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SECOND QUARTER 2023 OUTLOOK

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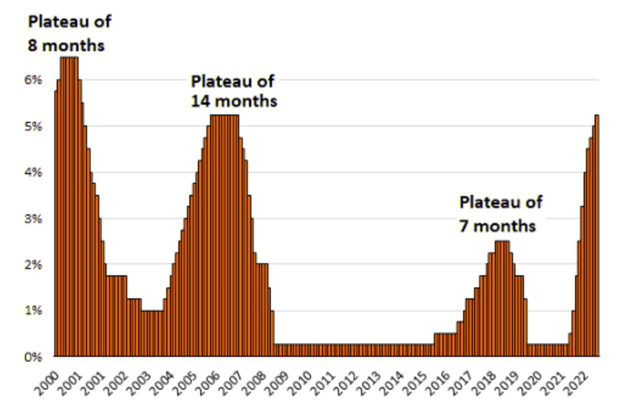
Fed Dancing Between Raindrops by Fighting Inflation

While Trying to Avoid an Economic Hit

Act One of the hiking cycle likely ended with the Fed increasing its funds rate by 25 bps to 5-5.25 percent which will likely prove to be its peak/terminal rate. Time will tell whether this will prove one hike too far. Act Two will likely prove more difficult for the Fed as it attempts to dance between the raindrops by lowering inflation, while at the same time, avoiding an economic hit. This difficult balancing act will test the Fed's willingness to keep its funds rate steady to fight inflation until at least year end even if the economy turns down sooner. During the most recent three tightening cycles, once its funds rate peaked, the Fed held at that level between 7 and 14 months (see Figure 1). No doubt, in a presidential election cycle, political pressures will build on the Fed to quickly lower rates if the economy slows.

Time Between Peak Rate and First Cut

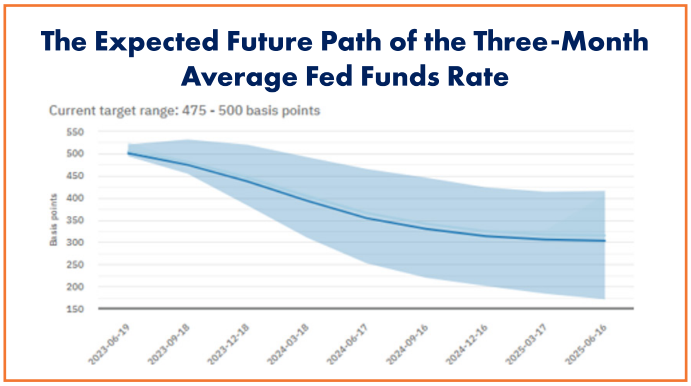


(FIGURE 1) Source: Bureau of Economic Analysis, Bureau of Labor Statistics, Federal Reserve

Dancing Between the Raindrops

Financial Markets Expect Funds Rate Cut by Year End

Contrary to the Fed's view, financial markets anticipate a funds rate cut of 75-100 bps to occur during the second half of this year (see Figure 2). More than likely, financial markets' expect last year's rapid and steep rate increases will result in a deeper economic slowdown than the Fed assumes. In agreement with the financial markets, roughly two-thirds of economists look for a recession beginning in the next 12 months – how deep varies. More optimistic, Goldman Sachs Economic research gives only a 35% probability for a recession. With all three major equity indices up for the year, equity market investors still seem to show less concern for a potential major economic slowdown. Perhaps, equity investors may be responding to increased earnings estimates looking out into 2024.

