McVEAN
TRADING & INVESTMENTS, LLC

Weekly Economic Update

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Volume 107, Number 5 **August 11, 2023**

We are back from our annual trek to the far north of Maine to converse, discuss and argue about all things economic with some of the best and brightest in economics and finance. This year, the focus was solidly on debt and inflation, and whether they could persist in tandem. No matter where the conversation started – the importance of rating agencies, Japanese curve control, higher for longer, even sidebars on politics – it all devolved to inflation and debt. The consensus was for inflation to follow a path not unlike that perceived by the Federal Reserve – with sticky service inflation a persistent problem. The worry about debt was the failure of anyone in Washington to show any sign that the rapidly rising interest cost on what is already owed would lead to moderation in future asks. The fact that the US depends on the kindness of strangers to fund our deficits – a contribution seen by many as a fair price for the US being the world's leading superpower (no longer only) – was reflected in discussions about the future of the dollar and crypto.

It is often more interesting to think about what was not discussed when so august a body meets in August. We heard very little about Europe – or oil. Japan came up, but mostly as an example of what could happen with a huge debt load. Some time was spent on yield curve control given the recent timid steps away, but most looked at Japan as an example of what not to do -- or as a fading funding currency -- not as a major economic player. The outlook for China was often compared or contrasted to Japan – particularly on demographics and rising debt burden. Our own view is that debt is two very different things depending on whether one is in a capitalist economy or a communist autarchy. Given our view that multinationals have a lot of political clout in capitalist societies, the friction when they need to borrow in competition with government is meaningful. In nations like China, debt – which is the transfer of control over an asset (often savings) from one entity to another – is far more easily solved by confiscation. Ask Jack Ma, or Crown Prince MBS.

Our role at Camp Kotok is often as bomb-thrower. Unlike attendees who represent major Wall Street firms or their ilk, our position at a smaller commodity trader in Memphis means we do not have to be as circumspect in our comments – even under Chatham House rules. We challenged the sticky inflation argument with the view that inflation was already well under 3% (2.2% GDP deflator in Q2) and the difference between 2% and 3%, while meaningful to the Fed and the likelihood they hold firm on rates, is not a make-or-break issue for most firms. We have been on a roller coaster from under 2% into double-digits in the short term – and now back to 2%, based on the last three months of CPI (0.47% cumulatively). We argued that the unemployment rate was likely to hit 3% before it hit 4%. Note that from here a 4% unemployment rate would suggest a recession was underway according to the Sahm rule. Finally, we ended a dark conversation about when the US may enter recession by arguing that we were already at the bottom of a thirty-six month long manufacturing cycle (look at China, then Europe) and that the next eighteen months would be climbing out.

We posit that US based multinationals will get at least their fair share of that uptick in global growth – and so we do not see a US recession before 2025. Even then, we suspect it would take a new policy mistake – and the traditional long and variable lag. Right now, our leading contestant would be the FOMC overstaying its current stance leading to the onset of outright deflation down the road – as now in China. The bottom line is that in a world which has fit no model over the past three years, we think it behooves all of us to force the conversation out of the box and consider uncomfortable or atypical scenarios. We believe the money wave is in the rear-view mirror – and the surprise is the upsurge in real growth at the same time inflation abates. Our current Q3 insights see more of that paradox on the way.

With second quarter GDP data in the bag, and data on jobs, wages, and CPI for July – we can begin setting the parameters for where the third quarter is likely to come out. The Atlanta Fed's GDPNow started at 3.5%, and has now risen to 4.1%. The major sources of improvement on the second quarter's 2.4% increase are from consumption and inventories (each adding about 1% to growth), with government flat, trade up slightly and investment cooling from second quarter strength. Their outlook for a 3.2% rise in consumer spending essentially extrapolates the 0.24% gains averaged over the past three months. Bottom line, trend drawing is about the best one can do at this stage. We will endeavor to box in the third quarter with the same methodology – starting with nominal growth, then inflation, real GDP, hours, productivity, wages, unit labor costs, implications for margins, and what that means for the fourth quarter. Trends can always change – and the return of student loan payments is a significant new factor late in the third quarter – but we need to start somewhere. Spoiler alert! The economy looks fine, with solid growth and declining inflation the most likely outcome.

