Fourth Quarter 2023 — Economic and Capital Markets Commentary

Tapped Out?

"The entire world economy rests on the consumer; if he ever stops spending money he doesn't have on things he doesn't need – we're done for." – Bill Bonner, Author

Consumer spending growth, a critical factor not only in the U.S. but also in the global economy, has been remarkably resilient over the past several years. But new developments raise doubts as to whether that spending growth can continue. Over the summer, the outlook for U.S. consumer spending growth began to weaken slightly due to several coinciding factors:

- Interest rates remain at elevated levels, affecting both consumer appetite for borrowing and business investment decisions.
- Economists estimate that excess personal savings, bolstered by pandemic stimulus, have now been entirely used up.
- Incremental pressure on consumers, such as federal student loan payments restarting in October of 2023, high shelter costs, and higher gas prices may put additional strain on household budgets.

Below, we take a moment to look at each of these factors in more depth.

Interest Rates

As the year began, consensus estimates were that the Federal Reserve would lower interest rates by year end as recessionary concerns rose. However, continued low unemployment and strong wage growth and business investment have so far made interest rate cuts unnecessary. During their September meeting, the Federal Reserve reiterated their stance that interest rates would remain at these levels or possibly higher to continue to dampen inflation.

Higher interest rates, while a boon for savers and bond buyers, are slowly having the Fed's desired effect. Residential housing prices stopped their meteoric rise as mortgage rates remain over 7%, while the hurdle rate (the return businesses seek before committing capital to a project) for investment opportunities stands significantly higher than it was just two years ago.

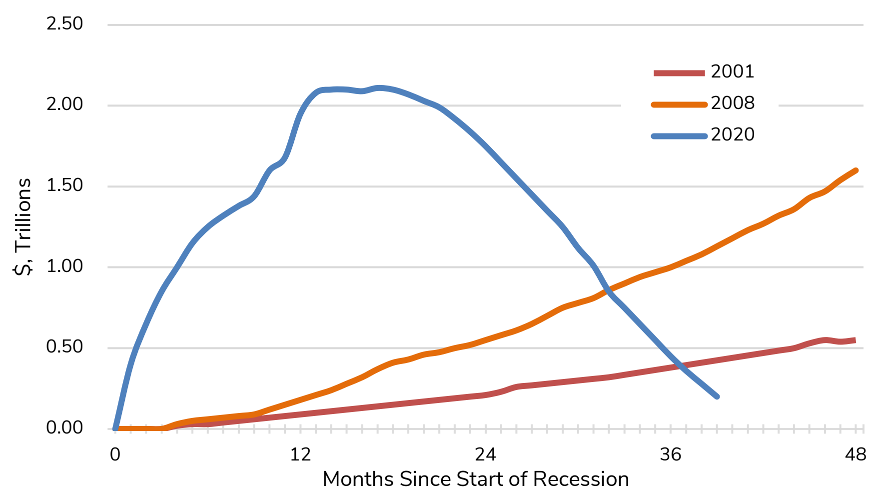
While a decline in inflation would be beneficial for the overall economy, it may also indicate that consumer demand has weakened.

The End of Covid Savings

Having been flush with savings and higher wages since the post-Covid recovery began, many consumers may start showing signs of spending fatigue. A report by the Federal Reserve Bank of San Francisco in August, supported by other analysis from U.S. banks, suggests the estimated $2 trillion in savings accumulated in the first year of Covid may have finally been exhausted. While the current unemployment rate remains low and wage growth remains strong, the depletion of those excess funds could become a headwind for additional consumer spending growth over the coming quarters.

As the graph shows, the spike in savings and subsequent expenditures coming out of the brief but extreme 2020 recession was unique compared to other recent recessions and was a contributing factor to the sudden bout of inflation the economy experienced.

