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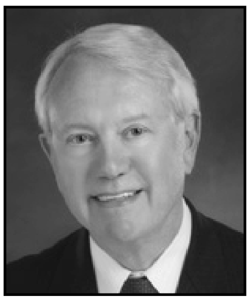
ECONOMIC PERSPECTIVE

Political Economics: Waiting for Santa to Rally

By Jim Flinchum



Jim Flinchum

During the third quarter, the U.S. economy began badly and then got worse. Additionally, most forecasters see some degree of recession next year, but how much?

The stock market: By the end of September, the S&P 500 was down 24% year-to-date. Growth stocks were down 30% compared with value stocks losing 17%, suggesting the "risk-off" mentality remained strong. Energy stocks did the best, up 35%, while communication services stocks did the worst, losing 39%. New home sales are down 14% and getting worse.

It has been another bad year for those who follow the old investment theory of allocating between stocks and bonds, as both stocks and bonds declined this year. Many financial plans assume bonds do better when stocks go down. Not necessarily! Traditional asset allocation hasn't worked this year or last year.

Worldwide, most nations followed the U.S. into bear markets. Asia lost 33% year-to-date. Europe lost 28%. Australia lost about 17%. With a 6.1% gain, Latin America has been the best region this year, which is rare and reflects the upsurge in commodities.

Commodities: The Dow Jones Commodity Index is up almost 14% but mostly in the first quarter. That was largely driven by the 39% increase in the energy index during that quarter.

Our journey on the long and winding road to energy independence at reasonable prices has been interrupted by Russian President Vladimir Putin's war. As a result, we find ourselves sniffing the oil in Iran and Venezuela. One advantage of clean energy over oil is we don't find ourselves in bed with such people as Iran leader Ayatollah Ali Khamenei and Venezuela's President Nicolás Maduro.

Remember the oil embargo of 1972? This is worse! Then, there was no contemporaneous war. Russia was not blackmailing Europe with natural gas. There was no lingering pandemic recovery. Even Mother Nature was kinder in 1972 with no major hurricanes, earthquakes or fires.

Inflation: The National Association of Business Economics predicts inflation will drop from 8% this year to only 3.8% next year. Year-over-year wage inflation has already dropped to 5%, certainly less than general price inflation, but headed in the right direction. Decreasing the rate of inflation is clearly the primary goal of the Fed. The question is whether the higher interest rates will force us into recession. The answer is yes.

Some believe our current inflation was created intentionally, to "inflate away" our $31 trillion national debt. They are mistaken.

The labor force: Sometimes, good news is bad news. If the labor force gets stronger, so does inflation, which causes the Fed to increase interest rates, which drives down the stock market.

Some good news is that over a million job openings disappeared last month as employers cut back on hiring. That's good news?

The latest jobs report showed a healthy 263,000 jobs were created last month, and the unemployment rate dropped to 3.5%, matching a 50-year low. A strong jobs market is inflationary — therefore, the Fed must weaken it!

Raising interest rates will decrease the demand for workers but won't

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increase the supply of workers. The closely watched labor force participation rate remains stuck around 62%. Getting people back into the workforce is critical. The prime-age workers (25-54) have already returned to normal, with about 82% participation in the workforce. Far fewer workers over 55 have returned to the workforce, with more workers taking retirement than expected. The Brookings Institute estimates that at least 1.8 million workers cannot return due to "long-Covid" (Think: brain fog and fatigue). A fully staffed child care industry would also help get many mothers back into the workforce, where they are badly needed.

Interest rates: After raising rates five times this year totaling 300 basis points (3%), the Fed is expected to increase rates by another 75 basis points in November and probably in December as well, before slowing down. This has been "warp" speed. Wall Street is panting breathlessly for "the pivot" when the Fed starts decreasing rates. However, a mere pause in raising rates would excite the bulls!

The dollar: At a 40-year high, the dollar is strong. It hurts our exports and crushes developing nations who have dollar-denominated debt. As long as the U.S. is a relatively safe place for cash, foreigners will continue to park their money here, which drives up the dollar.

In normal times, our strong dollar would cause imports to rise, exports to fall and our trade deficit to become worse. However, these are not normal times, and that trade deficit has gotten smaller for five straight months due to never-ending supply chain problems and weakening global growth. Peace in Europe will weaken the dollar and strengthen other currencies, and that's good news.

Perspective: The stock market always overreacts. Earlier this year, it overreacted to any news on inflation. Now, it overreacts to any news from the Fed. Yes, there was a time when it could have acted more promptly but that is too late now. The Fed must catch up — both to crush inflation and to protect its reputation.

The problem of crushing inflation is complicated by "monetary lag." Increasing interest rates today won't change the economy tomorrow. There is a lag time before the impact is visible, usually somewhere between six and 14 months. Because the Fed uses backward-looking data, it may push too hard before the impact of past increases becomes visible. There is a real probability it will push us into recession by protecting us from inflation. The Fed needs to pause the future increases long enough to evaluate the impact of past increases.

Don't be misled by strident official statements from the Fed. One of the most powerful causes of inflation is "inflationary expectations." If enough people believe inflation is coming, it becomes self-fulfilling. If a Fed governor says they will stop raising rates before inflation becomes ancient history, they would be banished from their headquarters on Constitution Avenue.

Free-floating anxiety: I do worry about the cost of unpredictable events. Hurricane Ian may cost us over $100 billion, and we still haven't repaired the flood damage in Kentucky earlier this year nor even the fires in California. Climate change is expensive. The pool for reinsurance is not infinite. Property insurance premiums must rise sharply.

Another major unpredictable event that Putin and Kim Jong Un both sink further into madness, releasing tactical nukes. Ignoring the human costs, the financial cost of rebuilding will eliminate any possibility of balanced budgets among nations for many years.

Because October is usually the worst month of the year and because the market has already fallen 24%, I suspect we are much closer to the market bottom than the top.

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