Inside Business

The Hampton Roads Business Journal | Insidebiz.com

JANUARY 16, 2023 $1.00

ECONOMY

Political Economics: Conflicting Predictions

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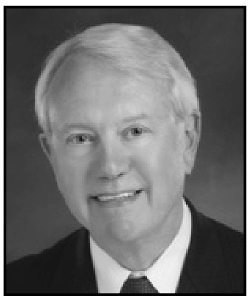

Jim Flinchum

Market watchers joke that the smart money goes into the bond market while the dumb money goes into the stock market. After all, the two markets are different things — related, but different. Sometimes, they even make conflicting predictions. For example, the stock market believes inflation will continue to be a problem, but the bond market does not.

Inflation and supply-chain problems were weakening the economy as the year began. That weakness spilled over to the stock market by spring. By year-end, the stock market continued to fall, but the economy was already improving enough to spark debate on whether a recession is imminent. That depends on the Fed.

The stock market: It was the worst year since 2008. At year-end, the S&P 500 was down 18.11%. It would have been worse, but a 7.56% gain in the third quarter blunted the full-year loss. Growth stocks lost a whopping 29%, compared with value stocks losing a mere 5.2%, suggesting the "risk-off" mentality remained strong. Energy stocks did the best, up 65.7%, while communication services stocks did the worst, losing 40%.

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! The S&P 500 was down 18%, compared with its bond index, which is down 14.5%. Traditional asset allocation hasn't worked for investors this year nor last year.

Internationally, it was a bad year for stocks. Latin America did the best last year — up 11.4%. In comparison, Asia was down 23.46%, Europe was down 14% and Australia was down 4.5%. Pundits disagree on how much blame goes to Vladimir Putin.

The dollar: Rising interest rates usually strengthen the dollar, which politicians love but exporters loathe. Geopolitical affairs also impact the dollar, as foreign money managers reduce risk by increasing their demand for dollars and weakening their demand for other currencies. It is ironic that Putin increased the value of the dollar last year by increasing fear. The dollar peaked in September but is still too strong, especially for poorer nations.

Commodities: The Dow Jones Commodity Index was up almost 21% last year. That was largely driven by the 42% increase in the energy index. Precious metals were flat while industrial metals were down 7.6%. While I still like gold and copper, I'm more sanguine about other commodities.

Inflation: Just as the World War II generation still worries too much about depression, the baby boomer generation still worries too much about inflation. Inflation started rising in 1977 when it was 6.5%, rising 13% in 1979 and 12.5% in 1980, before falling to 8.9%. That was five years to become traumatized, and we were!

One problem is our use of year-over-year inflation data. Sure, 2022 inflation was 7.1%, but that ignores the change that occurred at midyear. The annualized rate was 10.6% for the first seven months, dropping to only 2.5% for the last five months. The longer we keep interest rates high to choke down inflation, the greater the risk of a "hard landing" or a recession.

Even if much higher interest rates won't choke down inflation enough, we've also stopped increasing the money supply. Too little growth in the money supply also increases the risk of a recession. It will soon be time to declare victory over inflation and slowly unwind the interest rate increases, money supply decreases and quantitative tightening. As the late founder of Vanguard, Jack Bogle, advised us, "don't just do something, stand there!"

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

The latest jobs report showed a healthy 223,000 jobs were created last month, which was the fewest in two years. The unemployment rate dropped to 3.5%, matching a 50-year low. A strong jobs market is considered inflationary — therefore, the Fed must weaken it?

While raising interest rates will decrease the demand for workers, it won't increase the supply of workers. The closely watched labor force participation rate remains stuck around 62%. Getting workers, especially older workers, back into the workforce is badly needed.

Interest rates: After consistently raising rates in 2022 at warp speed, the Fed is expected to increase rates again this month, but how much? Wall Street is panting breathlessly for "the pivot" when the Fed starts decreasing rates. However, a mere pause in raising rates would provide enough relief to excite the bulls.

Because long-term interest rates reflect both long-term interest rates and long-term inflation expectations — the current interest rate inversion, where long-term rates are already significantly lower than short-term rates — the bond market is predicting lower inflation, contrary to the stock market. The bond market is correct.

Crypto: Bitcoin has fallen from near $69,000 to near $17,000. However, that loss cannot be blamed on the spectacular collapse of FTX in the Bahamas. Some have confused FTX with a Bernie Madoff-style Ponzi scheme. At this point, it appears to be more typical of a fraudulent commingling of funds than a Ponzi scheme. Either way, there are so many reasons to distrust the many cryptocurrencies that it seems unfair to blame it on FTX.

Free-floating anxiety: While I am worried about the upcoming debt ceiling debate in our newly crippled House of Representatives, I see no possibility of a depression and only a modest possibility of a financial crisis. Assuming we do experience another recession, I don't foresee a severe one, like 2008-09, nor a long one. We've never entered a recession with such a strong labor market.

Partly because globalization has recently become a disappointment, due to political timidity, I am more concerned now than ever before about geopolitical problems. As the Russian military has apparently become a paper tiger, a cornered rat like Putin cannot be ignored. China's Xi Jinping has been taking notes, as well as every tinhorn populist in Latin America. This makes cash, U.S. companies and even gold more attractive to me.

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