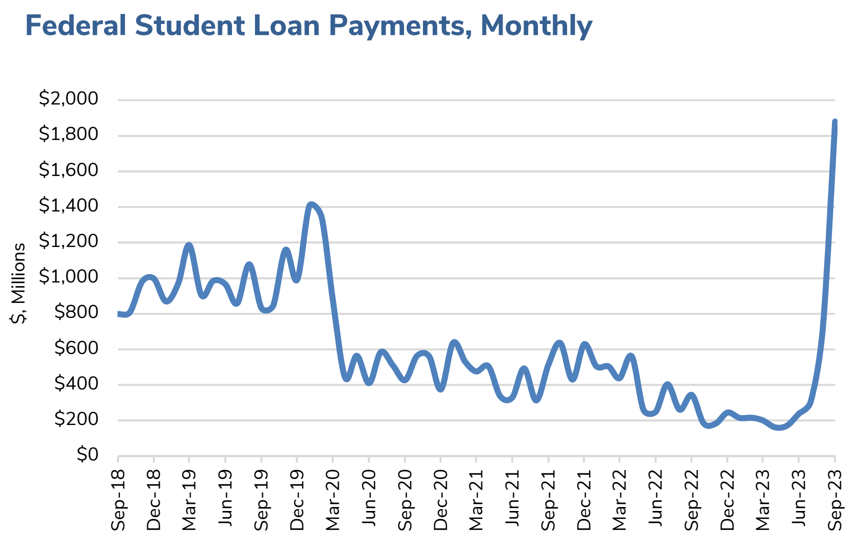
Accumulated Savings During Past Recessions



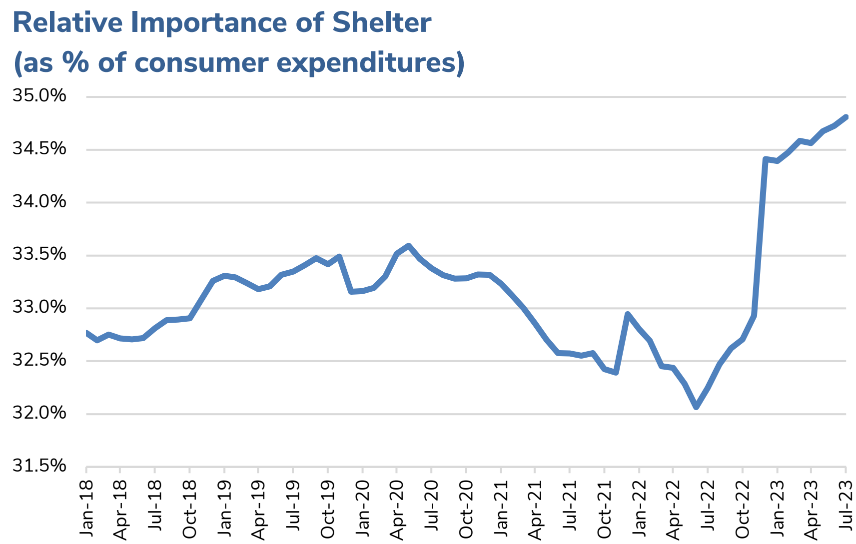
It should also be noted that the glut of savings during the opening year of a recession is unique, making estimates on the long-term effects difficult; there is simply no precedent to explain how the consumer may behave going forward.

Small Pressures

Additional dents to consumer spending come from an area that has been exempt for the past three years: Federal student loan payments. Economists estimate that student loan payments constitute roughly 0.5% of aggregate monthly consumer spending. While small, this, in addition to the factors mentioned above, is another headwind U.S. consumers will face going forward. As displayed in the graph, when the October 1 date for the resumption of payments neared, borrowers rapidly began repaying past loans to avoid new interest charges in the months ahead.



Another continuing pressure on consumers is the elevated cost of shelter in the U.S. Both home purchases and rentals costs have developed into a larger part of consumers' expenses. While home prices have started to level off and, in some markets, even decline slightly, higher mortgage rates have substantially increased new homebuyers' monthly payments. At the same time, rental prices continue to increase as landlords are also squeezed by higher rates. That said, rental vacancies have started to return to normalized levels, typically a leading indicator of flat or lower future rental costs.