We start our deliberations with the income proxy – the product of hours worked times average hourly earnings in the private sector. This monthly calculation provides an excellent estimate of nominal GDP. In the second quarter the income proxy rose at a 4.5% annual rate, while nominal GDP was 4.7%. In the four quarters before that, the income proxy rose 7.2% and nominal GDP rose 7.4%. In the year before COVID, the income proxy rose 4.1% and real GDP 4.3%. The 0.2% gap is not persistent, but over time these two measures track closely enough for government work.

Over the past six months, compensation and hiring trends have been very stable – so we have a high level of confidence that a simple extrapolation will generate a decent starting point for our analysis. Private sector hiring has run between 0.10% and 0.19% a month – averaging 0.14%. Total hiring has been even more stable running between 0.12% and 0.18%, with the same average. Meanwhile, private sector wages ran between 0.27% and 0.45%, averaging 0.36%. With no change in hours worked, that implies an 0.5% monthly rise in income – or 6% annualized. However, the average workweek has been declining steadily from its peak of 34.9 hours back in March-May 2021 – and two of the past three months were at 34.3, back to the pre-COVID norm from October 2019 to January 2020. We choose to hold the workweek at 34.3 for August and September. Thus, assuming two months with 0.5% hikes in spending power generates a 5.7% estimate for nominal GDP growth in the third quarter. Playing with the inputs a bit we get a range from 5.4% to 5.9%. That is higher than the 4.7% in the second quarter, but down from 6.1% in the first.

Next up, to split nominal GDP into real and inflation, we guesstimate the PCE deflator based on the known second quarter readings and an estimate based on July CPI. There are methodological differences between CPI and PCE based on weights and treatment of medical care, etc. -- but the difference in monthly changes over the first half of 2023 has been 0.00%! Thus, we are using this month's 0.17% rise in headline CPI to estimate July headline PCE. We then extrapolate the series for two months at the six-month average of 0.20% (as we predicted over a year ago). There is a clear downtrend, but the earlier steep decline in energy prices has reversed in August, so we want to be conservative. That produces a 2.1% inflation rate for the third quarter. Again, wiggling the inputs with three-month or twelve-month averages creates a range of 1.9% to 2.4% -- even back-to-back 0.3% increases results in just 2.5% PCE (and likely GDP) inflation. These levels should still keep the Fed on hold in 2023 – and since the November CPI data comes out after the December FOMC meeting, the very earliest they would ease is most likely in 2024.

Our highest growth estimate (5.9%) and lowest inflation guess (1.9%) imply 4.0% real GDP. At the other end of the spectrum: 5.4% - 2.5% = 2.9%. Neither are as high as the current GDPNow, but they do suggest that the probability of real growth accelerating from Q2 into Q3 is high. This would be the fifth quarter of above trend growth (averaging over 2.5%) after the two-quarter recession in early 2022 caused by the end of child care credits. The combination of the stimulus from the Inflation Reduction Act and the big boost in transfer payments from indexation has buoyed consumer spending and investment. Government has also been a positive force in the past year after being a drag for most of the COVID era. Once again, growth would be surprising to the upside, while inflation cooled faster than expected. Rather than waiting for the long and variable lag to kick in, we think it is time to consider alternative scenarios very seriously.

Our central tendency on GDP and inflation suggests 5.7% nominal growth and 2.1% inflation for a 3.6% growth rate. That surge in volume is certainly a lift to companies -- even if labor costs are rising. However, it looks to us like margins will still be holding up in the third quarter due to improvements in productivity. Given our view that firms need to be in trouble for a full year before they react, we stand on our belief that there will be no recession before 2025.

As we noted above, wages increases and hiring have been very stable over the past six months – resulting in a 4.4% annual rate of increase in wages (0.36% monthly average) and hours worked increasing at an 0.8% average in the first and second quarters. The Productivity report has a pop to a 2.6% annual rate for hours in the first quarter followed by a crash down -1.3% in the second, but the average is 0.7% -- close to the result based on private hours worked. We estimate that trend continued in the third quarter, with hours worked up at a 0.8% annual rate. With 3.6% growth in real GDP, that would imply output per hour was up at a 2.8% annual rate – well above the 1.3% average of the past four quarters (which is close to the 1.4% average of the past eighteen years). Given what we know about technology layoffs from the big firms and their rapid rehiring by lower tier employers, the productivity numbers would suggest that they found better homes!

