**QUARTERLY REVIEW & OUTLOOK** **Q2-2024**

*"The Fed's job is like a tightrope walker trying to keep their balance while walking on a thin rope. One misstep and they could fall into a recession or cause inflation to spiral out of control."*

*Laurence Ball, Professor of Economics at Johns Hopkins University*

If anything, Federal Reserve Chairman Jerome Powell knows his history. In our last letter we wrote how today's inflation resembles the pattern seen last in the 1970's. If history were to repeat itself, we would see inflation bottoming soon and begin an uncomfortable ride back up again. Powell is very aware of this possibility and that is one reason he has chosen to keep interest rates "higher for longer" to reduce the chances of this reacceleration occurring. The federal funds rate has been set between 5.25% and 5.50% for months now as the Fed has had the luxury of continuing to see reduced inflation coupled with a generally resilient economy and labor market, i.e the Goldilocks scenario of not too hot and not too cold.

Economists generally believe that inflation will continue to decline. However, it must be noted that the year-over-year rate has already tumbled from 9% down to 3% and any further improvement may be akin to "you can't get blood from a turnip". However, if there is more inflation to be squeezed out of the system, then the Fed may soon be able to reduce interest rates, taking pressure off of everything from mortgages, car loans and company borrowings.

Are there signs that inflation may be bottoming now and soon will go back up? The Fed's favorite inflation gauge, PCE (Personal Consumption Index), came in at 2.6% in May which indicates price pressures still persist, though declining slightly. The labor market remains buoyant, with job gains continuing and unemployment still relatively low. If Powell reduces rates now, this could exacerbate these already tight areas of the economy and cause inflation to rise. However, if he waits to lower rates, the already slowing economy could fall into a recession. For example, lower-end consumers are already feeling financial stress as seen by credit card balances moving up and discretionary purchases starting to soften. Now you're seeing the "tightrope" scenario as balancing different parts of the economy becomes ever more challenging.

As many of you are aware, the stock market has exhibited fairly narrow leadership for quite some time, and this is seen by the extreme outperformance of the Super 7 companies such as Microsoft and Nvidia. Not only are they benefiting from the excitement of artificial intelligence, but they tend to have very little borrowing needs that they can't internally finance with their strong balance sheets. Thus, higher interest rates have a far less negative impact on them. This

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is not the case for much of the rest of the market as higher rates send their costs soaring to meet their continuous borrowing needs. Many of these companies financed their spending at low interest rates, but over the next few years this debt will have to be refinanced at potentially much higher rates and costs. However, if the Fed is able to reduce interest rates, the rest of the market outside the Super 7 could start to benefit. The performance of stocks has broadened out slightly over the course of this year and this trend may accelerate if rates decline.

In conclusion, the stock market can continue to be constructive and even broaden out if Jerome Powell and the Federal Reserve stay on the tightrope. They need growth to continue, employment to remain buoyant, interest rates to decline and inflation to moderate. So far so good for the much-maligned Fed. Let's hope the Election uncertainty, international conflicts and other unforeseen events don't knock them off balance.

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