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National Economic Intelligence Report

Prepared by Beacon Economics, LLC
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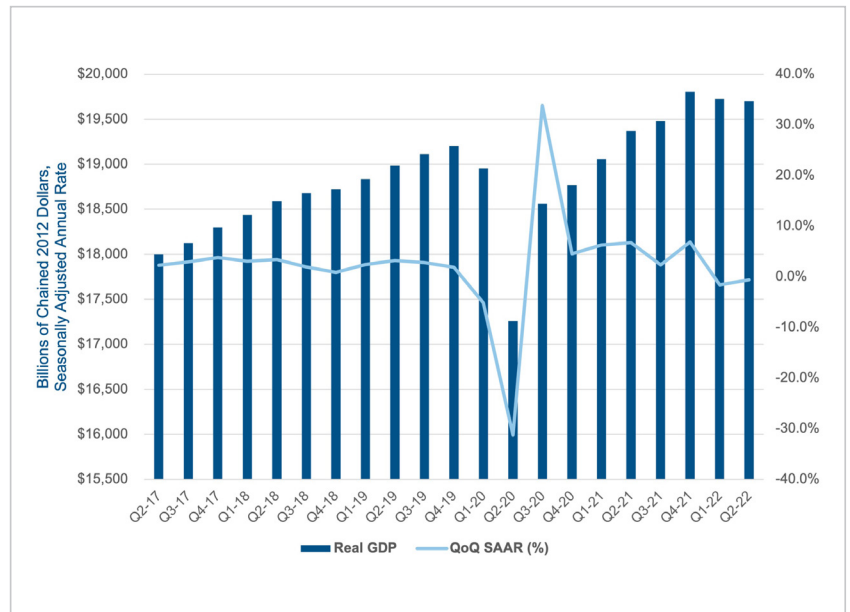
Economic Outlook: Nationwide

Overview: We Ain't Out of the Woods Yet...

- The first half of 2022 was not a recession in the United States, as the decline in output was not created by increases in slack capacity. Rather it was driven by rapidly shifting patterns of demand, which in turn were driven by frenetic changes in Fed policy.
- While parts of the U.S. economy will remain cool because of rising interest rates, consumer spending will continue to push the overall economy forward for the rest of the year and into 2023.
- Inflation may be peaking, but it will not decelerate rapidly—expect price growth and interest rates to remain elevated in the near term until the Fed gets serious about quantitative tightening.
- The potential for a real recession in the nation will increase as the Fed uses quantitative tightening to control inflation and push up real (rather than nominal) interest rates. The faster the better in order to prevent a truly deep business cycle.
- The economic wildcard comes from the growing Federal deficit and massive debt levels. A lot will depend on how long bond markets tolerate the excessive federal deficits and growing levels of debt.

If a recession is defined as two quarters of negative growth, then the first half of 2022 was one of the oddest recessions the United States has ever seen. The data suggests that overall output in the nation fell about 0.5% in the first half of the year. Yet over the same period, the U.S. unemployment rate dropped from 3.9% to 3.5%, and the nation added 3 million jobs, even as industrial production climbed to a record-high level. If that was a recession, then long live the recession! And yet real growth has slowed, and there are signs of stress in parts of the economy, such as new housing.

To understand where the United States economy is now, it is useful to make a distinction between two kinds of stresses that can occur. One form of stress is a decline in aggregate demand, which gives rise to a typical business cycle. The other comes from rapidly shifting changes in the components of aggregate demand—changes that in the aggregate are expansionary but nevertheless cause reduced productivity as suppliers struggle to adapt to shifting patterns of demand. The United States is currently experiencing the latter situation. This means we can have the seemingly paradoxical condition of an economy experiencing reductions in productivity even as it operates at capacity (i.e., low growth and falling unemployment).



