fathom
ASPIRIANT INSIGHTS

SECOND QUARTER 2024 INSIGHT

Investing Outlook

Los Angeles | San Francisco | San Diego | Silicon Valley | Orange County | New York | Minneapolis | Milwaukee | Cincinnati | Austin

In this Issue

Investment Strategy & Research Highlights

- Higher interest rates are slowing inflation and depleting excess savings. Paired with real wage challenges, this may lead to reduced consumer spending and economic growth.
- The United States remains resilient. Despite an increase in business bankruptcies, the potential for a "soft-ish" landing exists, supported by robust employment and the wealth effect.
- The Magnificent Seven's significant market share in the S&P 500 introduces risks if their performance falters. As Artificial Intelligence (AI) is still in early adoption stages, its macroeconomic impact remains unclear.
- Restrictive monetary policy affords the Federal Reserve the flexibility to intervene if necessary, while substantial fiscal deficits warrant caution.
- It is important to construct investment portfolios designed to perform well under a wide range of market conditions.

Intro

The market has experienced significant fluctuations in early 2024, as investors navigated through various economic uncertainties. These include the impacts of inflation, interest rates and general economic conditions, alongside geopolitical tensions and conflicts. A key contributor to recent market volatility has been the interplay of fiscal and monetary policies, with the former proverbially having one foot on the gas and the latter one foot on the brake. Despite running large, potentially unsustainable fiscal deficits, the U.S. maintains a strong employment market and steady economic growth. At the same time, restrictive monetary policies have tightened credit, affecting mortgages and other loans. However, high interest rates have renewed the Fed's capacity to stimulate the economy if future challenges arise.

Naturally, higher interest rates are slowing inflation, pressuring real wages and depleting excess savings. Combined, these factors are leading to reduced spending, growth and profits. To sustain spending levels, consumers are increasingly turning to credit, including through buy-now/pay-later services. Despite credit card rates hovering around 22%, it's surprising to see credit card usage remains robust. As a case in point, Visa recently achieved a 17% surge in profits, significantly exceeding earnings expectations.

Elsewhere, higher interest rates are discouraging business activity, affecting both spending and investments. This slowdown has been exacerbated by a reduced availability of bank credit, leading to lower inventories and declines in key growth indicators such as the Purchasing Managers' Index (PMI) and shipping container volumes. Consequently, we're not surprised to see an uptick in business bankruptcies. However, some of these pressures are mitigated by lower commodity prices, which reduce costs for production inputs like oil, natural gas, copper and corn. Despite current business conditions, the likelihood of achieving a "soft-ish" landing has improved since 2022, largely supported by the economy's stability and the wealth effect.

Equity Investment Valuations & Economic Growth

Equity investment valuations are influenced by economic growth, which itself is driven by labor growth and productivity improvements. Using several valuation metrics—including price-to-earnings, price-to-sales, price-to-book, enterprise value-to-EBITDA, and price-to-cash flow—valuations for U.S. Large Cap Growth stocks are currently stretched well above their historical norms and long-term averages. This suggests a generally optimistic outlook that future economic growth, along with subsequent sales and profit increases, will exceed average expectations, therefore justifying today's elevated valuations. Given the importance of this assumption, it warrants a detailed analysis of the factors contributing to economic growth.

Long-term economic growth is shaped by changes in the workforce (i.e., the total number of workers and hours worked) and enhancements in productivity (related to efficiency gains and improvements).

