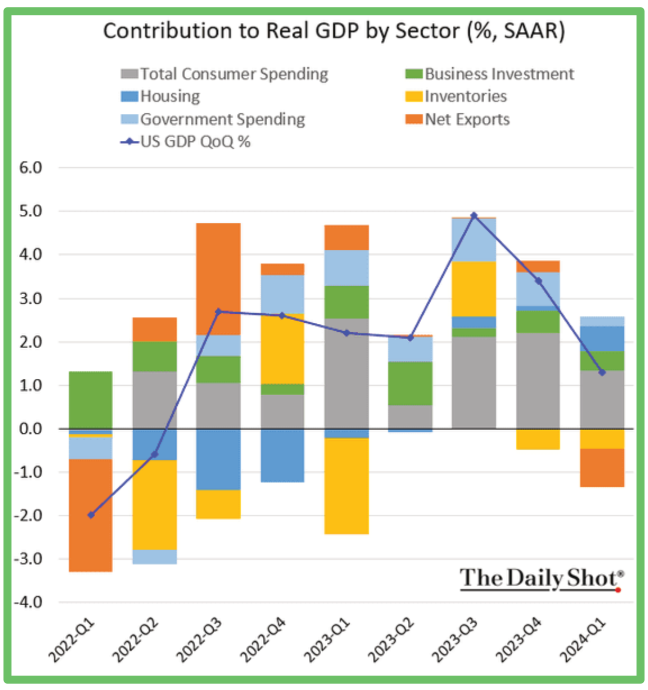
Summer 2024

JAMESSON associates

Recent Economic Events

There are some signs that the American economy is slowing down. GDP grew roughly half as fast in the first quarter as it did late last year. Job gains are weaker, and the unemployment rate is up. Unfortunately, these developments have not yet translated into continued improvement in inflation. The Federal Reserve may be reaching a point where it must consider the strength of the economy rather than the level of inflation in its deliberations. It has already reduced the pace of Quantitative Tightening (shrinking its balance sheet).

The second release of first-quarter GDP reduced the pace of growth to only 1.3% (down from an initial 1.6% estimate). Recall that fourth-quarter 2023 growth was 3.4%. The most important downward revisions were the pace of consumer spending and the foreign trade picture. The good news in the report was that both residential and commercial construction were revised upward, keeping overall sales to domestic buyers relatively steady from 2023. However, depending on the real estate market to bail out the economy is a dicey proposition. Home prices are still rising, and interest rates remain high enough to keep affordability at multi-year lows. Commercial real estate has its own problems.



The job market has been the foundation of the resilient economy. Steady job growth coupled with wage gains in excess of price increases have helped American workers maintain spending momentum. But there are signs of reduced demand for labor. Job openings have dropped to roughly 8 million from a level of close to 9 million at year-end. While this still easily exceeds the total of unemployed Americans, the ratio of openings to unemployed is now near 1.2x, down from about 2.0x at its recent peak. The unemployment rate is 4.0% up from a multi-decade low of 3.4%, while the average work week has retreated to 34.3 hours, suggesting that workers are seeing less in their weekly paycheck than the growth in hourly wages implies.

At the same time as we are seeing many of the growth statistics weaken, inflation remains well above the Fed's 2% target. Whether we look at CPI or the PCE price index and consider either the headline rate or the core rate, there has been a lack of progress so far in 2024. It appears that, just when we see improvement on some categories (used cars or airline fares), others pop up (insurance or medical costs). Prices are navigating a volatile period of normalization and catch-up. Monthly core

Recent Economic Events-continued

inflation rates have bounced between .3% and .2% this year, which, if you take the average and annualize, results in a year-over-year rate of 3%. That won't cut it. In late 2023, we saw a few unchanged readings along with .1% gains. To get to the 2% target, we need a repeat of that performance.

