THE AUDIBLE...

Be stubborn about the process ... flexible about the conclusion!

The audible

Every NFL coaching staff walks into Sunday with a game plan.

Coaches spend the week studying film ... personnel packages ... formations ... tendencies ... down-and-distance probabilities. They dissect what an opponent has done, where they've had success, where they've struggled and, ultimately, construct a game plan they believe gives their team the highest probability of winning.

There's just one small problem ...

The guys on the other sideline have been doing the exact same thing.

You can prepare for what you *believe* you're going to see. You can study historical tendencies and assign probabilities based upon every piece of information available to you.

But until the ball is kicked off ... you don't know exactly what the other team is going to give you.

Sometimes they line up exactly as expected.

Run the play.

Sometimes the quarterback gets to the line, sees the safety creeping down, recognizes pressure coming from somewhere it wasn't supposed to ... and changes the play.
Audible.

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And sometimes you need to play an entire half before enough information accumulates to recognize that something more meaningful needs to change.

You can't make halftime adjustments if you never play the first half.

Longtime readers may remember we've used football before when discussing probability … specifically Pete Carroll's infamous decision to throw the football from the one-yard line against the Patriots in Super Bowl XLIX … the result was an interception … leading to countless Monday morning quarterbacks telling the world how much smarter they were than the guy who actually got his team to the show.

That discussion was about *outcome bias*. A high-probability decision doesn't suddenly become stupid simply because it produced a bad outcome.

This is different.

This is about what happens when **new information changes the probabilities themselves**.

Which brings us to one of the most important principles underlying our investment process:

Be stubborn about the process … flexible about the conclusion.

The game plan

Last month, in *Recalculating*, we walked readers through what the Rate of Change (RoC) data was telling us about the economy.

Growth was slowing … while inflation had reaccelerated.

More importantly, we discussed why neither trend should be extrapolated indefinitely.

Remember, we're not particularly interested in arguing whether growth is "good" or "bad" … or whether inflation is "high" or "low."

We're interested in whether they're **accelerating or decelerating**.

It's the direction and magnitude of change … the second derivative … that helps us identify changes in the economic environment *before* they become obvious in the headline data.

Based upon comparative base effects, lead/lag relationships, current NowCasts and the incoming data, our highest-probability path currently looks something like this:

August … Quad 3: Growth decelerating / Inflation accelerating
September … Quad 1: Growth accelerating / Inflation decelerating

October … Quad 2: Growth accelerating / Inflation accelerating
November … Quad 4: Growth decelerating / Inflation decelerating

Importantly … **that's the game plan … NOT a promise.**

We're not trying to predict the final score before kickoff. We're trying to understand the probabilities well enough to know how we want to play the game … while remaining disciplined enough to change when the information changes.

We're willing to put a probable path on paper because having a framework matters.

But we're not going to defend September's Quad 1 in October simply because that's what the math suggested in August.

If the data changes … we change.
If the signals change … we adjust.

That's not abandoning the process.

That IS the process.

The current HE framework similarly identifies August as Quad 3 and September as Quad 1, while its mid-quarter work describes the broader sequencing as a 3-1-2 Quad Count.

So … what are we actually seeing on the field?

Inflation … deceleration doesn't mean deflation

Let's start with CPI.

July Headline CPI increased **+0.07% MoM**, reversing June's **-0.42% MoM** decline.

Read that sentence again because it's a perfect example of why Rate of Change matters.

Prices **increased sequentially in July** … yet the YoY inflation rate **decelerated** to **+3.36% from +3.53%**.
Both statements are true.

Energy provided some relief, falling **-1.48% MoM**, while Food increased a relatively modest **+0.08% MoM**.

Core CPI tells a similar story.

Core increased **+0.22% MoM**, while the YoY rate slowed to **+2.48% from +2.59%**, its slowest YoY pace since February.

Shelter … because apparently, we're contractually obligated to discuss the largest component of CPI every month … increased for the **75th consecutive month**, rising **+0.14% MoM and +3.18% YoY**, though that YoY rate decelerated from **+3.28%**.

Rent increased **+0.26% MoM / +2.86% YoY**, while Owners' Equivalent Rent increased **+0.26% MoM / +3.22% YoY**.

Interestingly, the reported Shelter number received considerable help from Lodging Away from Home, which fell **-2.75% MoM**, slowing to **+2.97% YoY from +4.90%**. Meanwhile, real-time Apartment List rents remain **-1.1% YoY** … another reminder of the enormous lag embedded in the government's Shelter calculation.

So … inflation is decelerating … Case closed?!

Not quite.

The August inflation NowCast currently sits at **+3.47% YoY**, which would represent approximately **+11 basis points of sequential acceleration** from July's reported CPI.

That's the distinction we've been hammering on for years.

A deceleration today tells you where inflation has been … when combined with comparative base effects and forward-looking data … it also helps guide you where it may be going.

And right now, the math continues to suggest a little more wobbling ahead.

Growth … looking back while looking forward

Growth provides the other side of the equation.

Preliminary Q2 Real GDP increased just **+1.49% QoQ SAAR**, down from **+2.07%** previously, while YoY Real GDP growth slowed to **+2.10% from +2.68%**.

That's a fairly clear deceleration.

But underneath the headline, the economy wasn't exactly rolling over.