Now, with hourly wage rates running 4.4%, and output per hour up 2.8%, we estimate unit labor costs are rising at 1.6%. Once again, this is below our estimate for price increases at 2.1% – as firms are maintaining the line on labor costs even at a 3.5% unemployment rate. We draw two very out of consensus conclusions from these data: 1) with margins solid -- and perhaps widening, from already very strong historical levels – and volume growth above trend, firms will do more of what is working. That means real GDP should continue to surprise to the upside. The outlook for inflation becomes a bit more clouded – but as we estimate it at 2.1% for the third quarter after 2.2% in the second, we are less concerned than the Federal Reserve. They may stay "tight", but we do not see policy as restrictive when overnight rates are 5.5% and nominal growth in the third quarter is between 5.4% and 5.9%! Once again, we will voice the heresy that if you had just landed from Mars, your evaluation would have to be that the FOMC has not moved fast enough!

The second conclusion is that at a 3.5% unemployment rate, the US is not yet at full employment. As in late 2019, we have trended sideways at an average 3.6% unemployment rate (our seventeenth month in July 2022, compared to eleventh month in February 2020) and unit labor costs are still running well behind price hikes – suggesting that labor is losing share! In 2019 Q4, unit labor costs -- at 1.5% for the past year -- were 0.5% below the 2.1% nonfarm business deflator. That was the same spread as the year earlier, at 1.6% unit labor costs and a 2.2% deflator. In 2022 Q2, annual unit labor costs are up 2.4% for the year – and prices 4.0%. That comes after a year of 7.3% unit labor costs and 8.3% inflation. It is not wage rates that matter – or even real wage rates – but unit labor costs. Moreover, with unit sales rising well above estimated potential growth, firms appear to be in the catbird seat. We expect hiring will continue to surprise on the high side – and that the unemployment rate is more likely to hit 3% before the still expected recession pushes it to 4%. Indeed, if we are right about 3%, we wonder how high it might ever go in recession, when firms are less likely to let workers go.

This newsletter has a lot of math – and we admit that we were as surprised as we expect readers will be when we evaluated just how strong the third quarter might be in the US. However, the focus is simple – where are we in the business cycle and which direction are we heading. We believe we are at the bottom of a global economic cycle – with China still mired in a manufacturing recession, and Europe struggling to exit. The US – which is much more service-oriented economy – exited first and fastest as it imported deflation from the rest of the world. As we have noted many times, we do not see a US economy, a European economy and a Chinese economy – but rather the top, middle and bottom of a global whole. The US, as the suburbs, had the flattest cycle in its real economy – but volatility in asset prices. The Euro-zone and European Union had less of a recession than expected largely because of Ukrainian migration. Add that nation to the mix and it is easy to identify the unfortunate few.

That is the nature of cycles. The upturn is driven by expectations of growth – which become increasingly unrealistic (trees don't grow to the sky). At some point, a policy error or shock leads to a reevaluation, and a pull back. The more the pain is shifted to the bottom of the economic ladder, where there is less ability to deflect by dipping into savings or passing it along by reducing spending or hiring – the deeper the downturn. In this downturn, an already aging cycle in 2019 was T-boned by COVID. It could have been catastrophic. However massive money printing – especially in dollars, the source of global liquidity – allowed many firms and individuals to adjust more rapidly without having to touch their own safety net. Fear was high – which usually sparks the pullback- but stimulus provided enormous relief. Typically, a recession deepens as many fear they are the target of layoffs or business losses – until time and reality reveal the unfortunate few. Once the majority realizes it is not their heads on the block, a return to normalcy for the masses starts the upturn. That is where we believe we are now. China is the epi-center of the unfortunate few. Their economy is in trouble and their weakening currency exports deflation to those who want lower prices. In Europe, the inflation decline already seen in the US will soon buoy confidence. Meanwhile, in the global suburbs, fear of being the victim has been replaced by fear of missing out – again. True, the Fed is not helping, but it is no longer a drag. True, fiscal stimulus is sidelined until the election and maybe beyond. However, with real growth running above potential and profit margins solid – we expect that the capitalists who run US multinationals will get more than their share of the global upturn.