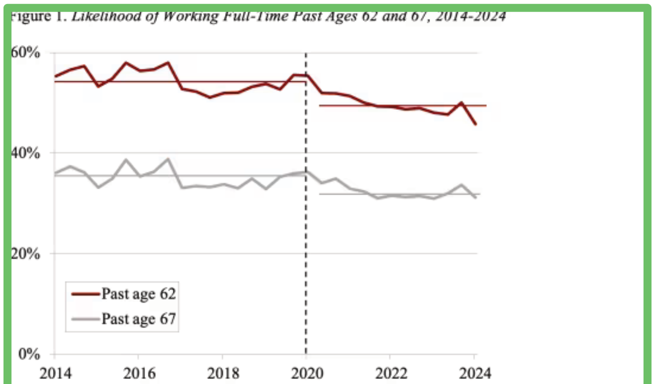
To the extent that similar results seem unlikely, the Fed is trapped. They don't want to be blamed for a recession in an election year but are faced with their own insistence that the 2% target is sacrosanct. I see three not so great possibilities. One, the status quo, hold rates at current levels for the next few meetings, hoping that inflation moves their way. However, hope is never a good strategy. Two, rip off the band-aid by modifying the 2% target, allowing an earlier reduction in the overnight rate and a cessation of QT. Three, misdirect by citing weaker economic statistics (employment, consumer spending, a stock market swoon) and pivoting to the other side of their dual mandate. The upcoming FOMC meeting in mid-June should give us some insight as to the approach the Fed will take. I put myself in the camp arguing for a change in the inflation target, but I fear that option will not be chosen.

Commentary

Who are the slackers now? It is ironic that Millennials and Generation Z have been labeled as such by their elders, but recent data suggests that the term should be reserved for Baby Boomers.

In the wake of the pandemic, Baby Boomers accelerated their march towards retirement. It is estimated that there are approximately 2.7 million excess retirees versus the pre-pandemic trend. Furthermore, a new survey by the Federal Reserve Bank of New York uncovered a sharp drop in the expectations of Americans about working past 62 years of age.

Figure 1. *Likelihood of Working Full-Time Past Ages 62 and 67, 2014-2024*

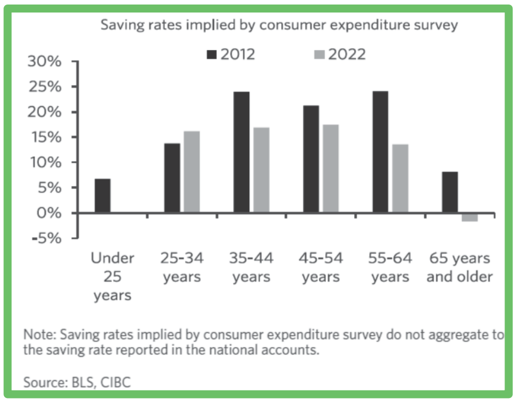


Notes: The vertical dashed line indicates the start of the pandemic. Horizontal lines indicate pre- and post-pandemic means.
Source: Felix Aidala, Gizem Kosar, and Wilbert van der Klaauw. 2024. "The Post-Pandemic Shift in Retirement Expectations in the U.S." Liberty Street Economics blog. Federal Reserve Bank of New York.

How has the "Me Generation" pulled this off? I think the pandemic is responsible. First, there was a tragic loss of life when Covid hit. This had a profound impact on peoples' life expectations. Workaholics realized that "You Only Live Once". Coupled with the psychological impact, money was almost literally falling from the sky. Pandemic-era stimulus checks bolstered finances across the board and the rapid increase in household net worth (both stocks and home equity) provided an unexpected windfall to support early retirement. The ranks of IRA millionaires are at an all-time high.

