Schroeder | Capital Management, LLC
Global Investment

Investment Review and Outlook – Summer 2023

The U.S Economy – Growth is Accelerating:

The U.S. economy is accelerating. This past Thursday, July 27th, the Commerce Department announced that gross domestic product (GDP) grew at an inflation-adjusted 2.4% annual rate in the second quarter, faster than the 2% economists had expected. This followed the final GDP estimate for the first quarter of 2023, revised upward from 1.3% to 2.0%. This surprising growth occurred despite the Federal Reserve's most restrictive monetary actions in four decades. These strong readings add confidence to the notion that the U.S. may avoid a long-threatened recession with hope that the Federal Reserve can orchestrate a "soft landing" for the U.S. Economy.

Supported by a still tight labor market, the consumer continues to spend, particularly on services. Representing 70% of GDP, the consumer sector has been the main cog in the current economic expansion with 60% of GDP centered in household consumption, i.e., durable goods, nondurable goods, and services. Furthermore, housing represents a 35% share of overall household consumption expenditures and has been relatively firm. It should also be noted that the Conference Board's Consumer Confidence Index, which measures and compares how consumers view the overall economy, business conditions and the labor market over the next six months, climbed in July to a two-year high.

In the months to come, however, the consumer may be put to the test as COVID-19 stimulus enhanced savings accounts contract, and higher lending rates deter consumers from seeking loans for durable goods and mortgages. There have also been some red flags recently such as lackluster June retail sales data and historically high credit card debt that is financed at higher rates. These may be warning signs that may eventually cause consumers to reduce discretionary spending.

The labor market is still strong but there were aspects of the recent Labor Department's June report that Federal Reserve officials find troubling. Specifically, the unemployment rate fell to 3.6% from 3.7% in May that indicates workers are successfully finding new employment. Also, we have seen a series of weekly initial unemployment claim declines since mid-June. In addition, the average hourly wage increased 0.4% in June and was up 4.4% over the recent 12-month period. This suggests employers are more competitive on the salary front to attract workers they need, putting upward pressure on wages.

Second Quarter Corporate Earnings Reports – Encouraging:

Second-quarter earnings season got off to an encouraging start. Although business has been difficult for most companies, many have posted better-than-expected results, and investors seem to be anticipating some improvement in the second half of 2023. The consensus is for aggregate earnings for S&P 500 companies to fall 7%, which would mark the third-straight quarterly decline.

Most importantly, the results from the big money center banks did not show elevated signs of stress in the financial system, given the early spring turmoil for the regional lenders. Those results included profit gains and minimal red flags, such as abnormally large increases in loan loss reserves, which are accounts created to provide capital for potential loan defaults. This development calmed worries about any near-term banking crisis, but with interest rates still on the rise, the resultant impact on the health of the overall financial system is being watched closely.

Inflation – Trending Lower:

As the economy continues to advance, the inflation outlook continues to improve. This was reflected in the June price data, which showed slowing inflation on both the consumer and producer (wholesale) levels. On a 12-month basis, the Consumer and Producer Price Indexes were down notably from 2022 highs, with the latter near the Federal Reserve's target growth rate of 2.0%.

The Bureau of Economic Analysis (BEA) reported that during the month of June, the personal consumption expenditures (PCE) index was up 0.2%, matching economists' estimate and above the prior-month advance of 0.1%. On a year-over-year basis, however, the PCE slowed to a 3.0% rate from 3.8% in May and down meaningfully from 4.3% in April, the lowest in two years. Core PCE, excluding the volatile food and energy sectors, displayed a gain of 0.2%, monthly, and advance of 4.1%, annually, which was generally in line with expectations and more modest than the month-ago figures. Importantly, core data information is a key focus for the Federal Reserve in its interest-rate setting policy. On balance, PCE inflation is headed in the right direction.

The Consumer Price Index (CPI) for June came in at 0.2%, compared with the 0.3% estimate. On a year-over-year basis, the rate was 3.0%, also 0.1% below expectations, versus the May advance of 0.1%. This marked the twelfth-consecutive monthly decline since the index peaked at 9.1% in June of 2022. Gasoline and airline fares fell meaningfully, while the cost of shelter (specifically rent) spiked. The important core CPI rose 0.2% in June, half the prior month's pace. On a 12-month basis, the CPI fell notable from 4.0% in May, to 3.0% in June.