Source: U.S. Bureau of Economic Analysis

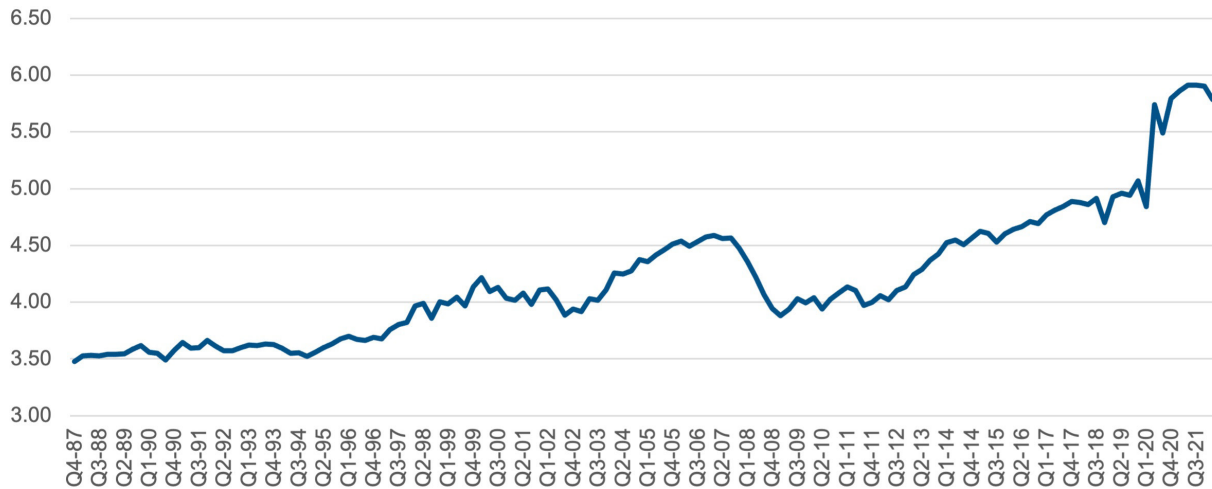
The rapidly changing pattern of demand is resulting in part from the nation's emergence from the historic COVID-19 pandemic. There has been an enormous shift from demand for goods back to demand for services now that the world has finally begun to move on. This is much to the chagrin of companies like Walmart and Target, which appeared to be operating under the premise that people would continue staying home 23 hours per day, judging by the excessive inventories of pajamas and kitchen appliances in warehouses.

The bigger shifts in the structure of demand have been driven by the excessive stimulus the federal government and Federal Reserve enacted in response to the pandemic. Now we are seeing the backlash as they try to withdraw that stimulus to constrain the predictable side effects—namely inflation, excessive consumer demand and bubbly financial markets. Functionally speaking, policymakers went from maximum acceleration to maximum braking over a single year, something that would create turbulence in even the healthiest economy.

The U.S. Congress approved \$6.1 trillion in fiscal deficit spending in 2020 and 2021, significantly more than the actual losses to the economy from the pandemic. For example, households received \$2.60 of direct support for every \$1 of lost income. This level of borrowing should have caused bond markets to swoon and interest rates to rise sharply, but the Federal Reserve swooped in with \$5 trillion in quantitative easing. This paid for all the deficit spending by increasing the nation's money supply by 35%, far and away the greatest short-run expansion of money supply ever seen in the United States.¹

