The Smithfield Forecast

A QUARTERLY SURVEY OF TRENDS

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A Note From The Chairman Emeritus

I continue to be impressed by the long-standing prediction from our economist, Michael Drury, that the United States will not experience a recession in 2022 and 2023. Remember that this prediction ran counter to those of a vast majority of Michael's fellow economists. Stay tuned.

Seized by a fit of laziness, I did not finish any books during the prior quarter. Therefore, I have no book reviews personally for this issue of the Forecast.

— Bob Kopf

SMITHFIELD THIRD QUARTER 2023

Can the US economy trundle along at a muted rate of growth for several more quarters, despite high interest rates and a low unemployment rate – or is a recession as certain as many forecasters insist? Well, investors believe that the Fed is nearly done, after it skipped tightening in June. Despite a warning that a majority of the FOMC expected two more hikes in 2023, financial markets have less than one priced in (but, with no cuts until next year). Meanwhile, the Congress has resolved the debt ceiling crisis, largely by agreeing to kick that can past the next election – with the federal budget effectively locked down until then. Thus, the direction of the economy over the next several quarters will be determined primarily by the decisions of business leaders – in anticipation of how they think consumers will react to the positive of cooling inflation and the negative of student loan payments restarting.

We have been steadfast in our belief that there would be no recession in 2023, in large part because businesses have been exceptionally nimble at adjusting to the rapidly changing economic environment as the world re-opens after COVID, while dealing with the consequences of the war in Ukraine. Despite widespread fears that rapidly rising interest rates would derail the economy, growth has remained positive in early 2023, with real GDP advancing at a near trend 1.3% annual rate in the first quarter and expected to rise between 1% and 2% in the second. We expected a year ago that growth would cool to its long-term potential – which we see as 1.5%, based on 1% productivity and 0.5% labor force growth.

We also expected inflation would fall faster than expected – with headline inflation subsiding faster than the core. This reflects two realities. First, that it has was the flood of money that created inflation, and the decline in money, resulting from the Federal Reserve ramping up overnight interest rates, means there is no fuel for the fire. Second, that those prices that spiked first and fastest – like food and energy – spurred businesses and governments to rapid action. Globally, governments paid out subsidies to protect the consumer – especially in Europe – while businesses offered alternatives and workarounds as they sought to maximize profits from the price distortions and subsidies. The result is a year later energy costs are lower than before the invasion began, and food prices are no longer a driver of inflation. That role is now primarily due to a normal laggard – rent, which is also showing signs of slowing, even declining, soon.

Indeed, excluding owners' equivalent rent – a fictitious price that no one really charges and no one pays – the CPI was rising at a 1.2% annual rate for the six months ended in May. That is down from 3.7% and 10.8% in the two six months periods before that, respectively (and from 1.9% in 2019). Meanwhile, rental income, which includes the difference between what the BEA says homeowners earn in fictitious rent and what they actually spend on financing and maintenance, has been rising at a torrid 1% a month, indicating far less real inflation in housing expense. Thus, the impact of inflation has been greatly overstated over the past two quarters – allowing still solid growth in personal income to sustain real growth.

The greatest threat to consumption continuing to buoy the economy is the restart of student loan payments in September. Over 40 million debtors will face an average $393 monthly payment (according to the NY Federal Reserve) – generating a $188 billion hit to spending power. That would be 0.7% of GDP, and certainly could take a bite out of second half growth. However, there are several caveats: 1) the Supreme Court will rule on whether Biden's debt relief program is legal; 2) some of the hit will be absorbed via weaker inflation if consumption cools during the holidays; 3) the still substantial savings for higher income households, who have the largest payments, will mute the impact (especially as parents get involved); 4) some relief will occur via graduated payments – or just plain failure to pay, as before. Bottom line, we believe that a full restart of student loans (no Supreme Court reprieve) will trim about 0.5% off the annualized real growth rates reported for both the third and fourth quarters of the year. That would still allow the economy to grind forward at a meager, but still positive pace, of about 1%. Moreover, that episode may provide a pause that refreshes, rather than marking the beginning of slide into recession.

A recession is a correction of excesses – and the excess that most feel this next recession must cure is the high level of inflation. As we have noted, that battle may already be won – and if not yet, then we expect inflation will be among the first casualties of a consumer slump during the key spending season of the year. Goods prices have already been correcting, as supply chains are improving at the same time weaker post-COVID demand has pushed manufacturing into recession globally. Thus, if spending slumps further late this year, service consumption – particularly for travel and entertainment – is likely to be at the core of those cutbacks. As in the goods sector, this should lead to both an improvement in currently too scare labor availability and a cooling in demand – with competition driving out price pressure quickly.

