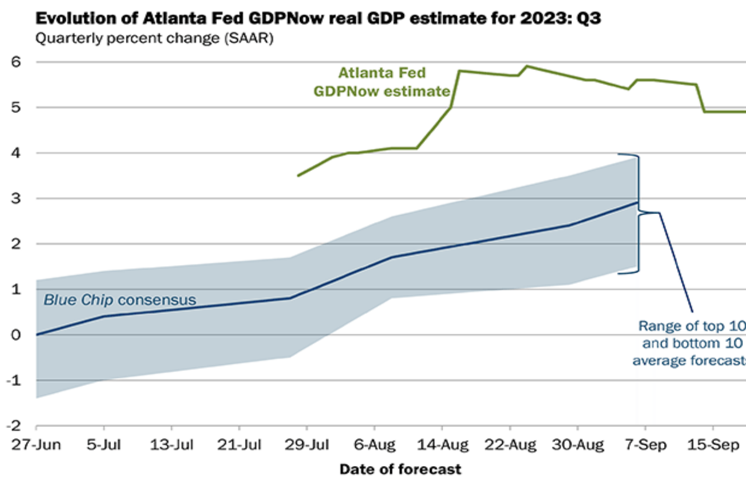
JAMESSON associates

Fall 2023

## Recent Economic Events

A most unusual story has unfolded in the American economy. Aggressive monetary tightening appears to have had little impact on GDP growth so far this year. Furthermore, initial indications of third-quarter growth show acceleration. Job gains have moderated, but wage increases (regular and strike-induced) continue to be elevated. Construction workers are busy building new homes, high-tech factories, and repairing roads and bridges. Best yet, inflation has cooled, offering the Federal Reserve the option of pausing rate hikes. One would be forgiven for assuming that Goldilocks has returned. Before we conclude that the porridge is just right, we should remember the challenges: student loan payments, rising energy prices, and a dysfunctional political system.

Second quarter GDP was revised to a gain of 2.1%, up marginally from the 2.0% increase posted in the first quarter. The key driver, as it almost always is, was personal consumption. However, a good portion of the growth was contributed by business investment and government spending. These latter two factors were related to the push for renewable energy encouraged by incentives in last year's IRA legislation. Prospects for the current quarter are even more robust. The Federal Reserve Bank of Atlanta projects growth just a bit under 5% while the Blue Chip economic survey is predicting a gain almost 3%. Wow!




Jobs are a key factor in the economy's resilient performance. Over three million American jobs have been created in the last year. August's somewhat muted total of 187,000 would have been near the average had not Yellow Freight declared bankruptcy and the writers and actors strike been resolved. The unemployment rate bounced up to 3.8% in August because over 700,000 new job seekers entered the labor force. Even so, the rate remains below the presumably full-employment mark of 4%. In fact, adjusted for retirements, the United States has never had a higher percentage of working age Americans employed than we did last month. The tight labor market has led to substantial bargaining power for workers. Airline pilots saw wage gains of 40% in their recent contracts, an increase now targeted by the UAW. Full-time UPS drivers secured compensation which will total $170,000 at the end of their contract period.

The biggest surprise in the current economic mix is the strength of construction. Normally, higher interest rates are killers for this area of the economy due to the leverage inherent in real estate development. However, after initially weakening, residential construction has rebounded. The lack of existing homes on the market because of the reluctance of homeowners to give up their low mortgage rates has forced those looking

## Recent Economic Events-continued

for shelter to seek new homes or resign themselves to renting. As a result, multi-family starts are running over 50% higher than pre-pandemic and single-family starts are up over 20%.

While housing has been a surprise, the bigger story is in factory construction. The combination of the CHIPS and IRA legislation has provided incentives for companies to target production in the United States. Construction of manufacturing facilities is up 150% from pre-Covid levels. Not to be left out, domestic infrastructure spending has also skyrocketed. You can thank the bipartisan Infrastructure bill passed in early 2021 for the proliferation of orange cones on America's highways.

CPI inflation has dropped to 3.7% year-over-year in August, down from over 9% in June of 2022, but up from 3% in June this year. The culprit has been a rebound in energy prices. The core rate, which excludes food and energy, has fallen to an annual gain of 4.3% but has slowed even further in the last three months to an annualized 3.2% rate.

So, can Jay Powell declare success? Well, inflation is down but not out, and there are economic challenges looming. Student loan payments, suspended during and after the pandemic, are now set to resume. This will drain billions of dollars from personal spending as will higher gasoline prices. Congress is at loggerheads over the Federal Budget, threatening a government shutdown.

However, there are always challenges, and remember that growth is more common than not. I believe that we are in an economic sweet spot with robust employment supporting an economy that is neither too hot, nor too cold. The three bears should keep an eye on the breakfast table.

## Commentary

Artificial intelligence and industrial policy represent two alternative approaches to growth over the longer term. The former highlights the promise and danger of unbridled technology while the latter aims to direct investment in a paternalistic top-down manner. They can be thought of as the current versions of the never-ending conflict between the private and the public.

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Artificial intelligence burst onto the scene in the guise of ChatGPT, achieving 100 million users in an unprecedented two months. As a comparison, Facebook took 54 months and Netflix 120 months to reach that level. An estimate from Goldman Sachs suggests that as AI becomes fully integrated into the economy (about a decade down the road), it will boost economic performance at a rate of 1.5% per year. This is projected to add 11% to baseline S & P 500 earnings by 2043.

Of course, there are skeptics — primary among them the writers and actors on strike against the movie and television industry. There are more issues than just AI, but the prospect of being replaced by computers is near the top of the list. More general concerns have been expressed by many of those involved with developing AI. They suggest that allowing unregulated growth in the software could threaten human beings with irrelevance or extinction.

