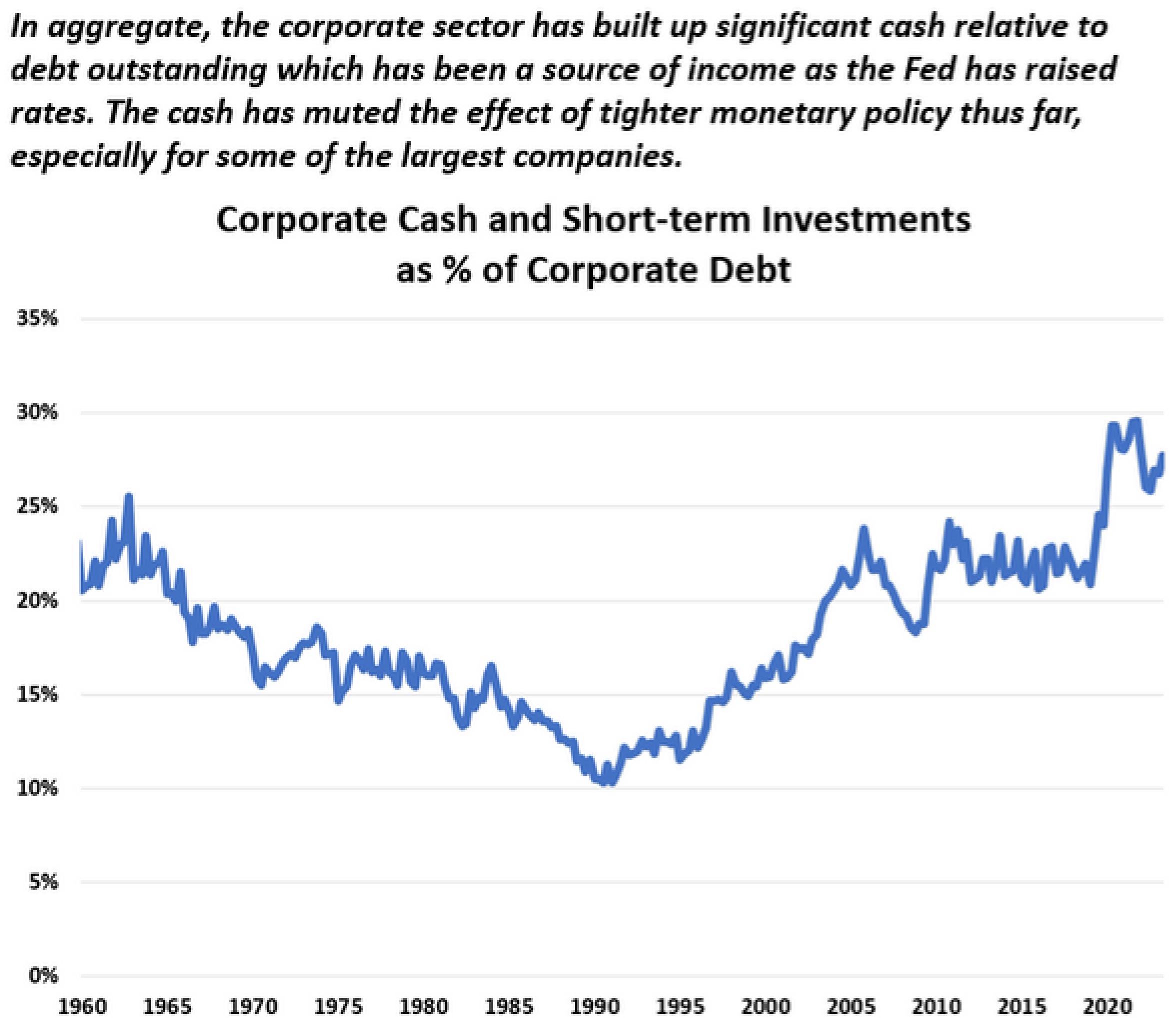
September 18, 2023

Despite inflation popping higher in August, the consensus outlook remains for the Fed to keep interest rates steady until starting to lower them next summer. However, that outlook has changed frequently and is still far from certain. Complicating the picture for policymakers and prognosticators is the fact that moving away from an era of zero interest rates is bizarrely having a J curve effect on some parts of the economy, where higher rates are actually stimulative to a degree before they start to bite.

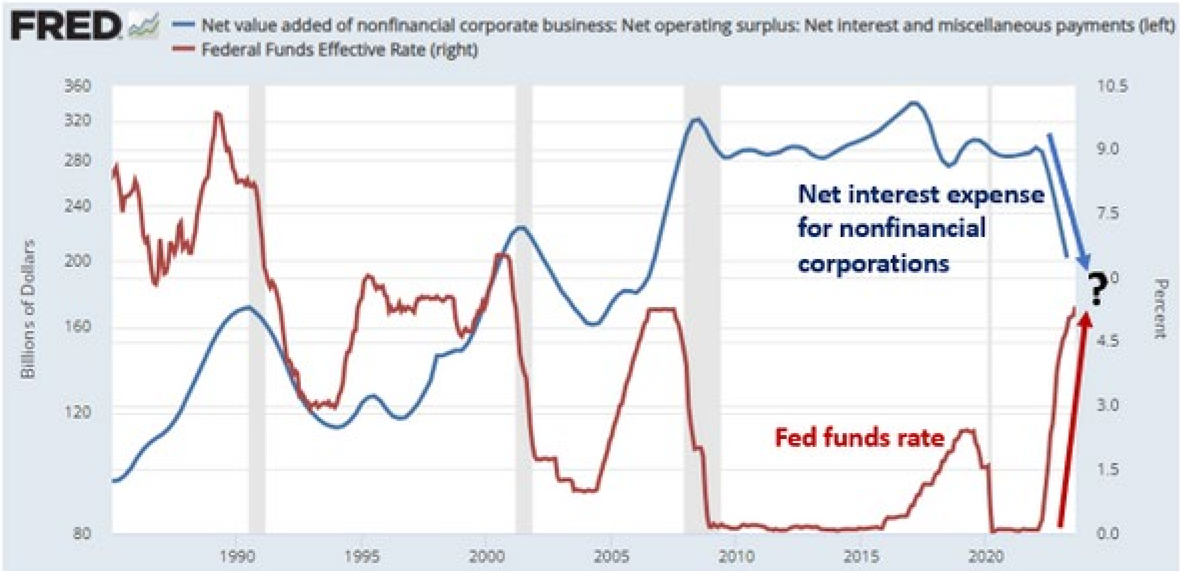
One example of this J curve effect is corporate profits. Like the economy, profits have in general held up better than expected when the Fed started raising interest rates, and that is thanks in part to those higher rates that were supposed to derail everything. So far, the corporate sector has in aggregate been a net beneficiary of higher rates as far as earning more from higher yields on its cash holdings than it is paying out in higher financing costs on its debt. For nonfinancial companies, net interest expense has *declined* 31% since the first quarter of 2022.

The corporate sector built up a significant amount of cash in recent years, and that stockpile is now earning a nice return over 5%. At the same time, like many homeowners (but not so much like the federal government), many corporations locked in low rates on a lot of their debt and thus have yet to feel the pinch of higher rates.

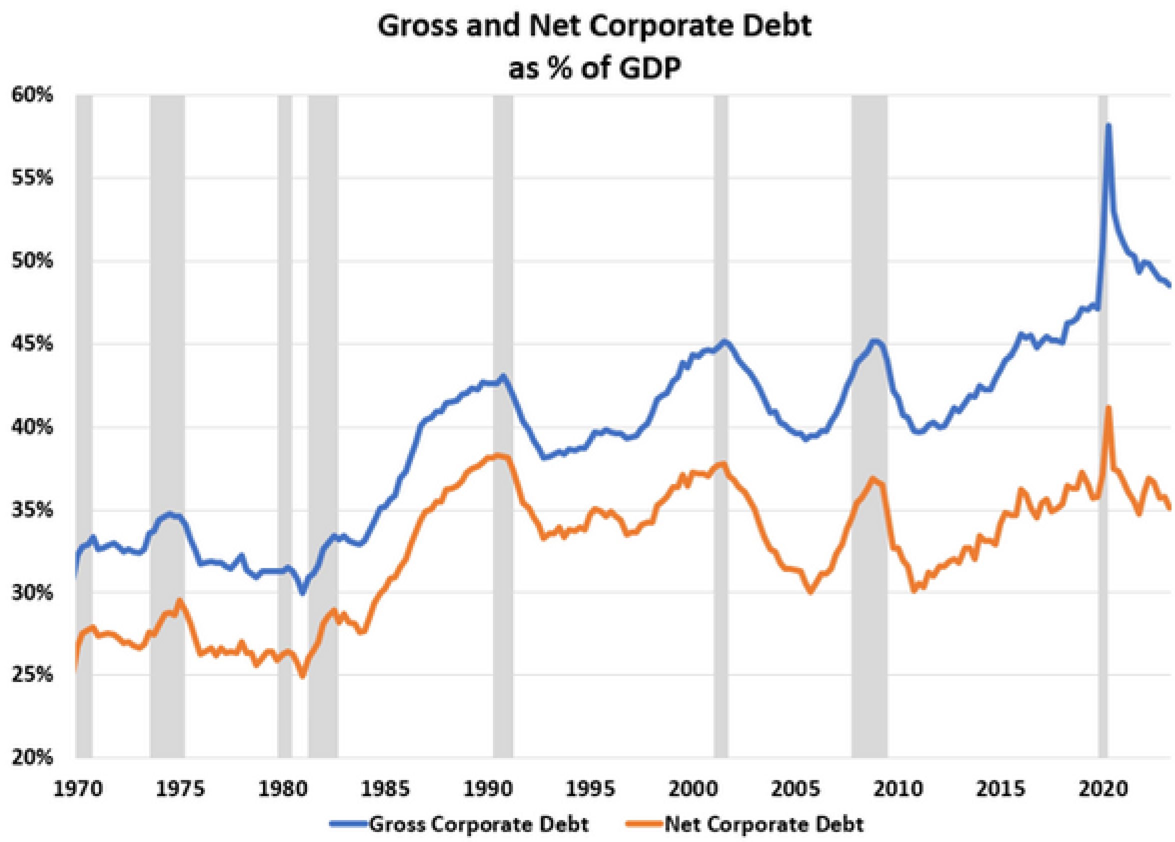
Nevertheless, if the Fed stays the course long enough, higher rates will eventually have their intended effect of slowing the economy and dragging inflation back to 2%. Determining how high rates need to go and how long they need to stay there is complicated by the even longer and more variable lags of monetary policy that are the result of the extreme measures taken during the pandemic.



As a result of locking in long-term rates when they were low and earning more on its cash, the corporate sector in aggregate has yet to feel any pain in terms of higher net interest expense – indeed the opposite.



Gross corporate debt remains extremely elevated relative to GDP; however, net of cash and short-term investments, corporate debt is below the peak levels reached in the past four recessions.



Many of the largest companies hold a lot of the cash and less of the corporate debt outstanding. The relative balance-sheet strength of large companies likely explains part of the outperformance of large cap stocks. On a relative basis, small caps are back to trading close to where they were at the end of the dot-com bubble versus large cap stocks.

Sources: Ycharts, https://fred.stlouisfed.org/, BEA, AOWM calculations

Soft Landing | Fed policymakers grow hopeful

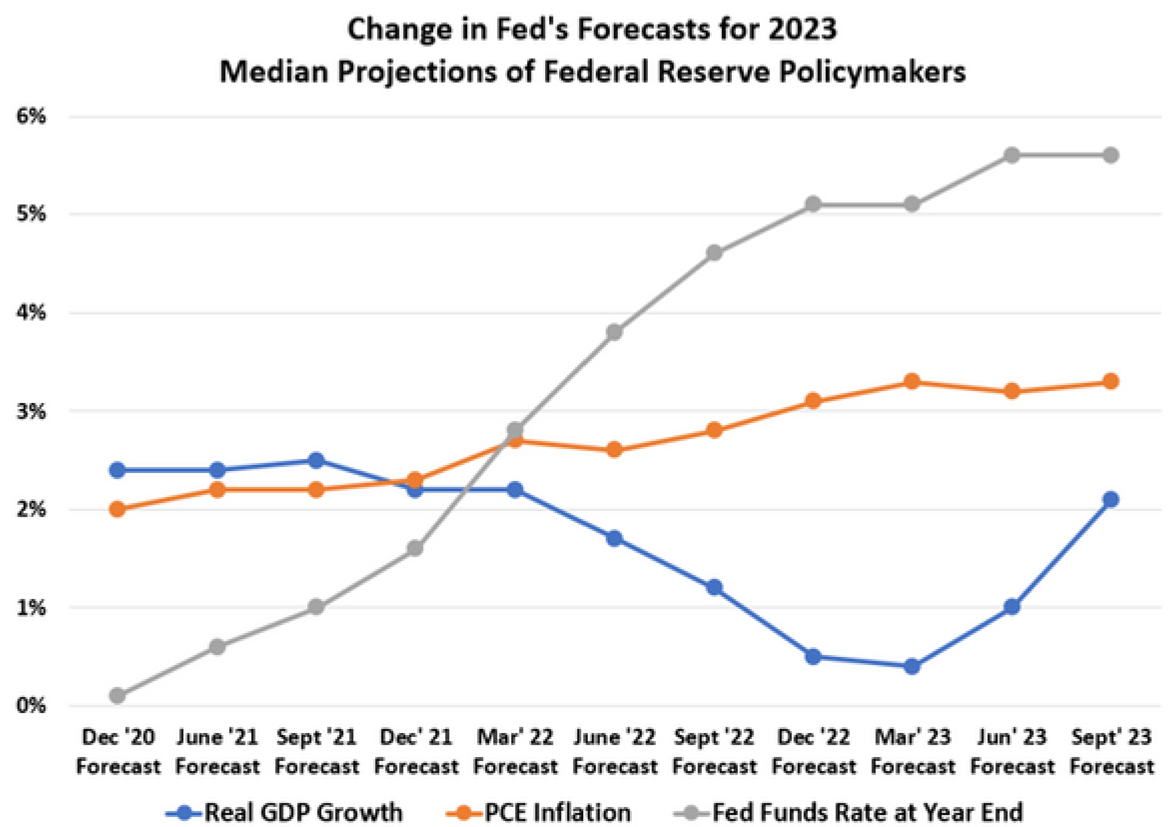
September 25, 2023

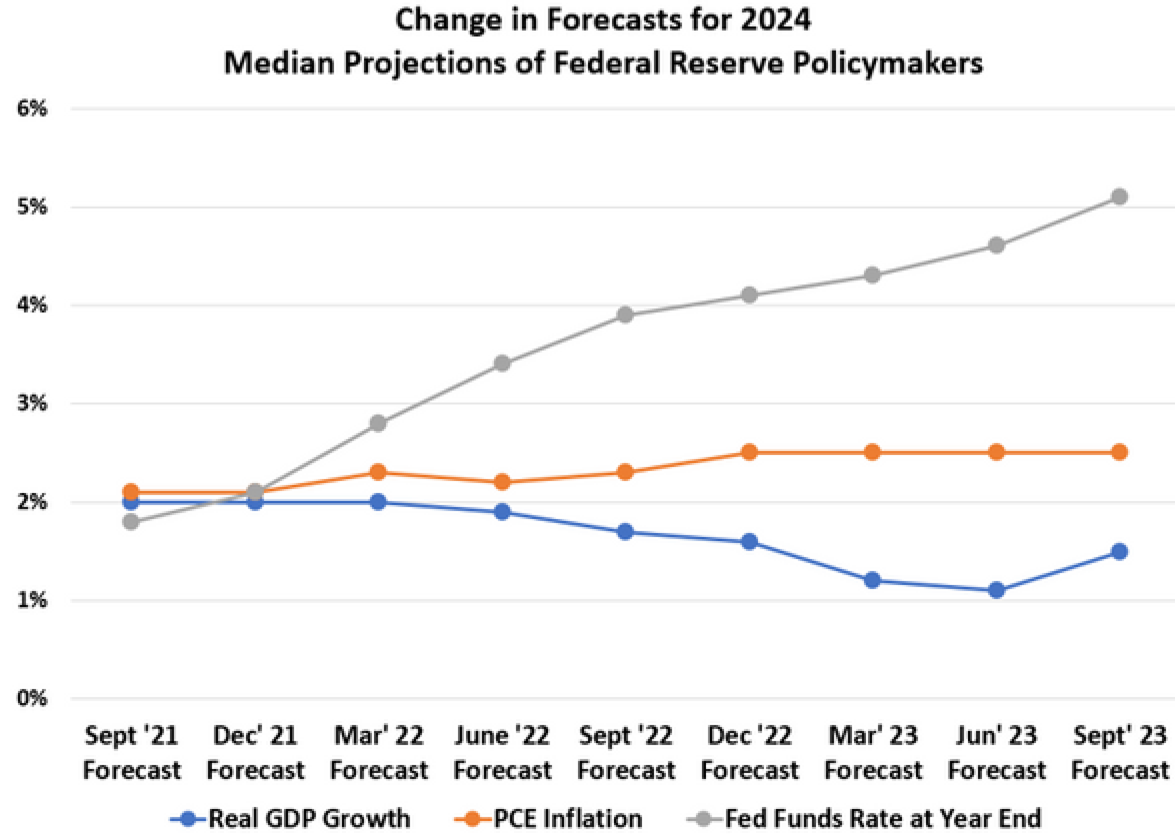
At their meeting last week, policymakers at the Federal Reserve left unchanged their target for the overnight Fed funds interest rate but indicated they expect to keep short-term rates above 5% through the end of next year. While a brighter economic outlook drove the projection for rates to stay higher for longer, the stock and bond markets both sold off on the news.

The Fed has been investors' friend for a long time, but there is growing concern that may be changing. Barring a calamity, policymakers are strongly intimating that the era of ultra loose monetary policy is over as they are projecting the Fed funds rate to still be above its supposed long-run neutral level of 2.5% through at least 2026.

The Fed's projections should be taken with a large grain of salt, however. After all, back in December 2020, policymakers were forecasting that the Fed funds rate would still be pegged at zero right now. Indeed, given its track record, the Fed's current forecast for smooth sailing could be what worries investors the most.

Fed policymakers now expect to hold short-term interest rates above 5% through the end of next year, but their economic outlook brightened with expectations for higher growth and a minimal increase in unemployment.





Median forecasts by Fed policymakers

Percent

Variable	Median[1] 2023	2024	2025	2026	Longer run
Change in real GDP	2.1	1.5	1.8	1.8	1.8
June projection	1.0	1.1	1.8		1.8
Unemployment rate	3.8	4.1	4.1	4.0	4.0
June projection	4.1	4.5	4.5		4.0
PCE inflation	3.3	2.5	2.2	2.0	2.0
June projection	3.2	2.5	2.1		2.0
Core PCE inflation[4]	3.7	2.6	2.3	2.0	
June projection	3.9	2.6	2.2		
Memo: Projected appropriate policy path					
Federal funds rate	5.6	5.1	3.9	2.9	2.5
June projection	5.6	4.6	3.4		2.5

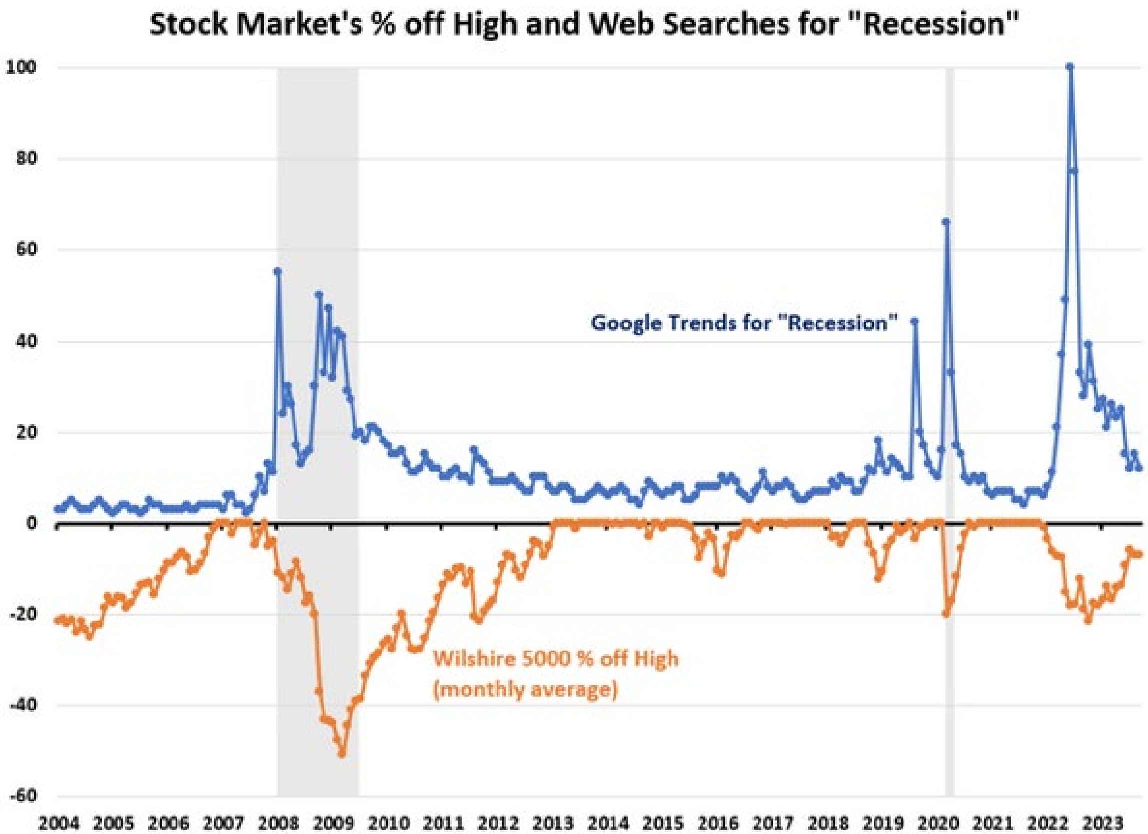
Higher growth

Less unemployment

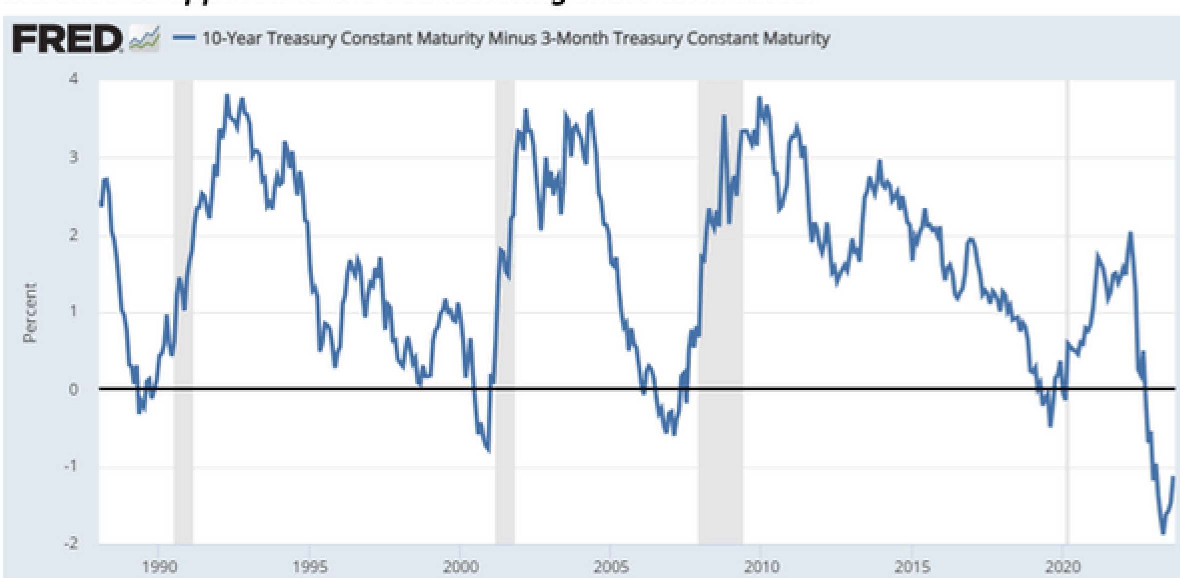
Declining inflation

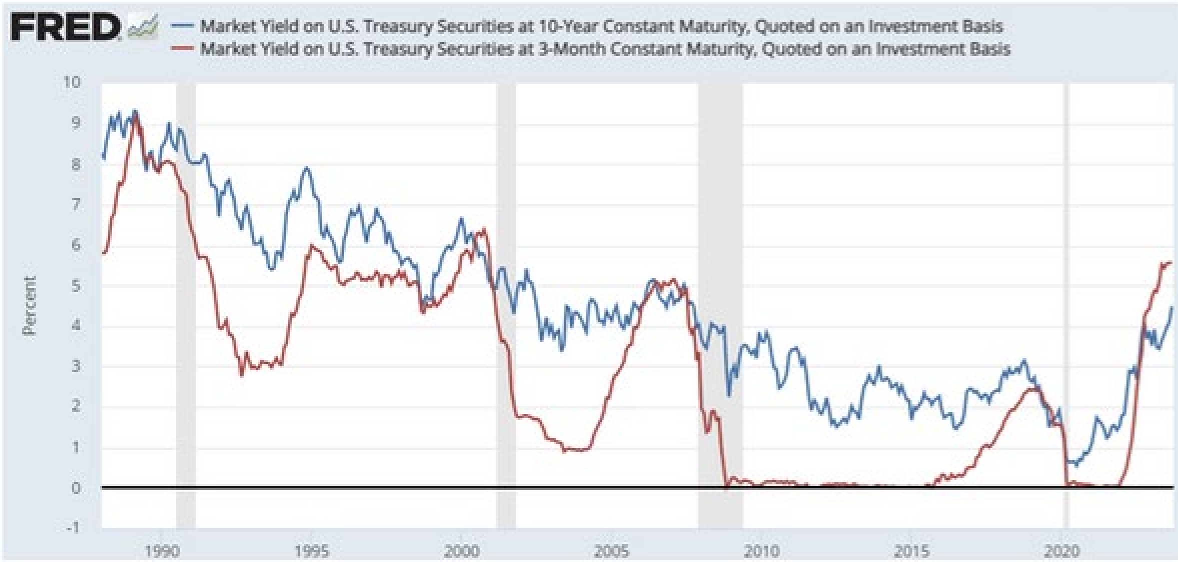
Rates higher for longer

Recession fears are waning, but history shows they can quickly resurface.



