A Turning Point for the Economy

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In investing, as in life, it is important to learn from the past, appreciate the present and plan for the future. This is particularly true at turning points.

In the early weeks of the New Year, we do appear to be at an economic turning point. Fourth-quarter GDP and consumption deflator data, due out this week, may give the impression of continued solid growth with still strong year-over-year inflation. However, a more real-time assessment of the economy suggests a significant cooling in both, with monetary and fiscal tightening contributing to the slowdown. That being said, it should be recognized that an environment of slow growth, low inflation, low interest rates and strong profit margins is likely to re-emerge in 2024, providing support for higher asset prices. While there are too many short-term risks

to justify a very aggressive strategy today, it still likely makes sense to prepare for this environment rather than trying to time market swings in what will likely be a very volatile 2023.

Fourth-Quarter Data: Looking Beyond the Averages

Data due out this week should help complete the picture of 2022 - a year of moderate economic growth and high inflation.

On economic growth, we believe real GDP grew at a respectable 2.3% annualized rate in the fourth quarter. While this is below the consensus expectation of 2.7% growth, it still appears to suggests the economy stayed firmly out of recession in the fourth quarter of 2022. It also implies a fourth-quarter year-over-year growth rate of 0.8% which would be above the Fed's December projection of 0.5% year-over-year. However, it is important to recognize that the economy was losing momentum throughout the fourth quarter:

- Following solid gains in August, September and October, we estimate that real consumer spending fell by a revised 0.2% in November and then fell again by 0.2% in December.
- Light-vehicle sales, which had recovered to 15.2 million units in October fell to 14.3 million units in November and 13.3 million units in December.
- Single-family building permits fell for a 10th consecutive month in December to their lowest level since 2016 (apart from the pandemic-distorted April 2020), and,
- After modest gains in the prior three months, manufacturing production posted sharp declines of -1.1% in November and -1.3% in December.

Mathematically, this slide in activity during the fourth quarter increases the odds of a significantly lower or even negative GDP growth rate for the first.

On inflation, we believe Thursday's GDP report will show a fourth-quarter year-over-year personal consumption deflator increase of 5.5%, only marginally below the Fed's 5.6% year-over-year projection. However, the monthly data, due out on Friday should show a significant deceleration from 6.1% year-over-year in October to 5.0% in December. Similarly, average hourly earnings, which were up 5.1% year-over-year in September were only up 4.6% year-over-year in December.

First-Quarter Reality: Drags and Cushions

Moving into the first quarter, fiscal and monetary drags on the economy will continue.

The single most worrying statistic is the personal saving rate which we estimate rose to 2.9% in December but which remains far below its 7.5% level of a year ago or its 7.7% average from the five years before the pandemic. The saving rate is the difference between disposable income and outlays, measured as a percent of disposable income. Over the course of the pandemic, many lower and middle-income consumers were able to achieve some improvement in living standards due to government pandemic aid. The sharp fall in the saving rate over the past year likely reflects their attempts to maintain those living standards when that aid ended by both reducing their savings and increasing their debt. Indeed, credit card debt rose by 15.2%, or $154 billion, over the year ended in November.

This clearly is not sustainable and returning to balance between consumer income and consumer spending will likely act as a drag on consumption going forward. This assumes no further fiscal stimulus before 2025 at the earliest. Indeed, a resumption of federal student loan payments over the summer will actually intensify the squeeze on consumers over the second half of the year.

In addition to this, we expect that, after a good fourth quarter for international trade, the impact of weak overseas growth and a high dollar will hurt net exports, while the construction and auto sectors will continue to

hurt by higher interest rates and some flexibility in work locations which looks like a permanent legacy of the pandemic.

Finally, from a supply side, we are entering the New Year with the unemployment rate at a 53-year low of 3.5% and very weak growth in the working age population. This, on its own, will tend to drag on economic activity.

There are, of course, some offsets.

Social security recipients received an 8.7% cost of living adjustment in January which will help consumer disposable income as will an unusually large inflation adjustment in tax brackets. Of course this is just to offset the impact from last year's inflation. However, while inflation has been increasingly squeezing consumers over the past year, these cost-of-living adjustments will be providing relief starting specifically in January 2023.

In addition to this, the banking system remains well capitalized, there are few signs of overbuilding or overproduction in any cyclical sector of the economy and still huge job openings should make it easier for laid-off workers to find positions than is normally the case in a cyclical downturn.

On balance, this still suggests a mild recession at worst with still a possibility that the economy just manages to avoid recession altogether.

On inflation, the last six months have seen a less than 0.2% average monthly increase in CPI. We expect that to pick up to about 0.3% per month over the first half of 2023, reflecting the impact of a falling dollar and Chinese reopening on energy prices and the knock-on effect of wage increases in partial compensation for previous inflation. (Contrary to the rhetoric from some monetary hawks, this doesn't mean inflation is trending back up – it just means that, after a surge, it naturally takes some time to settle down again.) On a year-over-year basis, inflation is very likely to fall over the next few months, since CPI inflation in the first six months of 2022 averaged 0.8%. By June of this year, we expect headline year-over-year CPI inflation to dip below 3.0% for the first time since March of 2021.

Thereafter, inflation will likely slowly drift downwards. Industry data show rents falling on a month-to-month basis and, by the second half of this year, this should begin to convert the biggest remaining driver of higher inflation into a driver of lower inflation. More importantly, in a slow-growing but normalizing U.S. economy, long-term trends of diminished union power, greater inequality and information-technology-driven competition should erode inflation, just as they did in the four decades before the pandemic.

Investing for the Future: The Silver Lining of Too Tight Money

With this outlook, the Federal Reserve would be wise to call a halt to rate increases. However, judging from recent speeches and interviews from Fed officials, they still seem determined to increase rates more than once this year. Consequently we expect that they will raise the federal funds rate by 0.25% next week and again on March 22nd. It is now a very close call as to whether they will hike rates one last time to a range of 5.00%-5.25% in May, as seemed to be there intention at the time of the December meeting.

If they do, and particularly if there is significant market and economic disruption from the brewing debt ceiling fight, the U.S. economy may well stumble into recession in 2023. Such a recession would be entirely unnecessary as inflation is on track to return to moderate levels and any childish game around the debt ceiling is very unlikely to yield thoughtful fiscal reform.

However, what is bad for American workers and consumers may not, in the end, be bad for American investors. Whether we end up in recession or not in 2023, we are likely to emerge from this year with a slow-growing, low-inflation economy in 2024. This slow growth should temper wage demands, helping maintain strong margins. Moreover, in the absence of fiscal stimulus, 2024 will likely see easier monetary policy and

lower interest rates. In short, the economic environment of the middle of this decade may look quite like the environment of the middle of the last decade, with the possible difference of a falling, rather than rising, dollar. For U.S. investors, this should support higher prices for both global equity and fixed income assets, suggesting the opportunity that exists in looking beyond the cyclical risks of 2023 to a better investment environment in 2024 and beyond.

For more insights, visit the On the Minds of Investors webpage.

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