CONGRESS ASSET
MANAGEMENT COMPANY, LLP

ECONOMIC AND MARKET OUTLOOK

Third Quarter 2023

Our current economic state resembles Goldilocks in her quest for the perfect porridge. For some observers, our economy is too strong and faced with prolonged, elevated inflation. For others, the economy is too weak and stands on the precipice of recession. The villain, for most, is the Federal Reserve Board (FRB), which increased short term interest rates at 10 consecutive FRB meetings, until recently pausing. To be sure, the economy occupies a unique spot where declining inflation is juxtaposed with full employment, complicating the outlook. Historical precedence and current economic markers suggest that the economy continues along its slow growth path with a heightened risk of slowing further in 2024.

Unlike Goldilocks, one never attains a “just right” economy. Pandemic-related distortions continue to influence the economy’s path. The consumer, responsible for almost 70% of Gross Domestic Product (GDP), has replaced spending on goods for experiential opportunities. The strong labor market has bolstered the consumer as unemployment remains below 4% and compensation measures stay strong. Excess savings from the pandemic, while down from their highs, are estimated at almost $1.5 trillion dollars and consumer debt burden as a percentage of disposable income is modest.

U.S. Unemployment Rate

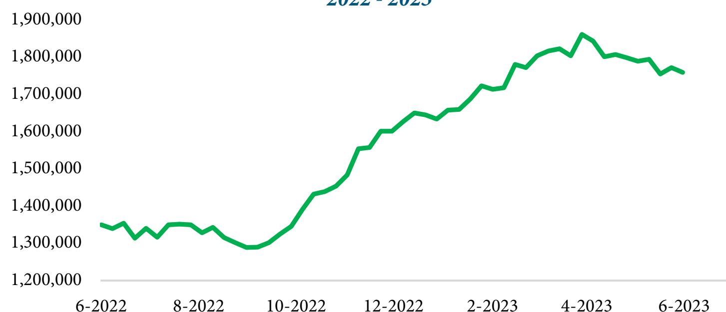
2013 - 2023

Source: U.S. Bureau of Labor Statistics, Unemployment Rate June 2023

Continued consumer robustness is key to avoiding a recession. The preponderance of data suggests that spending will support growth, but dark clouds are forming. As strong as the labor market has been, the weekly Continued Unemployment Claims report, an early indicator of economic vitality, is trending higher. Mortgage rates are approaching 7% again, potentially crimping home buyers or purchases of big-ticket items. In addition, banks have begun to tighten lending standards across consumer and commercial loans, which could weigh on growth going forward.

Continued Unemployment Claims

2022 - 2023



Source: U.S. Employment and Training Administration June 2023

30-Year Fixed Rate Mortgage Average in the United States

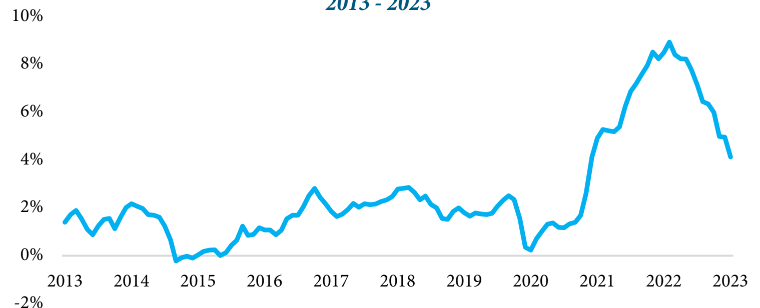
2013-2023

Source: Freddie Mac, 30-Year Fixed Rate Mortgage Average in the U.S. June 2023

Post pandemic, the developed world is struggling with inflation and higher interest rates. The United Kingdom’s inflation rate was running at 8.7% through May. Domestically, inflation has cooled significantly from last year, but the Consumer Price Index (CPI) is still running at a 4% annual rate. With the upper limit of the Federal Funds rate set at 5.25%, the U.S. has an inverted yield curve, usually a precursor to recession. Also, the FRB continues the more arcane practice of shrinking its balance sheet, the second part of its two-pronged fight against inflation. Fed actions work with long and variable lags suggesting that the FRB should cease raising rates for this cycle.

Consumer Price Index

2013 - 2023



Source: U.S. Bureau of Labor Statistics May 2023

Washington’s passing of the Fiscal Responsibility Act of 2023 eliminated the risk of a U.S. debt default. As importantly for the U.S. economy, it signaled the end of pandemic induced fiscal spending programs. Student loan forbearance programs will cease this summer forcing almost 27 million former students to make obligatory loan payments. As the 2024 election cycle looms, discussions will likely turn to budgets, taxes, and the implications of deficit spending. State governments are already feeling the effects as California, New York, and New Jersey are facing deficits as tax revenues have not returned to their pre-pandemic era pace. Taxes will rise or spending will slow, either one threatening growth prospects.

The global picture is similar to the U.S. with prolonged inflation and higher interest rates presenting challenges. China has yet to regain its pre-Covid form. The Chinese Communist Party has increased

monetary and fiscal support to help turn the Covid corner. Should the latest initiatives succeed, China's growth should have a salutary effect on the global economy.

While the economic impacts of Russia's invasion of Ukraine have been largely contained to the region, the recent insurrection by the Wagner paramilitary group has weakened the Russian regime. This could upend the status quo either through Putin's downfall or by Russia escalating with greater weaponry or broadening the theater. Either outcome could weigh on stock market valuations and growth prospects.

The stock market, as measured by the S&P 500 has returned close to 15% this year, belying economic concerns, the failure of three influential regional banks, and the debt ceiling histrionics. Generative artificial intelligence (AI) captured investors' attention in the second quarter, benefiting a small group of technology companies in advance of any real earnings impact. AI has the potential to be a generational change in how companies and organizations use technology which should create numerous investment opportunities. Large capitalization stocks such as Apple, Microsoft, and Nvidia have carried the load this year, accounting for most of the year-to-date returns, but some of the initial exuberance may be overdone. We anticipate this will change as smaller companies and those in other industries will benefit from supply chain improvements and moderating inflation.

Current bond yields remain attractive for more conservative investors given the substantial increase over the past year and with real yields now positive. Enticing returns for ultra-short fixed income investments have led investors to money market funds, with balances now exceeding $5 trillion. An overreliance on short-term instruments, however, may introduce re-investment risk or limit the opportunity for capital appreciation in the future.

The rise in stock market indices has increased valuations. We anticipate earnings will grow next year to support stocks, but volatility will likely increase as index leadership broadens. Stock returns in the second half of the year are unlikely to match the first. We believe our focus on high-quality companies with demonstrated profitability and growth will continue to benefit our portfolios given the uncertainty ahead.

Investment Oversight Committee
Daniel A. Lagan, CFA Chief Investment Officer

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