KEIM ASSET MANAGEMENT, LLC
Preserving Your Lifestyle

July 13, 2023

HIGHER FOR LONGER

Dear Investor:

The inflation situation is still the number one issue driving Fed policy and the markets. You probably know that the June FOMC meeting was the first time the Fed took a pause in raising rates since they started in March of 2022. There was a lot of debate over this, and it was a big deal that they finally decided to take a breather. I was definitely in favor of it. The point is to give them more time to try and assess what effect all these prior increases are having on the economy. I know I mentioned this before, but it's important to realize there is very substantial debate over the "lag effect" of these prior rate hikes. No one can be certain of the time it takes for these to do the work expected in slowing down the economy. There are a lot of moving parts, and this is one reason it's easy to overtighten and send us into a recession. A soft landing is still the preferred option, but hard to achieve. I remember Larry Summers saying it's like trying to adjust the shower in an old hotel.

The futures market is currently predicting a 92% probability of another quarter point hike at the upcoming July meeting. That's as close to a done deal as we get in finance. Many people believe that will be the last one, that we have reached the top. Opinions after that point begin to diverge. The probabilities are quite high that rates will stay near that level for the rest of the year. There is some weight being given to them going a little higher, and some a little lower. Last year and earlier this year, people believed that the Fed would already be starting to cut by this point in time. Now we are talking, higher for longer, most likely the rest of this year. This is a good example of why I'm always reminding clients not to put too much stock in forecasts. It's very hard to predict the future. Sometimes the train goes down the tracks and we end up about where we expected. Other times things change rapidly, we are way off, and we end up somewhere completely different.

Inflation is moving in the right direction, but we still have a long way to go to get to 2%. The June CPI was just released, and headline inflation was down to 3% over the last 12 months. That's a number that gives us some comfort, but it's not the one the Fed focuses on. Core inflation, which takes out food and energy, was still at 4.8% over the last 12 months. In June of 2022 it was running at 5.9%, so it really hasn't come down that much. The current reading just for the month of June this year in both categories was a very low 0.2%. If we are lucky enough to stay at a rate this low for several months, we would be in a range of 2% - 3%, which would be great news. Obviously, it's too soon to have a firm opinion on the likelihood of that happening.

The economy is continuing to perform better than expected. The final reading for Q1 GDP ended up at 2%. This was much better than earlier expectations. Now estimates for Q2 are running in the range of 1.25% to 2.3%. Again, much higher than expected months ago. This is one reason the market is expecting rates to be higher for longer. Signs of a slowdown are fairly modest. Bill Gross and Larry Summers, both heavy hitters, believe that some people still have money from their pandemic savings that is being spent now. They both expect that money to run out by the end of this year, and that will contribute to a slowdown. That makes a lot of sense, we will have to wait and see. Another big issue right now is the job market. Job gains averaged 399,000 per month last year, as many people returned to work as the pandemic waned. These were in the categories that were hit the hardest, like restaurants, lodging, travel, etc. In the first six months this year, the monthly average has been 278,000. The June number that just came out was 209,000, which may indicate we are gradually slowing down. We can't be sure as this may be substantially revised next month, and one month is not a trend. The Fed is convinced that the job market must slow more, and unemployment must rise to some degree to achieve their 2% inflation goal.

Housing has been a mixed picture. Existing home sales are over 20% lower than a year ago. This is due to low inventory and high mortgage rates. Housing affordability is near a 37-year low. Inventory is low because, generally speaking, people with 3% and 4% mortgages have no interest in selling and taking out a new mortgage in the 6% to 7% range. The low inventory has caused existing home prices to continue to go up, when you would have thought low demand would bring them down. On the other side of the coin, new home sales are doing very well. There is abundant inventory and builders are buying down the mortgage rates to help make the homes affordable.

The stock market is up double digits so far this year, and the bond market is also in the black. This certainly makes opening our account statements a little more enjoyable. The most recent low point since the pandemic bailout was on October 12, 2022. At that time the SP500 had a low close of 3577.03. Since then, the SP500 is up over 900 points or over 25%. This has caused some people to declare we are in a new bull market. Only time will tell if they are correct. What I am sure of is that it's been a fairly narrow market. In Q1 many sectors were participating to some degree. That basically faded, and by the end of June and currently, the market has been driven by only three sectors and the superstar names in those sectors. They are: Apple, Microsoft, Nvidia, Amazon, Meta, Tesla, and Alphabet. These companies have produced close to 90% of the recent gains. These names were hit very hard in the 2022 decline and are now generally back to where they were. If we are in a new bull market, over the next year we would expect to see many of the other sectors do well and advance in price.

We hope you are enjoying the summer. Please feel free to contact us anytime to discuss your portfolio.

Best Regards,

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