One of the leading indicators that has been flashing red for nearly a year is the yield curve, which has continued to un-invert. That is common before a recession begins; less common is for the yield curve to right itself by having long-term rates increase as opposed to the Fed lowering short-term rates.





Sources: Ycharts, https://fred.stlouisfed.org/, Federal Reserve, AOWM calculations

The Economy | Weaker and stronger

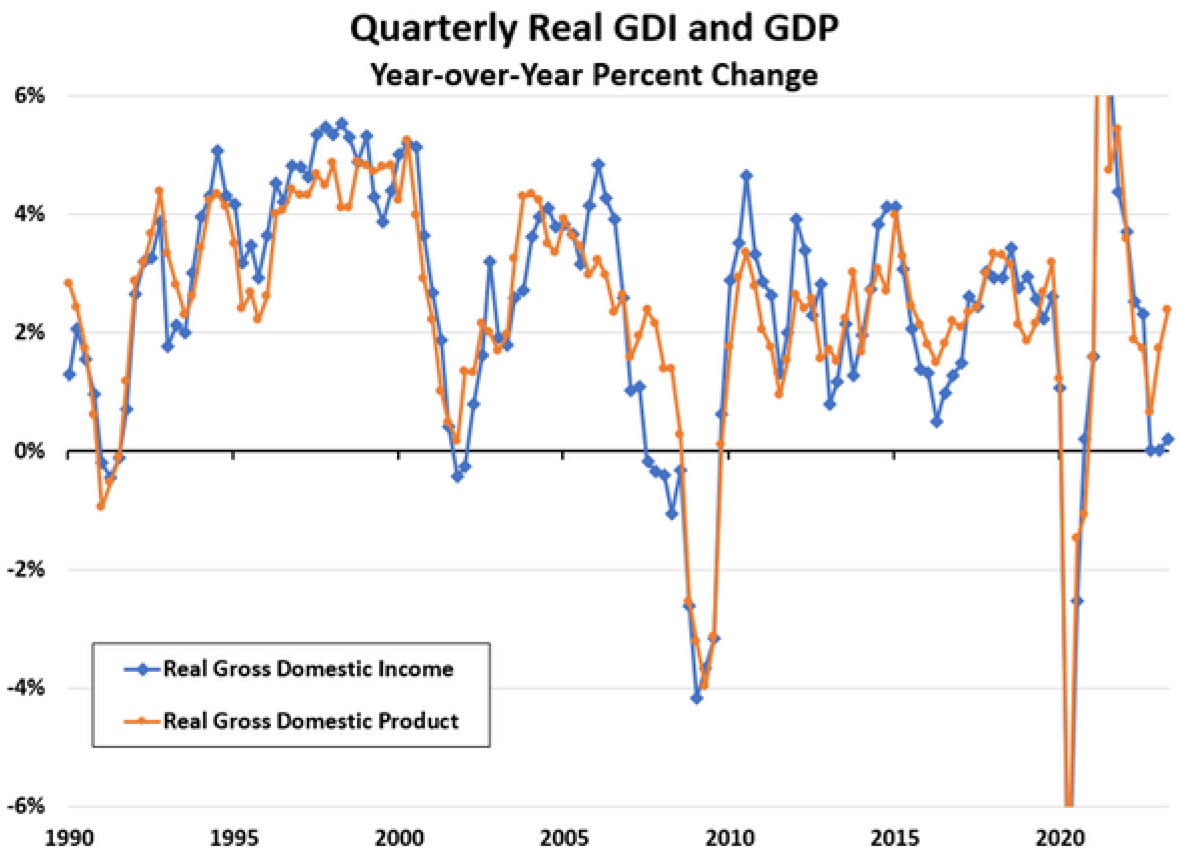
October 2, 2023

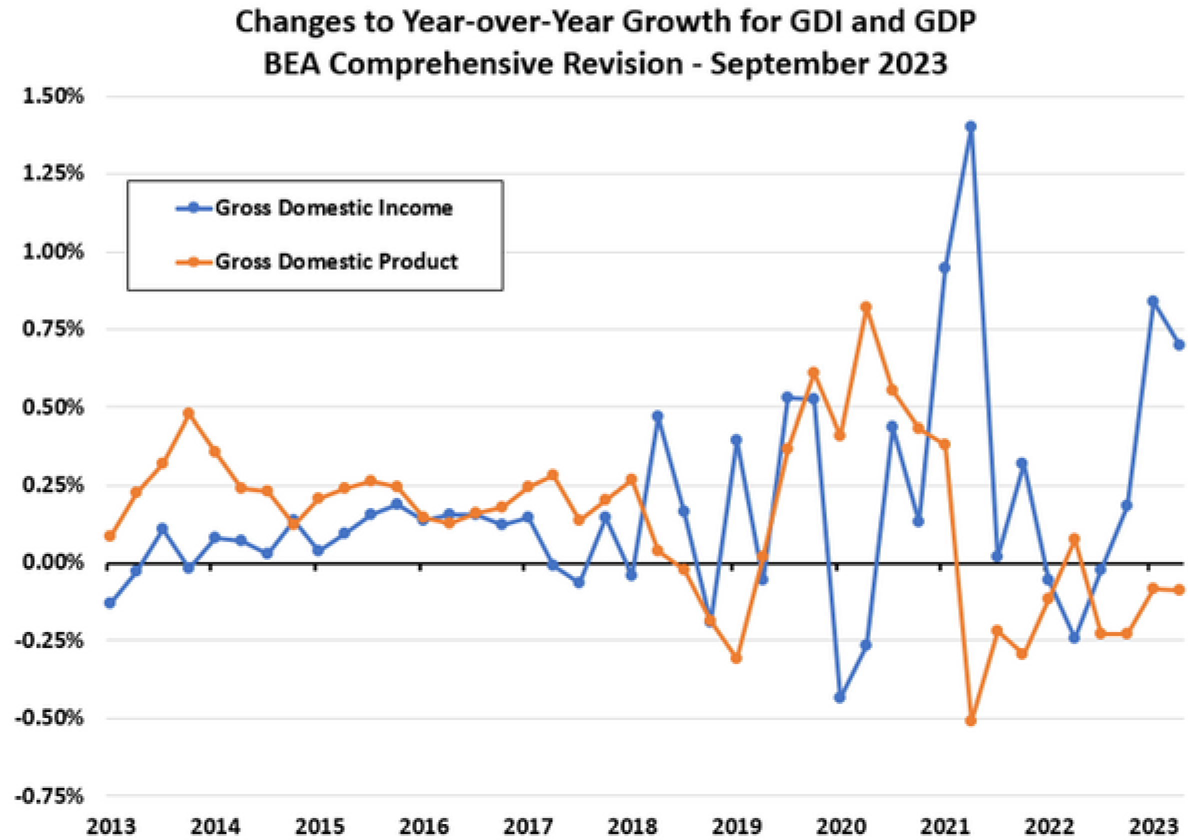
Last week the U.S. Bureau of Economic Analysis made comprehensive revisions to its estimates for Gross Domestic Product (GDP) and Gross Domestic Income (GDI). For the second quarter, GDP was revised down slightly while GDI was revised higher. Despite the revisions to the twin measures of the economy, they continue to paint different pictures of the economy's strength over the past year with GDI indicating the economy is at best not shrinking while the GDP data suggests economic growth is accelerating.

The downward revision in GDP was largely driven by lower consumer spending. How well the consumer holds up over the next three months will be a large determinate of whether the economy can skirt a recession. The fourth quarter is seasonally the strongest quarter for consumer spending and in turn the economy. That critical quarter is arriving at the same time that student loan payments recommence, pandemic savings has dwindled, and energy prices are again rising (not to mention the ratcheting effect of higher interest rates and the lingering risk of political dysfunction in DC).

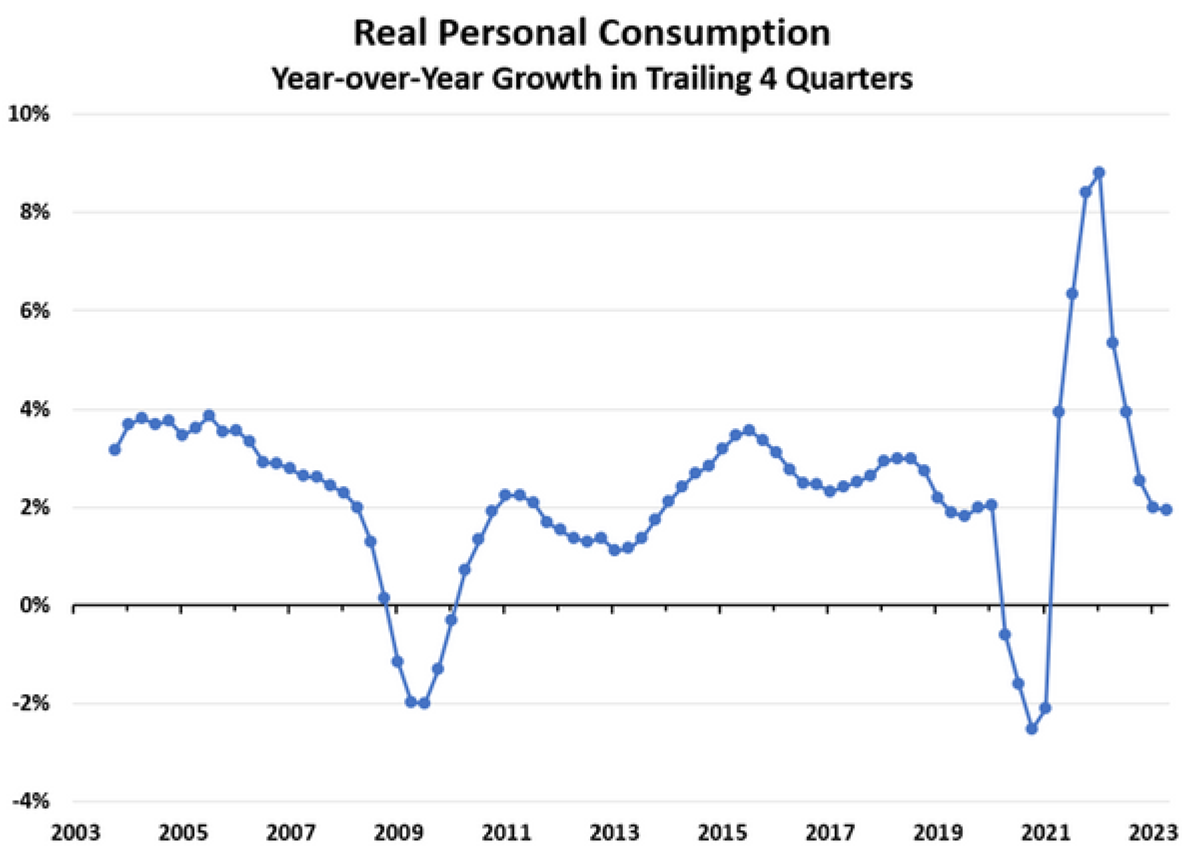
Even with the ongoing support of a strong labor market, the strength of the American consumer will be tested in the coming months.

Previous estimates of GDI for the most recent three quarters had shown negative year-over-year growth. Those estimates were revised higher last week but still indicate the economy is weaker than suggested by GDP growth.

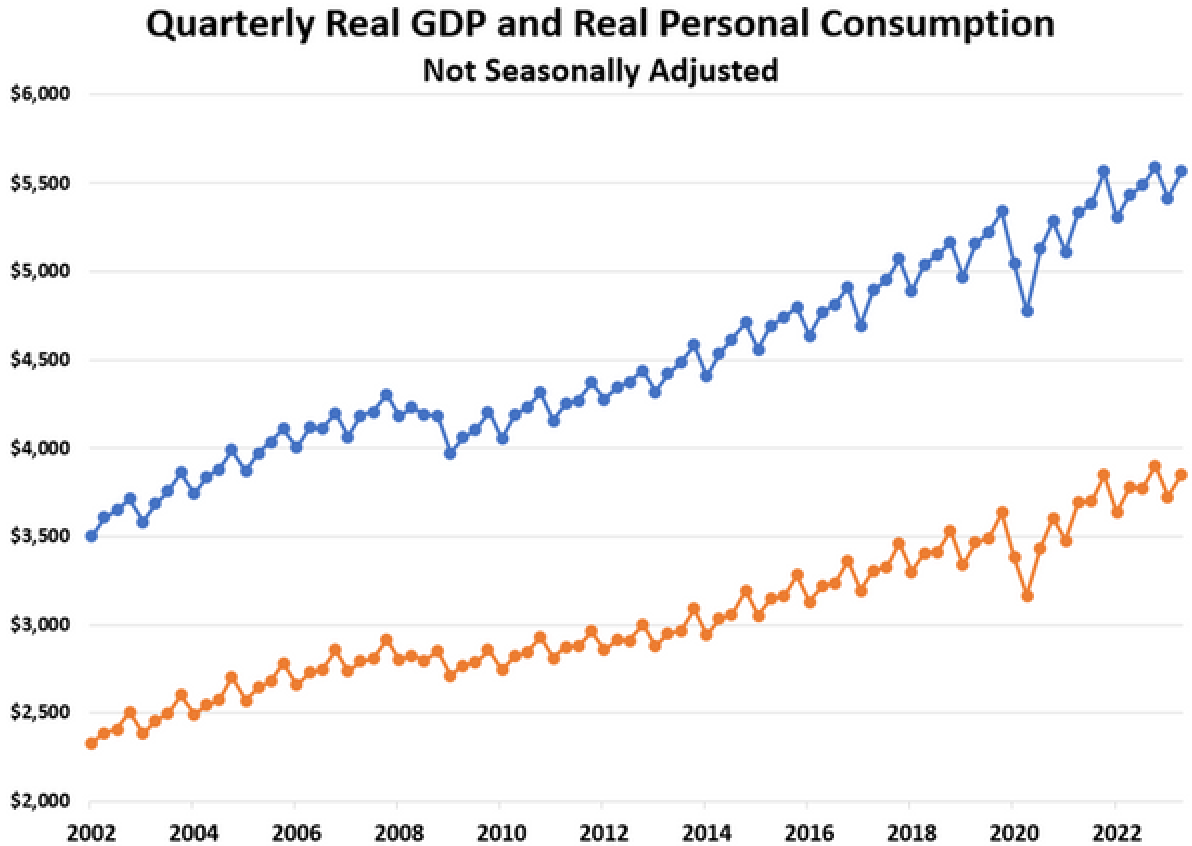




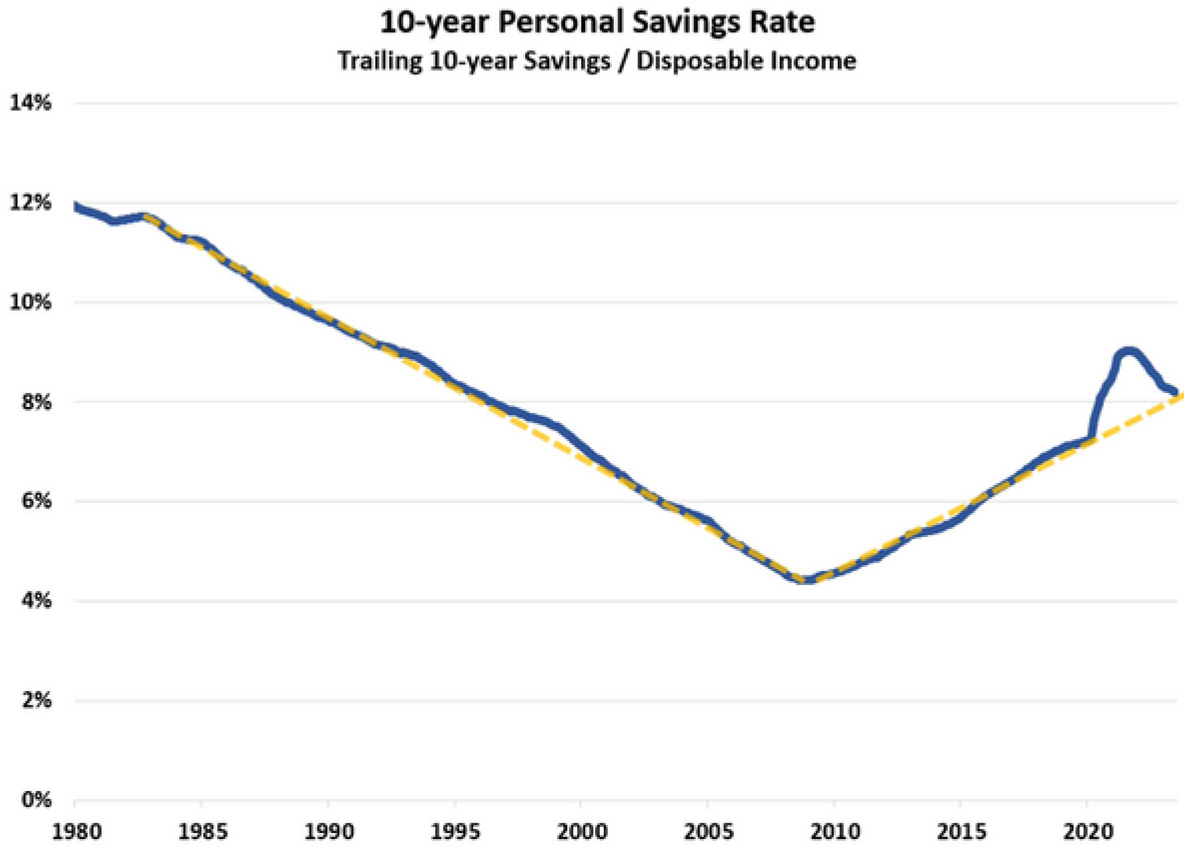
Personal consumption for the second quarter was revised lower, but the current data still offers hope that consumer spending is landing softly.



Consumers are facing several hurdles as the economy heads into the fourth quarter which is usually the seasonally strongest.



Estimates vary for how much excess pandemic savings individuals have left; however, based on the trend in savings before the pandemic, the excess savings may be largely gone.



Sources: Ycharts, https://fred.stlouisfed.org/, BEA, AOWM calculations

Jobs Report | Volatile report creates volatility

October 9, 2023

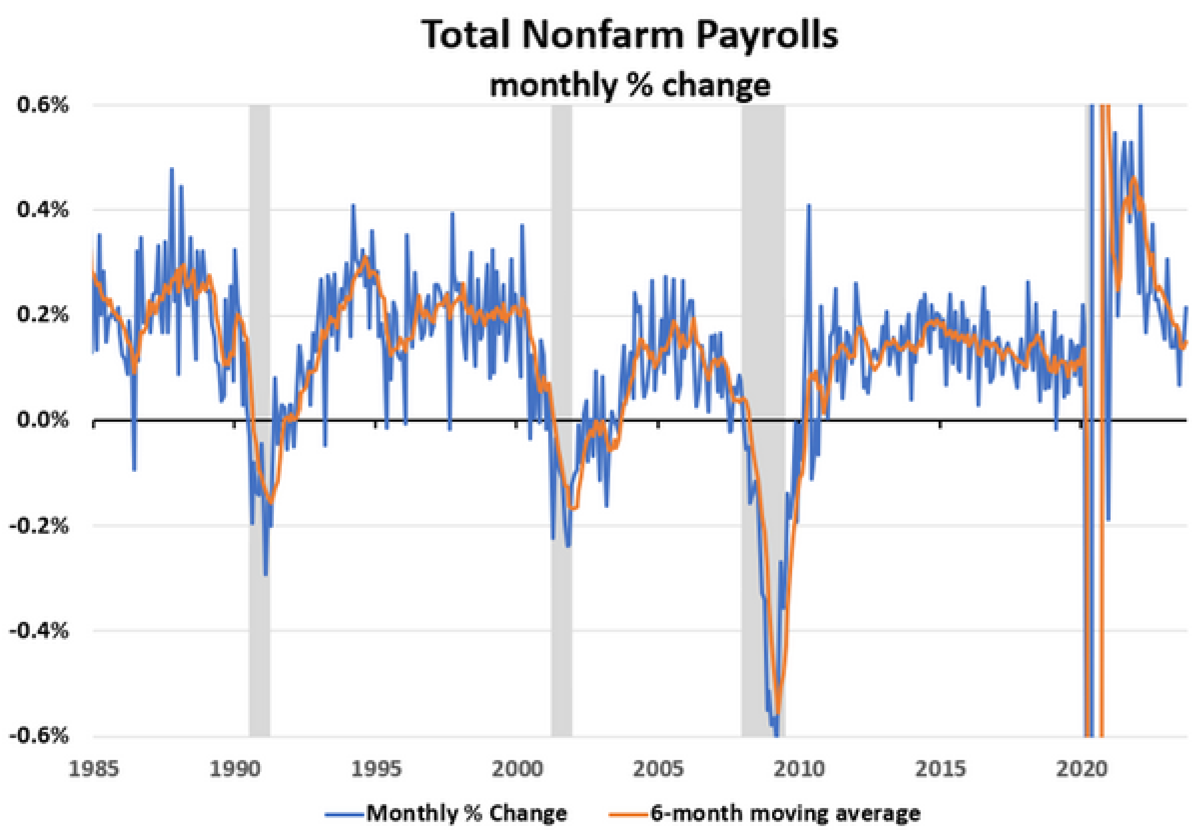
The strong jobs report for September generated wild swings in the market on Friday. Based on initial estimates, the economy created far more jobs last month than was expected, and payroll estimates for the previous two months were revised higher in a break from the streak of downward revisions. The unemployment rate also remained unchanged at a low 3.8%.

The news sparked a nearly 1% sell off in the stock market Friday morning on apparent fears that the report was too good and would force the Fed to keep interest rates even higher for even longer. But the market rallied and ended the day up over 1% - perhaps because the S&P 500 came close to a key technical trading level that attracted buyers; or perhaps investors were comforted by indications that wage growth is slowing; or perhaps they came to believe that the jobs report was too good to be true and would ultimately be revised down significantly; or perhaps the short-run machinations of the market are just indecipherable.

