When the Facts Change: Adapting for Uncertain Times

John Maynard Keynes, a towering figure in economics, revolutionized the field with his Keynesian school of thought. Born in 1883, Keynes's influence peaked during the Great Depression, when his theories shaped economic policies. His fundamental tenet was that governments should boost spending during economic downturns to stimulate demand, reduce unemployment, and curb spending during prosperous times.

However, the practical application of Keynes's theories often proves challenging. The U.S. federal government, for instance, struggles to curb spending even during economic booms. As the saying goes, a government program is the closest thing to eternal life. This is evident in the current U.S. fiscal deficit, which stands at 5.9% of GDP, a level that had only been seen during recessions before the 2008 financial crisis. This situation underscores the complexity of implementing Keynesian economic policies in practice. Despite robust GDP growth and low unemployment, running large deficits is not helping to bring inflation rates down.

Keynes was also known for his pragmatic approach to economics and is famously quoted as saying, "When the facts change, I change my mind. What do you do, sir?" This is a great quote to help illustrate the importance of a data-dependent approach to policymaking.

The Federal Reserve, a data-dependent institution, is grappling with a complex economic situation. The combination of low unemployment, robust GDP growth, and large budget deficits has allowed inflation to remain stubborn, defying expectations of a swift retreat. This is reflected in elevated consumer prices, which strain household budgets and raise concerns about consumers' purchasing power. The persistence of this inflation adds a layer of complexity to the Fed's efforts to achieve its 2% target, presenting a challenging backdrop for monetary policy.

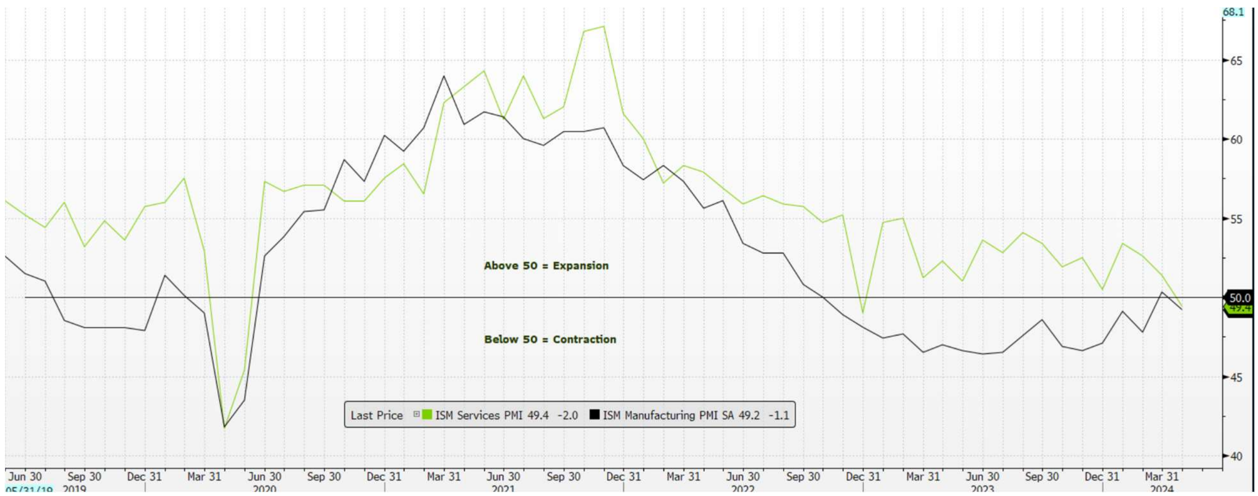
At the same time, labor market indicators hint at a softening trend. Nonfarm payrolls registered modest gains in the previous month, but with wage growth slowing and a slight increase in the unemployment rate, there are signs of potential slack in the job market. Despite the historically low unemployment rate, employers are displaying a growing caution in hiring, reflecting their concerns about economic uncertainties.

This month's Viewpointe explores recent data and provides insights into the evolving economic conditions shaping monetary policy decisions.

April Economic Data

Economic data from April indicated signs of a slowdown in the U.S. economy. The ISM services index dropped to 49.4 following 15 months of expansion (a reading below 50 indicates contraction). The Federal Reserve's hawkish tone will likely shift following recognition of this near-term slowdown, with wage growth moderating to a 0.2% month-over-month increase in average hourly earnings. This suggests some easing in inflationary pressures, although uncertainty remains.

Several sectors are susceptible to shifts in the economic climate. Construction spending fell by 0.2% in March, and job openings in the industry also declined, highlighting the impact of rising interest rates. Similarly, the ISM manufacturing index dropped to 49.2, reflecting the manufacturing sector's challenges over the last 18 months.



