The Quarterly Perspective

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ABOUT

Harman Wealth Management

At Harman Wealth Management, we provide private, advanced, independent planning and investment management to individuals, families, and institutional clients.

We value in-depth economic research, evidence-based investment methods, and rigorous risk management. We are committed to insightful, objective solutions, and always working solely for the best interest of our clients.

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Persistent Economic Growth Defying Recession Expectations…So Far

After taking on the double whammy of hot inflation and rising interest rates, the U.S. economy continues to demonstrate surprising resilience into 2023.

For well over a year now, the consensus economic outlook focused on mounting recession pressures, believing a stark contraction was imminent. Those forecasts were not completely unreasonable. After all, a snapshot from last June would have shown inflation had yet to peak, the Fed was realizing aggressive rate hikes would be warranted, and the world was reeling from a global commodity disruption caused by the Russian invasion of Ukraine.

Yet, here we are. In the face of such immense challenges, job growth has pushed on. GDP growth actually increased in the back half of 2022 and consumers have shown incredible durability.

In light of resilient economic growth, the forecasts for a downturn haven't gone away. For each new month and quarter of growth, forecasters have simply pushed the recession predictions further into the future. With such a disconnect, it is fitting to address a few of the biggest questions now.

How has the Economy Been Able to Avoid a Recession?

Let's be clear, forty-year highs in inflation and interest rate hikes of five percent in just over a year are enormous challenges. This toxic combo was indeed a common force in many prior recessions. So, the real question is, "How have we been able to avoid a recession at all?"

While the past can be insightful, there are a number of unique complexities to the current economy going overlooked.

Perhaps, most of all, there is little recognition that the economy was de-synchronized by the pandemic shutdown and re-opening. By mid-summer 2020, some parts of the economy were seeing enormous demand, while other segments didn't get fully going until 2022. This de-synchronization likely means the U.S. is experiencing a "rolling recession" whereby different sectors of the economy are slowing and recovering at different points in time.

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For example, let's examine residential real estate. With record low mortgage rates in 2020 and 2021, Americans indulged in a huge refinancing and home-buying spree. After mortgage rates spiked last summer, refinancing disappeared and home buying screeched to a halt.

Evidence now points to an emerging rebound in housing. While unrealistic to assume home buying returns to the torrent pace of 2021, the uptick appears to have legs. Sales are rising month-to-month, homebuilder confidence is in a steady uptrend, and permits for new builds are increasing. In essence, it appears as if residential real estate *had* its recession.

(Continued on page 2)

Similar developments were seen in the technology sector (remember those highly publicized layoffs last year?), as well as the financial services and consumer discretionary sectors. For many of these sectors, forecasts for a year ahead show a return to growth.

Is a Recession Still Possible?

Even with surprising durability, the U.S. economy is not in the clear just yet. While some sectors appear to be on the mend, the aggregate slowdown across the economy is clearly not over. According to the ISM purchasing managers index, broad manufacturing has been in contraction since last November.[1] Retail sales look similar, spending thirteen of the last fifteen months in slightly negative territory.[2]

Most concerning is the steady rise in job losers since last September.[3] Over the last half year, job growth has been carried by the sectors last to reopen - health care, education, leisure, and hospitality. Eventually, the *"return to work"* movement will subside. If so, the unemployment rate, which at 3.7% has teetered at sixty-year lows, could easily start to deteriorate.[4]

Under a "rolling recession" scenario, the effects may still be modest though. As some sectors make their downturn, others may be in recovery, essentially, offsetting each other. It may simply lead to an extended "sluggish" economy of low growth while avoiding a deep, correlated recession altogether.

"However, today's economy compares more similarly to earlier recessions that experienced lighter, less severe consequences."

What Does it Mean for Investors?

Over the last three decades, experienced investors have seen three recessions each with their own unique set of calamities. By training, they tend to brace for the worst. However, today's economy compares more similarly to earlier recessions that experienced lighter, less severe consequences.

Notably, today's economy is only three years into the current expansion. Historically, shorter expansions have tended to build fewer excesses that can amplify problems when recessions occur. Likewise, consumers paid down debt ratios during the shutdown period. Yes, they have taken a hit over the last years of inflation, but they are not poised to see a huge pullback in demand.

What about last year's market pullback? Of course, let's not forget that. It is a common belief among investors that markets are "anticipation" machines, both turning down before recessions start and turning up before they are over. With inflation coming down, and the Fed expecting interest rate cuts in the next six to twelve months, perhaps markets are looking through whatever difficulties are left economically and anticipating the next recovery.

Sources:
1 Institute for Supply Management
2 Census Bureau
3 Bureau of Labor Statistics
4 Bureau of Labor Statistics

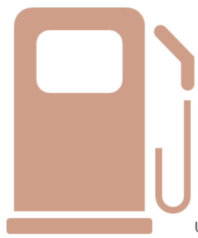
"Last year's peak of CPI at 9.0% is now reporting at 4.0%, and there is a fair chance of dropping into the low 3% range soon."

The Case for Inflation Normalizing Back to 2%.

Is the Fed's goal finally within reach?

After two consecutive years of menacing inflation, worries developed that it would take years for inflation to return to normal. While more work is still yet to be done, a considerable amount of progress has been made. Last year's peak of CPI at 9.0% is now reporting at 4.0%, and there is a fair chance of dropping into the low 3% range soon.(Source: Bureau of Labor Statistics)

Let's explore what's helping:



Gasoline Prices

-26.7%

From one year ago. Prices have stabilized to levels consistent with 2011-2014.