What we are wondering aloud is whether a widely expected recession – which most believe will be shallow – cannot be avoided. In our view, this boils down to whether businesses can continue to nimbly adjust – now to a world in which nominal growth quickly ebbs toward 3%, with inflation falling to 2% (or less) with real growth under potential. Our key lead indicator of real GDP is always profits, which have remained stronger than expected because firms have consistently raised prices faster than unit labor costs. True, tight labor markets have driven up wages for lower income workers, but total labor costs have been limited by a combination of trimming salaries for more skilled workers and an ever-widening trade deficit – increasingly with even lower income nations than China, like Vietnam. Even the low-end hiring surge this year appears to be due to work spreading, as employers finally find bodies to relieve the long workweeks of those already employed –as well as for exhausted small businesses owners themselves!

One rarely discussed source of better-than-expected global economic growth (due to the deep political divide on the issue) is immigration. Germany, and more generally

Europe, have avoided their projected deep recession because population growth soared by 1.8% as Ukrainian refugees settled, worked, and spent inside new national borders. Similarly, virtually all the recent strong US job growth has been filled by new immigrants, who account for the bulk of the rise in labor force participation among the prime work age population. This labor source provided the low-end workers needed to replace native employees, who were paid higher wages as they moved up the job ladder. That process helped limit wage inflation to less than price increases, maintaining profit margins and economic growth.

Thus, the key question for late 2023 and 2024 is: have firms already picked the low hanging labor saving fruit? Can they offset even slower revenue growth through less hiring, smaller wage hikes, more and cheaper imports – or will they resort to layoffs of low-end workers driving up the unemployment rate and crimping consumer spending as in traditional post-war cycles? A major unknown is how low can the unemployment rate go? Many see a sub-4% unemployment rate as unsustainable. Yet, in 2019 at 3.5%, unit labor cost growth was not exceeding then modest inflation. Have businesses found a new labor equilibrium, with higher pay for scarcer low-end workers – who traditionally spend more of their income – paid for by cheaper imports, relatively higher prices, and more limited wage gains at the top of the job ladder? It is not the traditional model, but it may be the future, as labor demographics shift with the retirement of the baby boom and a lack of younger replacements. We are hoping for the best, while wary of the risks. And, as the battle for control of Congress and the White House heats up, we are cognizant that the outcome of how currently unfettered businesses perform over the next several quarters will likely have lasting consequences for the economy.

— Michael Drury

BOOK REVIEWS

THE END OF THE WORLD IS JUST THE BEGINNING

By: Peter Zeihan

On page 3 the author tells us "Since 1945 the world has been the best it has ever been ... [and] ... the best it will ever be." He then goes on for close to 500 more pages to demonstrate how this is inevitable. After World War II the U.S. Navy has policed the oceans of the world, allowing globalization to develop. Globalization has boosted the world economy through improved division of labor and secure supply chains. However, Zeihan foresees Americans from withdrawing from this role, with the result that deglobalization is underway. The other negative trend he sees is declining populations, especially in the developed economies. In fact, he predicts population not just declining but collapsing. In the case of China, due to the years of its "one child" policy, he sees population collapse within the next decade. Fewer people means fewer workers means declining production. In six major sections of the book he shows how this will play out in terms of transportation systems, finance, energy, industrial materials, manufacturing, and agriculture. Although he makes a plausible case for this apocalyptic prediction, I have some serious quibbles with it. For one, he provides no references for his assertions. In particular, I think he is out of his depth in his discussion of climate change. I know that atmospheric science is highly nonlinear, and yet he uses simple linear extrapolations to predict future temperature rises.

He does cite sources for many of the charts and graphs that he uses. My issue there is that they are very hard to read. They appear to be screen shots from his computer, and as such they have very small print and poor color contrast. They probably originally used color and transferring to black and white leaves too many indeterminate shades of gray.

The one positive to be taken from this generally negative book is that in his discussions of how this will play out in various countries, it appears that the United States is positioned to weather this storm better than most. Perhaps another "American Century" is down the road!

— Henry Haller, III

REVOLUTIONARY CHARACTERS

By: Gordon S. Wood

I would recommend this book for anyone interested in the philosophies that went into the American Revolution. Wood devotes a chapter each to eight of the most prominent figures of the time. One issue in particular that he highlights is the question of slavery, which is the source of much of the criticism leveled by recent historians at men who in the past have been mostly idolized.

The first two chapters, on Washington and Franklin, did not tell me much that I did not already know. These two, while great leaders, were not very deep thinkers in terms of abstract political philosophy. However, after these two, the following chapters on Jefferson, Hamilton, Madison, John Adams, and Thomas Paine I found most interesting as he compares and contrasts their various visions on how government should be organized. Finding Aaron Burr profiled in chapter 8 came as somewhat of a surprise, as I never thought of him as a founding father.

Perhaps no period in modern history was as rich in political ideas and political philosophy as the period of the founding of our country. Back then, a handful of abstract thinkers could dominate the intellectual climate. Today's situation is far different, especially with the advent of social media, where anyone with an opinion can be heard. This book serves as a good introduction to those influential people and their ideas that formed the basis for our republican form of government.

— Henry Haller, III