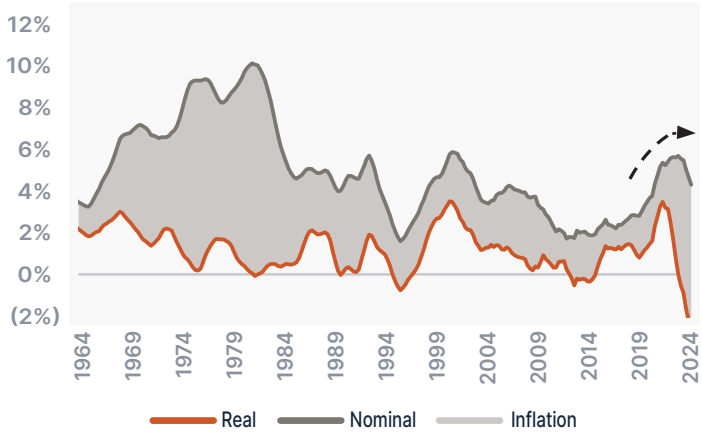
Wage Growth & Inflation

While inflation has receded from its highs, it remains above the Fed's 2% target. In March of this year, the Consumer Price Index (CPI) rose by 3.5% on a year-over-year basis, with Core CPI (which excludes food and energy) up 3.8% year-over-year. Wage growth, as shown in **Figure 1**, is at its highest levels in decades as companies increase spending to attract and retain talent—a sign of a generally tight labor market. However, on a three-year rolling average basis, inflation has outpaced these wage gains, a trend particularly harsh for lower-income households which lack significant savings or other financial assets to buffer the impact of rising costs. Despite a decrease in inflation over the past year, we continue to see many Americans falling behind. The rise in part-time jobs and increasing credit card delinquencies are just two indicators of this ongoing challenge.

FIGURE 1

U.S. Compensation per Hour Real vs. Nominal

3-Year Rolling Average



Data as of 3/31/24. Source: Aspiriant analysis. Data from Bloomberg, Bureau of Labor Statistics, National Bureau of Economic Research. Please see additional disclosures regarding third-party data and other considerations.

To get inflation, and in turn, supply and demand back in balance, it's necessary to dampen demand and/or expand supply. The Fed addresses the demand side by aiming to reduce demand through higher interest rates and constraining credit use. Now that pandemic-related dislocations have subsided, supply is primarily influenced by labor growth and productivity.

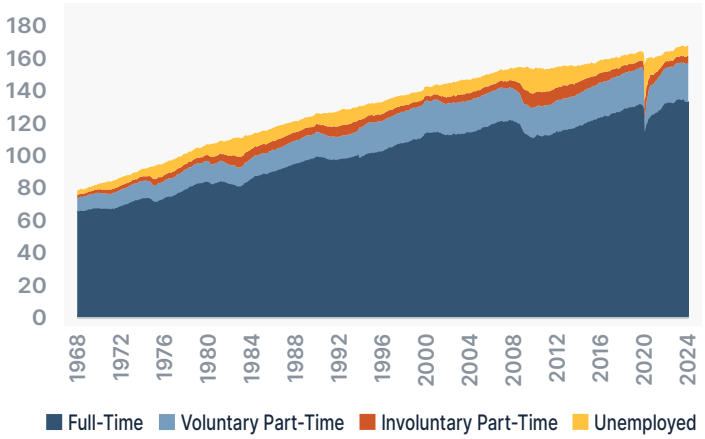
The Labor Market

Figure 2 illustrates the size of the labor force over the past 50-plus years. Since 1968, the labor force has grown by an average of 1.4% per year, maintaining this long-term average in recent years as well. Currently, approximately 161 million Americans are employed, with 6.5 million workers unemployed.

FIGURE 2

Labor Force

Millions



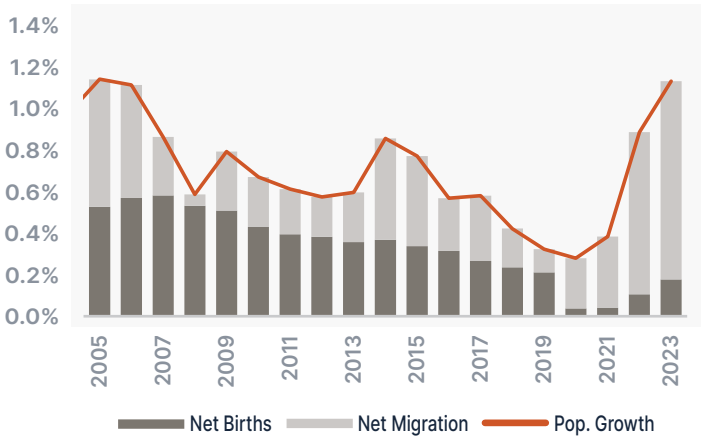
Data as of 3/31/24. Source: Aspiriant analysis. Data from Office of Management and Budget, Federal Reserve Bank of St. Louis, Bureau of Labor Statistics. Please see additional disclosures regarding third-party data and other considerations.

The unemployment rate—the number of unemployed workers relative to the overall labor pool—is a key indicator of potential slack in the current labor market. Unemployment typically spikes in or around recessions and catalyzes during post-recession recoveries as people return to work and productivity increases. With the pandemic's dislocation behind us, during which unemployment peaked at 14.7%, the rate has now stabilized at 3.8%. This is near the lowest levels observed over the past 60 years and aligns closely with pre-COVID levels. Currently, there are approximately five million more employed Americans than in February 2020. However, in recent months, the labor force has expanded more quickly than the number of newly employed workers, nudging the unemployment rate up by about half a percent. While still very low, it is no longer at its historical lowest point.