The Federal Reserve – Recent Action and Future Expectations:

This past Wednesday, July 26th, the Federal Reserve increased interest rates by a quarter percent to a range of 5.25%-5.50%, following a brief pause in increases in June. This represented the 11th rate increase since March 2022 and the highest level of rates in 22 years. Chairman Jerome Powell also said that it was too early to determine whether further rate hikes would be necessary.

In March, the Fed had predicted a mild recession during the latter part of 2023 and into 2024. However, along with this past Wednesday's action, the Fed reversed that position. They stated that while a noticeable economic slowdown could still be expected toward the end of the year, the recent resilience of the economy caused them to temper their view and not forecast a recession.

While a "soft landing" for the U.S. economy remains plausible, the central bank is also mindful of overtightening the monetary reins that could further hurt business and consumer loan growth which is essential to economic expansion.

Included in the Fed's formal statement announcing the recent rate increase was the following:

"Recent indicators suggest that economic activity has been expanding at a moderate pace. Job gains have been robust in recent months, and the unemployment rate has remained low. Inflation remains elevated. The U.S. banking system is sound and resilient. Tighter credit conditions for households and businesses are likely to weigh on economic activity, hiring, and inflation. The extent of these effects remains uncertain. The Committee remains highly attentive to inflation risks.

"In determining the extent of additional policy firming that may be appropriate to return inflation to 2 percent over time, the Committee will take into account the cumulative tightening of monetary policy, the lags with which monetary policy affects economic activity and inflation, and economic and financial developments."

Chairman Powell has often said the central bank will be “data driven” in formulating monetary policy and is strongly committed to returning inflation to their 2% objective. The Committee’s assessments will take into account a wide range of information, including labor market conditions, inflation pressures and expectations along with financial and international developments.

Investment Strategy:

The current backdrop for the stock market appears to be relatively positive. In the short term, this has not been lost on Wall Street and has resulted in the upward movement of equity prices during July. The favorable trend of cooling inflation figures largely in this, along with mostly better-than-expected economic data of late. Treasury market yields and the value of the U.S. dollar have also given a boost to cheaper U.S exports and to stocks. A popular perception that growth companies may be more valid investments now than we have seen since pre-pandemic times is also evident. The rather resilient consumer is supporting this view along with a still healthy labor market. Collectively, these factors mitigate concerns about a “hard landing” recession for the U.S. economy over the near term. Whether this view is correct or not will require more time.

Our view is that the economy has experienced a “rolling recession” in several industries for some time, namely housing, consumer durables, financials and some technology segments that are more economically sensitive, along with selected retail categories. As mentioned earlier in this writing, fundamentals within particular segments of our economy have improved nicely in recent months, especially related to consumer spending.

Equities have continued to recover from a very difficult performance in 2022 that saw the heavily index-weighted technology sector get decimated as interest rates rose, company earnings fell and a very real fear of a recession appeared on the horizon. Fortunately, our client portfolios avoided the bloodbath in technology stocks as we were significantly underweighted in that sector.

The equity market rally has been fueled by the strength of the mega-capitalized stocks recovering from last year. Corporate layoffs and downsizing helped these companies’ profitability. Of note, the top 10 companies of the S&P 500, (mostly represented by the top 7 technology companies in the U.S.), comprise 30% of the index. Furthermore, these companies currently trade at historically high valuations and are very susceptible to selling pressure on negative news.

With overall corporate earnings still on the decline, it hasn’t been smooth sailing for some stocks that had been surging in the stock market when they reported disappointing earnings. Also, an ever-present risk in the markets is that the Federal Reserve is maintaining its restrictive monetary stance and the uncertainty as to when interest-rate hiking will be concluded.

We are closely monitoring both valuation levels and the financial progress of securities in our client portfolios. We are very focused on researching portfolio additions that possess very high-quality managements and financials, especially those companies with low debt. Employing disciplines for securities valuation and the qualified selection of future investments has historically enabled us to capture future enterprise value while minimizing the market risk to our client assets.

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