Summary

Economic data for the week included a revision downward for U.S. Q2 GDP, as well as improved but still negative ISM manufacturing. Housing results were generally positive, from the standpoint of home prices and pending sales. Labor market data was mixed, with continued signs of slowing, but remaining decent.

Global equities experienced gains, with U.S. stocks outperforming most foreign with benign economic, inflation, and interest rate news. Bonds rose along with a pullback in interest rates. Commodities were led higher by crude oil and industrial metals.

Economic Notes

(0/-) The second edition of **U.S. GDP for Q2** was revised from 2.4% in the first release downward to 2.1%, versus expectations for no change. The adjustment was due to revisions lower for private inventory investment and non-residential fixed investment, offset by stronger state/local government spending. The PCE price index was also revised a tenth higher each for headline and core, ex-food and energy, to annualized rates in Q2 of 2.6% and 3.8%. After the two consecutive negative quarters in Q1-2022 and Q2-2022, the GDP growth range for the past year has steadied between 2.0-3.2%, a bit above the long-term expected pace.

The Atlanta Federal Reserve's GDPNow measure for Q3-2023 is showing a robust (to say the least) estimate of 5.6%. The Blue Chip economist forecast shows a more reasonable median expectation of about 2.5%, within a range of about 1% to 3.5%. While it's difficult to find a mainstream economist estimate anywhere near 5-6%, the Fed's modeled estimate is based on data releases so far, which include a 2.9% contribution from still-strong consumer spending (although down in recent weeks), a 1.3% rise in private inventories (which tends to have a mean-reverting quality), as well as gains in other areas, such as government spending, and fixed investment (non-residential and even residential, the latter of which had been a detractor). It's obvious that the overall pace of growth continues to hinge on the strength of the consumer; unfortunately, other data has been pointing to record-high and rising credit card balances, making this growth source a bit more tenuous. This remains a key reason why the odds of recession in the next 6-12 months have not faded completely, with classic indicators still pointing to high odds of stress.

Now that we're into the hurricane season and considering recent conditions in the Southeastern U.S., natural disasters have a mixed impact on the economy. In the most current case of Hurricane Idalia, the preliminary estimated damage of $15-20 bil. (as reported by AccuWeather) is about a tenth as much as that of Hurricane Ian last year. These events vary dramatically, as any shutdown, like the extreme case during the pandemic, obviously creates a lack of business activity. Even a short-term regional pause from a storm can reduce national GDP growth in the quarter it happens to some extent. Ironically, at the same time, rebuilding from a natural disaster has been a 'positive' for growth, resulting from the production of goods and employment created in subsequent quarters of recovery (notably as destruction of property doesn't subtract from GDP). This has been particularly noted after hurricanes, earthquakes, and other catastrophic events, especially in the U.S., but even in the emerging world—all dependent on the ability of the region to procure funds to implement the rebuilding efforts. On a more negative note, insurance underwriters have become increasingly more reluctant in providing coverage for hurricanes, flooding, and earthquakes. This is due to a rising frequency but also higher construction and personal property costs, as charged premiums can't keep up enough to make business sense for the insurers. Some of these costs may end up falling on the Federal government, which also ends up as GDP growth.

(0/+) **Personal income** rose by 0.2% in July, a tenth below the prior month and the 0.3% median forecast, driven by a 1% rise in rental income and decline in transfer receipts. **Personal spending** rose 0.8%, two-tenths stronger than in June, and a tenth better than expectations. Spending on services over the past year remains up over 8%, more than twice that of goods, and positive by several percent in 'real' terms. The personal saving rate

fell by -0.8% to 3.5%. The PCE price index for July rose 0.2% on both a headline and core level, which brought headline PCE up slightly year-over-year to a rate of 3.3%, while core rose just over a tenth to 4.2%. These were in keeping with expectations, with the rises due to base effects from last year.

