Winter 2024

The Quarterly Perspective

Fed Weighing Interest Rate Cuts as Progress on Inflation Continues

Policy Leaders Deliberate on "When," not "If" For Lowering Rates

As markets move into 2024, the reverberations of pandemic policy still continue. Fortunately, though, the issue now is how policy leaders retreat from measures to fight inflation and steer the economy back to something resembling normal.

After global disruptions and overly accommodative policy catapulted inflation to 40-year highs, leaders were forced to respond aggressively. Over the course of 2022 and early 2023, the Fed adjusted interest rates at an accelerated pace also not seen in over 40 years.

But, finally, normalization seems to be at hand. No, It doesn't mean a return to 2019 prices. Correcting inflation doesn't work that way. Instead, it means the pace of economic changes, moving month-over-month and year-over-year, are now moderating. The recent development offers support for the Federal Reserve to begin cutting restrictive interest rates and bring them back down to neutral levels.

The debate ahead is not really about *"if"* rates should go lower, but rather *"when"* they should commence. As outlined below, the case is mounting. If trends hold, it will be very difficult to defend not making cuts by mid-year.

Core PCE Inflation Drawing Closer to Target Range

Perhaps the strongest case for cutting rates comes from the Fed's own preferred metric for inflation, the PCE Index (i.e. personal consumption expenditure). On an annual basis, it now sits at 2.9%.[1] However, the last seven months have been even better. Since May, the run rate for PCE, excluding food and energy, is moving at an annualized pace of 1.7%.[2]

In the context of bringing down inflation to 2.0% (the Feds' stated goal), it looks like things are moving on track. A look ahead shows that three of the next four months should also see reliable declines. If it truly materializes, the Fed could be looking at 2.0% when the April PCE report gets delivered in late May.

> *"However, the last seven months have been even better. Since May, the run rate for PCE excluding food and energy is moving at an annualized pace of 1.7%."*

Labor Markets are Balancing

Strong distortions in the labor market were also blamed for contributing to inflation, but now seem to be resolving. Initially, demand surges coupled with ongoing restrictions led to significant gaps in the workforce. Matters were further complicated as retirements accelerated. Ongoing impediments to legal immigration also slowed workforce growth. The net result feed wage increases which ultimately were passed on to consumers.

Huge progress was seen in 2023. While higher interest rates slowed consumer demand, the real progress was in labor force participation. The last two years recorded the highest number of labor force participation growth since the late 1970s at the peak of boomers entering the workforce. [3]

(Continued on page 2)

AUTHOR

Christopher Riggs, JD, CFP®

Christopher Riggs leads portfolio strategy and research for Harman Wealth Management. He writes extensively about the economy and markets. His responsibilities include macroeconomic analysis, portfolio construction, and leading the HWM investment committee.

Along with the founder of Harman Wealth Management, Dean Harman, Riggs also heads Alphalytics Research, a subscription-based research service to investment professionals across the U.S. The service emphasizes rigorous and robust data analytics in the context of the U.S. business cycle.

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.

CONTACT US

HARMAN
1725 Hughes Landing Boulevard
Suite 1250
The Woodlands, TX 77380
Phone: (281)719-8601

www.harmanwealth.com

"For 2024, normalizing means the flow from producers to consumers no longer has major kinks that cause upward mispricings."

"Surprising economic strength is slowing the urgency for cuts, but all in all, that's not a bad development."

"Nonetheless, the Fed's "soft landing" is emerging. In the big picture, a return to normal is a return to stability and seasoned investors understand that patience is rewarded in the long run."

Nonetheless, more progress is needed. Even modest estimates show the workforce is still at least one million workers short. Likewise, surveys show job openings are relatively high. The Fed will be cautious on this front considering the potential to reignite a new inflation trend driven by escalating wages.

Supply Chains are Smoothing

Remember the empty new car lots of 2021? Yes, it was merely representative of the massive supply chain interruptions that fed inflation.