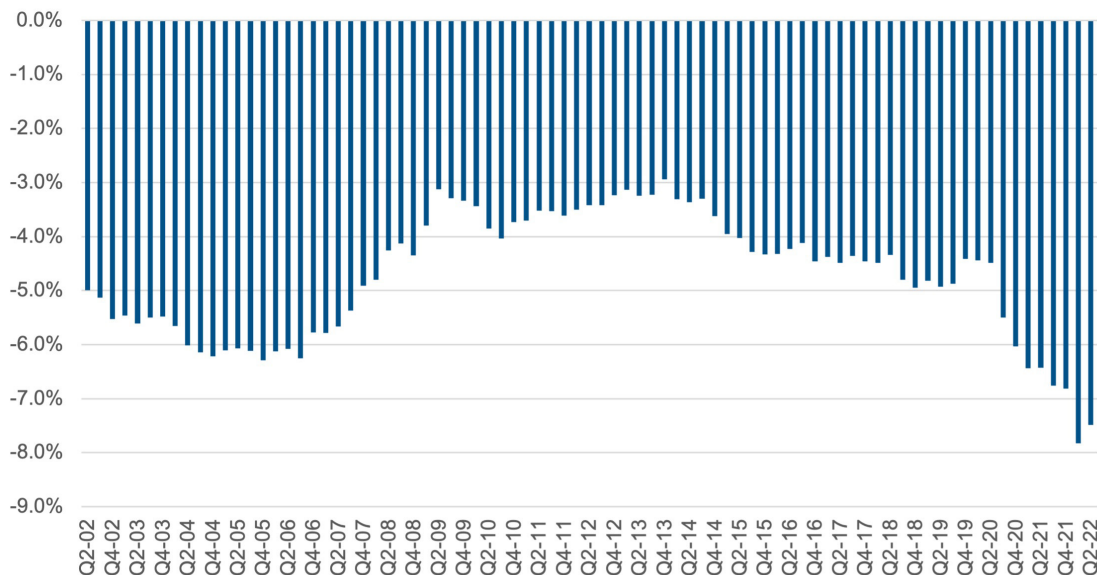
¹By functionally monetizing the nation's enormous fiscal deficit, the Fed enacted what might be the first true experiment in Modern Monetary Theory (MMT)—the expansion of the money supply to cover deficit spending. And given the path the U.S. economy is currently on, it is safe to assume that the massive drawbacks of using this system to run a government have become apparent. Budgets without accountability will inevitably cause problems.

HOUSEHOLDS; NET WORTH / GROSS DOMESTIC PRODUCT



All this cash set off the explosive growth in asset prices that turned into a \$30 trillion increase in U.S. household net worth, a surge of 25%. This expansion of wealth supercharged consumer demand and set off a proliferation in related investments such as homebuilding. While tight labor markets and solid growth make good headlines, none of this is sustainable. Consumer spending now accounts for the highest share of U.S. GDP since 2006, a not insignificant comparison. The consumption binge is also apparent in the rapidly growing U.S. trade deficit, which accounts for the largest share of GDP since the run-up to the Great Recession.

NET EXPORTS AS PERCENT OF GDP (REAL)