(0) The **ISM manufacturing index** for August improved upward by 1.2 points to 47.6, ahead of expectations calling for 47.0. Growth was seen in five of the 18 industries, including defensives, such as alcohol/tobacco, as well as petroleum/coal and transportation equipment; the other 13 sectors declined, led by cyclical segments like furniture, plastics, and metals. By composition, production rose several points to neutral (level of 50), while employment and prices paid improved, but remained in contraction. Closely-watched new orders fell a half-point, further into contraction. Overall, this index reflects continued stress in the manufacturing sector, with a reset in inventories continuing, although there are few signs of deeper worsening in end demand.

(0/+) **Construction spending** rose 0.7% in July, just above the 0.5% expected, and similar to June's pace. Private spending in both residential and non-residential both increased, the former more than the latter. While public residential spending rose sharply, this was offset a bit by the public non-residential segment. However, as construction costs rose nearly a percent in the month, the 'real' spending result in the month was negative.

(+) The **S&P Case-Shiller 20-city home price index** for June saw a gain of 0.9%, a tenth higher than expected, on a seasonally-adjusted basis. Every city in the index experienced gain in the month, led by rises of 1.0-1.5% in San Diego, Seattle, and New York. Year-over-year, the national index improved by a half-percent to -1.2%, and just -0.1% under the peak level a year ago on non-seasonally-adjusted basis. (Seasonal adjustments are dramatic in real estate to compensate for the busy summer selling season.) Home prices have fared better than expected, not following a pattern downward one might see during a recession, which has been helped by inventories staying tight. At the same time, the lack of price relief has tightened housing affordability conditions further, from not only expensive houses but still-rising 30-year mortgage rates in the 7.5%-ish range. Buyers are forced to absorb this extra expense, but something has to eventually give, notably with student loan payments turned back on, implying that discretionary spending is the area that will have to take the brunt of what gets cut first. On the fringe, this tends to be restaurants, travel, etc., which have been sustaining the 'services' segment of the economy upward thus far. Should this reduced buying power begin to build, it might be reasonable to assume a toll would be taken on broader economic spending.

(+) The broader **FHFA house price index** for June rose 0.3%, a tenth higher than expected. By census division, New England led with a 2% gain, while East North Central (upper Midwest, WI to OH) fell by nearly a half-percent. On a year-over-year basis, the series accelerated by another 0.2% from the prior month to 3.1% on a seasonally-adjusted measure. This survey points to continued strong home price stability, granted this survey includes non-urban areas as well, which have tended to see fewer price fluctuations.

(+) **Pending home sales** rose 0.9% in July, exceeding expectations of a -1.0% decline. Regionally, the West saw a gain of over 6%, while the Northeast fell by an equivalent amount. Year-over-year, pending sales improved by about a percent to a -14% rate. The monthly strength potentially bodes well for existing home sales in the next few months.

(-) The Conference Board's **consumer confidence** index for August fell -7.9 points to 106.1, compared to a higher 116.0 level expected. Assessments of both current conditions and future expectations fell at similar rates, and the labor differential declining about half as much. Per the administrator of the series, a pre-occupation with inflation drove the negativity, particularly as it applied to higher grocery and gasoline prices, which tend to be quite visible on a daily basis.

(0) **Initial jobless claims** for the Aug. 26 ending week declined by -4k to a seasonally-adjusted 228k, just below the 235k median forecast. Continuing claims for the Aug. 19 week rose by 28k to 1.725 mil., above the 1.706 mil. consensus expectation. The largest declines were in OH, HI, and MO, with OH results likely related to potentially fraudulent claims activity. The insured employment rate has risen to 1.2%, which is above the 1.0%

rate a year ago. In reviewing the DOL's chart of recent initial claims versus those of a year ago, there is still little apparent difference—in particular, no dramatic spikes upward.