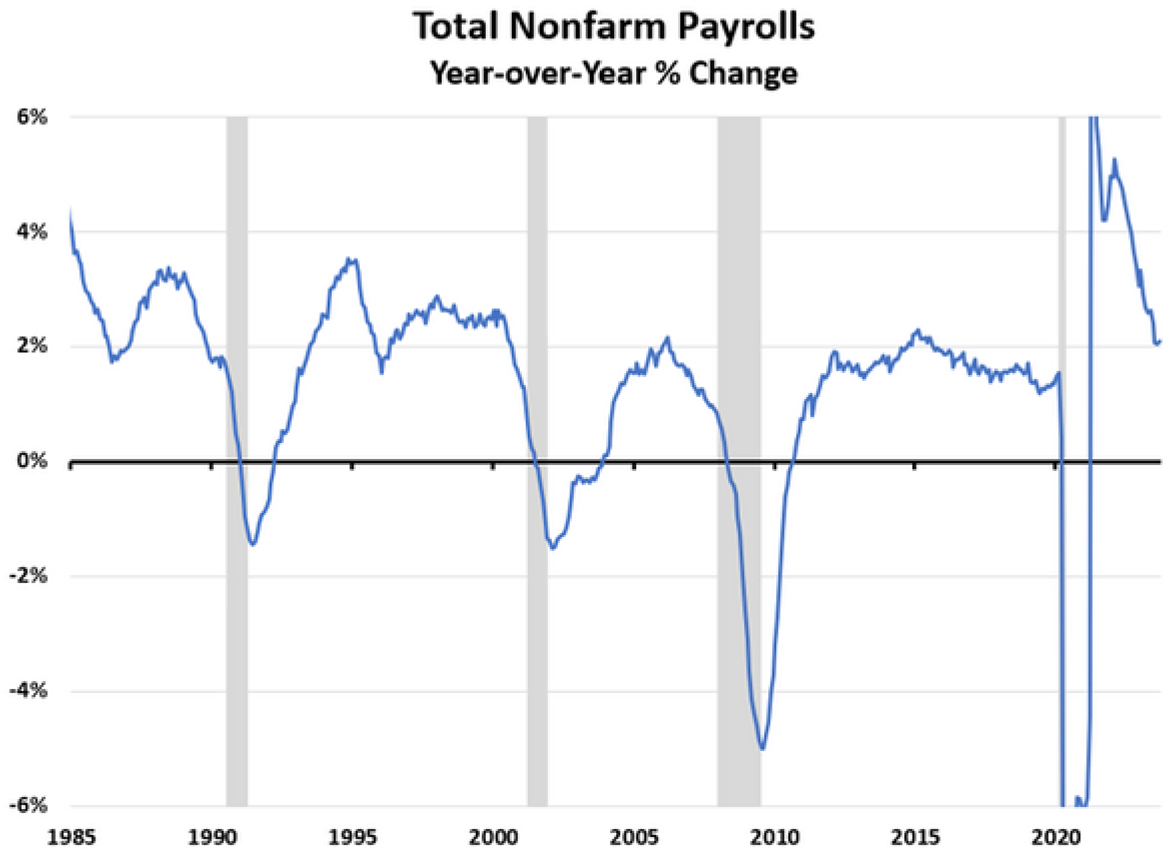
The monthly payrolls data is certainly volatile and subject to large revisions well down the road, so some skepticism is warranted. But a positive trend must start somewhere. Future months will bear out whether this was a one-off good month or the end to the slowing trend in hiring.

Long-term interest rates still ended Friday higher, though down slightly from the initial spike in the morning. The 10-year Treasury yield has now decisively reverted to the mean. If inflation continues to trend back to 2%, the three-year rout in the bond market may be nearing its end.

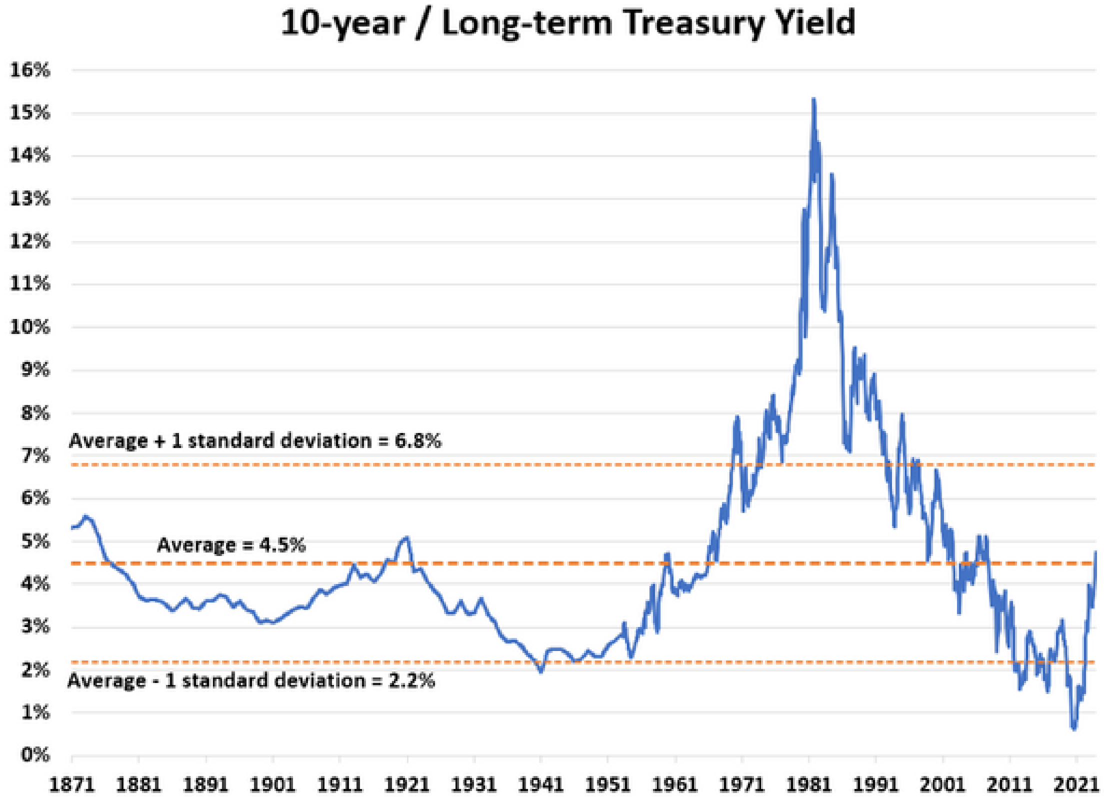
The monthly payroll data is volatile and subject to significant revisions in the future. Nevertheless, the September jobs report was a potentially good sign for the strength of the economy.



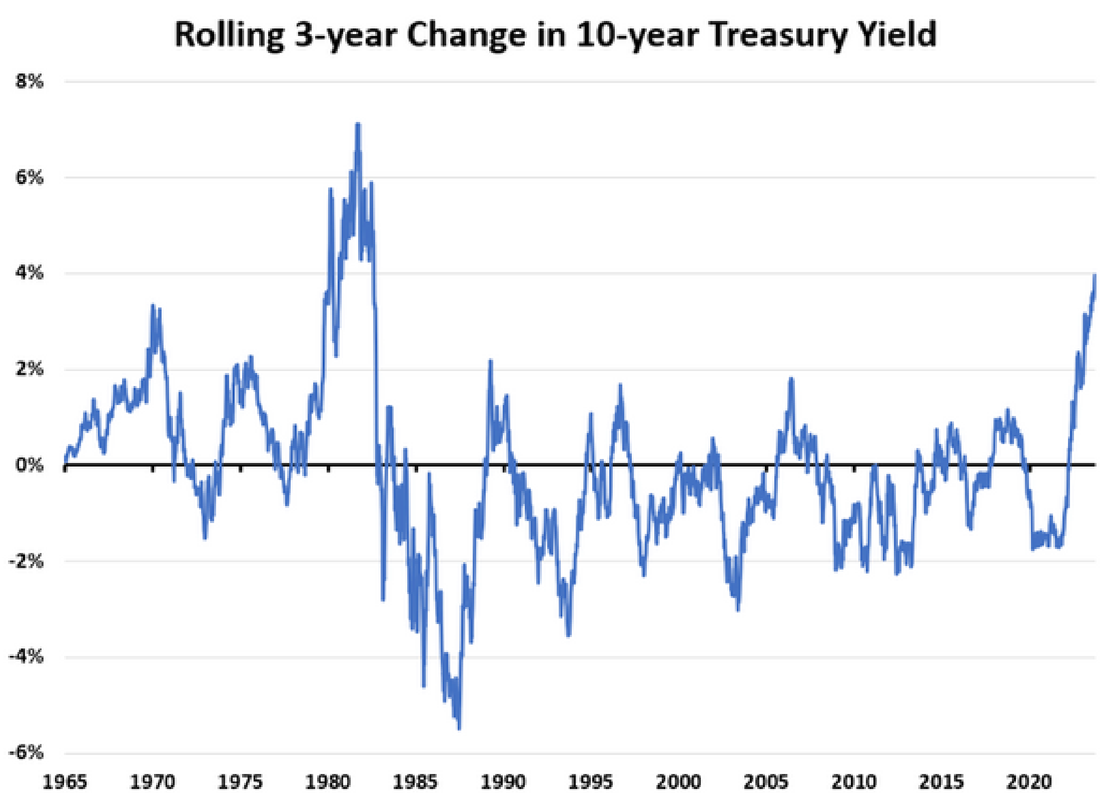
The payroll numbers give a good glimpse into where the economy currently is, but less insight into where the economy is going.



Interest rates moved higher on the strong jobs report. The 10-year Treasury yield has decisively broken its four-decade downtrend and is above its very long-run average around 4.5%.



The move up in long-term rates over the past three years is only exceeded by the change in interest rates experienced in the late 1970s and early 1980s.



Sources: Ycharts, https://fred.stlouisfed.org/, http://www.econ.yale.edu/~shiller/data.htm, BLS, AOWM calculations

Stocks | Banking on 4th quarter seasonality

October 16, 2023

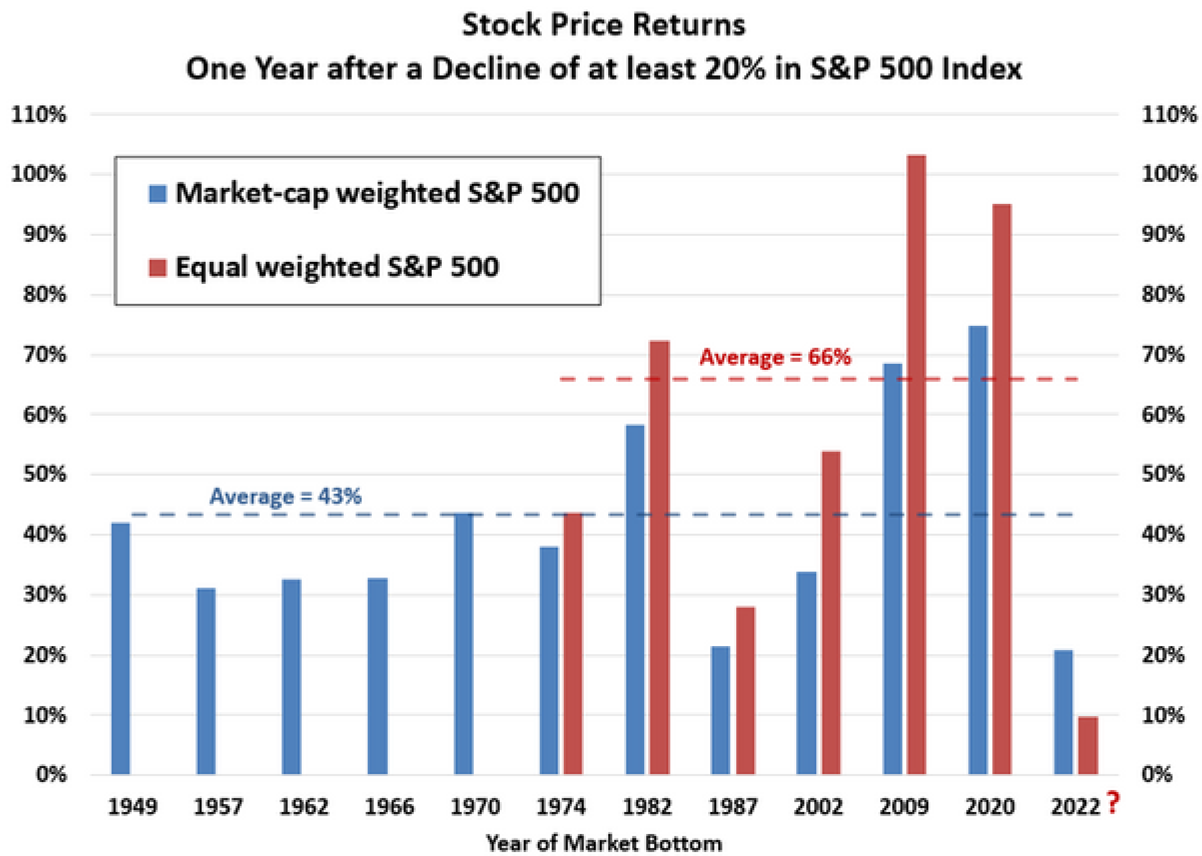
Since the market low last October, stocks have had a historically weak rebound. The S&P 500 index is up less than half the return typically seen in the year following a major market bottom, and a version of the S&P 500 that equally weights the stocks in the index is also uncharacteristically lagging when it usually outperforms.

The market is befuddling prognosticators of all stripes as it fails to follow any historical bear or bull market analog. Nevertheless, stock investors are hoping the recent weakness was just the usual seasonal headwinds that will give way to the frequent year-end rally.
On average, the fourth quarter is a good one for stocks. Whether that holds true this year may depend on whether inflation holds to its usual seasonal pattern. Consumer prices, as measured by the non-seasonally adjusted Consumer Price Index (CPI NSA), usually increase at a steady clip to start the year before levelling off in the latter half. While year-over-year inflation has moderated significantly, the CPI NSA has yet to show indications of a seasonal pause in inflation this year.

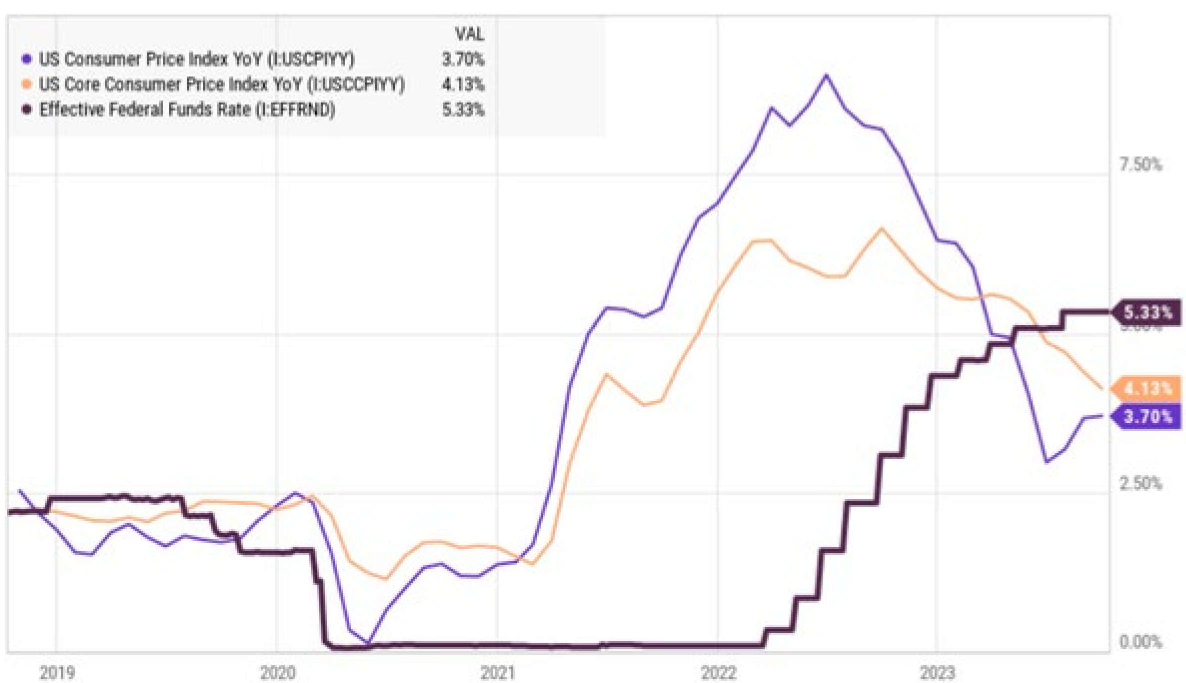
If consumer prices don't take a respite in the coming months, policymakers at the Fed could be compelled to increase interest rates further which would upset current market expectations.

Since the market low last October, most stocks have had a meager rebound with the equal weight S&P 500 at the same level it was at eleven months ago.

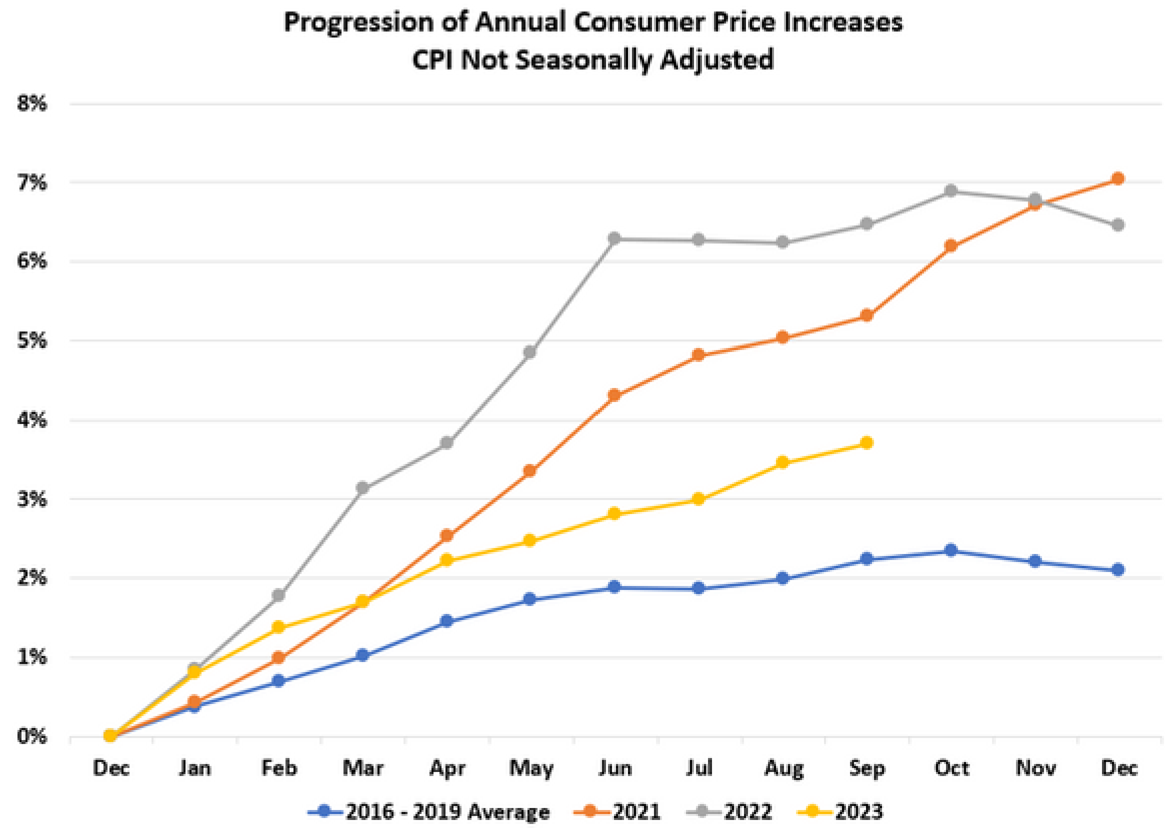
If last October was the market low, the past year represents a historically weak rebound for stocks after a decline of at least 20%, especially for the equal weight S&P 500 which typically outperforms early in a bull market.

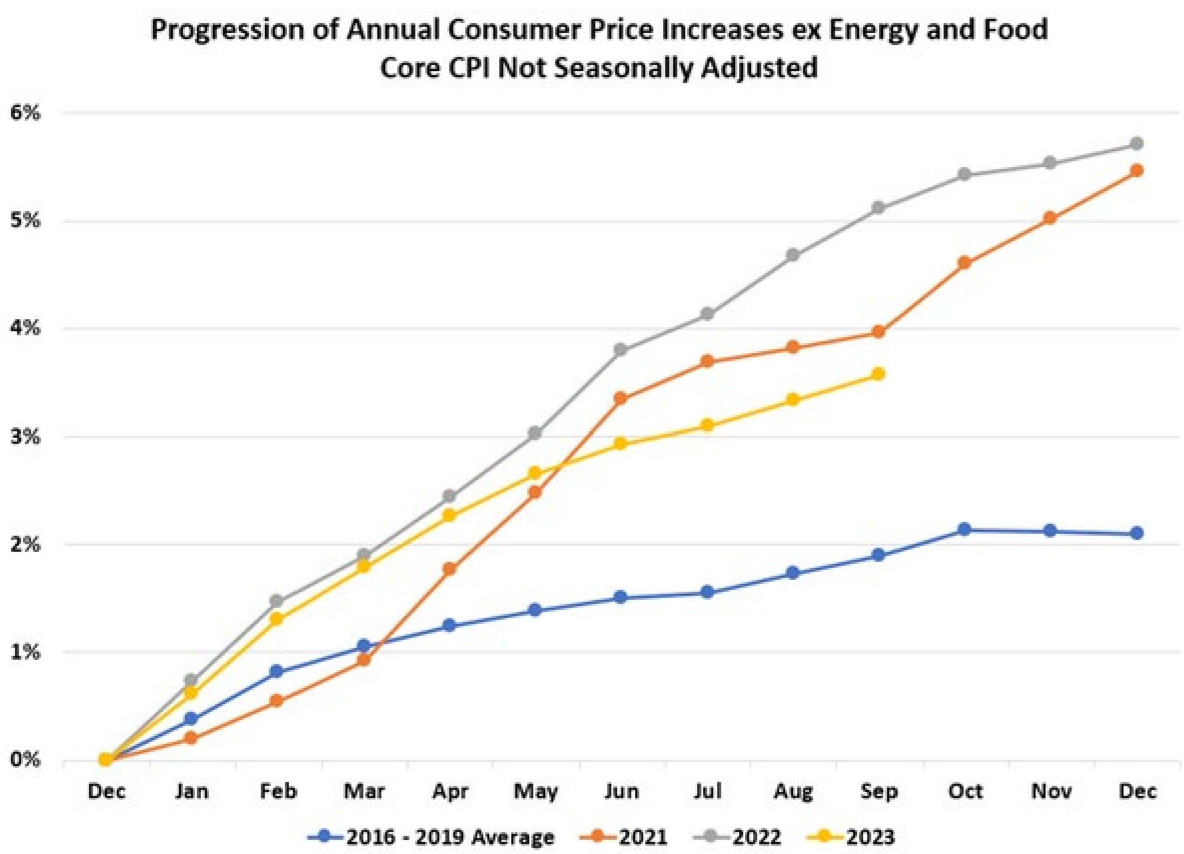


Inflation has moderated greatly from its peak but is still above the 2% target.



Increases in consumer prices have yet to slow as they typically do in the second half of the year. The absence of a seasonal pause could compel the Fed to increase interest rates further.





