

Mid-Quarter Update

A quick review of U.S. economic activity presents a promising picture at this point in the year. Second quarter real Gross Domestic Product (GDP) just came in at 2.4%, exceeding expectations. The Consumer Price Index (CPI), known as headline inflation, has declined from 9% to 3% in the last year. Unemployment remains low at 3.5%, near record lows. Wage gains are now exceeding inflation, and consumer sentiment is improving. This all means that the economy is growing, inflation is decreasing, most people who want a job have one, and consumers are feeling better about their current and expected condition. All in all, a very good report.

The favorable economic picture has led to positive returns for both stocks and bonds in 2023 and stands in contrast to what had been generally expected as we entered the year. There was a widespread expectation that the economy would experience a recession this year. These fears were well grounded and based on a number of reliable warnings, the validity of which remain in place. But so far, the economy and the markets have defied the expectation of recession.

While the list of positives is impressive, the full impact of the Federal Reserve's (Fed) extended and aggressive attack on inflation remains to be seen. Their goal has been to reduce overall demand in order to bring it back into balance with supply, thus eliminating the inflation impulse. Taking a comprehensive view of inflation, getting to the 2% target is not going to be an easy task and will take some time.

The continuing strength in economic activity at a time when inflation is falling has led to an increase in hopes that we might enjoy an economic soft landing. For this to happen, inflation would have to drop sharply and quickly, without unemployment rising much from its low levels. While possible, historic precedent suggests the odds of it happening are pretty low. While we would welcome a soft landing, we believe it is prudent to remain on recession watch.

As investors, we want a favorable economic backdrop so businesses can prosper and grow. But what we really want to do is invest in the stocks and bonds of companies that can demonstrate improving business fundamentals in both good

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and bad times. Such companies will be defined as high quality, which is the most essential element in our investment approach and which will continue to guide our selections.

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