(-) The government **JOLTs** job openings for July showed a decline of -338k to 8.827 mil., below the rise to 9.500 mil. expected. By industry, declines were led by professional/business services (-198k), health care/social assistance (-130k), and state/local government/education (combined -129k); conversely, openings rose in technology (101k) and transportation/warehousing/utilities (75k). On the additive side, the job openings rate fell -0.2% to 5.3%, and the hiring rate fell a tenth to 3.7%. The layoff rate was flat at 1.0%, while the quits rate fell a tenth to 2.3%. After peaking mid-2022, openings have steadily fallen in a measured way as labor markets cool. But, they haven't fallen off a cliff, which is perhaps a baseline the Fed has been using.

(0) The **ADP private employment report** saw a gain of 177k for August, below the 195k expected. However, July results were revised upward by nearly 50k, further into expansion. Services jobs rose 154k in Aug., due to education/health (52k) and trade/transports/utilities (45k), while leisure/hospitality jobs decelerated (to 30k). Goods-producing jobs rose 23k, half of those being in manufacturing. As with a variety of other indicators, this continues to show a slowing pace, although not bad by any means.

(0) The employment situation report for August exceeded expectations in some respects but deteriorated in others. **Nonfarm payrolls** rose by 187k, exceeding the 170k level expected. By segment, health care (71k), leisure/hospitality (40k), social assistance (26k), and construction (22k) saw the most robust gains. On the other end, transportation/warehousing jobs fell back (-34k), along with a major trucking company bankruptcy, in addition to negative impacts in motion picture/sound recording (-17k) from the Hollywood strike. The latter two anomalies accounted for more weight to negatively elsewhere, tempering the downside a bit. Additionally, temporary employment also declined by -19k, which tends to be at the fringe of jobs being added or subtracted in the economy.

The **unemployment rate** rose by 0.3% to 3.8%, exceeding expectations for no change. This included a 222k gain in household employment, with the labor force participation rate rising by several tenths to the highest level since pre-pandemic—the latter was noted by improved employment for youth (16-24) and women of 55+—both of which were taken as positives. The U-6 underemployment rate similarly rose by 0.4% to 7.1%, led by a gain in part-time workers. **Average weekly earnings** rose 0.2%, a tenth below expectations; year-over-year, the pace declined a tenth to 4.3%. Average weekly hours rose a tenth to 34.4.

Question of the Week

What has changed in the asset allocation environment over the past few years, particularly as related to changes in interest rates?

A critical starting question from a financial planning standpoint is often phrased as: How can an investor earn the highest possible return while not taking on excessive risk? In practicality, this translates to the easiest or most diversified way of earning 5-10% per year over the long-term. (The low side of this range represents the multi-decade historical return for bonds, with the high side being that for stocks.) Using a simple mix of two assets, such as the classic 60/40, it's presumed the 'ideal' falls somewhere in the middle. Since the financial crisis, which is amazingly now over 15 years ago, policy interest rates falling to and staying at zero sharply reduced the attractiveness of bonds as a contributor to portfolio return. So, under that 'there is no alternative' (TINA) environment, the load fell to equities, which became almost entirely responsible for the generation of returns. The natural effects of this in a low-rate environment were higher valuations, which tend to result in longer-term expected returns in a self-correcting mechanism.

Today, conditions have evolved. With treasury notes yielding upwards of 4%, and corporates more than that (not to mention high yield and floating rate bank loans yielding in the 8-9% range), bonds have again taken on

more of their share of the load. This is particularly true as after-inflation real yields have risen from negative levels, through zero, and now moving into the positive, as measured based on nominal yields vs. long-term inflation expectations. Financial markets have required an adjustment because of this, which incorporates the pressure of higher rates on the economy and stock earnings. This may continue to be the case in coming quarters as these policy impacts flow through due to their 'long and variable lag' nature, as described by the Fed and economists discussing monetary theory.

The critical part of the story is that there are now multiple sources of return for the first time in nearly two decades, which some investors may not be used to. The higher level of yields also provides additional return buffer, whether it is on a monetary policy level if rates need to come back down, or translated through to bond duration, which can benefit positively if that's the case. Granted, some U.S. stocks remain more richly priced in some sectors, offset somewhat by cheaper valuations for foreign stocks, although one has to consider differences in regional sector composition. Ultimately, assuming that inflation levels continue to fade lower and out of troublesome territory, long-term planning assumptions have benefitted from this 'normalization' and balancing out of conditions.