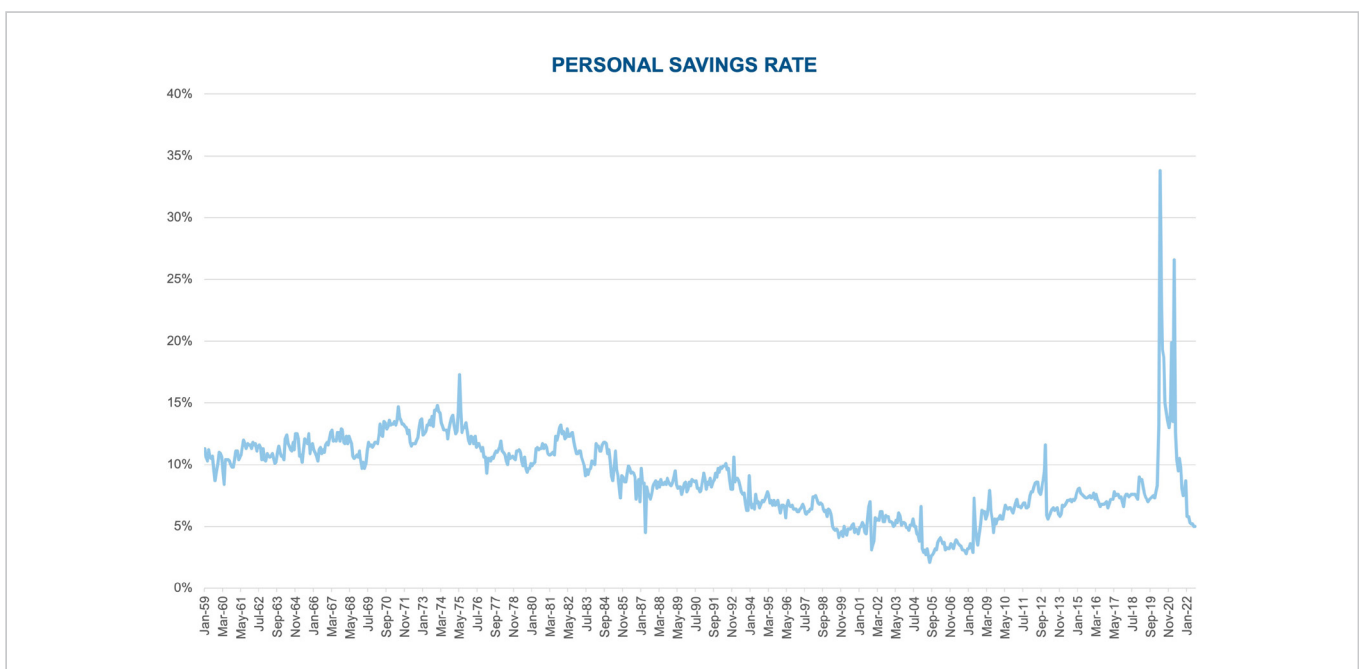


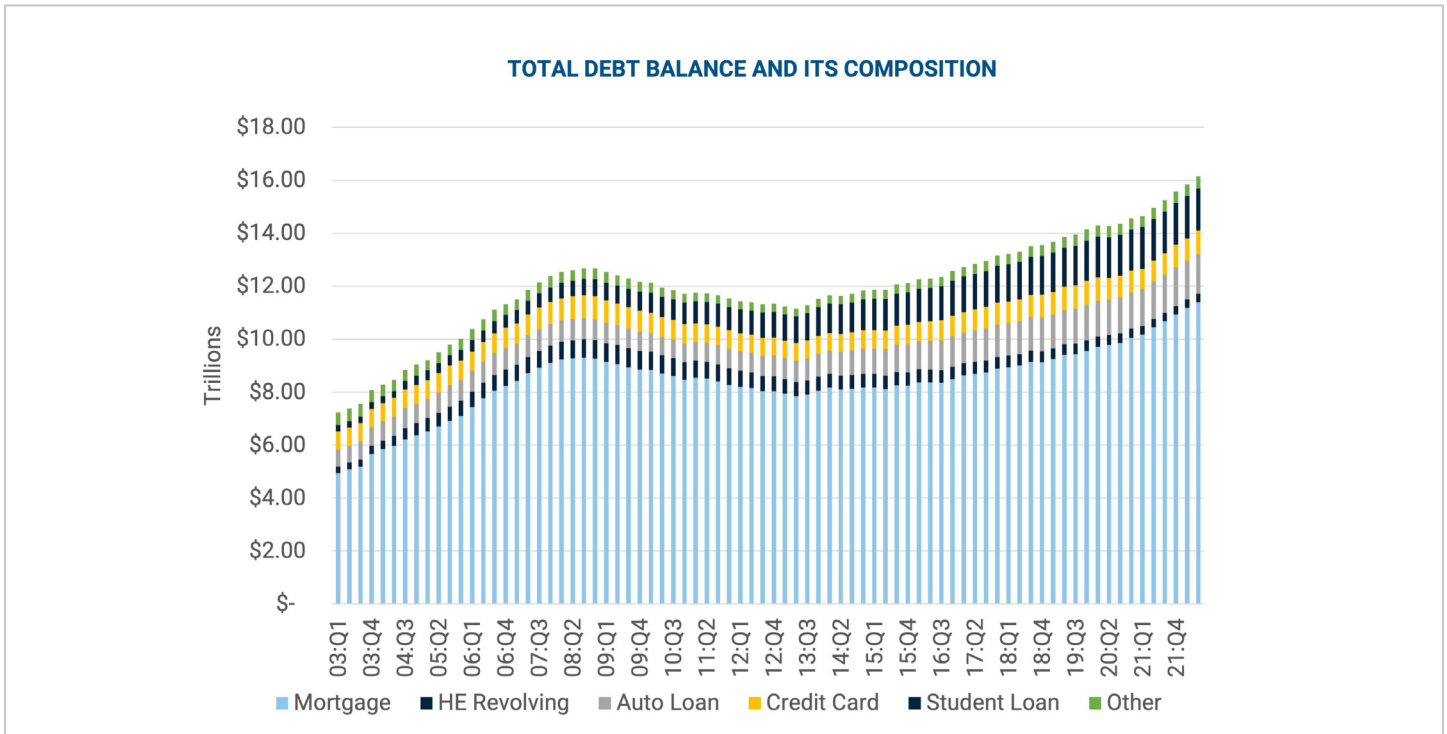
Unfortunately, all this new demand has also led to inevitable price inflation. As the saying goes, inflation is the necessary consequence of too much money pursuing too few goods. Price growth is now at the highest pace since the 1970s, which has forced Fed policy to pivot sharply from loosening to tightening. Within a year of ending quantitative easing, the Fed has started steeply raising the federal funds rate. This represents a startling pace of change and one that is uncharacteristic of past Federal Reserve Boards that have typically operated much more cautiously.