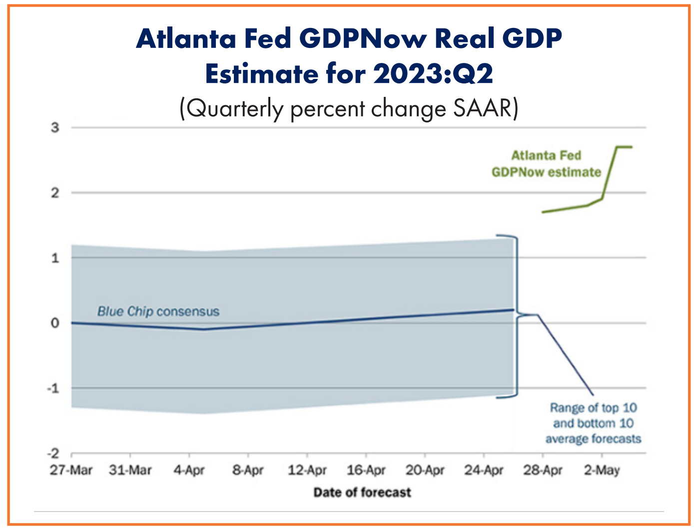


(FIGURE 2) Source: Federal Reserve of Atlanta

Second Quarter GDP Growth

Likely to Reflect Slowing Consumer Spending

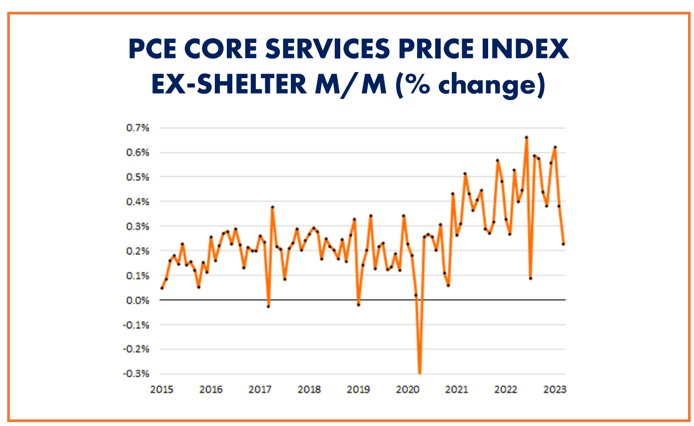
The first reading for U.S. GDP showed first quarter growth slipped from 2.6% in the fourth quarter to 1.1% (SAAR). Despite the slow GDP growth, consumer spending grew 3.7% in the first quarter contributing nearly 2.5% to GDP growth. Even with the first quarter consumer spending surge, nearly all of it came in January. The last two months of the quarter actually showed negative real consumer demand growth. With such short notice of a consumer demand surge in January, producers and retailers dug into their inventories to supply that surge. Meeting demand out of inventory rather than new orders acted as a 2.5% drag on GDP growth. Normally, when inventories supply a major part of consumption demand in a quarter, in the next quarter, production should step up to help producers and retailers rebuild their inventories and boost GDP. However, with consumption dropping off, the current quarter may receive much less of a boost from inventory rebuilding. Initial second quarter GDP estimates from the Atlanta Fed's GDPNow model show a forecast of 2.7% growth. In the same report, Blue Chip consensus estimates for second quarter GDP growth range roughly from plus or minus 1% (see Figure 3). With consumer spending slowing, it seems likely that the GDPNow forecast will pullback under 2%.



(FIGURE 3) Source: Federal Reserve Bank of Atlanta, Blue Chip Economic Indicators and Blue Chip Financial Forecasts

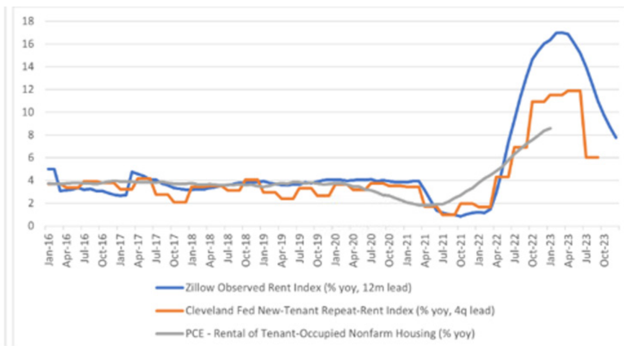
Services and Shelter Inflation Trending Lower

Core Services ex-shelter receives a great deal of focus from the Fed for the very simple reason that it contributes to roughly half of the core Personal Consumption Expenditures Price Index (PCE). Therefore, the Fed should be pleased by the recent three-month downward trend for the core services component – reducing pressure on the overall PCE Price Index (see Figure 4). Shelter prices, a second major component of the price indices, should also begin trending lower in the second half of the year from their current upward trends. Shelter prices indices lag by 12-13 months changes in the rental and housing markets (see Figure 5). This proves important with shelter prices contributing roughly one-third of the CPI and 15-20% of the PCE Price Index. Recently released forecasts from the Richmond Fed predict rapid shelter price declines through the fourth quarter of 2023. The potential for stabilizing inflation later this year would provide a key positive influence on consumer attitudes, business planning, and economic forecasts.



(FIGURE 4) Source: Bureau of Economic Analysis, WOLFSTREET.com

**Market Rent Indices vs.
PCE Rent Price Index**



(FIGURE 5) Source: Zillow, Federal Reserve Bank of Cleveland, Bureau of Economic Analysis via Haver Analytics