Sources: Ycharts, https://fred.stlouisfed.org/, BLS, AOWM calculations

Fiscal Policy | Working at cross-purposes

October 23, 2023

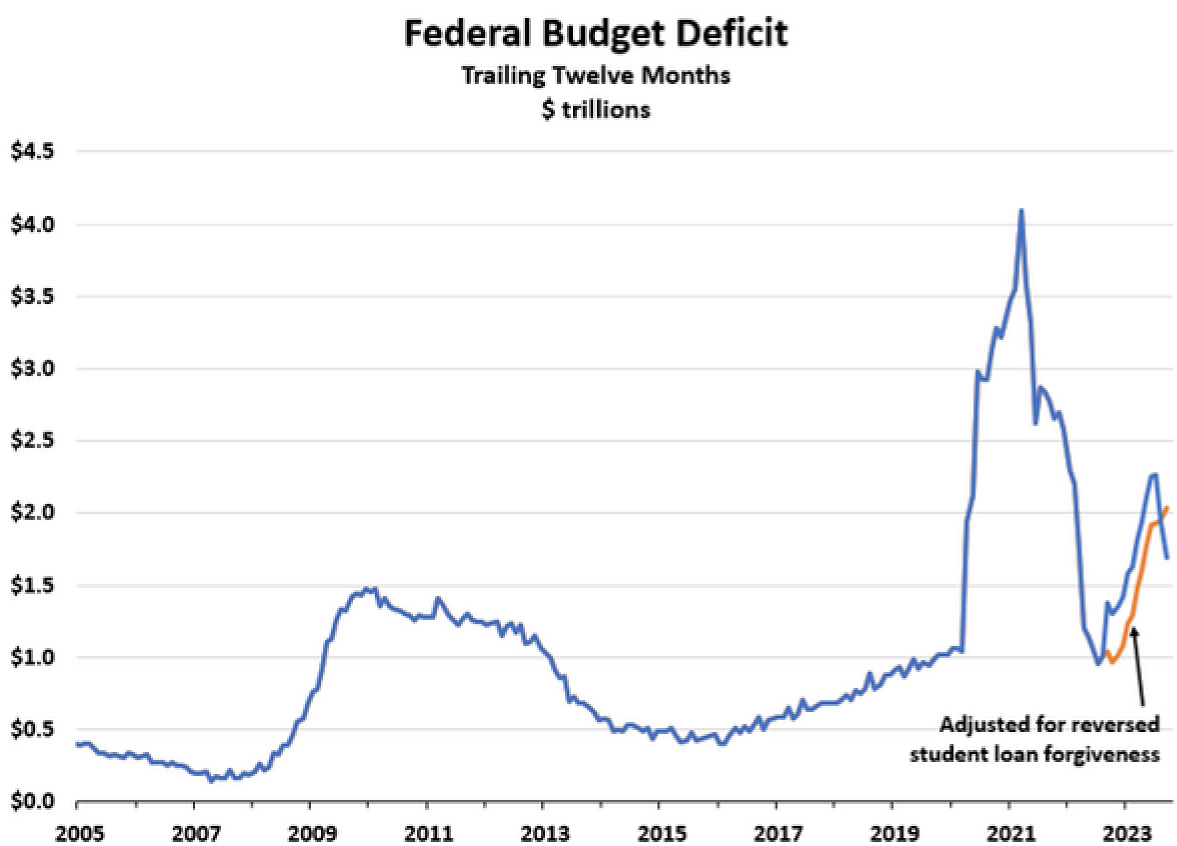
The official figures released last week showed the federal budget deficit widened to $1.7 trillion for the 2023 fiscal year ending September 30. It was actually worse than that. In the previous fiscal year, the government had booked a $337.3 billion outlay for student loan forgiveness; when that the Supreme Court ruled that unconstitutional, the accounting outlay was reversed making the deficit for FY 2023 look smaller than it really was. Excluding the student loan forgiveness back-and-forth, the federal deficit increased to roughly $2 trillion or nearly 8% of GDP, which is twice the size of the 40-year historical average for the deficit as a percent of GDP.

The automatic inflation adjustments on entitlements and the cost of higher interest rates on the federal debt helped to increase outlays while tax revenue has fallen back from the pandemic high. As a result, fiscal policy has been working at cross-purposes to monetary policy – stimulating the economy while the Fed is working to slow it to cool inflation.

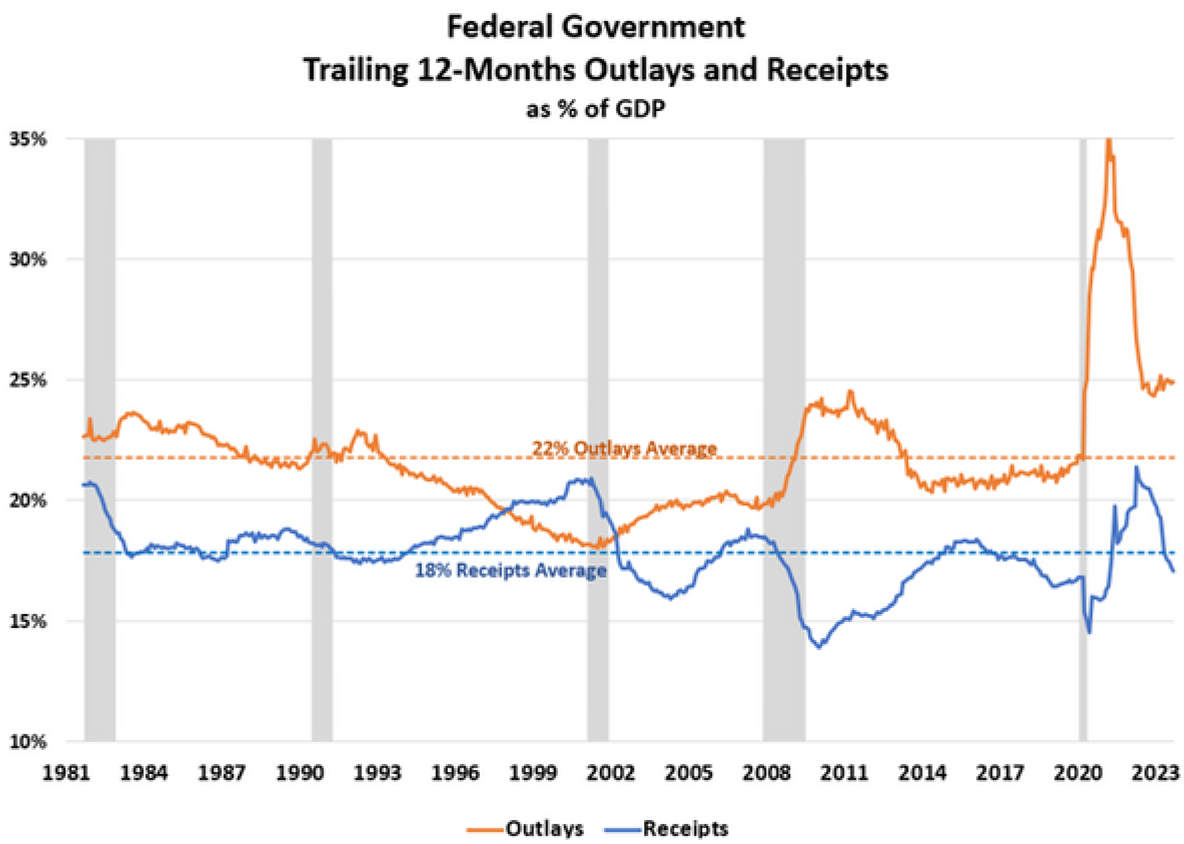
Monetary policy always operates with long and variable lags. The era of zero interest rates and extreme pandemic stimulus likely delayed the impact of higher interest rates. In addition, the growing size of entitlements and the federal debt have further complicated the Fed's job by making the federal budget more pro-cyclical when inflation is high and rates are rising. The factors that have delayed the impact of the Fed's actions may yet amplify their ultimate effect.

For a long time, government officials have been able to operate as if there are no hard trade-offs – budget deficits could be disregarded, and inflation and interest rates could remain ultra-low. With long-term rates spiking higher and inflation still stubbornly higher than desired, those golden days appear to be over.

The federal budget deficit was officially $1.7 trillion for the 2023 fiscal year ending September 30. Adjusting for student debt forgiveness, the deficit was around $2 trillion or almost 8% of GDP (twice the 40-year historical average).



Federal outlays have remained elevated following the pandemic while receipts have fallen back below their long-run average as a percent of GDP.



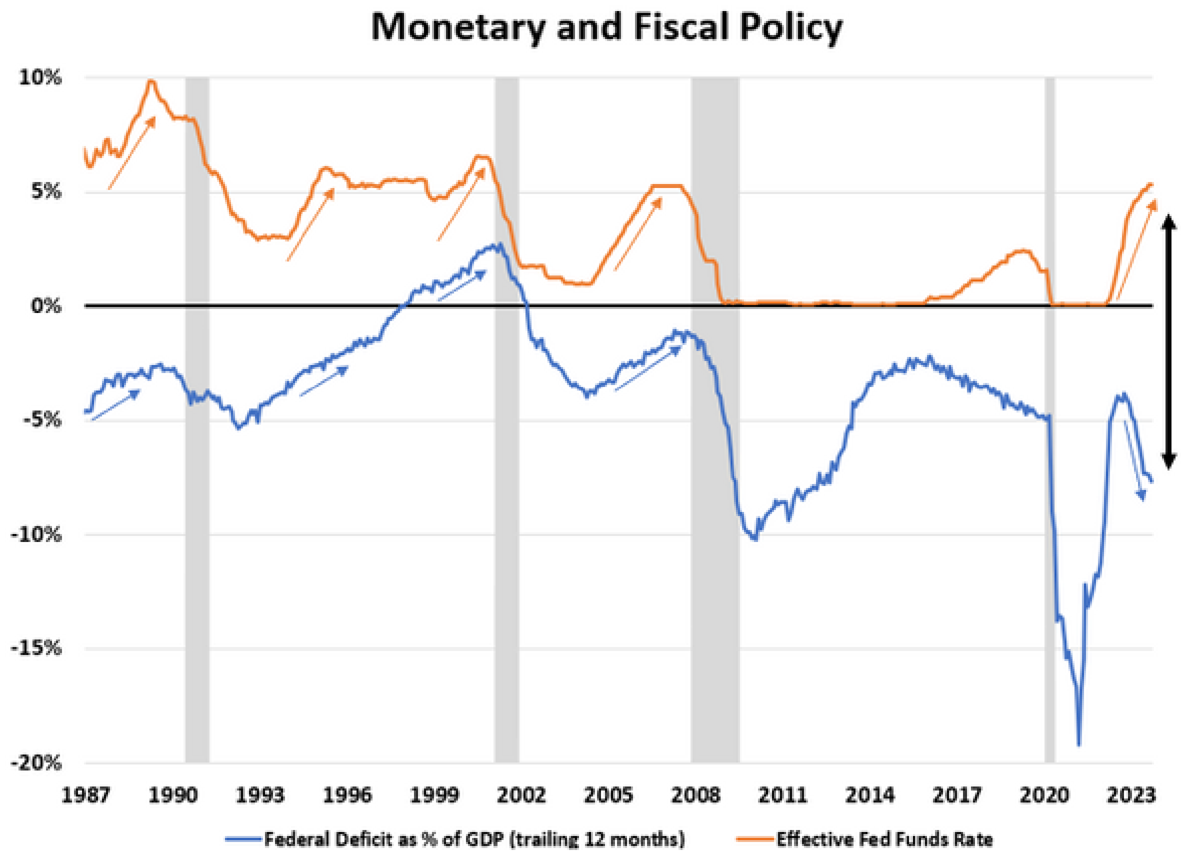
Federal Government Budget
Fiscal Year ending September 30
$ billions

RECEIPTS	2022	2023	Y/Y Chg	% Chg
Individual Income Tax	$ 2,632	$ 2,176	$(456)	-17.3%
Social Insurance & Retirement (Payroll Tax)	1,484	1,614	130	8.8%
Coporate Income Tax	425	420	(5)	-1.2%
Other	355	229	(126)	-35.5%
Total	**$ 4,896**	**$ 4,439**	**$(457)**	**-9.3%**

OUTLAYS	2022	2023	Y/Y Chg	% Chg
Social Security	$ 1,219	$ 1,354	$ 135	11.1%
Health (including Medicaid)	914	889	(25)	-2.7%
Medicare	755	848	93	12.3%
National Defense	767	821	54	7.0%
Income Security	865	774	(91)	-10.5%
Net Interest	475	659	184	38.7%
Veterans' Benefits & Services	274	302	28	10.2%
Education*	340	296	(44)	-12.8%
Transportation	132	127	(5)	-3.8%
Other	194	401	207	106.7%
Total*	**$ 5,935**	**$ 6,471**	**$ 536**	**9.0%**
Federal Deficit*	**$(1,039)**	**$(2,032)**	**$(993)**	

****Education outlays and the deficit adjusted to remove $337.3 billion in student loan forgiveness that was included as an outlay in 2022 and reversed in 2023.***

Unlike in previous rate tightening cycles, this time fiscal policy has been working at cross-purposes to monetary policy – increasing economic stimulus while the Fed has been working to slow the economy to cool inflation.



Sources: Ycharts, https://fred.stlouisfed.org/, US Treasury, https://www.fiscal.treasury.gov/reports-statements/mts/current.html, AOWM calculations

Monetary Pooh-bahs | Thus far well pleased

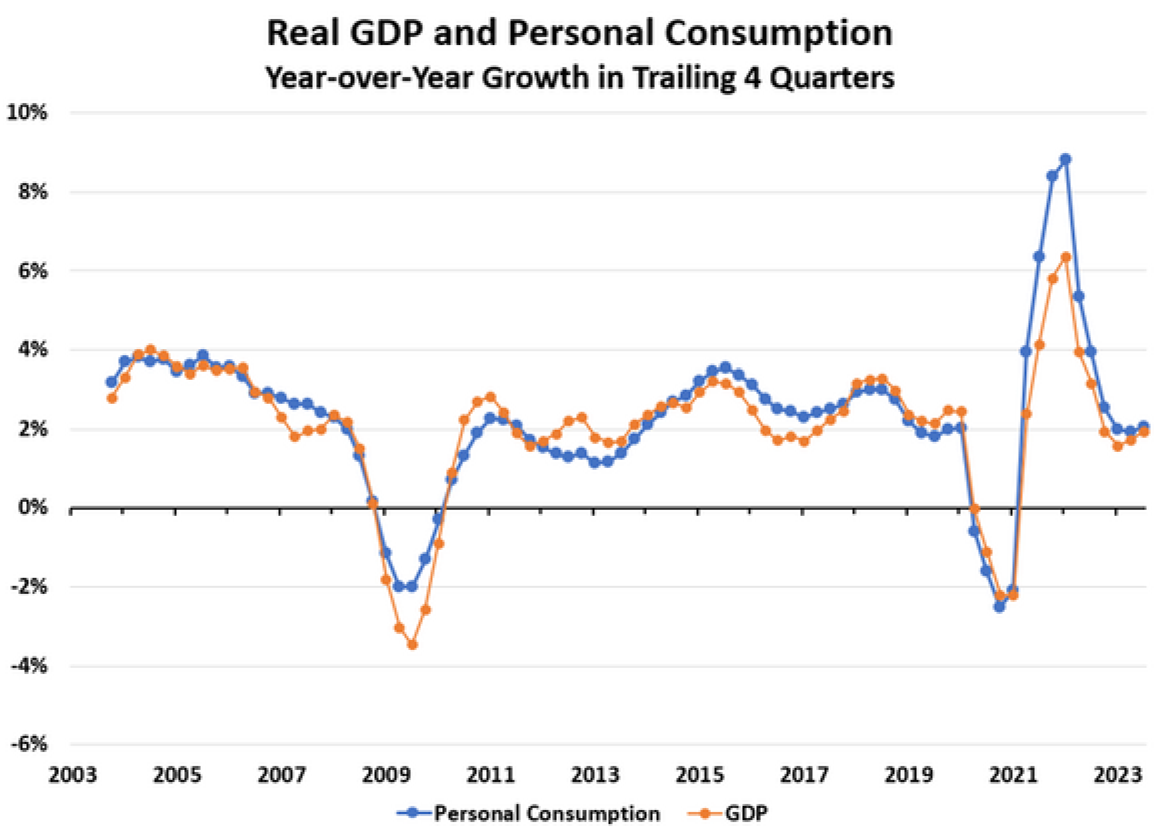
October 30, 2023

If back at the start of 2022 you were a pooh-bah in charge of monetary policy and partly guilty of awakening inflation from its decades-long slumber, you would be relieved and perhaps a little haughty about where we are today.

Interest rates have returned to more historically normal levels after more than a decade of extremely accommodative monetary policy. Inflation has retreated from more than 9% to 3.7% with the promise of a continued steady retreat. The unemployment rate remains remarkably low at 3.8%, and the economy appears to be chugging along at a steady pace. In addition, the so-called everything bubble is so far deflating in a very civilized fashion with prices for various assets normalizing without crashing. If we are to have a soft landing from the pandemic flights of fancy, this is what it looks like.

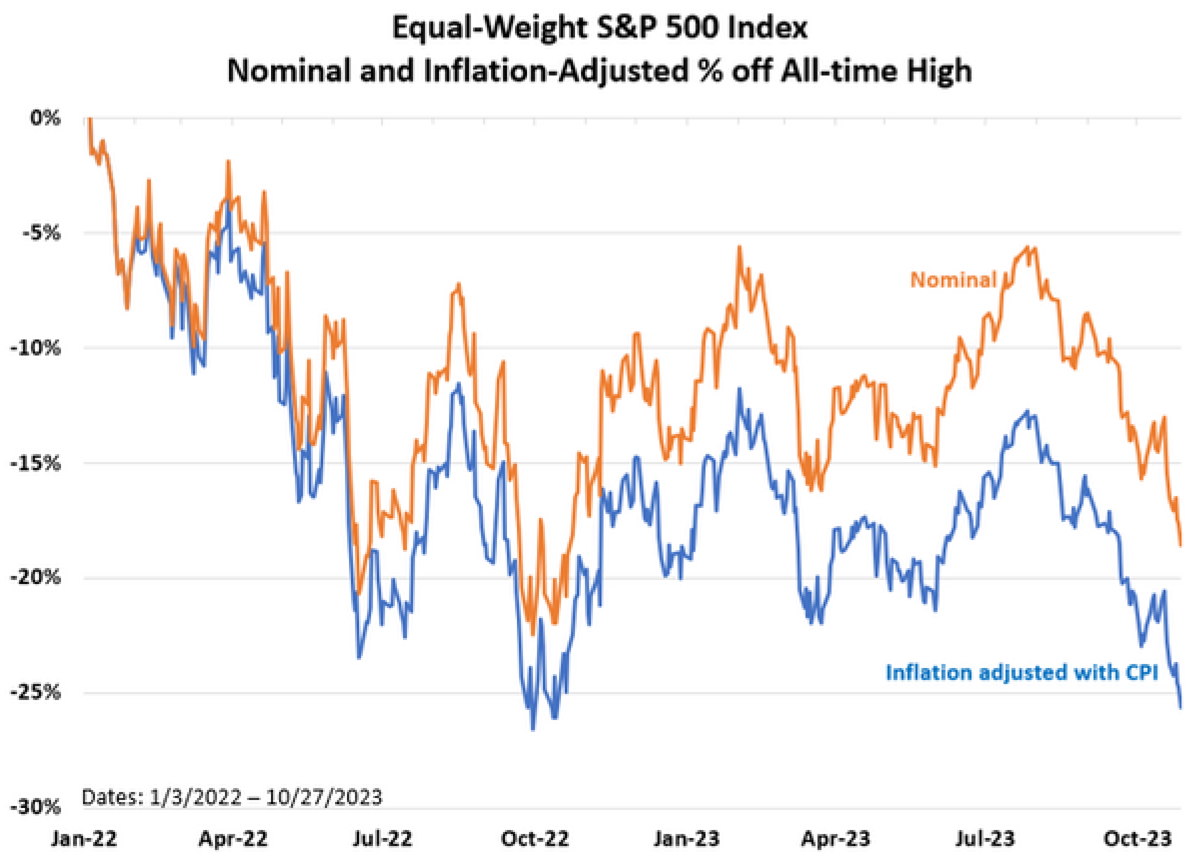
And yet, the victory is far from won. History teaches that news of inflation's demise can be premature, the risk of a recession remains elevated at times like these, and the herd is ultimately prone to drive a less orderly market recalibration. The pooh-bahs should be pleased but humble.

Consumer spending and thus the economy continued to provide encouraging signs of resilience and steady growth in the third quarter.

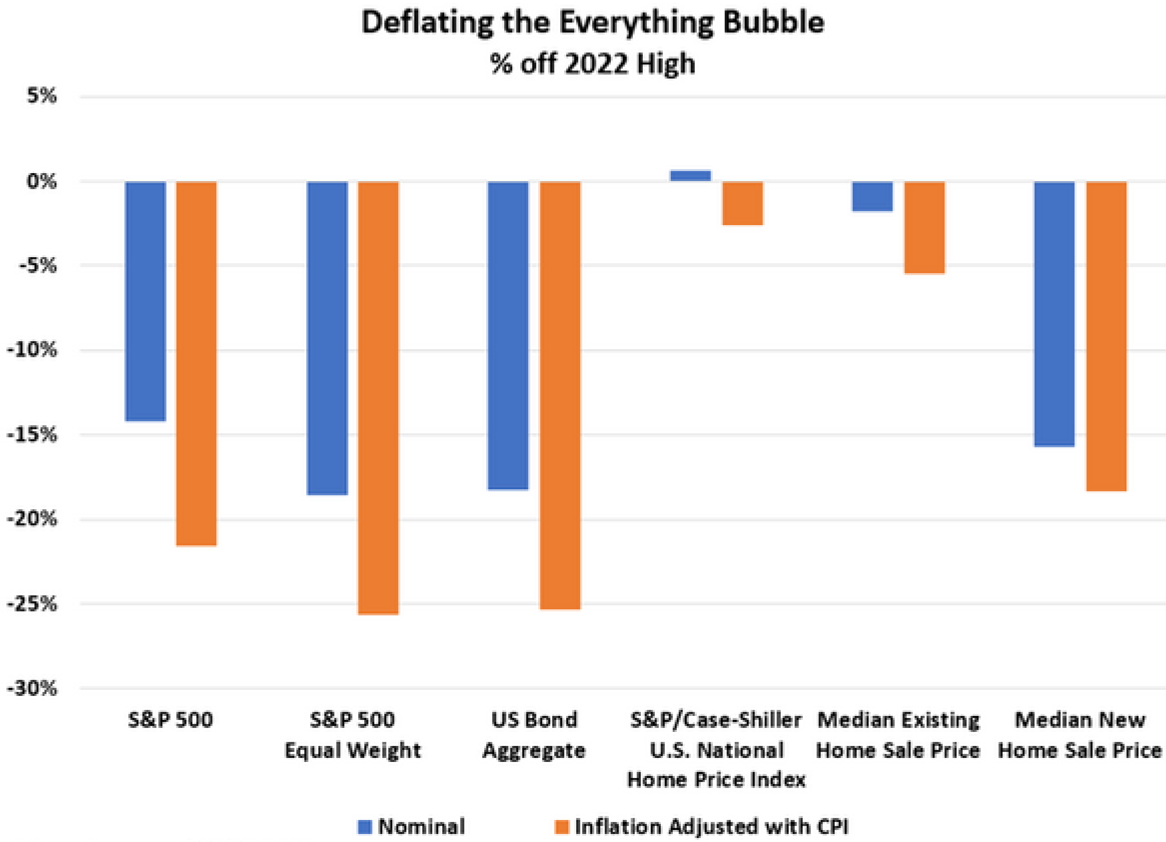


While real disposable personal income is up from last year, it hasn't increased in recent months and remains below its pre-Covid trend. Decreased savings has largely fueled the growth in personal consumption.

Stocks have trended basically sideways for more than a year – an ideal soft-landing outcome for policymakers.



Slowly retreating consumer price inflation can potentially help to rebalance asset prices without a wrenching sell off.



Price returns as of 10/27/2023

Sources: Ycharts, https://fred.stlouisfed.org/, BEA, AOWM calculations

Rising rate environment | The mountaintop?

November 6, 2023

Last month, the stock market rallied on an unexpectedly strong jobs report. This month, the stock market rallied on a weak jobs report that revised away some of the previous month's good news. To the extent there is any consistent rationale to short-term market swings, hopes for a soft landing undergird every upswing as a recession is the biggest short-term risk facing stocks.

