CONGRESS ASSET
MANAGEMENT COMPANY

ECONOMIC OUTLOOK & MARKET REVIEW | 2Q24

KEY TAKEAWAYS:

1. **The US economy continues to grow and has pulled most of the developed world into a largely benign growth environment.**
2. **A sustained US expansion is built on a strong labor market, sound private sector financial metrics, and continued fiscal spending.**
3. **Markets are pricing in interest rate cuts beginning this summer, but we believe longer-term rates will remain elevated given the growing federal deficit and inflation that remains above the Fed's target. The path for interest rates holds significant implications for 2024.**
4. **Companies that can maintain earnings growth should fare better in this environment and diversification should benefit investors as index leadership is likely to broaden away from large tech companies.**

Over the last few years, the U.S. economy has been like the little blue engine in the 1930 folk tale The Little Engine That Could. Much like the storied blue engine, the economy has overcome conventional wisdom, scaling post-COVID challenges and in the process pulled the developed world into a benign growth environment. Recent economic releases suggest inflation is cooperating and global growth, ex China, is improving.

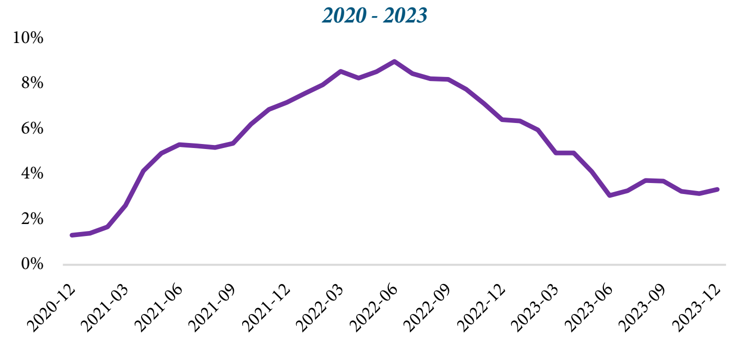
In the U.S., as the presidential election began to heat up, the Federal Reserve (Fed) reassured investors of their intentions to lower the short-term interest rates it controls in an effort to alleviate economic restraint and improve growth prospects for this year and next. This helped propel a strong first quarter for stocks as the S&P 500 returned about 10%. In contrast, perhaps anticipating a rockier road than the Fed implied, bond yields rose moderately, pushing bond prices down.

Global financial markets exuded a positive aura during the first quarter as well. Stocks rallied throughout much of the world reflecting improved economic outlooks and the shedding of the post-COVID malaise. In a confirmation that the world is moving past the last vestiges of the Great Financial Crisis of 2008, the Bank of Japan ended its negative interest rate policy after eight years and raised short term interest rates for the first time since 2007. The Nikkei stock market notched its first record in 34 years and has returned about 20% this year.

The increasing acceptance of a sustained U.S. expansion is built on three pillars: a strong employment scenario, sound private sector financial metrics, and continued fiscal spending. At the same time, the rampant inflation of 2022-2023 appears to have eased, though the cumulative effects remain with greater impact to lower income Americans.

U.S. Consumer Price Index - % Change from a Year Ago

2020 - 2023

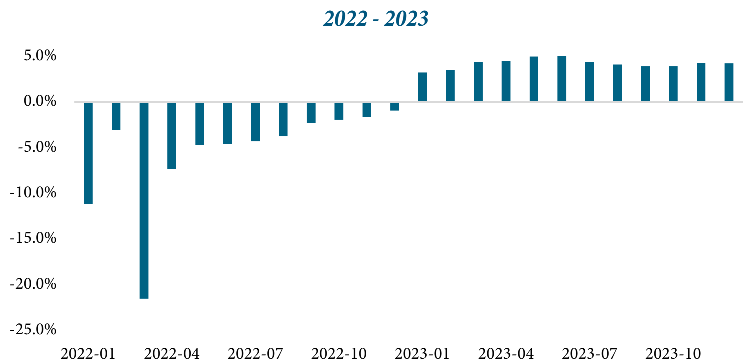


Source: US Bureau of Labor Statistics

The robust labor market is bolstered by new job creation. The severe labor shortages of the immediate post-pandemic era have eased, lowering labor cost inflation. Fed Chairman Powell attributed this to stronger participation in the labor pool, from both workforce returnees and immigration. Unemployment remains under 4% and real disposable income continues to increase. Some caution is warranted, however, as the breadth of job gains across industries has lessened and new jobs are not being posted at the heady rate of a few years ago.