Aside from population growth, discussed below, there are two ways to increase the supply of labor. One way is to grow the share of the population that works. Currently, about 63% of the working-age population—people ages 15 to 64—are in the labor force, which includes both employed and unemployed workers. This percentage, also known as participation rate, is slightly lower than it was before the pandemic. The difference is mainly driven by a lower percentage of older workers—ages 55 and above—in the labor force. Nevertheless, we are close to the historical average and have been consistently around these levels for much of the past 10-plus years. The other method to increase labor growth is to extend the number of hours worked by those who are employed. However, average weekly hours have been generally stable for the past 35 years and sourcing more labor through an expansion of the workweek seems remote, especially now as more workers place a higher value on work-life balance.

FIGURE 3

Population Growth by Driver



Data as of 3/31/24. Source: Aspiriant analysis. Data from Office of Management and Budget, Federal Reserve Bank of St. Louis, Bureau of Labor Statistics. Please see additional disclosures regarding third-party data and other considerations.

Population growth is the principal means of growing long-term labor supply. In **Figure 3,** we segment the components of population growth by net births (births minus deaths) shown in dark gray and net migration in light gray. Since 2005, the trend through 2020 was downward, with both components declining. Lower fertility rates, elevated deaths and lockdowns during the pandemic caused population growth to hit its lowest point in 2020. Since then, population growth has recovered, largely due to net migration, which accounted for 85% of population growth in 2023. The strength of the U.S. economic recovery and the relatively better opportunities in the U.S. are the principal factors driving this immigration. Overall, population growth in 2023 was substantially above readings from the last several years, marking its largest increase in nearly two decades. With potential changes across the federal government in the coming months and voters citing immigration as one of their top policy priorities, the likelihood of sustaining this higher population growth remains uncertain. If net migration decreases and is not offset by higher workforce participation, especially among those ages 55 and over, the economy could be at risk of structurally lower growth and potentially more volatile and higher inflation.

Productivity & Capital Expenditures

Productivity growth is the other potential lever to drive economic gains, help balance supply with demand and durably return inflation to its target. Improvements in productivity through the adoption of new technologies and processes allow the economy to produce more goods or services per unit of input, whether capital or labor. Over the past 20 years, productivity has typically expanded between 0% and 1%. Recently, we have observed some upward movement in productivity, albeit not significantly above its usual range.

We are beginning to see a modest uptick in corporate capital expenditures (capex). Capital expenditures, which are long-term investments in assets like machinery, new technologies and systems, can enhance efficiency and productivity when executed effectively. More than 10% of 2023's capex was related to artificial intelligence. The question now is whether AI can impact productivity as significantly as the late 1990s and early 2000s did when the broad adoption of personal computers, enterprise software and e-commerce applications pushed productivity above 1% for several years. Or will AI's benefits be limited to the micro or company level, potentially leading to significant job losses with minimal impact on overall productivity growth? As we are still in the early stages of AI adoption, its macro-level impact remains unclear.

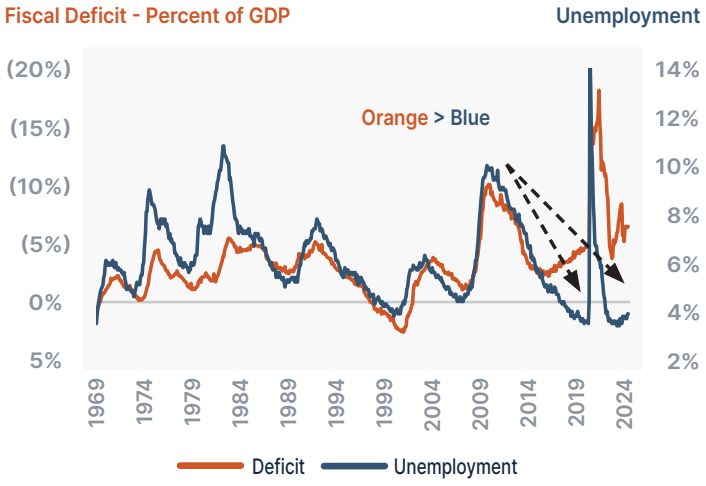
Deficit Spending

Another driver of potential near-term growth is spending. Similar to individual spending, government expenditure stimulates economic growth by generating higher incomes for people and businesses.