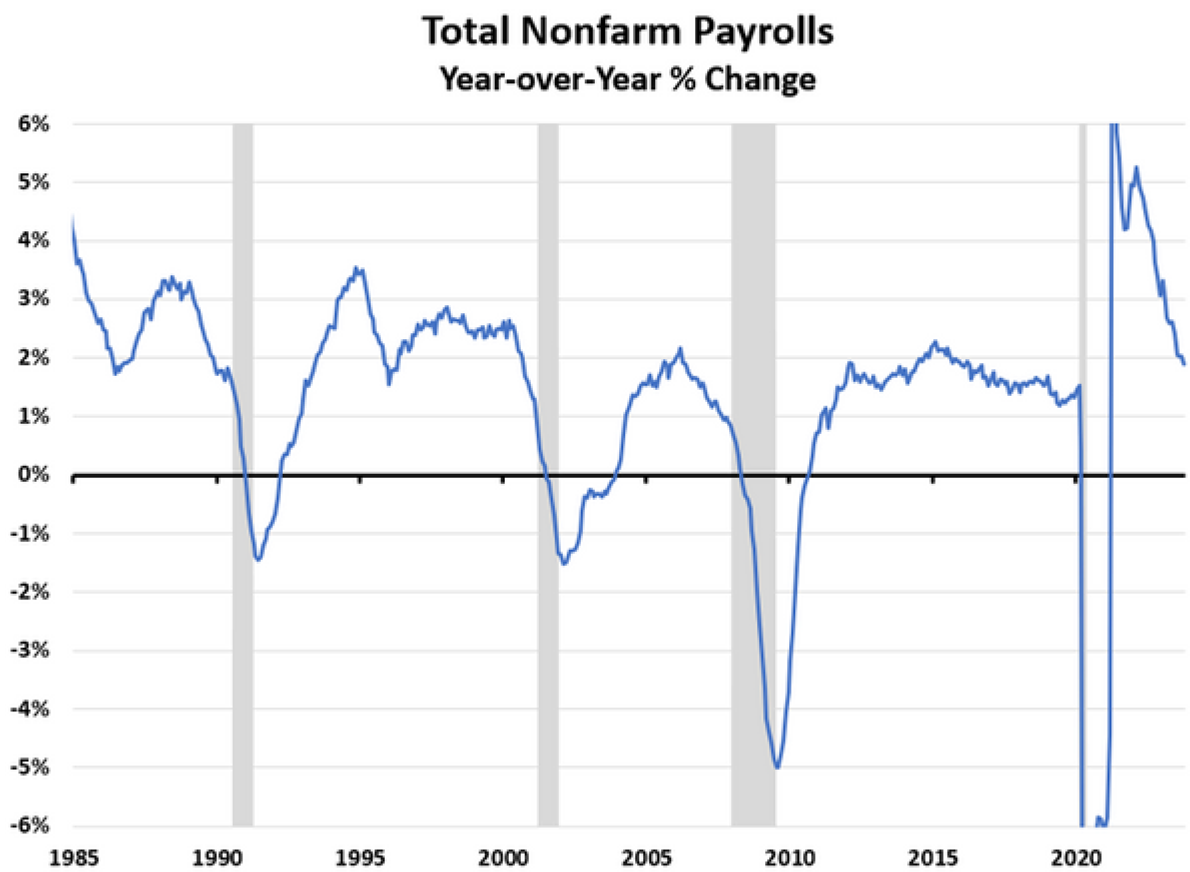
The jobs report for October underscored that the economy is slowing despite the apparent acceleration in GDP growth last quarter. Coupled with comments this past week by the Fed Chair, Jay Powell, the update on the state of the labor market moved the market consensus firmly towards the view that the Fed is done raising interest rates.

The end to the rising rate environment (at least for short-term rates) eliminates some uncertainty for investors but is unlikely to foster a sustained uptrend in stock prices on its own. That will depend on where the economy goes from here, and the current stance of the Fed keeps the risk of a recession elevated.

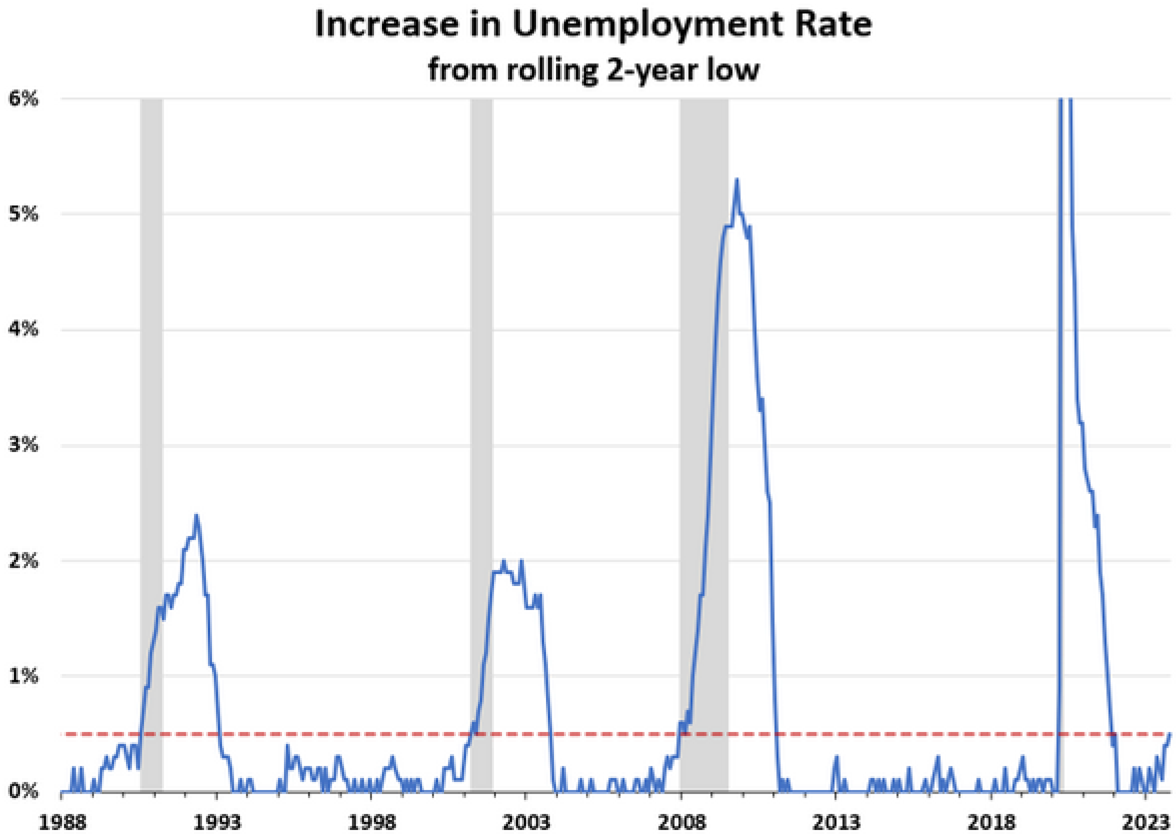
Even without higher short-term rates, financial conditions are likely to tighten further as inflation hopefully continues to decline (increasing real, inflation-adjusted rates) and the Fed continues to shrink its balance sheet (putting upward pressure on long-term rates). In addition, unlike in recent decades when the Fed would begin reducing interest rates before a recession began in an attempt to forestall a downturn, policymakers may be wary of cutting rates or ceasing quantitative tightening with inflation above its 2% target until a recession has clearly begun.

Recessions often look like soft landings until they aren't; however, it can also be said that soft landings (though rare) can look like a looming rendezvous with the ground until the wheels gently touch down. The market will swing back and forth as investors strive to discern what is possible and probable.

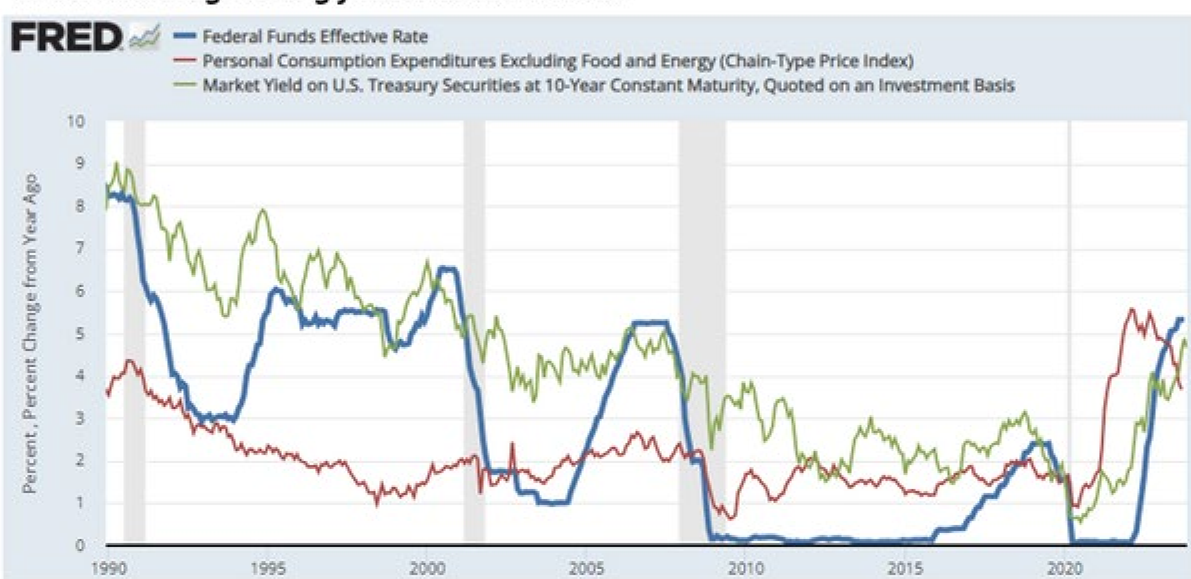
While previous payroll estimates were once again revised lower and the pace of growth continues to slow, the current strength of the labor market is still indicative of a growing economy.



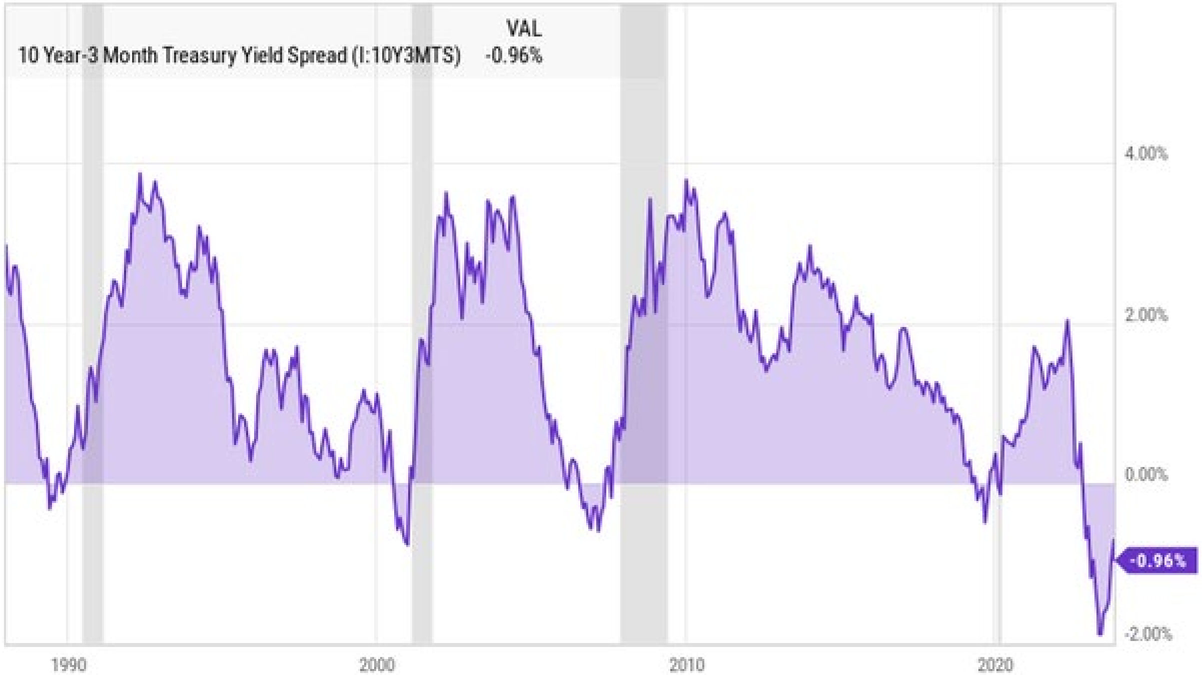
The unemployment rate remains low but has increased to 3.9%, up from 3.4% in April. In the past, such a rise in the unemployment rate has been indicative of a weakening labor market and pending recession.



The consensus view is that the Fed is done raising short-term rates. If so, policymakers will be banking on falling inflation and a shrinking Fed balance sheet to continue tightening financial conditions.



The yield curve typically un-inverts before a recession, but it may not this time as the Fed is unlikely to cut short-term rates when inflation is above its 2% target until a recession has clearly commenced.



Sources: Ycharts, https://fred.stlouisfed.org/, BLS, AOWM calculations

Banks | Recession cancelled?

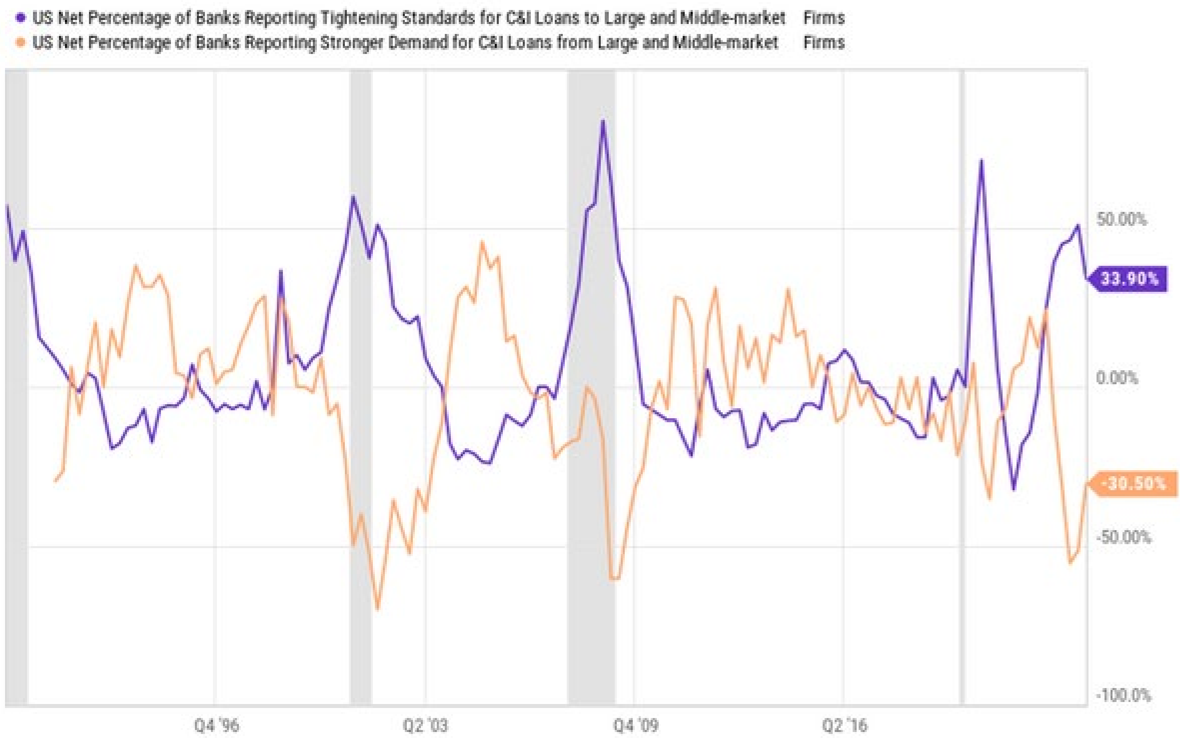
November 13, 2023

As concerns of a recession have receded, the number of banks tightening lending standards has declined as well. The Fed's latest survey of senior loan officers also indicated improving demand for business loans. Both would be more typically associated with an economy that is nearing the end of recession than the start of one and thus are a hopeful sign the economy will avoid a downturn.

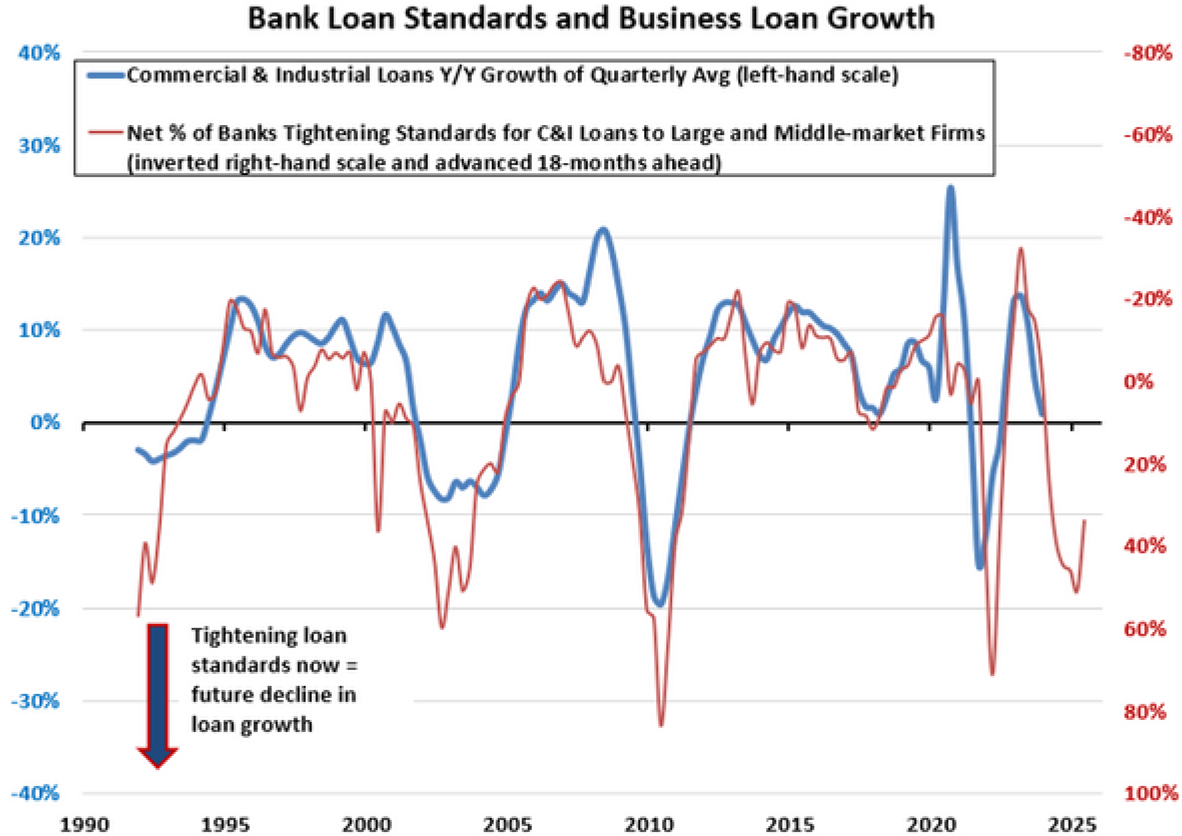
Nevertheless, the credit tightening banks have already done is still likely to slow economic growth if not tip it negative. The amount of commercial and industrial loans outstanding is now down slightly compared to a year ago; and, if the past is a guide, banks are likely to reduce further the credit they extend to businesses over the next couple of years.

The data remains conflicted. Time will tell.

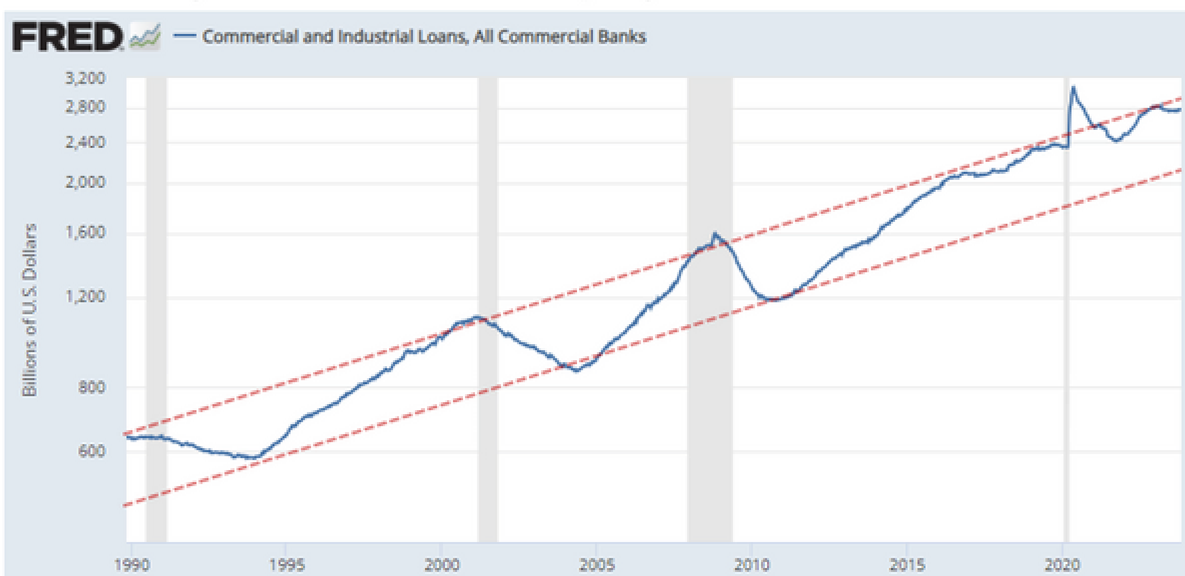
Fewer banks are tightening commercial lending standards and demand for business loans is improving – both positive indicators for the economy.



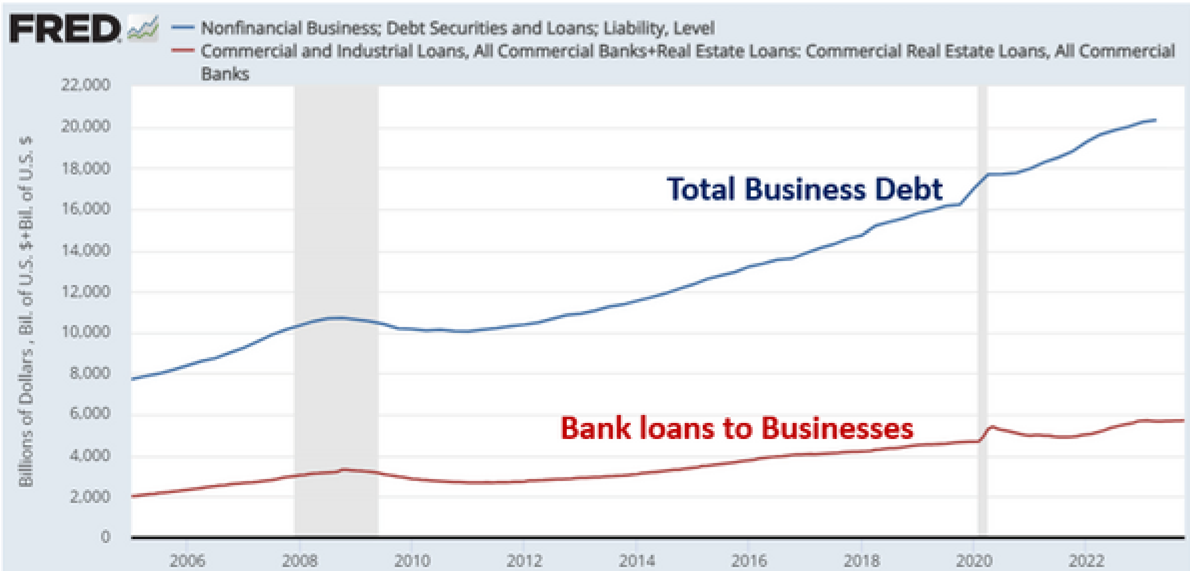
Based on the tightening in lending standards that has already occurred, business loans are still likely to decline in the coming months which will be a headwind for economic growth.