Real Personal Consumption increased **+3.12% QoQ SAAR**, contributing **+2.12 percentage points** to GDP. Real Private Fixed Investment increased **+6.78%**, adding another **+1.20 percentage points**.

Meanwhile, Net Trade subtracted **-1.01 percentage points**, inventories subtracted **-0.67**, and Government Spending another **-0.14**.

Again …

The headline matters … but not as much as forward directionality and what's underneath it.

And some of the higher-frequency growth data is becoming increasingly interesting.

July's ISM Manufacturing Index increased **+2.3 points to 55.6** … its highest reading since May 2022 and its seventh consecutive month in expansion.

⇒ New Orders rose to **56.7**.
⇒ Production jumped **+6.3 points to 58.5**.
⇒ Backlogs increased **+4.5 points to 55.0**.
⇒ Employment rose **+3.1 points to 52.8**, moving into expansion for the first time in nearly three years.

Small businesses are beginning to echo some of that improvement. The NFIB Small Business Optimism Index rose **+2.4 points to 99.8** in July, moving above its historical average, with sizable improvements in Hiring Plans, Capital Outlays, Job Openings, Expansion Plans and Economic Outlook.

Industrial Production increased **+0.20% MoM** in July, although its YoY RoC slowed to **+1.08% from +1.29%**.

That's not uniformly strong data.

It's not supposed to be.

Inflection points rarely arrive with every economic indicator moving in perfect unison.

The backward-looking growth data is telling us where we've been.

Some of the higher-frequency data is beginning to tell us where we *may* be going.

Each data point has a different weighting in the models.

And this distinction matters considerably as we approach September.

Getting to the line

If the current RoC relationships hold, growth should begin accelerating as we move into September while inflation experiences another modest deceleration.

That combination would move us toward **Quad 1 … Goldilocks**.

From there, current base effects suggest growth could continue accelerating into October while inflation reaccelerates alongside it … shifting the environment toward **Quad 2 … Reflation**.

Both environments have historically been constructive for markets ... though **what performs best within those environments can look very different**.

Also, a very important distinction ... "Stocks are going up" isn't an investment process.

Understanding the economic environment ... identifying which asset classes, sectors and factors historically respond favorably to that environment ... and then requiring market signals to confirm the thesis is considerably closer to one.

And then there's November.

Our current math suggests another potential shift toward Quad 4, with both growth and inflation decelerating.

The further out we look, the wider the range of potential outcomes becomes. September's defensive formation is coming into view ... November is still sitting in the film room.

Could that happen?

Absolutely.

Does that mean we're positioning today as though November has already arrived?

Absolutely not.

Does every Quad 4 mean "market crash"?

Nope.

Remember ... as we stated above:

"You can't make halftime adjustments if you never play the first half."

To Audible, or not?!

This is where forecasting and risk management have to coexist.

We spend an enormous amount of time and resources studying comparative base effects, lead/lag relationships, economic data and market signals ... while incorporating institutional research from firms like Hedgeye Risk Management ... because we want to understand the **most probable path forward**.

But probable doesn't mean predetermined.

→ If September's expected growth acceleration doesn't materialize ... that's information.

→ If inflation doesn't behave as the comparative base effects suggest … that's information.
→ If our market signals begin moving contrary to the expected economic environment … ALSO information.

We don't get bonus points for stubbornly defending a forecast.

The best coaches aren't necessarily those who devise the perfect game plan on Tuesday. They're the ones capable of recognizing on Sunday when the opponent is giving them something different.

→ Sometimes you run the play.
→ Sometimes you audible.
→ Sometimes you get into the locker room at halftime, erase half the whiteboard and make a more meaningful adjustment.

This is why we constantly emphasize following the signals rather than becoming anchored to the game plan. The economic data helps us establish the most probable environment ahead … but the market signals help determine how we actually manage risk and position capital as that environment develops.

In football terms … the game plan tells us what we expect the defense to do. The signals tell us what they're actually doing.

And when those two materially differ … we adjust.

The important part is knowing **why** you're making the adjustment.

Final thoughts

There's an interesting misconception in investing that changing your mind demonstrates a lack of conviction.

We'd argue the opposite.

Conviction should reside in your **process** … not your predictions.

We have a view today.

Based upon the data currently available, we believe the highest-probability path takes us from **Quad 3 in August … toward Quad 1 in September … Quad 2 in October … with another potential Quad 4 developing in November**.

→ We've done the film study.
→ We've built the game plan.
→ And we play the game … daily.

Some things will unfold exactly as anticipated … others won't.

The challenge isn't predicting every defensive formation before the offense breaks the huddle.

The challenge is recognizing when what you're seeing on the field differs materially from what you prepared for … and having both the discipline and humility to do something about it.

Be stubborn about the process … flexible about the conclusion.

Ultimately, a financial plan should operate similarly.

We can model income, expenses, Social Security, pensions, taxes, investments, insurance, healthcare and longevity based upon everything we know today.

But life has a funny habit of changing the defensive formation after you've already called the play.

A good plan anticipates probabilities … a better process continually evaluates them.

Because the goal isn't always to prove the original plan was right … it's to put yourself and your family in the best possible position … every step along the way … especially should circumstances change.

And when they materially change?

Audible.

If you'd like to discuss if a possible audible could positively impact your retirement income plan, investment strategy, tax planning, or long-term financial goals, we'd be happy to help.

[Schedule your free consultation today.]

As always … Good investing!

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