Over the past decade, our policymakers have been pushing the "pedal to the metal" when it comes to spending, as illustrated by **Figure 4**. The orange line represents our fiscal deficits. Please note it is inverted, so deficits are shown as negative numbers that are increasing. Generally, you would expect to see larger national deficits when unemployment is rising. That's precisely what occurred from 1970 to 2015. Whenever the country was losing jobs, the national government stepped in to stimulate growth with deficit spending to help get people back to work. However, over the past decade, policymakers seem to have become accustomed to running large deficits, even when the strength of the economy and jobs market didn't call for it. **Figure 4** highlights this phenomenon with dashed black arrows when deficit spending was high, despite low unemployment, which is the case today.

FIGURE 4

Federal Deficits vs. Unemployment



Data as of 3/31/24. Source: Aspiriant analysis. Data from Congressional Budget Office, Office of Management and Budget, U.S. Department of the Treasury, Bureau of Labor Statistics. Please see additional disclosures regarding third-party data and other considerations.

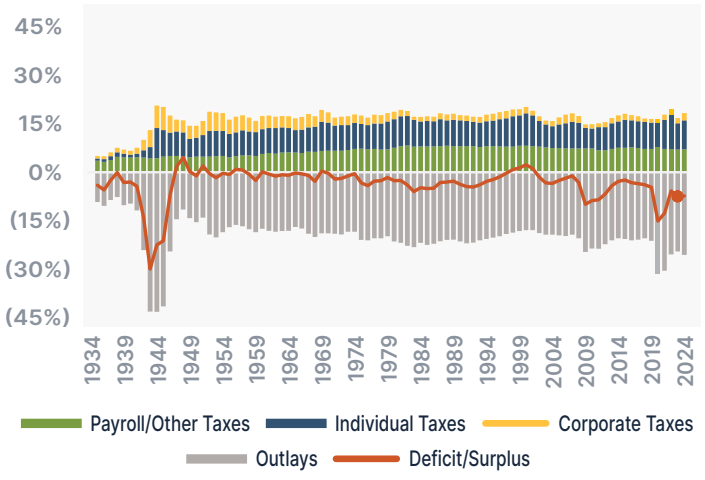
Our national government has been operating at a deficit for most of the post-World War II era, with deficits intensifying over the past 10-20 years, despite no apparent need to run deficits at all. Although this estimate is imprecise, we're expecting a deficit in 2023 of roughly $1.7 trillion or approximately 6% of GDP. To put that into perspective, this level is comparable to what we experienced during the Global Financial Crisis of the late 2000s, even though we are not currently facing a crisis—financial, geopolitical, existential or otherwise.

The majority of our national revenue, as illustrated in **Figure 5**, comes from individual taxes and payroll taxes, which have steadily increased over the years. We've all felt it. At the same time, corporate taxes have declined alongside lower corporate tax rates, significantly reducing their contribution to government receipts. Since there appears to be reluctance to tax corporations to balance our budget, we're faced with two less popular options: taxing individuals significantly more or substantially cutting spending—neither of which any career or aspiring politician is likely to support, especially during an election year.

FIGURE 5

Federal Budget Revenues and Outlays

Percent of GDP



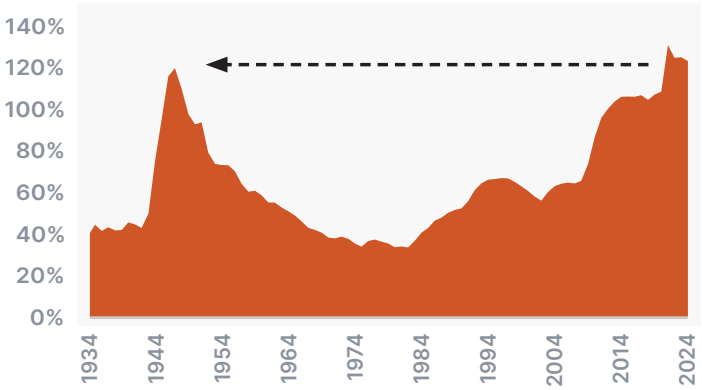
Data as of 3/31/24. Aspiriant analysis. Data from Congressional Budget Office, Office of Management and Budget, U.S. Department of the Treasury, Bureau of Labor Statistics. Please see additional disclosures regarding third-party data and other considerations.

