KEIM ASSET MANAGEMENT, LLC
Preserving Your Lifestyle

July 19, 2024

September Rate Cut?

Dear Investor:

In 2020 our annual real GDP for the year was negative (2.2%). That was the year of the pandemic. The US Government and the Federal Reserve released over $8.5 trillion dollars in stimulus and financial relief programs. I've talked about this many times in the last few years. It was an historic moment in our economic history that will be studied for decades to come. The unanswered question is: what would the 2020 GDP have been without these programs? I don't think anyone really knows. It's clear that we would have been in a depression of enormous magnitude as economic activity plummeted due to the government policies requiring people to stay home from work. Since then, we have been working off this huge bubble of stimulus. Real GDP in 2021 was up 5.8%, as all this money led to a very hot economy. Inflation also took off, and was 4.7% in 2021. In 2022 inflation hit a high of 9.1% in June and ended the year up a sky high 8.0% over 2021. The Fed slammed on the brakes and did large interest rate increases at all seven of their meetings. This did have a major effect, and brought the GDP all the way down to 1.9% in 2022. The Fed continued to raise rates aggressively until July of 2023. This led to numerous predictions of recession and a hard landing, which fortunately for us all, did not happen. Things generally stabilized as people still had money to spend, and the supply chain situation became much better. Real GDP for 2023 ended up at 2.5%. I'm spending a minute going over this just to give you a better feel for where we are right now. Our GDP for the first quarter of 2024 was only 1.4%. Estimates of a possible range for the second quarter are between 1.25% and 2.25%. It looks to me like the big wave of money has finally run its course, and we are back to a somewhat normal economy.

Many economists think that we are beginning to slow down. Taking a look at our unemployment picture does offer some support for this view. For 2022 and 2023 unemployment averaged right around 3.6% for both years, with about 6 million people officially counted as unemployed. The monthly readings slowly began to trend up in the second half of last year. They have been in a very distinctive uptrend this year, with the latest June reading coming in at 4.1%, and 6.8 million unemployed. This may not seem like a big change, but to economists who follow this, it's a very substantial increase. History shows that unemployment can often accelerate rapidly once certain thresholds are crossed. This will be something the Fed will be watching very closely. We also see that the moving average of new jobs being added each month is continuing to decline. Recent comments by the Fed indicate that they are no longer focusing exclusively on inflation, but are starting to view the rising unemployment as the other risk which has to be considered once again in their policy decisions.

Recent comments by Steve Miller, Chair of the Institute for Supply Management (ISM) Services Business Survey Committee, in his June report were very enlightening. These were made after the Index contracted recently for the third time in the last 49 months. He says "The decrease in the composite index in June is a result of notably lower business activity, a contraction in new orders for the second time since May 2020 and continued contraction in employment. Survey respondents report that in general, business is flat or lower, and although inflation is easing, some commodities have significantly

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higher costs." This is notable, as the ISM Services Index has generally been very strong for the last four years, with only one other negative month before these recent negative readings.

It looks to me like the higher for longer interest rates we have been talking about may have done their job. Inflation has come down quite a bit, and now we have some early signs that things appear to be slowing down. I see this as the huge liquidity wave finally being brought back under control. While no changes are expected from the Fed at their upcoming July 31st meeting, the market has currently put a 95% probability on a rate cut at the Sept 18th meeting. For that to happen, the Fed will need to see that inflation is continuing to decelerate, and also that the second quarter GDP is in the expected range. If the inflation readings are higher than expected, or the second quarter GDP is notably stronger than expected, they might continue to stay on hold.

The S&P500 has been doing well this year as I'm sure you know. It was up about 10% in the first quarter and then added another 4% in the second quarter. It took another spike up in July, but could not hold onto those gains. We are in a modest sell off as I'm writing this letter. SP500 earnings in the first quarter came in just a touch under 6.0%, which is a very solid number. The second quarter reporting is just getting going, and expectations are for growth in the range of 8% - 9%. The solid earnings situation and the outlook for rate cuts have been driving the market. According to Factset, analysts are expecting total earnings growth this year of 11.0% to about $243.49, up from $220.17 last year. They are projecting earnings growth of 14.7% for 2025 to $278.73. In no way is this guaranteed. Projections can change overnight. However, the acceleration you see going into 2025 is based on expectations of cheaper money.   Lower interest rates always stimulate economic activity.

To conclude, there is a very strong possibility that the Fed has gotten it right. The Fed's annual Jackson Hole Economic Symposium is coming up in late August. While I would not expect Chair Powell to address rate cuts directly, I think by then we will all have a pretty good idea if things are still on track for that first cut. If he maintains a neutral posture, we can likely expect that first cut to finally happen.

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

Best Regards,

David E. Keim

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