Real Disposable Income - % Change from a Year Ago

2022 - 2023



Source: U.S. Bureau of Economic Analysis

Private sector spending continues to be resilient, aided by labor market strength and solid balance sheets. Businesses have benefitted from steady corporate profit margins and an era of low interest rates that allowed them to replace high-cost debt with longer maturities at lower rates. Consumers also took advantage of low rates as many homeowners locked in mortgages with rates below 4%, keeping

debt burdens manageable. Consumer spending as a result remains healthy, with real spending growth averaging 2.5-3%.

Government spending should continue to support the expansion, as well. Pandemic era fiscal stimulus programs were huge, and without "shovel-ready" projects lined up, the spending and economic tailwinds will last a few more years. Combined, the CHIPS Act and the Infrastructure Bill, both passed in 2021, approved $1.3 trillion in additional government spending. Of that, over $800 billion of funds have yet to be allocated or spent.

The financial markets face a myriad of challenges this election year, but currently economic growth is not one of them. Each challenge, such as war, can have expansive socio-economic consequences. Each must be given its due but the path of the domestic markets this year likely hinges on the course of interest rates and the inflation level.

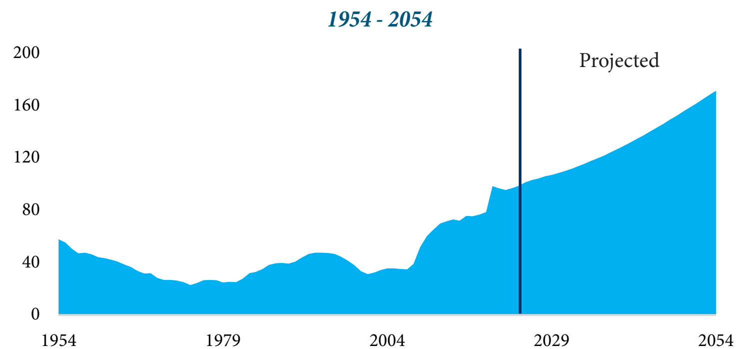
We believe that caution regarding interest rates is warranted. The Fed, through its Open Market Committee, controls short-term interest rates and regularly forecasts its economic outlook and anticipated interest rate moves. The Fed has indicated it will lower short term rates this summer. This is welcome as lower rates promote investment and can bolster stock market valuation. Stock market action over the last five months, however, suggests the anticipated rate cut is already embedded in stock prices.

Investors appear to be anticipating lower longer-term rates, akin to rates experienced in the 2010's when monetary policy was dominated by "lower for longer" type mandates. This is misguided, in our view. The Fed does not control longer term rates, which are impacted by a host of economic factors including the cumulative federal deficit and more immediate issues such as inflation.

Regarding the deficit, U. S. Treasury Secretary Janet Yellen, representing the administration, recently suggested that ten-year Treasury interest rates are likely to remain near current levels for the next decade. Today, this interest rate is about 4.2%, far higher than the rate experienced during the 2010's. This is partly attributed to the Congressional Budget Office's recent forecast for federal debt to skyrocket over the next few years.

Federal Debt Held by the Public (% of GDP)

1954 - 2054



Source: U.S. Congressional Budget Office

Inflation, unlike federal spending and deficits, is a political priority with current implications for investors and the electorate. The alarming 9% inflation rate from 2022 is history, but the descent to the desired 2% rate has paused. Much blame has been attributed to the costs of housing, a large component of the Consumer Price Index, that is expected to abate over time. But many commodity prices have also started to rise. Most importantly, crude oil and gasoline are both up double digits.

Election years, even ones during expansions, generally bring stock market volatility. With stock valuations elevated, the path for interest rates holds significant implications for 2024. We anticipate that longer term interest rates will remain volatile but generally around current levels. Companies with the ability to maintain earnings growth with waning pricing power should fare better. Stock market participation should broaden from the large tech players as they are facing both regulatory actions and more competitive threats.

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

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