National Debt & Interest Outlays

Consumers are not the only ones grappling with the new realities of borrowing in today's higher interest rate environment. The Federal Government, long regarded as one of the least disciplined spenders, has overseen a significant increase in our national debt, which now stands at approximately 120% of GDP. As shown in Figure 6, this level mirrors that reached during World War II, when such spending was arguably necessary to preserve our way of life. After World War II, it took roughly 40 years of economic growth and some fiscal discipline to reduce our national debt to approximately 40% of GDP. However, over the subsequent 40 years, we tripled our debt balance back to around 120% of GDP, where it remains today.

FIGURE 6

U.S. Government Debt



Data as of 3/31/24. Source: Aspiriant analysis. Data from Congressional Budget Office, Office of Management and Budget, U.S. Department of the Treasury. GDP is gross domestic product. Please see additional disclosures regarding third-party data and other considerations.

That seemingly constant flow of stimulus over the decades likely improved our standards of living but it may also have diminished our future debt capacity—particularly if we need it urgently in the future. Rising debt levels, while worrisome, have translated into manageable debt servicing costs as interest rates declined over much of the period. In fact, from 1971 to 2021, net interest outlays often remained below 2% of GDP, only rising to approximately 3% for about 12 years (from 1985 to 1996). However, future debt servicing costs are expected to exceed 3% of GDP, or $1 trillion annually, due to our ballooning national debt levels and higher interest rates. Additionally, as the Fed maintains higher rates for an extended period, our ability to invest in more productive purposes—such as roads, infrastructure, energy and cybersecurity—is limited.

These projections by the Congressional Budget Office, stark as they may be, assume an average interest rate of 3.3% on all federal debt. Current rates are well above those estimates. Therefore, the decisions our policymakers make in addressing these issues will dramatically impact outcomes both for individuals and the country.

Final Thoughts & Portfolio Considerations

The U.S. economy has continued to outperform expectations and shown resilience to Federal Reserve tightening. The reasons for this ongoing economic strength are manifold. Significant government transfers and the buildup of excess savings during and after the pandemic have allowed consumers to draw down these funds as inflation and interest rates spiked. Private sector balance sheets—covering both individuals and companies—were robust going into and coming out of the pandemic. Many were able to lock in debts at low fixed rates, thereby shielding their spending from the effects of higher interest rates.

Since 2018, public sector spending has shifted from countercyclical to procyclical, with the federal government now running wide deficits during a period of low unemployment. Wage gains have been the strongest in decades and consumers are spending more of what they earn. Rising asset values have also given people, particularly in more affluent households, the confidence to continue spending even when incomes have not kept pace with inflation. Additionally, there are five million more people employed than before the pandemic, adding new consumers and more spending into the economy. On balance, while this resilience and economic strength are positive, they likely mean that inflation, as recent readings would suggest, may remain slightly above the Fed's target for some time.

For investors, a lot of the data looks atypical, with U.S. valuations, profit margins and fiscal policies ranking high on that list. Yes, monetary policy has shifted from extremely accommodative to restrictive but the key questions are: For how long? And where will it settle? While we can acknowledge the historical context of these datasets, it is important to construct portfolios designed to be resilient across a wide range of potential outcomes. Now is the time to lean into fixed income, given the attractiveness of yields relative to inflation, recent history and expected broad equity returns. Additionally, moving forward—unlike in 2022—fixed income should behave more as a portfolio ballast and offset a greater share of equity drawdowns, as the path of interest rates is more influenced by changes in growth than by changes in inflation.

We think investors should favor international equities and, in particular, value stocks, which appear to be priced more reasonably and therefore offer a greater margin of safety. U.S. equities, especially large-cap growth stocks, are once again priced to perfection.[1] The Magnificent Seven represent about 30% of the S&P 500, which could spell danger if their recent stumbles become more pervasive. Meanwhile, equities seem to be losing support related to growth, earnings, buybacks, IPOs and M&A activity. Therefore, within U.S. large-cap equities, we prefer defensive and high-quality companies with durable business models which have historically provided compelling risk/reward opportunities in both up and down markets. Finally, where appropriate, we believe investors should have some exposure to private markets in areas such as private credit and secondaries, among others, to capitalize on market dislocations, long-term secular trends and broaden portfolio diversification.

