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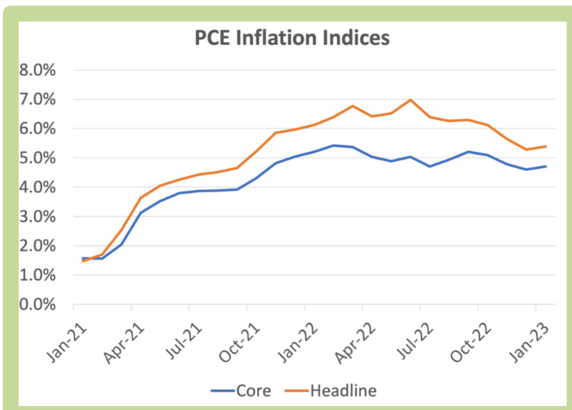
Recent Economic Events

Buoyed by a strong labor market and a push to bring globe-trotting supply chains home, the American economy has, so far, shrugged off the impact of monetary tightening. Personal consumption has surprised to the upside, driven by a return to spending on services from buying goods. The impact of that shift can be seen in the disparate movement of prices. Goods prices, which jumped in the aftermath of the pandemic when traditional services spending (restaurants, travel, entertainment, etc.) was not an option, have now mostly stopped rising. However, services prices have taken the baton as providers try to cover increased labor costs by charging more for what they offer. A reversal of zero-Covid policy led to a reopening of China's economy, boosting demand for raw materials to supply restarting factories.



Fourth-quarter GDP advanced by a solid 2.7% as the combination of personal consumption, business investment, and net exports offset the weakness in residential investment. Current indications from the FRB of Atlanta project first quarter growth over 2%. Once again, those who bet against the American consumer were proven wrong with January retail sales jumping by 3%. Notable categories contributing included restaurants and new car dealers. With Covid restrictions mostly in the past, travel also showed strength.

Unfortunately, inflation measures reflected the pickup in spending. Headline and core PCE price indices rose .6% in January, well above expectations. Plus, the year-over-year gains registered 5.4% (headline) and 4.7% (core), both showing acceleration, not deceleration, from December. Service price increases accounted for the lion's share of the gains.

We need look no further than the tight labor market to explain the inflation turnaround. January saw a gain of 517,000 jobs along with upward revisions to both November and December. The unemployment rate fell to 3.4%, a figure last seen in 1969. Not sure I had started shaving in 1969. The number of unemployed Americans continues to shrink while job openings stay high. There are now roughly two unfilled positions for every unemployed worker. The transition from excess supply of workers to chronic shortage has prompted employers to retain labor even in the face of weakening demand. They fear the costs of training and being unable to rehire when business picks up.

The other big story in the report was the .3% increase in wages coupled with a jump in the average work week. The combination boosted weekly income by over 1% for the month and over 8% for the year. This is great news for the consumer and helps explain the robust spending we have seen so far this year. The downside is the pressure it puts on businesses to raise prices to recoup increased worker costs.

Recent Economic Events-continued

The hope had been that productivity would offset wage gains as new technology entered the picture. That hope was undermined by the fourth-quarter report showing productivity at a below expected 1.7%. This left unit labor costs up 6.3% over the last year — too high for a 2% core inflation rate.

Most have noticed that gasoline prices have stopped falling and are bouncing back up. This trend is also evident in the industrial commodity markets. The reason: China's restarting economy. The reversal of the ill-fated zero-Covid policy resulted in a wave of infections in China that severely tested the medical resources of the country. However, it appears that the wave has crested, and recent statistics indicate that the Chinese economy is on the mend. The combination of individual savings from lockdown spending restrictions and government stimulus efforts seems to be paying off. Maybe goods prices aren't so benign after all.

Putting all the recent economic releases in context suggests that things are not slowing down as the Federal Reserve had hoped from its aggressive monetary tightening. Wage strength and China's reopening are unwelcome developments on the pricing front. Although this economic strength argues for a reduced chance of near-term recession, it also argues for even higher interest rates, which could precipitate a more serious slowdown later.

Commentary

The dirty little secret of economics is that the drive for efficiency in production leaves demand far behind supply. It has always been government's job to plug the demand hole to keep the economy running. In ancient times, it was wars and pyramids; medieval times brought religious wars and cathedrals. Today we have defense spending and social safety nets. The practical result of this need is government deficits.

According to the famous economist Paul Simon, "One man's ceiling is another man's floor." In the context of government deficits, this means that there must be a surplus somewhere. That surplus is the extra demand in the private economy over and above what it otherwise would be if left to its own devices.

Let's dig into this. What would happen to demand in the economy if the federal government were to balance its budget? To be as non-partisan as possible, suppose we both raise taxes and cut spending. An increase in taxes would reduce income to individuals and profits to businesses. Reduced spending for either current consumption or investment would follow. At the same time, lower government spending would mean fewer tanks and planes, cutting demand for defense contractors. It would mean lower Social Security and Medicare/Medicaid payments as well. Landlords in retirement communities would suffer, as would doctors, hospitals, and all the support staff for our medical industry.

Commentary-continued

Some would contend that private demand would meet the challenge. However, to do so, private entities would have to take on debt because their income is going to be lower. Remember, while government debt doesn't really have to be repaid, private debt does. No, I am afraid that without the extra dollars pumped into the economy due to debt-financed government expenditures, the economy would be smaller than it is.

There is another problem as well. After the initial hit to the economy, the basic fact of supply outrunning demand remains. Any gains in efficiency (read fewer workers) results in less income for consumers and less demand for goods, etc. While the sound-bite slogan, "government must live within its means" has emotional appeal, it simply won't work without out a lot of pain in the private economy.

