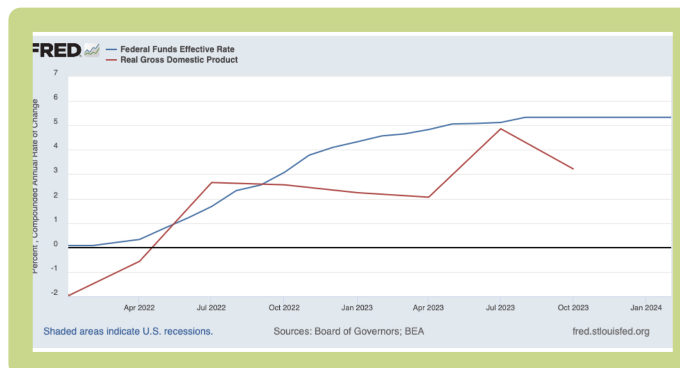
# Recent Economic Events

The American economy continues to defy the Federal Reserve. Personal consumption has been a key driver, benefiting from strong employment and rising wages. You also can't discount the significant government incentives included in the figures. Inflation has retreated from its high point but seems to have stalled on its journey to 2%. An important part of the price picture is the cost of housing. The lack of homes for sale has supported housing prices even in the face of 7% mortgage rates. It appears that higher interest rates are adding to, rather than dampening, price pressures in this area.




Therein lies a key paradox: the economy is doing well despite substantially higher interest rates than prevailed pre-pandemic. Part of the strength we are seeing is undoubtedly due to amnesia about what we might have considered normal prior to the sub-prime meltdown known as the Great Financial Crisis. For the fifteen years prior to the GFC, the overnight rate averaged over 4%, while in the ensuing 15 years it averaged less than 1%. The average from the end of the Treasury/Federal Reserve rate cap agreement, which ended in 1954, to date has been over 4.5%. The median (which throws out the extremes) was a little over 4%. As you can see from the nearby graph, GDP has been on the upswing even as rates jumped.

Real GDP rose by a solid 3.2% in the last quarter of 2023 and current estimates suggest first-quarter gains in the range of 2.5%. This was reinforced in the Federal Reserve's recently released Beige Book, which reported an economic uptick in early 2024. The consumer has been the main driver of the growth with contributions from all the key categories except inventories. Due to Federal funding and incentives, construction, both public and private, is booming.

The strong labor market has been a major support for spending. The February report showed 275,000 jobs created and an unemployment rate of 3.9%. This marks the 25th straight month of unemployment below 4%. Having a job is only part of the equation. For consumers to spend, their wages need to at least keep up with inflation. In February, average wages were up by 4.3% from a year ago. As I have noted in the past, the average has been held down by the mix of jobs. If we look at the same job from last year to this, the wage gain is closer to 6%.

Headline CPI inflation was 3.2% in January while the core rate (excluding food and energy) was 3.9%. The PCE inflation rate was lower at 2.4% headline and 2.8% core. All these figures are down from the peak and heading in the right direction. This suggests that the typical worker is keeping ahead of the price increases. However, the statistics belie the reality for many. Necessities like food, gasoline, and

## Recent Economic Events-continued

rent have stayed elevated, and don't get me started on car insurance premiums. Inflation as felt by the consumer is still too high and will likely keep the Federal Reserve on hold until more progress is made.

Housing inflation has been a thorn in the Fed's side. Normally, when interest rates rise, the first part of the economy to feel the heat is housing. Not this time. Because rates rose so quickly and by such a large amount, homeowners felt trapped in their current abodes. Relinquishing a 3% mortgage to trade up in house size at a new 7% rate could double the monthly payment, and few are willing to do so. As a result, the supply of houses has been constrained, sending potential homeowners to the new home market or into a tight rental market. So, higher rates are actually causing upward pressure on housing costs.

Reality has refused to conform to standard economic theory. The economy is growing faster than it was when the Fed began to tighten; the labor market has stayed healthy; inflation has come down, but maybe despite the Fed, not because of it. The situation reminds me of the old chestnut regarding economic developments, "That works in practice, but it never will in theory."

## Commentary

Artificial intelligence hype has gone into overdrive. However, sometimes hype is justified (see Mahomes, Patrick). There are two big unknowns. First, will AI be the productivity accelerator that the optimists suggest? Second, if it is, will the gain come from AI helping humans do more or by simply supplanting them?

Productivity has picked up strongly in the last year, benefiting from a normalization of supply chains and from the experience gained from dealing with the challenges of the pandemic. The most recent figures show productivity grew by 3.2% in the fourth quarter, holding gains in unit labor costs to only 0.4%.

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In my opinion, AI is contributing as well. JPMorgan Chase recently announced that a pilot program which they have offered their commercial customers to help project cash flow has eliminated 90% of the process' manual work. Customer service centers offering AI assistance to their operators have experienced efficiency gains of 30% to 40%. IBM reported a 10-fold (!) increase in designer productivity through the use of Adobe-supplied AI tools. Of course, this is only scratching the surface, but note that these improvements are not just at the margin. They are significant enough to upend business practices. The huge expenditures being made by businesses of all sorts suggests that more and more stories of productivity gains will be forthcoming.