Market Notes

Period ending 9/1/2023	**1 Week %**	**YTD %**
DJIA	1.57	6.73
S&P 500	2.55	18.95
NASDAQ	3.27	34.86
Russell 2000	3.67	10.17
MSCI-EAFE	2.53	10.60
MSCI-EM	1.52	5.13
Bloomberg U.S. Aggregate	0.48	0.89

U.S. Treasury Yields	**3 Mo.**	**2 Yr.**	**5 Yr.**	**10 Yr.**	**30 Yr.**
12/31/2022	4.42	4.41	3.99	3.88	3.97
8/25/2023	5.61	5.03	4.44	4.25	4.30
9/1/2023	5.53	4.87	4.29	4.18	4.29

U.S. stocks started off well last week, particularly Tue. as job openings declined significantly (presumably lowering the probability of another Fed rate hike). The downward revision of Q2 GDP on Wed. also pointed to lowered likelihood of a hike, at least relative to a revision upward. Later in the week, the employment situation report reaction was mixed, with signs of labor slowing a positive in terms of keeping Fed policy where it is, but the sharply higher unemployment rate again raised some recession concerns.

By sector, cyclicals broadly gained, led by technology, materials, energy, and consumer discretionary, each with returns of 3-4% on the week. Defensive industries utilities and consumer staples lagged with declines. Real estate also rose over a percent for the week.

Foreign stocks performed positively, albeit to a lesser degree than in the U.S., with the exception of Japan, which outperformed all markets. In EM, results were widely mixed by country, with Chinese stocks rising upon additional stimulus measures being announced, including lower foreign currency reserve requirements, and reduced down payments and rates for home buyers. The infamous homebuilding firm Country Garden, China's largest property developer, is on the brink of default, after missing several bond payments and is apparently considering a restructuring. This again highlights still-present risks in that nation's real estate sector—which directly accounts for at least a quarter of GDP—which the government may need to absorb, reducing other monies available for broader economic stimulus to businesses and consumers.

Bonds fared positively last week, along with a decline in interest rates—no doubt helped by the mixed economic and inflation data that added to assumptions the Fed could keep further rate hikes on hold. High yield and floating rate bank loans outperformed investment-grade debt, with a current yield advantage. Based on the New York Fed's Corporate Bond Market Distress Index, which goes back to 2005, continues to show 'easy' conditions, with little sign of stress—in both investment-grade and high yield. Foreign bonds were mixed, with a stronger U.S. dollar helping U.S.-denominated emerging market debt outperform local bonds.

Commodities gained across the board, led by energy and industrial metals, and precious metals also up a percent. Crude oil prices increased a sharp 7% last week to over $85/barrel, with growing expectations that OPEC+ nations will keep production cuts in place until the end of the year at least. Energy price rises were muted likely in response to less destruction than expected by the recent hurricane, as well as the location—storm landfall near production or storage facilities has tended to add more stress to pricing this time of year.

Have a good week.

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Sources: FocusPoint Solutions, American Association for Individual Investors (AAII), Associated Press, Barclays Capital, Bloomberg, Citigroup, Deutsche Bank, FactSet, Financial Times, First Trust, Goldman Sachs, Invesco, JPMorgan Asset Management, Marketfield Asset Management, Morgan Stanley, MSCI, Morningstar, Northern Trust, PIMCO, Standard & Poor's, StockCharts.com, The Conference Board, Thomson Reuters, T. Rowe Price, Univ. of Michigan, U.S. Bureau of Economic Analysis, U.S. Federal Reserve, Wall Street Journal, The Washington Post. Index performance is shown as total return, which includes dividends. Performance for the MSCI-EAFE and MSCI-EM indexes is quoted in U.S. Dollar investor terms.

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Notes key: (+) positive/encouraging development, (0) neutral/inconclusive/no net effect, (-) negative/discouraging development.