SCHLINDWEIN ASSOCIATES
INVESTMENT COUNSEL

Disconnect

2025 was a rewarding year for financial markets and investor portfolios. While a bit uneven, economic activity generally was favorable and inflation remained within a tolerable range. All investors likely are consumers, but not all consumers may be investors. A popular measure of consumer sentiment ended the year very near its historical 48-year low. Such lows more often than not have coincided with recessions, the most recent being that triggered by the pandemic. While inflation has backed off from prior highs, prices for many consumer items have remained sticky to the upside. This outcome likely has played a role in consumer sentiment and its seeming disconnect with other key variables. Economic trends and changes in investment market price levels are loosely correlated, but an understanding of relationships is useful for setting investment strategy.

PERSPECTIVE

Changes in annualized quarterly rates of change for U.S. real GDP are shown in Chart I. Actual data for the past two years are followed by consensus forecasts for the next 1½ years. After a subdued rate in 4Q2025, real growth is forecasted to stabilize around +2% in each of the next six quarters. This rate of growth, and importantly its consistency, should support gains in employment, wages, and capital expenditures. Such an outcome should be supportive for gains in stock prices. The actual experience of the past two years of a much higher volatility in the quarter-by-quarter growth rate of real GDP seemed to have had minimal impact on the trend in stock prices.

Annualized quarterly rates of inflation, as measured by the Consumer Price Index ("CPI"), are shown in Chart II. The quarter-by-quarter volatility of the CPI over the next 1 ½ years is forecasted to be markedly lower than that of the past two years. At the same time, the inflation level itself is expected to remain above the policy target of +2%. It seems likely that market participants and policy makers will be able to adapt to this somewhat higher rate if more stability does prevail in the rate itself. Expectations for further cuts in the Fed's target policy rate remain but could shift if a less favorable inflation rate emerges.

The closely monitored consumer sentiment index as measured by the University of Michigan is shown in Chart III. Of note here is the determination that favorable versus unfavorable crosses over at a value of 100. This level implies an unfavorable bias to interpretation as less than 10% of actual monthly readings are 100 or higher. The latest reading of 52.9 is very close to the all-time low reading of 50.0 set in June 2022. By many other measures, it would seem reasonable to expect that the advance in sentiment since than would have been much greater. Given the favorable performance of financial markets, perhaps other factors are at play. Included could be growing income disparities, uneven participation in risk assets, domestic policy uncertainties, and generally higher levels of geopolitical unrest. While these other factors may not lend themselves to desired quantitative measurement, they would seem to have some explanatory value.

INVESTMENT IMPLICATIONS

Stock indexes generally are near all-time highs. Real economic growth is positive and stable with low expectations for a recession. Inflation has settled in at a modestly above-target but seemingly acceptable level. And yet a disconnect exists between these variables and consumer sentiment with its near-historical low reading. This low level could be a harbinger of less favorable economic and market outcomes ahead. However, if favorable economic outcomes prevail, an upside break in sentiment could occur. All of this suggests some moderation in portfolio risk-asset exposure, but a goodly exposure in any event.

CHART I

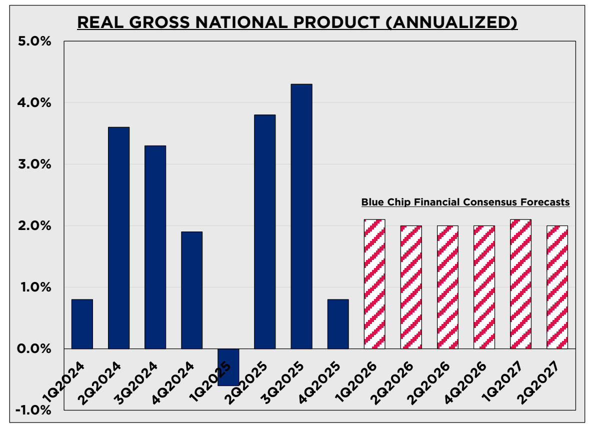

CHART II

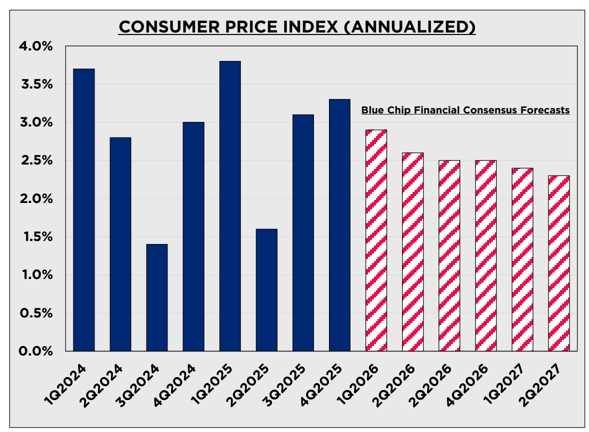

CHART III