Commentary-continued

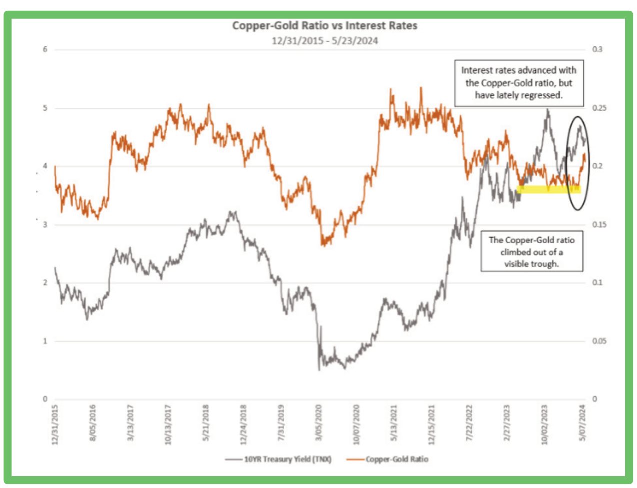
Note the nearby chart from CIBC, which estimates savings rates by age cohort. From 2012 to 2022, the savings rate of older Americans (mostly Baby Boomers) has declined. In fact, those over 65 are now spending more than their income (negative savings). Of course, if the value of their assets (at an all-time high) continues to appreciate, the spending can continue. The other interesting item on the graph is the increase in savings rate for those 25-34 years old. Perhaps the constant drumbeat of stories about Social Security running out of money is sinking in.



To end on a hopeful note, if Baby Boomers continue to spend while Millennials save, the economy should be in good shape. As Bismarck was said to remark, "God takes care of children, fools, and the United States of America."

Market View

After a pullback in April, the stock market raced to new highs in May and early June. Longer-term interest rates rose to 2024 highs in late April, but have since returned to March levels. Crypto-currencies and precious metals have posted new highs, but even more impressive has been the bull market in copper, driven by the projected jump in demand for electricity to power data centers running AI. Utility stocks have been star performers as well. This latter development is reminiscent of the fortunes made in supplying Gold Rush miners with picks, shovels, and blue jeans. Other commodities have had a more mixed performance.



The stock market rally has been surprising, but they always are. This one is being powered by a combination of AI-driven growth, ample liquidity, and expectations of Goldilocks (not too fast, not too slow) economic performance. Can it continue? The most dangerous words in the investment arena are, "It's different this time." In order to make that case and not look really silly six months from now, a few trends must stay in place.

The AI bandwagon doesn't have to get even stronger, but it does have to maintain momentum and broaden out to other sectors. The initial

Market View-continued

beneficiaries have been companies producing the hardware and software for training AI systems and those large companies expected to be the initial users. As more companies adopt the technology and develop use-cases, the promise of improved productivity and enhanced growth will become real. Consequently, the next stage will see a shift towards users of AI, not trainers and providers. The areas of focus will be companies with logistic issues (truckers, railroads, etc.) and those with large numbers of white-collar staff (lawyers, accountants, medical administrators). Of course, the data center builders and suppliers along with the aforementioned utilities providing power stand to benefit as well. Don't forget green energy companies either.

Comfortable liquidity conditions will depend on an economy that slows but still grows. This should give the Federal Reserve some cover in lowering interest rates even if inflation is not declining as they would like. However, were inflation to cooperate, that would be the best of all worlds.

I believe that fixed-income will continue to be range-bound with a bias to higher rates as the yield curve eventually normalizes. Cash returns are still very good and investments up to three years couple good income with modest price volatility. If I am correct that the economy will not tumble into recession, corporate bonds offer better returns than nominal Treasuries. The real rates offered by TIPS will be winners unless the inflation rate falls below the Fed's target.

While speculations like bitcoin and gold have performed quite well, remember that they produce no income. Returns are entirely dependent on the willingness of investors to pay more. I am more inclined to recommend the miners producing copper, silver, and the other materials necessary for the electrification of the modern economy. Oil is a special case. We will continue to need fossil fuels for the foreseeable future, but recent price weakness should not be ignored. Even with OPEC and its allies holding back production and two shooting wars that impact access, oil prices have shown weakness.

Editor's Notes

Ford recently announced that within two years drivers would not have to keep their eyes on the road. That means that the time is coming when a car can drive as well or better than I can. I got a taste of this when I drove my sister to the airport for a very early morning flight. When I started out, all manner of warning lights appeared. Assured that they would go off in due time, I continued the journey. Upon my return to Scottsville, I could not figure out how to turn the car off. The lights stayed on, and the key fob proved unsuccessful. After some five frustrating minutes I got back in the car and noticed the start/stop button. Pushing it was the secret. While others may be worried about the coming AI singularity when computers will be smarter than humans, I have gotten a leg up with a car that has me beat already.

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