Rates on the long end have been pushed by inflation, while on the short end, they have been pushed by the Fed. While still low from any long-run vantage point (and still negative in real terms), they nevertheless have started to put significant pressure on rate-sensitive sectors such as real estate, some consumer durables and business investment. This accounts for the weaker growth numbers in the first half of 2022. But to reiterate, this is not a recession; it is an economy modestly cooling from white-hot to red-hot.

Consumers and Housing

Prices in the United States are rising because of intense consumer demand, driven by wealth effects—and this has not been to the detriment of demand, as suggested in hyperbolic headlines such as “Consumers Crushed by Inflation.” While inflation is higher than earnings growth, consumer spending is still growing in real terms, and U.S. savings rates remain at 5% of disposable income – high compared to the run-up to the Great Recession. Certainly, a subset of households suffer when prices rise, particularly those on a fixed income. All this being said, inflation will not cool down until real consumer demand does, and we are still far away from that happening.





For now, consumers will carry the U.S. economy forward for several reasons:

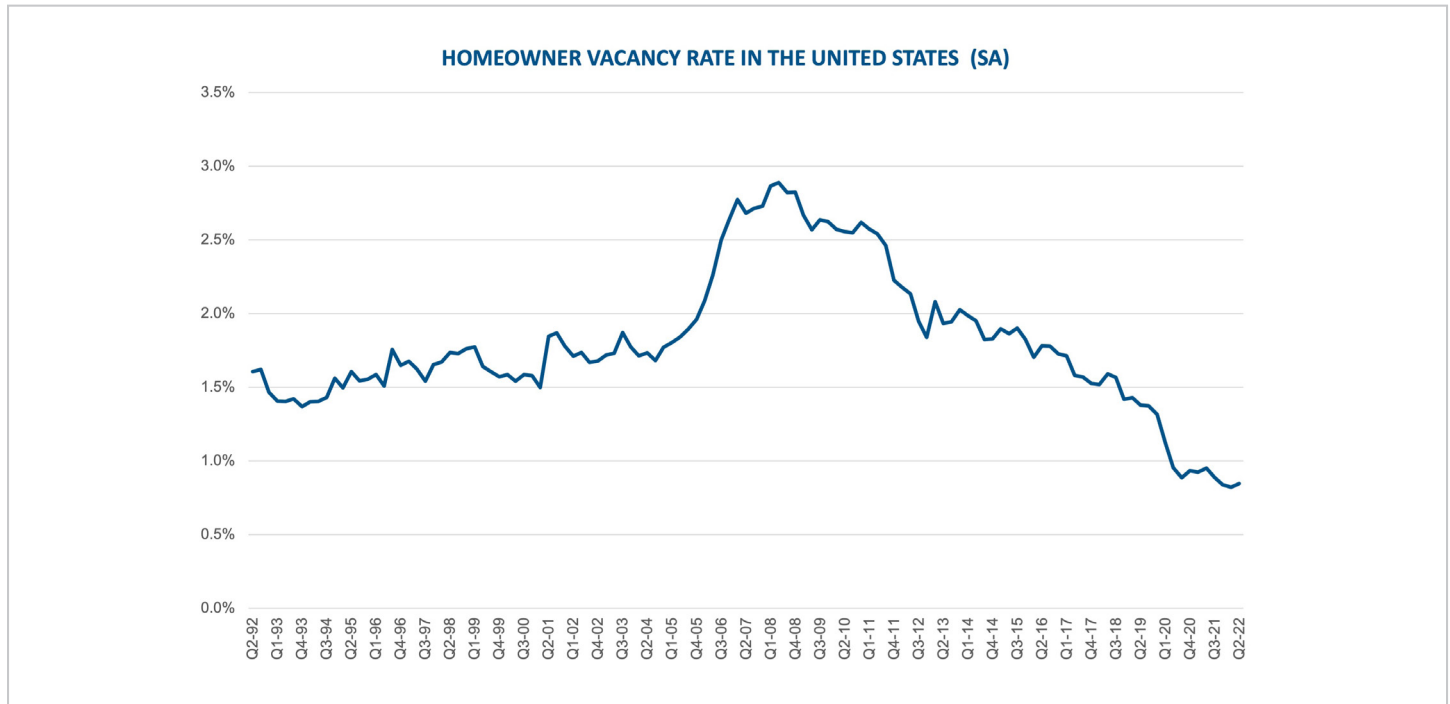
1. There is still a lot of new wealth kicking around to keep demand strong, even with recent declines in the equity markets.
2. Earnings increases are at record high levels due to labor shortages, particularly among less-skilled workers, who typically spend most of their disposable income immediately.
3. Rising interest rates are simply not that central of an issue for most households now. Debt servicing levels fell to their lowest levels ever during the pandemic as consumers took advantage of ultra-low interest rates to refinance their homes.

