KLCM Advisors, Inc.

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Confidence

It was the best of times, it was the worst of times, it was the age of wisdom, it was the age of foolishness, it was the epoch of belief, it was the epoch of incredulity, it was the season of Light, it was the season of Darkness, it was the spring of hope, it was the winter of despair, we had everything before us, we had nothing before us, we were all going direct to Heaven, we were all going direct the other way—in short, the period was so far like the present period, that some of its noisiest authorities insisted on its being received, for good or for evil, in the superlative degree of comparison only. The opening passage of Charles Dickens's *A Tale of Two Cities* has been quoted many times to highlight how wildly viewpoints of a situation can contrast.

When thinking about current economic conditions, "It was the best of times, it was the worst of times" comes to mind. The US economy, having come through the aftermath of the pandemic, is still growing at an approximate rate of 3%. Consumers, in the aggregate, have little debt, wages are up significantly, and unemployment is at 4.1%. Historically, this combination would be regarded as nirvana, truly the best of times. However, consumer sentiment - as measured by the University of Michigan is hovering around 70. To put that into context, the same measure was 78 in June of 2020, when most had just been told to shelter in place for the foreseeable uncertain future. Over the past 50 years, this measure has spent little time below these levels, and most of those instances occurred in the nadir of sharp recessions - the worst of times.

The seeds of this despair began with responding to the pandemic and normalizing life afterward. Normal recessions take a toll on an economy and result in reduced demand, excess capacity, and subdued bargaining power - for both producers and workers. These moments lead to springs of hope as economic green shoots emerge. As time passes, consumers heal and feel like they have everything before them again. The pandemic was wildly different in that the economy was essentially slammed shut. In an effort to maintain the status quo, our government flooded the system with free money. This was sent, in many cases, directly to individuals. Many were working from home, receiving stimulus checks, and having their spending constrained due to the lockdowns. When the economy eventually reopened, instead of the gradual building recovery we typically see post-recession, this recovery was a full-blown sprint to spend.

The euphoria of being set free and - as we wrote at the time a recovery - "led by consumers who will start with a full head of steam and bank accounts to match" resulted in a boost to consumer confidence peaking around 88 in April of 2021. Having emerged from what might be described as a fairy tale world of free money and restricted spending, consumers raced to spend. Instead of finding "deals," consumers ended up finding higher prices, longer lead times, and in many cases, suboptimal customer experiences. To top it off, many were being asked to return to the office, which upset the new work-life balance they had achieved. From that point forward, confidence plummeted for over a year before troughing at 50 in the summer of 2022, the lowest reading in history. The combination of soaring inflation, increasing interest rates, and wages that were not keeping up led consumers to feel that this recovery was really the winter of despair. At the extreme, new home buyers saw increasing interest rates met with increasing home prices! For some, the feeling was that there was no way out of their parent's basements. They had nothing before them!

Inflation peaked concurrently with these low consumer readings at a little more than 9% in June 2022. Attempting to slow down this inflation, the Federal Reserve embarked on an interest rate hiking cycle that peaked at 5.5%. For the past two years, this has led to a slower-growing economy and moderating

inflation. During this time, consumer confidence slowly moved higher, reaching current levels in early 2023 when unemployment bottomed at 3.4%. As the economy continued to slow and unemployment started to tick up from historically low levels, consumer confidence began to stagnate.

Confidence is defined as "the feeling or belief that one can rely on someone or something." Given the turmoil that our country and our economy have undergone over the past four years, should it be surprising that consumers lack confidence? In the moment, the recent experiences we've endured seem truly unique; however, in the longer arc of time, it is likely that the problems we've faced and the opportunities in front of us only differ by degrees of comparison. It is unlikely that these are the best of times or the worst of times. In an era of informational overload where sensationalism results in headlines screaming that both are true, who could blame anyone for being sufficiently confused and hunkering down until figuring out what is real. So, have the last 18 months of consumer malaise been the calm before the storm or a national pause that will refresh?

There are plenty of potential storm clouds on the horizon, including but not limited to the upcoming US elections, the exploding national debt driven by never-ending fiscal deficits, conflict in Ukraine, and most recently, an escalating conflict in the Middle East. It is important to remember that there are almost always issues that need confronting. Rarely, however, are these problems permanently unsolvable. We need look no further in the rear-view mirror than the pandemic.

Recently, the unemployment rate has started to increase. This increase and a slowing inflation rate have provided the Federal Reserve ample cover to "recalibrate" its interest rate policy. Having paused their interest rate hiking cycle in July of 2023, they recently cut interest rates at their September meeting. We believe the past 18 months will prove to be a relative pause in consumer credit creation that has slowed the economy without tipping it into a recession. Assuming no major financial accident or bolt from the blue, we believe that as the cost of credit falls, the economy will regain its footing and extend this cycle with moderate growth over the next few years. As the cost of capital falls and wage increases continue to catch up to the inflation, we have already experienced, economic growth will remain solid and corporate profits will once again broaden.

We believe this broadening of corporate profitability is a major transition in the investment environment. How this broadening benefits many industries was readily observed in 2021 and early 2022 before the rapid interest rate increases necessary to slow inflation raised the cost of capital dramatically. In that environment, capital formation slowed, and capital flowed to only the highest returning endeavors. A "soft landing" for the economy - followed by broad moderate economic growth, form the basis of our investment outlook. This broadening of growth combined with a falling cost of capital also changes the dynamics of the market and could result in new leadership within the equity market. At a minimum, it will provide the backdrop for many companies and industries to prosper.

While some of the storm clouds mentioned earlier could result in a choppy near-term environment, we would expect to find opportunities in that choppiness to exit some positions that have reached full value while also investing in new ideas that will benefit from a refreshed and extended economic cycle. As returns on cash decline, fixed-income investors will need to extend their duration in order to generate the levels of income they have grown accustomed to. We have spent much of the past year doing this work on our clients' behalf, enabling them to enjoy an income stream that is well in excess of what is currently available in the market.

Considering the new set of choices available, now is a great time to revisit investment plans and consider modifying them if necessary.