The good news for 2024 is supply chains are returning to normal functioning. Upon seeing the word "normal" many frustrated consumers will quickly point out prices are nowhere near the "normal" levels of 2019 (and they are right). For 2024, normalizing means the flow from producers to consumers no longer has major kinks that cause upward mispricings. In some regard, the Fed has given more credit to the smoothing of supply chains for the path of inflation coming down than anything else.

What Does it Mean for Investors?

For those wanting rate cuts quickly, the test will be patience. The reality is that rate cuts may not come as soon nor as sizeable as hoped for. Inflation's downward path will still likely be bumpy. Surprising economic strength is slowing the urgency for cuts, but all in all, that's not a bad development. Nonetheless, the Fed's "soft landing" is emerging. In the big picture, a return to normal is a return to stability and seasoned investors understand that patience is rewarded in the long run.

Sources:
1 U.S. Bureau of Labor Statistics
2 Ibid
3 Bureau of Labor Statistics (BLS)

Consumer Sentiment Still Downbeat, Despite Low Unemployment and Improving Markets

Americans Still Adjusting to Inflation Damage

"…Americans are still in the doldrums when it comes to perceptions of the economy."

Despite progress on the inflation rate and unemployment rates hovering at the lowest levels of the last fifty years, Americans are still in the doldrums when it comes to perceptions of the economy. The disconnect is unusual but offers some insight into the long-lasting negative impact of inflation. Considering the following:

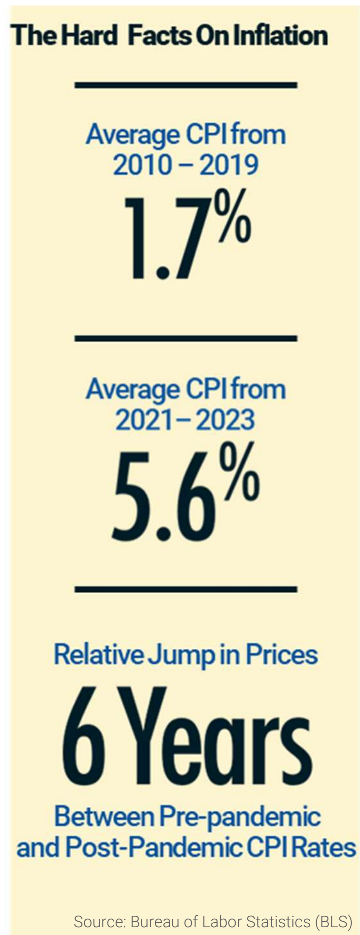
The "Good"

- The unemployment rate is at 3.7% which is considered an economy at "full employment".[1]
- The unemployment rate is lower than every other period since the 1960s except for a brief window in 2019.[2]
- Because of the strong labor market, household incomes have been increasing faster than inflation since the third quarter of 2022.[3]
- Since the bear market bottom in October of 2022, the S&P 500 has fully recovered from its prior high, and has been up eleven of the last sixteen months.[4]
- Real GDP ended the 4th quarter up 3.1% year over year, far higher than the expected pessimistic forecast of a year ago.[5]

The Downtrodden

- According to Gallups' Economic Confidence Index from January, 74% of participants considered current economic conditions as "fair" or "poor." That stands in stark contrast to the same survey from January 2020, when 62% scored the economy as "Excellent/Good."[6]
- Likewise, when asked about the future outlook, 63% saw the economy as "getting worse."[7]
- The University of Michigan Consumer Sentiment Survey, with 70 years of history, published similar findings. Fourth quarter scores were in the lowest 7th percentile since 1955.[8]
- The Gallup index also showed that 63% of respondents are still saying rising prices are causing moderate to severe financial hardship for their household.[9]

"The Gallup index also showed that 63% of respondents are still saying rising prices are causing moderate to severe financial hardship for their household."



Sources:
1 Bureau of Labor Statistics (BLS)
2 Ibid.
3. U.S. Bureau of Economic Analysis
4 S&P Dow Jones Indices LLC
5 U.S. Bureau of Economic Analysis
6 Gallup
7 Ibid
8 University of Michigan
9 Gallup

Investment Wisdom from Warren Buffet's Right-Hand Man

Investing legend Charlie Munger passed away in November at age 99.

