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JAMESSON associates

Recent Economic Events

When I was very young (less than five years old), I had a blow-up toy, taller than I was, with the face of Bozo the clown. It was heavily weighted at the bottom so whenever you punched Bozo, he would lean over almost to the ground and then bounce right back up. This, of course, provided me no end of entertainment as it did my parents and grandparents. I tell this story because I don't want you to think that when I call American economic performance the Bozo Economy that I am being pejorative rather than complimentary.

The United States has continued to grow and add jobs even as it has absorbed punch after punch. Monetary tightening has been aggressive; bank failures have rattled confidence and reduced credit availability; and the debt-ceiling circus has reinforced the dysfunctional system in charge of our country. Despite all this, the American consumer has kept the faith, boosting consumption to new highs and apparently processing the increased costs of housing (both prices and mortgage rates). Builders are building, and new home sales are at multi-month highs. To be sure, the other consequence of consumer resilience is the stubbornly high level of core inflation, which seems to have plateaued well above the Federal Reserve's target. Can the positives continue to offset the challenges?

The job market is the most robust part of the American economy. According to the establishment survey, 339,000 jobs were created in May while the figures from the previous two months were revised upward. This represented the 14th consecutive month that job growth beat the market consensus. Although job gains exceeded expectations, the unemployment rate (which comes from the household survey) jumped from a post-pandemic low of 3.4% to 3.7%. The two surveys frequently disagree over a one or two-month time frame but tend to converge over the longer term. So, while unemployment rose, it's still well below the Federal Reserve's estimate of full employment. Labor force participation remains at a post-pandemic high. Consumer spending continues to be powered by record numbers of job holders pulling down solid wage gains (up 4.3% from a year ago). It is further enhanced by modest household debt levels and still-material excess savings from the pandemic.

It was that consumer spending which led to the 1.3% gain in first quarter GDP. While below expectations, the reason for the shortfall was a big decline in inventories. Essentially, the consumer bought more than businesses anticipated, leading to an unexpected draw on inventories. Initial indications suggest a positive second quarter, helped by a stabilization, then a slow but steady increase, in new home sales. It may appear unbelievable to many, but strong employment and wages have convinced enough folks to become homeowners despite sharply higher mortgage rates. Even a small uptick in housing starts is enough to turn the drag on GDP to a slight plus.

While consumers are keeping the economy out of recession, they are also allowing businesses to keep raising prices. Core inflation has been uncomfortably sticky. The Federal Reserve continues to predict an imminent decline in core inflation, but it just isn't happening. The most recent core PCE inflation report from April showed an unfortunate .4% increase, bringing the annual gain up to 4.7% from 4.6% the previous month. The improvement in the core rate from its peak last February of 5.4% has been grudging. In fact, the core rate is now running above the headline rate which registered 4.4% versus a year ago in April down from the cycle high of 7% last June.

Recent Economic Events-continued

Let's dig into this. A year ago, the cherry-pickers were bemoaning $6 eggs and $5 gasoline. Snarky comments about excluding food and energy from the inflation figures abounded. Last I checked, prices are a lot lower, putting a few more bucks in the household pocketbook. Three additional pluses will act as tailwinds for the economy. First, money market funds have attracted record dollars at rates near 5%. The interest passed along to owners of these funds will supplement spending. Second, there are still billions of dollars of excess consumer savings from the pandemic. Finally, while few are true believers, the stock market is bounding ahead, up about 20% from the low point last October.

Now I don't want Pollyanna to grab the by-line on this article, so I need to point out that there are some significant headwinds as well. Credit is becoming tighter. Bankruptcies are up and banks are increasing scrutiny of borrowers. Since a modern economy runs on credit, some slowdown can be expected. Student loan forbearance is ending. For a significant number of borrowers, this will represent a hit to the budget. Dollars spent paying down loans will not be spent on consumption.

How all the crosscurrents will settle out is beyond my abilities to forecast. However, I'll point out that plenty of folks have gone wrong betting against the American consumer. As long as the labor market stays strong, my money is on Bozo bouncing back.

Commentary

There is a fairy tale known as "The Emperor's New Clothes" where a willful delusion perpetrated by the elite royal courtiers is pierced by a small boy's truth telling. The parallel to the market's belief in the Federal Reserve's effectiveness is striking. Here we are about a year and a half into a tightening cycle and yet the impact on the real economy has been marginal at best.

The Fed spent most of the 21st century trying to push inflation upward with a combination of rock-bottom interest rates and quantitative easing. Didn't really work. More recently, they have switched gears, raising rates and shrinking their balance sheet in the pursuit of lower inflation. While the headline rate has receded from its highpoint, the core has been quite stubborn, perhaps even beginning a renewed ascent.

This record of failure suggests that there is something else that is driving inflation besides the machinations of the Federal Reserve. What could it be and did something change in the last few years that has changed the game? I believe so.

The factors that kept inflation under control over the past twenty years or so have included Chinese labor, fracking, and low interest rates.

China joined the WTO in the late 1990s and utilized its cheaper labor to become the factory to the world. This reduced costs for all types of manufactured goods while it hollowed out manufacturing in the advanced economies of the world, especially the United States. Walmart flooded the country with these goods, undercutting American products. For most of the 21st century, goods prices have been stable to down.

Coming out of the sub-prime recession, fracking started to boost American production of oil and gas, ultimately making the United States the largest producer in the world. The increase in supply helped cap energy prices, knocking them down

Commentary-continued

from over $100 a barrel to below $75 for most of the last ten years except for the temporary spike due to the Russian invasion of Ukraine. Natural gas prices have also been held down over this period.