Commercial and industrial loans are still near the top end of their trend range. Based on the past three non-pandemic recessions, banks could reduce lending to businesses by 10% to 20% over the next few years.



Despite tightening bank lending, total business debt is still growing as companies have access to debt financing via the public debt markets and private credit loans outside of the banking system.



Sources: Ycharts, https://fred.stlouisfed.org/, Federal Reserve, AOWM calculations

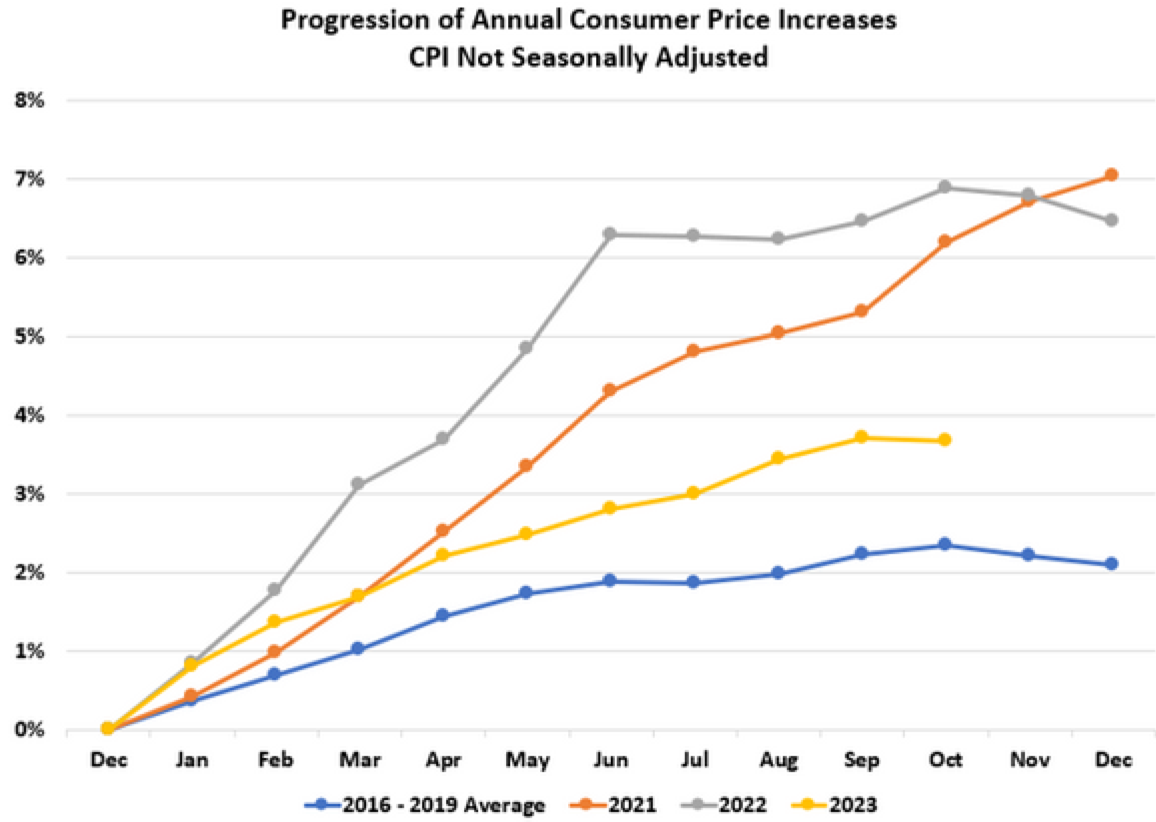
Stocks | Racing higher

November 20, 2023

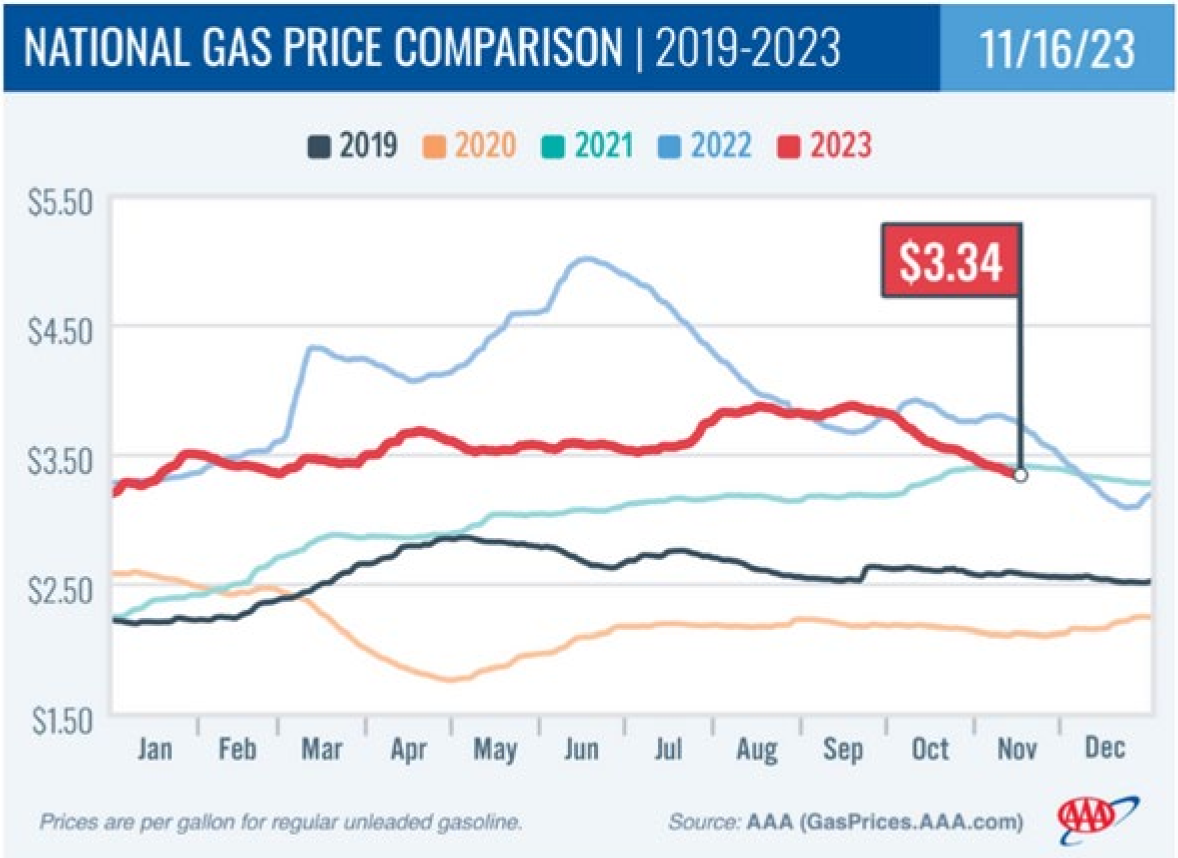
A slightly better than expected inflation report last week on top of the slightly weaker than expected jobs report has helped to send stocks racing higher with the S&P 500 up nearly 10% from its late October low. Stocks are volatile creatures, but such a quick upswing in the market is still relatively rare, happening less than 1% of the time since 1960. It is unfortunately just as likely to happen in a market trending down as one trending up (or perhaps in the current circumstances as one trending sideways).

The big swings are indicative of investors' shifting moods about the potential direction of the economy. The current sentiment is back to expecting that inflation will continue a peaceful retreat to 2% allowing long-term rates to mellow and the Fed to begin reducing its target short-term rate next spring as economic growth motors on unabated. However, it is hard to see why policymakers would risk reigniting inflation by reducing interest rates if the economy is not struggling. And a struggling economy would not align with the current risk-on sentiment.

The Consumer Price Index was basically unchanged in October with assistance from lower energy prices. The seasonal slowdown in inflation is expected to continue through the end of the year.



Gas prices need to continue falling if energy prices are to remain a tailwind for lower year-over-year inflation.



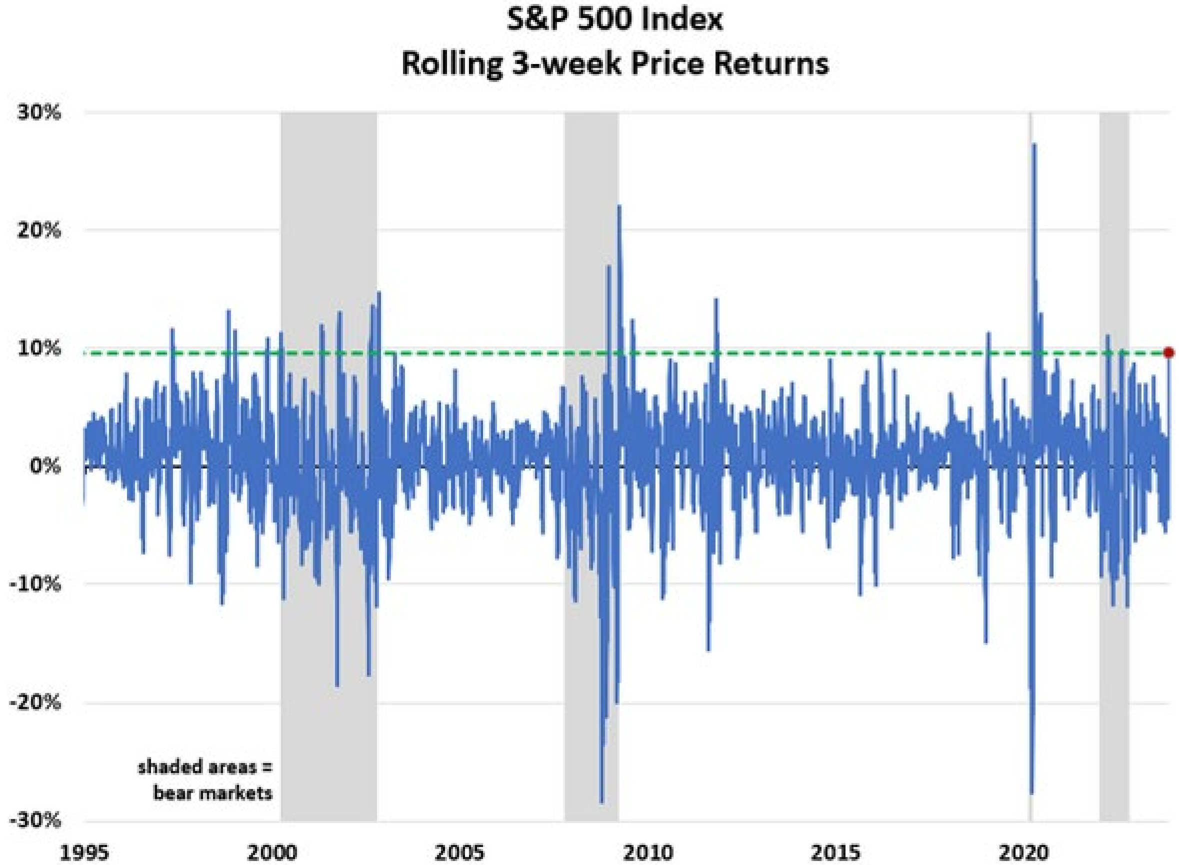
Investors currently expect the Fed to cut its target short-term rate four times next year - which may be an optimistic outlook for inflation (stock market's vote) or a pessimistic outlook for the economy.

CME FEDWATCH TOOL - MEETING PROBABILITIES

MEETING DATE	350-375	375-400	400-425	425-450	450-475	475-500	500-525	525-550	Expected Future Rate Changes
12/13/2023			0.0%	0.0%	0.0%	0.0%	0.0%	100.0%	No change
1/31/2024	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	100.0%	No change
3/20/2024	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	30.0%	70.0%	No change
5/1/2024	0.0%	0.0%	0.0%	0.0%	0.0%	24.0%	62.0%	14.1%	**25bps cut**
6/12/2024	0.0%	0.0%	0.0%	0.0%	4.6%	31.2%	52.8%	11.4%	No change
7/31/2024	0.0%	0.0%	0.0%	2.8%	21.1%	44.6%	27.1%	4.3%	**25bps cut**
9/18/2024	0.0%	0.0%	1.7%	14.0%	35.4%	33.9%	13.2%	1.7%	**25bps cut**
11/7/2024	0.2%	2.9%	16.1%	35.3%	31.9%	12.1%	1.5%	0.0%	**25bps cut**
12/18/2024	0.4%	3.9%	17.5%	35.1%	30.5%	11.3%	1.4%	0.0%	No change

**Probability of specified target range for fed funds rate at future Fed meeting dates based on current fed funds futures contract prices as calculated by CME.*

The S&P 500 Index was up nearly 10% to start November. Such quick upward moves are relatively rare and just as likely to occur in a market trending down as one trending up.



The Data | Confirming all biases

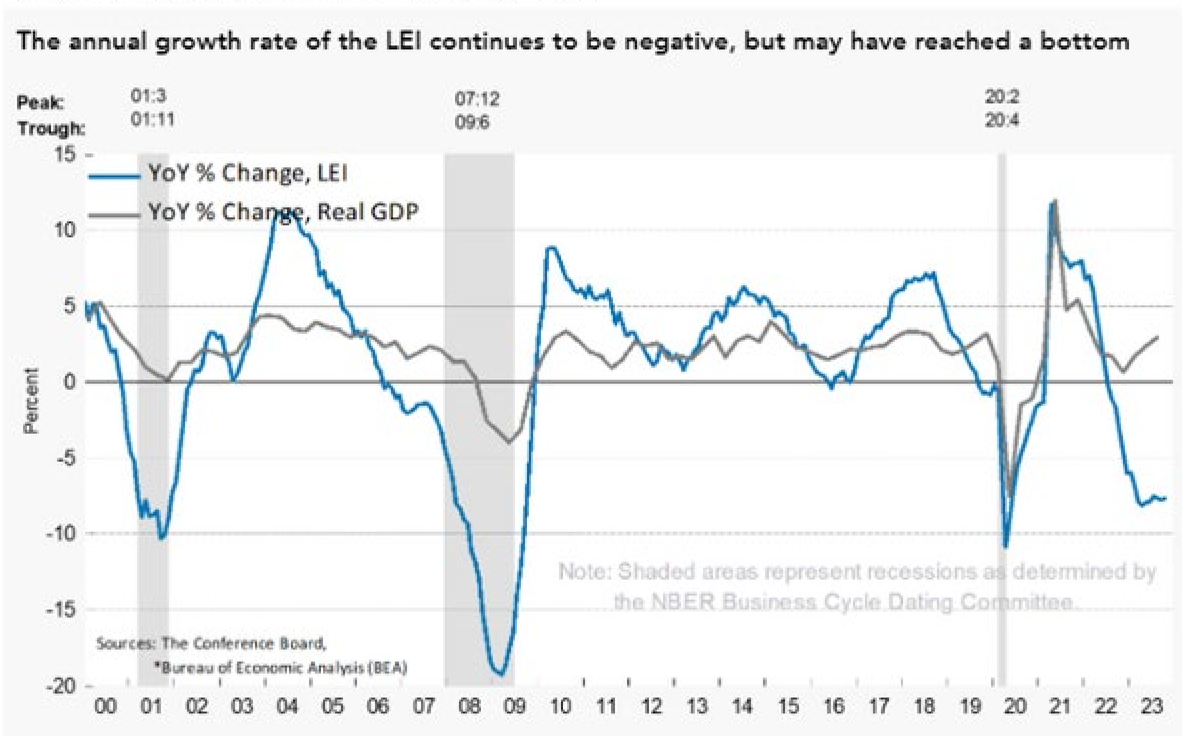
November 27, 2023

For investors, there has rarely been a time so fraught with the dangers of confirmation bias. Whatever your view – optimistic, pessimistic, or muddling – there is a plethora of data to support you. Coming off pandemic highs, many economic indicators have been trending in the wrong direction for some time, while the absolute level of economic activity remains relatively strong.

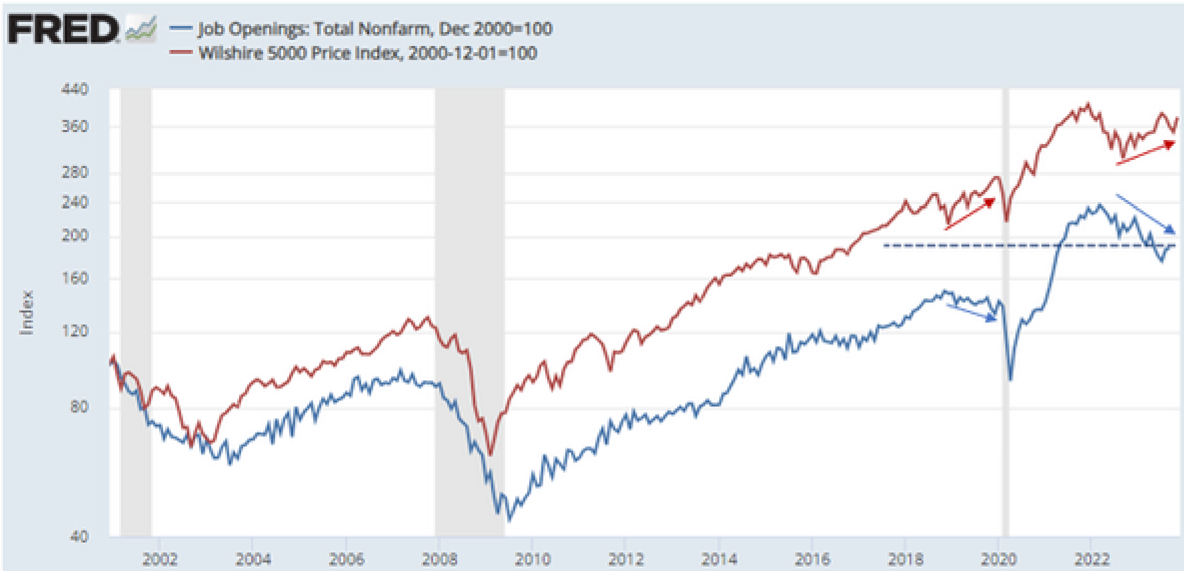
One example is the labor market, which continues to be in apparent robust health while the trend has the feeling of an oncoming cold. Take job openings, which are declining, down 21% from their high, but remain 32% above their pre-Covid level. Or the employment of temporary workers – historically a canary in the coal mine for the labor market – which is 7.2% off if its peak but basically level with where it was before the pandemic. Or the unemployment rate which is up 0.5% from its low but remains at a historically low level of 3.9%. The trend in new jobs created is also declining, but payrolls are still up nearly 2% over the past year (assuming future revisions to the data don't change that).

Given the uncertainty, most stocks have muddled along sideways over the past year. The largest stocks, on the other hand, have investors bravely charging forth in the faith that the pandemic high will be sufficient to carry the economy through a period of normalization that avoids a downturn. As a result, mega cap stocks have significantly outperformed. Such outperformance has occurred four other times over the past fifty years: twice the market has subsequently prospered and twice it has not – may your bias be warily confirmed.

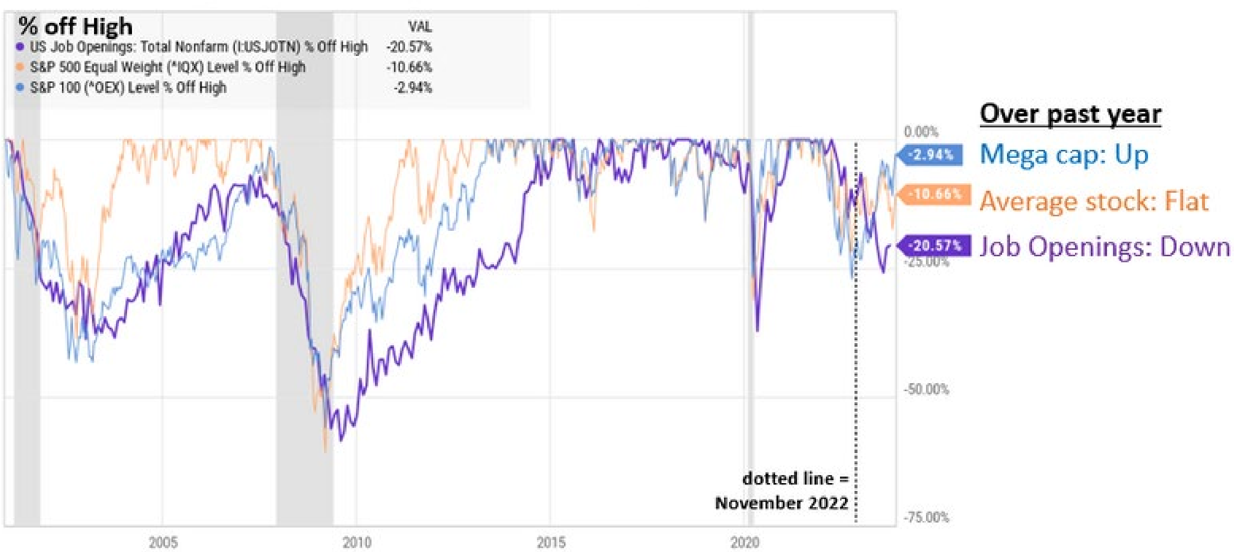
While economic growth has improved this year, leading indicators continue to portend future economic weakness.



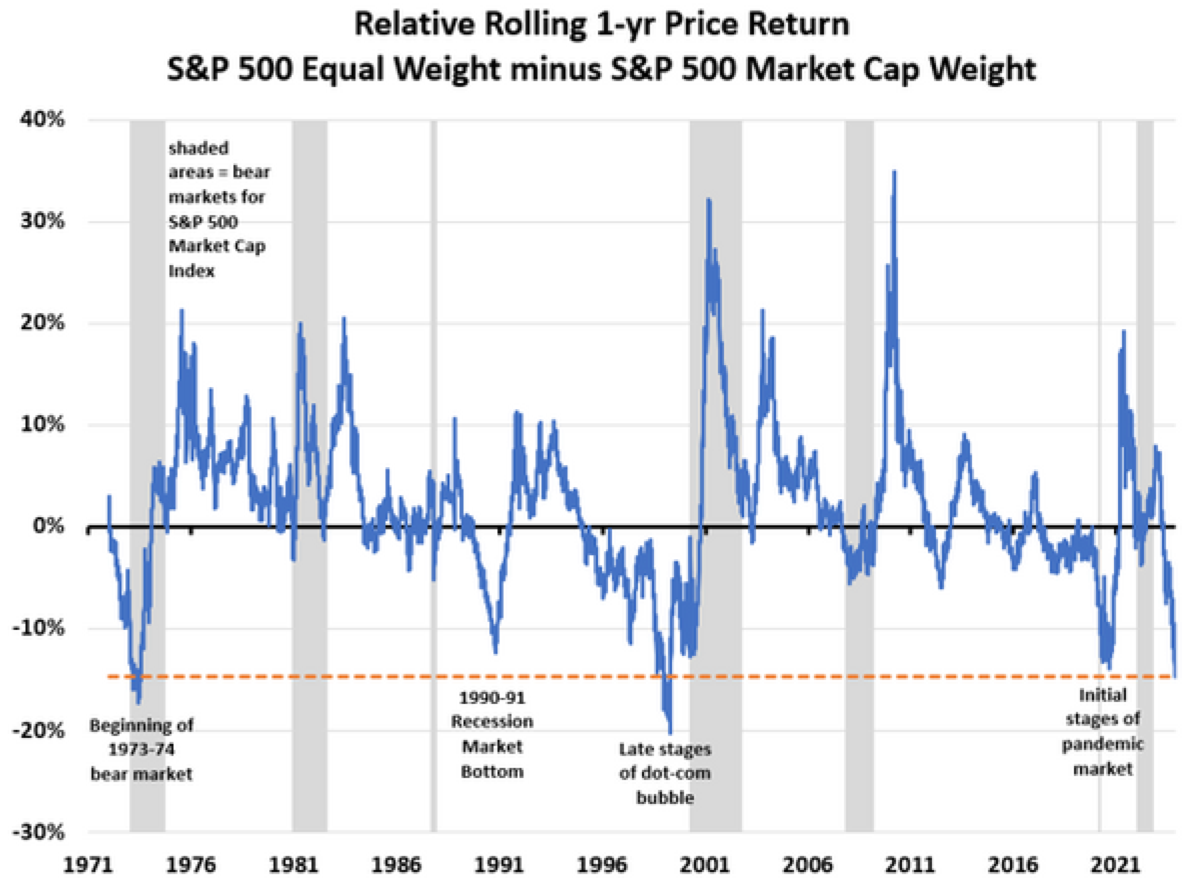
Job openings and the stock market tend to trend together. Over the past year they have been heading in opposite directions. However, job openings remain 32% above their pre-pandemic level which offers hope that the labor market is merely normalizing, not retrenching.