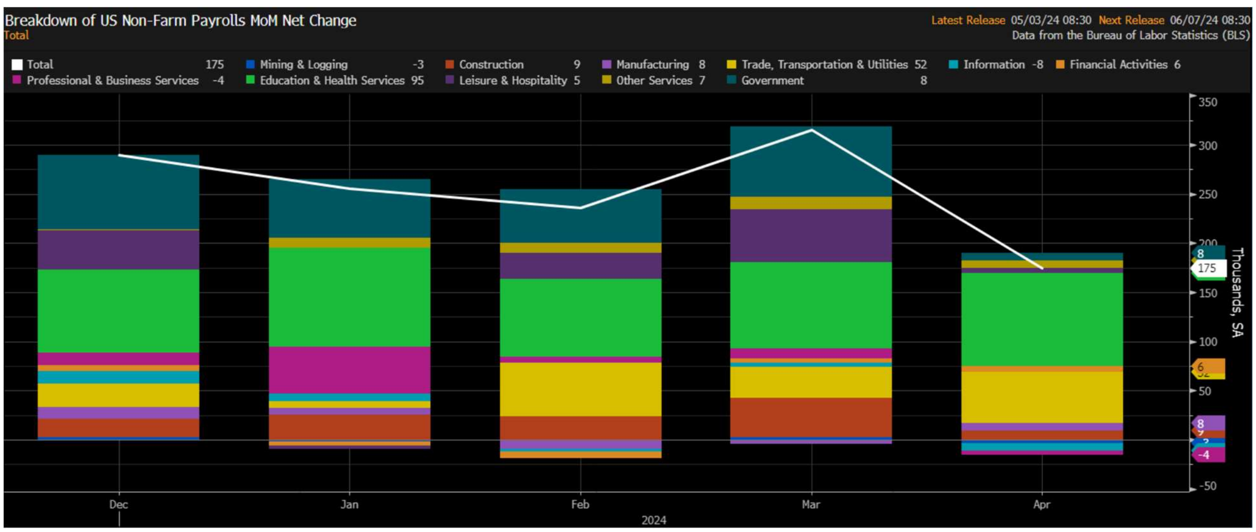
This slowdown may introduce some slack in the economy, potentially opening the door for an interest rate cut in September or November.

	CME FEDWATCH TOOL - CONDITIONAL MEETING PROBABILITIES							
MEETING DATE	350-375	375-400	400-425	425-450	450-475	475-500	500-525	525-550
6/12/2024			0.0%	0.0%	0.0%	0.0%	8.7%	91.3%
7/31/2024	0.0%	0.0%	0.0%	0.0%	0.0%	2.2%	29.2%	68.6%
9/18/2024	0.0%	0.0%	0.0%	0.0%	1.0%	15.1%	48.1%	35.7%
11/7/2024	0.0%	0.0%	0.0%	0.4%	6.3%	27.5%	43.5%	22.4%
12/18/2024	0.0%	0.0%	0.2%	3.5%	17.4%	35.9%	32.4%	10.7%
1/29/2025	0.0%	0.1%	1.7%	9.6%	25.6%	34.3%	22.8%	5.9%
3/19/2025	0.0%	0.9%	5.9%	18.0%	30.2%	28.2%	13.9%	2.8%
4/30/2025	0.4%	2.8%	10.5%	22.7%	29.4%	22.8%	9.7%	1.7%

Payroll Trends: A Mixed Bag amid Economic Uncertainty

The U.S. labor market is showing divergent trends across different sectors, reflecting the complexity of the economic environment. The government, healthcare, and education sectors continue to exhibit robust payroll growth, bolstered by approximately 100,000 jobs per month from hiring foreign-born workers. However, the broader picture reveals underlying weaknesses: temporary employment is plummeting, manufacturing jobs have stagnated for the past year, and even the once-resilient information sector shows signs of decline.