The key here is that current use cases are focused on improving processes that are in place today. The biggest part of the improvement will involve

## Commentary-continued

entirely different ways to do things. The internet originally replaced snail mail, overnight shipping, and faxes. Now it is ubiquitous, taking over our quest for information and for goods shipped to our front door. I anticipate AI will prove equally transformative and likely over a shorter time frame. After all, ChatGPT saw 1.6 billion visits in January and already has over 180 million registered users. The case for enhanced productivity is very strong, if not proven.

On to the question that is far more important to us as human beings. Will AI replace humans? For some jobs, it will, just as backhoes have replaced ditch-diggers and Word replaced typing pools. Any function that relies on a repetitive task is at risk of replacement by AI, analogous to robots taking over the assembly line. The difference is that it is not repetitive blue-collar work that is threatened, but repetitive white-collar work. For example, someone who writes a regular newsletter based on recent economic statistics and market trends. Good thing I am transitioning to semi-retirement.

Some jobs are safe. Anything requiring direct contact with people (teachers, medical professionals) will find the option to use AI a real benefit. With the aging of the developed world a well-established trend, the potential of AI to aid caregivers will be a boon.

My conclusion is that AI is real and will boost the potential growth of the economy by making workers who use it far more productive. There is no way to put the genie back in the bottle. While white-collar functions will still be needed, far fewer individuals will be doing them. Humans will gravitate to those professions which value our ability to connect with others. The promise and the threat go hand in hand, but this is not that different from other transformative technologies of the past. The difference is that it will impact the more educated and affluent rather than those lower on the socio-economic ladder. This realization is bringing the left and the right into agreement on the need for guardrails. I predict another area of accelerated growth — politicians offering proposals to regulate the use of AI.

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## Market View

Stocks, gold, and Bitcoin have broken out to all-time highs, but commodities and fixed income haven't joined the party. Investors can be excused for being puzzled at the early 2024 market action.

First let's look at stocks. There is little doubt that artificial intelligence has been a key driver of the increase in equity prices this year. However, that is not the only catalyst. Weight-loss drugs have had a very beneficial impact on those drug companies offering them. While much has been made of the performance of the "Magnificent Seven", the number of new highs suggests that the buying is broadening. That said, the market is exhibiting signs of euphoria. I am expecting a pullback of 5% to 10% in what I believe is an ongoing bull market.

## Market View-continued

Since I believe that the economy will navigate 2024 without a recession, the areas to focus on include industrials, retail, and energy. If we get the correction I am expecting, that would be the time to join the AI revolution. For those who are looking to invest outside the US, India and Japan would be at the top of my list. The former is the fastest-growing large emerging economy, and the latter has finally broken free of a more than 30-year funk.

**One-year Total Return**

| | Two-year | Three-year | Five-year | Seven-year | Ten-year | Thirty-year |
|---|---|---|---|---|---|---|
| Up 2% | 2.7% | 0.7% | -2.7% | -5.6% | -9.4% | -21.6% |
| Up 1% | 3.6% | 2.5% | 0.7% | -0.8% | -2.8% | -10.0% |
| No Change | 4.6% | 4.4% | 4.2% | 4.2% | 4.2% | 4.4% |
| Down 1% | 5.6% | 6.3% | 8.0% | 9.7% | 12.0% | 22.7% |
| Down 2% | 6.6% | 8.3% | 11.9% | 15.4% | 20.5% | 45.8% |

Treasury notes yielding over 4% are enticing. However, I believe that we will see higher intermediate and long-term rates as the market prices in sticky inflation and higher volatility. Also, a higher growth path for the economy in general due to AI implies higher rates over time. Today, the sweet spot is in the two to three-year area. See accompanying table which shows the total return (price change and interest received) for a one-year holding period under various rate scenarios.

Cryptocurrencies have ridden a wave of investment triggered by the SEC's approval of Bitcoin ETFs. More buyers; same supply; higher prices. This area is the very definition of speculative, but everybody needs to have some fun. As I have previously advised, don't get carried away. Devote no more than 2% to 3% of your portfolio to the sum of crypto and precious metals. That means selling some if you have been a big winner.

More traditional commodities have languished as attention has gone elsewhere. Agricultural products have been under downward pressure, as have industrial commodities. Much of the weakness can be traced to the Eurozone and the sad-sack Chinese economy. While Europe may be bottoming, I find it hard to believe that China will hit its recently announced 5% growth target, given the lack of any cogent plan to do so. Commodities need a more coordinated global upswing before an investor can commit dollars.

## Editor's Notes

*Internet sleuths have clearly uncovered the fact that I have entered Senior Citizenship based on my admission in the winter newsletter. As a result, I am seeing an uptick in targeted emails for members of my age cohort. Hearing aid come-ons and special deals from AARP are regular inbox arrivals with the latter sporting increasing discounts — 15%, 25%, 43%. Pretty soon, they may pay me to join. However, the one that really hit home was the offer for cut-rate burial insurance. By purchasing, I would alleviate any worries that my family might have once I am gone regarding the costs of my eternity. I remain unconvinced. In fact, I take comfort in the realization that the insurance company expects my premiums to exceed the ultimate payout. When the emails stop, then I will worry.*

Michael Jamesson
Jameson Associates
Scottsville, NY
(585) 889-8090

Mjamesson@aol.com
Michael@JamessonAssociates.com