Industrial policy also has supporters and skeptics. The most prominent examples include two legislative bills seeking to promote domestic production of semiconductors and renewable energy. As a result of the incentives offered, construction of manufacturing facilities aimed at these areas has exploded. Hundreds of billions of dollars are committed to building factories so far and the expectation is that the process is in its early stages. Pushback has come from both expected and unexpected quarters.

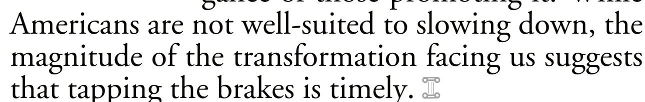
## Commentary -continued

Free-market purists have pointed to the failures of previous attempts at promoting renewables (Solyndra) while conveniently forgetting about successes (Tesla). While it is hard to argue with the better track record of markets in fostering new technology, it is also hard to argue against climate change. Furthermore, the upheaval in supply chains when Covid hit brought the geopolitical security issue to the fore. I suspect that not all the current frenzied construction will prove profitable, but I believe that enough will to make the effort worthwhile.

*Progress equals change; change equals anxiety.*

The unexpected pushback has come from the UAW. They are striking for a variety of reasons, but a key issue is the reduced workforce that may be needed for electric vehicles versus gasoline-powered ones. The number of parts in an EV versus an ICE is on the order of 50%, but when you zero in on moving parts, the percentage drops to 1% (20 versus 2,000). Fewer parts, fewer workers to put them together.

I raise these two topics to point out something that should be obvious to us all but is sometimes lost in the shuffle. Progress equals change; change equals anxiety. The unease comes from both the potential impact of the change and the arrogance of those promoting it. While Americans are not well-suited to slowing down, the magnitude of the transformation facing us suggests that tapping the brakes is timely.



## Market View

On a year-to-date basis, the most comprehensive stock market index, the S&P 500, has gained about 16%. The Dow is up much less but the NASDAQ much more. The world's most important commodity, oil, has gained about 10%, while the shiniest, gold, is up roughly 6%. Over in fixed-income land, the 10-year Treasury has seen its yield increase about 50 basis points, resulting in a price decline of 5%, give or take. 30-year mortgage rates are holding over 7%. These price moves are consistent with a growing economy, not one on the brink of a recession.

If rate increases are at or near an end and a soft landing is at hand, where should we be investing? Past examples regarding investment returns when the Federal Reserve finishes its tightening cycle may be more misleading than predictive this time. A study by Charles Schwab published earlier this year noted that stock returns after the last rate hike were all over the board. The average was essentially flat. However, a closer examination of the data uncovered the fact that from 1953 to 1981, the last hike almost always resulted in stock market losses at the six-month and twelve-month point, while those since 1989 almost always produced gains. This suggests that something was different in the two periods: That difference was the steady rise in inflation in the former period followed by its decline in the latter. The pattern is now upended, suggesting that we should be very careful in applying historical examples.

| Final Rate | S & P 500 Return | |
|---|---|---|
| Hike Date | 6 months | 12 months |
| 1953 - 1981 | -6.21% | -2.97% |
| 1989 - 2018 | 12.44% | 15.38% |

## Market View -continued

With current stock valuations stretched, I believe that special situations are a better choice than overall equity indices. Energy is the lifeblood of the global economy. Renewable options have been battered this year and are now at more reasonable investment levels. However, the combination of underinvestment in traditional oil and gas along with supply restrictions by Saudi Arabia make me more inclined to put dollars to work in this arena. One of the best ways that I see to take advantage is in Master Limited Partnerships (MLPs) which sport elevated yields. Do your homework on the individual names, however.

Another area that has had its share of negative publicity is real estate. Investing in real estate through public REITs offers the benefits of diversification and yields that are much higher than typical stocks. Once again, spend some time evaluating the portfolio of any REIT you are considering.

If you don't buy the soft-landing scenario and expect a recession, stay away from equities until at least the point when the Fed starts lowering rates.

Long-term interest rates tend to peak before the time that the Fed stops raising short-term rates. In effect, the market is anticipating the Fed's actions. However, in this case, there is an important caveat. In times past, the level of longer-term rates as captured by the 10-year Treasury has generally been at least equal to the terminal overnight rate set by the Federal Reserve. If the 10-year were 5.5% or higher, I would be strongly bullish. At 4.25%, not so much.

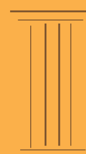
If you want to put money to work in fixed-income, I believe that two options are attractive. Short-term, the two-year Treasury is yielding about 5% and has little price volatility. Long-term, Treasury Inflation Protected Securities (TIPS) are a good bet. The 5-year TIPS is yielding about 2.2%, so if inflation averages more that 2.3% over the next five years, you will do better than buying the regular Treasury. If you expect 3% inflation as I do, the return is even better.

Commodities have done quite well this year even in the face of a weaker China and a strong dollar. This suggests to me that there is underlying momentum. I would lean towards industrial commodities and those tied to decarbonization (lithium, uranium, etc.) rather than precious metals.

Finally, money market rates are 5% plus. That's not chopped liver.

## Editor's Note

*Three, seven, and eleven are lucky numbers. A few weeks ago, our washing machine started making noises not associated with efficient operation. We called our trusty repairman, Yuri, who informed us that the transmission was shot. One. The cost for repair was as much as a new machine, but he advised us that we could get a used model for less than half the price. Susan was very interested because she was not dying to learn a new digital interface. We traveled to the used appliance showroom where we found a model likely older than any of our sons with dials, not buttons, and arranged for installation. When they arrived to set up the machine, we found that the shutoff value was leaking. Two. Less than a week later, water was collecting in the basement near our tankless water heater. A new model completed our trio of expenses. At this point, I am wary of the phrase, "come seven, come eleven".*



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