Excluding the largest stocks, most stocks have gone sideways over the past year, defying the downtrend in economic data but not rallying on the persistent strength of the level of economic activity.



The equal weighted S&P 500 has beaten the market cap weighted index 60% of the time since 1971 but has greatly underperformed over the past year. That doesn't provide much insight into where the market will go from here, other than to say that mega cap outperformance is unlikely to continue for long.



Sources: Ycharts, https://fred.stlouisfed.org/, https://www.conference-board.org/topics/us-leading-indicators, BLS, AOWM calculations

The Present | As uncertain as the future

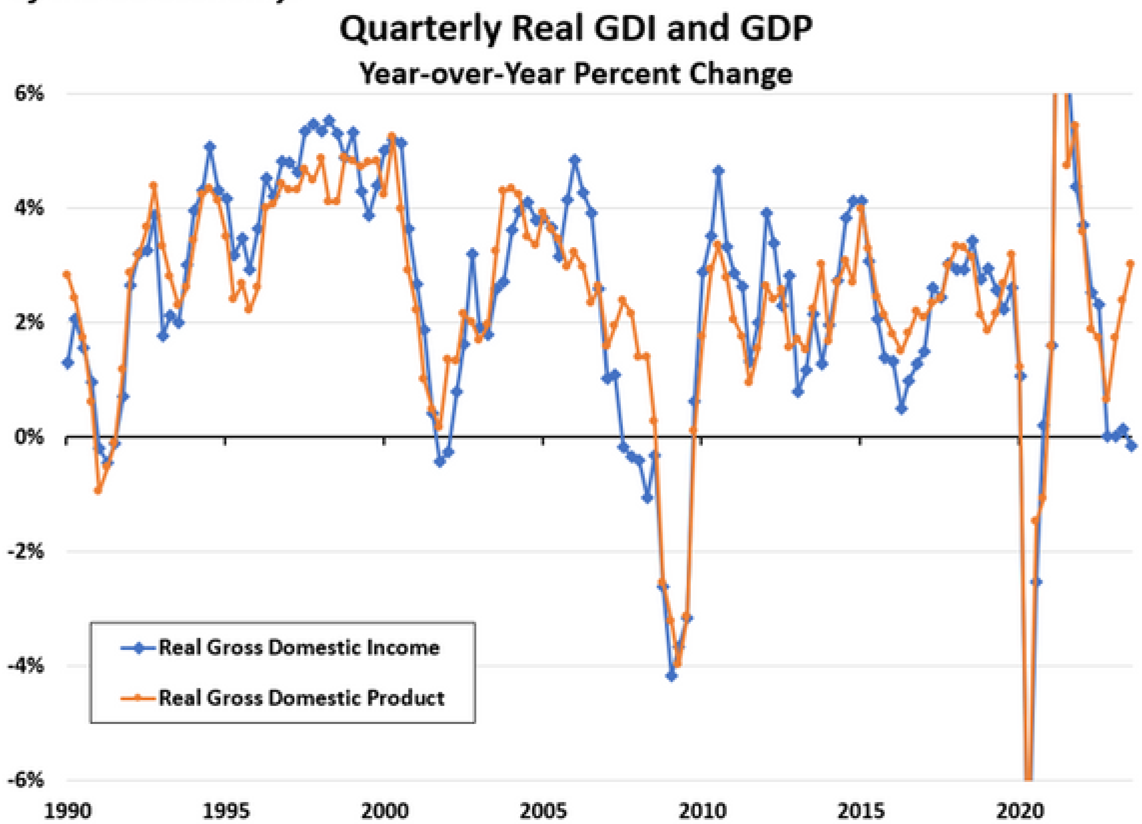
December 4, 2023

Last week, the initial estimate for real GDP growth in the third quarter was revised higher to a blistering 5.2% annualized rate. At the same time, the U.S Bureau of Economic Analysis released its initial estimate of Gross Domestic Income (GDI) for the third quarter that continues to indicate the economy is stagnating. Future data revisions will likely narrow the discrepancy, but for now the variance between the two in estimating year-over-year economic growth has never been larger.

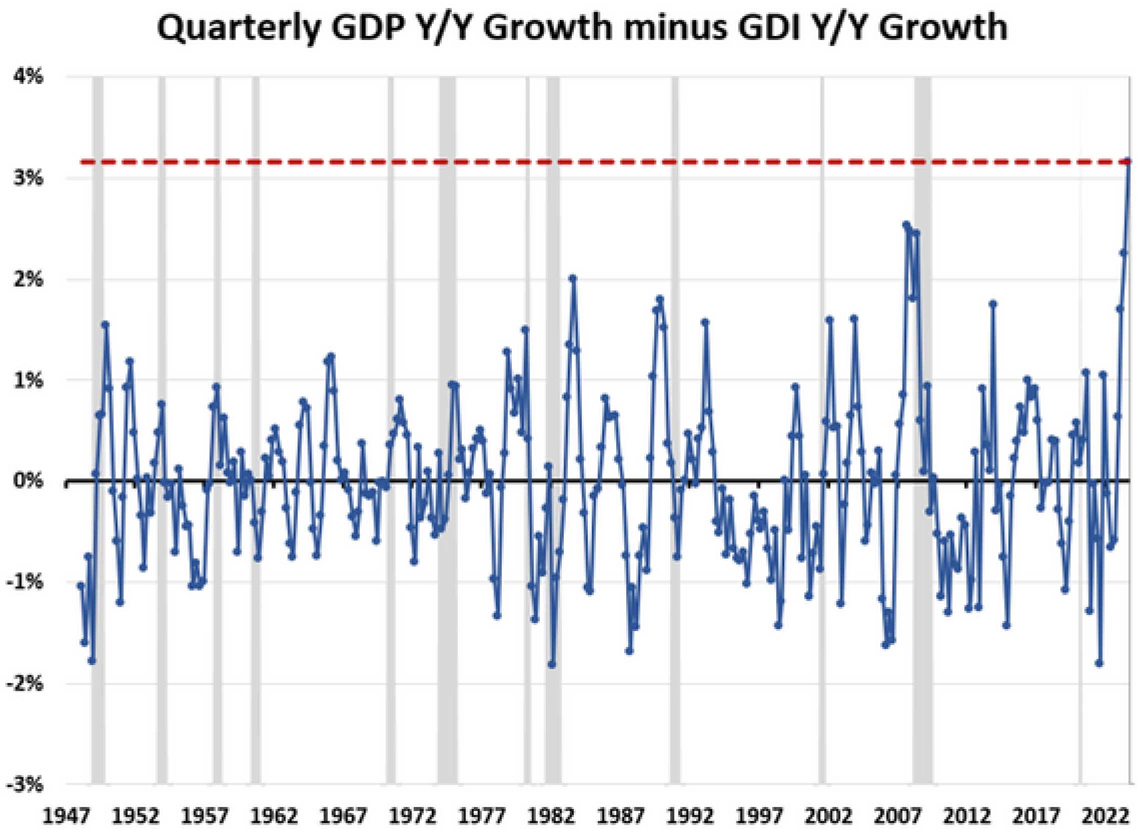
These twin measures of the economy, which should be equal in theory, have been telling different stories for the past four quarters. Attempting to accurately measure a $27 trillion dollar economy is not an easy task; anticipating where it is headed when the statisticians produce diametric estimates of its present state is even more challenging.

The uncertainty has kept stocks oscillating in sentiment with both measures to some degree – up this year as GDP growth has accelerated, but effectively flat for the past two years much like GDI.

Gross Domestic Income (GDI) and Gross Domestic Product (GDP), which should be equal in theory, continue to paint very different pictures of the current state of the US economy.

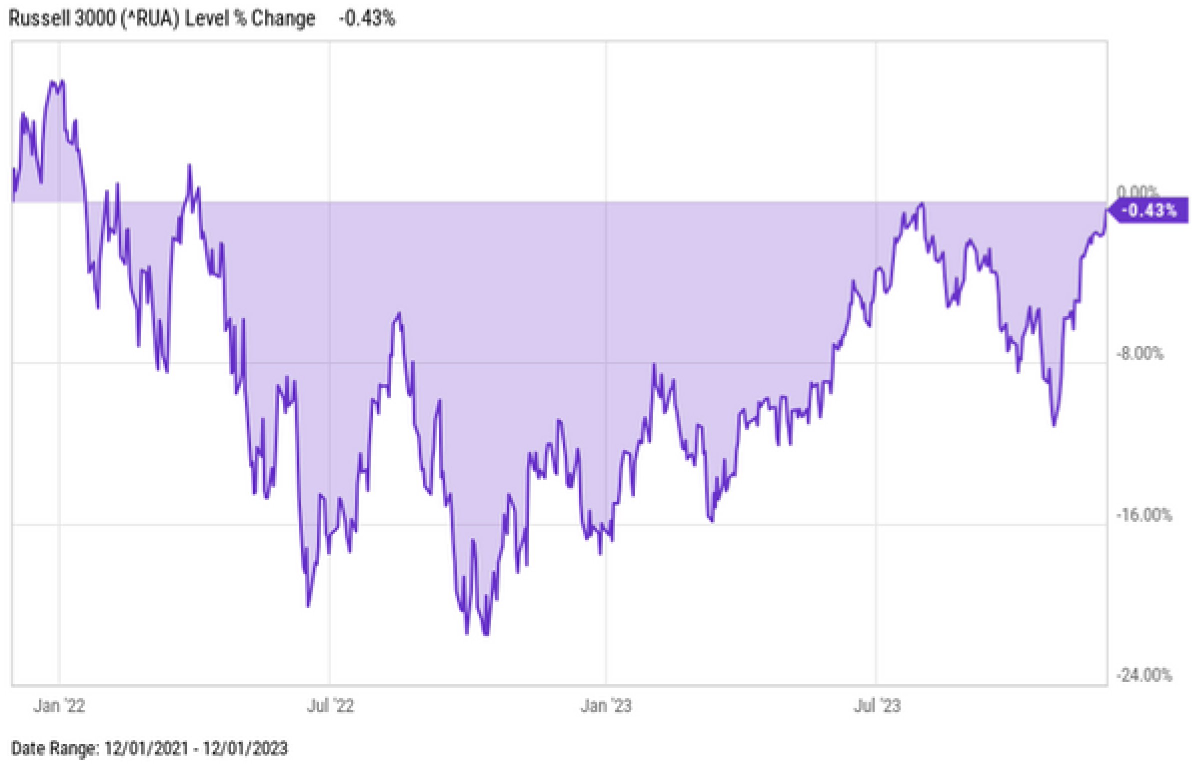


Future data revisions will likely narrow the discrepancy, but for now the variance between real GDP and real GDI in estimating the growth of the economy over the past year has never been larger.



Stock indexes have rallied this year as GDP growth has accelerated; however, like real GDI, they have basically gone nowhere for two years now.

Despite the strong rally in November, the Russell 3000 Index, which encompasses most publicly traded stocks in the US, is still flat over the past two years and would be more negative without the surge higher in mega cap stocks this year.



Sources: Ycharts, https://fred.stlouisfed.org/, BEA, AOWM calculations

Earnings | The wind beneath the market's wings

December 11, 2023

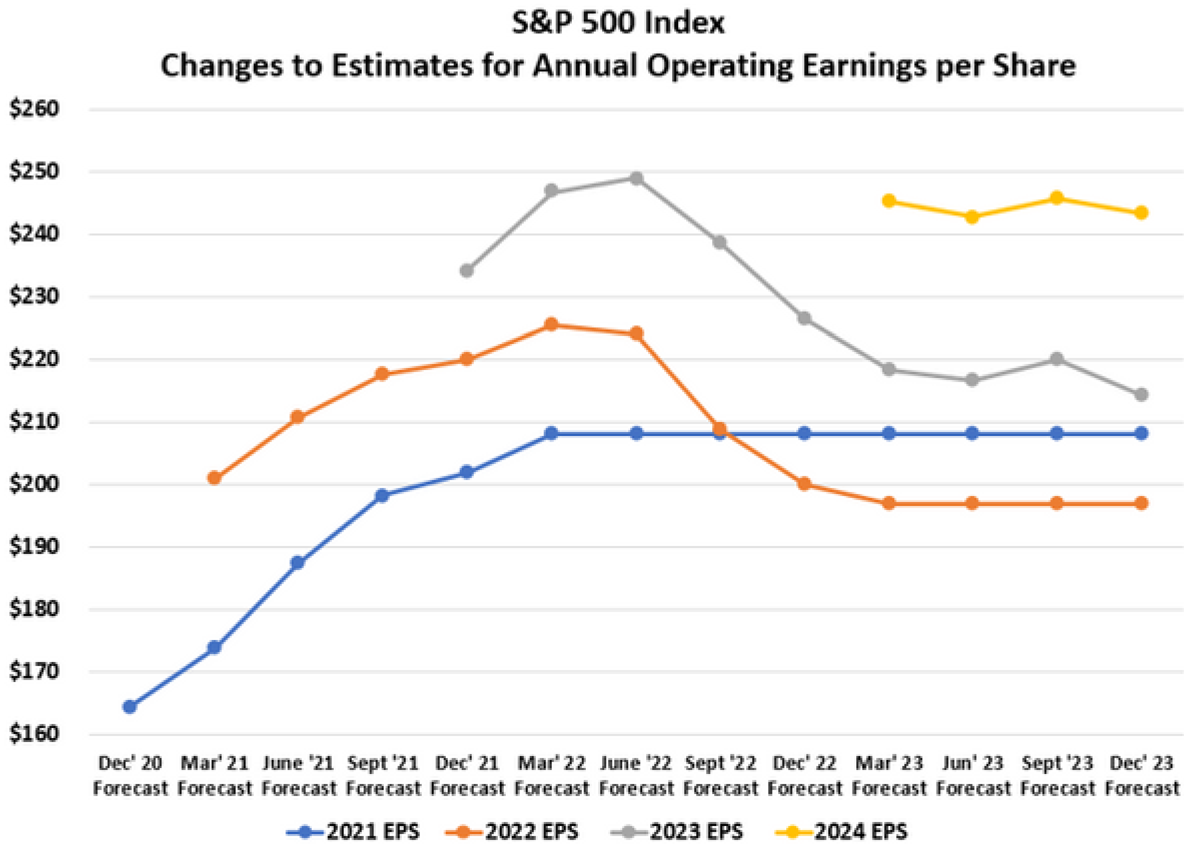
Generally good corporate profits have bolstered the stock market this year. The direction of earnings plays a large role in determining the direction of the market. Optimism is fueled by profits that tick higher; conversely, even a short-term setback in the bottom line can feed a pessimistic outlook among investors or break the spell of a speculative fever.

While profits surged in 2021, they have stagnated the past couple of years (albeit at an elevated level). The current consensus is that earnings will resume growing rapidly in 2024. The top seven companies in the S&P 500 Index have led the way this year in that regard as their earnings have rebounded and their stock prices have skyrocketed.

Expectations for next year are ambitious. Even if earnings are less glorious than forecasted, the market will likely avoid a major downturn as long as profits continue trending higher. A recession would result in a discombobulating decline in earnings, but stock investors are placing a low probability on that risk materializing.

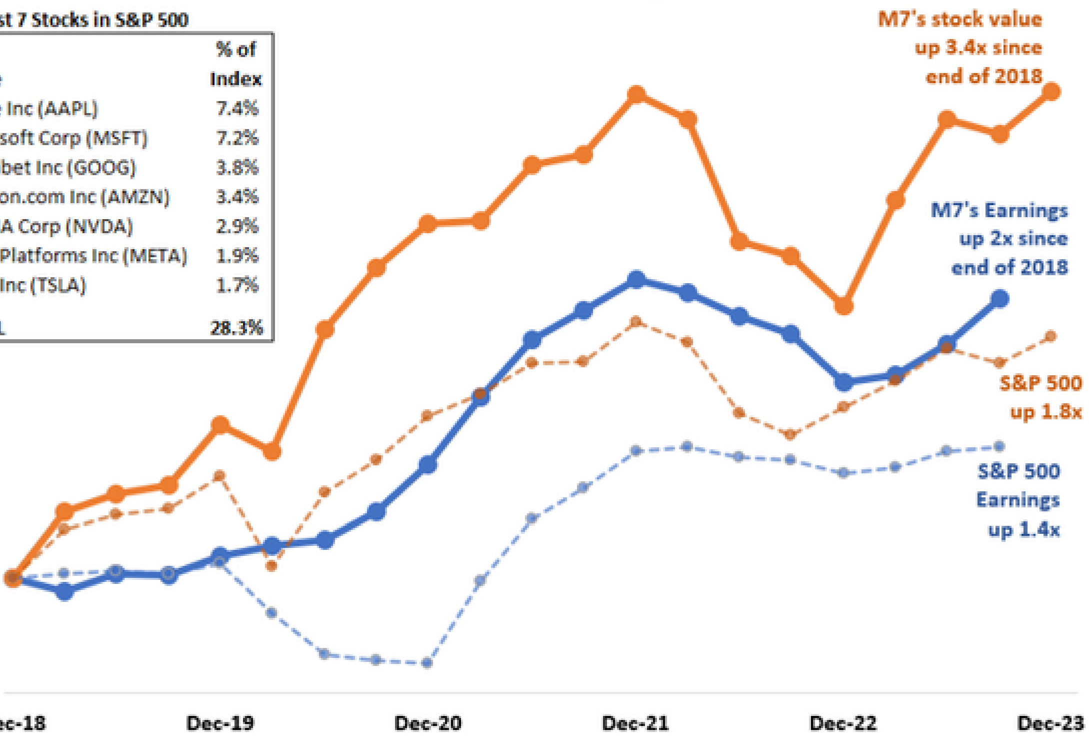
Like the economy, corporate profits have held up relatively well this year. As a result, earnings are ambitiously anticipated to accelerate higher in 2024.

Corporate profits surged in 2021 well ahead of initial expectations but have since stagnated. Nevertheless, high earnings expectations for 2024 have not changed much in recent quarters as investors hope for a resumption of double-digit earnings growth.



Much of the S&P 500's return this year is due to the largest seven stocks which surged higher as their earnings rebounded. Their valuations continue to run well ahead of earnings which need to keep growing swiftly to live up to expectations.

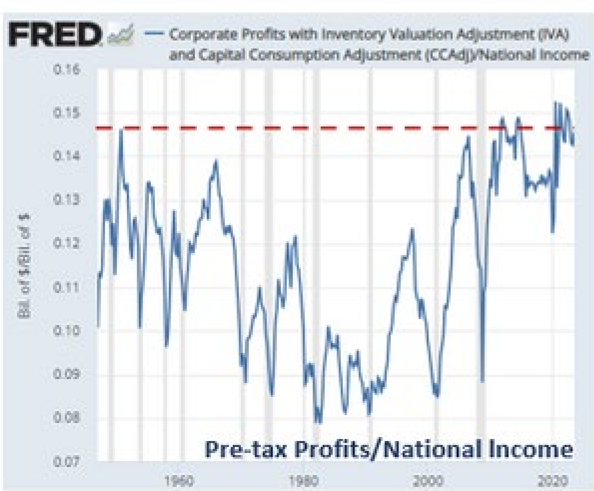
Magnificent Seven vs S&P 500 Index
Valuation and Earnings



Largest 7 Stocks in S&P 500

Name	% of Index
Apple Inc (AAPL)	7.4%
Microsoft Corp (MSFT)	7.2%
Alphabet Inc (GOOG)	3.8%
Amazon.com Inc (AMZN)	3.4%
NVIDIA Corp (NVDA)	2.9%
Meta Platforms Inc (META)	1.9%
Tesla Inc (TSLA)	1.7%
TOTAL	**28.3%**

As a share of National Income, corporate profits remain at a historically elevated level, especially on an after-tax basis.



Sources: Ycharts, https://fred.stlouisfed.org/, www.spglobal.com/spdjji/en/indices/equity/sp-500/#overview, BEA, AOWM calculations

The Dots | Portending a pivot

December 18, 2023

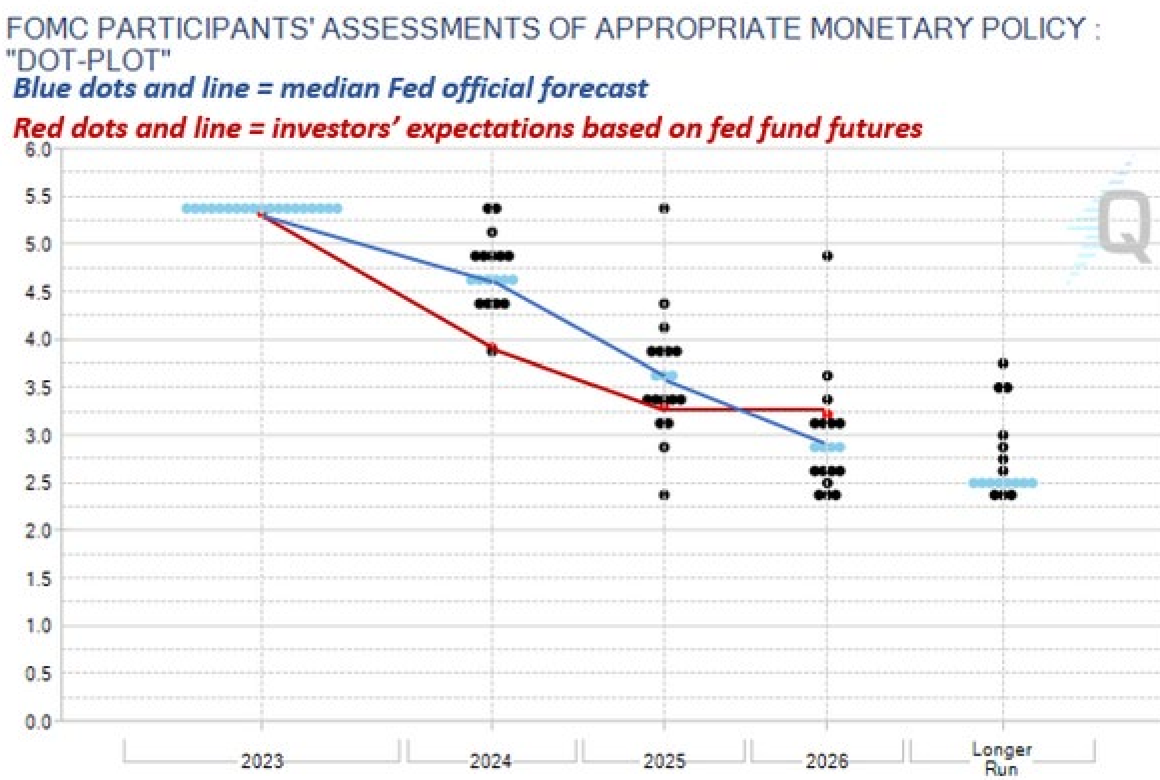
Investor sentiment has swung back and forth over the past two years, often driven by hopes the Fed will declare victory over inflation and pivot toward cutting interest rates sooner rather than later. For months, policymakers have insisted it was far too early for such talk. Last week, they changed their tune and sped up their projected timeline for lowering rates.

The dot plot of forecasts by Fed officials portends three quarter-point rate cuts next year with the fed funds rate declining to 4.6% by the end of 2024. Just three months ago, policymakers indicated that they expected the fed funds rate would still be above 5% at the end of next year. In response to the change in the Fed's outlook, interest rates across the yield curve headed lower as investors amplified the Fed's pivot with their own expectations for six rate cuts next year which would send the fed funds rate below 4%. All of which provided further fuel for the recent strong rally in the stock market.