Finally, higher fuel prices that started at the end of the summer as markets reacted to Saudi and Russian production cuts only add additional pressure on the consumer.

Tapped Out?

Over time and in the face of a myriad of domestic and international challenges, the U.S. consumer has proven to be incredibly resilient. Nevertheless, the current environment, partially engineered by the Federal Reserve, may soon create a less favorable atmosphere for continued high levels of consumer spending growth in the near-term.

However, the higher interest rates mentioned above are also creating one of the most fertile bond investing environments in over 15 years. At Mitchell Sinkler & Starr, we are taking advantage of higher interest rates for clients with fixed income exposure and speaking to other clients about the place bonds traditionally have had in client portfolios.

- Mitchell Sinkler & Starr's Portfolio Managers

Economic and Capital Markets Data

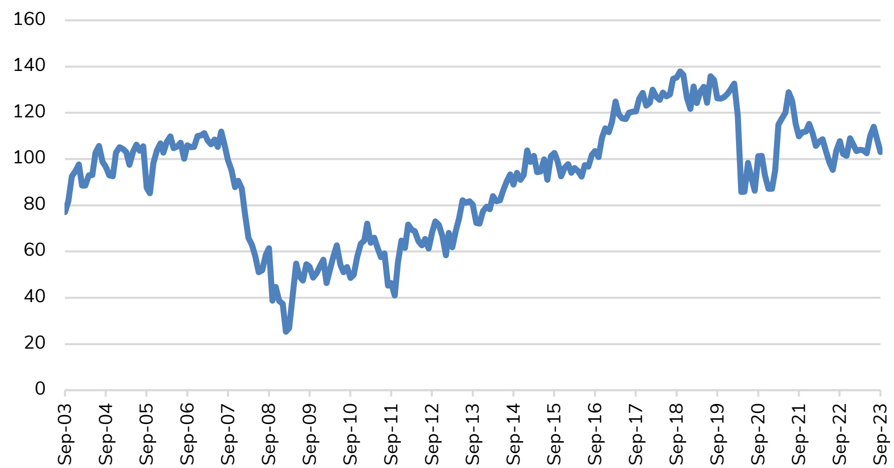
	September 30, 2023	(One Year) September 30, 2022	(Three Years) September 30, 2020	(Five Years) September 30, 2018
S&P 500 Index	4288	3586	3363	2914
Price / Earnings Ratio	21.0	17.6	26.1	21.1
Dividend Yield	1.50%	1.75%	1.79%	1.80%
Federal Funds Rate	5.25%	3.25%	0.00%	2.25%
10-Year U.S. Treasury Yield	4.57%	3.83%	0.69%	3.06%
Gold ($ per oz)	1,848	1,662	1,886	1,191
Oil (Brent, $ per barrel)	90	88	41	83
GDP (Annualized)	2.1%	-0.6%	-31.4%	3.5%
Unemployment	3.8%	3.5%	8.4%	3.7%
Inflation (Annualized)	3.7%	8.3%	1.3%	2.3%

GDP Data as of June 30, 2023; Federal Funds Rate is Lower-Bound; Inflation Data as of August 31, 2023

Sources: U.S. Federal Reserve, Bloomberg Finance L.P., Bureau of Economic Analysis

Quarterly Charts

Consumer Confidence



While consumer spending has been the focus of the commentary above, consumer confidence should not be ignored. This measurement focuses on business confidence, employment conditions and six-month future family income expectations. It is still reading well above both the Great Recession lows and Covid Recession lows.

S&P 500 Index - 5 Years

By the end of the third quarter, equity markets had pulled back from their summer peak, as higher interest rates on bonds made equities slightly less attractive in the short-term.