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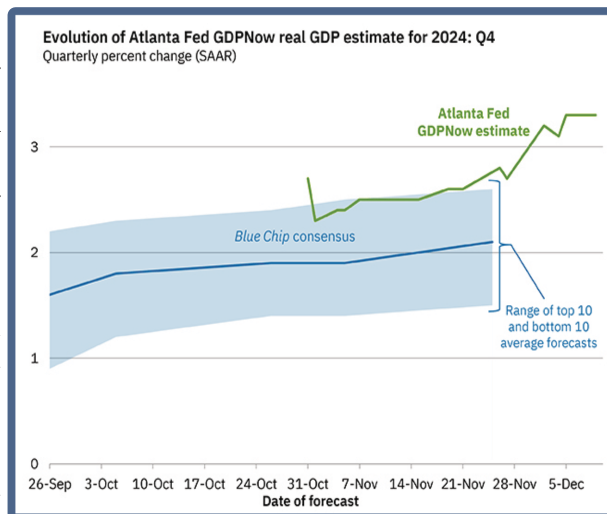
Recent Economic Events

The most salient feature of the American economy is its refusal to follow the script. Significant monetary tightening by the Federal Reserve was expected to slow GDP, inflation, and the labor market. The former has remained rock solid while the latter two are plateauing at levels causing the Fed no end of concern. Indicators which previously had excellent records of predicting recession have failed. It is always dangerous to suggest that "This time is different." However, the current facts make a strong case.

Real US GDP posted another above-potential showing in the third quarter, advancing by 2.8%. While this is a slight drop from the 3% second quarter figure, the key reasons for the slowdown were the volatile trade and inventory factors. If we exclude them, along with government activity, to zero in on private domestic purchasers, growth once again topped 3%.



Headline CPI rose by 0.2% in October, pushing the annual rate up to 2.6%. The core rate which excludes food and energy gained 0.3% for the month and 3.3% for the year. The so-called Supercore, which tries to get to the heart of services inflation, continues to post 4%-plus values. The stall in progress on inflation has become the Federal Reserve's worst nightmare. Far from being able to declare victory and set a schedule to reduce rates, they are forced to try to change the focus.

Initially that focus was to shift to the other side of their dual mandate (full employment). A very weak jobs report for August prompted the 50-basis point cut in overnight rates when the FOMC met in mid-September. In hindsight, that move proved overzealous based on the much stronger September employment report. October job numbers were distorted by both the Boeing strike and the double hurricanes which landed in the Southeast US while the employment surveys were being compiled. The most recent release on jobs showed both a strong gain in jobs (227,000) in November and upward revisions totaling 56,000 for the previous two months. There was an uptick in the unemployment rate to 4.2%, but this is still below the recent peak. Wages rose 0.4%, keeping the annual gain at 4.0%.

The above set of statistics reinforces the idea that a recession is not on the immediate horizon. In fact, the projection from the FRB of Atlanta is currently pointing to a robust 3.3% growth figure for fourth quarter GDP. While not definitive, their quarterly projections have been quite accurate over the last few years when many recession indicators have proved otherwise. For example, the Leading Economic Indicators produced by The Conference Board have pointed downward for over 30 months in a row. The Federal Reserve's preferred measure of the yield curve, current overnight rate versus 18-month forward rate, has been consistently negative for almost as long. In the past, both measures had very good records in foreshadowing a recession.

Why has a recession been averted? First, the American economy has shifted from manufacturing

Recent Economic Events-continued

to services. Consequently, the need to borrow to build factories is far less of a factor. Higher interest rates may hamper traditional businesses with needs for physical facilities, but they actually benefit service companies with huge piles of excess cash. Second, the Federal Government has not been bashful about spending. The deficit compared to GDP is at an all-time high for an economy not facing a recession or war. Third, while many Americans are suffering from high prices as evidenced by the recent election, the most affluent are much better off. They are enjoying a record level of household wealth (both stocks and home equity) which has powered their spending. The top 20% by income spend as much as the bottom 60% do, driving consumption and consumption drives GDP.

It's hard to make the case that any of these trends is poised to reverse. While some manufacturing may return to the United States, the economy is overwhelmingly focused on services. Chances for a big reduction in the deficit are not great considering that entitlements, defense, and interest are off limits and the 2017 tax cuts are clearly going to be extended. That will continue to reward the affluent. At the risk of looking quite silly a year from now, "This time is different."

Commentary

As President Obama famously said, "Elections have consequences." We are still over a month away from the inauguration of a new administration, but the proposed changes in policy represent a clear break from the status quo. The most significant issues are tariffs, immigration, tax cuts, and cutting waste, fraud, and abuse in government spending. However, President-elect Trump is famously mercurial, making it difficult to separate the signal from the noise in his statements. Until he takes office and deals with a closely divided Congress (Republicans lost a seat in the House even as they gained four in the Senate), everything is speculation. Nevertheless, gaming it out is worth a try.

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Tariffs have been a go-to threat in the Trump playbook from day one. He imposed some, but overall used them more as a negotiating chip than a core strategy. Furthermore, previous history and most every observer suggests inflation will increase if tariffs are levied. Given his promise to actually bring down prices, I believe only token tariffs will find their way into action.