Billionaire investor, Charlie Munger, was best known as Warren Buffet's right-hand man, but he carved out well deserved reputation all on his own. Both men originated from Omaha, but Charlie was six years older than Warren. The two never met as kids even though Charlie worked at Buffet's grandfathers' grocery store as a teeneager. Although Munger was less well-known, he was equally as brilliant. He served as Vice Chairman for Berkshire Hathaway for forty-five years and passed away last November at the age of 99

Charlie was highly regarded for his remarkable wit and was truly a student of investment wisdom. Here are some of the favorites:

"It is remarkable how much long-term advantage people like us have gotten by trying to be consistently not stupid, instead of trying to be very intelligent."

"Go to bed smarter than when you woke up."

"There is no better teacher than history in determining the future… There are answers worth billions of dollars in a $30 history book."

"You don't have to be brilliant, only a little bit wiser than the other guys, on average, for a long time."

"I try to get rid of people who always confidently answer questions about which they don't have any real knowledge."

"Those who keep learning, will keep rising in life."

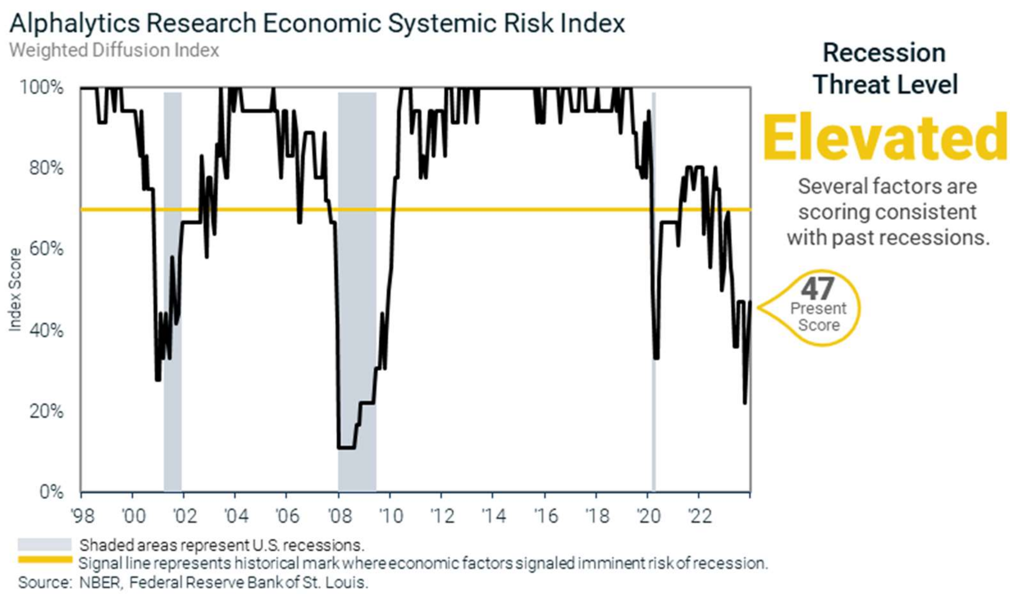
"The big money is not in the buying and the selling, but in the waiting."

Source: Poor Charlie's Almanack: The Essential Wit and Wisdom of Charles T. Munger (2023)

"Real GDP surged in the back half of 2023, coming in at +4.9% and +3.3% for the 3rd and 4th quarters.

Business Cycle Risk Profile

- The latest index value reflects the pre-existing recession risk that has been acknowledged since the spring of 2022.
- Four of the nine underlying inputs are flagging.
- Assuming the economy has experienced a rolling recession, it looks like the worst of the economic slowdown is behind us.
- Real GDP surged in the back half of 2023, coming in at $^+$4.9% and $^+$3.3% for the 3rd and 4th quarters.
- Slowdowns emerged in housing, technology, transportation, and manufacturing, but each sector appears poised for a return to growth in 2024.
- The Fed planned rate cuts will help both business activity and investors sentiment in the back half of 2024.



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

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 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.