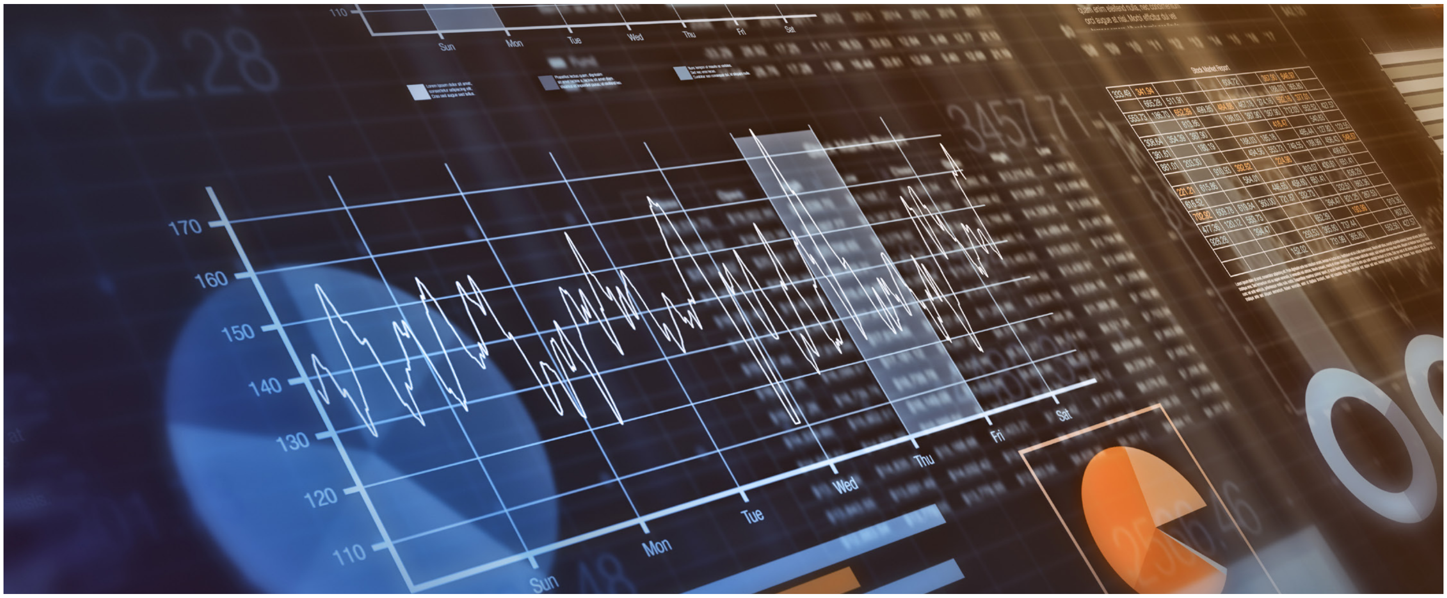
Investment Conclusions

Equity Markets

Timing of Peak Short-term Rates Key to Financial Markets — The economist, Milton Friedman, theorized that monetary policy impacts demand and inflation with "long and variable lags." That theory will now be tested over the next 12 months as the economy meets the reality of last year's series of steep Fed funds rate increases. The impact may be happening with the ebbing of service and shelter inflation. We will also shortly know whether the Fed went too far by increasing its funds rate in the face of a possible recession. Financial market history shows that on average, equity markets bottom roughly six months after short rates peak. Ultimately, financial market performance will depend on whether the economy retreats into a recession or a more favorable soft landing.

Fixed Income

"Income" in fixed income now carries real meaning – As 2023 progresses, lengthening bond duration, by degree, will likely prove increasingly attractive when and if the economy slows and inflation comes down from its current elevated levels. Alternative investments can also be used for that portion of the portfolio historically committed to fixed income; alternatives tend to be less correlated with stocks and bonds. That diversification will also prove particularly valuable with the current investment uncertainties.



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The S&P 500 Index is a market-capitalization-weighted index of the 500 largest U.S. publicly traded companies by market value, the index is widely regarded as the best single gauge of large-cap U.S. equities.

The Russell 1000 Value Index measures the performance of those companies in the Russell 1000 Index with lower price-to-book ratios and lower forecasted growth values. The Index is calculated on a total return basis with dividends reinvested and is not assessed a management fee. It is not possible to invest directly in an index.

The Russell 2000 index is an index measuring the performance of approximately 2,000 small-cap companies in the Russell 3000 Index, which is made up of 3,000 of the biggest U.S. stocks. The Russell 2000 serves as a benchmark for small-cap stocks in the United States.

The Russell 2500 Index is a broad index, featuring 2,500 stocks that cover the small- and mid-cap market capitalizations. The Russell 2500 is a market cap-weighted index that includes the smallest 2,500 companies covered in the Russell 3000 universe of United States-based listed equities.

The MSCI World Index captures large and mid-cap representation across 23 Developed Markets (D.M.) countries. With 1,633 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country.

The MSCI EAFE Index is an equity index which captures large and mid-cap representation across 21 Developed Markets countries around the world, excluding the U.S. and Canada. With 920 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country.

The MSCI Emerging Markets Index captures large and mid-cap representation across 24 Emerging Markets (E.M.) countries. With 1,125 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country. An index is a portfolio of specific securities, the performance of which is often used as a benchmark in judging the relative performance to certain asset classes. Indexes are unmanaged portfolios and investors cannot invest directly in an index. An index does not charge management fees or brokerage expenses, and no such fees or expenses were deducted from the performance shown. Past performance is not a guarantee of future results.

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