Deportation promises are another matter. If there is one thing that could cause a spike in inflation or a recession or both, this qualifies. Few will defend deporting the 300,000 or 400,000 undocumented immigrants convicted of crimes. The question is logistical. What country will take them? After that, things get tougher. Agriculture, construction, and hospitality industries have a significant number of potential deportees. A concerted effort to deport even a portion of these people will cause disruption and labor shortages. In fact, if not for immigrants (legal and illegal) over the past few years, the labor force would not have grown at all. And labor shortages cause wage gains — and wage gains spur higher costs.

Commentary-continued

Extending the 2017 tax cuts is a done deal, but additional cuts will run into fiscal reality. Campaign promises to exclude tips, Social Security, and overtime income would create trillions of dollars of additional deficits and hence federal borrowing. That will push up interest rates even if inflation doesn't result.

The Department of Government Efficiency promises to slash Federal spending by $2 trillion. If this is an annual goal, it would represent close to a 30% cut, while if it were spread over ten years, it would come to about 3%. The former is mathematically impossible if entitlements which Mr. Trump has vowed to protect, defense spending, and interest on the debt are excluded. The latter is doable but will run into Congressional resistance on specific programs. The history of deficit cutting recommendations (Grace Commission, Simpson-Bowles) being adopted by Congress is dismal.

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My handicapping suggests tariff threats will be used to negotiate, but not materially impact, trade. There will be enough deportations to boost wages in key industries, but not enough to sink the economy. The most significant impact on immigration will be greatly reducing future inflows. Any significant new tax cuts will die in Congress as will any meaningful spending cuts. The net impact is upward pressure on prices and interest rates. Higher for longer seems a safe bet.

Market View

The stock market jumped right on cue when the results of the election were confirmed. November was one of the strongest months on record for equities. Bonds did not fare as well. Both markets followed the expectations noted in the fall newsletter. Victory lap complete, but what about the future?

As always, equities have both pluses and minuses to consider. The pluses include record highs which tend to beget more record highs. AI is starting to show promise in areas beyond microchip hardware, leading to a broadening of the advance to companies not in the Magnificent Seven. Finally, the economy is showing few signs of slowing down, which is supportive of ongoing strength in the market. The minuses are mostly related to worries over valuation and the jump in positive sentiment. Valuation alone is not a catalyst for a bear market, and sentiment can swing from euphoria to despair seemingly overnight. There will be a correction at some point (probably early in the next Administration), but that should represent an opportunity to "Buy the Dip."

Let me take a side trip to the question of renewables versus fossil fuels. During the first Trump administration, renewable energy saw sharp increases in use as their cost structure plummeted. While Biden has been President, the US regained its crown as the largest oil producer in the world. In business, economics rules. It is wise to remember that technology is a driver of cost. While it is obvious that technology has lowered the cost of renewables, it has also benefited oil production. Subterranean sensors and AI have driven down the cost of fracking for oil, putting real pressure on OPEC. However, in the long run, renewables will benefit even more from technology's falling cost. The drive towards electrification of the economy will not stop over the next four years.

Market View-continued

Longer-term fixed-income assets have spent most all of the Federal Reserve's tightening cycle anticipating lower rates. The inverted yield curve has finally begun to exhibit a more normal slope with longer rates exceeding shorter ones from about three years on out. However, the 30-year Treasury Bond still offers a lower rate than the three-month Treasury Bill. I continue to argue that this is not sustainable. At some point, the longer-term bonds will have to offer a reasonable premium to short rates. While we wait for that to happen, investing in the two to three-year range seems the best bet. If you believe that a recession is unlikely, corporate bonds in that maturity range will provide more return than Treasuries.

Commodities in general have had a tough time. Their lack of price appreciation has led to a dearth of investment in the arena. When investment dries up, shortages ultimately appear. While energy dominates the global commodity market, I would recommend a more balanced approach to commodity positions. This means roughly equal shares of foodstuffs, metals, and fuels. I don't think there is a big hurry to jump into this market and would recommend a dollar-averaging approach over the next few quarters.

If there is one area that has overdone itself in the wake of the election, it is crypto-currencies. Bitcoin has topped $100,000, and its ratio to gold is at an all-time high. There will be a correction. For those of you prescient enough to own crypto as part of your overall portfolio, make sure the percentage doesn't get too high. That said, this market is not going away. The total market value of cryptos is now near $3.5 trillion and major financial firms are validating its arrival as a part of an investment program.

Editor's Notes

Susan and I are concerned about the environment and have always used paper bags for garbage rather than plastic. As many of you know, New York State has banned the use of plastic bags in grocery stores, forcing us to choose between bringing our own reusable bag or paying a nickel for paper at our most common grocery stops. That's a cost beyond my budget, so I have adopted a clever work-around. Whole Foods and Trader Joe's still provide paper bags for free. I make a point of visiting one of these stores at least once a week to score the free bag. You might question the extra 20-mile round trip or the extra time it takes, but I know that those nickels will add up over time.

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