Only in recent months are consumers turning to new debt to fund consumption. The consumer cycle still has a long way to go, as empty automobile dealer lots can attest.

For all the worry about rising interest rates, the main problem is sticker shock. Nominal rates are up, but not as much as inflation. This means that real interest rates are still negative. For example, a lender who loans \$100 today at a 5% rate would receive \$105 back at the end of the year—but it would buy less in real terms because prices went up 6% over the same period. The impact of rising nominal interest rates on housing and consumer spending is actually a function of having to reprice deals. Real buying power has not been reduced.

One of the more ominous topics in the news lately is the sharp growth in new homes for sale. It is easy to have visions of the housing collapse that led the United States into the Great Recession. The expansion in new homes for sale has caused some economists to predict a housing “correction,” which can be interpreted as falling home prices. Homebuilder sentiment in the nation has collapsed.

But a correction within the housing market does not make much sense. There is a massive amount of equity in the current U.S. housing market, driven by a decade of low mortgage debt accumulation. The industry is also characterized by incredibly low inventories of existing homes for sale. Inventories have risen to 3.3 months of supply from 2 months of supply at the end of 2021, but this is still lower than the 4 months of supply that were available in 2005 in the midst of the sub-prime bubble and much lower than the 11 months of supply on the market after that collapse. Overall, housing vacancy rates are still at a record low level, following a decade of weak building trends. This is not a market due for a collapse, unlike the market in 2006—at least not yet.



The major problem for new housing is the ultra-low mortgage rates homeowners currently enjoy, meaning anyone who sells now will have to go from a sub-3 rate to something in the 5+ category. That is not a move most homeowners will make—unless they must. The “move-up” market has been all but frozen and will continue to be so until rates begin to decline again, something that seems unlikely given the current state of inflation.

There is ongoing and pent-up demand to enter the housing market by those ready to make the leap into ownership. Unfortunately, most first-time buyers are not qualified to buy a new home and are looking into less expensive existing homes. Again, this is challenging due to those current homeowners being locked into the lower rates. The answer for builders is clear—it’s time to focus on new entry-level housing.

The Inflation Outlook

The conversation about inflation today, even among economists, has been startlingly off track. Over the past 12 months, most major inflation forecasts have continued to suggest that we have reached peak inflation—only to be disappointed when an even higher number comes out. These broken forecasts often list the “causes” of inflation by noting which parts of the consumption basket have experienced the most significant price increases—oil, cars, food, etc. Basic monetary theory tells us that this is completely wrong. As Milton Friedman famously noted, inflation is everywhere and is always a monetary phenomenon, meaning that without an increase in the money supply, price levels are functionally limited.