After two years of rhetoric aimed at convincing the public that they have learned the lessons of the past and are committed to restoring price stability, it is surprising for policymakers to project an easing of monetary policy when inflation remains well above the Fed's stated 2% target, the economy does not appear to be in a recession, and financial markets are running hot. In the Fed's defense, the inflation-adjusted fed funds rate is unlikely to decline even with a few nominal rate cuts next year and may even tick a little higher, so monetary policy will remain restrictive (although policymakers seem intent on not letting policy get as restrictive as it has in previous tightening cycles over the past fifty years).

The powers-that-be are also likely always weighing undisclosed concerns that might make the recent shift less surprising if known. However, if that is the case, there is debatable wisdom in the Fed's attempts at transparency that lead to large swings in the market based on conflicting communications, inconsistent logic, and unreliable projections (as in fairness most forecasts are). It makes one long for the days when Alan Greenspan would be intentionally incomprehensible and Fed watchers would endeavor to divine the direction of policy by the size of his briefcase. The mystery inspired more confidence.

While investors expect the Fed to cut rates next year even more than policymakers have suggested, they think short-term rates are likely to remain higher in the long term than policymakers are projecting.



Blue dots indicate the median projection. Data is based on the economic projections published on December 13, 2023.
Red dots indicate the effective rate implied by the year-end FedFund future price.

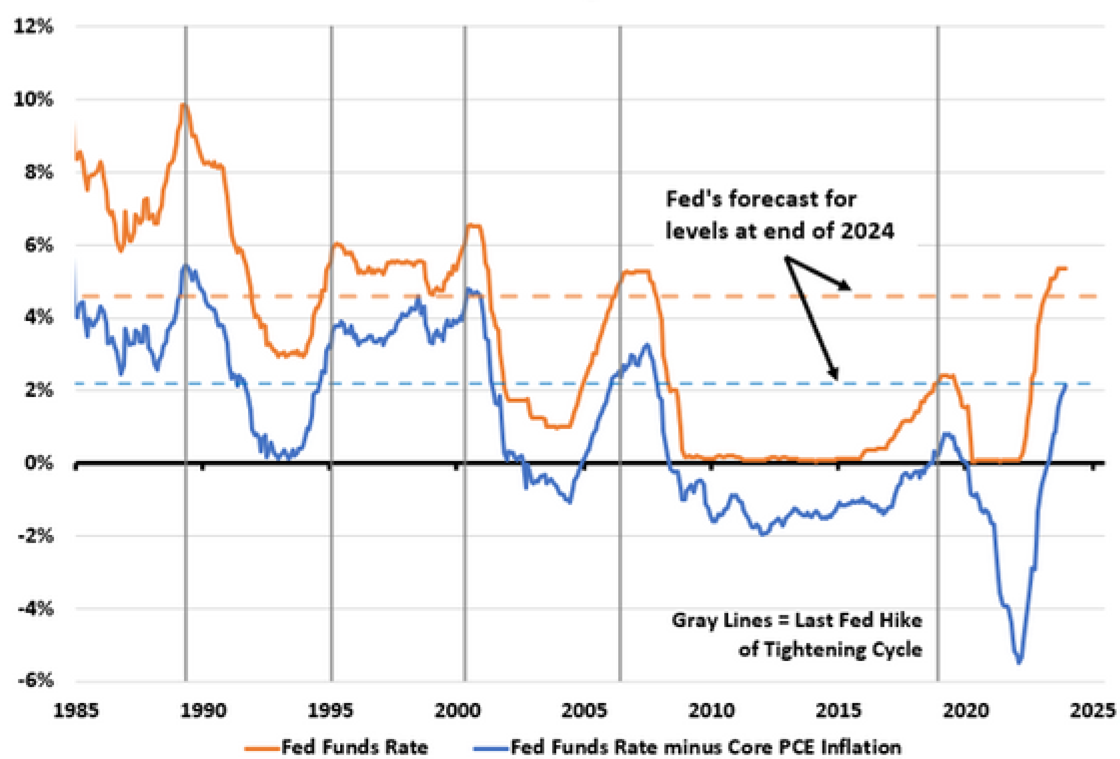
Investors expect the Fed to cut its target fed funds rate at almost all their meetings next year. Even with the shift in the Fed's outlook, that seems unlikely if the economy is still strong and unemployment remains low.

CME FEDWATCH TOOL - MEETING PROBABILITIES										
MEETING DATE	325-350	350-375	375-400	400-425	425-450	450-475	475-500	500-525	525-550	**Expected Future Rate Changes**
1/31/2024				0.0%	0.0%	0.0%	0.0%	10.3%	89.7%	No change
3/20/2024	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	6.8%	62.7%	30.5%	**25bps cut**
5/1/2024	0.0%	0.0%	0.0%	0.0%	0.0%	5.6%	52.9%	36.1%	5.3%	**25bps cut**
6/12/2024	0.0%	0.0%	0.0%	0.0%	5.1%	48.6%	37.7%	8.2%	0.5%	**25bps cut**
7/31/2024	0.0%	0.0%	0.0%	4.3%	41.9%	39.3%	12.7%	1.7%	0.1%	**25bps cut**
9/18/2024	0.0%	0.0%	3.8%	37.4%	39.6%	15.9%	3.0%	0.3%	0.0%	No change
11/7/2024	0.0%	2.5%	25.9%	38.9%	24.0%	7.4%	1.2%	0.1%	0.0%	**25bps cut**
12/18/2024	2.0%	21.3%	36.3%	27.0%	10.7%	2.4%	0.3%	0.0%	0.0%	**25bps cut**

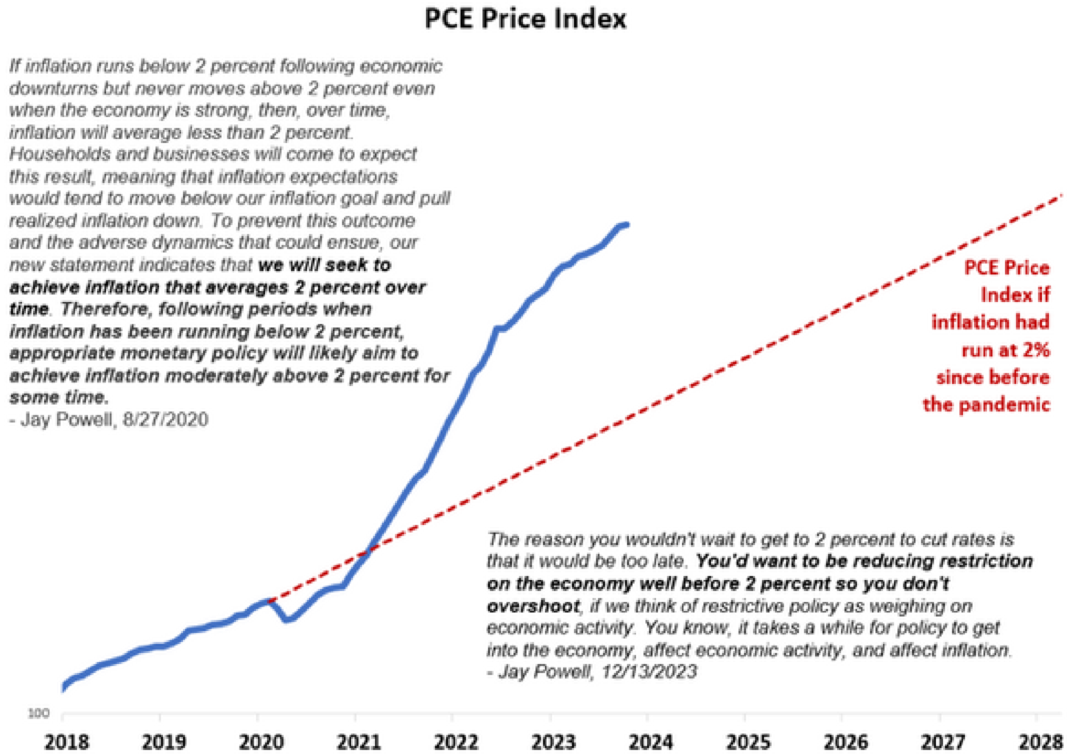
**Probability of specified target range for fed funds rate at future Fed meeting dates based on current fed funds futures contract prices as calculated by CME.*

The inflation-adjusted fed funds rate has historically topped out at 3% or greater. Policymakers don't appear to want it to get that restrictive this time.

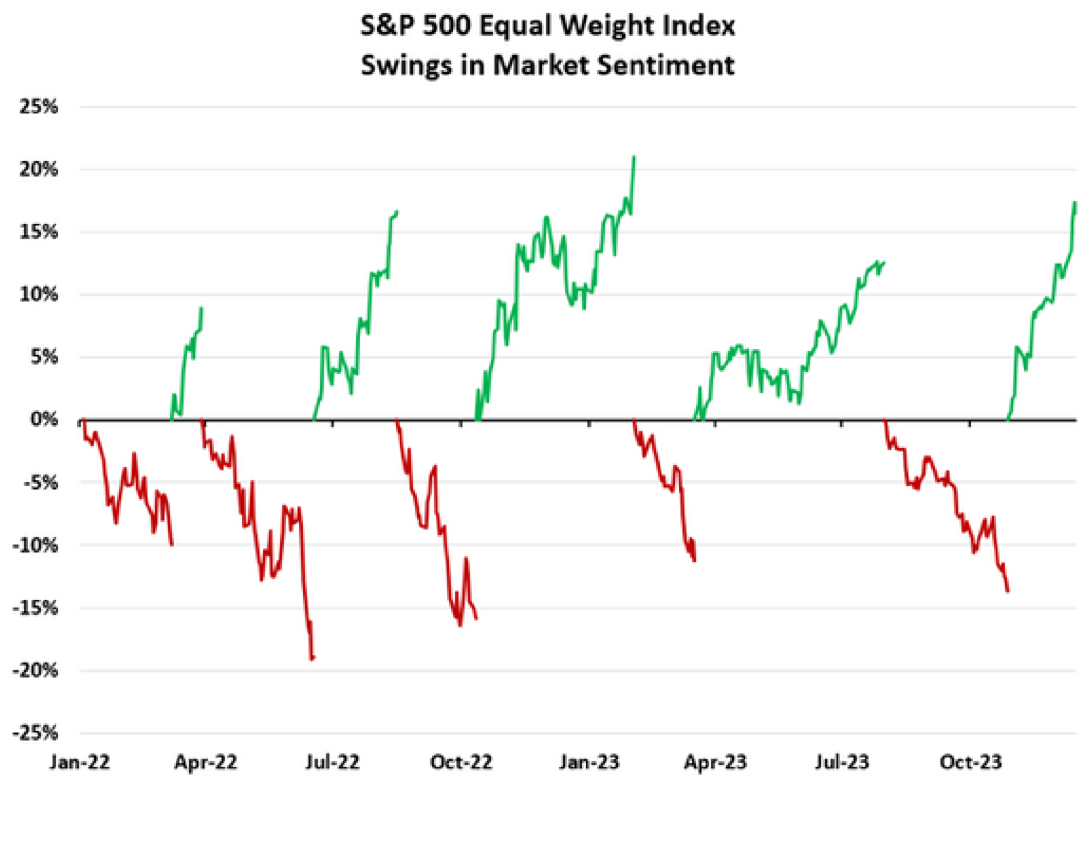
Nominal and Inflation-Adjusted Fed Funds Rates



By Jay Powell's stated logic, it's OK for the Fed to overshoot 2% inflation after it has been below 2%, but it's not OK to undershoot after it has been well above 2%. Thus, policy is effectively biased towards average inflation that is higher than 2% over time with 2% being the targeted lower bound.



Investor sentiment has swung back and forth several times over the past two years. If the market is stuck in a sideways trend, the current uptrend may have largely run its course.



The Market | Santa Claus came to town

December 26, 2023

The end of the year has historically been good to stock investors more times than not, and Santa did not disappoint this year. Since its recent low on October 27, the S&P 500 Index has increased for eight straight weeks - a rare run that it has only exceeded three times in the past sixty years.

The index, which is the most commonly used measure for the US market, is within less than 1% of setting a new all-time high. With investor sentiment having swung carefreely bullish, the market seems poised to set a new high-water mark in the near future.

However, for stocks to head much higher and break their sideways dance of the past two years, the reigning optimism about the economy and inflation will need to be fully realized. This is not a market priced for any hiccups.

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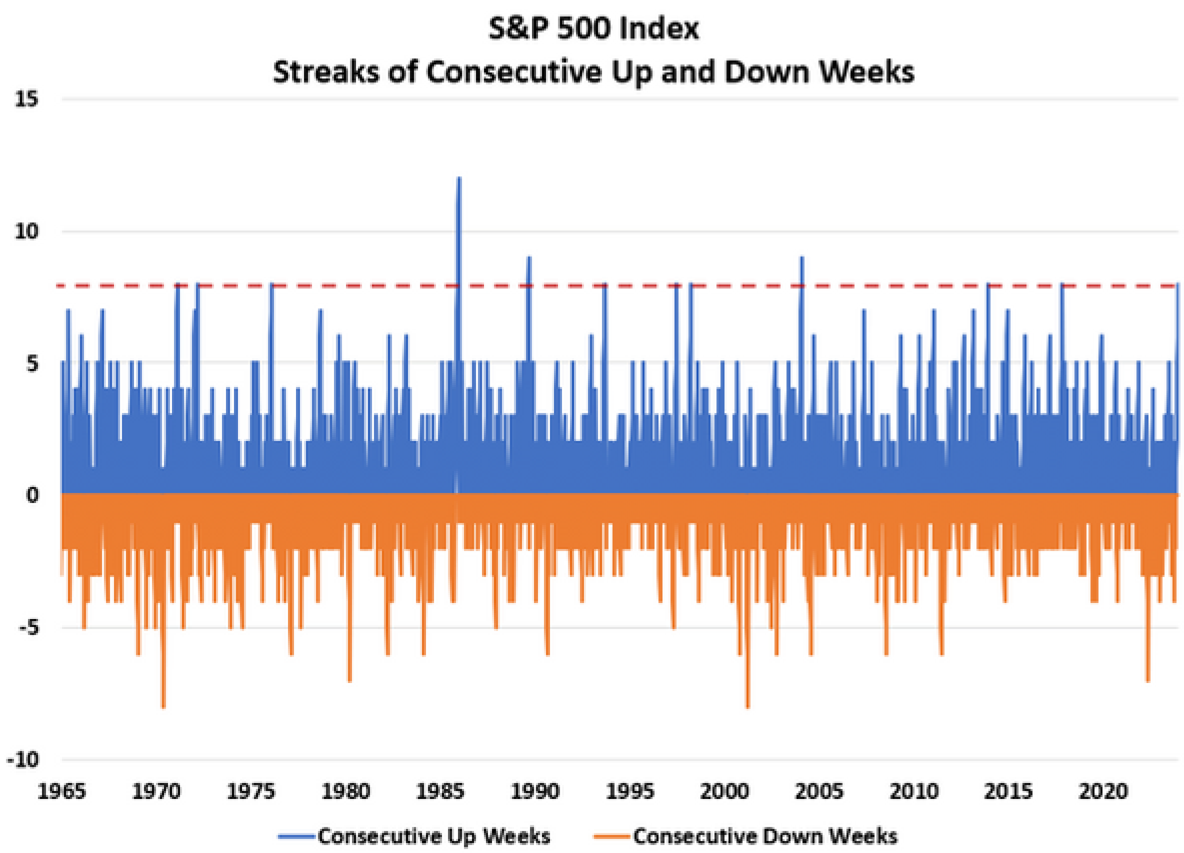
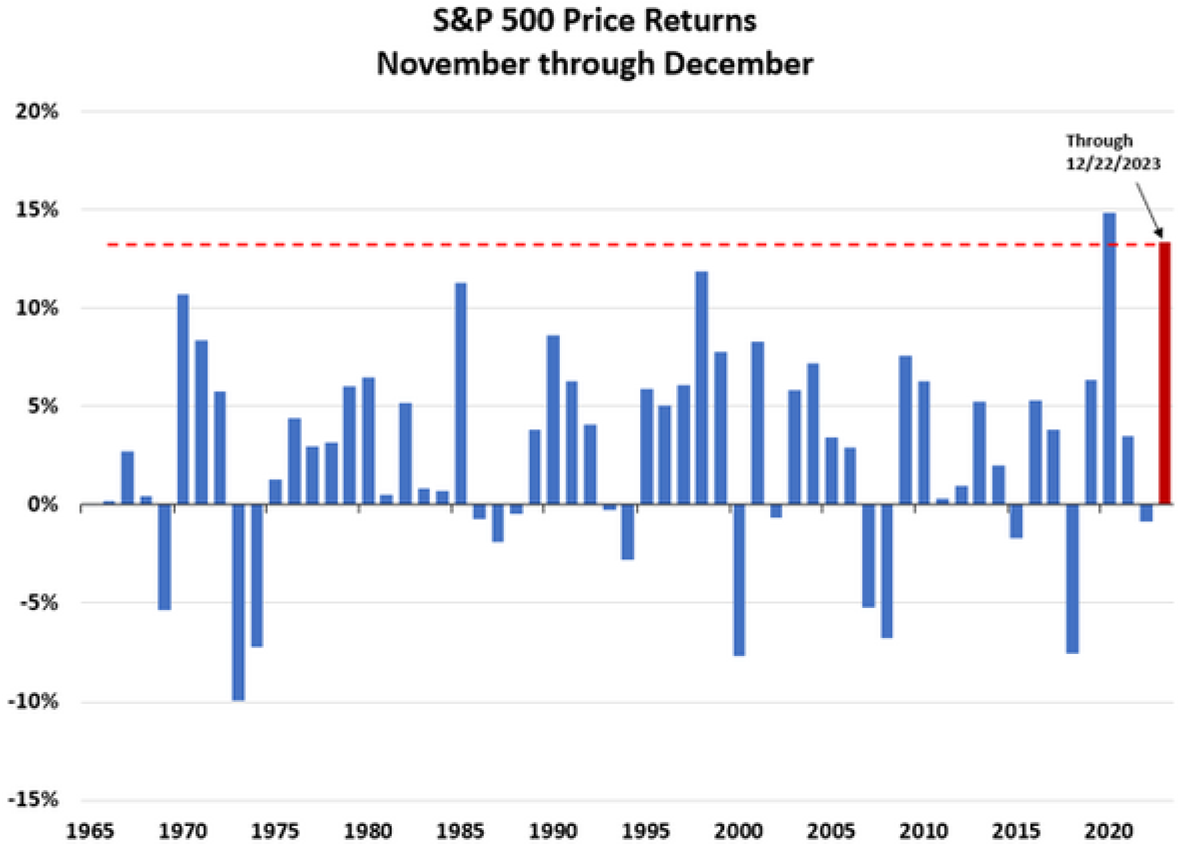
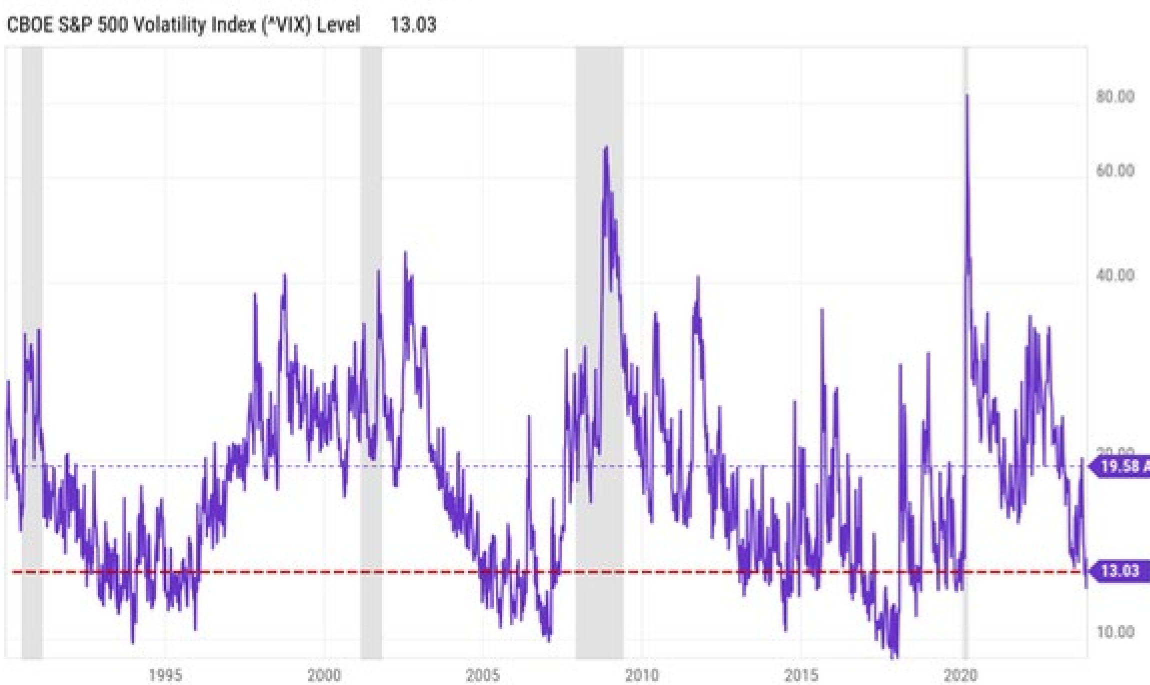


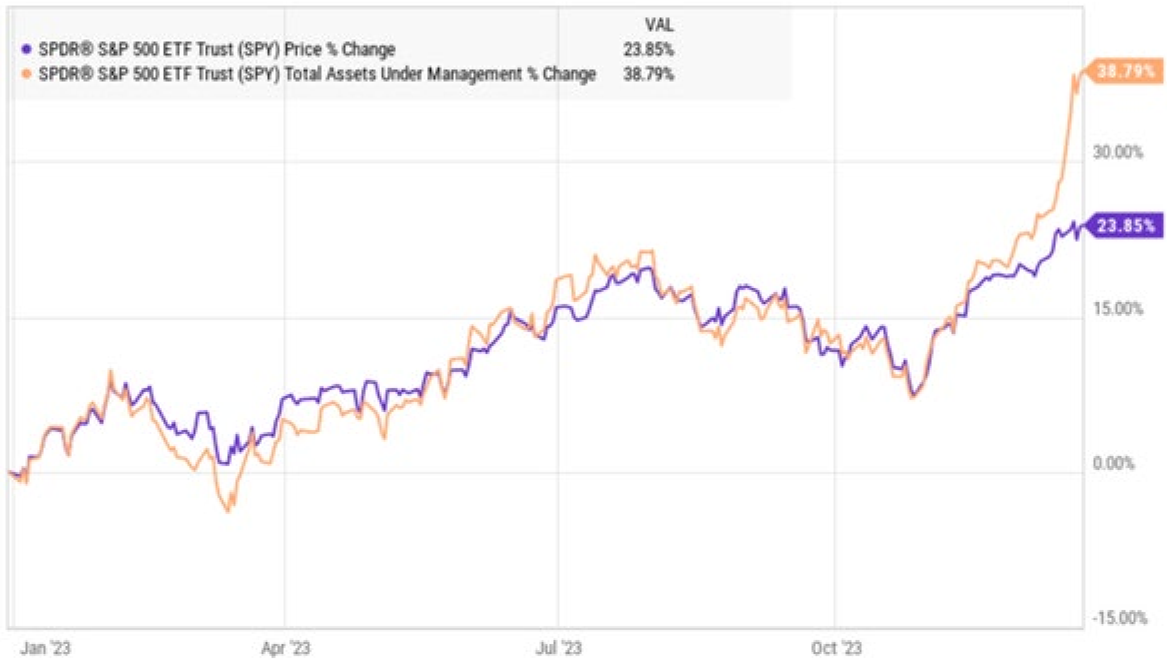
The past two months are also on track to be one of the strongest ends to a calendar year over the past six decades, currently only exceeded by the pandemic bull market in 2020.



Investor sentiment has turned carefreely bullish with the fear gauge of expected volatility at historically low levels.



Another indicator of positive market sentiment, especially for retail investors, is the recent large inflows into the biggest passive ETF tied to the S&P 500 Index.



The past five years has seen two market turning points around year end.

Sources: Ycharts, AOWM calculations

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