



Market Commentary
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English Version

Insigneo Weekly Dispatch

The Data Will Write the Story

Our thoughts on the Federal Reserve's meeting this past Wednesday.

Guidance on investments and the major structural factors behind your clients' portfolios.

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The Data Will Write the Story

“I do not see the ‘stag’ or the ‘flation’”. This was Chairman Jerome Powell’s answer during the press conference held this past Wednesday, when asked if he was thinking about the possibility of stagflation in the economy. As a refresher, stagflation is a combination of stagnant economic growth and higher inflation, one of the worse possible scenarios for any economy. Although sparingly, Wall Street had been talking about the possibility of stagflation over the past few weeks. Thankfully, this scenario is one that Powell does not think is highly probable, and frankly, neither do we.

No stagnation and no inflation could imply an economy that will continue to grow and inflation that will continue to trend lower. In other words, the elusive soft landing could still be in play. To be fair, we do not believe that a soft landing is impossible; however, we do not think that it is highly probable. True, the economy appears to be strong, and inflation, although stickier than expected, has trended lower. However, in addition to economic growth and inflation, there is a third variable that is needed to achieve a soft landing; the labor market. Most on the Street are focusing on the first two variables to try to envision the path of the economy. However, a strong, or simply stable, labor market is also a key ingredient in the soft-landing recipe, and this often-overlooked variable is one that has the potential to derail economic growth. This does not mean that we live in a binary world where the economy is either experiencing stagflation or not. Not at all, but in an average economic cycle, it is not

often that we see sustained growth, combined with low inflation, and high employment. After all, the economy is a cyclical beast.

A scenario that we are closely monitoring is one where the labor market might not be as strong as it appears on the surface. The most recent report from the Bureau of Labor Statistics published this week showed that the number of job openings in the economy is at the lowest level in three years, lower than most on Wall Street expected. Granted, it is better to see softening in the labor market through less hiring, rather than more firings, but the trajectory of data points such as this one merit watching. It would be great for the economy if the labor market could achieve balance through less job openings, as this could still lead to growth while helping tame inflation. However, if less hiring eventually devolves into meaningful job losses, it could potentially lead to a recession. Numbers released by the Conference Board's Consumer Confidence Index the day before the jobs report was published seemed to also indicate a cooling labor market. This index saw consumer confidence drop to the lowest level in two years, seeing consumers' pessimism over the labor market and the economy increase. Dana Peterson, Chief Economist at the Conference Board, said in a statement that "Consumers became less positive about the current labor market situation, and more concerned about future business conditions, job availability, and income". Lower confidence could potentially lead to lower consumer spending, deteriorating an important variable that has been underpinning a resilient economy. In fact, the same report showed that consumers are already citing lower intentions to spend on services such as

dining and entertainment, as well as finished products such as cars and appliances. For now, reduced spending is mostly being seen in the bottom 20% of consumers on the income distribution. This segment of the population has traditionally accounted for less than 10% of the overall spending in the economy. However, reduced spending in areas such as dining, entertainment, and manufacturing, industries with high degrees of variable costs, could lead to increased layoffs as companies try to protect profit margins, quickly spreading labor market weakness up the income distribution spectrum.

The current earnings season could shed some light on this situation, and what it may reveal is something that merits close monitoring. Most of the focus so far this season has been on earnings from mostly Large Cap Technology companies. Supported by strong balance sheets and driven by promising growth potential, these types of companies tend to be less cyclical in nature. As Seema Shah, Chief Global Strategist at Principal Asset Management smartly qualified them during a recent Bloomberg interview, they tend to be "macro-agnostic". Contrary to Large Cap Tech, companies in consumer sensitive sectors of the economy tend to be tightly linked to the economic cycle. We have been seeing companies in these areas facing more pushback from consumers, who are becoming less willing to absorb higher prices brought about by higher inflation. This dynamic is now manifesting itself in a stronger manner, as many consumer-sensitive companies are citing less sales growth, some even reducing their full-year outlooks as a result of slower growth. Faced with a combination of lower revenues and higher costs,

many of these companies could reduce their labor force to protect profit margins, eroding the current strength in the labor market. We are not implying that this scenario will occur with absolute certainty; however, we do envision its possibility, so along with the possibility of a soft landing, we must also account for it.

The good news is that, for now, the Federal Reserve is not seeing a scenario that would involve stagflation, nor one that would see inflation rising in a sustained manner. During its meeting on Wednesday, the Fed announced that, as expected, it was leaving interest rates unchanged. More importantly for investors, Chairman Powell also indicated that he did not see a need to hike rates, a possibility that had been floating around the markets in recent months. In no uncertain terms, Powell stated “I think it is unlikely that the next policy rate move will be a hike.” Adding “I do think it is clear that policy is restrictive. We believe, over time, it will be sufficiently restrictive.” The Fed’s general message appeared to be that current monetary policy was doing what it was supposed to do, and that they would continue to remain data

dependent. In other words, interest rates are likely to remain higher for longer.

Wall Street breathed a sigh of relief at the fact that Powell took rate hikes off the table. Going into the meeting, the market was pricing in one rate cut for 2024, likely occurring in December. After the meeting, the market now expects the first rate cut to occur in November. As the economy continues to evolve through the cycle, closely monitoring the data will be key. All scenarios, ranging from a perfect soft-landing to a meaningful recession, are still possible. We do not envision either end of this range as highly likely, but we will continue to monitor the data and keep you informed as it continues to evolve.



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