Paradoxically, low interest rates engineered by the Fed allowed venture capital investors to fund all manner of money-losing companies. Uber disrupted taxi pricing; Airbnb held down lodging prices; MoviePass promised you would only have to pay for the popcorn. Cheap money subsidized users as the businesses reached for scale.

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The Fed fought the secular pressures of disinflation with little success. Now, the worm has turned. The tailwind of Chinese labor is now a headwind; their labor force is shrinking. The US now has a labor shortage just as it is trying to bring cutting-edge manufacturing back home. This will cost money, as will the transition to renewable energy. While wind and solar are competitive when they are producing, they are not producing all the time. That requires storage, and because renewables are located much farther from users than are fossil fuel plants, there is transmission loss to account for as well.

It is because of these secular changes that inflation has changed from a general downward path to an upward one. The Fed has had nothing to do with it. So while I am not a little boy telling an obvious truth, I will point out that the Fed's powers are as real as the emperor's clothes.

Market View

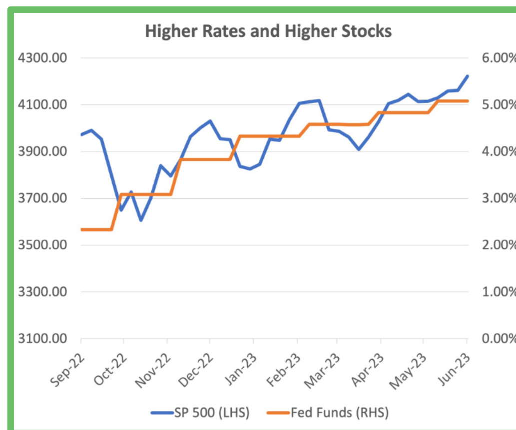
Timing is everything. My last newsletter was published the week before the collapse of Silicon Valley Bank and Signature Bank. There was a clear break in expectations pre- and post-failure. Well, that is the risk that anyone making financial predictions faces. My concern at that time was that with little sign that inflation was likely to settle down to the Fed's target, higher rates and tighter liquidity would be with us longer than many expected. This would lead to stiff competition for risk assets, causing real headwinds for the prices of stocks, bonds, and real estate. After an initial swoon, stocks have regained momentum while bonds have been trading in a rather tight range. Commercial real estate has taken a hit, but single-family home values appear to have stabilized. Commodities are losing ground across the board.

Let me start with my base case scenario. It is driven by two secular trends: labor shortages and the transition to renewable energy. The Federal Reserve has one or two additional rate hikes in store, not because inflation will settle down to the 2% target, but because the increases are not having their intended impact. Inflation is likely to recede but only to the 3% area. After a while, the Fed will declare success in the inflation fight. However, because 3% is not 2%, cuts in the overnight rate will be grudging. Short rates are likely to move towards the mid-3% level by the end of 2024. At the same time, longer-term rates will edge upward as the market realizes the days of zero interest rates are in the rear-view mirror. The economy will slow but will not succumb to a significant recession. We may even skate through with a soft landing. It is the labor market that will determine.

What does that mean for each of the major investing categories? As measured by the S & P 500, stocks have rallied by over 10% this year. The gain

Market View-continued

from the low point last October is closer to 20%. With cash alternatives yielding near 5%, few gave a second thought to investing in equities. That skepticism has been instrumental in the rally. If the Fed is near the end of its tightening cycle, and the likelihood of a recession is receding, stocks are not a bad place to be. Admittedly, valuations are higher than we would like, but companies have been able to keep earnings above expectations. We can't discount the fact that the market has been led by a small number of technology stocks, but recent developments in AI may very well justify the excitement.



I remain quite negative on fixed income. The fact is that longer-term Treasury notes and bonds are yielding far less than short-term options. Why give up yield while locking in your money for the long term, especially in the face of a deluge of Treasury borrowing? If I am wrong, and we fall into a recession with unemployment jumping, then bonds will perform well for a while. However, eventually a normal yield curve will be restored with long rates higher than short ones.

Commercial real estate is not only subject to location, location, location, but it is also being buffeted by changes in work and shopping habits. I would let the correction run. On the other hand, single-family home prices appear to have stabilized. The United States has underbuilt housing for at least a decade. Demographics and a shift in favor of workers and wage gains should support that market.

Industrial commodities shouldn't be falling in price, but they are. China's restart has not been as strong as expected, and oil prices are down even in the face of OPEC cutbacks. Maybe EV sales (34% share in China, 23% Europe, 7% US) are having an impact on oil demand. Supply chains are returning to normal, and it is unlikely that inflation will spike enough to boost interest in precious metals.

In summary, cash looks good as do high-quality stocks on pullbacks. Stay away from long-term bonds and be choosy on real estate. A generally slowing manufacturing landscape argues against industrial commodities while housing may boost lumber.

Editor's Notes

We are back north once again, having escaped hot and humid New Orleans in early May. An uneventful trip saw us home in Scottsville in time for a Mother's Day celebration. Alas, on the following Wednesday, I tested positive for Covid. I was not happy. For about ten days, my routine consisted of waking up, eating breakfast, taking a nap, eating lunch, taking a nap, etc. The one good thing about the ordeal was that I got to eat in bed. Susan was cooking my meals and putting them on a tray outside the bedroom door which I would retrieve and prop up on the bed to eat. I really got used to the extra service, so if you run into her be sure to tell her how much her husband would appreciate being pampered as if I were still convalescing.