The deficit/surplus conundrum is another example of the paradox of savings. If one individual saves more, that may benefit him, but if the entire populace does, that results in less consumption and an economic contraction. In fact, you can look at the federal deficit as dis-saving for the entire country. Were the deficit to fall, it would result in net saving for the entire country, and consequently, less consumption.

This analysis can be extended to our trade deficit as well. This deficit provides a surplus to the rest of the world, allowing production of items that wouldn't have a market save for the US. It also facilitates trade between other nations based on the ability to use a stable currency. This liquidity is crucial for the global economy.

Rather than living within my means, I prefer to live beyond my means as long as the costs don't appear on my personal debt statement. That's what deficits (government and trade) allow me to do.

Market View

The market has finally realized that the Federal Reserve is going to take the short-term interest rate into the vicinity of 5.50% — maybe even higher. Furthermore, prospects of a near-term rate reduction have faded into the future. Consider that the one-year Treasury bill yields over 5%, offering stiff competition to equities and longer-term fixed income securities. In fact, as I write, there is no Treasury bill, note, or bond yielding much less than 4%. Why take the price risk when you can lock in a guaranteed rate well above dividend yields or coupons on bonds with longer maturities?

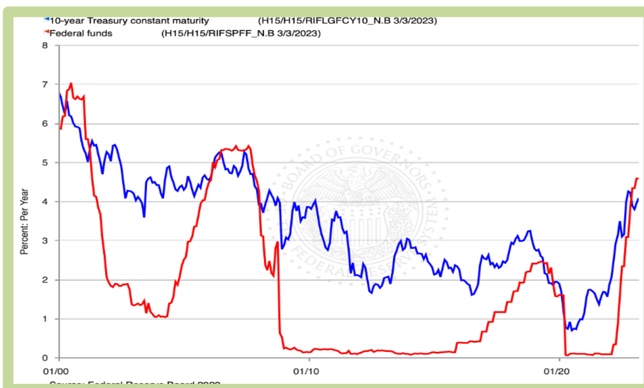
Liquidity is the lifeblood of financial asset valuation. More liquidity = higher prices, less = lower. The Federal Reserve has not only been raising rates (up 4.50% since last March), it is also extracting liquidity by shrinking its balance sheet. At this point, the economy has navigated the increase in interest rates quite well, mainly because it is only recently that rates have exceeded the increase in prices. That is now changing as bankruptcies have increased and stress has hit lenders. Delinquencies have crept upward on credit cards and auto loans. Office landlords are defaulting on their mortgages. Loan officers have increased borrower scrutiny, and the reversal of deposit gains in the banking industry has forced smaller banks to turn to the Federal Reserve for funding. These are all signs of a much different liquidity picture than the one we witnessed in the wake of the pandemic. The heady stock market gains of 2020 and 2021 were partially eroded in 2022, and 2023 promises a very challenging environment.

In my December newsletter, I averred that both stocks and bonds had come too far too fast. I expected a lower low before a sustainable bull market could begin. I still believe this. For equities, use rallies to pare positions, especially those of lower-quality companies that may have previously benefited from low rates and ample access to funding. A well-protected dividend should be the hallmark of those stocks you decide to hold.

Market View-continued

My skeptical views of real estate have not changed. Real Estate, whether residential or commercial, is the most leveraged investment asset there is. Higher rates simply make it less valuable. We have seen multiple-month decreases in home prices, leaving them lower than a year ago. There are more declines to come.

Precious metals have probably peaked because of rate competition and inflation's moderation. Gold tends to do well when inflation is a surprise, not when it is simply hitting expectations. Industrial commodities will get a boost from China's reopening, but they are hard to invest in without added costs. Green commodities are a good long-term bet, and oil is likely to continue upward because of the lack of investment in new production.



The drop in interest rates on intermediate and longer-term bonds from October into January was clearly overdone. The ten-year Treasury tends to peak just before or coincident with the top in the overnight rate. It also tends to zero in on the terminal rate in the cycle. If indeed the Federal Reserve takes the overnight rate to 5.50%, buying or holding the ten-year at current rates near 4% doesn't seem like a good idea to me. Keep in mind that the last time the overnight rate was over 5% (in 2006), the ten-year Treasury also yielded over 5%. A lot of uncertainty remains over the strength of the economy and the path of inflation, but if the next few statistical releases confirm the strong job market and inertia on core inflation, the inverted yield curve is at risk. Will we see a 5% ten-year Treasury? Not predicting it, but the risk is presently greater than the reward.

So where to put investment dollars? Short-term, high-quality options in money market funds invested in Treasuries or in Treasuries themselves are a low-risk way to finally collect a positive return versus inflation. I would limit maturities to two years until we get some clarity on the economy and inflation. I honestly don't think that this will occur before mid-year. In the meantime, enjoy collecting your interest payments at the highest rates we have seen in over a decade.

Editor's Notes

One of our family sayings is, "there's always a story." This is usually uttered when some bad twist of fate has occurred. However, it can be more universally applied. Trading our snow brush for a sun shield, we left the cold, gray skies of Scottsville for the sunny, blue skies of New Orleans. On the way, we stopped at a rest area on the interstate. Normally, this is a straightforward operation, but I was struck by a sign I observed in the men's room. It pleaded, "Please don't blow your nose in the sink." This put me in mind of the command to not think of a pink elephant. Rather than dissuading, it opens the possibility. Not having the sniffles, I demurred. Back into the car, we removed the sun shield we had in the front windshield, and I noticed a warning tag which stated, "Do not drive with shield in the window." Phew, I'm glad I noticed that, or our trip might very well had another story to tell.

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