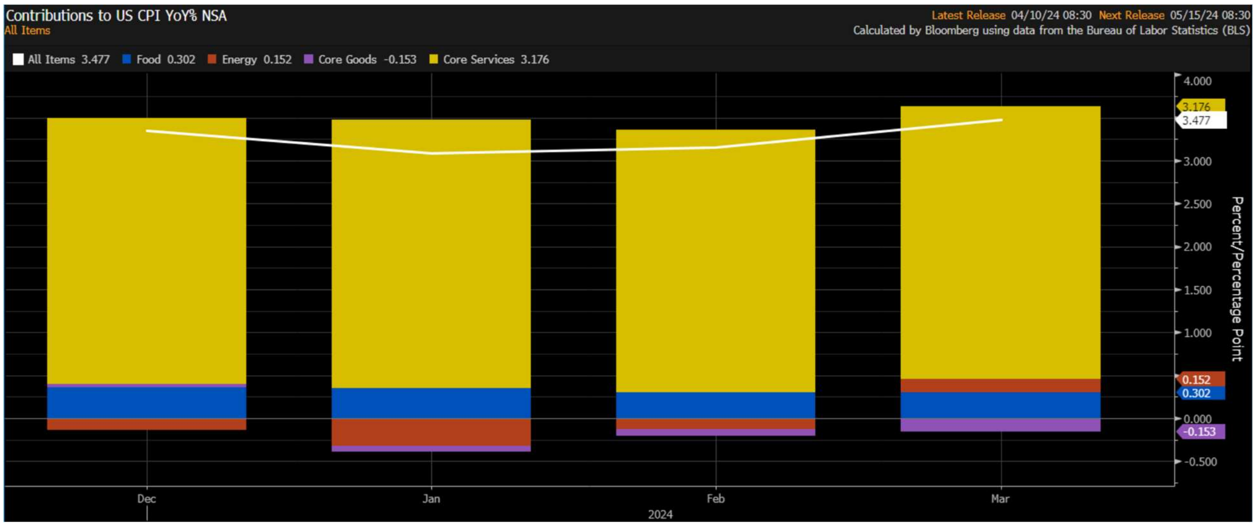
Wages also reflect a bifurcated trend. While the construction and manufacturing sectors are still experiencing rapid wage gains, sectors like retail, travel, and leisure are witnessing a sharp slowdown in wage growth. This divergence highlights the varying impacts of inflation across different industries.



Inflation Challenges

Despite these discrepancies, inflation remains sticky, buoyed by the sustained purchasing power of middle and high-income consumers who have maintained solid job prospects and income growth? This dynamic creates a challenging scenario for low-income earners as their purchasing power erodes, widening the inequality gap. The persistence of inflation is likely to continue until the economy experiences a recession that significantly raises unemployment, reducing spending by middle-income workers, which is the cornerstone of consumer spending.

The chart below helps illustrate the outsized impact of "Core Services" on overall CPI. Not shown, the bulk of the core services are being driven by housing costs, also known as "Owners' Equivalent Rent."



Navigating these complex labor market dynamics is challenging for policymakers and businesses. The interplay between sector-specific wage trends, inflationary pressures, and changing consumer behavior will likely shape the economic landscape in the coming months. As always, staying informed and adaptable will be crucial for successfully managing the uncertainties that lie ahead.

Economic Outlook

Despite mixed signals in other areas, U.S. vehicle sales stood out positively, rising to 15.7 million annually. The Federal Reserve has taken a cautious approach, maintaining interest rates of 5.25%-5.5% and considering a slowdown in Quantitative Tightening (QT). This approach aligns with the current economic landscape and the need for prudence in policy measures.

Monetary Policy Decisions

The Federal Reserve is in a difficult position, balancing persistent inflation risks and slow economic growth. The central bank’s decisions on interest rates and other monetary policy measures directly impact the economy's trajectory. Recent data and evolving economic conditions will shape future policy decisions, with the Fed keeping a close watch on inflation and labor market trends to inform its next steps.

The future trajectory of inflation will determine the Federal Reserve's next move. A synchronized spike in prices in January has raised concerns about inflation's persistence, leaving its future trend uncertain. The Fed's response will be closely tied to how inflation evolves over the coming months.

Navigating the Market's Crosswinds: HPWM Investment Strategy

Macro Environment and Market Trends

Recent economic and financial data paint a mixed picture for investors. While inflationary pressures have somewhat subsided, the latest jobs report indicates that labor markets are starting to soften. Other key indicators point to a potential slowdown in the U.S. economy. This has led to a cautious stance by the Federal Reserve, which is likely to delay rate cuts until September or November. Still, recent comments from Chair Powell indicate a bias toward keeping rates elevated.

Sector Outlook and Positioning

- **Equities**: While the equity markets have faced headwinds, recent data on softer inflation and labor markets could be a bullish catalyst for stocks to reach new highs. We focus on resilient sectors in high-interest-rate environments, particularly those with stable earnings potential.
- **Fixed Income**: Given the outlook for elevated policy rates, we continue to emphasize shorter-duration bonds that offer attractive yields with minimal interest rate risk, with an emphasis on 3 to 7-year maturities. High-yield bonds present selective opportunities, provided investors can withstand potential volatility.

Global Market Dynamics

Global trends further influence our strategy:

- **Emerging Markets**: Strong exports from South Korea suggest robust global demand, providing a positive backdrop for emerging market equities, while challenges like geopolitical tensions and inflation remain.
- **Developed Markets**: European markets are showing signs of recovery, with rate cuts likely in certain regions. This bodes well for selective European equities, but we remain cautious due to potential market volatility.

Conclusion

The economic landscape remains complex, with inflation, interest rates, and geopolitical factors all playing significant roles. However, a disciplined and well-diversified strategy can navigate these crosswinds, identifying opportunities and safeguarding portfolios against potential downturns.

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