Gasoline prices serve as the perfect example. While there is little doubt that the conflict in Ukraine has reduced the available oil supply in the world, if the money supply hadn't been expanded so dramatically, the shortages would have led to only modest increases in the price of gasoline and a corresponding decline in its consumption. But that isn't what happened in the United States over the last year. Gasoline prices nearly doubled from the summer of 2021 to the summer of 2022—and yet there was almost no decline in U.S. vehicle miles driven or gasoline purchased. This clearly shows that gasoline prices went up a little because of supply constraints but went up a lot more because of the increased demand driven by the excessive stimulus.

While oil prices are moderating, and the pain at the pump is finally diminishing, it does not mean inflation will end. When an economy has an excess supply of cash, prices must rise to absorb it. Even now, the ratio of money supply to nominal GDP suggests 20% to 30% more inflation over the next few years—a wide range that depends on the impact of current inflation trends on monetary velocity. More inflation will have to occur unless the Fed removes the excess money from the system through quantitative tightening.

Strangely, the Fed has chosen to combat current inflation primarily through hikes in the federal funds rate rather than quantitative tightening. This decision has done little to help inflation as it has yet to significantly reduce the money supply. Notably, the Fed's strategy is supposed to change this month as it starts reducing the Fed balance sheet by a moderate \$100 billion per month. This forecast anticipates that inflation will begin to slow further, but only at the cost of a sharp increase in interest rates—particularly at the longer end of the yield curve. Just how much interest rates will rise is difficult to say. The experience with the so-called “taper-tantrum” a few years ago when Janet Yellen tried to reduce the Fed's balance sheet suggests it could be severe. We simply don't know yet.

What we do know is that increasing real interest rates will be more painful for the economy than the increases in nominal rates to date. The result will be a substantial decline in asset prices and a drop in aggregate real demand, which may cause the economy to contract for real. One big question is whether the Federal Reserve will be willing to stay the course or whether they will backpedal, driven by the same populist fears that caused the overstimulation of the economy in the first place. Chairman Jerome Powell was clear in his August 26 speech at the Kansas City Fed's annual policy forum in Jackson Hole, Wyoming. He said he was serious about enduring on this course of action—but this forecast continues to have its doubts.

The Fed has managed to put itself between the rock of inflation and the hard place of asset price declines. The one bright spot in the current situation is that if the Fed does little, inflationary pressures will eventually peter out on their own. This is not like the inflation of the 1970s, when the root problem was excessive annual increases in the money supply rather than the one-time massive increase that happened in 2020-2021. However, the couple of years of high inflation that would result would cause issues for the U.S. economy. Would those issues be recession-causing? It's difficult to say. The United States experienced a great deal of inflation during the 1970s, but it took the shock of an oil crisis in the mid-'70s to create an actual recession.

Where Do We Go From Here?

The second half of 2022 will look better from a growth perspective than the first half, given how strong fundamentals still appear in the private sector. Inflation will continue to run hot, and interest rates will continue to rise as a result. However, this forecast does not see those circumstances as recession-causing. Instead, expect a slow pace of overall economic growth, with weaker numbers from the more rate-sensitive sectors.

There are two potential paths for the economy starting in 2023. The first path stems from weak Fed action, where fear of a political backlash keeps the Fed from using quantitative tightening at the necessary level. If this happens, inflation will continue eating into real asset values and incomes and generally pushing interest rates up. Any small shock could cause a recession or lead to three or more years of very weak growth, leaving consumers in a relatively poor financial position at the end.

The second scenario is that the Fed stamps out inflation in the near term by aggressively reducing its balance sheet. That would drive up interest rates in the short term, cool financial markets sharply and possibly create a modest recession next year, led by retrenching consumers. But the nation would emerge with a strong private sector.

Moreover, both these scenarios miss the elephant in the room: the federal debt. One part of the equation that has not been dealt with is the nation's huge federal debt level and the rising burden of carrying such debt, given rising interest rates. It is anyone's guess as to how long bond markets will give the U.S. government a blank check, but at some point, bond buyers will become worried, and politically tough choices regarding fiscal rebalancing will need to be made.

How that shakes out remains to be seen, particularly given our strained political times. There will be a reckoning, but exactly when is hard to say. But when the nation's debt does come home to roost, all the above scenarios will be off the table, and the situation will look much worse.

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