



Insigneo Weekly Dispatch

The Fed is Important, But So Are Other Variables

Exploring other variables that could impact U.S. markets,
including tariffs and consumer spending.

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I am thankful that I chose a career in investments and not in the culinary arts, because to be completely honest, I probably would not have made it very far as a chef. Tell me to break down a company's financial statements, and I will gladly do so. Tell me to cook lasagna in the oven, and there is a good chance that I will end up burning dinner. In fact, I almost did, as I sat down to research material for this piece. I was so engrossed in what I was reading, that if the oven timer did not go off, I would probably have had to order take out for dinner. Sadly, that would not have been the first time...

But that got me thinking, sometimes we can get so focused on one thing, that it is easy to lose track of other important things around us. Lately, the market has been laser-focused on one thing, the Fed's next move. In fact, the market's expectations of when the Fed will cut rates change weekly, if not daily, as investors parse through the latest data point to try to get a glimpse of things to come. To be fair, this is a very important subject for the markets, and one that we have written extensively about. The Fed has not changed its tune much, saying that rates will stay higher for longer, a view that we also subscribe to. This does not mean that they will not cut rates, but that the decrease in rates is likely to be a gradual process. Bottom line, we can all agree that the pace and direction of rate cuts is indeed very important for the markets. But what about the other dynamics that we are seeing out there that are also important? The ones that

tend to get little coverage as the focus remains on the Fed. We thought it might be worthwhile exploring two of these other topics in this piece.

An important dynamic that got limited coverage was the Biden administration's announcement that it was raising tariffs on a number of goods imported from China. Mainly, the administration is raising tariffs on steel and aluminum from 7.5% to 25%, semiconductors from 25% to 50%, Lithium-Ion batteries from 10% to 25%, solar cells from 25% to 50%, and most importantly, electric vehicles from 25% to 100%. The theory behind the tariffs is to prevent China from flooding the U.S. market with underpriced goods. The reality is most likely politically motivated, with the most significant tariff increase being levied on electric vehicles. This increase should theoretically have the biggest impact on domestic EV manufacturers like Tesla. However, Tesla faces little domestic competition from Chinese EV manufacturers, with most of the head-to-head competition being played out in foreign markets like China, Europe, and Latin America. In fact, the tariffs might even create a slightly negative scenario for Tesla, as countries like Brazil have already said that they will absorb excess EV capacity from Chinese manufacturers such as BYD, in essence, creating more price competition for Tesla. Arguably, the tariffs on steel and aluminum will create the largest benefit for domestic producers such as Cleveland Cliffs, Steel Dynamics, and Alcoa. However, the more meaningful impact of the tariffs is not likely to stem from the tariffs themselves, but from China's response to the tariffs. It is possible that China's response could also be symbolic in nature; however, depending on what this might be, it could

impact some U.S. domestic industries in a disproportionate way, relative to the minor benefits brought about by the administration's tariffs.

Another important dynamic that we are monitoring closely is the behavior of the U.S. consumer. The consumer is important to the economy and the markets from two different yet congruent angles. The first and most obvious angle is one where consumer spending habits will impact overall demand and eventually companies' sales and margins. The current earnings season has shown a degree of divergence between companies in the Consumer Staples sector that have relatively inelastic demand, compared to companies in the Consumer Discretionary sector that sell products that can be more easily substituted. An example of this dynamic can be seen when we compare two Consumer Staple companies, Procter & Gamble and Kimberly Clark, with two Consumer Discretionary companies, McDonald's and Starbucks. Procter & Gamble and Kimberly Clark did see the impact of inflation driving costs higher and compressing margins. However, to a certain degree, these companies are able to pass on higher costs to consumers as the products they sell are relatively harder to substitute. You can try to substitute with a less expensive brand of toothpaste, deodorant, or tissue paper, but at the end of the day, you are not going to stop using these products.

On the other hand, companies that sell products that are not essential to consumers are seeing more meaningful drops in sales. In its recent quarterly earnings report, McDonald's stated that it was experiencing slower sales as the consumer

was simply eating out less. This was particularly noticeable in the lowest-earning segments of the population, which constitutes the company's largest demographic. At the same time, Starbucks, which caters to customers further up the income scale, also saw slower sales growth in the U.S., as higher inflation is reshaping consumer behavior. At current prices, having the daily specialty coffee is creating meaningful expenses for consumers, who are adapting their behavior and either consuming less or seeking better value elsewhere. In fact, value-conscious consumer behavior is becoming very apparent for other companies such as Walmart. In its most recent earnings report, the company reported a meaningful increase in sales, specifically citing tailwinds from increased demand from higher-end consumers, as this segment of the population is "trading-down" the product chain in an effort to seek better values. The company noted that as sales at physical Walmart and Sam's Club stores rose a healthy 4%-4.5% over the previous year, online sales, which are predominantly driven by higher-income segments of the population jumped 22% over the same period. These examples, as well as many others throughout the economy, suggest that, in general, U.S. aggregate spending and consumption is trending lower.

The second, less obvious, angle of the impact of consumer spending on the economy and markets is even more important than the first. As we mentioned, lower consumption leads to lower sales. However, if lower consumption becomes persistent, as we have been seeing, it will eventually force companies to react, as they attempt to protect margins. When faced with higher inflation, companies will initially try to pass on higher costs to

consumers to minimize the impact on profit margins. However, when companies can no longer do this as consumers push back by spending less or seeking lower cost options elsewhere, companies are forced to cut costs or risk a further drop in margins. This next layer of cost reductions usually begins by decreased hiring of new employees; however, this can turn into layoffs if conditions do not improve. Layoffs tend to begin with hourly wage-earning segments of the population but can quickly move up the spectrum to salaried employees. As we can imagine, increased layoffs feed the downward spiral of decreased consumption as people lose their jobs, which can devolve into a more serious problem like a recession.

In a recent report, Goldman Sachs noted that in this past quarter "the average earnings surprise has been 11% while the average sales surprise has been 1%, pointing to margins as the key drivers to better-than-expected earnings", expanding that "amid an environment of rising input costs in 2021 and 2022 companies began to take action to protect their margins and bolster profitability." (Goldman Sachs/May 2024). Basically, rising earnings are not being driven by rising sales, but by better cost controls. Cost controls are appropriate to protect margins, but these effects tend to be temporary in nature. In a strong economic environment, better earnings should be mainly driven by stronger sales, not just cost reductions. As of now, companies appear to be controlling costs by hiring less workers. If this benign dynamic can remain in place, a cooling job market would actually be good for the economy and equity markets, as it could lead to lower inflation while maintaining stability in the labor

market. However, this is a precarious balance to maintain. If the consumer is not as strong as expected, less hiring may not be enough to protect profit margins, possibly leading to more layoffs, in turn leading to less spending, and so on.

The consumer, and in turn the labor market, can quickly alter the pace and direction of an economic cycle, affecting company profitability and equity markets. We are not implying that things are going to play out exactly this way in the current economic cycle. However, it is an important scenario to consider and one that tends to get overlooked as the markets remain focused on the Fed. Again, the Fed's actions are very important for the market;

however, we do not want to ignore other important issues that could also impact markets. After all, we would not want to burn dinner by remaining focused on one thing and losing sight of everything else around us.



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