U.S. Energy Information Administration

FUEL PRICES: After peaking above $120 per barrel last June, oil prices have stabilized at remarkably lower levels. For May, crude oil averaged under $71. Because fuel has strong indirect effects on other categories, lower fuel costs also temper inflation in other categories. (Source: U.S. Energy Information Administration)

TRANSPORTATION: Breaking through the backlog in new car production has reduced price pressure across the automotive industry.

Used Cars

-9.4%

*Manheim Used Vehicle Value Index

Zillow Observed Rent Index

+4.8%

Annual Change... after peaking at 17% in February 2022.

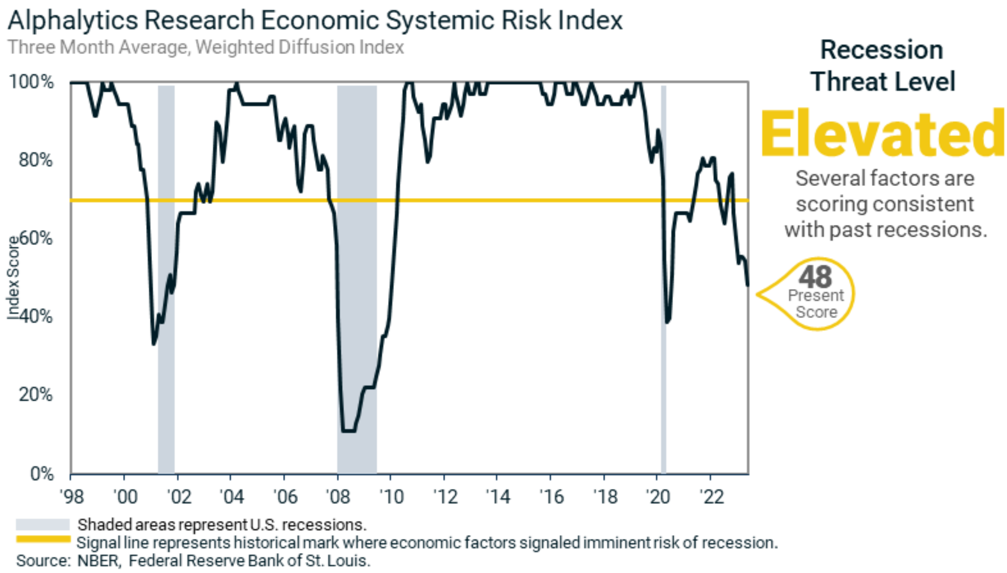
HOUSING: Housing costs have been the largest problem component for inflation calculations. Why? Because housing carries a large proportionate weight of the CPI metric and it severely lags.

Alternative data shows that housing inflation peaked well more than a year ago, but it is just showing up in the Fed's numbers now. That data also suggests that housing inflation is coming down rapidly, offering hope that the Fed's metrics will also show that same decline over the coming year.

"Renewed home building and buying may assist the recovery in durable goods and manufacturing."

Business Cycle Risk Profile

- As cautioned since last summer, the index value reflects an elevated risk of a recession to the U.S. economy.
- Early warning signals related to inflation have subsided. Late warning signals related to employment recently triggered over the last two months.
- The rebound in housing is apparent. Renewed home building and buying may assist the recovery in durable goods and manufacturing.
- The Fed may raise interest rates one-to-two more times before the end of 2023. Already, the Fed is expected to decrease rates four times in 2024.
- Real GDP for the 1st quarter reported at 1.3%. Expectations from the Federal Reserve of Atlanta are suggesting 2nd quarter GDP reports at 1.8%



Interpreting the Index Score:

- The index score measures nine economic factors that have demonstrated co-movement with the deteriorating conditions of the past seven recessions dating back to 1970.
- When the index score is at 100, it means all nine of the factors are measuring at levels consistent with past economic expansion.
- When the index score is below 100, it means that one or more of the weighted factors has moved to a level consistent with past economic contractions.
- In aggregate a score of 70 or higher is interpreted as a composite profile consistent with past economic expansion. A score lower than 70 is interpreted as a composite profile consistent with past economic contraction.
- Markets can, and sometimes do, demonstrate volatility even though the economic factors are measuring consistent with expansion.

Interested in Adaptive Business Cycle Investing?

Today's markets, economies, and policies are more complex than ever, challenging investors on what to watch and when to take action.

At Harman Wealth Management, we understand sound investments are uniquely supported by the conditions that favor them. And, when conditions change, so do the investments that benefit.

That's why we conduct rigorous and disciplined tracking of the U.S. business cycle. We also track the cyclical factors that shape our investing environment, like currencies, commodities, and rates. We embrace a world where investing dynamics are constantly evolving and believe it's imperative to have an investment strategy that adapts with it.

With Adaptive Business Cycle Investing we invest consistent with business cycle forces, aligning investments with the conditions driving returns in the present, rather than chasing what worked in the past.

About Harman Wealth Management

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We value in-depth economic research, evidence-based investment methods, and rigorous risk management. We are committed to integrative advanced planning by aligning investment objectives with business cycle opportunities and risks.

At Harman Wealth Management, our aim is to help clients realize their goals within a disciplined, insightful, and rewarding relationship.

For more information about Harman Wealth Management or investing with the business cycle, contact us at 281-719-8601.

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Investing involves risk including the potential loss of principal. No investment strategy can guarantee a profit or protect against loss in periods of declining values. Past performance is no guarantee of future results. There is no guarantee that a diversified portfolio will outperform a non-diversified portfolio in any given market environment.

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In general, the bond market is volatile as prices rise when interest rates fall and vice versa. This effect is usually pronounced for longer-term securities. Any fixed income security sold or redeemed prior to maturity may be subject to a substantial gain or loss. Bonds are also subject to other types of risks such as call, credit, liquidity, interest rate, and general market risks.

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