Second quarter 2024 investing outlook and insight provided by:

John Allen, CFA,® CAIA
Chief Investment Officer, Partner

Marc Castellani, CFA,® CAIA, CIMA®
Managing Director, Partner

Camila Kremer, CFA,® CAIA
Senior Research Analyst, Partner

[1] *Priced to perfection is a term used to describe investments assigned high valuations generally based on exceptionally optimistic expectations of future performance with little to no margin of error.*

Important disclosures

Aspirant is an investment adviser registered with the Securities and Exchange Commission (SEC), which does not suggest a certain level of skill and training. Additional information regarding Aspiriant and its advisory practices can be obtained via the following link: aspiriant.com.

Information contained herein is considered confidential, private and Aspiriant proprietary inside information that is intended only for the audience to which Aspiriant has knowingly distributed this presentation to, either by way of request or voluntarily. Any redistribution of this material without our prior express written permission is a violation of Aspirant's privacy policy adopted to comport with various state and federal privacy laws that may subject any unauthorized distributor to legal action.

All opinions, figures, charts/graphs, estimates and data included in this document are as on date and are subject to change without notice. The statements contained herein may include statements of future expectations, for general market performance or economic conditions, and other forward-looking statements that are based on our current views and assumptions and involve known and unknown risks and uncertainties that could cause actual results, performance, or events to differ materially from those expressed or implied in such statements. Forecasts, projections and other forward-looking statements are based upon assumptions, current beliefs and expectations. Forward-looking statements are subject to numerous assumptions, estimates, risks and uncertainties, including but not limited to: economic, business, market and geopolitical conditions; U.S. and foreign regulatory developments relating to, among other things, financial institutions and markets, government oversight, fiscal and tax policy. Any forward-looking information should not be regarded as a representation by Aspiriant or any other person that estimates or expectations contemplated will be achieved, as the future is not predictable.

Past performance is not indicative of future results. There can be no assurances that any strategy will meet its investment objectives. All investments can lose value. The performance and volatility of an investor's portfolio will not be the same as the index. Indices are unmanaged and have no fees. An investment may not be made directly in an index. The data used in this material was obtained from third-party sources the firm believes are reliable and internally. Aspiriant is not responsible for the accuracy of any third-party data used in the construction of this presentation. This information alone is not sufficient and should not be used for the development or implementation of an investment strategy. It should not be construed as investment advice to any party. Investing in securities, such as equity, fixed income and mutual funds, involves the risk of partial or complete loss of capital that prospective investors should be prepared to bear. Any reference to securities, directly or indirectly, is not a recommendation and does not represent a solicitation to buy or an offer of a solicitation to sell such securities. Any statistical information contained herein has been obtained from publicly available market data (such as, but not limited to, data published by Bloomberg Finance L.P. and its affiliates), internal research and regulatory filings.

As used herein, the term "AI" represents artificial intelligence and includes machine learning and large language models.

Consumer Price Index (CPI) is used as a key indicator of inflation or deflation in the economy.

The Enterprise Value-to-EBITDA (EV/EBITDA) ratio is a valuation metric used to assess the valuation of a company as a whole relative to its earnings before interest, taxes, depreciation, and amortization (EBITDA).

Fiscal deficit represents the shortfall between what the government spends and what it earns through taxation and other sources of revenue during a specific period.

Gross domestic product (GDP) measures the monetary value of final goods and services produced in a country in a given period of time.

Magnificent Seven stocks include Amazon, Alphabet, Apple, Meta, Microsoft, Nvidia, and Tesla.

Net interest outlays refer to the total amount of interest payments made by the government on its outstanding debt, minus any interest income received.

Net migration tracks the net change in population due to migration.

Nominal wages refer to the actual dollar amount received by an individual for their work.

The Price-to-Book (P/B) ratio is used to assess the valuation of a company's stock relative to its book value per share.

The Price-to-Cash Flow (P/CF) ratio is used to assess the valuation of a company's stock relative to its operating cash flow per share.

The Price-to-Earnings (P/E) ratio is used to value a company's stock by comparing its current market price per share to its earnings per share (EPS).

The Price-to-Sales (P/S) ratio is used to assess the valuation of a company's stock relative to its revenue per share.

Real wages take into account the effects of inflation on purchasing power.

The wealth effect is a behavioral economic theory which suggests consumers spend more as the value of their assets rise and their wealth increases, even if their income does not.